# Better business post-covid: lessons from luxury

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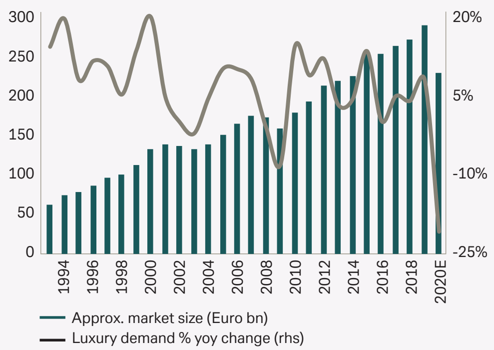
It is a shocking thought – along with many other things this year – that never before has the gap between the best and worst performing luxury companies been as wide as it has been in 2020. But just as companies are looking to rebuild, they have been charged with doing so in a different way. That is because ESG principles have escalated dramatically in the minds of customers and investors this year. Firms will have to produce less, avoid waste, and build products that last forever. This shift has forced some introspection over an existential question: Is the definition of luxury in tune with today's consumers?

This urgent need for self-reflection is not confined to luxury firms. Indeed, companies across many other industries face a similar challenge. From our vantage point as specialists in the luxury sector, we can identify several steps that luxury firms should take as they shift to a different business model – one that enables them to recover from the current crisis while addressing rising ESG concerns. Companies in other sectors should take note.

## No place for complacency

Covid hit the luxury goods industry at a moment of very healthy expansion. However the market, worth €1.3tn of which €280bn is personal luxury goods, has seen uneven growth over the last five years.

### Covid: an unprecedented blip in personal luxury goods demand growth




Source: Bain & Co., Deutsche Bank estimates

During this time there has been significant demand polarisation towards a few relevant brands able to drive consumer appetite through newness, recognisability, captivating marketing strategies, and direct client engagement. Ongoing changes are further testing companies' ability to stay on top and drive the changes. These include (i) the emergence of a new younger and more volatile consumer, (ii) the role of the Chinese nationality as a key driver of demand and of Mainland China as an increasingly strategic domestic market, (iii) a new set of values and priorities which are raising ESG awareness, (iv) the digital acceleration and its implications for distribution and communication.

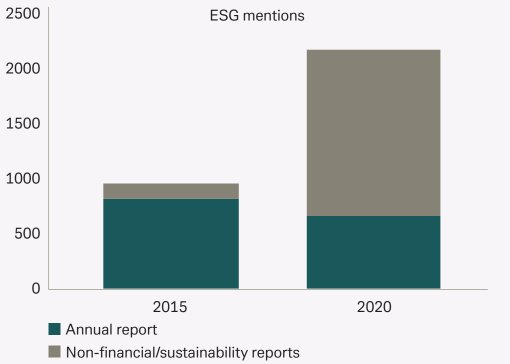
Many companies have witnessed a significant margin compression as store productivity is suffering from sub-optimal top line performance, and as escalating costs became necessary to sustain brands and implement successful strategies. The profitability divide between the best and worst performers has never been larger, and many companies have embarked in extensive turnaround or brand relaunch strategies in the last few years.

## ESG matters: need to walk the talk

The sustainable revolution has begun and covid has accelerated the awakening: the environment is the defining issue of our time, and younger consumers are seriously concerned about it. A new generation of consumers increasingly back their beliefs with their shopping habits, favouring brands that are aligned with their values and avoiding those that don't.

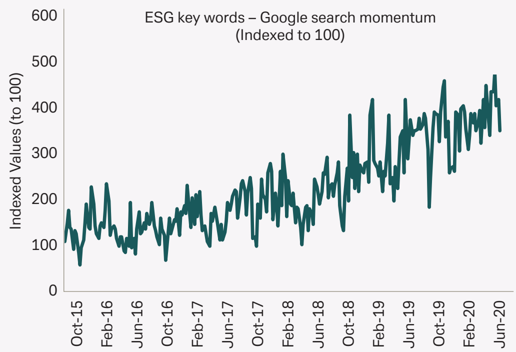
Luxury goods companies are rushing to shine in ESG terms by ticking all the possible boxes from a reporting standards and an objective setting viewpoint, but this is still in more PR territory than reality. We believe ESG is here to stay, and the ability to blend newness, quality and CSR themes will shape the winners of the future.

