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Lashed to—gulp!—China

Evan Lorenz writes:

Luxury-goods sales and asset prices sink or swim together, it stands to reason. So it was, in the fall of 2002, that high-end purchases weakened as the dot-com market crashed and the prescient rumors of war in Iraq grew more persistent. Not surprisingly, as *The Wall Street Journal* then reported, the "fashion industry is downbeat for the spring."

A generation later, stocks, bonds and cryptocurrencies are slumping, interest rates are rising, Europe is warring and China—the second-largest market for so-called Veblen goods—is locking down. Heeding the cyclical echo, *Grant's* is bearish on Hermès International (RMS in Paris), the worldwide luxury purveyor.

Admittedly, the visible evidence in the boutiques of Manhattan might support a different conclusion. A *Grant's* reader reports that on a visit to New York last week his wife queued up to get inside the Dior and Maison Van Cleef & Arpels flagship stores only to discover that what she wanted was sold out. According to MasterCard's SpendingPulse data analytics, American consumers boosted their credit-card spending on luxury purchases by a year-over-year margin of 26% in April.

In the first three months of 2022, sales growth, measured from the year-ago period in constant currencies, came in at 27% for Hermès, 23% for LVMH Moët Hennessy Louis Vuitton S.E. and 21% for Kering, which owns such high-end houses as Gucci, Yves Saint Laurent and Balenciaga. "The strong growth in sales at the beginning of this year reflects the desirability of our collections and the confidence of our customers," Hermès's executive chairman, Axel Dumas, crowed in an April 14 press release.

But the Moët kind of bubbles aren't the only ones popping nowadays. From their respective heights in 2021 or 2022, the S&P 500 has dropped by 17%, the Nasdaq Composite by 27% and the Goldman Sachs Non-Profitable Technology Index by a whopping 71%. Nor are losses confined to public equities: Year-to-date, the Bloomberg U.S. Aggregate Bond Index has lost 12% of its value; and, according to a Refinitiv index that tracks venture-capital performance, investors in private tech companies are nursing losses of 45.8%.

But now, instead of riding to the rescue, the Federal Reserve is raising rates (supposedly, by an additional 200 basis points this year) and peeling off assets (supposedly, at a rate building to $95 billion a month by September).

CEOs have taken notice. Citing an "industry-wide downturn," Meta Platforms, Inc. is enacting a hiring freeze, Robinhood Markets, Inc. is implementing an employee cull and Mr. Market is slashing his formerly extravagant stock-based executive compensation. All in all, the tech industry will be minting fewer luxury shoppers.

Meanwhile, hodlers are left to wonder how much their digital wampum would have bought at the checkout counters of Kering-owned Gucci, LVMH-owned Off-White and Hublot (stores which have lately begun to accept crypto) before a cool $1.5 trillion was erased from quoted cryptocurrency values in the post-November digital bear market.

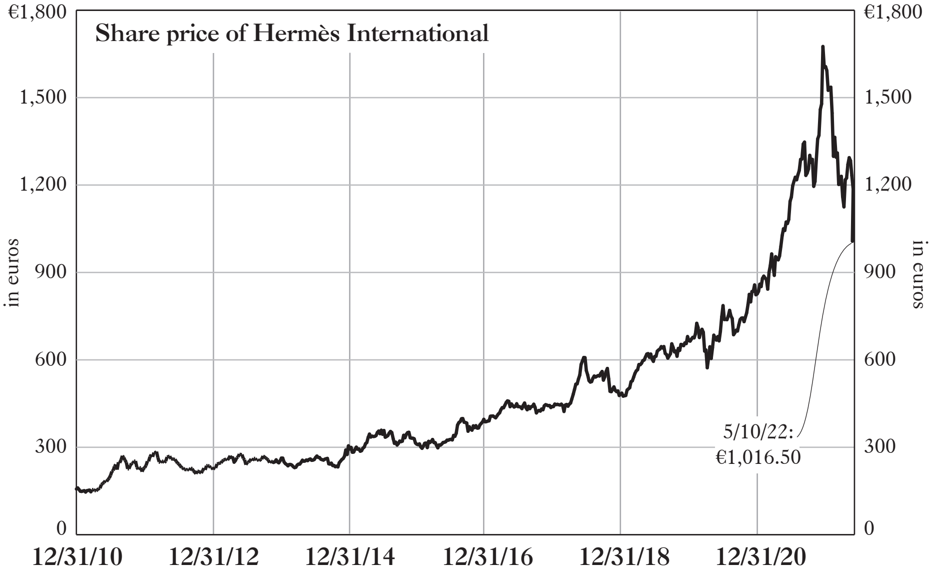
The war in Ukraine, along with rampant inflation, is tightening European purse strings. The latest readings of the GfK Consumer Confidence indexes for Germany and the UK are well below their 2020 Covid lows. In Denmark, gauges of consumer spirits are plumbing 33-year lows.

