'Industry and Competitive Analysis' course
Professor Karel Cool
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CAN LUXURY GOODS CONGLOMERATES SUSTAIN ABOVE-NORMAL RETURNS? THE GUCCI GROUP CASE

[redacted]

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PART I – THE LUXURY GOODS INDUSTRY

1. Definition

The Luxury Goods industry is defined by the personal consumer goods positioned in the high end of the market. Luxury products transcend product functionality. Traditionally, the Luxury Goods industry has been associated with French families and designers, still represented by the Comité Colbert[1], but it is becoming a global industry.

The main characteristics of luxury goods are:

- A strong branding that relates to an exclusive and wealthy lifestyle.
- High quality, especially in terms of design
- Premium pricing

The luxury brand is perceived as being exclusive (82% of consumers), high quality (80%), stylish (75%) and extravagant (65%). Only 55% perceive it as lasting and only 51% perceive it as expensive.[i]

2. Market overview

2.1 Market segmentation

Total sales in 1999/2000 amounted to USD 60 to 80 billion. The market growth has been 6.3% between 1996 and 1999, and is supposed to be 7-10% between 1999 and 2003[ii]. The market can be divided into different business segments and geographical areas.

Business segments

The market is divided among:

- Fragrance and cosmetics (24 to 37% of the luxury goods, depending on estimates[iii])
- Ready-to-wear and fashion (14-30%)
- Leather and shoes (13-16%)
- Watches and jewellery (8-32%)
- Wines and spirits (15-22%)
- Table wear (4-5%)
- Accessories (5-9%)

Geographical segments

The market is divided into 3 geographical areas: in 1999, USA accounted for 30%, Europe for 34%, and Asia for 36% (increasing to 60% if we include purchases abroad by Asian tourists).

[1] http://www.comite-colbert.fr

2.2 Growth, operating margins and concentration

In terms of sales, LVMH, Estee Lauder and Richemont are the 3 big players, with respectively 17%, 12% and 19% operating margin, whereas ex pure players like Gucci offer 14% operating margin, or a true pure player like Hermès, 25%.

The expected growth and operating margin differ by segment[iv]:

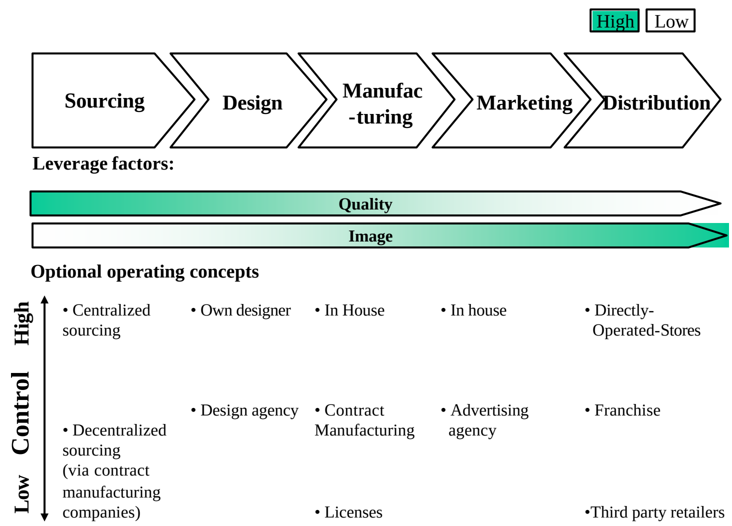
	Expected growth	**Operating margin**
- Shoes and Leather goods	12%	25%
- Jewellery and watches	12%	20-25%
- RTW & Fashion	10.5%	15%
- Tableware	10.5%	N/A
- Cosmetics and Fragrances	5.5%	10-15%

The industry is quite fragmented, although an increasing M&A activity in the recent years has set the trend towards consolidation. Even though the segments appear to have a relatively high concentration, the dominant players differ among the segments[v] and the total industry is far from consolidated. However, big conglomerates have emerged: LVMH accounts for 18% of the total luxury goods market (mainly leather goods and shoes), whereas Richemont accounts for 6% (mainly watches and jewellery), or Estee Lauder for 7% (mainly in cosmetics and fragrances):

	MS of top 3 players	**Top 3 players**
- Shoes and Leather goods	53%	LVMH (30%), Prada (14%), Gucci (9%)
- Jewellery	61%	Tiffany (36%), Richemont (17%), Bulgari (8%)
- Watches	65%	Rolex (26%), Richemont (22%), Swatch* (17%)
- RTW & Fashion	23%	P R Lauren (9%), T. Hilfiger (9%), Marzotto (5%)
- Cosmetics and Fragrances	57%	E. Lauder (21%), Shiseido* (21%), L'Oréal* (15%)
- Total	31%	LVMH (18%), E. Lauder (7%), Richemont (6%)

** Only sales with prestige segment taken into account*

2.3 Analysis of the value chain



Source: Authors

We focus on the 3 most strategic parts of the value chain that define luxury goods: manufacturing, marketing / advertising (brand image generation), and distribution.

Manufacturing

Production is crucial in maintaining image and quality. The production is a "métier", combining the founder reputation (Louis Vuitton), craftsmanship, and a long-term commitment to the business.

Marketing / Advertising

The industry is more a pull than a push industry, explaining the large amount of money invested in advertising (corporate or product specific level). On average, luxury goods industry spends more than 7% of its sales in advertising. (see table on page 35)

Distribution

For some, distribution is one of the key elements in the value chain. As S. de Rosen, a luxury-goods analyst at J.P. Morgan, argues: *"If there is one critical word in the luxury business, it is "execution". People think about the luxury business in the wrong way - they think about brands. But luxury companies are primarily retailers. In retailing, the most important thing is execution, and execution is all about management. You may have the best designed product, but if you don't get it into the right kind of shop at the right time, you will fail."* [13]

That probably explains the rationale behind the increasing trend of owning and controlling the distribution. For instance, the focus for many luxury brands like Gucci is "on directly operated stores and carefully selected wholesale doors, where we are able to ensure that all products are presented to our customers in a way that capitalizes on the exclusivity and ultimate allure of our brands" (annual report 1999, Gucci)

In luxury goods, retail directly operated stores (DOS) have been growing much faster than other forms of distribution over the past five years. The reason for that is because there is a perceived need for better control of the brand. In the 1980s and 90s, when companies delegated the sale to third parties, the priority of these parties was to make the luxury goods available to a wide customer base. To achieve this, they offered often-uncontrolled discounts. The discounts, combined with a broader availability of the product, diluted the brand image and reduced the willingness of customers to pay a premium for the products. This led to the need to control the brand and thus to integrate the distribution channels.

To regain control of the distribution, many brands have started to acquire franchises and reduce wholesale and duty free. For Gucci, the share of DOS has grown from 63% of total sales in 1998 to 69% in 2000[vi]. For Richemont, the same share has grown from 39% in 1999 to 45% in 2001[vii]. Companies who have historically been manufacturers only (like Montblanc) have started developing both directly operated stores and franchises.

For other (selected) major luxury business, the share of DOS in total sales in 2000 is as follows:

Tiffany and Louis Vuitton - respectively 100%, Hermès - 63%, Bulgari - 50% and Polo Ralph Lauren - 43%.[viii]

In addition to the DOS, there are four other main distribution channels in the luxury goods industry:

1. *Directly operated stores (DOS)*
2. Franchise
3. Wholesale distribution
4. Agents
5. Licenses

These channels differ in the degree of control, capital requirements and profitability:

	Control	Capital required	Profitability
DOS	High	High	Low
Franchise			
Wholesale Distribution			
Agents			
License	Low	Low	High

Source: SSSB, Nov 2000 and McKinsey

This trend towards full control and ownership of the distribution helps solve some of the problems associated with other distribution channels and has some distinctive advantages[ix]:

- If helps solve the problem of distribution and display control, the creation of the right atmosphere and architecture and the subsequent ability to change quickly
- Controls the product quality and price and the service quality, which in many luxury shops was satisfactory. (Most of the luxury goods retailers cultivate regular high spending customers only (> US $ 100.000 a year) and do not provide any extra service to the other clients.
- Allows to get immediate customer feedback
- Allows for a higher margin as the retail margin is captured and defense against retailers' pressure on margins
- Better control of the grey market

However, there are many downsides that are sometimes ignored. The downsides are:

- The strong increase of the financial risk.
  - The investments required for stores on highly visible areas are high with a trend to increase: the requirements for small boutiques are up to US $3-5 million, and for flagship stores - up to US $10 - 15 million [13]. In addition, here is an increasing competition for the diminishing supply of prestigious locations in high-end streets. Luxury goods companies spend between 5-7% of sales on capital expenditure every year, which is mainly invested in new stores and refurbishment.
  - There is an increased financial risk associated with the inventory management, the leasing/financing commitments and the rigidity of the cost structure

- The additional business risk. The risk of business failure increases, as the skills required are quite different for owning/leasing and managing a shop than for developing and marketing a brand.

The degree of integration of distribution and the associated question of the control of the distribution channel is a key question in the luxury goods industry. It appears that it depends mostly on management ambition and management risk-taking attitude. Studies performed by SSSB point out that there is no obvious correlation between a company's success and its level of distribution integration.

Integrating the whole distribution can be rewarding in periods of high growth, but can be extremely dangerous in downturns, as the operating risk is different and the business (risk) is also different. Therefore, advocates of full integration probably overlook the risks associated with it and a mix between the different distribution channels is generally probably more appropriate.

It may therefore be argued to have own stores in highly visible areas, where the brand image control is key, but to develop franchisees and agents (with very strong brand guidelines and controls) give the necessary flexibility and transfer part of the operating risk. There should however be a trade-off analysis performed between the retailer's margin and the cost of decreased risk. Depending of the countries, wholesale distribution can be appropriated (in US and Japan, department stores are very important distribution channels for cosmetics and shoes. In France, only few department stores are potential candidates for luxury goods retail: Galeries Lafayette, Samaritaine, Printemps and Au Bon Marché, but these stores are usually owned by the luxury conglomerates).

<u>Brand Name</u>

☞ ***The brand name is a key asset in luxury goods.*** The brand image makes the company non imitable and non substitutable. However there is a high risk of substitution with another brand, leading to intense rivalry for the final customer. A small chunk of customers who choose to remain loyal to their brand / product, such as the clientele of Chanel's n°5. According to Leslie de Chernatony & Gul McWilliam "the varying nature of brands as assets"[x], there are 5 possible roles for brand names:

- As devices to show marketing control
- As differentiating devices
- As a means of communicating a guarantee
- As an aid for rapid decision-making (short hand device)
- As symbolic devices to enable consumers to express something about themselves (projecting self image)

2. 4 Analysis of the five forces (M. Porter's framework)

<u>Industry rivalry</u>

The competitiveness in the industry can be qualified as relatively **high**, but given the high margins and the customers' perception about the price, the competition is not on price, but rather on quality and image perception, as well as on the ability to attract the right designers (see "war for talent" in the section on trends)

Competitors

The barriers to entry are very high, as they are the intangible image and the perception built around the brand. As Bernard Arnaud said: "You need at least 30 years to build … a brand. But when you have got some, you can resist any crisis." Hence, buying an existing brand early can be assimilated to buying a Ricardian rent.

