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BY STEVEN TREPPO AND BART SAYER

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Forecasting the Winners in Luxury's Slow Recovery

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A year and a half ago, amid fear and uncertainty triggered by the worst financial crisis since the Great Depression, the luxury goods market contracted significantly, demonstrating that it was no longer impervious to the vicissitudes of the economic cycle. Now, with the International Monetary Fund forecasting global GDP growth of 4.5 percent in 2010, and stock markets around the world rallying more than 60 percent above their lows, a recovery appears to be under way.

But many luxury goods and services companies are unlikely to prosper in the new era of luxury about to unfold, mainly because they are pursuing strategies that do not reflect the way the downturn has changed their core markets. Instead, an outsized share of the growth will be captured by companies that understand the markets' shifts and are devising and quickly executing a new, carefully balanced strategy to exploit them. In the more mature markets, winners will be the companies that retain the brand loyalty of the very rich while reengaging with a chastened base of aspirational buyers. The adaptations required by these strategic shifts will, moreover, serve these companies in good stead as they look to tap into the increasingly vital, and distinct, luxury markets of developing countries.

There are already clear signs that segments of the luxury markets are rebounding modestly — even as other retail segments continue to stagnate. Some luxury goods purveyors have dramatically outperformed discount retailers since the March 2009 bottom. Beginning its climb from this low, Hermès reported a 55.2 percent jump in net profit in the first half of 2010, driven by a 23 percent rise in first-half sales growth. In June 2010, all LVMH divisions grew revenue year over year, with Louis Vuitton recording double-digit revenue growth. Meanwhile, Walmart sales for the second quarter of 2010 grew only 3 percent.

Some high-end automakers also seem to be shrugging off the effects of the recession. At the Frankfurt Motor Show in September 2009, car buffs were treated to an exceptional crop of new luxury sports cars, including Maserati's GranCabrio, Ferrari's 458 Italia, and Bentley's Mulsanne, with estimated price tags of US$150,000, $250,000, and $300,000, respectively. In June 2010, Mercedes-Benz reported double-digit percentage growth for the eighth month in a row, with 113,3000 units delivered — the best recorded June sales in the company's history. Although sales were up in every region compared to last year, rapid growth in China was a key factor in the group's record-breaking figures. During the first six months of the year, China experienced 120 percent growth. Closely following were other BRIC countries: India (up 83 percent), Russia (up 76 percent), and Brazil (up 73 percent).

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The cloud hanging over the heads of luxury marketers is the likelihood that the global recovery will be shallow, slow, and patchy, according to the consensus of economists. Some are forecasting that the global luxury market's full recovery will happen in 2011, but others predict it will be a few years beyond that.

This forecast translates to an uneven outlook for the highly differentiated and stratified luxury markets. As financial crisis uncertainties wane, the very rich, who are less exposed to the vagaries of the economy, have already resumed purchasing the most expensive offerings of the most elite brands. But the fears of less-wealthy consumers — the so-called aspirational buyer segment, which represents 60 to 75 percent of the $225 billion global luxury market — have not been so easily allayed.

Aspirational buyers flocked to the lower and middle product and service tiers of luxury companies during more prosperous times, providing the impetus behind a majority of the growth in the overall luxury market. But their purchasing power was hard hit during this recession, and many of them reduced or eliminated spending on luxury goods and services. The major question for luxury markets today is whether these aspirational buyers will resume spending at a pre-recession clip or thrift will become the new normal.

The most successful luxury companies in the slow recovery ahead will be those that persuade aspirational buyers to resume spending on their brands. First, they will change the assortment of products they offer and modify their advertising messages to lure aspirational buyers back to the market. If they haven't already, successful luxury companies will consider creating or acquiring mid- or lower-tier brands to attract aspirational buyers who can no longer afford their premium brands. Ralph Lauren, Giorgio Armani, and Calvin Klein have long provided good models for building a multi-tier brand portfolio. Now, high-end designer brands such as Stella McCartney, Roberto Cavalli, and Jimmy Choo are following this strategy. Jimmy Choo recently announced that it would create a lower-priced "limited edition" designer collection for retailer H&M.