### Companies are ticking the formal boxes…




Source: Deutsche Bank on Alphasense. Search terms: Environment, Responsibility, Inequality, Sustainability, Climate change, Biodiversity, Clean water, Poverty, Education, Responsible production, Upcycling, Recycling, Emissions. Based on a representative sample of listed luxury companies

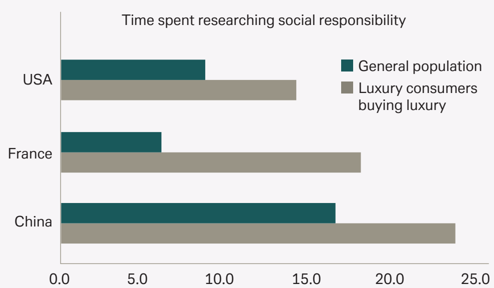
### Covid has accelerated consumers and public opinion attention towards ESG and sustainability...




Source: Deutsche Bank, Google trends search

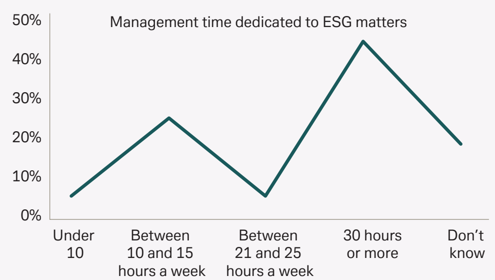
All the buzz is forcing all brands to accelerate on ESG. However, there is a disconnect: consumers are not yet walking the talk, despite being more sensitive to ESG issues.

### … however consumers do not walk the talk




Source: dbDIG, Consumers Survey, October 2020, Deutsche Bank research

### … while for companies ESG is a focus



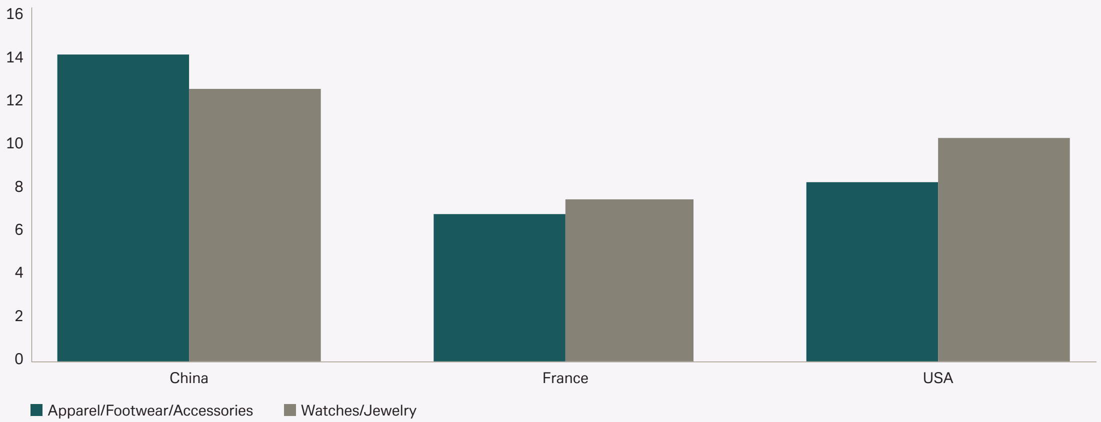

Source: dbDIG, Corporate Survey, October 2020, Deutsche Bank research

Yet, the pandemic has brought the moment closer when consumers will adopt more sustainable shopping behaviour. Successful companies will be ready for when they do and, thus, they must embark on the following changes.

1. *Formal change.* For now, companies are focusing on formal requirements: ticking all the boxes to achieve sustainability scores, which translates into positive publicity. This is a relatively fast change which will be perfected once universal reporting standards will be adopted, making targets and progress measurable and comparable.

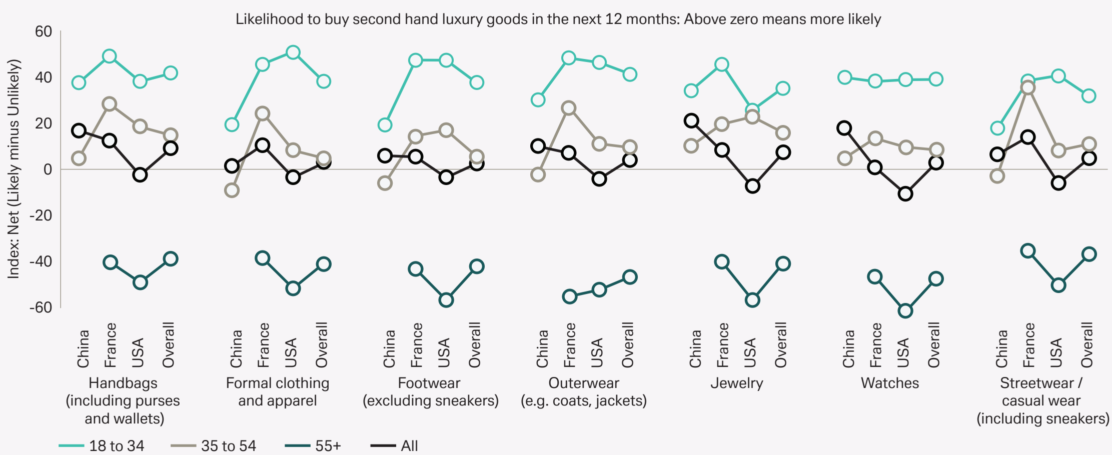
2. The next phase is *substantial change*, adapting to World 2.0. This means implementing radical changes to products, durability, production processes, distribution and ultimately the business model. Companies will have to think differently: they will have to produce less, avoid waste, and make products that last forever. Companies will have to conceive products ecologically. This includes sourcing, localised manufacturing, upcycling, and recycling in production processes. Other considerations include building circularity in the business model and whether to have a direct involvement in new models like resale or rental. This will take time and effort.

