Bulletin

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Mind my aura

THE DRIVERS OF SUCCESS IN LUXURY GOODS INDUSTRIES

A raft of plant closures in the British steel sector have been blamed on a strong exchange rate and fierce Chinese competition. They have also focused attention on those niche industries where Britain has been selling into Chinese markets with marked success. Walpole, the alliance of British luxury brands, has recently published research by Frontier Economics on the underlying drivers of their performance. This bulletin examines those drivers, and explores whether they are sustainable – and exportable to other industries.

Britain's luxury producers have a strong story to tell. Frontier's report for Walpole on "the economic and financial contribution of high-end creative and cultural industries" reveals that while they may account for not much over 2 per cent of the country's gdp (£32.2 billion in 2013), they supplied over 4 per cent of our merchandise exports. At a time when anxiety is increasing over the scale of

Britain's current account deficit, the vitality of a sector which produces three-quarters of its output for export is clearly important.

Luxury goods production has been expanding far more rapidly than the output of the economy as a whole, at an annual average rate between 2010 and 2013 that we estimate to have been as high as 7.8 per cent, and with a still faster rate of export growth. Employment growth in the sector has been faster still, averaging 12.6 per cent between 2010 and 2013.

When measuring their contribution, all industries like to claim "spillover benefits" for the rest of the economy. (These often have to be taken with a pinch of salt, since if aggregated for all industries they would tend to produce a total value significantly greater than total gdp!) But the luxury goods industries have a stronger claim than most. Spillover effects occur upstream – businesses in this category tend to invest heavily in skills and build longer and stronger relationships with their suppliers or manufacturers, and also to source relatively more in the UK – but also downstream, through their demonstrable contribution to the travel and leisure sector by attracting "shopping tourism".

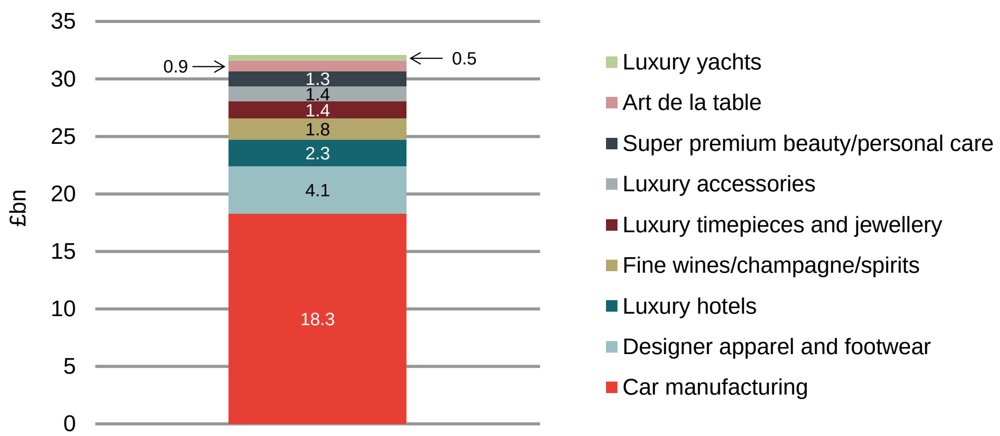
Recent research has indicated that nearly 40 per cent of luxury goods purchases worldwide are attributable to tourists. British data indicate that as much as 50 per cent of sales of luxury watches and jewellery, fashion, cosmetics and perfumes are tax-refunded, and therefore attributable to non-residents. The Middle East and China between them seem to have accounted for just over half of all tourist sales here last year.

In a recent survey, over 80 per cent of Chinese tourists cited shopping as a vital part of their trip. And recent data cited by The Economist suggests that the Chinese now account for 29 per cent of the sales of luxury goods worldwide, two-thirds of these purchases being made outside their own country. The importance of attracting them to do their "shopping tourism" in the UK was belatedly recognised by the Government in the changes it made to the visa system that were announced during the Chinese President's recent state visit.

WHAT'S IN A NAME?

Luxury goods have to be defined clearly, and data collected at the firm level, since national accounts do not distinguish them as a specific sector. The work Frontier has carried out, at both the national and international level, follows European definitions. Our analysis included the categories shown in the chart, and arrived at the following estimates of their contributions to gdp in 2013. As the chart shows, luxury car manufacturing is by far the largest element in the UK, and it has also been the fastest-growing. But other sub-sectors display a number of the same characteristics, and share some common drivers of success.

