

The Competition of Luxury Fashion Industry

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Abstract

This paper discusses the valuation of Hermès, a renowned luxury products manufacturer and retailer. The company name is associated with quality, exclusivity, and craftsmanship. The analysis includes discussion of main key points about the company, income statement, balance sheet, industry specific ratios, beta, and weighted average cost of capital. The financial statements and all calculations over the period of the last five years are included in the accompanying Excel spreadsheet. Hermès faces multiple business rivals including Prada, another high-end fashion designer, selected as the main competitor in the portfolio paper. Although the focus of the paper is on Hermès, the comparison of the two companies results in heavy coverage of Prada. To gain more perspective, both companies are also compared to the industry standards for exclusive apparel and accessories. Hermès has strengthened its position over time and became the second most valuable luxury brand in the world.

Key words

industry, manufacturer, retailer, industry competition, balance sheet analysis

1. Introduction

The average price of a Birkin handbag made by Hermès is around \$20,000 and easily reaches six figures price tag when exotic leather and custom order pieces are requested. Its resale market is also lucrative; the model in white crocodile leather was auctioned at Sotheby's at approximately \$380,000 back in 2017. Luxury

handbags became a well thought out investment with value appreciation said at times to outperform the gold (Hale, 2021).

2. Theoretical framework

2.1 History

French fashion house Hermès International Société en commandite par actions, often simply referred to as Hermès, is one of the largest luxury fashion houses. The first factory, originally specializing in equestrian equipment such as high-quality saddles and harnesses, was opened by Thierry Hermès in 1837. The product line expanded and evolved over time into a lifestyle brand featuring apparel, shoes, accessories including jewelry and watches, home, and original riding goods (Net Advantage, 2023b). Signature items include famous Birkin and Kelly handbags, fine silk scarves, and perfumes. Many of the items are crafted in France and distributed over 45 countries. Approximately 20,000 employees are engaged in the company focusing on affluent customer who appreciates craftsmanship and timeless design. This type of consumer demands excellence of product and throughout the whole shopping experience (Hermes.com, n.d.).

2.2 Current Position

Hermès, with its design, production, distribution, and retailing in 300 stores worldwide represents the second most valuable luxury brand in the world. The company stocks trade on Euronext securities market (ENXTPA) under ticker symbol RMS. Market value of shares has been steadily increasing. Current market capitalization based on a report retrieved on November 25th, 2023, is over 200 billion euros (Warring, 2023). According to the Global Industry Classification Standard (GICS), the company belongs to “Apparel, Accessories, and Luxury Goods” subsector under code “25203010” (Bellucci, 2019). The US NAICS code is “315990 - Apparel, Accessories, and Other Apparel Manufacturing” (Mergent, 2023).

2.3 Industry and Industry Competition

The luxury market has experienced significant growth in the last decade. It consists of nine segments, where luxury cars, luxury hospitality, and personal luxury goods together represent 80% of the total market. The personal luxury goods category, which Hermès belongs to, brought in \$313 billion revenue in 2022 (Jeong, 2023). The luxury goods are further divided into five subcategories as shown on Figure 1 below with luxury fashion having the biggest share:



Figure 1 - Luxury Goods Worldwide Revenue Share in 2022 (Jeong, 2023)

In recent years, the growth of luxury market significantly outperformed the growth of mass consumer goods markets. Although the industry experienced weakening demand of US and emerging countries in years 2015-2016, and more economic disruptions caused by Covid-19 in 2020, it has fully recovered by the end of 2021 (Jeong, 2023). The main drivers are high net worth individuals and tourism flows. Around half of the purchases are made while travelling abroad. Online retailing nearly doubled due to pandemic, thus contributing to further industry growth. The US and China account for 50% of the global luxury purchases (D'Arpizio et al., 2021).

In 2022, leather goods and saddlery account for major 43% of Hermès revenue, followed by 27% sales in ready-to-wear and accessory category, and 7% in silk and textiles. The company is currently expanding production sites to meet continuous high demand, keeping the leather workshops in France while maintaining traditional “savoir-faire” manufacturing methods inherited from six generations of craftsmen (S&P Net Advantage, 2023a).

