Keeping The Strategic Balance In The New Luxury Market

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An expanded new luxury space has proved irresistible to traditional luxury groups, mass-market conglomerates and hundreds of small 'boutique' companies. Winning in this space requires a delicate balancing act of stretching the brand without breaking it, expanding the product portfolio without diluting the profitability of core brands, and extending company capabilities without losing sources of advantage in increasingly competitive luxury markets.

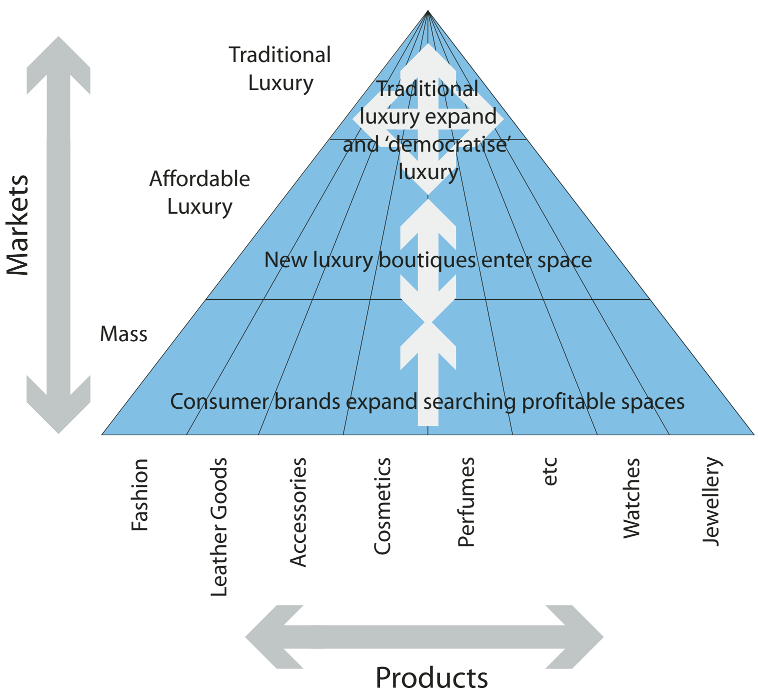


Fig 1. The Luxury Triangle

The luxury market space has—by tradition—been a select market where only the most exclusive brands compete, enjoyed by only the wealthiest individuals. Nowadays, a new expanded 'luxury' market spans a wide range of prices and product categories, effectively redefining the notion of luxury to include a limited edition crocodile handbag, a line of spa bath products and even a cup of speciality espresso coffee.

As luxury markets expanded, their premiums attracted companies from across the spectrum. But success in this attractive space has not been homogeneously 'luxurious'. For every success story there have been tales of overstretched brands, expanding luxury groups remaining heavily dependent on a few core brands for profitability, and companies entering and then exiting the luxury markets.

In this highly competitive space a new set of 'luxury survival rules' is emerging, requiring successful players to maintain a delicate balance: stretching brands without losing exclusivity, expanding brand portfolios without diluting profitability, and extending capabilities without losing unique sources of advantage.

THE 'LUXURY TRIANGLE': THE NEW LUXURY LANDSCAPE

Rising disposable income and demographic changes have allowed more people to 'afford' luxury. Leading this growth is a 'Global Elite', a sector estimated to represent 56 million households worldwide with annual earnings over $100,000. This sector has grown 40% in size in the last five years and is expected to reach 77 million households by 2007.[1] Additionally, a recent U.S. opinion poll found that 19% of American taxpayers believed themselves to be in the top 1% of earners, with a further 20% expecting to end up there in their lifetime.[2] Thus a large population either belongs to this luxury segment or behaves as if it does.

On the other side, luxury has become more affordable through lower-priced items, still with a significant premium over other products in their category. Affordable luxury products are within the reach of a consumer willing to 'splurge' in a category. Even if a Chanel suit is still beyond the reach of many, Chanel makeup offers a sense of luxury at an affordable price.

Consumers today are choosing to spend in different ways, prioritising 'feeling good' and well-being over 'owning' as a status symbol. Consumers also exhibit a bipolar tendency in their predisposition to pay. On one hand, they spend more when there is a strong value proposition, but they can be demanding price buyers flocking to discount outlets for standard products.

Competition in luxury markets has also undergone transformation. Entrepreneurs have targeted consumers with concept-and-experience based luxury, creating charismatic and stylish personality brands. At the same time, the growth of the 'affordable luxury' market has attracted large consumer brand companies suffering from slowing growth rates, private label competition, and increasing threats from concentration in distribution channels. It is not surprising that many companies looked to luxury markets as one way to stimulate growth.