However, the real story is the People's Republic of China, which accounted for 21% of worldwide luxury sales last year, according to Bain & Co., and which, by 2025, again says Bain, will deliver as much as 27% of those receipts, overtaking the United States as the world's most important high-end retailing geography.

Zero Covid, with its attendant mass lockdowns, presents today's immediate problem for Chinese luxury vendors, but real estate looms as the stumbling block of the future. The property market is China's growth engine, delivering nearly 30% of gross domestic product and accounting for an estimated 78% of the net worth of the Chinese consumer. The lockdowns are exacerbating a long-running correction in home prices (*Grant's*, Oct. 1, 2021). In March, distressed-property developers absorbed the unwelcome news of a 29% year-over-year slump in the sales of new apartments.

In the absence of a booming population, it's the creation of new spending power that holds the key to growth in Chinese luxury outlays. According to World Bank estimates, China's One-

A luxurious price



source: The Bloomberg

Child Policy has consigned the mainland to demographic stasis through 2030 (specifically, to growth at the rate of just 0.14% per annum). After which, says the forecasters, comes outright, inexorable decline.

"China, over the last 10 years, has been the largest buyer in luxury products, whether it is art, watches, wine—basically anything that they can buy that shows some commitment to culture," Wendy Battleson, a principal at Art Strategy Partners, LLC, tells me. "It has not been the States. It certainly has not been Europe. That is going to have a material impact and probably already has."

The high-end watch market is already bearing some of the scars of China's troubles. Since March 1, prices of used Patek Philippe Nautiluses and Audemars Piguet Royal Oaks have declined by 7.3%. "This is a natural market phenomenon, caused by the disruptive growth we have witnessed in recent times, which has led to a depletion of demand," Italian timepiece experts WatchAnalytics contended in an April 18 Instagram post. Be that as it may, the pullback in the prices of previously worn watches appears to be hitting the primary market. In April, Audemars Piguet cut the starting price on the new Royal Oak 50th Anniversary Collection to €260,000 from €325,000.

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Hermès, founded in 1837 by Thierry Hermès in the Grand Boulevards quarter of Paris, sold high-end harnesses and bridles to the carriage trade. In 1880, Thierry's son, Charles-Émile, pulled up stakes to 24 rue du Faubourg Saint-Honoré, where Hermès remains today. In 1914, the House (as the company refers to itself) received exclusive French rights to market a novelty called the zipper, or, as it was locally known, *la fermetùre Hermès*. Over the past century, the House added the Kelly bag (after Grace Kelly), the iconic Hermès *carrés* (square silk scarves) as well as watches, jewelry and ready-to-wear clothing.

A signature Hermès leather handbag can take up to 24 hours to create, and if that *sac à main en cuir* should ever rip, tear or otherwise suffer insult, one may present it for repair at any Hermès retail store, which will forward it to the appropriate House workshop in France.

Besides its legacy brand, Hermès owns Saint-Louis (high-end stemware), John Lobb (men's shoes), Puiforcat (silver) and textile and furnishing fabric companies Métaphores, Bucol and Verel de Belval. Last year, leather goods and saddlery made up 46% of the top line, followed by ready-to-wear and accessories (25%), silk and textiles (7%), perfume and beauty (4%), watches (4%) and other (14%). Sales to Asia excluding Japan account for 47% of the 2021 total, followed by the Americas (16%), Europe excluding France (15%), Japan (11%), France (9%) and parts unspecified (2%).

Though a globe-girdling brand, Hermès manufactures 78% of its products in France. And, while it has been publicly listed since 1993, the House remains a family concern with Thierry Hermès's descendants holding two-thirds of the outstanding shares. Following a failed takeover attempt by LVMH in 2010, family members have agreed to retain control at least through 2031.

Luxury is a cyclical business, but one that has historically outpaced GDP. Over the past two decades, Hermès's sales have grown by 10.5% per annum and earnings per share by 7.5% per annum. Over the same period, growth in worldwide GDP has compounded by 5.4% in nominal terms. Hermès, confident in the future, says it plans to add one new workshop each

Hermès International at a glance
all figures in € millions except per share data

	2021	2020	2019	2018	2017
revenue	€8,982.0	€6,389.0	€6,883.0	€5,966.0	€5,549.0
operating income	3,530.0	1,981.0	2,339.0	2,075.0	1,922.0
net income	2,445.0	1,385.0	1,528.0	1,405.0	1,221.0
earnings per share	23.30	13.21	14.55	13.40	11.62
diluted shares	105.0	104.9	105.1	104.9	105.2
cash	6,696.0	4,733.0	4,384.2	3,479.1	2,931.9
debt	25.0	43.0	50.1	50.0	53.6
total assets	13,847.0	11,051.0	9,881.1	8,451.9	6,768.2

source: company reports

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year for the next five years (no easy thing, given management's concern, expressed in the 2021 annual report, about tightness in the supply of artisanal labor).

