BRYAN, GARNIER & CO

Luxury Goods

E-COMMERCE: BACK TO THE FUTURE?

CONSUMER, BRANDS & RETAIL WHITE PAPER JULY 2018

Contents

Beyond the slight slowdown expected in 2018, the luxury industry should remain dynamic, benefiting from the ramp-up in digitalization and e-commerce as a source of additional growth. At a time where no single model is really emerging, we bet on brands taking greater internal control of e-commerce over the medium term.

After a very good year for the sector in 2017, when our sample of luxury groups saw average sales growth of 8%, we are forecasting further positive growth in 2018 (+6% on average), which could nonetheless be reduced to just 1% by negative forex effects.

Combined with the rising importance of the millennial generation, one of the engines behind this positive sector momentum is the acceleration in e-commerce, which represented 9% of the market in 2017 but is set to account for 25% in 2025. Almost 40% of market growth in coming years could therefore stem from this channel.

At this stage, it is difficult to establish which luxury brands will be the most capable of benefiting from the trend, because in our view, luxury e-commerce is in its teething stages and no single business model is dominant. Overall, the more wholesale and affordable a luxury brand is, the more present it is in e-commerce. Each brand could be seen to have its own specific business model, whether via a partner, a multi-brand or an internal platform. Further out, we expect e-commerce to be brought in-house, as is already the case for the most emblematic brands.

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1. Executive summary

In a luxury market set to remain dynamic in 2018 (+8% organic growth on average for our sample of luxury groups) in line with 2017 performance, we have tried to analyze in more depth the potential and challenges that millennials and e-commerce present for luxury groups and brands.

Although millennials (the so-called 'generation Y' born between 1980 and 2000) already accounted for 30% of the luxury market in 2017 vs 27% in 2016, the figure is expected to reach 45% in 2025 according to Bain & Co estimates. For some brands, millennials represent an even higher share. At Gucci, for example, online sales accounted for 56% of 2017 sales. While millennials tend to shop more frequently than their elders, especially in China, where they make almost eight times more purchases a year, they often shop for cheaper and more entry-level products such as small leather goods, footwear and entry-level bags. In addition, millennial customers are far less loyal to brands and almost find the purchase experience more important than the brand itself. Luxury brands are aiming to make these more fickle customers loyal by using social media to increase retention rates and attract them into stores in a bid to boost sales per square meter. Millennials also influence older generations through social networks. However, given the volatile nature of millennials, it seems essential that brands do not focus their strategies on these customers alone, but instead present a balanced offer between the generations.

As a consequence of the growing presence of millennials, the amount of e-commerce in the luxury industry is also increasing constantly and this trend should continue in coming years. While e-commerce only accounted for 6% of the entire market in 2014, it represented 9% in 2017 on Bain & Co estimates and should even reach 25% in 2025. This implies a CAGR in sales of 20% in online commerce between now and then, compared with 3% for offline. E-commerce could therefore account for 43% of growth in the market out to 2025. This type of distribution is therefore strategic for luxury brands and groups.

Several business models coexist, with no one really standing out at this stage as the most relevant. Directly operated websites, third-party brand distributors (Yoox, Net-A-Porter, mytheresa) and marketplaces (Farfetch, Luxury Pavillon) are the most common models. Each brand has developed its own model, sometimes within the same group depending on its size, product offering and its exposure to retail or wholesale markets. The model developed can also differ from one country to the next.

However, ecommerce's 9% presence in the luxury market masks differences between groups: less than 3% of sales for hard luxury players such as Richemont and The Swatch Group (and even 0% for Chanel), 4% at Gucci and Louis Vuitton, probably 9% at Burberry but almost 20% for certain affordable luxury fashion brands such as Tory Burch.

Overall, online sales tend to be higher when a brand is more exposed to the wholesale market, present in the fashion segment and positioned in affordable luxury.

While it is difficult to say which group is better equipped to face the challenge and opportunity presented by e-commerce, we believe that major winners further out will be 1) groups with the highest financial means to finance the investments associated with the development of digital; and 2) brands that put in place digital strategies coherent with their physical distribution channels. Finally, over the next five to 10 years, we could see moves to control digital distribution better and bring it in-house, as happened 10-15 years ago with physical distribution of luxury brands.

2. Solid growth in the luxury market...

The luxury market restored some color in 2017 after a very difficult 2016, and the situation should remain favorable during 2018. The year was characterized by a rebound in China, a mixed situation from one brand to the next, a polarization of the market, younger customers and the faster ramp-up in e-commerce.

Renewed growth in the luxury market in 2017 (+6%)

GROWTH OF 6% IN 2017...

Bain & Co estimates the entire luxury market (including luxury yachts, private jets, luxury hotels, upscale wines and spirits and luxury cars) at almost EUR1,160bn, up 5% in 2017. The personal luxury goods market gained 6% on a constant currency basis in 2017 (Bain & Co and Altagamma estimates) to reach EUR262bn after virtually stable sales in 2016. The rebound that we expected as of November 2016 exceeded our hopes, which were initially based on growth of around 4%, and the uptick even gained momentum throughout the year. The positive trend was the highest since 2013 and was driven by recoveries in Greater China and in Europe.

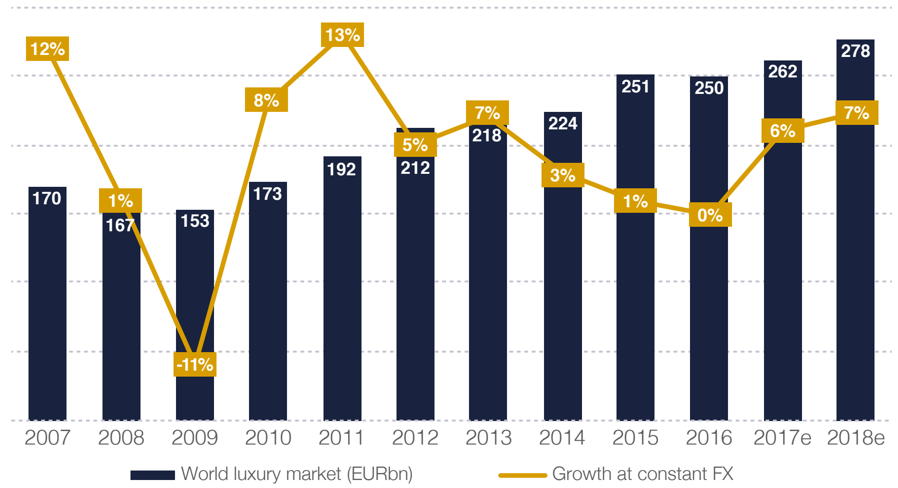
For 2018, in a first assumption, Bain & Co forecasts growth in the sector of between 6 and 7%, in line with 2017. We are therefore witnessing a normalization in the pace of growth.

In addition, Bain & Co is forecasting an average annual growth rate in the luxury market of 4-5% by 2025 to reach almost EUR350bn, driven, among other factors, by the middle and upper middle classes in China, the new generations (Y and Z) and the boom in e-commerce.

...THANKS TO CHINA!

Beyond Mainland China, where market growth reached almost 20% last year to EUR20bn (Bain & Co estimates) driven partly by the acceleration in consumption by middle classes, note also the excellent performance in the rest of Asia (+9%), especially in Hong Kong and Macau, which returned to positive territory in 2017 after double-digit declines in 2015 and 2016. In contrast, the Americas region showed modest growth of only 2%, due to the crisis affecting US department stores, even though various indicators showed a robust year-end, partly thanks to wealth created by outstanding financial market performances. However, the US market remains complicated. In Europe, the luxury industry posted robust growth of 7% to almost EUR87bn on Bain & Co estimates, thanks to the rebound in tourist flows (especially in the UK).

FIG. 1: GROWTH IN THE GLOBAL LUXURY MARKET (2007-2018E)



Source: Bain & Co; Bryan, Garnier & Co

The duty-free market increased by almost 20% according to Global Blue figures (+8% in France), thanks also to the positive trend in local consumption prompted by the more buoyant backdrop.

Sales to Chinese customers (35% of the total market according to our estimates, of which more than two-thirds were outside Mainland China) rose by more than 10% in 2017 after a decline of 3% in 2016, in line with the trend seen between 2012 and 2015. We estimate that Chinese clients account for more than 50% of The Swatch Group sales, close to 45% at Richemont, around 35% for Louis Vuitton and Gucci but below 30% at Hermès. Sales to US customers (22% of total) remained stable while sales to European customers (18% of total market) rose by almost 2%. However, compared with the 2012-2015 period, Chinese consumers did not make their purchases in the same geographical regions. Growth with Chinese customers was particularly strong locally, thanks to omnichannel sales, the reduction in price gaps between China and Europe, and stricter border controls. It was also robust in Europe and Japan.

FIG. 2: CHANGE IN LUXURY MARKET BY MAJOR REGION

	EURbn	change 2017 (%)	change Fx-n (%)
China	20	15	18
Rest of Asia	36	6	9
Europe	87	6	7
Japan	22	4	8
Americas	84	2	2
RoW	13	1	0
TOTAL	**262**	**5**	**6**

Source: Bain & Co; Bryan, Garnier & Co

FIG. 3: GROWTH IN LUXURY SALES WITH CHINESE AND NON-CHINESE CLIENTELE

In %	12-15 CAGR	2016 change	2017 change
Chinese clientele	13	-3	11
Non-Chinese clientele	-2	2	3
Total market	**2**	**0**	**6**

Source: Bain & Co; Bryan, Garnier & Co

Very dynamic Chinese customers (+11%)

HEALTHIER MOMENTUM

The rebound in the luxury market in 2017 was primarily underpinned by positive momentum in the retail segment (+8% including +5% same-store with a low scope/surface effect of 3%), compared with growth of 3% for the wholesale segment, which was affected by the department store situation in the US. While in 2012, brands in the luxury sector opened almost 1,000 directly-operated stores, in 2017, this figure had risen by "just" 350, but with considerably more renovations and extensions. In addition, growth in the market was driven more by volumes (for example, the rise in volumes at Louis Vuitton exceeded 10% in 2017) than by prices. For these two reasons (no price increase and no store openings), we consider that momentum is healthier since it is more sustainable.

In 2017, momentum was particularly robust in footwear (+10%) and jewelry (+10%), whereas the ready-to-wear and watches segments, two markets particularly sensitive to the wholesale network, posted growth of 3% each.

Younger customers

The tendency to find increasingly younger customers in the luxury market amplified during 2017. Bain & Co estimates that the share of generation Y customers (born between 1980 and 2000) in the total market rose from 27% in 2016 to 30% in 2017 to almost EUR78bn, or an increase of 16%, whereas the share of generation X consumers remained stable, at 38% of the market.