## Consumers are willing to spend only a touch more for ESG-friendly products (per cent of those willing to pay more)



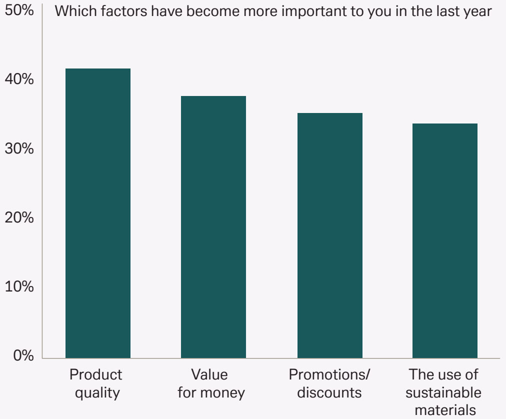

Source: dbDIG, Consumers Survey, October 2020, Deutsche Bank research

## The younger generation is driving interest in regenerative business models



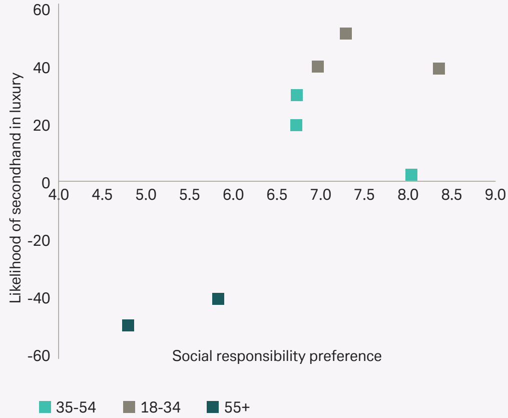

Source: dbDIG, Corporate Survey, October 2020, Deutsche Bank research

## Sustainability is not the key decision criteria




Source: dbDIG, Consumers Survey, October 2020, Deutsche Bank research

## Younger consumers prefer second-hand, sustainable products




Source: dbDIG, Corporate Survey, October 2020, Deutsche Bank research

### Don't waste a good crisis

Covid has opened the door to World 2.0. Irrespective of the negative impact on global economies from the virus, the next decade will be disruptive for the luxury sector. A strong response requires, first of all, leadership and a mentality which is fit to the task.

The adoption of new, versatile business models is needed and this increases risks for luxury players, as it requires higher fixed costs, investments, and a potential reset in operating leverage. Larger players and conglomerates therefore have an advantage, and we believe this will drive more consolidation in the sector.

### So what should companies do?

1. *Set the new trend:* A wave of younger consumers is hitting the sector: it is expected that the 45-and-younger demographic will represent about 50% of demand in 2025. They are voicing new values for their shopping, they are more thoughtful, they want to buy less and buy better. Buying luxury is conventionally buying a product (or experience) to blend in, to be accepted, or to stand out, while choosing an aesthetic or a set of values. Yet luxury is moving from being the mere hedonistic satisfaction of one's impulses to a higher level purpose. Ethics will be as important as aesthetics and customers will favour brands with a purpose. Sustainability will be an integral part of consumers' perception of quality. Firms must position themselves to stimulate conversations on values and debates for the environment and society.

2. *Produce less, shop less, shop better:* This should be a given in luxury. But it is not, perhaps sometimes because of the quality or durability of the products, or that fashion styles change so drastically so frequently. Either way, many luxury products have seen their life cycle shorten. The answer is a greater product quality through use of best materials and a stricter production process. The aim is to extend the life of products and reduce waste. In addition, this will provide brand and product appeal with scarcity value and extend the desirability of a product while helping extend the cycle through a resale channel, thus generating a circular economy. Exclusivity, quality, transparency and traceability will shape demand trends. We cannot but quote the key advertisement of a famous outdoor brand, "Don't buy this jacket", as the perfect example of a more sustainable approach to consuming, and selling. The theme is: reduce, repair, reuse, recycle, reimagine.