Thus traditional luxury markets evolved from a narrow band of products and brands serving a select group of consumers to a 'luxury triangle,' spanning traditional and new luxury products and consumer groups. The emergence of this luxury triangle **(Figure 1)** has subsequently changed the rules of competition and requirements for success.

CHALLENGES TO WINNING IN THE LUXURY TRIANGLE

Success in the luxury triangle requires addressing three fundamental challenges and involves deciding how far to stretch brands, portfolios, and capabilities.

Issue 1: How far can a company stretch luxury brands, without eroding their exclusive image?

A stroll in the new 'Spazio Armani' in Milan offers the opportunity to indulge in a pair of Armani Jeans or a Giorgio Armani suit. But you can also find Armani homeware, sunglasses, perfumes and even chocolates. The Italian firm has spread its aura of fashion to a wide variety of product categories.

However, as Pierre Cardin discovered in the 1980s, a brand cannot be extended indefinitely—if it becomes too common it is devalued. Stamping the brand name indiscriminately on T-shirts, key chains and even paint can effectively destroy a brand. Gucci was following a similar path, as internal family disputes resulted in a largely uncontrolled multiplication of licences. Domenico De Sole, head of Gucci from 1994 to 2004, retransformed the company by buying back licences and, with designer Tom Ford, revived the brand's value. However, no sooner had they achieved this than they embarked again on extending Gucci's presence into ready-to-wear, accessories, sunglasses, shoes, fragrances and watches. This expansion was tightly controlled, yet its future success is far from certain. Gucci's current financial performance may again signal the limitations of aggressive expansion.

As Gucci, Armani and other luxury brands have demonstrated, brand equity can be successfully leveraged into new product categories, lower-ticket items and product extensions. But they constantly risk becoming devalued in the eye of the consumer. What strategies do successful companies employ to maintain the aura of glamour and exclusivity while embarking on expansive brand strategies?

Issue 2: How far can companies expand their luxury portfolio in markets where creativity and exclusivity limit synergies?

Bernard Arnault, head of LVMH, challenged the view that luxury companies have to focus on a single brand. By 'managing creativity for the sake of profit and growth…' Arnault built an empire controlling over 50 luxury brands, acquiring brands where the common denominator was the luxury appeal to consumers. However, LVMH still relies on its Louis Vuitton brand for 20% of revenues and, more importantly, for 60% of profits. Another luxury group, Gucci, remains dependent on the Gucci brand for 60% of revenues - and all of its profits.

Table 1 outlines lead brand contribution to revenues and profits at several luxury groups, highlighting the challenges of a luxury portfolio strategy. Can success in one luxury brand be replicated in another? What real synergies can be transferred from one luxury brand to another?

TABLE 1: LEAD BRAND CONTRIBUTION TO FINANCIAL RESULTS (2002)

Company	Lead Brand	% of total revenues	% of total profits
LVMH	Louis Vuitton	22%	62%
Gucci	Gucci	61%	126%
Richemont	Cartier	60%	66%
Tod's	Tod's	60%	na

Source: Company Data

Issue 3: How far can a company stretch its capabilities, before eroding its advantage in luxury markets?

Alongside luxury firms, consumer brand giants like Unilever ventured into affordable luxury markets. These markets were created as firms offered products that, while at a premium over traditional products in their category, were accessible to a growing number of consumers. One successful example was Unilever's transformation of its Dove soap brand into a global franchise with 2003 sales totaling more than $2.5 billion, making it the world's largest cleansing brand.

The impetus to stretch the Dove brand came as part of a strategy of moving from being product-to brand-driven. For Dove, this involved leveraging the brand's luxurious moisturising image into an entire line of affordable luxury products. The strategy resulted in building a brand franchise growing at a 30% annual rate, while the brand's traditional bar soap market declined at 2% per year.

For Dove, Unilever leveraged its marketing expertise, consumer intimacy, technical expertise, and global customer relationships. However, the company has not been always been successful, as suggested by a series of setbacks and restructurings of its 'prestige' fragrance brands. In these areas, Unilever lacks a unique brand franchise and, more importantly, it had weaker consumer intimacy and customer relations to build brands in increasingly competitive markets.

The challenge of stretching firm capabilities involves understanding a company's unique combination of skills and know-how applicable to luxury markets. What is the mix of firm capabilities that enables success in luxury markets against strong competition?

THE SURVIVAL RULES IN THE LUXURY TRIANGLE

Stretching the brand…while maintaining exclusivity

Stretching successful brands is tempting. Besides the opportunity it affords for increased revenue, lending the 'magic touch' to related products helps leverage the investments required to support a global brand. Stretching can involve extending a

STAMPING THE BRAND NAME INDISCRIMINATELY ON T-SHIRTS, KEY CHAINS AND EVEN PAINT CAN EFFECTIVELY DESTROY A BRAND

brand into 'affordable,' 'affinity' or 'diffusion' product lines.