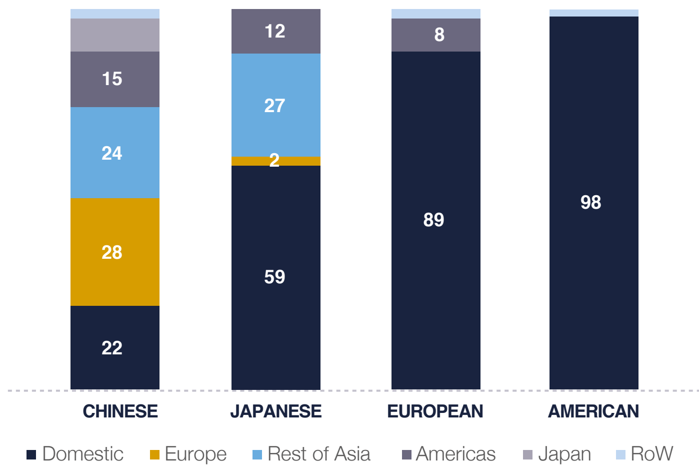
We estimate that almost 80% of growth in the luxury market in 2017 stemmed from the Y and Z generations. Millennials are penetrating the luxury market and have very clear tastes and behavior patterns that also influence older generations. Brands that benefited from this trend were capable of adapting their offer to these customers. In our view, the three best examples are **Louis Vuitton**, **Gucci** and **Balenciaga** (Kering). In general, most luxury brands say that millennials purchase more often (around 8 times for Chinese millennials) than generation X and baby boomers, but with a lower average spend than other generations and with a higher propensity to buy footwear, especially sneakers. Similarly, generation Z (born after 2000) is beginning to emerge in the luxury market. Y and Z generations are less loyal to brands and more volatile. They ascribe more importance to the purchase experience and less to the brand itself.

FIG. 4: LUXURY MARKET BY GENERATION

In % of total market	2016	2017
Generation X (1965-79)	38	38
Generation Y (1980-2000)	27	30
Generation Z (2000…)	0	2
others	35	30

Source: Company Data; Bryan, Garnier & Co

FIG. 5: NATIONALITIES AND PLACE OF PURCHASE (PERCENTAGE OF TOTAL)



Source: DFS, Deloitte; Bryan, Garnier & Co

As such, in our view, it is risky for a brand to focus its product development strategy on millennials alone. A good balance between modernity and heritage, such as Louis Vuitton's, is better in our view.

Different purchase behaviors depending on nationality

As Fig. 5 shows, the place of purchase of a luxury product varies from one customer to another. Figures by DFS and Deloitte show that European and US luxury goods consumers most often buy in their respective domestic markets, followed closely by Japan. In contrast, Chinese customers from continental China still shop very little in their country (28%), despite the trend that emerged last year showing a repatriation of their purchases to China following government policies such as lower taxes, strengthened border controls, limitation of credit card purchases abroad, and the FX-driven price gap reduction and omnichannel sales. Chinese customers buy luxury products primarily during trips to Europe and the rest of Asia (especially Hong Kong).

E-COMMERCE RAMPING UP…

Online sales were particularly robust in 2017, gaining 24% to almost EUR23bn, or 9% of the total market. This trend follows on from a CAGR in e-commerce sales of 25% between 2013 and 2016. The share of online sales in the global luxury market stood at just 5% in 2014, meaning that it virtually doubled between 2014 and 2017, even though it still remains modest. The online market is divided into three equal parts between the brands' own websites (Gucci.com par example), e-tailer sites (Yoox.com and Farfetch.com for example) and generalist distributor sites such as neimanmarcus.com, Saksfifthavenue.com and Sephora.com. We discuss the challenges of e-commerce in more detail further on. Nevertheless, these figures hide some very different figures according to brands (luxury or affordable luxury for instance).

According to certain experts, 30-40% of growth in the luxury market in coming years is set to stem from the online segment, illustrated by recent moves in the industry: the the acquisition of YNAP and watchfinder.com by Swiss group Richemont and the stake taken (amount not disclosed but clearly minority) by Chanel in the UK group Farfetch (2016 sales of GBP160m, or a gross merchandise value – GMV – of GBP547m or EUR630m).

3. …underpinned by the ramp-up in e-commerce…

A quarter of luxury sales could be generated online by 2025

E-COMMERCE BECOMING A GROWTH DRIVER

Sector growth is now more 'normalized'. Inflation has virtually disappeared; penetration of emerging markets is no longer a major growth driver now that the majority of luxury groups have already taken positions; and store openings are limited or often offset by closures, especially in Asia-Pacific and above all in China, where many brands were overly aggressive and not sufficiently selective in terms of network expansion. **So, luxury brands now have fewer options in order to outperform the sector.**

They can:

1. Place the focus on **product innovation** while respecting the "modernity - heritage" paradigm in order to seduce consumers, especially new ones, and keeping the legacy of the brand's image intact.

2. **Reshape distribution**, whether via the physical store network (closures, relocations, extensions and store renovations) by improving the purchase experience in stores, or and above all, by betting on **e-commerce** and more generally digital.

Historically, luxury brands have been sceptical about e-commerce given their aim to **preserve the exclusive nature of their products, especially in terms of image and price control, as well as the upscale purchase experience offered to customers**. This explains online penetration rates close to 0% at the start of the 2000s. However, four factors have prompted luxury brands to turn towards the digital market and invest in this segment:

1. Younger customers, millennials, for whom digital is essential.

2. The curiosity of older generations toward e-commerce and digital.

3. The already well-established density of physical store networks.

4. Difficulties in the wholesale network, especially in the US.

As shown in Fig. 6, this trend started to take shape in 2010, when e-commerce represented just 3% of the total luxury market and began to materialize in 2014, driven by the emergence of online distributors specialized in multi-brand platforms and the development of directly operated e-commerce sites. By 2015, e-commerce's share had risen to 6% of the market.

Bain & Co figures suggest online should reach 25% of the total luxury goods market by 2025, vs 9% at present.

