Swetha Ramachandran (GAM) –Luxury's Broadening Appeal

Tom Yeowart: Swetha, welcome to the podcast. It's really good to have you on.

Swetha Ramachandran: Thank you for having me. It's a pleasure.

Tom Yeowart: So to kick things off, Swetha, I'd love to hear how you came to join the industry?

Swetha Ramachandran: It was somewhat by default because I was at university in my final year studying economics. My base case was always to go do a postgraduate degree, a master's in economics. I think somewhere towards the end of my final year, a bit of academic fatigue set in and I was like, maybe I should get a job, experience the real world for a bit. And by that time it was a little late for the standard applications. And there were two investment banks recruiting at that time. And I applied to one of them, which I ended up working for. I started my career at Goldman in their equity research division in Singapore, which was also quite exciting because it meant leaving London and living somewhere different.

Tom Yeowart: And so you started off as an Asian equity analyst at Goldman. You then went to Credit Suisse and Alliance Bernstein and then joined GAM in 2012. How did you end up focusing on luxury goods and can you tell us a bit more about the genesis of the strategy itself?

Swetha Ramachandran: After Singapore, I actually moved to Paris for a couple of years. A lot of my peers were doing MBAs. I decided to do something a little different and do a master's in French literature. And after that I moved to Credit Suisse to analyse the beverages sector on the sell-side, which was a consumer-related sector. And then from there, I had always been interested in investing from the buy-side angle rather than making recommendations, which I didn't know necessarily how they would be acted upon.

So I was very keen to sort of, if you will, put my money where my mouth is and test my skills out on the buy-side, which is how the transition happened to Alliance Bernstein. When I actually moved to GAM on the European equity team, I was a generalist and then started to focus more and more on consumer as time went on. And then the opportunity to manage this luxury brands fund, which GAM has actually had since 2008, presented itself when there was a change of manager with the old manager stepping down to do something different. She works for the Swiss Opera at the moment. So I would say that's quite a change of scene. And that's how I got the opportunity to really cut my teeth in learning how to run money in a very focused sector, which is the luxury sector.

George Viney: And that opportunity to run a thematic fund focused on luxury goods came along and you didn't look at it and think, I don't want to do that. So there must have been something about the sector that you understood already that it had its attractions. So what were they?

Swetha Ramachandran: Absolutely. So I had been an analyst covering the sector for quite a long time, and I did understand that luxury was widening. There was a big generational change happening. If you looked at when I took over the fund, it would've been maybe a third of the consumers of luxury goods were millennials and younger. Now it's flipped completely. In the last four years, there's been a dramatic uptake of consumption of these products by younger generations. It's more like two thirds of the sector's demand derives from younger generations. So there was a big change happening. There's also obviously the aspirational emerging middle class, particularly with the Chinese consumer that was emerging, that was driving a lot of growth.

And so what really excited me about the sector was this opportunity to tap into emerging market growth at a developed market cost of capital. To invest in companies that are listed in the West that benefit from developed market governance structures, but have this exposure to the emerging market and particularly Asian consumers.

Tom Yeowart: What's driving that shift to younger consumers?

Swetha Ramachandran: It's really interesting how luxury has managed to make itself more relevant. I think for a long time, particularly the wealthy or the upper middle classes in the US and Europe had somewhat forsaken luxury, seeing it as the purview of the nouveau riche and leaving it maybe for Asian consumers. I would say the pandemic has been a decisive factor in flipping that on its head, where we've seen renewed engagement in the luxury category among Western consumers at a time when actually China, ironically, has been quite depressed because of the cumulative effect of rolling lockdowns there.

The US has been such an interesting market for luxury because it's the wealthiest country in the world. Yet per capita, US consumers have not spent anywhere near as much on luxury as Asian consumers. Not just Chinese, but also Japanese and Korean consumers. Some of that, I think, has been cultural in that historically US consumers have preferred to invest in homes, in cars, rather than necessarily fashion. That I think has changed because of this generational shift with younger consumers who are more plugged into social media looking at what their peers around the world are wearing or doing.

Some of it is also that younger consumers have been maybe shut out from traditional home ownership with house prices being so expensive and have chosen instead to adopt a sort of a 'YOLO' mentality. You only live once, and engage in living well. And there's a really interesting article just this week in The Economist that talks about how the young spend their money, and the argument that was being put forward is that younger people today, self-care is a basic necessity. In the way that the post-war generation didn't have time or the appetite for such self-indulgence, that is really changing now quite materially.

Social media has played a big part, globalization, where we're all plugged into the same trends, that is also all played into why these brands are today so much more culturally relevant. One example I'd like to highlight is the campaign around the World Cup, for example, involving Leo Messi, as well as Cristiano Ronaldo, playing a game of chess on a Louis Vuitton chess board, which is quite iconic. And you think for luxury brand to insert itself into a cultural moment like that speaks to the fact that these brands are moving away from their core competence, which is making leather goods, to becoming more cultural brands if you will. And it's racked up at last count, over 85 million views on Instagram.