Expansion into 'affordable' categories involves offering products that offer a 'taste of luxury' to a broader market. Although at significant premium to standard products, lower unit prices make the products within the reach of a wider population. Common categories for 'affordable' expansion include handbags and leather accessories, sunglasses, perfumes, cosmetics and other accessory products. At Gucci, accessories today make up 70% of total sales. Even Chloé, traditionally focused on clothes, launched a line of bags and eyewear in 2001 and in just two years accessories represent 25% of sales.

Expansion into 'affinity' categories has been popular for luxury brands. Watchmakers Bulgari and Chopard found natural extension of watch brands in jewellery. While Bulgari traditionally had a jewellery line complementing its watch offerings, a series of line introductions helped the jewellery division grow faster than the original watch business. Bulgari further extended to perfumes in 1993, a line of accessories in 1997, eyewear in 1998 and more recently even ventured into product categories such as 'design hotels'.

'Diffusion' offerings involve building a family of brands with different propositions in the same product category, but benefit from the halo effect of the parent brand. Armani has done this in the fashion industry with five distinct brands ranging from the high-end Giorgio Armani to the informal everyday wear of Armani Exchange and Armani Jeans. Each brand is aimed at a different customer segment and has its own positioning, distribution network and retail strategy.

Regardless of the approach, three principles can help a company profit from the expansion without diluting its most valuable asset, the value of the brand:

- **Keep a tight control on quality, distribution and production:** Successful companies managing the tension between brand extension and exclusivity have kept tight control on quality in all aspects of its relationship with consumers. Brands like Gucci, Yves Saint Laurent and Burberry were rescued by the aggressive buying back of poorly managed licences. Control of market 'touch points' allows brand image to be synchronised along the entire consumer experience. But complete vertical integration is not the only way to achieve this. Licences are necessary and can be beneficial, for example, in manufacturing specialised products where the brand owner has little experience (e.g. Louis Vuitton sunglasses, Calvin Klein watches). Licences are also beneficial for access to distinct geographic markets, as Burberry and Paul Smith found in Japan. But these licences are tightly controlled. According to British designer Paul Smith, "The key thing is the control of all aspects. I have been to Japan 48 times since 1984."
- **Maintain the aspirational value of the brand:** Legendary brands maintain, above all, their exclusive aura. The perception of exclusivity can be created in many ways, including limited distribution or production, brand communication and high price tags. Actively restricting access can also create a sense of uniqueness. For example, the Hermes Birkin bag, named after British actress Jane Birkin, has an opening price of $6,000 and a top of the line price of $85,000 - if you fancy crocodile leather and gold closures adorned with diamonds. But it is also impossible for a customer to walk into a Hermes boutique—the sole retailers of the bag—and buy one. The waiting list

reached two and a half years when the company closed it, and a waiting list for the waiting list opened. Prada also offers limited edition items, and Dior has developed a made-to-measure business. Even with high margins, these products represent a tiny fraction of turnover, but they raise the 'aspirational bar' of the entire brand.

- **Avoid overexposure:** Brand extension in luxury markets is more limited than other markets. Even if companies control the entire value chain and selectively create exclusive items, the pressure to grow can ultimately lead to the brand losing its allure through overexposure to the point of customer disappointment.

Expanding the brand portfolio… without diluting profitability

With limits to expansion of individual brands, many companies inevitably contemplate adding brands to their portfolio. In luxury markets while general portfolio economics may apply, a few portfolio rules are particularly important:

- **Don't overestimate synergies:** Success cannot be easily replicated from one luxury brand to another. Maintaining the individuality and creativity of brands and imposing operative procedures and financial targets has proven challenging in the personality-driven luxury sector. Combining 'creative' and 'commercial' processes have proven difficult. The advantages of a brand portfolio must compensate for spreading management attention across relatively independent businesses. In luxury groups, shared activities have largely focused on back-office operations, real estate and advertising. These synergies have not significantly contributed to the bottom line.
- **Don't overpay for synergies that likely don't exist:** It is well known that most acquisitions create value for the shareholders of the acquired firm, destroying value for the acquiring firm. The infamous 'winner's curse' suggests that the value of synergies is often included in acquisition prices. This is dangerous for luxury acquisitions, where the value of synergies has yet to be established and a brand's luxury image can demand premiums. The danger of overpaying for luxury brands should be carefully considered. Competing in luxury markets is less likely to benefit from traditional synergies and rather synergies must be identified in true value-creating activities. Putting two medium-sized troubled firms together does not produce a winner; it often just produces a large troubled firm.
- **Revitalising brands can be cheaper:** Luxury conglomerates and consumer companies have been more successful reviving brands than creating them. Procter & Gamble converted its traditional beauty brand 'Oil of Olay' into the new 'Olay', an affordable luxury brand that joined its 'billion dollar brands' list in 2003. However, making a new luxury brand commercially successful has proven difficult. LVMH has invested time and resources in establishing the designs of Christian Lacroix, a designer that attracted media attention for its 'avant-garde' designs in the 90s. But, after more than 10 years, the brand has yet to produce a profit.
- **Kill the tail:** Companies must actively manage brand portfolios, building core brands with their best talent, while harvesting lower performing brands before they drain resources. Luxury brands take time to develop the allure and require significant investment in advertising, public relations and designer costs. The return on the investment may take years to be realised. 'Hockey stick' financial projections can result in wasted financial and management resources, when such resources are often the keys to building the successful brands.