The barriers to stay are also very high: there is a continuous need to "feed" the image, to maintain the perception but still to respond to customers' needs and changing expectations. The trade off between exclusivity, stylishness, extravagance and lasting image makes it difficult to be for a long time in the business. There are many examples of brands that failed along one of the parameters (Pierre Cardin completely lost his image).

There are hardly any barriers to exit (if the business has built a network of DOS, if might be time and efforts consuming to sell them / to undue the leasing contracts, but as these DOS are usually on highly visible and coveted places, we do not see that as a barrier to exit). Given the high barriers to entry and to stay and the low barriers to exit, the dynamics of the industry are: few big players and only the best, as the others either cannot get in, or are easily out.

Substitutes

There are no real substitutes for the luxury goods except not buying the goods, as it is not a necessary need.

Suppliers

The bargaining power of the suppliers depends on the segment. As some tended to have increased bargaining power, this leads to the concentration and vertical integration trend in the industry, one of the reasons for which is to lessen the bargaining power of the suppliers. Until now, there is not observed concentration among the suppliers of the luxury goods industry among themselves. There is however a trend for larger houses to buy smaller suppliers and to deprive the market form access to those suppliers.

Customers

There are two types of customers:

- The super-rich
- The middle-market customers, who selectively trade-up to higher levels of quality, taste and aspiration

The super-rich customers (or High Net Worth Individuals) seem not subject to the world economic cycles. In addition, they are a growing number. Estimates[xi] predict that their number will increase from ~ 26 millions in 2000 to ~ 40 millions in 2005 (an increase of ~ 9% p.a.)

The middle-market customers are those that are willing to buy luxury goods, but "they want the hottest, trendiest design, which increasingly have to be marketed in creative and expensive ways" [13]. They can potentially expand the market quite dramatically, as they are part of the upper-middle class. They are considered to be both a great opportunity (show no price sensitivity when buying the "hottest" product) but they are also a threat. "They are more demanding, more selective and show less brand loyalty than the HNWI".[13]

This implies for the luxury goods industry a difficult equilibrium between the two kinds of customers, because both are not necessarily compatible. This can lead to a difficult trade off between satisfying a smaller number of loyal customers and a larger number of more volatile customers.

New entrants

The new entrants are mainly new designers who start their own brand on their own. Usually, these new entrants, if successful, are quickly acquired by the big names of the industry, by providing them the needed infrastructure for growth. However, new entrants, if remaining independent, can represent a threat by capturing the volatile middle market customers. We do not believe that new entrants are a real threat for capturing the stable HNWI customers. These customers go after the established name and the perception build around it, after the quality and design. All these elements take time to be built, which makes the threat of new entrants less significant.

2.5 Growth drivers of the global luxury goods industry

- The socio-demographic changes (growth of the professional women segment and trend towards single households)
- The world economy and the global wealth (economic slowdown and crisis like September 11 affect the industry as consumer confidence vanishes and travelling activities decrease)
- Exchange rates and fluctuations (high dependency on sales to Asian tourists make industry vulnerable to exchange rate fluctuations).

Asian tourists especially Japanese, take advantage of luxury goods prices which are significantly lower than in their home countries. Louis Vuitton, for example, sells 40% of its output to Asian tourists.

Economic slowdown has a major impact on the luxury goods industry, since consumption of luxury goods are highly independent on consumer confidence. However, high-end classic brands are usually less affected than aspirational or fashion brands due to their wealthier client base; for which luxury goods remain affordable. The travel retail represents around 40% of the Luxury Goods sales. Therefore, a decrease in the travel industry has a direct negative impact on the sales. So the Gulf crisis, the Asian crisis, and ultimately Sept. 11 have badly hit the market.

As global wealth is increasingly linked to stock market strength, a crisis in the financial markets affects the luxury goods industry.

3. Trends

The major trends are vertical integration, consolidation, brand stretching / diversification and war for talent[xii].

3.1 Vertical integration

The trend towards vertical integration is not only on the distribution side. There is a whole trend to integration along the whole value chain. Upstream, the vertical integration goes through the

- *Restriction/abandonment of licensing agreements.* The latest example is in 2001, when "Polo Ralph Lauren President-COO Roger Farah is quoted as saying the company might look to end some of its licences and develop products itself as a way of gaining control and a bigger share of profits".
- *Buying up of manufacturers*: In 2001, Gucci "acquired Di Modolo design studio and production facilities, designing and manufacturing high-end luxury timepieces. Before the acquisition, Di Modolo already designed watches for the Gucci group."

Downstream, the integration goes through:

- *Buying back franchised operations*: in 1999-2001, Gucci repurchased back for instance many of its Japanese and Spanish frabchise outlets
- *Open new directly operated stores*: In February 2002, Jil Sander opened a 10.000 square feet store in London, between Bond street and Saville Row.
- *Scale down / discontinue sales through third party retailers*: In 2000, Tiffany's "stopped supplying domestic department stores and jewellers to concentrate on expanding its own network of stores.

3.2 Consolidation

The consolidation is accelerating in the luxury business. It appears that size is increasingly important in order to smooth the business cycles, to provide growth, diversification, synergies opportunities, and to allow for better vertical integration. Some analysts argue that a luxury business should be "large enough to harbour several brands, and not be tempted to over-exploit (and destroy) a single label. That means having a pipeline of brands and products "under development", and devoting considerable resources to old-fashioned "R&D". "[13]

In 2000, LVMH closed 15 deals; Richemont closed 4, Gucci 4, and Prada 2.

Some examples: In December 2000, Richemont acquired 100% of les manufactures Horlogères; in May 2000, Gucci acquired 100% of Boucheron and in 2001 - 67% of La Bottega Venetta; in September 2001, Bulgaria acquired 75% of Bruno Magli.

Several reasons to buy can be identified:

- *Financial markets*: boost growth ratios by acquiring more businesses
- *Growth*: only limited potential to stretch their own brand without being overexposed and losing of exclusive appeal
- *Diversification*: step into new category (eg table ware) where the company is not present yet and lacks market or product know-how
- *Synergies*: increasing negotiating power - raw material, real estate – rather than cost cutting – usually gains from synergies in productive efficiency is close to nil…)
- *Vertical integration* (acquire manufacturing companies in order to control quality or buy retailers to access scarce retail locations and get better control of the brand image). The

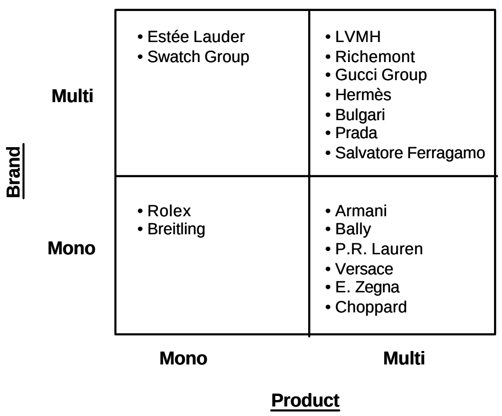
general consensus in the industry is that revitalizing a brand is less costly than building one from scratch. Acquirers have to be good at picking winners!

The reasons to sell are:

- limited financial resources: limited financia l resources restrict growth and competitiveness
- lack of product / market know-how for accessing new product categories or foreign markets
- lack of marketing power (marketing becomes increasingly strategic to build brand awareness in this highly competitive and fragmented market).
- brand failure to generate above-normal returns in comparison to other brands in the portfolio (eg. recent sale of Pommery by LVMH)
- ineffective synergies with the rest of the group
- capital gains

3.3 Diversification

The major luxury goods companies' portfolio has evolved from mono brand to multi-brand and from mono-segment to multi-segment.



Source: Authors

This evolution has been dictated by hope of achieving economies of scale and scope and by the hope of reducing the impact of brand life cycles. The result of this evolution will be analysed in further details in the second part of the paper.

Examples of mono-brand / mono-segment are Rolex and BreitlinG. Usually, brands have one core segment, and additional one(s) for diversification. Examples are Armani, Bally, P. R. Lauren, Versace, E. Zegna, Choppard.

Some brand go to multi-brand, either mono-segment or multi-segment. Examples of multi-brand / mono-segment are Estée Lauder and Swatch, and examples of multi-brand / multi-segment are the ones which are usually considered as conglomerates: LVMH, Richemont, Gucci Group, along with Hermès, Bulgari, Prada, Salvatore Ferragamo.

3.4 War for talent

In this industry driven by creativity, a brand has to attract and retain the best creative talents. In addition, as the industry becomes more dynamic and competitive, there is a need for good managers, thus the war for attracting the best of them.

Some examples of this war for talent for creative designers: the move in 2000 of Alexander McQueen from LVMH / Givenchy to Gucci Group, where he launched his own brand; the move in 2001 of Christopher Bailey from Senior Designer of Gucci to Design Director of Burberry and the move in 2001 of Stella McCartney from Head of Design of Chloé (Richemont) to Creative Director of her own label with Gucci Group.

On the manager side, some examples are the move in 2001 of Bernardo Sanchez Incera from International Director of Zara to Director of European Fashion with LVMH and of Giacomo Santucci from MD Helmut Lang with Prada to General Manager with Gucci Division.

4. Creating and Sustaining competitive advantage

4.1 How to create your competitive advantage?

In the Luxury Goods industry, time and size matter: competitive advantage comes from both.

Time

- **Reputation** (thanks to their reputation, brands like Chanel are considered 'religion' brands). Reputation will allow a brand for diversification (Kenzo launching Kenzoki, a cosmetics line). On the other hand small brands with high creativity can enter the market on specific niches very easily. Most of them will die some months later. Those who survive will become luxury brands and are likely to be acquired.
- **Trial cost** is high in the Luxury goods industry, since pricing is high. The caveat is that customers usually have a good purchasing power. Consumers are loyal to a brand because the brand consistently delivers quality and respects the customers' self-image. Then, inducing a customer to switch is like changing his self-perception: purchasing luxury goods is both a financial and an emotional investment. For the incumbent, the challenge is to continually reinforce customer loyalty while at the same time attracting new ones. Luxury goods are experience goods. So the new entrant will have to create the buzz and convince the customer to try its product (therefore sampling in cosmetics) so that he re-defines his self-image.

Size

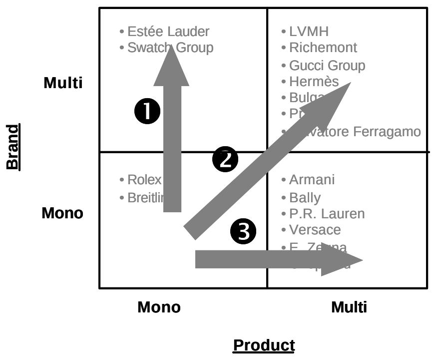
- **Installed base** (network) is very important in luxury goods industry, where word of mouth plays a major role in order to create the hype. At the same time, luxury goods are very special regarding network effect: the appeal of a brand is inversely related to the number of customers. The more exclusive the brand, the more desirable it is. So the brands will have to play a very special game called 'the illusion of exclusivity'. That is why so many brands are doing what can be called 'mass luxury goods' (Lancome, at L'Oreal is a good example). Similarly, many luxury products are becoming a commodity (champagnes, etc…)

- **Complements/hosts:** there is no real technical complement in that industry, but cross selling is increasingly strategic for luxury goods companies. Hence the diversification in shoes, table ware, eyewears, etc… Rich customers enjoy purchasing different products with the same brand name (Chanel from feet to eyes…). So the incumbent interest is to offer a wide enough range of products to meet all the customers' needs. Having a wide portfolio of products will allow for cash cows that will provide the necessary funds to invest in an early-stage brand and new activity. Success breeds success.