What drives growth is the rich getting richer. Every three years, the Federal Reserve polls households about their wealth and income for its Survey of Consumer Finances. In the 21 years ended 2019, the wealth of the top 10% of wage earners jumped by 209.1%, to an average of $4.8 million. Over the same span, the net worth of earners in the middle of the income distribution (the 40%–60% slice) rose by 76.8%, to an average of $223,600.

Perhaps surprisingly, Hermès says it plans to raise prices by just 3.5% this year. One might suppose that designer dresses, handbags and watches would have more pricing power. However, haute couture houses pride themselves on hiking prices in line with rising costs. High prices relative to the cost of the merchandise (Hermès earned gross margins of 71.3% of sales last year) mean, arithmetically, that luxury-goods makers need only lift price tags slightly to offset the pressure of inflationary costs.

Following a 7.2% sales decline in 2020, Hermès came roaring back with a 40.6% year-over-year leap in 2021. To give a sense of scale, the company had compounded revenues at a 10.8% clip in the five years ended 2019. Owing to the surge in sales, Ebitda margins rose to 46.3% of revenues last year, an all-time high and up from 40.9% in 2019. Index makers, duly impressed, added Hermès to the CAC 40 index in 2018 and to the Euro Stoxx 50 in 2021. Management would also like you to know that it achieved an ESG score of "A" from MSCI last year.

Investors, the recent share-price wobble notwithstanding, are capitalizing the post-Covid jump in sales growth and profit margins as if they were for all time. Hermès changes hands at 43.5 times trailing earnings and 25 times trailing enterprise value to Ebitda. In the five years ended 2019, it has traded at an average of 40 times earnings and 21.2 times Ebitda.

Of the 22 analysts who follow the stock, seven say buy and four say hold. However, there's no such equivocation on the part of the insiders, who, over the past 12 months, have spent €20.3 million purchasing a net 16,693 shares.

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The Street acknowledges some of these headwinds but denies that they will knock luxury growth off-course. In a March 8 note, a Bernstein Research team led by Luca Solca laid out three scenarios for 2022: Worst case, the sector grows 1% ("Looser monetary policy persists because Russia takes over Ukraine and economic sanctions need to remain in place indefinitely"); base case, the sector grows by 10% ("Governments continue the monetary tightening, while the war in Ukraine is resolved through diplomatic solutions"); and best case, the sector grows by 18% ("Monetary policy tightening is postponed, while the war in Ukraine is resolved through diplomatic solutions").

Missing is the macro situation actually in front of our eyes: namely, central banks tightening, the Ukrainian war persisting and China's housing crisis not abating. Nevertheless, analysts pencil in 16.7% sales growth and 10.7% EPS growth for the French luxury giant in 2022.

Hermès's success in China itself constitutes a risk factor for the company's share price. In the decade ended 2021, sales to Asia ex-Japan, i.e., mostly China, soared by 426% to €4.3 billion versus a 133% growth in sales to the rest of the world, to €4.7 billion. In consequence, non-Japanese sales in Asia now make up 47% of the total, from 28% in 2011.

For Hermès, it's hard to overstate the importance of the world's most populous country. If China were to stagnate this year while sales to all other geographies grew by 20%, the House's top line would show growth of only 10.5%, thereby missing expectations. If, over the past decade, sales in China had grown at the same pace as sales outside of China, 2021 revenues would be 26.4% smaller than they are now. With its current geographic exposure and valuation, Hermès is an expensive play on the continued effervescence of what economist Thorstein Veblen would call the Chinese leisure class.

However, real-time indicators are flashing amber. The Federation of the Swiss Watch Industry reports that Chinese watch sales dropped by 27.6% year over year in March after reporting a 2.6% year-over-year rise in the first two months of 2022. Over the five-day vacation period around Chinese Labor Day, which falls on May 1, travel spending in China slumped by 43% from the year-earlier reading.

"For the quarter, net sales in mainland China declined [by] mid-single digits," Estée Lauder Companies, Inc. CFO Tracey Thomas Travis explained on the May 3 earnings call. "Following a strong Lunar New Year in February, sales declined in March as additional Covid restrictions impacted many cities—most notably Shanghai, where our distribution center servicing the country is located."

The situation has only deteriorated since the end of March. The makeup giant slashed the guidance proffered on May 3 for the financial year ending June 30, implying that organic growth will drop by 10% to 18%, year over year, in the final fiscal quarter. Taking a pencil to the back of an envelope, we judge that sales to China will drop by around 45% or so in the summer quarter.

The bright side: shorter queues at the better boutiques.

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