George Viney: Your mention of self-indulgence and self-care gets to some of the emotional, behavioural drivers of the sector. Before we get there, can you define luxury for us? What it means to you and how it's different from say, premium?

Swetha Ramachandran: It is a difficult sector to define quantitatively in a sense because you have, for example, the former CEO of Hermès, which I would consider a pre-eminent luxury brand, who has distanced himself and said, we are not a luxury brand, we are a quality artisanal brand that's focused on craftsmanship. So it's quite interesting how they've dissociated themselves from the word luxury. For me as an investor, when I look at a luxury brand, what I really want to see is a combination of four Ps, if you will.

So there's of course the product and we want the product to have luxury characteristics, which areas such as wines and spirits, cosmetics and skincare, personal luxury goods, watches and jewellery, fashion, leather accessories, all of these lend themselves to. So, we're looking at consumer facing, which also have a certain positioning. We want these products to be positioned in a way that they're not mass market, that by definition their audience is limited to middle class and upper middle class consumers. And also that they have provenance. This, I think, is essential to defining what a luxury brand is. If we look at the oldest luxury brands, Hermès, which I just mentioned has been around since 1837, as has Tiffany. And then we have watch brands that date back to the 17th century. So provenance, history, authenticity, all of that that gives a brand legitimacy is very important. And then I think ultimately there's also this idea of promise. When we look at luxury, we are also looking for a combination of history, but innovation, which is very important for these brands to keep renewing themselves with ever younger generations of consumers.

And the best brands we find are those that can rest on the laurels of their provenance and their history, but also keep exciting consumers with the promise of new products.

George Viney: How big is that market and how do you separate out those different relevant product categories?

Swetha Ramachandran: So Bain estimates, for example, that the entire luxury goods market is probably just over a trillion Euros in size. And that includes various subcategories such as the personal luxury goods market, which actually is only about a third of the total. And then we've got luxury autos, which interestingly enough makes up the largest proportion of that sub-segment because of the importance of classic cars and the resale market. And then wines and spirits, hospitality, cruises, private jets, fine dining, homewares... there's a lot of sub-sectors that go into making up this €1.1 trillion market. From an investor standpoint, the listed companies within the sector actually tend to fall within the personal luxury good sector. So that is about a €350 billion market by size in terms of revenues but obviously spawns of course some of the best known companies that we're all familiar with, such as LVMH, Kering. So these would be companies in the fashion and leather goods segment, but also watches and jewellery such as Richemont etc., and including privately held companies such as Rolex, Patek Philippe, which we can't directly access as investors, but indirectly through their retail operations.

George Viney: Is there an archetypal luxury goods shopper? Does that work across some of the categories that you mentioned? I'm thinking that there are lots of wealthy people that aren't necessarily natural buyers of these goods and services.

Swetha Ramachandran: Prior to me even coming to the sector, you know, I might have had an impression that it's, if you've seen the Devil Wears Prada, that it's the people in that movie who are the classic luxury consumers. But the reality is somewhat different. And this is where I think the changes that we're seeing in the world today with the centre of gravity of consumption shifting eastwards as well as becoming younger, are coming into play here. There's a really interesting statistic I just came across, which is that the average young generation alpha luxury shopper starts to become a luxury shopper at the age of 15 versus their millennial counterparts who first became acquainted with luxury brands later on, maybe 19 or 20, which admittedly is still very early. It used to be the case a decade ago that the average Western shopper would perhaps become a luxury consumer in their forties once they had maybe attained a certain level of financial comfort. And that has changed a lot now with the consumer becoming ever younger.

So even though there's no such thing as an archetypal luxury shopper, I would say there are certain characteristics. It tends to be a sector that in certain categories is perhaps more female led, which ties in well with the rise of female wealth, particularly in Asia. I think household formation characteristics play a part. People are getting married later, having children later, having fewer children. All of this allows for a longer period perhaps, of consumption on the self, which lends itself to luxury consumption as well. So there are some traits that we think are interesting and common to luxury shoppers. Mainly that they're getting younger and that they're being more led by the Asian and specifically Chinese consumer.

Tom Yeowart: The shift east is presumably linked to the growing middle class and growing affluence and those sort of trends. But as you also mentioned, there's a big behavioural aspect where I imagine a lot of 15 year olds may start their journey, but they're not really starting their journey because they're wealthy. It's aspirational. Can you talk more about those behavioural drivers that support luxury consumption over time?