2.4 Industry trends

The luxury goods market worldwide is expected to grow from 2022 to 2026 by 6% (Hazan et al., 2022). The purchases of high-end brands are expected to reach 419 billion US dollars by 2028. Increased sales are projected due to the rising number of high net individuals and air traffic. Ecommerce is an emerging category for luxury brands since online sales were previously not associated with excellent service. Millennials and Gen Z customers demand sustainability in fashion, it is expected. The main trend is exclusivity. While American and European customers associate luxury goods mainly with quality and style, Chinese customers value exclusivity and extravagance. Brands are working with K-pop culture artists as customers are willing to pay for products associated with their favorite artists (Jeong, 2023).

2.5 Market competition

The market competition includes luxury goods brands such as Louis Vuitton Moët Hennessy, Chanel, Gucci, Dior, Cartier, Rolex, Prada, Burberry etc. To pick the most appropriate industry comparison, one must be familiar with the portfolio of products the brands offer and the information available. For example, Louis Vuitton Moët Hennessy (LVMH) product range includes beverage industry and therefore exceeds apparel sector, Cartier and Tiffany & Co are jewelry-heavy focused, and Chanel is comparable but not publicly traded.

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Christian Dior is part of LVMH financials. For portfolio paper, Prada SpA (Prada) company is chosen as a main comparison for Hermès. Prada trades on Hong Kong Stock Exchange under symbol 1913. Figure 2 below shows most valuable luxury goods brands as of 2022 that compete in the personal luxury goods industry:

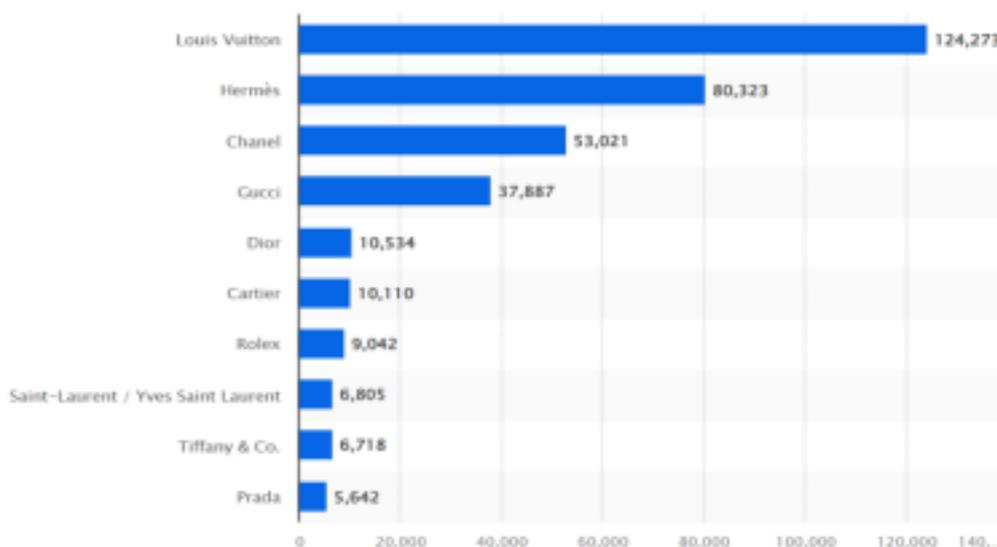


Figure 2 - Brand Value in 2022 in Million U. S. Dollars (Statista, 2023)

In the following section, financial statements and selected financial ratios of two companies, Hermès and Prada, are being discussed for the period from 2018 to 2022. The evaluation of financial performance over five years is then compared to industry standards. Finally, an insight into how the market values the selected companies is also being offered.

2.6 Financial Statement Analysis

In the following section, financial statements and selected financial ratios of two companies, Hermès and Prada, are being discussed for the period from 2018 to 2022. The evaluation of financial performance over five years is then compared to industry standards. Finally, an insight into how the market values the selected companies is also being offered.

