Also in this section

For daily coverage of business, visit
Economist.com/business-finance

High-end retailing

Lux in flux

MILAN

Luxury-goods firms can no longer rely on China to propel growth

IT TAKES at least a month to wash, comb, spin and otherwise prepare fine mohair to become cloth that is stitched into suits by Ermenegildo Zegna, a 107-year-old Italian brand. In Trivero, an Alpine village west of Milan, 150 artisans in an elegant factory work at carding, dying, weaving and warping. As looms rattle, bespectacled women stretch cloth over illuminated screens and check for imperfections. Others use a rack crammed with dried Spanish thistles to remove excess hair from fabric.

Zegna, run by its fourth generation of family owners, is distinctive in many ways. Big corporate successes are rare in Italy, which tends to nurture smaller firms. Sales from Zegna's 500-odd shops worldwide, plus earnings from selling to other producers, amount to an annual €1.2bn ($1.3bn) or so. It controls its entire supply chain, which is unusual even in an industry that cherishes raw materials. Three years ago it bought a 6,300-acre farm with 10,000 sheep in Australia. A spokeswoman brags that vertical integration at Zegna runs "from sheep to shop".

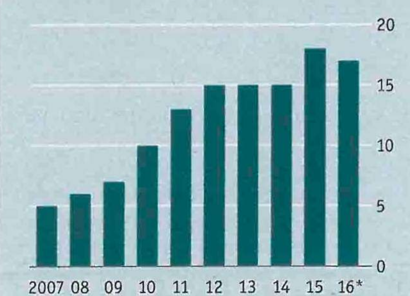
The company is also unusual because it has stayed independent of the few swaggering giants that bestride the luxury-goods world, of which the biggest is LVMH, Bernard Arnault's 30-year-old conglomerate; it incorporates Louis Vuitton, Dior and many other brands. Other groups include Kering, also based in Paris and the owner of Gucci, and Richemont, a Swiss specialist in watches and jewellery. (The luxury sector is also replete with minnows, of course—single brands with revenues of just a few hundred million euros, such as Versace and Missoni.)

But in other ways, Zegna is typical of the luxury business. European manufacturers dominate this €250bn industry, accounting for around 70% of production. And Zegna's past growth and present challenges are shared by firms of all sizes.

Luxury firms have prospered in the past by forging into new markets: first Japan, then America, then China, notes Armando Branchini of the European luxury-brands association in Milan. Jean-Christophe Babin, the boss of Bulgari, an Italian jeweller, says it was the spread of high-end, beautiful malls in Asia that did most for growth. In particular, status-hungry Chinese consumers propelled luxury's recent long expansion. Olivier Abtan of the Boston Consulting Group in Paris describes ever-richer Chinese consumers, with an utter "lack of inhibition" in displaying their wealth, as the best possible boost that the luxury industry could imagine.

Bling v Xi Jinping

China, personal luxury goods market, €bn



Source: Bain & Company *Estimate

The boss of one of the conglomerates recalls how difficult it was to balance rapid expansion of his brands against losing a perception of exclusivity. He resolved the dilemma by taking the theory of the "Veblen good"—one for which demand soars as it becomes more expensive—to an extreme, slapping ever-larger price tags on the firm's posh handbags and other items.

This Chinese boom is over. In the past four years Xi Jinping, China's authoritarian leader, has cracked down on political rivals suspected of corruption, discouraged ostentatious displays of wealth and turned Chinese tourists off shopping abroad by levying heavier duties on those who return with armfuls of Hermès bags.

Worse, because it could be a permanent shift, firms report changing tastes among Chinese consumers. They have been shunning big, shiny logos and—like Western shoppers—are now mixing cheap fast-fashion items with fewer luxury pieces. Last year, estimates suggest, China's huge luxury market shrank (see chart).

Solid economic growth in America in the past few years has helped sustain sales: stockmarkets and appetite for luxury goods reliably rise in step. Some retailers do report a recent uptick in Chinese demand over the past six months. Yet no one expects a return to the glory days. Terrorist attacks in Europe, slower growth in air traffic and lower spending in the region's airports are also hurting luxury sales. The watch business has been particularly hard ▸▸

hit (see next story). In Milan the chairman of a famous Italian fashion brand warns of saturated markets. Adding new shops in China is not viable, he says, when "you already have 200 retailers selling every sort of luxury item". He expects this year to be much like 2016—flat.

Mr Abtan foresees years of modest global growth, perhaps of around 3%. A spokesman at Gucci says that the overall market is growing at "perhaps 1-2%, so the pie is not getting bigger". The challenge at Gucci, he adds, is to achieve more "sales density" from existing shops.

Which kind of firm is best placed to deal with slower growth: giants, minnows or medium-sized firms like Zegna? The advantages of being a conglomerate in luxury include having more muscle to secure brands favoured spots and lower rents inside shopping malls. Luxury groups can also multiply the effect of their marketing and share back-office services.

A new argument for independent firms such as Hermès or Prada to join the big groups is the imperative to go digital. Luxury firms were slow to adopt sophisticated digital strategies so long as the going was easy. Only 8% of total personal luxury-goods sales take place online, compared with 16% for the rest of retail (excluding items such as petrol and groceries). But now the industry wants that to change.

Michele Norsa, a former boss of Salvatore Ferragamo, an Italian maker of shoes, notes that new online habits are being led by young consumers who account for a growing share of luxury spending. Online markets have appeared for second-hand sales; fancy frocks can be hired for a few nights from websites such as Rent the Runway. The big firms are thinking of how to profit from such new markets—something that small firms might struggle to do.

An Italian lawyer who has been involved in several big deals in the luxury sector expects more consolidation, and not only because the industry is slowing. In the online world, firms especially crave fine-grained data about the most attractive customers—for example, on the "super spenders", the minority of the ultra-wealthy who account for an outsized share of total spending.

Until now, brands within groups have jealously guarded customer information from each other. But conglomerates may start sharing. Next month LVMH will launch a common digital platform for its brands that will yield new sorts of data. It will compete with rival luxury sites such as Net-a-Porter, and promote the idea of "omnichannel" shopping (combining online and in-store purchases). A decade ago established brands "didn't see online platforms as even compatible with luxury products," says José Neves, the founder of Farfetch, an online seller of luxury goods. Now they see that having their own online presence is essential, he says.

Mr Abtan of BCG says the big groups are probably best placed to go down such digital avenues. They can invest and buy expertise to push traffic from websites to shops. Firms of Zegna's size also need to bring in skills and should be able to afford it. But the minnows may struggle. The next challenge for luxury-goods firms will be about more than controlling supply chains and colonising posh malls. They will have to understand as much as they can about consumers and their digital habits. From "sheep to screen" will soon matter at least as much as "sheep to shop". ■