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Luxury growth torch to pass from US to China in 2023

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Luxury's growth in Europe and the US slowed down over 2022, meaning more pressure is on China to rebound. Following a rough patch in the fourth quarter for most leading brands, with the exception of Hermès, luxury sales finally began to pick up in China after Covid-related restrictions were lifted on 8 January. But brands aren't out of the woods yet.

Kering CEO and chairman François-Henri Pinault visited mainland China at the start of the year and came back brimming with optimism. "Malls are full; streets are full. People have no fear of going out or that the policy could be reversed whatsoever. They are completely back to a normal life. I thought it would have been more gradual, but from what I saw, it's very, very encouraging," he told analysts during the Kering annual earnings on 15 February. During his visit, the executive met some government officials, including the secretary of the communist party for Shanghai. "I was very surprised by the level of support to quality domestic consumption, to the private sectors, to international companies… It looks like they are really committed to bringing back China to a level of growth that is much higher than what it was last year."

Sales to Chinese consumers globally are expected to grow by between 25 and 35 per cent in 2023, according to Bernstein estimates. "If the Chinese embrace the same 'Yolo' (you only live once) attitude the European and the American consumers have done before them, growth of Chinese spending could be in the high double digits," says Luca Solca, senior analyst at consultancy Bernstein. This is a sharp contrast with European and American spending growth, which is expected to slow down from high teens in 2022 to mid-single digits in the 2023 financial year, per Bernstein.

So, where does this leave the industry? In 2022, luxury again proved its resilience, logging 20 per cent growth, according to Bernstein estimates, and with blue chip brands at the top of the luxury pyramid performing better than others (Hermès, Dior and Saint Laurent shone; Gucci lagged behind). For top brands, record margins seen in 2021 have become the new normal, more or less maintaining their levels in 2022. (Hermès posted a record high operating margin of 40.5 per cent in 2022. "We see no reason Hermès couldn't post another record margin in 2023," wrote Morgan Stanley equity analyst Edouard Aubin.)

Hermès outperforms competitors in Q4 and full-year 2022

DATA SOURCE: COMPANY REPORTS

Simultaneously, the cost to compete has increased, with Dior and Louis Vuitton raising the bar in terms of investments: think the Dior show in front of the Egyptian pyramids or the Louis Vuitton x Yayoi Kusama blockbuster collection. Luxury stocks have responded well overall as the slowdown in the US and Europe has been softer than anticipated. "There's no strong recession in Europe and the US in the end, rather volatility and contraction," says Mario Ortelli, managing director of luxury advisory firm Ortelli & Co. However, aspirational customers are still affected by high inflation and the cost of living crisis.

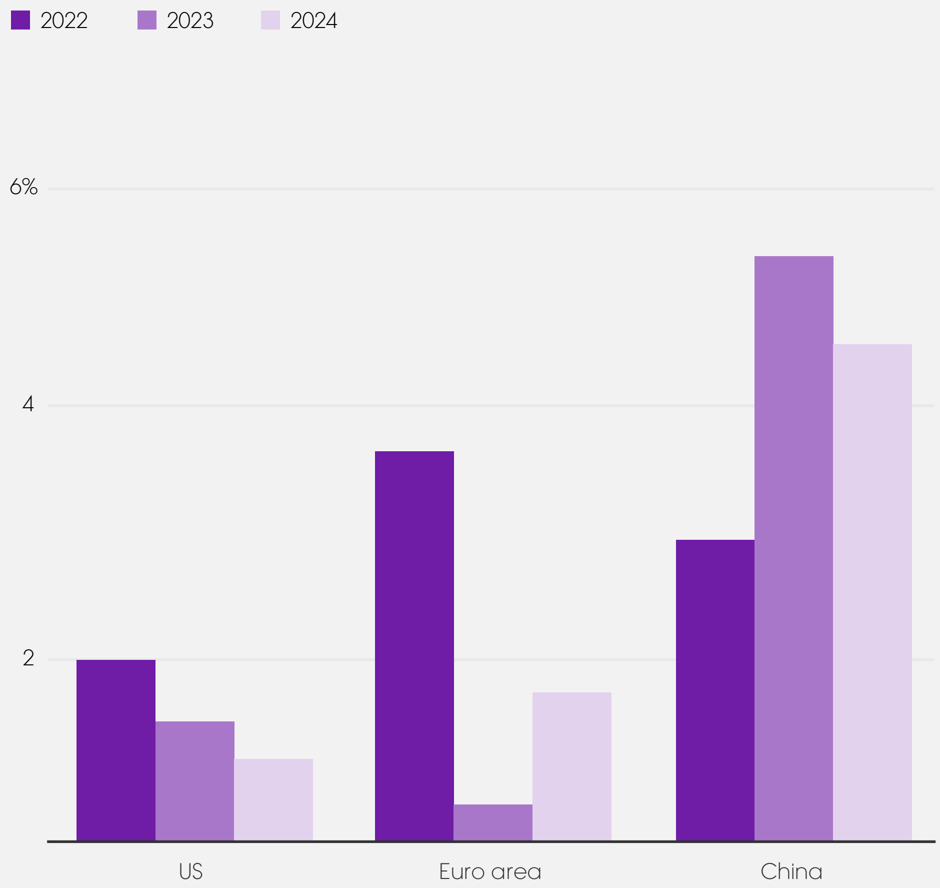
For now, all eyes are still on China. "China needs economic growth. It's no secret... I am quite confident that the Chinese leaders will use this period to revitalise Chinese growth. If this is the case, we have every reason to be confident and optimistic about the Chinese market. In Macau, where the Chinese can travel, the stores are full," LVMH CEO and chairman Bernard Arnault said during the conglomerate's earnings call in late January. However, LVMH CFO Jean-Jacques Guiony noted that it's difficult to identify an underlying trend during Chinese New Year, which boosted sales in late January.