4.2 Three successful ways of growing in Luxury Goods[xiii]

There are basically 3 ways of growing:

(1) Extend and defend core category (Todd's, Tiffany or Rolex)
(2) Build new categories via brand stretch (Armani, Hugo Boss or Versace)
(3) Extend brand portfolio (LVMH, Gucci, Richemont, Prada)



Source: Authors

These three ways are subsequent, as usually brands go first extending and defending the core category, then, if they continue, stretch the brand, and finally, if they believe in their management and integration skills, as well in the transferability of skills across brands, develop a portfolio of brands.

Here is an explanation of the above strategies:

<u>Extend and defend core category</u>

The brand must

- Increase sales by fully exploiting core segment and broadening its geographic reach
- Increase profitability via excellence in operations
- Build a distinctive strong brand (differentiation)

To do this, the skills that are required are: an excellent market and product know-how in the core categories and strong functional skills in e.g., design, marketing, sales and operations.

Build new categories via brand stretch

The brand must:

- Increase sales by leveraging the brand equity into new categories (Armani Casa)
- Establish own retail outlets
- Build brand loyalty (via direct marketing, etc…)

Here, the skills required are product and market know-how in the new categories, appropriate retail know-how, brand management skills and CRM capability, to build on the existing customer base and to understand / anticipate the customers' needs and expectations.

To assess whether the brand can be stretched, there are three dimensions along which it can be tested:

- Height of the brand: what are the aspirational extent of the brand benefits.
- Breadth of the brand: how versatile is the image.
- Depth: how competitive is the current category.

Extend brand portfolio

The brand must

- Identify, acquire and integrate under leveraged brands
- Build new brands

The skills required here are mainly the ability to successfully transfer the know-how across the brands (e.g., the way Gucci was restructured, applied again to restructure YSL), strong post-merger integration skills, in order not to loose key people and dilute the image and ability to design the organization and change this design when needed.

4.3 Key challenges in the industry

Financing

It is becoming a major key factor of success for worldwide brand diffusion. Global success requires strong R&D commitment (both in process and in product), strong advertising budget (corporate and specific) and finally strong commitment in retail. These financial requirements lead small brands, pure players, to seeking partnerships, relying on third party distribution network, narrowing product offering, and soliciting capital markets. Additionally, access to capital markets (ie becoming a public company) allow for extra acquisition currency, a possibility to issue debt and a mechanism to incentivize talent with stock options.

Brand life cycle

The dynamics and hyper creativity of the industry lead to shortening product life cycle. R&D in cosmetics allows the big players for launching breakthrough products within a year or two. The shortening life cycle facilitates entry for eventual new entrants. Even successful players like Chanel seem to transcend the life-cycle process while managing to capture a new market for each new generation while retaining their long-established clientele by leveraging the myth created behind Coco Chanel (successful new advertising for n°5 fragrance targeting younger people).

Diversification

4.4 Conclusion: the Winning Concept

According to some analysts, the winning concept of the future for the luxury goods industry is to be like a "big pharmaceutical groups that combine the management of a pipeline of brands at different stages of development, heavy investment in the creation of new products, and effective marketing and distribution".[13]

PART II - WHAT DOES A LUXURY CONGLOMERATE BRING TO A COMPANY?

1. Methodology

In order to identify the various soft and hard assets brought and developed by a luxury conglomerate to its subsidiaries, we tried to follow various analysis frameworks applying it to the example of the biggest luxury conglomerate, i.e. LVMH:

- We looked at companies bought by LVMH over the last decade (e.g. Guerlain, Givenchy) and analysed the changes in efficiency, positioning and organisation that appeared afterwards, and the rationale for that; we tried whenever possible to conduct interviews with managers working within these companies in order to get "insider" information.
- We conducted performance, positioning and organisational benchmark between companies owned by LVMH and other independent players positioned on the same segments (Tod's, Hermes); we studied the evolution of these two sets over a period covering the before- and after-acquisition in order to separate conglomerate-specific moves from industry-specific ones.
- We analysed companies that are historical assets of LVMH (for example: Christian Dior) and looked at the specific synergies brought by the headquarters.
- We performed interviews with independent retailers to better understand their relationship with the LVMH brands, but discovered no synergy yet in this area.

We concentrate our analysis on distinguishing conglomerates (multi-brand players) from pure players (mono-brand one), both having the ability to propose mono- or multi-product line portfolios.

The LVMH Company Brief Outlook

The LVMH conglomerate is quite unique in the sense that it gathers the largest range of luxury and premium goods available on the market as defined in part I. It can be argues that the definition can be widened, to include for example premium hotels or luxury cars which target the same clientele. It has rapidly expanded its scope of activities over the last decade through the acquisition of historical or emerging brands. The conglomerate operates five distinct divisions:

- The *Wines & Spirits division*, promoting various champagne, wines and cognac brands, including high premiums products (Château d'Yquem: most expensive Bordeaux)
- The *Fashion & Leather Goods* division, gathering brands such as Louis Vuitton, Loewe, Kenzo, Givenchy, Céline, Christian Lacroix, Fendi and Donna Karan
- The *Perfumes & Cosmetics division*, including Parfums Christian Dior, Kenzo Parfums, Givenchy, Guerlain
- The *Watches & Jewelry division* with brands such as Zenith, Ebel, Chaumet, Christian Dior, Tag Heuer
- The *Selective Retailing division*, developing its DFS, Sephora and local department stores (Le Bon Marché, La Samaritaine) network. Developing critical mass in the distribution network (Sephora in the US) seems to be a priority for the group

2. Competitive advantage brought by the Conglomerate model

We will analyse the competitive advantage brought by the conglomerate model through two different perspectives:

- The first perspective encompasses the structure and organisational model developed through the conglomerate model. This includes the power in the value chain, the risk diversification and the strategy evolution.
- The second perspective describes the synergies and operational management developed by the conglomerate.

2.1 Structure and organisation

Various distinctive competitive advantages have been identified as added value brought by the conglomerate:

- *Management Quality and Competitive Structure:* LVMH attracts, trains and promotes very valuable managers thanks to its external Public Communications and various links with universities and business schools. The Human Resource policy tends to promote people mobility across the vario us regions and divisions. Furthermore, the headquarters is very reactive in promoting Managing Directors coming from different industries when it thinks the move is pertinent for the subsidiary. As an example, the Perfume and Flagrance market is today controlled by players such as Unilever or Procter & Gamble alumni; within Givenchy (bought in 1989 by LVMH), LVMH has promoted a General Management coming from these industries, resulting in a totally new positioning of the brand on this market. Generally speaking, modern management techniques and organisational structures have often been brought to traditionally operating "boutiques".

- *Research and Develoment*: synergies are initiated across various Perfume & Cosmetics houses to limit the cost per unit in devebping new cosmetics and skincare products. However, it seems that these synergies are in an early stage.

- *Brands Global Repositioning*: one of the key added value brought by the conglomerate to its brand portfolio is the brand differentiation and re-positioning developed year after year to limit product cannibalism. This is especially true for the Watches & Jewelry division that recently integrated many new brands.

- *Funding*: a specificity of the luxury conglomerate is its ability to gather very high free cash flows from historical brands (about EUR 1 billion in 2001 for LVMH) that can be re-invested selectively in brands under development or restructuring. This war chest gives LVMH headquarter the ability to act rapidly and give access to better funding conditions to the subsidiaries, thereby creating better conditions for innovation and market reactivity.

- *Higher bargaining power with retailers and distributors world-wide*: although synergies seems to be limited at this point in time (Sales Forces are specia lised on one Product Line or Brand), potential synergies could emerge in the near future.

- *Economies of scale*: a surprising synergy brought by the conglomerate is economies of scale; this is true for the Fashion & Leather Goods division, a business unit that sell more than one million pairs of shoes under various brands (2001 figure) and leverage a strategic global manufacturing partnership with Italian manufacturer Rossimoda. This partnership is expected to deliver higher quality and profitability in this category.

- *Integration into selective retailing*: LVMH leverages its DFS and Sephora distribution network to push the various Perfumes & Cosmetics products. In some places such as Le Bon Marché, LVMH performs price discrimination resulting in a 10% higher price for its own products than in independent retailing! (This integration strategy is however challenged by some analysts as this is a much lower margin segment to operate in, bringing down the overall ROCE.)

- *International Expansion*: a strong expertise in international expansion seems to be brought to each subsidiary, especially after acquisition of new companies (Fendi, Kenzo, Donna Karan). In many cases, LVMH acted in two steps with new acquired companies. First, it modified and extended the product portfolio, an then developed the international network selectively. For many luxury goods independent brands, mastering the international expansion is quite challenging, requiring both funding, distribution networks and management. The conglomerate is able to gather these resources and leverage an existing distribution network[2].

2.2 Process and operational management

We identified various sources of competencies brought by LVMH to its subsidiaries:

- *Financial Discipline:* the LVMH conglomerate operates as a very financial-focused corporation in the sense that it manages its company portfolio very dynamically and imposes strict financial rules ("focus, profitability, cash flow" as core values presented by Bernard Arnault) to its subsidiaries with respect to use of capitals and return on sales; in other words, artistic and luxury creation has be profitable and yield high margins. The financial control and pressure performed by the headquarters leads to a better assessment of product and market opportunities. This financial discipline is done within each Division, through arbitrage between potentially competitive projects.

- *Higher Budgets for Marketing and Sales*: the LVMH group is able to gather higher marketing, advertising and promotional budgets, especially in the Perfume markets (critical mass) to ensuring a new product launch adoption; this is probably linked to the fact that the risk of failure in launching a new perfume is generally pretty high, and that a strong marketing investment is an efficient mean to get higher early adoption, word of mouth and, in a nutshell, higher success rate. Strong examples in the Perfume segment are Dolce Vita (Parfuns Christian Dior) and Champs-Elysees (Guerlain), two perfumes that recently used a very high advertising budget with respect to other individual boutiques. But this pattern is also true for other Divisions, such as Wines & Spirits (focus on growing start brands such as Dom Perignon, Moet & Chandon, Veuve Cliquot, Krug and premium cognacs in the US and Japan) and Watches & Jewelry (Chaumet and Zenith brands).