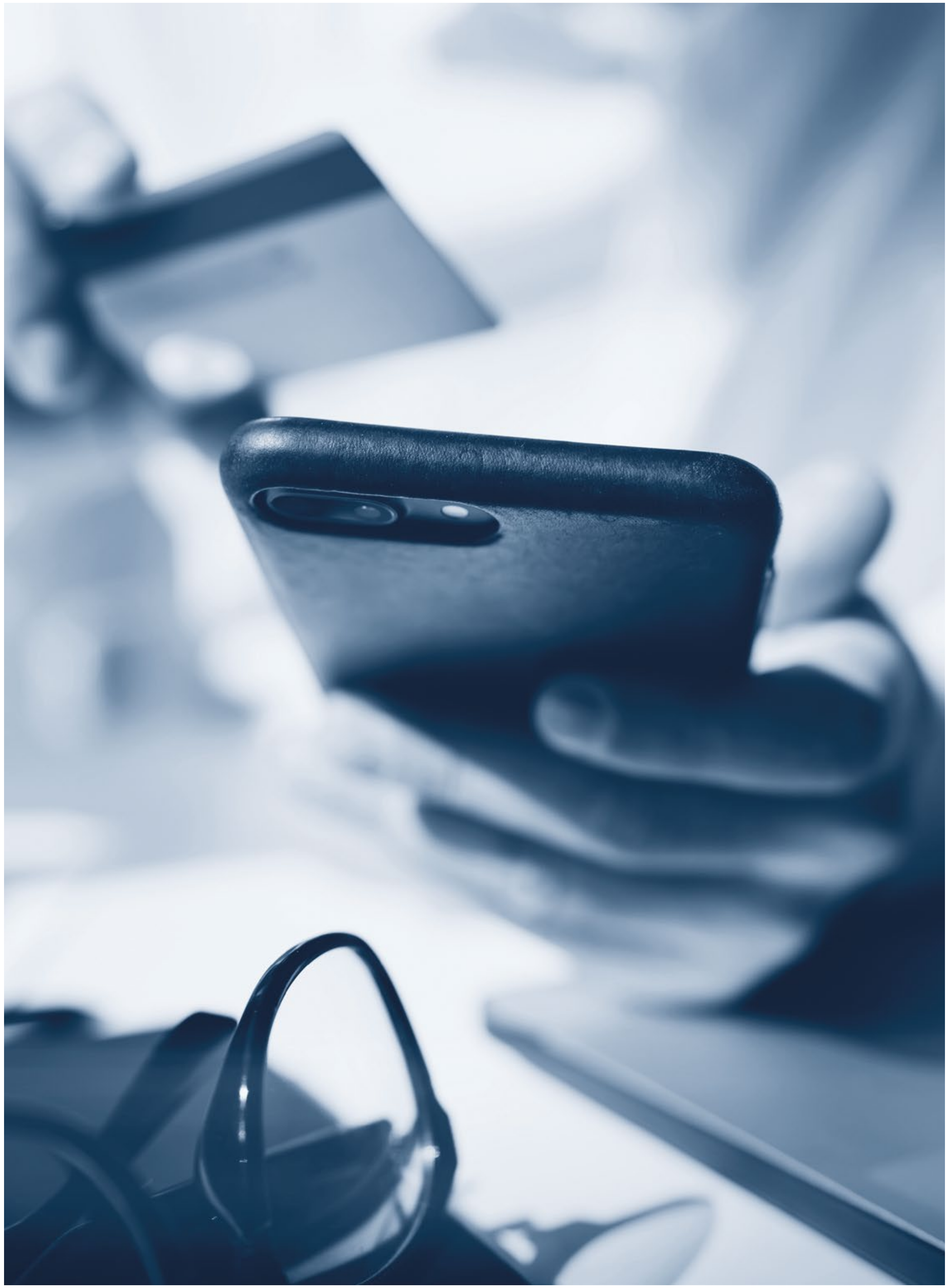


FIG. 6: CHANGE IN INTERNET PENETRATION RATE IN GLOBAL LUXURY MARKET

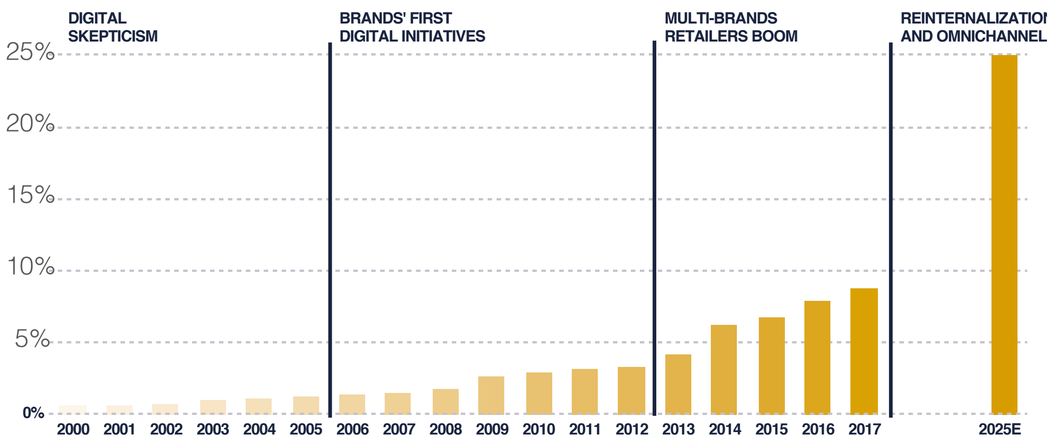
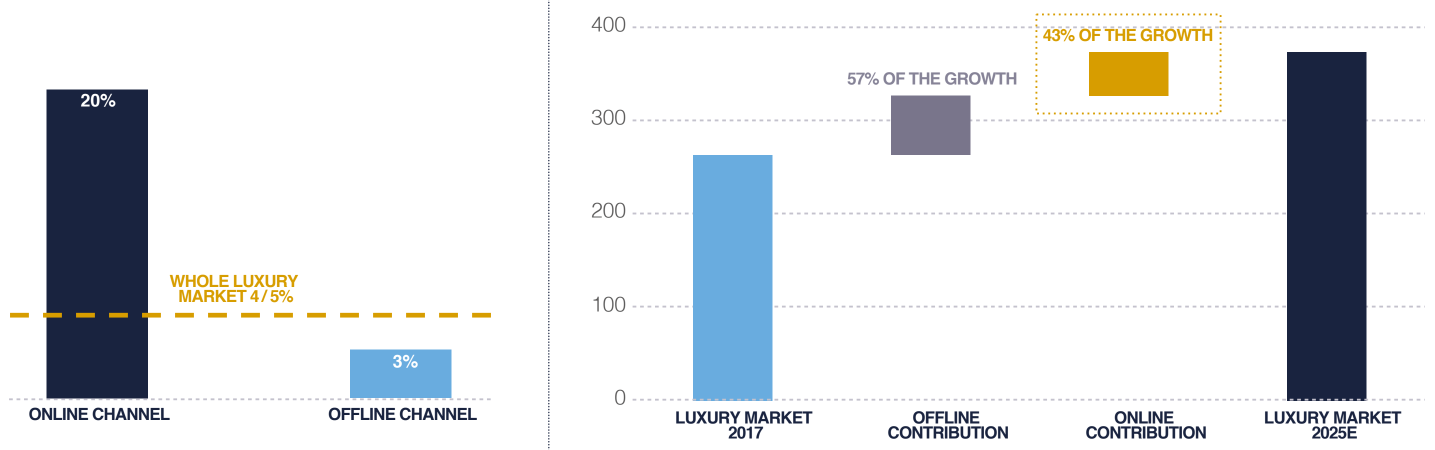


FIG. 7: E-COMMERCE IS BECOMING A KEY GROWTH ENGINE

2017-2025E CAGR IN THE LUXURY MARKET

BREAKDOWN OF LUXURY MARKET GROWTH OUT TO 2025



Source: Bain & Co; Bryan, Garnier & Co

E-commerce is set to grow almost 10x faster than physical stores

This is equivalent to the levels seen today in more digitalized categories such as cosmetics. The percentage is generally higher for smaller brands that focus their development on the wholesale segment, given their lower means to adopt a retail model.

So for US brand Tory Burch, the weight of e-commerce is above 20%. In addition, for certain US department store chains such as Neiman Marcus and Sak's, online sales can account for up to 30% of total sales.

In contrast, no luxury group in Bryan, Garnier & Co's coverage, with the probable exception of Burberry, as yet generates 9% of sales online.

E-commerce accounts for 7% of sales at LVMH or a total of almost EUR3bn annually. Within the group some e-commerce figures exceed this level, for example almost 10% for the wholesale brands Givenchy, Kenzo, Benefit and over 15% for Sephora based on our estimates (these figures are not communicated by LVMH). However, the Louis Vuitton e-commerce figure of approximately 4%, lowers the group's total online sales to 7% as mentioned before.

LVMH was an early mover in luxury e-commerce with the launch in 2000 of a multi-brand platform in the US called E-luxury. However, this site was closed in 2009 due to a lack of success and technological difficulties. The launch of 24Sevres.com in 2017 is therefore not the group's first attempt in online sales via a multi-brand platform.

Figures suggest that e-commerce is shaping up to be a clear growth driver in coming years for the luxury products market, with a CAGR out to 2025 set to run at 20% vs. just 3% for physical outlets. This is based on Bain & Co's forecast for a CAGR of 4-5% for the entire market. Luxury groups are expanding rapidly online, with e-commerce sales in Kering's luxury division rocketing by more than 70%.

In other words, between now and 2025, online is set to generate more than 40% of growth in the luxury market throughout the world vs. almost 60% for the offline, which also shows that physical distribution of luxury products, especially via directly-operated stores, is not dead. We still doubt that retail brands such as Louis Vuitton and Gucci will generate 25% of their sales online by 2025.

According to the majority of observers, directly operated stores or the retail network – as opposed to the wholesale network – remain vital for the industry. These stores are the crucial addresses that reflect a brand's strength and enable it to present the whole of its range, which is clearly less the case for e-commerce sites, whether directly-operated or not. The major challenge for brands is to get digital consumers to visit their stores, improve conversion rates, and ultimately sales per square metre, which is synonymous with growth in profitability.

BRANDS CATCHING UP THEIR LAG IN ONLINE SALES VIA MULTI-BRAND E-TAILERS

Given their lack of experience in digital and in view of the high investments necessary to develop a directly operated e-commerce site, many brands have turned to multi-brand e-commerce groups specialized in the luxury market to extend their exposure at a lower cost. Only certain diehard brands such as Louis Vuitton, Christian Dior and Hermès are not present on sites such as Farfetch and Yoox. And Chanel, with EUR8.6bn in 2017 has not even developed a directly-operated website. And in a bid to maintain control over its image, purchase experience and prices, its products (excluding perfumes and cosmetics) can still not be found on any e-commerce websites. However, Chanel's recent acquisition of a minority stake in Farfetch points at the very least to the beginnings of a change in stance.

In the eyes of most industry observers, the common point for all the groups and brands in the sector is the lag in digital development, whether deliberate or not. Groups are now appointing digital directors: LVMH nominated Ian Rogers (ex Apple) as Chief Digital Officer in 2015 (although he has not joined the group's executive committee), while Grégory Boutté (former CEO of eBay France) joined Kering in December 2017 as Digital and Customer Relations Director and member of the executive committee.

Various business models have emerged via these e-commerce players:

- **Third-party distributors** (Yoox Net-A-Porter, mytheresa …).
- **Marketplaces** which reserve space on their sites for third-party sellers in return for a commission fee levied on the sales (Farfetch, Toplife, Luxury Pavilion …).
- **Aggregators** which redirect internet users from their site to that of the brand (Lyst …).

Alongside **directly operated** sites such as Hermès.com, Louis Vuitton.com and Gucci.com.

FIG. 8: NON-EXHAUSTIVE OVERVIEW OF MAJOR LUXURY WEBSITES

Platform	GMV	Business model	Brands	Products assortment	Geographic reach	Launch
YNAP (Richemont)	>EUR 2,000m	Mainly 3rd parties retail	>1,000 brands and designers	Soft luxury, hard luxury	Mainly Europe and US	2000
mytheresa (Neiman Marcus Group)	ND	3rd parties retail	>680 brands	Soft luxury	Worldwide	2006
Matchesfashion (Apax Partners)	ND	3rd parties retail	>400 brands	Soft luxury	Worldwide	1987
24sevres (LVMH)	ND	e-retailers	>150 brands	Soft luxury, hard luxury	Worldwide excl. China	June 2017
Farfetch	GBP 547m	Marketplace	>200 brands and >750 high-end boutiques & designers	Soft luxury, hard luxury	Mainly US	June 2007
Toplife (JD.com)	ND	Marketplace	First partners: La Perla, Emporio Armani, Rimowa …	Soft luxury, hard luxury, beauty, home furnishings, electronics	China	October 2017
Luxury Pavilion (Alibaba)	ND	Marketplace	First partners: Burberry, Hugo Boss, Maserati, Guerlain …	Soft luxury, hard luxury, beauty, cars	China	August 2017
Lyst	USD 350m	Aggregator	>11,500 designers and brands	Soft luxury, hard luxury	Mainly US	2010

Source: Companies Data; Bryan, Garnier & Co

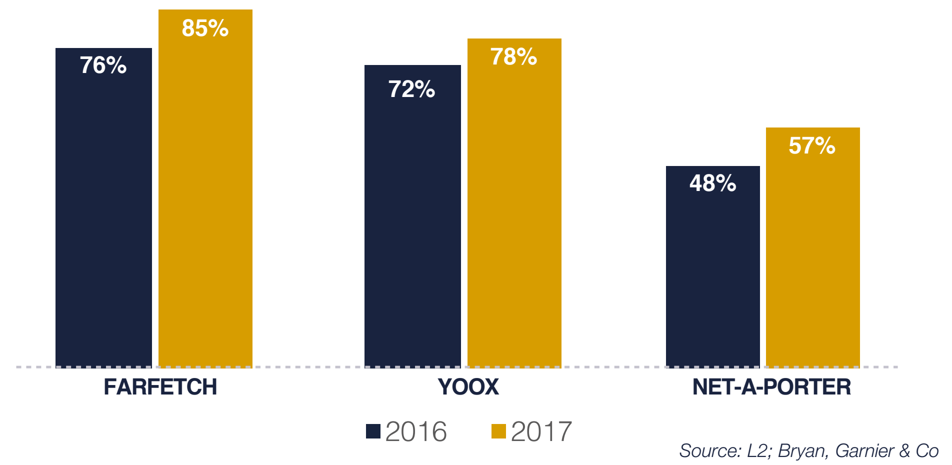
Momentum in multi-brand e-tailers specialized in luxury

Brands tend to outsource their online strategy to third-party distributors specialized in the luxury segment The number of online sales platforms for luxury goods has multiplied rapidly since 2010 – at the same time as most luxury brands, especially the smallest ones, have chosen to outsource the lion's share of their online strategy to third-party distributors. These distributors offer many advantages for traditional luxury brands/groups:

- Their specialization in the luxury market enables luxury brands to **guarantee a secure purchase environment** for their image as well as a coherent and controlled price positioning.
- Their **high-tech focus** enables them to collect a huge amount of customer data and analyze it to adjust the product offer and to better target marketing and communication campaigns for each brand. Also, innovations such as augmented reality, which would break a historical barrier to the development of e-commerce in a sector like luxury, are genuine advantages and ultimately help a more targeted communication and a greater personalization of the offer.
- Their **unrivalled distribution** infrastructure enables them to deliver parcels faster and further. This means within days or even a few hours, as offered by Farfetch and Gucci in 10 cities, and to a widened geographical scope, important for local designers that lack the reach of major global groups. Smaller brands with lower financial means can therefore reach consumers in more distant regions without having to open physical stores.

