

Luxury on sale: opportunity or value trap?



Luxury's sell-off looks mostly cyclical, and the best houses are on sale.

Thierry Hermès opened his Paris harness workshop in 1837, Louis Vuitton founded his maison in 1854, and Gabrielle Chanel opened her first boutique in 1910. We regard these houses as among the most durable consumer franchises in the world. This year, however, has tested investors' patience. Between May and August, Kering's Gucci brand cut prices on a range of its core handbags in France by 20% to 30%, a move almost unheard of among leading luxury houses. LVMH shares are down 41% year to date, Hermès 40% and Kering 32%, unwinding the gains of the Covid-era boom. The sell-off reflects an already-sluggish demand backdrop, compounded by worsening macro conditions in China and the conflict between the US and Iran, which has disrupted travel and weighed on consumer confidence around the world.

The question now is whether current sector valuations represent an attractive entry point for long-term quality investors or whether deeper structural issues justify a permanent de-rating.

How did this fall from grace transpire? In our view, the drivers are mostly cyclical or executional. Steep price increases post-pandemic combined with higher inflation and interest rates have left many aspirational buyers priced out of luxury. Revenue from clients spending less than €20,000 a year on luxury has declined since 2022, leaving the highest-spending cohort as the sole driver of growth. At the same time, the sector has lagged on innovation to drive engagement and recruit new consumers. Brands now face the challenge of restoring affordability and perceived value for money without diluting brand equity.

China is the exception: its slowdown has structural as well as cyclical elements. Chinese consumers were once the key growth engine of the global luxury industry. Mainland China rose from 6% of global luxury sales in 2010 to a peak of 21% in 2021. Including purchases made abroad, Chinese

consumers still account for around 20% to nearly 40% of sales at some of the major European luxury groups, although Chinese luxury consumption has fallen considerably since its 2021 peak. Falling property prices, tighter taxation of residents' offshore assets, depressed consumer confidence and a structurally declining 25-to-39 age cohort point to a more mature market, where growth is unlikely to return to the double-digit rates of the past.

Outside China, many issues are within management's control. Pricing and perceived value can be recalibrated, and creativity renewed. That renewal is underway. Over the past year or so, more than a dozen brands have changed creative directors, and early evidence is encouraging. Chanel has seen a swift and tangible response to Matthieu Blazy, while LVMH reported that Dior returned to growth in the second quarter, a year into Jonathan Anderson's tenure. Not every reset will succeed, but the industry is again investing in desirability rather than relying on price.

The underlying economics remain exceptional, with high gross margins, strong returns on invested capital and robust free cash flow. Competitive advantages of scale are intact. Luxury is a fixed-cost industry, so scale in communication, distribution, innovation and talent confers a material advantage, and larger brands can spend significantly more on marketing in absolute terms while still earning higher margins. That spending power funds flagship stores, VIP events and immersive experiences, such as the Dior Spa and Louis Vuitton's ship in Shanghai, that smaller competitors struggle to match.

China matters, but it is one market. American consumers, supported by the wealth effect from strong financial markets, have overtaken Chinese consumers as the largest cohort globally, and shoppers from other Asian and emerging markets now collectively spend more on luxury than Chinese consumers do.

Long-term demand is also supported by structural tailwinds. Wealth is becoming more concentrated: the top 10% of US households hold about 88% of US equity wealth, and clients spending more than €20,000 a year have driven all of the sector's growth over the past four years. Luxury goods increasingly act as markers of personal achievement and economic independence for women, often linked to career milestones. The transfer of wealth from Baby Boomers to millennials, a generation with higher brand awareness and per capita luxury consumption, should also be supportive over the longer term.

While remaining conscious of the risks, including a prolonged downturn in China, further pressure on aspirational demand and the possibility that some creative resets disappoint, we believe the sector's current difficulties are largely cyclical and, in part, self-correcting. The best luxury franchises combine pricing power, scale, global reach and outstanding cash generation, with growth runways measured in decades rather than years. We favour the largest houses, whose size and brand strength leave them best placed to gain share through the cycle. For long-term investors focused on quality and duration, we believe the sector remains an attractive place to compound capital, and see the recent de-rating as more of an opportunity than a warning.

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