Figure 1. Luxury goods categories and contribution to UK gdp (£bn, 2013)



PAST AND PRESENT

A vital characteristic of luxury goods is the "aura" of quality, the perception of status and exclusivity associated with them. A high proportion of their value-added is attributable to IP, or "brand". This explains why the businesses concerned are highly sensitive not only to counterfeit competition but also to their ability to control distribution. Luxury goods producers have been ready to take legal action not only against counterfeiters but to protect selective distribution, often challenging competition regulators to do so. And across Europe, there is a trend towards more direct control of the final retail sale. However, the switch to online purchasing even of luxury goods presents new challenges to the protection of the luxury "aura".

Another common theme in the success of these businesses is the importance of clusters. This is apparent "downstream" (as in the concentration of high-end shopping in certain locations, particularly in the most "exclusive" parts of London), and is clearly important to the protection of the "aura". But clusters are also important "upstream", in the concentration of design skills or – for example - the cluster of inter-related businesses in "Motor Sport Valley", running from Oxfordshire to Northamptonshire. Such concentrations are the source of other spillover effects, as the build-up of skills in particular locations fosters business growth and draws in other knowledge-based industries.

A more difficult question to examine is the essence of this "aura". It has to be underpinned by craftsmanship and customer service. But to what extent does it depends on creativity and innovation on the one hand, or culture and tradition on the other? Successful luxury brands have usually proved adept at combining the two, altering the balance as the go along, in response to their customers' changing tastes.

Luxury hotels in historic cities (such as London) bet heavily on the tradition card, while knowing it won't save them if their bathrooms are old-fashioned, their digital services aren't state-of-the-art or their food dull. An obvious example of dramatic transition is Burberry, from reliable British raincoats to creative and innovative high fashion, the much-counterfeited signature fabric pattern going through several reincarnations on the way. Luxury boat-building is similarly design-led, with echoes of great naval tradition as a veneer rather than a constraint on the product. A key characteristic of such luxury goods producers is their focus on creativity right up to the leadership of the business. And "heritage" tends to mean not so much historical association as established traditions of craftsmanship.

WHAT'S TO LEARN?

There is an obvious tension between luxury businesses' eagerness to underline the specificity of their way of doing business and a tendency of policy-makers to hold them up as a model for others to emulate. So how much of their drivers of success in building global sales is, or should be, transferable? What should others try to emulate?

- **Realising the critical importance of protecting IP and/or brand.** This is, of course, clear in a number of non-luxury sectors too, but with a significant difference. In other sectors, the remaining bits of value added tend to be derived from operations carried out overseas along geographically unbundled value chains. Work by both the Organisation for Economic Co-operation and Development and the World Trade Organisation have demonstrated how this, rather different, model works (Apple and Zara providing two obvious illustrations).

- **Capturing "heritage" and developing skills that embody it.** Luxury goods producers have demonstrated how these can provide an avenue to growth. But part of their charm is their aura of exclusivity, which is means they are not easy to replicate for a mass market. So a broader lesson would be:

- **Finding the right way of positioning your business in global value chains.** If you think of these value chains as sets of complementary inputs, the trick for advanced countries is to position their workforce as complements to inputs from lower wage/less skilled sources overseas. Of course the picture is constantly changing, with both wage and skills gaps shrinking, so that the complementary analysis has to be regularly refreshed, but it leads towards:

- **Understanding how nations now trade: in "tasks" rather than "goods".** This also helps towards an illuminate the key point that what is wanted in countries like the UK is not simply "upskilling" but a careful matching of skills to complementary inputs and skill sets existing elsewhere.

FUTURE PERFECT?

Meanwhile, what are the future prospects for the luxury goods sector? Frontier's work indicates that with the right regulatory framework, they will continue to grow at a faster rate than the economy as a whole. Even if the Chinese economy continues to slow, there is powerful momentum behind the growth of a middle class with appetite for high-end consumer goods as a badge of prosperity.

However, it's far from guaranteed this will continue to benefit the UK. London faces hot competition for "shopping tourism" from other historic European cities. Recent problems over visas, combined with the competitiveness of the euro, have switched Chinese traffic from London to other capitals, and thereby switched purchases to other European luxury brands as well.

Meanwhile, while online markets present a challenge, rapid advances in 3D printing offer these industries huge potential. The ability to individualise output is highly relevant to businesses which trade on their reputations for creativity, quality, specificity – and exclusivity. The forecasts in our report of continued above-average growth in this sector depend not only on growth in their target markets, but also on their ability to innovate, in design, product and sales techniques.

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