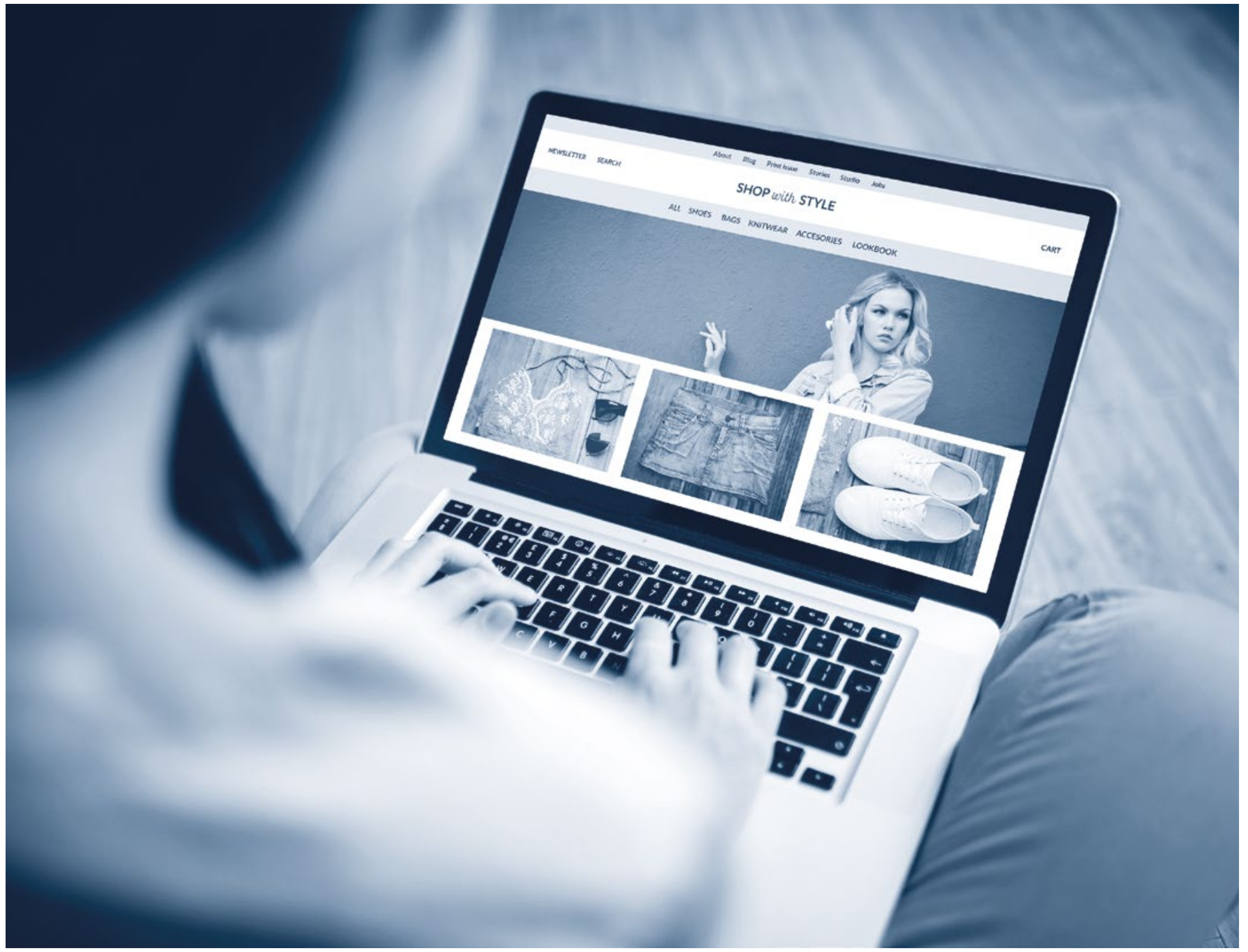
This outsourcing trend is emerging fast in complex and highly digitalized markets such as China, where luxury groups prefer to entrust pure players such as Farfetch, which has a strong reputation on the ground. Indeed, research agency L2 estimated that in 2017, 85% of soft luxury brands were referenced in the Farfetch marketplace (vs. 76% in 2016) and 78% on the retail site Yoox (vs. 72% in 2016) in China. Outsourcing is a first key step for brands before bringing online sales in-house.

FIG. 9: SHARE OF LUXURY FASHION BRANDS REFERENCED ON THE CHINESE SITE OF E-COMMERCE PLAYERS



Source: L2; Bryan, Garnier & Co

Brands tend to outsource their online strategy to third-party distributors specialized in the luxury segment



Are e-commerce giants credible distribution channels for the luxury sector?

When e-commerce giants such as **Amazon, Jing Dong** (JD.com) and **Alibaba** are extending beyond their original business into areas such as food retailing, physical retailing, creation and broadcasting of media content, and banking, **questions arise about the incursion of these operators into the luxury market**.

In our view, the three global majors do not have the credibility to rival e-commerce players specialized in luxury such as Farfetch or YNAP or directly-operated websites and reshape the competitive landscape in luxury distribution. Amazon, JD and Alibaba have built their development on the extent of their assortment, the competitiveness of their prices, which are criteria not associated with the luxury sector, and speed of delivery.

This value-retailer image, combined with a business model based partly on a marketplace where several sellers can compete with each other for the same product (which can even be a counterfeit), dissuades luxury brands from using these channels. Coach withdrew from Alibaba's Tmall marketplace in 2016 after just two years of presence. The brand did not control either the authenticity of the products sold or their selling prices, creating a significant risk for its image further out. Research agency L2 estimates that in 2017, **only 24% of luxury brands present in China had a store on the Alibaba Tmall marketplace and 10% on the JD.com marketplace**. These percentages need to be minimized, bearing in mind that the majority of brands concerned clearly do not offer a comprehensive assortment in their spaces, and that the brands in question are not those with the most upscale positioning.

The majority of luxury groups in our sample currently refuse to put their products on Amazon and Alibaba, whereas L'Oréal only sells certain mass-market brands on these websites (L'Oréal Paris, Garnier, Maybelline) and brands from its professional products division (L'Oréal Professionnel, Kerastase…) but not yet brands from its Luxury division such as Lancôme, Armani and Kiehls.

This fact has so far protected pureplay e-commerce sites specialized in luxury from the sector giants (Amazon, Alibaba, JD.com). However, **the launch of luxury Alibaba's Luxury Pavilion platform in August 2017 and JD's Toplife in October 2017** has reshuffled the pack. These new marketplaces can offer partner brands a far more selective purchase environment – Luxury Pavilion is only accessible via personal invitation – and total control of prices, while benefiting from the respective clout of Alibaba and JD. These are all factors that could please luxury brands. Today, JD.com's Toplife, which already counts La Perla, Emporio Armani and Rimowa among its partners, seems to be the platform that grants the most autonomy to brands in terms of assortment, price and design while helping them with marketing and logistics. However, it's too early to speculate on the success of these forays into the luxury market.

In contrast, at Amazon, a move into luxury seems even more unlikely. Yet with the aim of extending its product and services offering to satisfy all the needs of its Prime members, the prospect of the group entering the **upscale cosmetics/perfumes division seems more feasible in our view, albeit not in the near future.**

FIG. 10: PRESENTATION OF THE THREE E-COMMERCE GIANTS

	Amazon	Alibaba	JD
Global GMV (USDbn)	350	700	140
Active customers (m)	380	500	300
Business model	Retail + marketplace B2C	Marketplace B2C and C2C	Retail + marketplace B2C
Global platform's pricing image	**Weak**	**Very weak**	**Weak**
Sub-platform dedicated to luxury		Luxury Pavilion (Aug 2017)	Toplife (Oct 2017)
Brands' autonomy/control on the sub-platform		**High**	**Very high**

Source: Bryan, Garnier & Co

None of the leading brands (Estée Lauder, Lancôme, Dior, Guerlain…) in this segment are ready to play Amazon's game yet. However, Amazon has already created a section specifically for premium and beauty products on its site (referencing brands such as Burberry, Jimmy Choo, Rochas, Baxter of California and American Crew). A gradual move upscale cannot be ruled out if the discussions concerning a partnership between Amazon and luxury beauty products e-tailer Violet Grey, which sells La Mer by Estée Lauder and Dior, prove successful.

Emergence of WeChat as the new online sales channel in China

In a digitalized world increasingly based on mobile technology and where young Chinese people are often proving to be trendsetters, it is interesting to look at the momentum of **WeChat**, the mobile messaging application developed by Chinese tech group Tencent in 2011, as a new sales channel for luxury brands. Most of WeChat's 900m active monthly users live in China. The commercial arm of WeChat, **WeChat store**, was launched in 2014 and only in China.