The return to travel

China's real GDP is expected to grow 5.2 per cent this year, according to an IMF forecast, versus 3 per cent last year. However, growth is expected to slow after the reopening uplift. "Without reforms, we currently estimate growth to fall below 4 per cent over the next five years," wrote IMF economists Diego A Cerdeiro and Sonali Jain-Chandra. China said it would gradually resume issuing passports for Chinese mainland residents to travel overseas. But, with passport renewal delays, a limited number of flights and new habits to shop at home, it remains to be seen when the Chinese will travel abroad again in meaningful numbers.

Soft landing for the US and European economies in 2023

GDP real growth percentage change



DATA SOURCE: IMF

More than 80 per cent of Chinese spend will remain local in the long term, according to Flavio Cereda, equity analyst at financial services firm Jefferies. This translates into new luxury store openings in China. "While Shanghai and Beijing account for 28 per cent of luxury stores in China, the next most important city for luxury is Chengdu," the analyst noted. "Chengdu, Shanghai and Shenzhen are the fastest-growing cities in terms of absolute store openings, and next fastest are Dalian, Chongqing, Beijing and Shenyang," he wrote.

"Where are we seeing rebounds linked to mainland Chinese shoppers? Well, quite bluntly, a lot in mainland China itself since last month as well as in Macau where traffic has rebounded swiftly, and hotel occupancy is high," HSBC global head of consumer and retail Erwan Rambourg wrote in a note. "Hong Kong is lagging for now, but we see hopes for a rebound here as well."

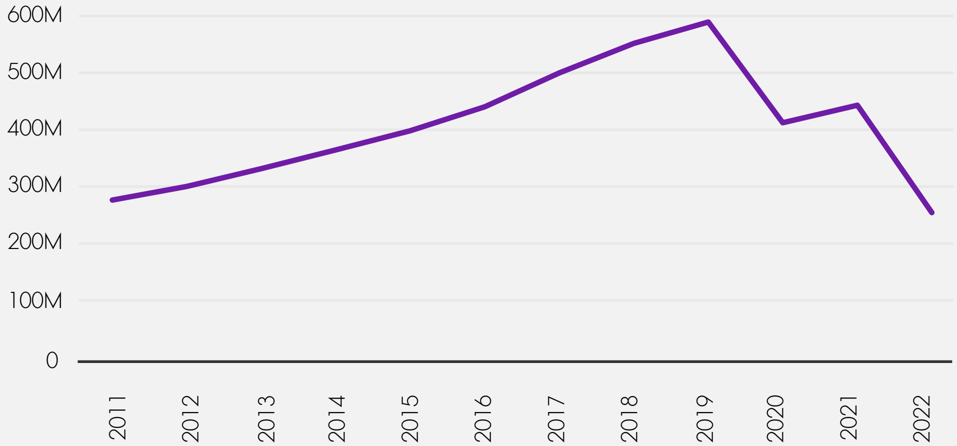
Rambourg describes the South Korean market as a "weak spot" despite some luxury brands investing in hosting shows (Gucci is to host its cruise 2024 show in May in Seoul). "Locals seem to finally be in a landing phase, which reminds us of what we are seeing in the US, i.e. headwinds affecting aspirational consumers, notably real estate, and the market is also not the easiest one to travel to just yet for mainland Chinese."