Swetha Ramachandran: Gaming, for example, is a very interesting example of how luxury brands are relating to younger consumers. So, Gucci had a Gucci Garden, which was a private destination on Roblox about a year and a half ago, where it emerged that a consumer was willing to pay more for a purely virtual Gucci handbag than for the actual physical equivalent. So this bag that they bought using Robux on the Roblox platform, did not exist in the physical world and cost more than the physical equivalent. So that's an example of how behavioural changes are also driving luxury consumption. Moncler, another brand, has been very successful with skins on Fortnite, which is a very popular game.

You're right, that these are not consumers who are buying the $20,000 Birkin bag, but these are consumers who are getting interested in these brands through these innovative new ways that were not necessarily the target market for luxury brands to be in. If you had told me a decade ago that Louis Vuitton's app with Yayoi Kusama, which has now become one of the most downloaded apps, that's helping younger generations of consumers discover both art as well as the Louis Vuitton brand, I probably wouldn't have believed it because until very recently, many of these brands were very reluctant of embracing online. For them, luxury was all about the store experience, about being discreet, about being private. They didn't want to be ubiquitous. Neither did they want the transparency that comes from being online. What's changed is that the consumer has changed and the consumer is demanding that these brands be online and that has forced a behavioural shift from the brands themselves.

Luxury brands are widening. They are being given a right to play in areas where they previously had none. So, Hermès started out as an equestrian brand. They used to make saddles for horses. Now their watch business is bigger than some standalone watch companies. So if we look at LVMH, for instance, their perfumes and cosmetics division is bigger than some standalone cosmetics and perfumes companies. So the fact that these companies are entrenching themselves into more and more areas of our lives... Prada selling yoga mats, Louis Vuitton selling dumbbells, you know, there's no limit to where it might end. That suggests that these brands are becoming part of people's lifestyles more than they are necessarily becoming product or category centric, which is quite exciting for them in terms of why they can stretch their wings. Fendi, which is an iconic leather goods brand, is actually one of the most successful furniture brands as well, which you might never imagine. But that's how much the consumer is giving these brands a sort of a right to play in these various areas that were previously closed to them.

George Viney: Why is it that Western brands, on the whole, have done really well at exporting their brand identity globally? It hasn't really worked in the opposite direction of Chinese brands being successful, selling into Europe or US brands into Europe.

Swetha Ramachandran: Luxury is universal in that all countries have had their own definition of luxury and their own categories in which they've played in. But the European companies, firstly they started with brand. In Asia, for example, you've got incredible craftsmanship and artisan know-how. You used to, at least in China, before the cultural revolution in areas such as porcelain and ceramics et cetera. A lot of that was destroyed with the Cultural Revolution and the fact that they wanted to move China forward in a direction that had nothing to do with the past. And as you now know, a lot of the very major artefacts of Chinese history are found in Taiwan, in the National Museum in Taipei rather than in China itself.

And so that sort of created a vacuum in China. So as China then started to become wealthier in the early nineties, and as consumers sought to display their wealth, there was nothing that was locally Chinese for them to be able to access because all of that know-how had been destroyed. And so that vacuum was then filled by Western brands. India, a little bit different in that it has always had a very rich history of textiles and jewellery, but again, very fragmented.

What the European companies have really done is that they started with a brand and then they professionalized and industrialized this to the ability that nobody else has done. And it's often an interesting question that's asked is that as a society or an economy industrializes, will it then develop its own luxury brands? And we can look at two previous examples of this, which are the US and Japan. And really to scale the US has produced maybe one luxury brand, Tiffany, which is now owned by LVMH and Japan as well, there are a few notable local luxury brands, but neither the US nor Japan has managed to develop anything close to the conglomerates that we have in Europe. And I think that is because Europe started with the brand and then in the 19th-20th centuries very quickly moved to professionalize and industrialize them. And of course we had a few visionaries such as Mr. Arnault and Mr. Pinault, who then sought to make them into these conglomerates as well.

George Viney: And maybe also a benefit in northern Italy and in Paris of intense competition between brands. A bit like the way that New York investment banking has spread around the world because they've had that competition. You've had that in France, Italy in particular, because they're not a lot of consumer luxury goods brands that have come out of Northern Europe.

Swetha Ramachandran: That's an excellent point. That also ties in with the supply chain. In addition to the competition and the talent then being fostered at these companies, you've also got the supply chain, which is quite unique to luxury goods in that this is a sector where the supply chain is heavily Europe dominated. So it would stand to reason that, that know-how that you have, for example, in leather production in France or in Italy in fabrics and textiles that that would foster and be seen in a European company rather than an international one.

Tom Yeowart: We've touched on China and mentioned its importance to the growth in the sector, which has been particularly evident over the last decade. But could you talk more about whether you see that as a very long term secular trend, which will continue to support luxury good consumption?