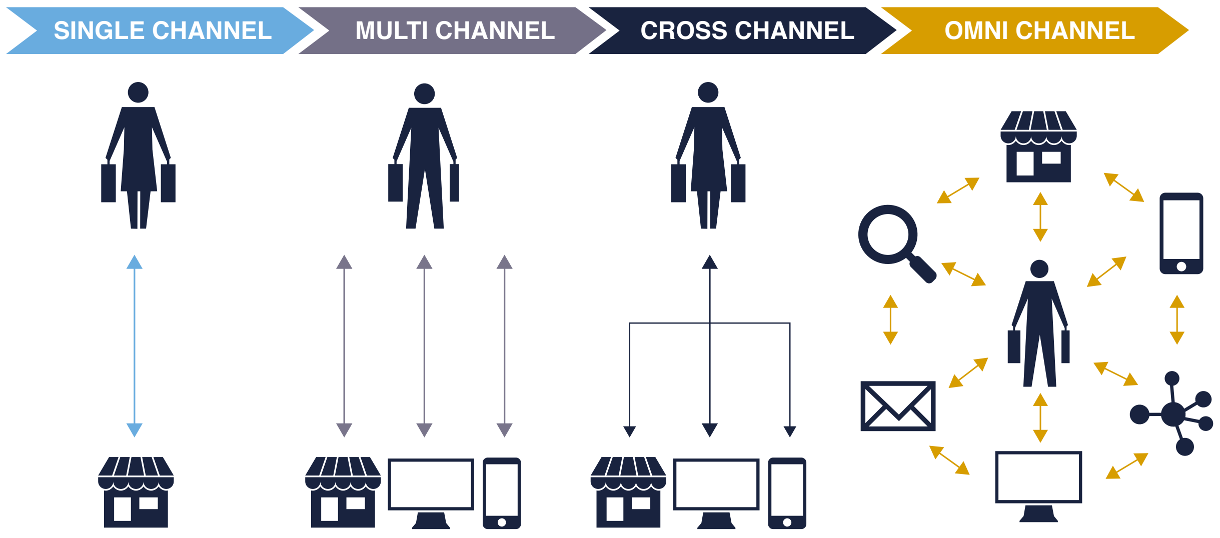
Within just a few years, **WeChat has become a key application in China. Major luxury groups have created official accounts on the application**, above all from a marketing perspective, **more than half of them sell via the channel**, including (Moncler, Coach, Dior, Givenchy, Cartier and IWC. However this is sometimes for a limited amount of time and a small number of lines. US brand Coach is emblematic: it withdrew from the Alibaba Tmall marketplace at the end of 2016 to refocus on its own website as well as on its WeChat space, including the WeChat Store.

Unlike many other e-merchants, **WeChat disintermediates numerous stages of the sales process, giving brands total control of their image and prices**. A brand can therefore post content on a news line to attract users to a page that it has created itself or even directly to its website. In addition to selling a product via the application, the brand can undertake surveys, obtain feedback on customer experience, offer click & collect and interact directly with customers via private messages. The brand's final objective is nevertheless to attract consumers into its stores in order to boost sales per square metre.

Louis Vuitton created an official account on the WeChat application (with no access to the WeChat Store option), like **Gucci**, another example of these two brands' selective strategies. Italian brand **Ferragamo** is also present on WeChat but only as a means of having digital contact with customers with no possibility of purchasing via this application. **Tod's** is currently negotiating with the WeChat application, although nothing has been signed for the moment.

Exporting this new sales model to western countries seems very likely at a time when brands are aiming to attract younger generations via mobile devices and more targeted marketing campaigns, while maintaining strict control of the purchase experience and prices. Among the applications already existing in Europe and the US, **Instagram** and **Pinterest already have a few similarities with WeChat that would be worth expanding on in order to attract luxury brands**. Nearly all luxury brands are already present on Instagram.

FIG. 11: HEADING FOR BORDERLESS ONLINE/OFFLINE OMNICHANNEL



Source: Bryan, Garnier & Co

BRINGING E-COMMERCE IN-HOUSE SEEMS PREFERABLE FROM AN OMNICHANNEL STANCE

Players in the luxury sector now need to satisfy rising customer expectations in terms of purchase experience and contact points (stores, tablets, smartphones etc.) For brands in Kering's luxury division, 60-70% of internet searches are made via a smartphone or a tablet and almost 50% of online purchases are already made by the same channels, in a good example of omnichannel distribution. **While it is true that the majority of luxury purchases are still made in stores, digital plays an essential role in the purchasing journey**, as a research tool, for price comparison and for after-sales service. Customers want to be able to navigate seamlessly between channels in order to benefit from the most fluid purchase experience possible. We estimate that 70% of luxury product purchases made in stores were preceded by internet searches on the brand's website or on specialized websites.

For consumers to buy any product from the brand at the right price, wherever they are, whenever they want and via any means they want (online, physical stores), **luxury groups therefore need to switch from a multichannel to an omnichannel model**. This means moving away from several distribution channels and multiple consumer touch points, or a cross-channel approach that aims to integrate channels for a more fluid consumer experience, to a perfect convergence of offline and online.

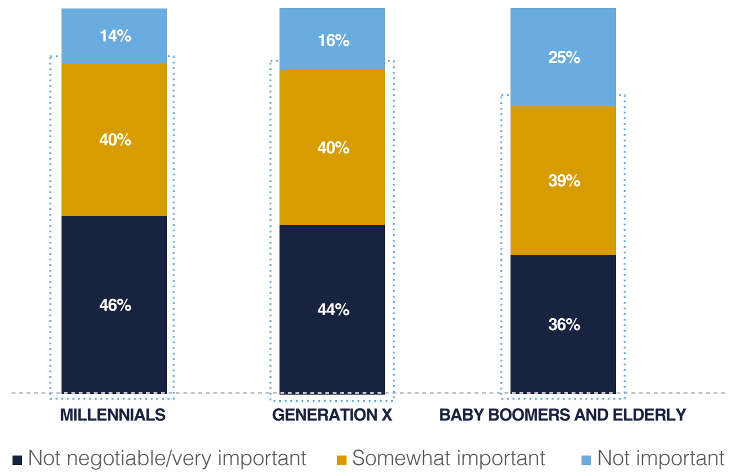
The recent acquisition of Yoox-Net-à-Porter (YNAP) by Swiss group Richemont is interesting in this respect. It illustrates the desire of a major luxury sector player not to be left behind by e-commerce or specialized platforms, and to understand this distribution format in depth. This can also be seen from a defensive stance given its 50% stake in YNAP dating from the Yoox and Net-A-Porter merger in October 2015.

Could this be the first stage of a deeper trend that could see other luxury groups take control of platforms such as Farfetch, Matchesfashion.com or mytheresa.com. Farfetch is seriously considering an IPO on the New York Stock Exchange by the end of the year at an estimated valuation of EUR5bn, APAX has a majority stake in Matchesfashion and Neiman Marcus controls mytheresa. Time will tell, but this is a prospect that cannot be ruled out at this stage.

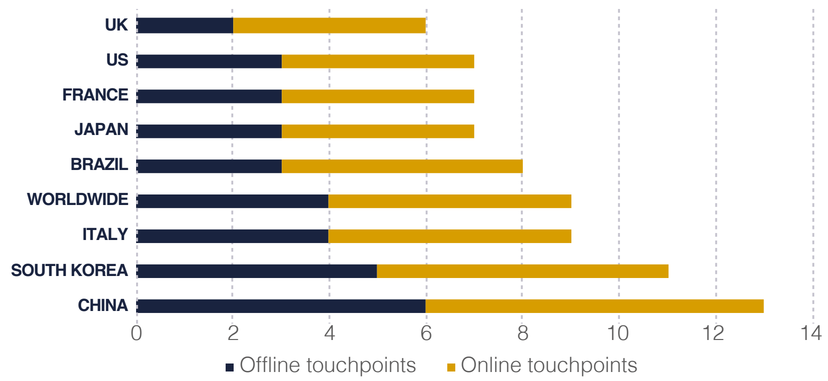
It is not just millennials who want a purchase journey that is standardized across many channels. In a study undertaken by BCG with 10,000 luxury product consumers in 10 countries, it is "fairly important" that a brand is accessible via different channels for 86% of millennials, 84% of generation X, and even 75% for baby boomers and older generations. Luxury brands realize that an ambitious digital strategy benefits all customers, regardless of age.

FIG. 12: CONSUMERS WANT MORE CONTACT POINTS

"TO WHAT EXTENT IS IT IMPORTANT THAT A BRAND CAN BE ACCESSIBLE VIA DIFFERENT CHANNELS"



NO. OF CONTACT POINTS GENERATED DURING THE PURCHASE JOURNEY FOR A LUXURY PRODUCT



Source: BCG; McKinsey; Bryan, Garnier & Co

Heading for a perfectly homogenized ecosystem of channels creating a fluid purchase experience

According to Invesp, a software and services provider specialized in conversion rates, if we take distribution as a whole as a proxy, retailers and/or brands with an omnichannel model have a significantly higher retention rate (89%) than those that without one (33%) Retention rate is vital because millennials switch easily from one brand to another. The rise in the retention rate for a luxury brand is often synonymous with a genuine visit to the brand's stores, building sales per square metre and profitability.

Chinese consumers again seem to be the reference point as China appears to be where the purchase journey for a luxury product is the longest, with 13 contact points (including sales in physical stores, website, mobile app, TV advertising, digital advertising, SMS, etc.). This compares with a global average of almost nine contact points. China is also the most digitalized, with seven online contact points compared to a global average of five. South Korea is not far behind.

The luxury sector has already understood the challenges of diversifying its marketing communication channels with consumers. So the potential to digitalize distribution channels and integrate them into an ecosystem seems huge. It would also avoid the cannibalization that is still too frequent between online and offline. However, in the roll-out of a genuine omnichannel strategy, we believe that the major luxury brands should firstly get to work on three major projects:

1. Renovating physical store networks

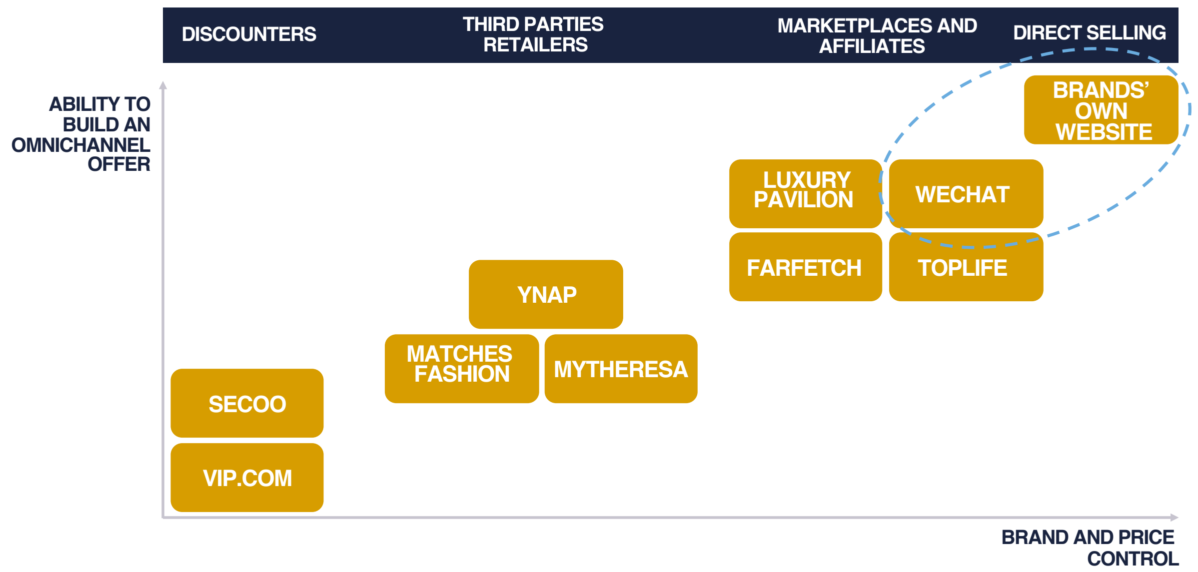
The central question is how to interact the most with consumers in stores in order to make the purchase happen. From this perspective, technology deserves a higher presence in luxury brand stores (at least the most strategic ones), or to be omnipresent. Digital in stores helps create strong ties between the store, the online sales platform and the brand's official website. **Interactive digital terminals** enable shoppers to discover the brand and the products, and order articles not available in the shop. **Decentralized cash registers**, where mobile sellers are equipped with digital tablets, **click & collect points** and **augmented reality mirrors** in stores all help to both enhance and digitize the purchase experience.