- *Merchandising Know-How*: one of the main characteristic of the conglomerate added value in the Fashion business seems to be its ability to leverage the creation image of star brands (John Galliano at Christian Dior, Alexander Mc Queen at Givenchy) to expand the scope and recognition of the brand first, and then promote and launch a full set of accessories (Christian Dior's margins are going up thanks to this strategy). Generally speaking, the conglomerate seems to bring modern marketing and merchandising techniques to traditional historical brands. In the Wine & Spirits segment, the

[2] In Asia (Japan, Hong Kong), LVMH has centralised its operations and co-located its retailing outlets (5% "global stores" world-wide.

conglomerate has been able to leverage and export marketing and merchandising concepts from mass markets products (bundling) and introduced marketed packages of wines (Trilogy of Grands Crus) or champagne (Cliquot Box).

- *Product Line Expansion ("milking the brand")*: a constant characteristic of LVMH across its various divisions is its ability to expand rapidly and aggressively the portfolio width and depth in order to create additional sources of revenues; this is a trend that we see in Perfume and Cosmetics (Dior, Guerlain, Kenzo), but also in Watches and Jewellery (Tag Heuer, bought in 1999, Louis Vuitton Watches). A significant example for that is Guerlain, a brand that has traditionally be positioned on the upper flagrancy segment. Since the LVMH takeover (1994), Guerlain has redefined its positioning with perfume and cosmetics products targeting new segments (25-35 active women) outside its traditional customer base. A second example is Christian Dior, an historical asset of LVMH: over the last decade, the brand has been re-positioned to yield higher margins (massive focus of new accessories' launch, creation of many perfumes and new cosmetics, higher brand awareness among new high income segments but lower product quality and less distribution exclusivity). In the Wine & Spirits division, new segmented products are launched: Moet & Chandon's Nectar Imperial in the US, Hennessy Classique for the Japanese market, Hennessy Private Reserve and Paradis Extra[3] designed to expand its customer base among cognac connoisseurs.

- *Inventory management:* this characteristic seems to be true in the Wine & Spirits business where champagne capacity is managed with efficiency.

3. Limits in the value brought by a Luxury conglomerate

Following the analysis of the LVMH group, we identified two major limitations – strategic and operational - that may hinder the business development of a pure player when integrated within a conglomerate.

3.1 Strategic constraints

Diminishing advantages of the business mix

LVMH is progressively loosing its initial business diversification advantage as globalisation and international economic interdependence strengthened in the recent years. As the main geographical areas tend to be financially and commercially affected in very close time intervals, LVMH cannot compensate anymore for the temporary weaknesses of a specific region. When a financial and economic recession happens in one part of the globe, such as in the US during the last two years, the repercussions in Europe and Asia develop rapidly, which endangers the whole financial balance of the conglomerate.
Similarly the business cycles of the different business divisions tend to shorten. Therefore the LVMH luxury conglomerate may hardly maintain a global growth in revenues by a compensation mechanism, which initially was a key-success factor of its strategy as a conglomerate. For example LVMH relied on the sales development of the perfumes and cosmetics division in the past five years to compensate for the cyclical slowdown of the wine and spirit business.

[3] Top quality cognacs

As a consequence, in case of an economic downturn, the luxury conglomerate may not be able to provide the financial support that a pure player would expect from the group. Eventually a commercially and financially more successful single player may have to give up part of its profits to the benefit of the corporate entity, willing to redistribute them to more lagging divisions.

Corporate strategy of the conglomerate negatively impacts operational divisions

The strategy of a conglomerate mainly consists in strengthening the key businesses and aggregating the cash from the strongest divisions to build a war chest which will be used to invest in future promising sectors, which may be core or non-core sectors. This is a financial "weapon" to bet on future revenue streams and take positions fast before competitors. The underlying outcome and risk of this strategic approach is that an irrelevant and unsuccessful investment may strongly diminish the corporate base of cash, and ultimately the funds that would otherwise be allocated to foster the business development of the different brands. For example, the recent unsuccessful diversification of LVMH in internet operations, such as the e-luxury web site, or in selective retailing such as Sephora, strongly undermined the financial corporate results of the group. This contributed to weaken the business image and financial credibility of the company and might have reduced its ability to access to an optimum cost of capital for further business development. Furthermore these negative performances may have been transferred at the operational level, by demanding the business divisions higher profit targets and constraining their expense plan. In this situation the pure player integrated in the luxury conglomerate may be worse off and temporary limited in its business development.

Business arbitrages at the expense of specific business divisions

In a luxury conglomerate, a pure player becomes one part of the brand portfolio and its performance tends to be assessed relatively to other brands. Therefore when the pure player demonstrates an inferior business growth compared to other brands of the portfolio, the conglomerate may reallocate the budgets to the benefit of the brands that may more rapidly produce profits. In this case the short-term focus and pressure on results may lead the luxury conglomerate not to take into account anymore the time dimension necessary to leverage the unique and creative assets of the pure player. Eventually the luxury conglomerate may consider to divest in a brand despite its creative uniqueness, such as the champagne Pommery LVMH is trying to sell. Despite innovative product launches and a strong brand communication, the product stock surplus combined with a weaker trend in consumption led LVMH "sacrifice" the Pommery brand among the other Champagne brands of its wide product portfolio, comprising Moet&Chandon, Veuve-Cliquot.

3.2 Operational arbitrages

As the global strategy of the conglomerate prevails, most of the operational arbitrages tend to be made at the expenses of the single business unit, ie in our case the pure player integrated within the group.

Limited flexibility in Human Resources management

Although the pure player may wish to benefit from the conglomerate talent pool, Human Resources mobility tends to be constrained by the unwillingness of the Heads of the operational divisions to break up their teams and let go their key-managers. This may be

emphasised in the context of luxury, where each business addresses specific customers, manages a brand with a specific "history" and "sophisticated" positioning, and requires unique operation processes. Building a combined functional and brand expertise requires time, therefore the operational divisions tend to keep their teams for several years. Furthermore managers often "feel" attached to the brands they develop and tend to receive little compensation incentive to join another business division of the group.
Therefore a pure player may unlikely benefit from a corporate support to enrich its management or creative team, while as an independent company, it can more easily attract new managers, providing it offers a motivating financial package, combined with a strong autonomy in decision-making.

Internal competition for budgets and support operations

As part of the luxury conglomerate, the pure player will face a strong competition with the other brands to maximise its share of the overall budget. The focus may be more on "internal politics" than on business and creative management, as the level of financial means in the luxury industry are key to foster performance development through strong advertising, extensive promotional marketing, resources in creative development. The final decision in terms of budget allocation is likely to be made by the corporate structure on past result criteria rather than on future performance assessment. Therefore a pure player, being considered a small part within the conglomerate brand portfolio, may not receive the required budget for implementing its business development plan.

Similarly when negotiating commercial agreements with suppliers and distributors, the heads of the functional divisions, such as Purchase and Sales, might only consider the increase in the total group business share that a single player will bring, without considering its specific needs to further expand. Therefore the outcome in terms of delays, discounts, retail presence are likely to be negotiated at a group level, but may not ultimately be redistributed to the single player. Since the suppliers and distributors are concerned with the profit derived from each specific brand, they might give better overall conditions considering the share of the luxury conglomerate in their businesses. The real advantages in terms of supplying delays, shelf-space, etc., might primarily benefit the "biggest" brands. The single player might lack the advantage of being a part of the Luxury conglomerate, while contributing to increase the bargaining power of the functional managers, by enlarging the base of the negotiation.

Profitability focus hindering creativity development

A luxury conglomerate tends to create a pressure on financial results at the level of each division and induce a form of competition between brands. This is likely to hinder the creative process, which is the underlying support of the brand, we previously defined as one of the key asset of a luxury goods player. The focus on results and profits might represent a risk in the longer term as managers will tend to abandon new creative product projects that may not be an immediate commercial success. In the longer run the risk is to loose the originality and identity of the brand and indirectly destroy the future consumer base, as they might no longer be attracted by the creative style of the brand and therefore not be willing to pay for the premium linked to any luxury product. Another distortion that might be generated by a conglomerate is a too radical transformation of the brand, without maintaining the link with the history of the brand. For example LVMH tried to revitalise the Givenchy brand by brutally changing the designer and assigning ambitious commercial targets to the new creator and his team. However the new products did not match anymore with the "spirit" and original style of the brand. As a result the Givenchy brand lost on both sides: the former loyal customers were shocked and unwilling to buy the new products, while the potentially new buyers were rather seduced by other radically innovative brands and therefore remain a marginal buyer group that did not compensate for the loss of the core base of clients.

4. Overall benefits of a Luxury conglomerate to a pure player

As previously described, a pure player may benefit from the integration in a luxury conglomerate to have access more easily to financial means and to a solid business structure, which are likely to boost its development. The key advantages a conglomerate may provide are a cheaper cost of capital to finance creative and business investments, an increased bargaining power and reduced cost of operations (raw material purchase, advertising, distribution and merchandising costs) and finally the easier search and access to skilfull creators and managers.

The constraints of joining a luxury conglomerate might be the financial discipline and imposed business targets, aligned to the group, which may not sufficiently take into account the specific situation and required business development stages of the pure player. The luxury conglomerate may also exercise a too strong influence on the creativity of the pure player and on its commercial applications, which might weaken the initial creative uniqueness of the single brand. Finally the managers of the brand might lack sufficient autonomy in their management and decision-making process, hindering their own business creativity.

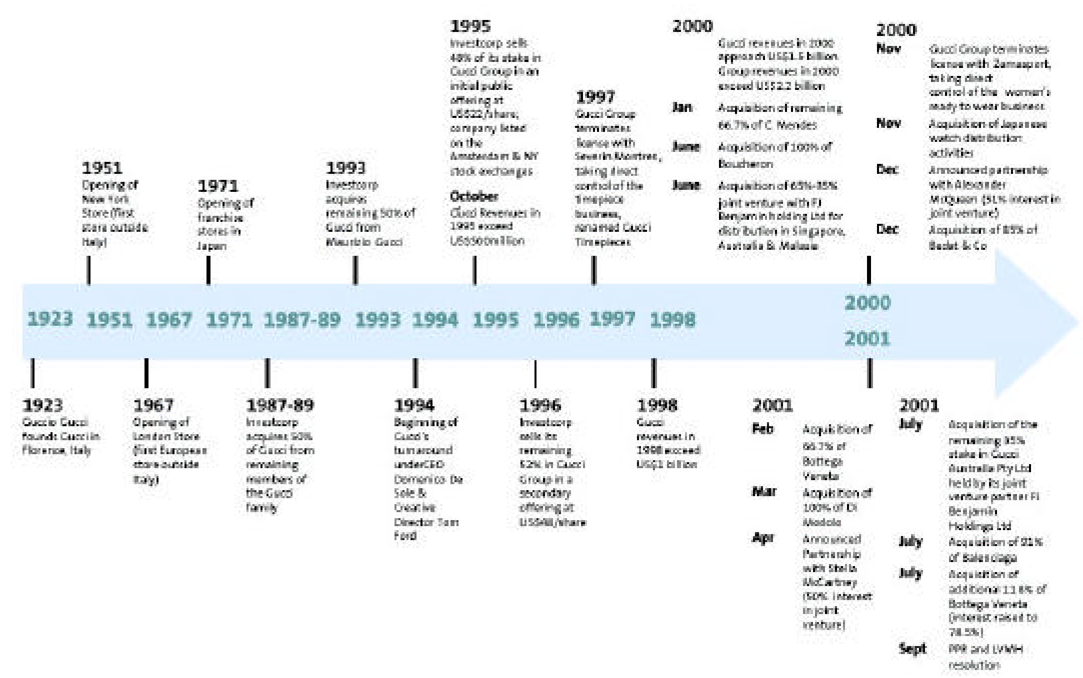
However following the consolidation of the luxury goods industry it seems increasingly difficult for a pure player to develop as an independent firm, unless the uniqueness and creativity of the brand may be transformed in successful commercial products with the support of streamlined business operations. This may apply to luxury business segments that do not require a large initial funding and do not necessarily target the mass-market. Fashion may be an example: the strategy of a pure player would be to build or revamp a brand, targeting specific customer groups, then developing and expanding the brand towards mass-markets products like perfumes and accessories. The pair Tom Ford and Domenico De Sole successfully applied this strategy when "relaunching" the Gucci brand. However their success rather appears the exception in the fashion sector, where the financial returns on initial investments usually take place in a five to ten year time frame. Furthermore the further development of the Gucci brand seems to have been fostered by the integration, creation of new luxury goods group, providing additional support to the brand.