Swetha Ramachandran: If we look back to when Beijing hosted the Olympics in 2008, the Chinese consumer made up less than 10% of luxury demand. Before the pandemic, that figure was a third, was 33%. Not only that, in 2019, the Chinese consumer drove virtually all of the growth for the luxury good sector. So, 90% of growth was being led by the Chinese consumer. In the last three years, there's been an interesting reversal of sorts, which is that the US consumer has really been on fire and the Chinese consumer, because of the impact of rolling lockdowns within China, as well as their inability to travel abroad has shrunk quite materially to the luxury good sector overall.

From a peak of about 33%, it's estimated that the Chinese consumer today is contributing to about 17% of the luxury sector. So clearly quite a material retrenchment. In large part, that's because of the absence of Chinese tourists on the world stage. So if we look back to 2019, more than half of what Chinese consumers were spending on luxury goods was taking place outside mainland China because of the attractive prices, which are lower in Europe because of the different duty and tax structures, as well as people traveling and experiencing and exposing themselves to new brands as they travel that they then want to purchase. Now that has completely come to a standstill. Not all of the brands that consumers would buy when they were traveling abroad have a footprint in mainland China. And so they were unable to make up for the shortfall through the increase in sales to domestic Chinese consumers. And then more recently, of course, I think it's safe to say that the rolling lockdowns we have seen since 2021 have had a very damaging effect on consumer sentiment.

Now what's really interesting is that we are coming to an end of that and there's been a clear rebound starting in January. The long-term picture I think is much more interesting, which is that China currently has a middle and upper middle class of about 400 million people. The Chinese government's common prosperity initiative that it unveiled in 2021 seeks to double this to 800 million by the end of the current decade. In China, the threshold for buying luxury goods is far lower from an income standpoint than in the west because at a much lower level of income, it's let's say $50,000 versus a $100,000 of household income in the West, a Chinese consumer will treat themselves to an entry level luxury purchase. So the more people that are entering that funnel of the middle class, the more target consumers there are for luxury products in China.

It's an incredibly underpenetrated sector today. So even though the Chinese consumer is very important to the luxury sector overall, we estimate that there are at most maybe 25 million consumers in China today that are purchasing any form of luxury products. That compares to a middle class of 400 million people, set to double to 800 million people by the end of the current decade should the common prosperity initiatives be successful, in itself of a total population base of 1.4 billion people. So these companies are barely scratching the surface. Louis Vuitton, for instance, has told us that in 2003, they had 300,000 Chinese consumers. By the end of 2018, that was 3 million in China and maybe another 2 million abroad. So that's still a small sliver of the addressable market in China that is availing of these products today, which is why we have high confidence in the long runway for growth from this consumer.

George Viney: I'd like to go back Swetha, to something that you said earlier on about the mixing of the industry towards younger consumers, the success the brands have had online and this seems to be a post pandemic phenomenon. You mentioned YOLO. We've heard the idea that no one wants to be the richest person in the graveyard, and so there's this impulse to spend. Do you think that that's sustainable? We hear a lot about the insecurity of the young, particularly when they're online. And maybe that feeling is expressed in the demand for brands which give people a sense of identity and community.

Swetha Ramachandran: So I think the industry has been relatively careful about not wanting to fuel consumption among people who really perhaps should not be buying luxury goods in the sense of their affordability. So if we look at buy now, pay later, which perhaps has been one of the culprits of this excess consumption in certain categories, buy now, pay later plays virtually no role in luxury brands. So luxury brands don't really allow buy now, pay later for the most part because they don't see this as a way of encouraging responsible consumption.

But there are some other aspects at play such as sustainability. So you're right, there is heightened insecurity among younger people, but also a desire to live more sustainably and perhaps to buy less but buy better. So this idea that people might not want to necessarily do a fast fashion shop every week, but accumulate more savings in order to buy something that really lasts. There's a UK based charity, Barnado’s that estimates that the average fast fashion item that's purchased is worn seven times before it ends up in a landfill. No one is doing that with a Gucci handbag or a Rolex watch or something that they have really invested a lot of money into purchasing.

People have, especially with the pandemic, started to flock to brands that they know and trust. And these tend to be the brands that are able to invest much more in communication and marketing, but also have had long histories such as luxury brands, and are able to give the consumer a distinct proposition for why they should be bought, which in many cases is the idea that they are more durable and longer lasting, and therefore can be purchased less frequently and last longer.

George Viney: And authenticity and brand heritage, it's only becoming more important as is the provenance of raw materials and clearly consumers are becoming more sensitive as to how these products get made. Can you speak a little bit about that, the sourcing of precious metals, stones, animal hides, and how there may be a tension among some of those younger consumer groups on those subjects?

Swetha Ramachandran: Absolutely. Supply chain transparency is so critical right now, and younger consumers are much savvier than their older counterparts in terms of identifying the sourcing of where their product is coming from. This is where I think blockchain technology has a huge role to play in the luxury industry. We've seen Prada, Cartier and LVMH jointly set up a consortium called Aura. Their idea is that they will use blockchain technology to identify the sourcing of the cashmere, for example, or the silk, down to the making of the end product, where the product is being sourced from.