Second, the successful companies will find ways to drive customer loyalty without resorting to overt or extreme discounting — dangerous practices that devalue luxury brands over the long term. (Louis Vuitton, for example, destroys unsold merchandise rather than cut prices.) But the savviest strategists can occupy a middle ground: Carefully targeted discounting can enhance a brand's value proposition, if it is offered selectively to high-spending, loyal customers in a manner that allows them to perceive it as a generous gesture during difficult times. Luxury companies can also safely discount if they are discreet — for example, engaging in limited "secret sales" on websites such as RueLaLa.com and Bluefly.com.

Third, successful luxury companies will continue to grow their presence in the digital world — one of the few remaining pools of growth. Traditionally, luxury retailers avoided online selling, claiming that the luxury goods buying process required human interaction and a superior in-store experience. Their stance was fueled by fears that price would trump prestige in the disembodied online world. However, a 2008 study conducted by Google found that 94 percent of buyers said making a luxury brand purchase online would not cheapen their image of the brand. (See "Time Is Money: Wealthy Drop Dollars Online," by Natalie Zmuda and Abbey Klaassen, AdAge.com, October 20, 2008.) Ninety-one percent would prefer to see their favorite luxury retailers offer their goods through the Web.

Forward-looking luxury retailers are now responding to this feedback by bringing their unique branded experiences to the Web. Burberry has created a social networking site, Art of the Trench, where customers can go to submit photos of themselves wearing their Burberry trench coats, comment on others' photo submissions, and post their comments to Twitter or Facebook. Gilt Groupe, an invitation-only online retailer of luxury brands, offers mobile shopping via iPhone, iPad, and Android apps, in conjunction with a presence on Facebook and Twitter. Louis Vuitton offers nearly all of its products through its website, and although Prada offers only accessories online, it predicts that within five years 40 percent of its U.S. revenues will come from online sales.

Finally, many luxury companies will also treat the challenge of reducing costs and building their business portfolios as a strategic opportunity to identify and reinforce their key capabilities, particularly with respect to manufacturing and quality. "Beyond ephemeral fashions, the values of quality and durability…take on particular importance for clients in the search of solid values," LVMH CEO Bernard Arnault wrote in the company's 2009 first-half interim annual report. Jean Baptiste Debains, president of Louis Vuitton Asia Pacific, adds, "People are more conscious about quality.… In short, luxury retail players have to up their game.… That's good news for us, because we have always banked on quality. We consider each item an investment."

As they work to shore up their base in the more developed markets, luxury companies must also begin planning for the next wave of growth. Opportunities with high potential will largely be found in emerging markets, where increasing demand for luxury goods is expected to double the size of the luxury retail market over the next 10 years. In the same time frame, BRIC consumers' share of global luxury spending is expected to dramatically increase from 30 percent in 2009 to 50 percent in 2020.

China, in particular, is driving much of the growth in emerging markets. The Chinese luxury market's rapid growth, from $9.4 billion last year to $14.6 billion, indicates it may be first in the world by 2015. Italian fashion houses such as Prada and Ferragamo report higher 2010 forecasts due to double-digit revenue rises in the first quarter, driven by a booming Chinese market. Prada's 30 percent increase in sales in the first half of 2010 was driven by a 47 percent increase in the Asian markets, and Ferragamo is pursuing plans to open 10 new stores in China. Even Hermès, which is often more conservative when it comes to expansion, solidified its belief in the huge potential of the Chinese luxury market with the launch of its local Chinese brand, Shang Xia, earlier this month.

Other developing markets, such as Brazil and Russia, are following China's lead. BMW Latin America experienced 85 percent growth in the first half of 2010, with the largest growth occurring in Brazil (up 131 percent). Competition in Russia's luxury auto market has also been heating up, with increased sales of models including Bentley's Mercury with a showroom price of $311,000, Rolls-Royce's recently released Ghost retailing for $410,000, and Lamborghinis averaging $221,000.

Recovery from recession will be a prolonged process, and it will usher in a new era of competition. In developed countries, successful luxury companies will be those that strike the proper balance between reigniting the heritage of their brands and extending their reach in new ways, primarily through online channels. As they seek to make inroads in the luxury markets of tomorrow, they will need to reinvent their sales and marketing strategies; Chinese high-net-worth individuals are by and large self-made, for example, and 20 years younger than their American and Japanese counterparts. The magnitude of these shifts suggest that not all of the winners will emerge from the ranks of established players — we may soon see the first luxury brands born online or in developing countries. +

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