Brands such as Hugo Boss, Burberry, Moncler and even Hermès have already implemented digitalization in certain stores, using sellers with tablets and CRM management.

2. Internalizing online sales of "in-season" ranges

In contrast, to offer a digitalized in-store purchase experience that is coherent with the e-commerce offer, selling online directly seems necessary or at least preferable. We believe that in coming years, **bringing online sales of current "in-season" collections back in-house, at least partially, will be a necessary move, given that these sales relate to the collections also available in physical stores**. This is likely to hamper expansion of multi-brand in-season websites such as Net-A-Porter, whose offer of major luxury brand products could therefore decline further out, and to a lesser extent Farfetch, whose marketplace model is based more on small local designers.

FIG. 13: DIRECTLY OPERATED SITES AND WECHAT SEEM TO BE THE MOST COMPATIBLE WITH AN OMNICHANNEL STRATEGY



Source: Bryan, Garnier & Co

Sales via WeChat can also be seen as a direct distribution channel that is compatible with an omnichannel strategy, where the brand has total control of its image and its price policy, and can link the online offer to its physical stores.

Kering and LVMH are present on WeChat. LVMH uses the platform for targeted sales operations, for example with Christian Dior; sales operations with bloggers or influencers (Givenchy); or for interacting with customers (Louis Vuitton). The main Kering brands are also present on WeChat, but as for LVMH, the platform is more a means of multiplying contact points.

In line with its very exclusive vision of distribution, Hermès is only present in the online sales market via its directly operated sites. However, aware of the need to develop its digital vision by offering an extended range of products, the group completely updated its US website last year, with the immediate result of increasing footfall, connection times and conversion rates. This digital transformation is due to take place in Europe during H1 2018 and in China towards the end of 2018.

3. Improving logistics networks

Standardizing offline and online channels also involves the roll-out of an efficient logistics network. **Transversal stock management** (where all distribution channels share the real-time state of stocks) **is vital to be able to offer a click & collect service or to satisfy showrooming fans**. At a time when consumers are getting used to the shorter delivery times offered by e-commerce giants, luxury groups also need to emphasise the efficiency of their home delivery process in order to improve the purchase experience.

Smaller brands and local designers with no digital expertise and/or the means to efficiently develop their own websites are likely to rely more on marketplaces to adopt an omnichannel strategy. Farfetch enables smaller stores to sell their products on its site, to link their stocks with the platform to offer click & collect and in-store returns, and to negotiate more attractive delivery prices with logistics groups, all for a commission fee estimated at 25%. The platform generated business volumes in 2016 of almost GPB547m and sales of GBP160m, up 70% year-on-year.

4. ...and by millennials

The millennial generation, born between 1980 and 2000, contributed significantly to growth in the luxury market in 2017 and should continue to do so in coming years.

Millennials already account for nearly 30% of the luxury market and often set new trends that are sometimes followed by older generations. However, millennials are also the least loyal to brands and more volatile in their choices since they are more sensitive to fast-changing fashion trends. The challenge for luxury brands, and especially those in the soft luxury segment, is to retain millennials without becoming too dependent on them. This will limit risks for the future and leave space to develop product lines targeting other customer types, often marketed at higher prices.

Millennials buy their first luxury products at a younger age than older generations. Above all, they shop more frequently, but typically spend less than average, so they can switch rapidly from one brand to another. This trend is particularly true for Chinese and Asian consumers and is noticeable to a lesser extent in the US and Europe.

Millennials are also more digitally connected than their elders and far more aware of sector trends. They are increasingly selective and demanding in terms of quality and availability, as well as the offline and online purchase experience.

RISING WEIGHT IN GLOBAL POPULATION

The millennial generation accounted for 31% of the population in 2015 according to UN statistics. By 2020 it is set to account for 41% of the global population, rising to 54% in 2025. In 2020, the combined X and Y generations, huge consumers of luxury products, will account for 85% of the global population.

- **Millennials are mostly located in Asia**
  Most of today's millennials are either Indian, Chinese or American. Indeed, statistics show that 58% of today's two billion millennials live in Asia with almost 385m in India. In Japan, which accounts for an important 8% of the luxury market, an ageing population means its share of millennials is much lower.

- **In countries with very low income per capita**
  Most millennials live in regions where per capita income is the lowest in the world. The exception is China, where certain millennials already have very high purchasing power, sometimes higher than that of their European and American counterparts. It's here where the middle class is set to grow the most in coming years in our view. This is reassuring for sustainability of growth in the luxury market and leads us to expect high medium-term growth in the sector.

Growth in the middle classes, especially in Asia-Pacific, but also in the Middle East and Latin America, could also drive growth in the market over the medium term. Growth in the percentage of millennials is very closely tied to the rising percentage of the middle classes. Millennials in emerging countries today are very likely to become the future middle and upper middle classes in countries with higher financial means, leading to an eventual rise in luxury industry spending.

This trend of the emerging middle class[1] is especially true in Asia. According to McKinsey, it will account for 51% of total Chinese households in 2025 vs. 27% in 2015, while the percentage of lower middle class is expected to remain the same (17%). Cap Gemini figures also point to increasing wealth creation in Asia-Pacific, noting that there were 5.5 million HNWIs in 2016 versus 3.3m in 2010.

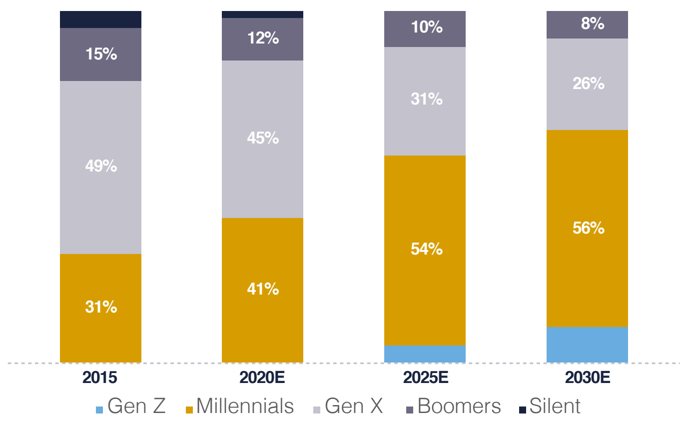
AN ACTIVE GENERATION IN THE LUXURY MARKET

Following on from millennials, generation Z, born after 2000, is beginning to emerge and already accounted for 2% of the luxury goods market in 2017. Combined, the X, Y and Z generations are projected to account for more than 75% of the total market in 2020 vs. 62% in 2015. Millennials have different purchase habits to baby boomers and gen-Xers. Their use of smartphones and social networks makes them more connected – and they buy different things, for example more sneakers in the footwear segment. One out of two pairs of shoes bought by female millennials are sneakers. They shop far more often than their elders, especially in China, but spend less. Their purchases are focused mainly on entry-level ready-to-wear and leather goods, mostly branded and with a higher "fashion" component.

A highly connected generation

Fig. 18 shows the degree to which buyers of luxury products on global scale are more connected than the average population,]broken down by generation. Among 46-55-year-olds, 90% of those who purchase luxury products used the internet in 2016 versus 55% of the generation as a whole. High purchasing power, an international mindset and professional occupations are all factors explaining this trend.

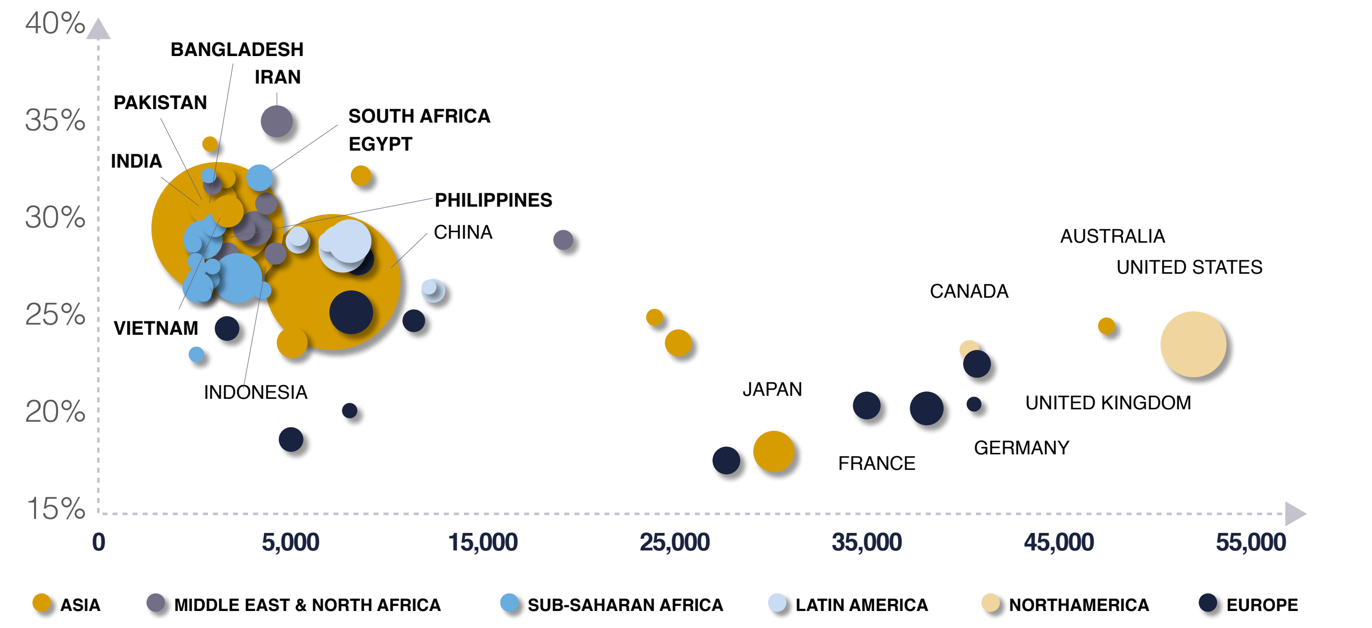
FIG. 14: PERCENTAGE SHARE OF VARIOUS GENERATIONS IN GLOBAL POPULATION



Source: UN; Bryan, Garnier & Co

1: Middle class: Brookings defines this socioeconomic category as households with per capita incomes between USD10 and USD100 per person per day in 2005 Purchasing Power Parity (PPP) terms