Yet, Chinese tourists are already back in Thailand. "Thailand is growing swiftly with both locals and mainland Chinese, which is prompting many brand managers to think that the luxury retail footprint will be insufficient to sustain demand," wrote Rambourg.

Japan saw solid growth in 2022, led by local clients and the return of tourists (notably from Hong Kong) who made the most of lower prices due to the weak Yen. In Q4, Kering sales in Japan were up 14 per cent, LVMH up 29 per cent and Hermès up 15.7 per cent.

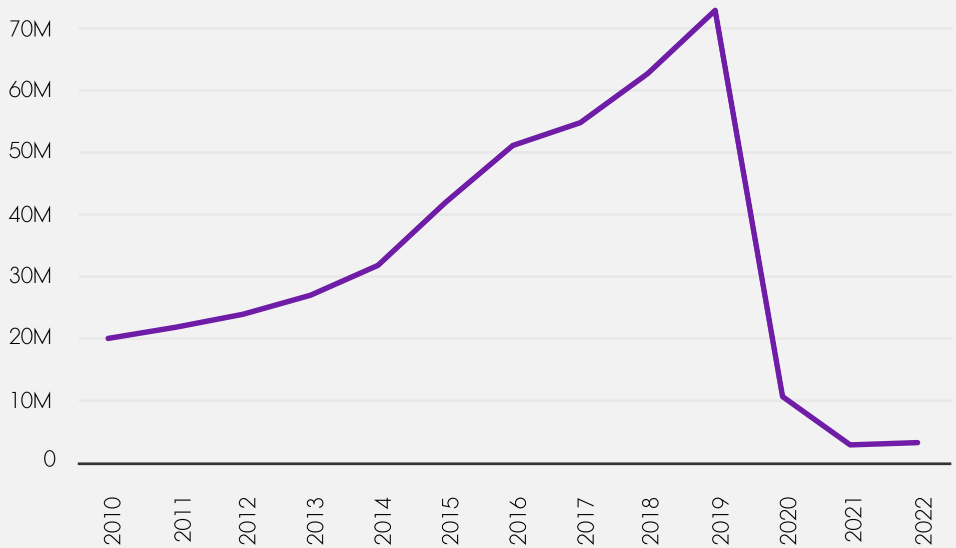
Tourism flows from China to Europe are not expected before the summer, Arnault said. However, once they return in large numbers, will luxury stores in Europe adapt their capacity and maintain the level of quality experience? Arnault dismissed concerns of packed stores: "The line outside the stores will probably lengthen, but inside there will be the same number of people who will get the same level of service," he said.

Domestic travel in mainland China is recovering slowly but outlook is positive
Domestic Chinese passenger air traffic in millions



DATA SOURCE: CEIC, HSBC

International mainland Chinese travel still well below pre-pandemic levels
Internationl Chinese passenger air traffic by millions



DATA SOURCE: CEIC, HSBC

Slowdown in the US

After continuing strength in Europe and the US in Q4 2022, Bernstein's Solca forecasts normalisation of growth in both markets. According to IMF projections, Europe and the US's economies are expected to slow to 0.7 and 1.4 per cent, respectively, in 2023. "The strength of the European market will depend on the tourist flows from the US and from Asia, while the US market will depend on consumer sentiment and whether Americans shop at home or in Europe," says Ortelli.

"What I think is emerging in the US is a clear sense that lower-middle-class consumers are under pressure while high-end consumers are doing very well," says Solca.