As well as for verifying authenticity, which again is quite important in an industry that is beleaguered with counterfeit. Having that blockchain transparency is also quite useful. In hard luxury, there's a really interesting company in the US called Brilliant Earth that is transforming the engagement jewellery market by providing blockchain transparency on the source of the actual stone. So when you're getting engaged, it's a happy occasion. No one wants to have a conflict diamond. And what this company is doing is to offer diamonds that are beyond conflict free in offering complete transparency at every point of where the product is being sourced from. And younger consumers are particularly resonating with this. So what I really like about the luxury sector ultimately is the consumer votes with their feet and the brands are forced to adapt in order to keep up with changing consumer preferences.

Tom Yeowart: Taking a step back, Swetha. Can you talk a bit about how the rules of the game are different in the luxury goods industry to the broader consumer goods sector?

Swetha Ramachandran: What I like to look for when I'm looking for a luxury stock is these undeniably high gross margins. Not just high, but stable as well as defensible. Because in a lot of cases you may have a situation where excess competition can eat away at the profitability of these companies. Here the moat really is the brand. So if you've got a strong brand that has high gross margins, that are stable and defensible over time, then that is usually a recipe for compounding value over a long-term holding period. And that's what we like to see. These businesses typically tend to be less cyclical. So for example, if we look back to the last global financial crisis, the luxury industry overall was down by about 7-8% in revenue terms. Some companies actually escaped practically unscathed.

These are businesses that are quite stable over time, defensive, have a very high margin structure, which firstly derives from high gross margins, but also they are then able to scale all of their operating costs quite nicely as well, which leads to very attractive EBIT margins and an attractive return on invested capital, which again, through time, can deliver substantial value for shareholders. What I like to look for also are companies that have full control of their distribution. And increasingly that's where luxury is differentiating itself from other consumer brands, which are more reliant on a wholesale channel, on department stores, which we know are challenged. Luxury brands have, pardon the pun, but the luxury of being able to invest in their own distribution channels and their own retail, which again allows them to maximize full price sales and limit the availability of discount inventory, which as we know is so destructive for margins of other consumer products.

Tom Yeowart: What are some of the red flags you look out for? A lot of these businesses have real heritage, but they also have to adapt and keep evolving to stay current. And there have certainly been examples of companies that have wonderful heritage, but they do stumble and lose their way. How do you identify those companies ahead of time?

Swetha Ramachandran: It's incredible, isn't it? Because on the one hand we're talking about timeless brands, but then some of them actually die a pretty horrific death. Pierre Cardin was actually the first brand to enter China back in the eighties, and now it doesn't exist. So it's quite remarkable and absolutely it's a sector where you can't just rest on the laurel of saying, this has been around for 200 years, it's going to be around for another 200. That's a recipe to losing a lot of investor money.

In some ways the job of identifying these red flags has become somewhat easier because of social media, because the feedback is so instant now from the consumers who are the ultimate arbiters of what product and what brand is going to work that if you can keep your antennae up onto what people are saying on social media about these brands, you'll have a pretty good feeling for how these brands are going to evolve. So very recently, there was an unfortunate incident involving Balenciaga and their very ill-advised advertising campaign and that pretty much instantaneously translated into a drop off in sales for the brand.

On the flip side, it can also be interesting to see when a brand is about to take off because the mood music around it, either on social media or the fashion press starts to get bigger. It used to be that the first port of call was the fashion press that decided whether you were going to make it or not. Now it's more the case that it's big influencers and celebrities that are making the case for whether a brand will succeed or not. And it's very important, particularly in markets like China, which are so vast, to cut through the noise by listening to these mega influencers and what exactly they're promoting, that can lead us to have a good feel for which brands are winning versus which are not.

Then there's the designer cycle as well. For instance, the recently departed designer at Gucci, Allesandro Michele, came on in 2015 to much fanfare, much excitement. The brand was growing gangbusters about 50-60%% every quarter. And then there's a natural cycle that tends to take place where designer loses their creative mojo and the brand starts to look a bit tired and the consumer isn't seeing anything new.

George Viney: So it's fair to say that there are certain brands and you mentioned Gucci, but presumably there's also certain price points as well, and certain categories which are more susceptible to fashion risk. And that they're also more sensitive to innovation, which is a good thing if well managed, but can also fade and die in the wrong hands.

Swetha Ramachandran: Absolutely. You will never see Hermès do plus 50% growth in a quarter because they won't. Their products are much more timeless, they're not as fashion and apparel led. Their leather goods business is built on this idea of supply constraints that is inherent to the business. So you'll never see that kind of volatility of growth necessarily. It'll be much more steady eddie than many other businesses, where it's all about capturing the next new thing.