FIG. 15: MILLENNIALS AND INCOME PER CAPITA



Source: Company Data; Bryan, Garnier & Co

FIG. 16: CHANGE IN SIZE OF MIDDLE CLASSES

Size of the Middle Class (m)	2010	2020e	2030e
World	**1 845**	**3 249**	**4 884**
North America	338	333	322
Europe	664	703	680
Central and South America	181	251	313
Asia Pacific	525	1 740	3 228
Sub-Saharan Africa	32	57	107
Middle East and North Africa	105	165	234

Source: Company Data; Bryan, Garnier & Co

Current millennials are the future middle classes and have a strong appetite for luxury brands. The generation is highly connected, especially those that purchase luxury products

FIG. 17: BREAKDOWN OF THE LUXURY MARKET BY GENERATION

In % of total market	2016	2017
Generation X (1965-79)	38	38
Generation Y (1980-2000)	27	30
Generation Z (2000…)	0	2
Others	35	30

Source: Company Data; Bryan, Garnier & Co

Millennials should account for 45% of the luxury market in 2025 vs 30% at present

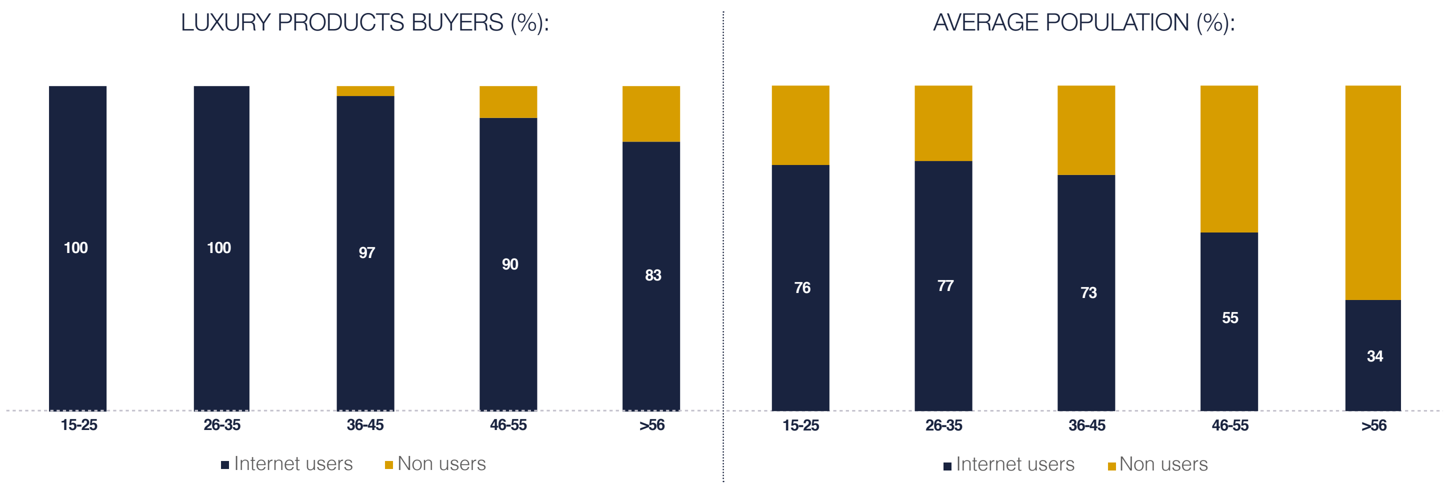
The management team at Kering showed its understanding of millennials when changing management at Gucci. From early 2016, the brand changed its product offering under new creative director Alessandro Michele, who saw the logo as part of the luxury brand's DNA and considered a more fashion-focused offer necessary to capture the millennial clientele. Previous creative director Frida Giannini had pushed the brand too far upscale between 2013 and 2015. Louis Vuitton's strategy, by contrast, has always been more balanced between modernity (fashion-focused and branded products, often with an entry range positioning), and heritage (classic products, fewer logos and more upscale).

Bain & Co estimates that purchases made by millennials could reach 45% of the total luxury market in 2025 vs. 30% in 2017, testifying to the importance of this customer base for the majority of luxury brands. Assessing the generational mix for the brands themselves is difficult.

However, while millennials represent 56% of sales at Italian brand Gucci, the percentage is slightly lower at Louis Vuitton (45-50%) and far lower at Hermès. With a less fashion-oriented image and relatively high prices, especially in soft luxury, Hermès is less attractive to millennials despite having its own website since the middle of the 2000s.

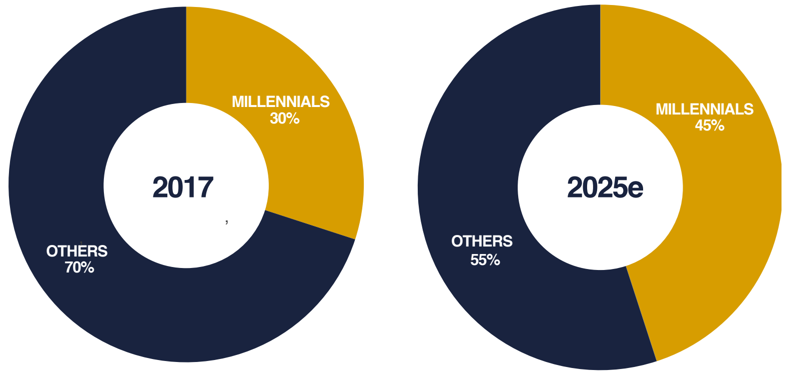
Fig. 20 highlights the huge share of e-commerce in younger generations' first-time purchases of luxury goods, especially generation Z. Bain & Co estimates that 14% of consumers in the 18-24 age group bought their first luxury product online, while for the 25-34 age group, this percentage is 9%. This reflects new generations' digital purchase habits, often via a smartphone or a tablet, which multiplies retail contact points. Luxury brands cannot ignore this trend and need to prepare for it. Contrast these figures with the percentage of luxury goods purchases made online by the 55-64 age group, which is around 2%.

FIG. 18: INTERNET USAGE OF LUXURY PRODUCTS PURCHASERS



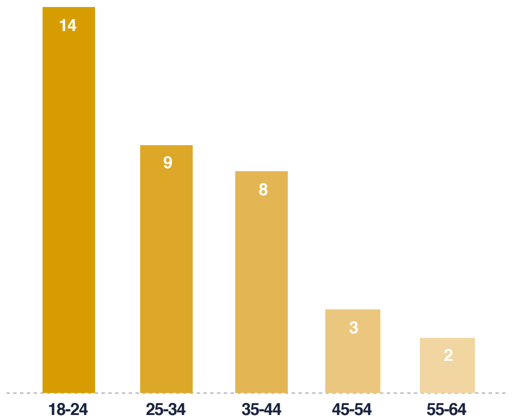
Source: Bain & Co; Bryan, Garnier & Co

FIG. 19: WEIGHT OF MILLENNIALS IN THE LUXURY MARKET



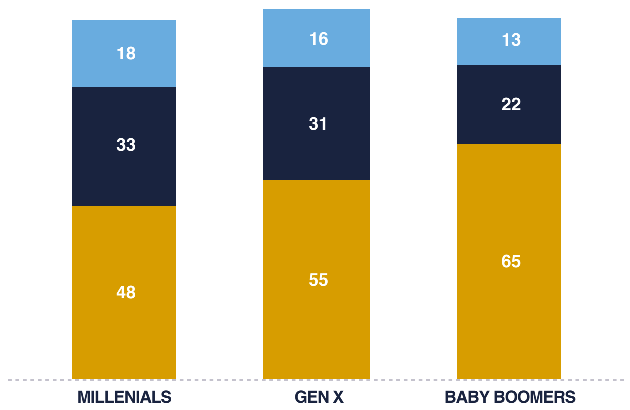
Source: Bain & Co; Bryan, Garnier & Co

FIG. 20: FIRST ONLINE PURCHASE OF A LUXURY PRODUCT BY AGE-GROUP



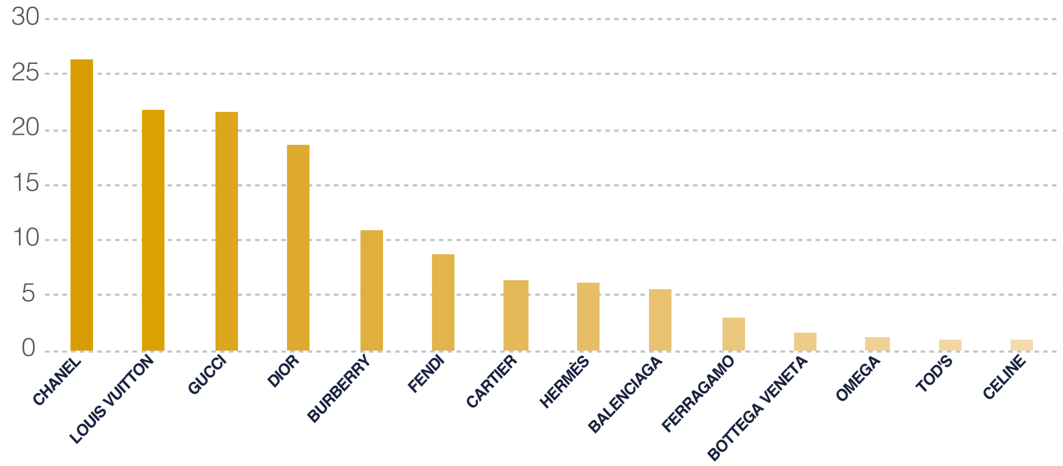
Source: Bain & Co; Bryan, Garnier & Co

FIG. 21: PLACE OF PURCHASE DEPENDING ON THE GENERATION



Source: Bain & Co; Bryan, Garnier & Co

FIG. 22: PRESENCE OF MAIN LUXURY BRANDS INSTAGRAM (MILLIONS OF FOLLOWERS)



Source: Instagram; Bryan, Garnier & Co

And very mobile

While almost 48% of millennials' luxury goods purchases are made in their home countries, this is also the most mobile age group, with the highest percentage of purchases made abroad. Millennials also purchase the most in travel retail. See Fig. 21.