Most of the other luxury segments such as wine and spirits, perfumes and cosmetics, are capital intensive to foster new product development, global and powerful communication and distribution. Therefore the viability of a pure player development strategy becomes rare and questionable. We may wonder to which extent the remaining pure players, such as Rolex or Armani are likely to be acquired by the existing luxury conglomerates such as LVMH or Vendôme group in a near future. Another business strategy might be the creation of another Luxury goods conglomerate, which might be the path followed by Gucci Group.

PART III – THE NEW KID ON THE BLOCK: GUCCI GROUP

1. The History of Guccio Gucci SpA

Exhibit 11: A colorful history
Company chronology



Source: Company data.
source: Goldman Sachs [15]

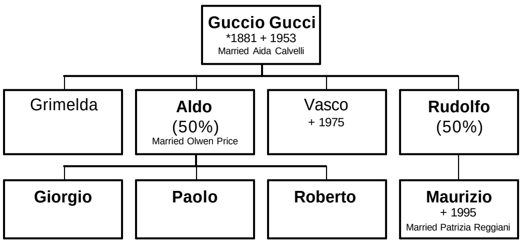
1.1 1923-1989: the Origins

The Gucci House was founded in Florence in 1923 by Guccio Gucci. Working as a waiter or bell boy [10] at the Savoy Hotel in London at the turn of the century, he observed that most of the "rich & beautiful" clients carried very ordinary luggage. Back in his native Florence in 1923, he opened a small luggage shop. He later expanded the range of products into other leather goods such as the classic Gucci bamboo-handled purse (1957), the classic Gucci loafer (1960), and expanded into textiles with silk scarves and foulards in 1962. [4]

When the founder died in 1953, he divided the company control between his two sons with a 50/50 split. Aldo, a hard worker, built the company into a full-blown international fashion house, while his brother Rodolfo dedicated his life to acting. When that generation passed away, they handed their shares of the company to their offspring, leaving effectively Maurizio as the majority shareholder.

War soon erupted in the family, which could not agree on a way to re-unite their holdings. A solution was found in 1989 in the form of Investcorp, a banking institution from Bahreïn (that had just recently made 2,5x their money in a transaction involving the jeweler Tiffany [1]), which bought over the shares of the three sons of Aldo [4].

The Gucci Family Tree



source: [3]

1.2 1989-1994: the Death Spiral

Still owning 50% of the business, Maurizio Gucci stayed on as Chairman and CEO. He thought a little more grandeur would suit Gucci well: he expanded the product range to more than 20,000 references, ranging from ashtrays to saddles [3], including many déclassé items [1] such as plastic handbags and canvas luggage [2]. He also developed the number of sales outle ts. This development was achieved mainly through licensing and franchising. Additionally, as the product range was managed by different members of the Gucci family and global regions were operating independently, there was no consistent display of goods across stores around the world [2]. Inevitably, soon the Gucci brand was diluted in the client's perception.

Several years of additional bad management left the company in shambles, with employees dispirited and suppliers angry waiting to be paid, and stopping the supply of goods to the stores [2]. The company had been loosing money, and on the brisk of bankruptcy after years of "bruising infighting among Gucci family members" [4] (it lost $23m on revenues of $203m). In October 1993 the company was placed in liquidation.

Investcorp (holdings at the time included also Saks Fifth Avenue [2]) was left with no choice than to buy out the last 50% stake from Maurizio Gucci for an undisclosed sum (thought to be in the neighborhood of $110-120m [3] or $400m for the overall investment [5]), allowing it at last to operate freely. (Incidentally, Maurizio Gucci was later murdered by his wife in 1995 [2]).

1.3 1994-1999: the Gucci turnaround

Investcorp called upon the services of Domenico de Sole, an Italian born tax lawyer, trained at the Harvard Law School. He was originally hired by Maurizio Gucci to solve a US tax issue with the IRS and went on to run the US division of Gucci after 1984. He became COO in 1994 and CEO in 1995 [9].

Investcorp started applying drastic financial control [1], by slashing costs in production, closing 650 points of sale, terminating 17,000 product references out of 22,000, and slashing costs [3].

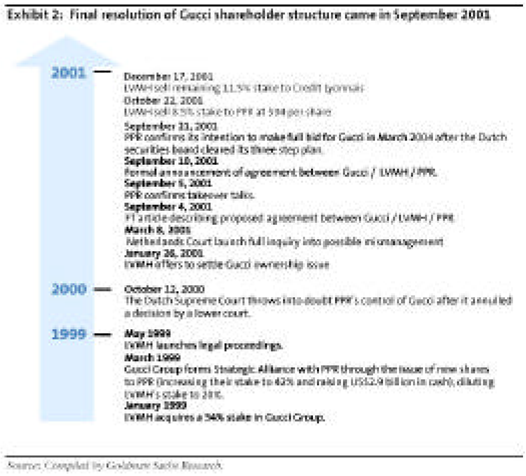
Internally the company was reorganized into 11 product lines, with "category managers" overlooking single lines. Tom Ford, who has been fired by Maurizio Gucci, was rehired [3].

The company soon recovered profitability and turned a $17m profit in 1994. In October 1995 the company went public on the New York and Amsterdam stock exchanges [1], providing a first exit for Investcorp. 48% of stock was floated at $22/share [3] (overall IPO at above $600m.). Just a few months later, a secondary offering in March 1996 allowed Investcorp to exit completely. The remaining 52% of stock was offered at $48/share, reaching $1.3bn [3]) (in 1995, the company recorded $83m of profits, on revenues of $500m).

Unfortunately, a major problem for de Sole and Ford surfaces, as although they retained full control of Gucci's products and image, they could no control the price of Gucci's stock and became immediately a takeover target. The 1997 Asian financial crisis brought the stock price down from $70-80 down to $40, where it remained throughout most of 1998 [5].

Already back in 1994, LVMH had attempted to buy Gucci with a $400m [11]. In 1997, Patrizio Bertelli of Prada quietly bought a 9.5% stake of Gucci stock [5]. Beginning in 1997, LVMH bought secretly 5% of Gucci on the market, and then bought Prada's stake. In January 1999, it held 26,7% [5] of the stock, and kept on buying more on the market, becoming the single largest shareholder with 34.4%. Although Bernard Arnault originally denied wanting to make a bid for Gucci, a merger would have made sense. LVMH could have used the new product pipeline from Gucci, while Gucci could have used the new valuable outlets of LVMH through which to sell its growing line.

De Sole and Ford did not appreciate the move: "the guy just asked himself over to dinner without calling first" [5]. Indeed, Arnault was unlikely to share any power with de Sole and Ford, who had just created a immensely valuable business out of ashes [5]. De Sole fought LVMH off, and persuaded the board to issue $2.9 billion of new shares, representing a 40% stake to white knight Pinault of PPR, who had just bought Sanofi Beauté with the intention of starting a luxury division of his own. That move diluted Arnault's stake to 20.6% and prompted him to file suit in Amsterdam. Then in December 1999, de Sole bought YSL from PPR for $1 billion for the tarnished ready-to-wear and perfume business [12].
After years of legal litigation, LVMH dropped the towel at a substantial profit in September 2001 in a process that gave PPR a majority control in Gucci with the option to bid for the remaining stock in 2004.



Source: Goldman Sachs [15]

We believe the process through which the tandem Domenico de Sole and Tom Ford turned the company around in just a couple years are key to understanding the uniqueness of the company and its main competitive advantage. The next section describes in detail the measures applied to this turnaround.

2. Sources of uniqueness and above-normal returns at GucciGroup

A detailed analysis of the actions that Domenico de Sole and Tom Ford undertook to turn around Gucci shows that they have created a strategy and a process to execute this strategy that not only enabled them to compete with the large luxury goods conglomerates such as LVMH, and Richemont, but actually to outperform them on several counts, including stock performance and compound growth.
In particular, we believe that they have achieved an extreme high-level of competence in several areas, which combined have created their unique competitive advantage.

2.1 Management

After years of inappropriate management, Gucci was taken over by a US trained lawyer, whose simple but effective methods contributed largely to the company's turnaround. De Sole acknowledged in an interview: "the most dangerous thing in business is not making decisions. I learned from Maurizio Gucci - he couldn't decide anything" [11].

De Sole brought in an American style to managing people, materialized by a <u>flat structure</u> and openness: "I try to hire good people and let them do their jobs as long as I know what is going on. Some CEOs don't know much about their companies, but I know everything." – de Sole [4].
The trust in his management team was however relative, and the <u>impeccable execution</u> of the strategy was key to its success: "I follow through, I call my managers all the time to make sure they have executed what they said they would do" – de Sole [4]. As an example, he would not hesitate to shut down stores immediately if they did not abide by the guidelines he defined for the brand [4]. Other examples of his very decisive character included slashing all the previous management's perks such as the company-paid three-mast sailing boat, and moving back the lavish headquarters built in Milan by Maurizio back to Florence.

Finally, de Sole used typical US <u>incentives</u> for his employees. He introduced stock-options for all top management and had all remaining employees benefit from a year-end bonus, pro rata of 30% of the group's profits [7].

Finally, many accounts relate that "de Sole is a formidable people leader" [7], a crucial quality in harsh times where drastic measures are indispensable.

2.2 Manufacturing

Additionally to putting his house in order, de Sole understood he needed to regain the confidence of his suppliers and retain the best amongst them.

Just after joining Gucci, he spent 3 months in the summer 1994 driving around Tuscany, meeting personally with all suppliers, regaining their confidence and assessing their <u>quality</u> [2]. He didn't hesitate to slash about 10% of suppliers who did not meet the quality standards [11].
As an <u>incentive</u> he offered to pay upfront future wages (it had never been done before) [4] and played on the prospects of a long-lasting relationship and steady work, an important feature in

Italy [4]. Indeed history showed that suppliers benefited immensely by the growth in sales y Gucci.