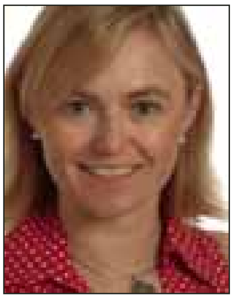
CREATIVITY, CONSUMER INTIMACY, A COMMITMENT TO IMAGE AND EXPERIENCE, AND ATTRACTIVE AND POWERFUL BRANDS ARE SOME OF THE REQUIREMENTS FOR SUCCESS

Extending capabilities… without losing unique sources of luxury advantage

For companies with luxurious ambitions, one final challenge is undertaking a realistic assessment of what combination of capabilities offer the greatest opportunity for success in luxury markets. Creativity, consumer intimacy, a commitment to image and experience, and attractive and powerful brands are some of the requirements for success. Understanding a company's source of success, particularly in the true value-adding activities, is a challenge to consider before—as opposed to after—expansion.

Choices about where to expand are particularly critical for entering luxury markets. Successful companies tend to prioritise moves around their core, moving to neighbouring spaces that leverage strong capabilities unique to the company. In luxury and affordable luxury markets. Four primary capabilities can be leveraged:

- **Channel dominance:** An effective distribution network consistent with the brand's desired position is key when entering new markets. Having it already in place accelerates customer reach and enables associated cost-efficiencies. Diageo, an alcoholic beverage giant with premium brands including Smirnoff, Johnny Walker and Bailey's, ventured into premium wines leveraging its global distribution structure. In addition to the channel advantage, they were able to imprint their branding capability on its premium wines.
- **Consumer intimacy:** Targeting a consumer segment requires deep understanding of consumer behaviour to drive product planning and development. From the consumer perspective, a company's credibility and reputation, matched with a positive brand experience, lead to openness to adopt new offers. Utilising both its brand building expertise and consumer intimacy, Unilever expanded its Dove range from soap to a broad bath and body line, leveraging key elements of the brand's traditional identity.
- **Operational excellence:** Taking expertise garnered with star brands into new segments offers the opportunity to use existing skills to capture new audiences. L'Oréal successfully positioned Plénitude as a higher quality mass-market brand, leveraging its R&D expertise in 'anti-aging' technology developed for Lancôme. Through sophisticated packaging and a slightly higher price point, while using mass distribution channels, L'Oréal was able to target a broader consumer segment.
- **Input control:** Swiss watch manufacturer Swatch owns over 15 watch brands, including luxury brands such as Omega and affordable luxury ones such as Swatch, CK and Balmain. But beyond its expansion into manufactured watches, Swatch also owns ETA, Frédéric Piquet and Nouvelle Lémania, three companies that satisfy 90% of the market demand for watch movements. Swatch's strategy leverages its unique power in the mechanical watch category.



The business of selling 'indulgences' at premium prices has proved to be very attractive for players that have successfully managed their growth. But these markets are changing and so are consumers, with boundaries continually being reset according to what is luxury and what is mainstream, what merits a premium and what does not. The same characteristics that can make a brand successful can ultimately bring about its fall.

Companies willing to compete in this space need to develop growth strategies that simultaneously:

- **Stretch successful brands—**while maintaining their perceived exclusivity;
- **Expand portfolios—**by identifying and leveraging synergies in value-adding activities; and
- **Extend capabilities—**by developing strategies that build opportunities in neighbouring market spaces without sacrificing sources of distinct advantage.

Clearly recognising and addressing these three simultaneous challenges defines the drivers of growth in the luxury triangle. Collectively they represent the challenge and opportunity for generating the expected results in this highly attractive and competitive market space.

References:

[1] *Boston Consulting Group: Trading Up: The New Luxury and Why we need it, 2002*

[2] *CDX IXIS: Luxury Goods Sector Report February 2003*

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