George Viney: And there's a murky area between, I suppose, masstige and higher price point fashion and the luxury sector. I'm thinking of that cohort of US brands, Coach, Kors, Kate Spade, who were amazingly successful and if you look at their gross margins, incredibly profitable, and would seem to have strong brands, but ultimately weren't timeless.

Swetha Ramachandran: I think that is a really interesting feature of the US brands versus the European brands. The US brands didn't develop brand equity in the same way that the European brands did because they built a heavy reliance on the outlet channel. So in the outlet channel, that's where you discount your product, you may make the same cash margin because you're also producing and selling a different product in that channel but it's very, very destructive for brand equity in the long term if you're not seen to be selling full price. The best luxury brands never go on sale. And there's a reason for that is because you don't want to encourage consumers to think of your product as something that can be discounted. You really want to get them used to buying your product at full price, which is something that the US brands have never really mastered. They're trying to wean themselves off a little bit from this dependence on the outlet channel, but it'll be very difficult considering what a huge proportion of volumes that makes up for many of these brands.

George Viney: LV also sells product in huge volume. Chanel, Gucci, these are all massive brands now. How big can they continue to get? It seems counterintuitive that the most popular brands can continue to get bigger because they will struggle to deliver on that promise of exclusivity.

Swetha Ramachandran: It's so interesting that when the Louis Vuitton brand hit 10 billion euros some years ago, the debate was, oh, well it's ubiquitous now. Now that it's hit 20 billion euros in size, the debate is when is it going to double from here. And I think a lot of that change is really because of the fact that these are no longer leather goods or fashion brands. These are evolving to become lifestyle brands playing into so many different areas of consumers' lives, that they're not restricted to growth in the leather goods market or the fashion market. If you look at an LV, which can gain so much cultural capital from a moment like the World Cup, the world is pretty much their oyster in terms of growth and where they could potentially grow. Why not grow in fitness equipment? Which, by the way, during the pandemic, they were selling £2,000, 2lb dumbbells. One of their best performing categories is fragrances, which arguably is not a core competence of theirs given their history. But again, people love the brand and want it to be a part of their lifestyle. So the right to play for these brands, which is what I keep coming back to, is massively wider today than it has been at any time in the past, which is what allows these companies to keep growing.

Tom Yeowart: We've talked quite a lot about the importance of heritage, but when you're looking at younger companies, what are the things you look at to give you confidence in the potential for brand permanence?

Swetha Ramachandran: So I'll give you an example of a company which IPOed at the end of 2013, Moncler, which we all know now. At that time I think there was a lot of scepticism about whether a mono product company, selling quite expensive down jackets could ever really move out of its niche. And now in a decade, the share price has gone up about four times. And I think nobody would argue whether it still has a right to exist or not, because it's built from its initial position as a niche purveyor of down jackets to becoming a more outdoors lifestyle brand, expanding into footwear, expanding into knitwear, always keeping their focus on the spirit of the mountains, which is what the origin story of the brand is. So Moncler, when it IPOed, the business model and the financial model was very akin to a traditional luxury model in that the gross margins at about close to 80% were very similar to what we were used to from the more established traditional brands.

Another aspect of these businesses that's very appealing, is that these are businesses that don't consume capital. Rather, they generate substantial amounts of surplus free cash flow, which are either then deployed into M&A, most typically that's what happens, or returned to shareholders via dividends or buybacks.

There are, of course, other examples that don't necessarily fit the bill. So more recently we had the IPO of Farfetch. Again, a newer unproven business model, luxury e-commerce company, seeking to disrupt the way that brands are sold. This is a business that relied very heavily on external capital, wasn't self-financing, wasn't able to generate surplus free cash flow. But if we look at 2020, they were the only game in town if you wanted to access luxury brands with stores closed, with brands themselves not really fully having proper online capability. Farfetch was the winner of the day. The share price in 2020 went up five times since the beginning. What concerns me in some of these instances with these business models, where they should have taken the winnings perhaps from the pandemic and chosen to reinvest that in a more sustainable business model. Instead, they chose to reinvest that in massive amounts of technology spend and are now again in a position where they're not free cash flow generative. The wider climate is very different in that the cost of capital is significantly higher today than it was in 2020. And so those businesses perhaps are more challenged today than they were then.

George Viney: Swetha, you mentioned a few things along the lines of choices that the companies make around pricing and channels and investments. Can you speak to us a little bit about the importance of management in luxury goods and managing these brands? It seems like the approach that LVMH or Hermès has taken, it's very distinctive and different to perhaps what would've been done 20 years ago in the industry. And that's one of the reasons why the big have continued to get bigger.