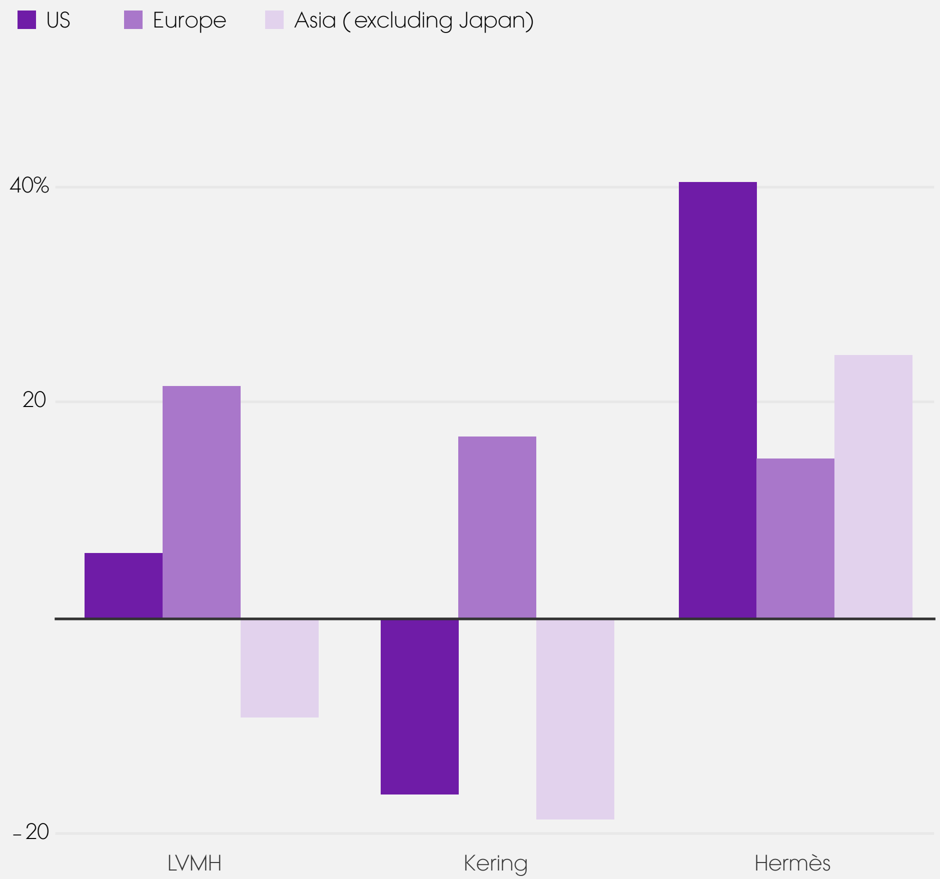
Mytheresa echoed the sentiment. "We see robustness in the high-end customer base. If aspirational customers come back, that would be fantastic. But, in the meantime, the luxury wardrobe builders are very solid," Mytheresa CEO Michael Kliger said. Farfetch also experienced a slowdown as consumers rein in spending: fourth-quarter revenue fell 5 per cent in 2022.

On the other hand, Hermès posted stellar growth in Q4 in the Americas (up 40.8 per cent). Hermès executive chairman Axel Dumas noted sales dynamics in California and Florida thanks to an influx of people, while on the East Coast, the situation is more complicated, but the opening of the store on New York's Madison Avenue has boosted sales. The house sees "no break in trend" at the beginning of 2023, Dumas said. Buyers of luxury watches are clearly doing well. The Swiss watch exports data for January 2023 show that the US market remains solid (up 26.4 per cent year-on-year in January), as Morgan Stanley's Aubin points out. Meanwhile, Kering revenue dropped 15 per cent in North America in Q4, with the group citing high inflation denting aspirational customers who bought Gucci in the past three years.
With that in mind, Gucci is to open "Gucci Salons" for its VIP customers with products ranging from €40,000 to €3 million, within flagship stores or in standalone locations. The first one is set to open in Melrose in April. Burberry, under CEO Jonathan Akeroyd, is also pursuing its journey towards elevation and reported strong performance in Europe and an improvement in the US.

Bernstein forecasts a growth of 13 per cent for the overall luxury market in 2023. "Chinese consumers take the torch from American and European consumers leading growth," Solca says.

Continuing strength in EU and US luxury demand in Q4

Q4 growth by region



DATA SOURCE: COMPANY REPORTS