2.7 Balance Sheet Analysis

Hermès assets totaled 8.5 billion EUR in 2018 and continuously grew to 17.5 billion EUR at the end of 2022 (see Figure 3 below). The consistent increase in current assets is especially notable in cash, flowing in from product sales, that accounted for 53% of total assets in 2022. The highest cash increase is from 2020 to 2021 in the amount of 41%. Although the total liabilities have also increased over the same period, the rate of growth is lower than that of its total assets. The company pursues a positive cash policy, which keeps borrowings at a relatively low level. Total equity grew at a faster rate than liabilities due largely to increases in retained earnings. A solid financial structure allows for a pursue a long-term strategy that includes creation, craftsmanship, and exclusive distribution network (S&P Net Advantage, 2023c).

Hermès (in Millions)	2018	2019	2020	2021	2022
Total Assets	8,451.9	9,881.1	11,051.0	13,847.0	17,459.0
Total Liabilities	2,977.2	3,305.2	3,660.0	4,435.0	5,003.0
Total Equity	5,474.7	6,575.9	7,391.0	9,412.0	12,456.0
Total Liabilities & Equity	8,451.9	9,881.1	11,051.0	13,847.0	17,459.0
Prada (in Millions)	2018	2019	2020	2021	2022
Total Assets	4,678.8	7,038.4	6,527.9	6,959.0	7,377.6
Total Liabilities	1,781.7	4,049.9	3,676.2	3,830.4	3,876.6
Total Equity	2,897.1	2,988.6	2,851.7	3,128.6	3,501.0
Total Liabilities & Equity	4,678.8	7,038.4	6,527.9	6,959.0	7,377.6

Figure 3 - Balance Sheet Highlights Comparison (S&P Net Advantage, 2023c; S&P Net Advantage, 2023h)

Even though the total balance sheet of Prada grew from 4.7 to 7.4 billion EUR over the same five-year period, the increase was not continuous (see Figure 3 above). The sharp 50% increase in total assets from 2018 to 2019 was followed by a 7% decrease from 2019 to 2020, and slow 6% growth in the next two years (S&P Net Advantage, 2023h). The main reason for the 50% growth of 2019 balance sheet was the compliance requirement to recognize the right to use the underlying assets of leases as non-current asset, as well as lease liability as long-term liability (S&P Net Advantage, 2023g). The highest cash increase is in 2021 in amount of 122% compared to previous year, driven by in-store sales. Prada's proportion of cash to the rest of the assets at the end of 2022 is 15%, way lower than the one of Hermès. Equity shows a steady increase attributable to positive net income closed into retained earnings. It is interesting to note that the 2020 decrease in retained earnings is offset by rise in reserves, resulting in overall rise in equity even during the pandemic (S&P Net Advantage, 2023h).

3. Conclusion

Hermès has been operating its global business successfully for many decades. The classic and timeless quality designs are synonymous with elegance, sophistication, and exclusivity. The psychological strategy of scarcity coupled with price increases results in high demand for the product reflected in the continuous revenue growth reaching \$11.6 billion in 2022. Company exceeds the industry standards for apparel, accessories, and luxury goods. With new store openings increasing online sales, and steady cash flow, the company attracts investors who wish to get exposure to the luxury market.

The exceptional leverage combined with remarkable sales produces a high operating margin and confidence in future outlooks. Apart from profit performance, resilience during economic crises is another example of the company's strengths. The ability to quickly adapt to challenges displays strong management. The expansion strategy is carefully planned and focused on impeccable product quality and on the building of unwavering customer loyalty.

Although the company weathered the storm of COVID-19 pandemic, the possibility of an overall economic downturn and subsequent decline in sales remains a possible risk for the future. Disruptions in the supply chain and scarcity of raw materials may arise due to geopolitical events or natural disasters beyond control, resulting in higher costs and lower profit margins. Another challenge Hermès faces globally is currency risk. The fluctuating exchange rates, and conversion could possibly lead to overstated costs and overpriced merchandise, thus negatively impacting financial performance.

To maintain a strong position, Hermès needs to stay relevant as a brand. To maintain its positive perception and avoid the cancel culture, the company must employ considerable effort and resources towards

sustainability and social responsibility. Investments in uninterrupted online presence enabled through the latest technology, pursuing creative collections, and building the image of prestige should all contribute to increased market share and value for shareholders.

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