INCREASED PRESENCE ON SOCIAL NETWORKS

Luxury brands have also built their social presences in recent years, in particular on Instagram and Facebook. The chart above is very revealing, showing for example that Chanel, with 26 million followers, is the most-followed luxury brand on Instagram despite being absent from all websites.

And Louis Vuitton, present only on Louisvuitton.com and 24sevres.com, is the second most followed brand on Instagram (22m followers). Among the top 15 most followed brands on Instagram, there are three Kering brands (Gucci, Bottega Veneta and Balenciaga) and four LVMH brands (Louis Vuitton, Christian Dior, Fendi and Céline). Note also that the Tod's brand (0.95m followers) is less followed than Salvatore Ferragamo (3 million) despite almost similar revenues. This could be explained by Tod's reticence to fully engage in a social media strategy unlike Ferragamo, which has been more active in this area.

Analyzing search trends by luxury brand name on Google is also a good indicator of the reputation of each brand and its ability to grow sales.

The compilation of Google Trends results in Fig. 25 is based on user searches for luxury brands over several years. It records the peak viewing score using an index of 1 (lowest) to 100 (highest).

The charts in Fig. 23 prompt several observations:

- For each of the brands shown, the Christmas period generates the highest search rates on Google for information on luxury brands, with trends returning to normal in January regardless of brand. The exception is Balenciaga, whose current brand collection renewal is generating enormous interest.

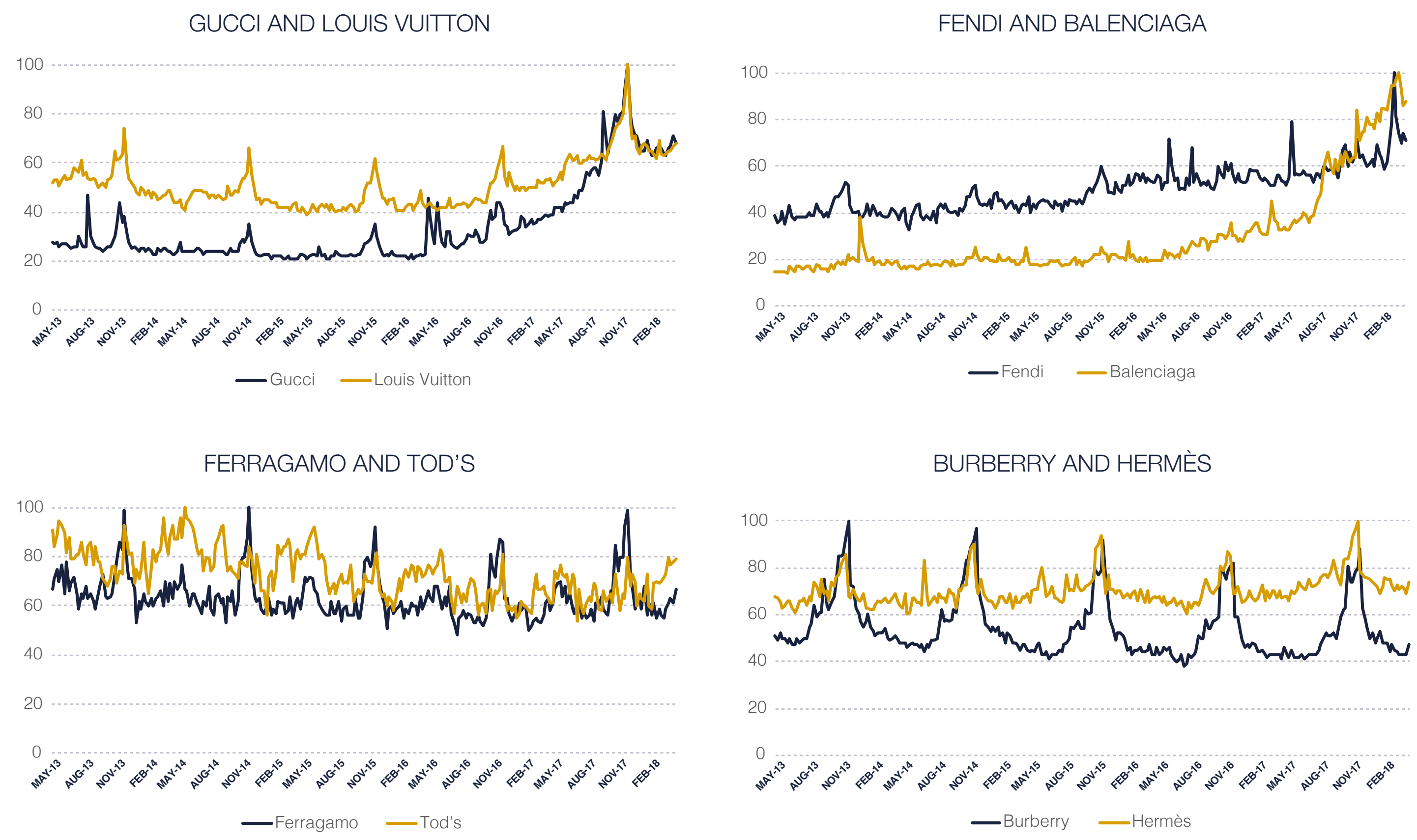
- Search trends for Gucci and Balenciaga (Kering) and Fendi (LVMH) reflect rising interest from luxury goods fans. There is a general upward trend for all three companies, culminating in a surge in Google searches throughout 2017.

- Internet users do not seem interested in either Tod's or Salvatore Ferragamo at the moment, thereby reflecting Ferragamo's relative failure to shake up its brand. The same could be said of UK brand Burberry. However, developments in the coming months should nevertheless be watched closely following the recent nomination of Riccardo Tisci (ex Givenchy) to replace Christopher Bailey as creative director.

- In contrast, it is interesting to note that searches for Hermès made by internet users are far more regular throughout the year, which reflects the brand's strategy and positioning focusing on modernity whilst maintaining its heritage.

Google search trends use a base 100 index with the top 100 representing a peak in searches.

FIG. 23: SEARCH TRENDS FOR BRAND NAMES ON GOOGLE TRENDS



Source: Google; Bryan, Garnier & Co

5. Conclusion: back to the future?

We forecast that in 5-10 years, digital distribution of luxury products is set to undergo the same transformation as physical distribution during the 2000s, switching from a wholesale to a far more retail business model. That switch saw transformation accompanied by an aggressive policy to open directly operated stores. It meant high initial investments, far stricter control of price policy and brand image, and better knowledge of end-customers (roll-out of CRM) with an optimized customer experience and stock management, to the detriment of the wholesale network.

This strategy resulted in better profitability levels for groups and brands, thanks to the higher margins from bringing distribution in-house. We expect the business models of certain e-commerce platforms based on a wholesale model to evolve and allow better control by the brands.

Often dominant weight of retail

At Gucci, the retail network generated 68% of sales in 2007 vs. more than 85% in 2017 from a total of 529 directly operated stores vs. 111 in 2007. For the entire luxury division at Kering, the share of retail rose from 53% of sales to more than 75% between 2007 and 2017 from a total of 1,388 stores. At Hermès, sales generated by the directly-operated stores have gained more than 10 points over the past 10 years to reach almost 83% of total sales in 2018.

Three recently announced operations point to future in-house management of digital distribution:

- The creation of the multi-brand e-commerce site 24Sevres.com by LVMH in June 2017 presenting almost 160 brands including Christian Dior, Louis Vuitton, Salvatore Ferragamo, Gucci, Tod's, Céline and a collection of 77 exclusive products. However, this project, which seems to have had difficulty taking off, is set to generate losses (that we estimate at EUR30-50m) for some years yet, according to LVMH's management. The policy demonstrates the group's ambition to control digital distribution of its brands by offering a premium purchase experience even if the offer is limited at this stage. 24sèvres can be seen as the digital continuation of the Paris department store Le Bon Marché.

- The operation by Richemont to buy the YNAP shares that it did not already own for EUR2.7bn testifies to chairman Johann Rupert's interest in this distribution niche following the acquisition of Net-a-Porter in 2010, despite the low weight of e-commerce at hard luxury groups. The move was probably also somewhat defensive and illustrates the group's aim to be less dependent on multi-brand retailers or wholesale networks further out.

- Chanel's acquisition of a stake in Farfetch, albeit a minority one, despite the group's reluctance to market Chanel products on the internet. The operation should enable the French brand to improve the efficiency of its digital tools and its relations with consumers.

FIG. 24: WEIGHT OF RETAIL IN SALES AT MAIN LUXURY BRANDS

Louis Vuitton	Hermès	Gucci	Bottega Veneta	Saint Laurent	Fendi	Céline	Cartier
100	85	85	83	69	75	75	70

Source: Company Data; Bryan, Garnier & Co

We think that Kering (which has a joint venture with Yoox launched in 2013 for eight brands including Bottega Veneta, Saint Laurent and Balenciaga that is due to expire in 2019), could implement a similar strategy to LVMH to bring its distribution in-house via its own e-commerce platform. We estimate the weight of the JV in YNAP's total sales at almost 5%. It remains to be seen how LVMH might react if the 24Sevres.com experience does not work out and whether it would make an acquisition. It is still too early to say but we are not ruling out this prospect.

For the moment, no one business model is really emerging. Models vary from one brand to another, even from one country to another for the same brand. Everything depends on the attitude of millennials and generation Z customers. Brands will have to adapt to a rapidly changing environment, especially in China, where the market is evolving quickly. This evolution also raises, in our opinion, the question of the sustainability of wholesale networks and multi-brand retailers where the buying experience is not often the most optimal. Chinese customers clearly seem to prefer to buy luxury products on websites developed by the brands themselves and then in physical stores (especially abroad) to the detriment of multi-brand e-merchants, feeling that this better preserves the authenticity of the brand in question.

In contrast, directly operated stores should not be particularly affected in our view. They are genuine showcases for brands as well as places of contact with the consumer, where the purchasing experience must be outstanding and probably. Increasingly, they are places to collect products ordered online. In contrast, the strategy to expand the directly operated store network is set to be far more selective, sometimes implying closures, a policy already implemented as of 2016 by the majority of luxury brands.

Three major challenges for luxury brands

In our view, luxury brands are facing three main challenges in digital and e-commerce in particular:

1. **Recruiting new consumers** (whether millennials or not)
2. **Using digital tools** to attract consumers back to stores, especially new generations, after having neglected them due to the boom in digital.
3. **Improving the customer retention rate**. According to BCG, 60% of purchasers of luxury brands are new arrivals each year, but only 20% of these new customers remain loyal to the brand the following year. This is particularly true of millennials.

Back to the future… in five to 10 years, digital distribution of luxury products is set to undergo the same transformation as physical distribution did during the 2000s…

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