Additionally, de Sole organized "a partner's program for the best and most dedicated artisans", helping them upgrade their facilities, and advancing money for high-tech machines if needed to boost their productivity [4]. "He offered financial and technical support in electronic support in electronic leather-cutting, as well as in order and inventory systems". [11].
In return, de Sole asked for significant returns in productivity, and retraining of workers in quality and efficiency "The small network of suppliers turned out 3.5 million leather pieces in 2000, up from 2.5 million the year before, and only 640,000 when de Sole took over. Production lead time has dropped by 40% over this period to 50 to 70 days" [11].

Finally, de Sole incentived the development of the Japanese model of supplier management, financially helping former employees to set up supplier businesses with Gucci in exchange for exclusivity [7].

Finally, de Sole introduced technology in manufacturing, including an innovative technique of hot water to mold leather before it is cut.

The Italian model for fashion and leather goods (a network of small manufacturing suppliers) differs here greatly from the French model used for instance at LVMH where manufacturing is done in-house.
Although it requires more quality supervision and coordination, not owning the means of productions has given more flexibility to Gucci, without restraining its capacity to develop manufacturing synergies with its suppliers. Additionally it frees up cash that can be put to better use for the firm in brand promotion and distribution.

However, Gucci is also strolling down through the backwards vertical integration path as well. The integration of Sanofi Beauté as YSL Beauté is giving it the internal capabilities to develop cosmetics and perfumes. Indeed an intra-group agreement was signed for YSL Beauté to develop the next fragrance for Alexander McQueen. Bedat also brought internal capability to develop watches and we understand that future Gucci timepieces will be subcontracted to them. But indeed the bulk of vertical integration is forwards with the replacement of the distribution channels with Directly Operating Stores (DOS) either bought back from former franchises or created from scratch.

2.3 Marketing

We described earlier that the Gucci brand had been over-streched and that it's perception as a luxury brand had been completely diluted. The duo redesigned the whole marketing mix, successfully changing the product mix, the pricing strategy, the promotion strategy and the distribution concept, introducing a unique Gucci approach to brand management.

Product mix

The main idea for both managers was that the brand should be consistent all over the world, and convey the right image: "I wanted unity of style so that the customer who flies from Tokyo to Milan to New York will find the same image" – de Sole [4].

One of the first measures was to slash unsuccessful product lines (a massive reduction in the range of leather products) and focus on quality. All manufacturing licenses were terminated and production was brought back to the Tuscany region, except for watches remaining in Switzerland [7]. Franchises were granted exclusively to sectors where craftsmanship is required, such as perfumes (Wella has a 25 year contract). Finally the low-end products were slashed (although providing a very high margin) because of brand dilution: "don't run after the last dollar".

Additionally both de Sole and Ford understood that they could not rely on designer extravaganza, and very early on, introduced commercial considerations into their work: "in their world, value comes from a brand image more than form a designer's artistry" [11].

Ford was then instrumental in developing the Gucci new look. He dropped the old look of red and green stripes that had adorned every Gucci product since its creation, and shifted towards an ultra-chic black minimalist look, that appealed to the fashion conscious clientele. He also understood that ready-to-wear (originally 10% of sales [1]) should be used as an entry product and image ambassador for the other much higher-margin products such as accessories (bags, ties, shoes, tableware and belts).

Indeed, Ford created a mechanism to design a pipeline of new products, heavily using technology. Working from Los Angeles or London, he sent drawings electronically to Florence, were they were shaped in 3-D, then modified using cupboard models, and finally made into prototypes, again slashing both costs and new product development time. Additionally, there is some evidence that he started to delegate part of the actual sketching to some 20 designers at Gucci and later to some additional 10 designers at YSL [11].

Pricing

Another measure applied immediately by de Sole was to reprice every single item in the product line, mainly downwards, to create a consistent positioning of the brand, taking into account the competitor landscape [4]. He stressed the importance of bringing value to customers.
Indeed de Sole was quoted on several occasions that it was stupid to try to chase the last dollar in sales if that created blurred perceptions and inconsistency with the clientele.

Promotion

We understand that the Gucci brand was not heavily advertised in the pre-de Sole years. In order to relaunch the new image imagined by Tom Ford, Gucci relied on the usual techniques for fashion: public relations and press advertising. The difference with the previous era was the emphasis on this tool.

Indeed in 1994, "there wasn't much money for advertising, so we decided to sink what we had into fashion which is a highly publicized business" – de Sole [5]. The two Milan ready-to-wear show in 1995 by Tom Ford were massive successes, and relaunched the brand into the forefront of the luxury goods field.

Gucci also used public personalities to showcase its products and create press coverage, such as with Hollywood stars: Madonna, Tina Turner [1], Nicole Kidman [12].

A massive global advertising campaign was then launched using the best fashion magazines [4]: increasing from $6 million in 1993 [4], to $28m in 1995 [5] to $70 million in 1997 [4], to $80m in 1998 [5] (representing between 6 to 12% of sales).

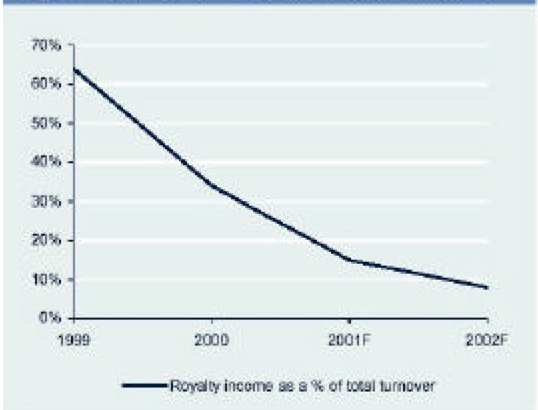
Distribution

De Sole is bullish in his ambition to control the distribution channel, for he believes that in order to deliver the right image to his clients, Gucci needs to control the whole supply chain from manufacturing to distribution where the brand image is finally conveyed to its clients.

In order to create the same look and feel all over the world, Gucci closed or bought back all franchises and licensees, including airport duty-free shops, and shops in shops in large department stores. "I am in the process of reducing the number of upscale retailers that carry Gucci" – de Sole [4]. He indeed closed down Gucci's presence at Harrod's in 1996, opening a new store back a year later.

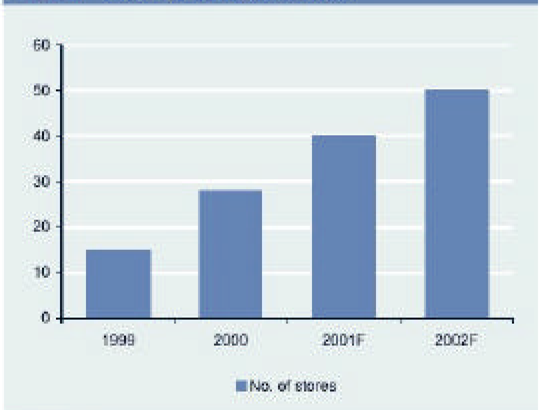
He also heavily promoted directly operated stores (DOS) in exclusive locations (Gucci Group: 67 self-owned stores in 1996 [1], 124 in 1999[5]). In 1999, all stores around the world were redesigned simultaneously, in order to impact the clientele worldwide simultaneously [7]. And again de Sole went on annual tours to check consistency of brand guidelines and closing down stores several times if necessary [2].

Fig 15 Royalty income as a % of total turnover



Source: Gucci, ING Barings estimates

Fig 16 Directly-managed stores



Source: Gucci

Source: ING Barings [16]

2.4 1999 – 2002: the integration of YSL Beauté and RTW

The legal battle between LVMH and Gucci occurred at the same time PPR was trying to develop a luxury goods division of its own, and when François Pinault was buying Sanofi Beauté. As part of the agreement to open the equity structure to PPR, Gucci bought Sanofi beauté for $1 billion in December 1999.

This marked the turning point for Gucci from a single brand company towards a luxury goods conglomerate, both on the multi product axis (leather, fashion, cosmetics, fragrances, watches and jewellery) and the multi brand axis (Gucci, Sergio Rossi, Bottega Veneta, YSL, Boucheron, Bedat, etc.). Could the recipe applied to revitalizing the Gucci brand work for the tarnished YSL brand?

Evidence shows actually that YSL was in very much the same state as Gucci:

- an over stretched brand with licensed on too many product categories: the YSL brand was imprinted on everything from cheap sunglasses to baseball caps [12].
- A poor distribution strategy
- A management torn between creativity and commercialconsiderations.

Interestingly, an INSEAD student report [17] written in 1997 had already spotted the internal difficulties at YSL and recommended the following:

"To go back to the path of long term sustainability, we recommend that the company:

- reactivate its image generator
- emphasize the quality of raw material procurement
- control quality by keeping an integrated manufacturing process, making it a core competence that will give it a competitive edge. It should of course not manufacture for competitors in case of excess capacity
- recreate a very strong interdependence between the marketing of the Perfume and the image creator's business to avoid any divergence and create synergies between two activities
- revitalize the virtuous cycle by a push strategy
- control distribution to have a scrupulous respect and coherence of the brand image".

Although there is not yet enough evidence to show the success of the YSL turnaround (the ready to wear business is not expected to break even before 2004, but YSL was back in the black in 2001), we believe de Sole and Ford are applying exactly the same strategy (and hence their unique resources) to YSL (and globally they are implementing the above mentioned recommendations!)

This brings additional benefits (potential synergies, shortened learning curve) but also difficulties (over-stretching management, capital expenditure) as they now strive to become an integrated luxury goods conglomerate.

Since management remains the same (it is noteworthy to indicate that YSL Haute Couture was not sold to Gucci by Pinault in 1999, and remained within its holdings. Yves Saint-Laurent decided to stop creating and retired in early 2002), we shall concentrate here on showing the marketing mix revival. The <u>new commercial orientation</u> of Gucci Group is evident in the following comment from Chantal Roos (YSL perfumes): "I would never have a conversation with Yves in which the cost of goods came up. Not anymore." [11]

<u>Product Mix</u>

Again, de Sole stresses the consistent brand image: "you have to have the same collection worldwide, and it has to be consistent" [9].

Not surprisingly, Gucci Group immediately <u>slashed licenses</u> that provided up to 75% of the house's revenue yet **devalued the image** [12].

"Controlling the brand means being selective about both the retail outlets and the licensees. YSL started 2000 with 167 licensees making items, ranging from shoes and eyewear to jewellery, that generated $57 million in royalty income the year before. It finished 2000 with only 62 licensees and royalty income of $33 million-dropping, among other items, shoes, baseball caps, socks and handkerchiefs." [11]

"Within three months the pair had eliminated most of YSL's 167 product licenses, bought back 11 franchised stores, sold the ready-to-wear factory in Tours, and launched accessories and footwear lines" [9].