Swetha Ramachandran: If we think that some of these brands have been around for 150, close to 200 years, the importance of taking a very long-term view in managing these brands becomes critical. And that's also plays into this idea of family ownership, which is quite a distinguishing feature of the luxury industry versus other industries. I mean, if we look back to the failed IPO of WeWork, I remember one of the clauses that people had a big objection to was that the founder's children were going to take over the business. That would just not be acceptable in any other type of business. But in the luxury industry, we have come to take it for granted that the children will, of course, succeed the parents. In a lot of the cases, that's because they have ultimate control of the business such as an LVMH, where the CEO pretty much can decide who is going to succeed him. But I think in many cases, this multi-generational aspect comes from the fact that these brands themselves have been nurtured and developed over so many centuries that it takes that much of an approach to manage them into the future.

If we look at Burberry, for example, which with a 20 year view has lagged in total shareholder return versus LVMH. I don't think it's entirely coincidental that they have somewhat had a revolving door of CEOs. They've had six CEOs in 20 years, where LVMH has had one. So that sort of long-term orientation in a company with stewardship by a family, can actually generate a lot of value for outside investors over the long term.

George Viney: Where has online been disruptive for the industry? It seems to have decimated huge swathes of retail generally, but it seems to have supported the growth of the large incumbent companies.

Swetha Ramachandran: I think luxury goods, that's why they're in a real sweet spot when it comes to online. Because you're never going to get somebody wanting to necessarily buy an Amazon knockoff version, an Amazon owned brand version of a Birkin. That's just not going to happen because the power of the brand is so there. The experience, the heritage, all of that is so much a part of the proposition of buying that.

Where I think it has been really interestingly disruptive, is in resale. So the resale market used to always exist in luxury on a mom and pop bricks and mortar basis. What online has done is to really transform luxury resale into a much more global and professional operation. Obviously we've got eBay and Depop more at the entry point level. But we also have specialized, dedicated luxury resale platforms such as Vestiaire Collective, The RealReal, and all of these are connecting buyers and sellers from anywhere in the world with resold luxury merchandise. Some of it is authenticated, some of it isn't. What this is doing is to help open up the luxury sector to a wider group of consumers, who when they're young, may not initially be able to afford a brand new handbag or a brand new piece of jewellery from Cartier, for example. But they might be able to access that through the resale market. And that has huge implications, I think, in terms of recruiting new consumers and eventually trade them up as their earnings grow into becoming first-hand brand consumers.

George Viney: Is that a risk for the primary market, if I can call it that, that that entry level demand is met through the resale market and so they don't have that direct relationship. They don't capture the sales for the smaller ticket item of lanyards and wallets and so on. Would you take the company line that this is ultimately additive because it's drawing people into the categories?

Swetha Ramachandran: The evidence suggests that it's additive to the more popular and the more timeless luxury brands. Because what luxury resale is doing, is taking share away from the aspirational brands, where instead of, let's say buying a Coach or a Michael Kor's bag first-hand, you might as well buy a second-hand Gucci or LV bag. So what it's actually doing is to funnel consumers away from the aspirational luxury brands straight to the top tier. A recent phenomenon that we're noticing is that consumers are accessing the luxury segment today, initially from a higher price point than they were doing in the past. And that speaks to the fact that these top tier brands are gaining a disproportionate amount of share, both through resale and primary from the more aspirational luxury brands.

George Viney: It's also because the mega brands have raised the price points so much, and their profitability reflects that. They already had fabulous margins but the margins have taken a step up post pandemic, and the valuations have gone up too. So is that a concern or do you feel like they control the distribution and supply chain and pricing and their own destiny as a result of that, that they can maintain that level of profitability at a consistent rate of growth and therefore the valuations are reasonable on that basis?

Swetha Ramachandran: So pricing has always been in this industry more of an art than a science. Ferrari will always tell you this, whenever they launch a new car, they have a price in mind that they want to launch the new model at, then they test the market for demand and then they actually find out that they're going to be able to sell maybe 2x what they had initially planned to at that particular price point. So they will increase the initial suggested price by about 20%. The soft luxury goods also see this, and I think in the last year they have, more than in the past, used inflation as sort of cloud cover to be able to put through price increases that they may have otherwise not necessarily done. And they have done this because they saw through the pandemic that their price increases had very limited impact ultimately in terms of volume. The elasticity of demand was so low that they said, well, maybe we should have been doing this sooner and been increasing prices all along instead of waiting for the pandemic.

There's a risk potentially that they may go too far because if we look at the cumulative impact of price increases today, a like-for-like Chanel handbag, one of their classics, is maybe 40 to 50% higher than it was in 2017, for arguably not very little difference in functionality or product appeal. But I think what these companies are betting on is that they don't mind if volumes go down. What they want is to keep flexing their pricing power and keep increasing prices because every unit of pricing is significantly more margin accretive than every unit of volume growth because of the way operating leverage works. And so they are betting on the fact that they will still have this hard-core of inelastic consumers who are happy to pay these higher prices even as maybe the more aspirational ones fall away.