3. *Rethinking the supply chain:* A new definition of luxury should encourage companies to rethink the end-to-end product lifecycle, the supply chain, and the management of unsold stock. What is the impact on people and society? This year's supply chain disruptions have highlighted the need for a manufacturing processes that are closer to home and directly controllable. Essentially, this will shorten the supply chain and reduce lead times, and can assist in a rethink of the whole value chain from creativity to delivery to post sale services and CRM. It may require greater

internalisation of manufacturing, which is incidentally also a positive in terms of ESG control. Here are the key points in the process:

- Start from the full price sell though to eliminate excess production. Plan production in line with real underlying demand. Flex the manufacturing process so that small batches, just in time production or in season replenishments become the norm. This helps pricing and brand equity over time. Over time, produce less to sell the same value.
- Products should be forever. Quality, durability, scarcity, and the ability to blend with changing tastes should be favoured as they will underpin the strength of brands and aid sustainability.
- Categories mix: Should all brands produce everything? Why not stick to core competences? This reduces complexities and could strengthen a brand. Of course, sales potential will fall and distribution may have to be resized, but if managed well, profitability will benefit in the long run.
- Walk away from the nonsense product calendar and roll out of the recent past. This means readjusting the product flow and the fashion shows to the actual seasons. This involves shortening the time to market to enable better control of the product journey to the end consumer
- "Think global, buy local" may require supply chains to shift closer to the end consumers
- Upstream integration could become necessary in order to ensure the quality of a product. It will also ensure the legitimacy and quality of the production process enabling the firm to meet ESG criteria (internally and externally)
- Sourcing: Adopt new technologies (like blockchains for traceability) and materials (eco-friendly materials, renewable materials, recycled material etc).
- Inventories management – Better planning and discipline on volumes should minimise unsold stock. Excess inventory can no longer be destroyed but channelled through legitimate off-price channels including the resale channels

4. *Spoil your local customers:* If there is something this pandemic has highlighted, it is the importance of local consumers. It is true that business models focused on serving the globetrotter consumer has led to many improvements in client engagement and global CRM platforms. However, sometimes these efforts have been directed more towards tourists rather than local buyers. Even when travel eventually recovers, strengthening local client engagement will diversify the risks.

5. *Resetting the distribution footprint:* The digital revolution, from social media to online shopping, has been accelerated by covid. The shift to online shopping has jumped forward several years and online sales have doubled or even trebled as a percentage of sales for many companies. It could soon become the most important sales channel, exceeding 30% of the contribution to sales in 2025 (from 12% in 2019), according to several industry sources, as brands leverage on the steepened learning curve to expand online assortment, further improve user experience and digital marketing. This completes the transformation into omnichannel integrating the digital and the physical space but questions the role of stores and wholesalers, especially physical ones. Yet, the ritual of buying luxury in a store is part of the industry's proposition, and stores are the perfect window onto a brand and its philosophy. Hence companies must adapt their stores into being a privileged space for customers to benefit from a unique experience. Stores will also be increasingly used as a stock or collection point for online purchases. Stores must change, though. Fewer will probably be needed, especially in a more sustainable world, and those that remain might be smaller. Network downsizing and store relocations/refurbishment will require broad shoulders.

6. *Make a decision:* Build scale or be small. Companies have several options to adapt their business models to World 2.0 but they all involve costs and change. Large firms can use some advantages from their existing scale. They can use data more effectively than small companies. They can also experiment with new trends and businesses in ways smaller firms cannot. They can also afford diversification. Furthermore, scale may drive a return to strategic consolidations and 'rescue' mergers and acquisitions along the value chain.

   Large companies will need to do this to compete with new independent brands or new business models that include digitally native brands, ESG native brands, or circular economy models like resale and rental. Niche brands offering unique products or perspectives will be the ones able to navigate the challenges of a polarised industry.

7. *Deal with second hand and rental models.* Brands need to tackle the rent and second hand models head on. In the interest of brand equity, they may want to step in and control the distribution, or partner with key players, or even consider proprietary second hand platforms. This will be an interesting space to monitor as the push to ESG and regenerative economies might create unavoidable diversification. Indeed, key pillars of the circular economy for fashion and luxury will include second hand and rental models. These will become more and more important as sustainability becomes a more pressing matter.

It is encouraging that these steps are not just confined to the luxury industry. That is because it means that investors, customers, and society more broadly are approaching a more unified vision of what we want our post-covid companies to look like. But while that makes the future somewhat more visible, it still leaves companies with the significant challenge of needing to pour investment into new business models. This requires the fortitude of leadership and that is perhaps the key thing that will differentiate the post-covid winners from the rest of the pack.