Distribution

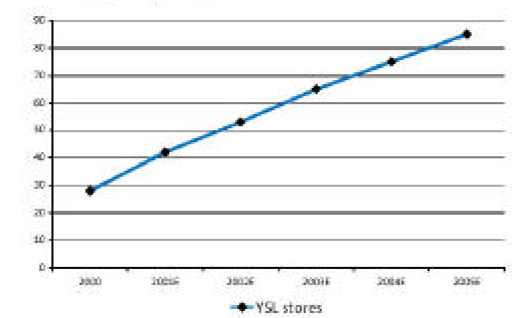
Gucci Group reiterated its strong belief in the control of the distribution channel and the development of DOS: "The idea here is to control [the brand] to within an inch of its life, from creation to production to distribution". [11]

In 1999, de Sole went on to close 5 out of the 10 distributor agreements YSL had in Japan in just a matter of days [9]. "The wide distribution conflicted with de Sole's notion of how to make a luxury brand seem exclusive" [11]. "Make something hard to find and you can command a premium for it." "Chantal Roos, now head of YSL Beauté, closed 1,300 of its 20,000 YSL "doors" (meaning total outlets). This year another 3,000 doors will close." [11]

Additionally, like the rest of the Luxury Goods industry, Gucci Group made a considerable effort to stop the gray market, which also diluted the brand and challenged the group's margin. (see [17] for a discussion on gray-market issues with YSL). "Like other luxury brands, Gucci sends investigators into stores to keep legitimate YSL suits out of discounters. Last year Gucci won a restraining order against a French Web site that was selling YSL perfumes without permission." "Gray market resales are a constant nuisance" [11]

As with the revival of Gucci, de Sole and Ford strongly believe in directly operated stores to revive the brand and with the "dismember in order to rebuild" approach [11]. "De Sole plans to spend $20 million a year on marketing and real estate" [11] with heavy investment planned in new boutiques: new flagships shops are planned for Beverly Hills, New York, London, Hong Kong and Milan [9].
"[In 1999] Gucci operated 15 YSL stores. Today [2000] it has 33, with 6 more scheduled to open by September. Plans call for a total of 50 to 60 stores by the end of 2002" [11]

Exhibit 17: We expect a rapid expansion in Yves Saint Laurent DOS



Source: Company data, Goldman Sachs estimates.
Source: Goldman Sachs [15]

3. The challenge of transformation from a mono-brand to a multi-brand group

We were unable however to find evidence that Gucci Group was immediately successful in applying all its competitive advantages to YSL, particularly in the field of brand image generation and manufacturing. Additionally extracting synergies from the new group, and managing the new brands looks like a strong challenge.

3.1 Image generation

As the Creative Director for both brands at Gucci and YSL, Tom Ford has the challenge to create a distinctive image for both brands. The first fashion shows for YSL by Tom Ford were reported to be a cheaper version of Gucci. This creates a huge problem, as the fashion shows contribute largely [17] to create the image required to generate big sales in the high-margin accessories associated with that image, such as handbags, eyeware, watches, perfumes and cosmetics. Hence, a key challenge will be to keep the new YSL look distinct within the growing Gucci empire [9].

Ford is trying to address this, and has presented the following image differentiation to the press which was perceived with confidence by Business Week: "the YSL brand is starting to recapture its star allure". [12]

Exhibit 24: Very different image but same customer base
Comparison of Gucci and Yves Saint Laurent

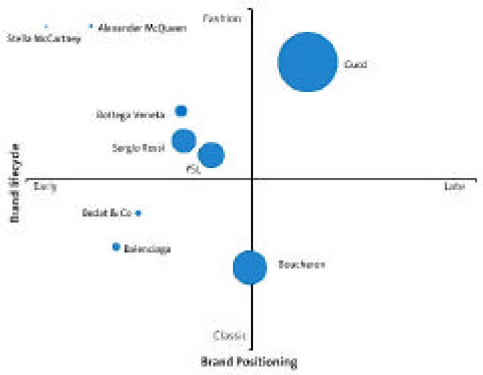
Yves Saint Laurent	Gucci
Timeless, modern	Trendier
Unattainable	Aspirational
Film star	Rock star
Limousine	Ferrari
Sexy, but complex	Obvious, easy
Brain	Body
Couture	Accessories
Paris	Rome, LA

Source: Company analyst meeting.

Source: Goldman Sachs [15]

We believe however that the problem shall not be resolved entirely as Gucci Group integrates more and more brands. Brand positioning shall be key, and keeping Chinese walls between them will reveal a challenge to the new conglomerate. Additionally, front-office synergies here are almost impossible as a blurring perception might result for clients.

Exhibit 15: Brand positioning, lifecycle analysis
2001E sales represented by bubble



Gucci's year end is January. Our 2001E figures refer to the year ending January 2002.

Source: Goldman Sachs Research.

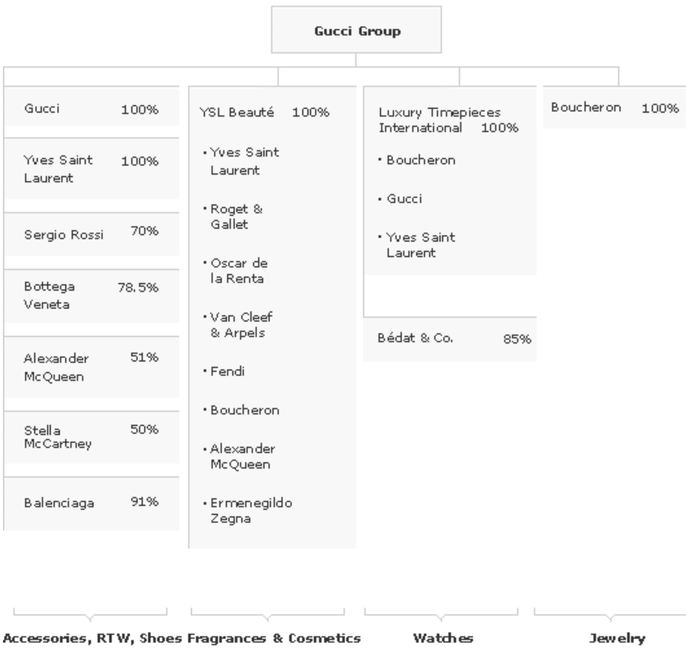
Source: Goldman Sachs [15]

3.2 Manufacturing

Although we found little evidence on the supplier relationships for YSL specifically, we believe Gucci Group is trying to develop manufacturing synergies for its portfolio. In particular, since leather goods account for less than 10% at YSL compared with 45% at Gucci, there is big opportunity for YSL to leverage Gucci's expertise in this field.
And indeed, the press reports that YSL's Mobassa bag was produced by Gucci's Tuscan network of skilled leather craftsmen [12]. "At Gucci's headquarters in Scandicci, outside Florence, artisans are stitching together next spring's YSL handbags" [9]. Additionally, "Bologna-based Sergio Rossi will now produce all YSL and Gucci shoes". [9].

<u>4. Is Gucci Group the right luxury goods conglomerate model?</u>

We have demonstrated earlier that Gucci created key competitive advantages that allowed the fashion house to emerge as the second or third (according to different ranking criteria) luxury goods conglomerate worldwide in just a matter of years. However, we need to understand whether these advantages are sustainable? Have they created a market dominance power, have they created a mechanism to extract Ricardian rents?



Source: Guccigroup.com

The turnaround process at Gucci has cause amazement and has become almost a reference int the industry. The new Burberry's CEO commented recently with envy: "turning a flagging brand around is called 'doing a Gucci', after Domenico de Sole and Tom Ford stunning success at building nearly bankrupt Gucci Group into an $11.1 billion (market cap) fashion power house' [8].

Business week wrote in 2000 [9]: "now this American Duo wants to repeat that performance with Yves Saint-Laurent, another faded star in the fashion firmament". "The stakes are big: success with YSL would clinch Gucci's reinvention as a diverse, high-profile luxury-goods empire with few rivals. 'This is the moment when the company is being transformed from a single brand to a multiple-brand fashion Group' – de Sole." "In particular a YSL makeover will enable de Sole's expanding group to challenge players such as [LVMH]".

"David Yoffie who oversaw a Harvard Business School case on Gucci: "In contrast to Gucci, [LVMH has] expanded into anything and everything – including some things they probably regret." [11]
"Non-withstanding the losses at YSL during its costly makeover, Gucci last year enjoyed a 21% operating margin on its narrower range of fashion, accessories and perfume. Is there a correlation between de Sole's ruthless control of distribution and profitability? There seems to be". The real proof will emerge in the next year of so, as de Sole and Ford try to replicate at YSL what they have already done at the rest of Gucci." [11].

A Goldman Sachs research uses a detailed approach to analyze the industry attractiveness, the company attractiveness and the stock attractiveness. Gucci emergedas the overall winner, with the best balance over all criteria. [15]. Its stock price also dominates the Goldman Sachs Luxury Goods stock price index

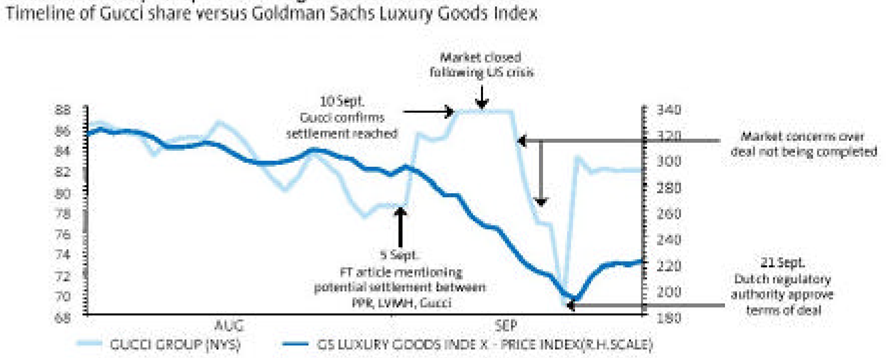
Exhibit 21: Company rankings: Gucci ranks at the top of the sector

	LVMH	Dior	Hermès	Swatch Group	Bulgari	Luxottica	Gucci
Brand franchise	++	++	+++	+	++	+	++
Growth	+	+	+	+	+++	+++	++
Control/Reduced risk profile	++	++	+++	=	+	++	+
Margin enhancement	+	+	+	=	++	+++	++
Capital structure	+	+	- -	- -	+	+++	-
Liquidity	+++	+	-	+	=	-	++
Valuation	-	=	-	+	+	+	+++
Average	+	+	+	=	++	++	++

Source: Goldman Sachs Research estimates.

Source: Goldman Sachs [15]

Exhibit 9: Share price spike following PPR offer and confirmation
Timeline of Gucci share versus Goldman Sachs Luxury Goods Index



Source: Datastream, Goldman Sachs Research.

Source: Goldman Sachs [15]

Analyzing the different components of the value chain at Gucci compared to the rest of the industry, we believe Gucci Group might have found a magical recipe. Are they unique and sustainable?

4.1 Management

It is undeniable that de Sole's seamless execution of a brand strategy developped with Tom Ford is the driving force behind Gucci's revival. However could the company survive without one of these two managers?

We believe the two assets should be analyzed separately.
Domenico de Sole's vision and execution has been analyzed extensively. His approach is not unique anymore, and there is evidence that LVMH has tried to copy his approach (e.g. DOS for Vuitton). Although it would prove difficult to find a replacement manager for him in the short-term with the right kind of charisma and understanding of brand development, we acknowledge he has been developing a top-management team that could operate without him, and could grow into his role. Additionally Goldman Sachs estimate his options to be worth 1-2% of Gucci's market capitalization, a healthy sum to keep him motivated to stay with Gucci.