While the magnitude of margin expansion is unlikely to be of the same order that we saw in the last two years, these brands are well-equipped with their pricing power to maintain these levels of margins today.

George Viney: We're doing this podcast, you've got a very successful fund focused on this particular theme. Valuations have stepped up, and LVMH is the biggest company in Europe. So, do you think that the virtues of the sector and its growth and its profitability is lost on investors in any way? And where's the opportunity today in the sector from a prospective return point of view?

Swetha Ramachandran: We have spent a lot of time talking about the soft luxury and the personal luxury good sector, but luxury is much wider. So we have, for example, Ferrari and Aston Martin, and we can debate the relative investability of both those companies. We also have luxury hotel operators such as Accor, Marriott, Intercontinental, wines and spirits, Pernod Ricard, Remy Cointreau. So this is a much more diversified sector than maybe investors initially give it credit for.

And at any given point in time, there are going to be certain sub-sectors that are outperforming others. What we see right now with the reopening of China, which has multiple implications for the luxury sector, is a very strong pent up appetite for travel coming back. So as a result, for example, in our fund allocation, we have about 15% of our fund is directly exposed to travel exposed stocks. And then of course we have categories such as wines and spirits, cosmetics and skincare as well, which benefit directly from this increase in mobility and people moving around and seeing each other. What the Campari CEO called revenge conviviality, which is this idea that people are really going out and spending time with friends that they haven't seen for a long time.

The reason for valuations having stepped up in the luxury sector in the last three months is really excitement around the reopening of China. We've talked a lot about how China was the biggest driver of growth for the industry before the pandemic, has really given up that mantle to the American consumer in the last two years. But they're in prime position to regain that because of the amount of accumulated excess savings in China. Widely varying estimates on this ranging from between 4 trillion renminbi to 12 trillion renminbi, roughly equating to about 6-8% of Chinese GDP. That's a huge amount of firepower. What we know from the US example where again, the US consumer had accumulated about $1.8 trillion of excess savings at their peak, is that there's a huge appetite when things start to return to normal for consumers to start living life as they used to. And part of that is spending money, going out, enjoying themselves.

And so that's why we're optimistic about the fact that we don't think the China recovery has been fully priced into shares at this point in time. Because if we consider that the Chinese consumer in absolute terms is down 35% relative to 2019 on luxury spend, the opportunity not just for catch up, but also for growth from the recovered base because of the volumes of new entrance to the middle class in China, remains substantial and offers a very long runway in our view.

Tom Yeowart: It's a really interesting juncture because, to your point, there's clearly demand coming from China which will be supportive. But there's also the potential for recession in the US and elsewhere. We've talked a lot about the big businesses becoming bigger and selling to a broader set of consumers. Does that make them more susceptible at the margins to recession?

Swetha Ramachandran: So this recession, I think, will be interesting in that at least in the West, what we're seeing right now is a loss of a lot of white collar jobs, tech recession in the US, and those consumers are perhaps going to be more impacted this time around than let's say they were in 2009 when it was a lot of over leveraged households perhaps. And that is probably why also the luxury sector was less economically sensitive in that perhaps it wasn't the target luxury consumer that it was as badly affected, as it may be this time around.

So that is definitely one thing I'm monitoring. Results from Burberry and Richemont suggest to me that the US consumer is moderating from a very high base. If we look at the US consumer, they are about 60% higher than they were pre-pandemic in terms of their contribution to luxury spending. It's not sustainable that that can continue to grow at these same rates, but we remain sanguine that we are going to see an orderly moderation of the US consumer rather than necessarily a falling off of a cliff. And if that is the base case, combined then with the secular upside from the recovery in the Chinese consumer that underpins earnings estimates quite comfortably, if not provides a floor from which they can increase from here on.

In terms of what it means on a company level. I absolutely believe going into a recession that the stronger brands will be better positioned than the weaker me too brands. And this is because they have more ability to invest.

Tom Yeowart: Turning to the closing question, what piece of advice would you give a young Swetha Ramachandran at the beginning of her career?

Swetha Ramachandran: There's no such thing as a stupid question. And I think maybe when I started my career I was a little nervous, and now maybe it seems unlikely given I can't shut up. But I was perhaps afraid to ask questions. On the flip side, that made me more resourceful to look for answers myself. But I feel like there's a lot that I could have done more efficiently had I just stepped up and asked questions and said, I don't know, put my hand up, because there's so much available to us in terms of information, resources, help. People in this industry have been incredibly generous with their time. And I think, were I to go back, I would've made better use of that by asking questions and reminding myself that there's no such thing as a stupid question. And that every question is productive.

Tom Yeowart: Great answer. Thank you very much for coming on.

Swetha Ramachandran: Thank you very much for having me. This was so much fun.