Tom Ford however seems to be a more scarce resource. Although there is a plethora of designers on the market (from John Galliano to Osvaldo Boateng), we found no evidence of them successfully blending artistry with commercial orientation, as most pure fashion houses loose money. He still has the challenge to develop in the long run distinctive images for the group's different brands, and can definitively not be replaced easily. We believe that his higher stock option package (estimated at 3% by Goldman Sachs) reflects this insight, and should keep motivated to continue developing the group, until it reaches a mature cruise-level.

We should also point out that integrating new brands will bring a lack of focus, and might stretch the attention of the two top managers, who might need to delegate a big part of their activities. Investment banks point that out that the group still lacks management capacity, although a vast program was undertaken recently to hire luxury goods professionals. Indeed the exponential growth in headcount from a few hundred people to several thousand supports the claim to built more middle management.

An additional challenge will rise in 2004, when PPR (which today owns a little over 50% of the Group) has the option to bid for the rest of the firm. We see little synergy today between PPR's operational assets (customer base, selective retailing network, international presence) and Gucci's vision: we believe there is a danger to try to integrate both companies above anything than back-office (for instance a PPR-level currency exchange hedging service), and modify management incentives. PPR's takeover should be smooth and leave the duo in command.

The following sales figure, in particular CAGR for product segments should support their claim to independence.

Fig 1 Breakdown of Gucci division's sales by product category

($m)	1996	1997	1998	1999	2000	CAGR 96/00	% change 2000/01
Leather goods	521.2	551.6	457.8	400.3	683.7	7.0	39.5
Shoes	155.0	165.6	148.7	164.8	178.2	3.5	8.1
Ready-to-wear	75.9	94.9	128.0	173.7	222.8	30.9	28.3
Watches	22.8	60.1	221.7	234.8	238.0	79.7	1.7
Jewellery		5.9	13.9	39.1	57.1	111.5	46.1
Ties/Scarves	40.5	29.6	25.3	23.0	28.5	-8.4	23.9
Other	26.5	20.5	23.1	32.0	42.3	12.4	32.2
Royalties	38.5	47.3	28.0	29.2	40.2	1.1	37.6
Intra-group					2.7		
Total	880.7	975.4	1,042.5	1,187.0	1,494.5	14.1	25.9

Source: Gucci, ING Barings estimates

Source: ING Barings [16]

4.2 Image generation

The top 2 lines YSL and Gucci are designed by Tom Ford. As mentioned earlier, there was a risk of finding the same concepts on both collections, as reported by the specialized press. We recommend that Gucci Group hires another designer to grow the brands separately, probably for YSL with its more classic and less fashion conscious focus, once Ford develops its distinctive identity. We also recognize that the group is also trying to build a pipeline of young designers brands to grow the brand portfolios (Alexandre McQueen, and Stella McCartney). Also we understand that although the main designs come from Ford, 20 other designers at Gucci and 10 more at YSL expand the concepts developed into accessories.

Although there are little synergies in terms of economies of scale to be found in design, there are a lot of economies of scope to be developed both in terms of learning curve (how to develop a new product using Tom Ford's approach with computers, how to test commercial impact of an artist's work), and in terms of product range where a brand can be expanded into higher-margin accessories.

Fig 4 Comparison of advertising and PR expenditure

	Spending	% of turnover
Bulgari (€m)	82.3	12.2
Gucci Division ($m)	93.8	6.3
Gucci Group ($m)	242.2	10.7
Hermes (€m)	72.3	6.2
LVMH (€m)	1,400.0	12.0

Source: Gucci, ING Barings

Source: ING Barings [16]

Additionally, there are some economies of scale to be developed with media buying as Gucci grows its turnover, although it will not match for some time the potential market power that LVMH has achieved in this market. Overall, although its brands are distinctive on the market, they do not command market power, and are not sustainable in the long run as they can easily come under attack from competitors targeting the same clientele with other concepts.

4.3 Manufacturing

Gucci Group has built a very solid base over the years to tighten its relationship with its suppliers, particularly in the fashion and leather goods segments. They have incentivized them both with capital and production tools. This creates much higher barriers to entry for a competitor wishing to subcontract to them than the current exclusivity agreements. Although the Italian model is to outsource this activity, we feel it is very close to a virtual vertical integration backwards, while providing flexibility to Gucci (very low barriers to exit, as investment can be considered as sunk costs).

Gucci Group is also developing economies of scale buy using the same suppliers to develop different lines of products for different brands.

Gucci is also building manufacturing capability in-house for crafts it did not master (fragrances and watches). Its current agreement with Wella on Fragrances is an issue, as it does not provide the right flexibility and economies of scale opportunities. However by building the capability in house it is probably developing both a bargaining power, and a second sourcing capacity for its other brands.

4.4 Distribution

Domenico de Sole's strong focus on controlling the distribution channel was instrumental in controlling the brand's image, and delivering consistent value to its clientele throughout the world. One might then consider that it is then developing some Ricardian rents by securing exclusive locations on the best locations around the world. Although the argument has some truth to it, it can be challenged.

Firstly, with the explosion of Directly Owned Stores (DOS), GucciGroup is now developing a real estate business, which is very capital intensive and not its core business. It is investing massive amounts in securing locations that cannot be leveraged with other brands since all DOS have to maintain an exclusive image. It can be argued however that a store offers economies of scopes by presenting different product segments (fashion, leather goods, perfumes, watches, etc.) under the same brand umbrella. Additionally Gucci might develop a bargaining power (and hence economies of scale) to negotiate more and more real estate locations.
However we recommend that Gucci Group develops a strategy to cover the best locations with a subset of their brand portfolio if they do not want to have all their brands compete for a slot of the same street.

Fig 2 Comparison of sales channels at end-2000

	Vuitton	Cartier	Hermès	Gucci	Bulgari
Directly-managed stores	284	155	98	143	72
Franchised stores	10 corners	50	99	43	27
Total	294	205	197	186	99

Source: Gucci, ING Barings
Source: ING Barings [16]

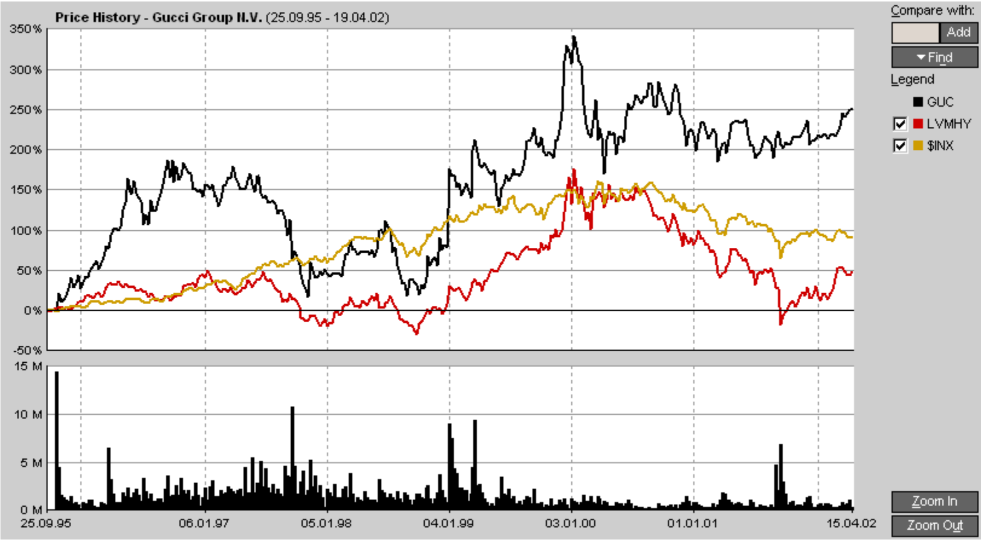
Secondly, the above chart shows that close competitors have developed the same strategy of DOS predominance and presence number, and that this not create a unique advantage on the market place. Collectively, Luxury Good houses create more barriers to entry to a new player wishing to enter the playfield, but do not really raise barriers to entry for existing players. Barriers to exit are low since most other players would be eager to grab the location opportunity.

<u>5. Conclusion</u>

"In difficult times, you get interesting break"', said de Sole in Business Week, who points out that while some of his heavily indebted competitors are suffering, Gucci is sitting on a $1.5 billion war chest." [12]

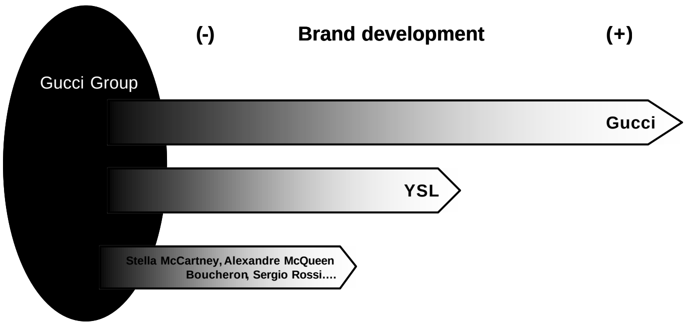
We argue that Gucci Group created unique resources by turning around very successfully Gucci and is trying to do so now with YSL. It developed a specific approach to management, manufacturing and supplier integration, brand management and distribution.
However our analysis shows that none of it is sustainable in the long run and that a challenger could easily capture the same customer value with a competing product, however good the execution might have been.

Indeed, analysts have mentioned that Gucci Group is now ready to compete with LVMH, and that that is reflected in Gucci's better stock performance. However, financial benchmarks show that smaller focused houses such as Hermès and Bulgari produce better ROCE and operating margins, but as they grow extensively, they tend to destroy value (according to Goldman Sach's analysis, Gucci's excessive cash flow actually destroys value by maintaining a ROCE below WACC) or to under-perform more pure-players in financial ratios.



Source: MSN Money – Comparison between Gucci and LVMH since Gucci's IPO (and with SP500 index)

We believe however that while LVMH is struggling to develop intra-group synergies after a bulimic M&A period, Gucci is developing the right approach to turnaround or develop each brand it acquires, i.e. sequentially, instead of trying to grow to quickly.



Source: Authors

We would argue that Gucci Group has a unique opportunity to strengthen its position until early 2004 before PPR has the option to acquire it completely. That option is still unclear, and it might actually be beneficial for PPR to sell its stake in the company by then to new shareholders. Floating it completely again would be a mistake, as it will make the Group prone to another hostile takeover.

De Sole is right: "you have to act quickly", and move ahead of competition. This is a game of timing before competition reacts (securing the best locations, developing the right supplier base, buying the best brands, hiring the competent professionals in the business) and of size (developing back office economies of scale and front-office economies of scope). However we sustain the main competitive advantage to date has been execution, but that process is not sustainable in the long run.

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We would like to warmly thank Jacques-Franck Dossin and Aaron Fischer from Goldman Sachs; Antoine Colonna, Global coordinator for the Luxury Goods sector at Merrill Lynch; and Jos Voss from Rabo Securities for their help in preparing this paper, particularly for sending to us their latest and most relevant material available on the sector.

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