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Family office news - issue 1: The investment side of luxury

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Hugh Devlin
CONSULTANT | UK

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Increasingly, we are advising families on private equity investments into businesses operating in the luxury sector be it fashion, travel or other consumer goods or services. Often a family member is drawn to this type of business because they like the product and can't imagine how the business could fail when the product is so good. One does need to differentiate between investments into established business and those into relatively young brands (or those which are to be relaunched).

One scenario which we see regularly is where an investment is made to provide a child of the family with a project. Frankly, this can be fraught with difficulties but particularly, in the luxury sector, it is even easier for the child to justify needless expenditure as a means towards 'developing' the brand. While it is often the case that a brand only fails because of the lack of access to capital to fund growth, every penny does need to count if the investment is to provide any sort of return other than keeping the child out of everyone's hair.

So what sort of things should an investment allocator look for? The first thing which crops up is not valuation (that comes later) but how much needs to be invested. Clearly much will depend on what stage the business has already reached. We have acted on a number of deals recently where, once terms have been agreed in principle, the investor has commissioned an independent consultant to review the business plan to determine whether the sum being invested will be sufficient to achieve what the investor is expecting. There often needs to be some careful drafting of the Heads of Agreement to give the investor sufficient comfort for him to incur the consultant's costs (these have ranged between $50,000 and $750,000 in our experience). Ownership of the resulting business plan is often a matter of negotiation.

The next issue which emerges is that of valuation. Here, the normal valuation mechanisms seem to go out the window and the sector creates its own. It's always worthwhile checking with an industry insider what the current parameters are, particularly since often what you will be approached to invest in will be, at best, operating at a break-even level. Much of the time one will be dealing with trademarks and it may be that what you are being offered are shares in a company with a license to use the trademarks. If that is the case, one needs to look quite carefully at the limitations of that license. As an investor, what you really want is for the trademark to be assigned to the company you are investing in (although this can limit the choice of available jurisdictions).

Success in the luxury sector revolves around knowing the right people to make things happen for you. The right agent, the right distributor, the right factory, the right attorney.

Nuance is so important in the product differentiation. It is no longer enough to go with the best agent you can find; if the rest of his stable are not complementary to your brand, you'll get lost.

If you do invest in a luxury brand, what might you expect? First, you are unlikely to see any real return on your investment for at least for seven years. The development of brand equity takes time. Who might you sell to? The three obvious groups, LVMH, Richemont and PPR have requirements which change from year to year. Private equity houses have been making acquisitions over the past couple of years and it will be interesting to see how these brands, like Jil Sander, Garrard and Ballantyne, fare. Currently, there is no private equity fund with sufficient investments in the sector to really benefit from the buying (or indeed selling) clout which the luxury conglomerates demand. Things can get further complicated if the brand shares its name with the creative director as the individual will often have different criteria which they will adopt in determining their disposal strategy. Designers get very protective of their brand, even if what is being proposed makes perfect sense from a business perspective.

Any investor in this sector also needs to think about what size they want the business to reach before choosing which segment of the luxury sector they wish to invest in. While it seems to be the case that fashion can expand into a diverse range of areas (including real estate!), it is a much more difficult move to start, in jewellery and then expand into clothing-although many people would be interested in booking into a Tiffany hotel.

One thing which is important is that it is rarely a good idea for the investor to be too actively involved creatively. One of the most important hires which a luxury brand can make is the range coordinator who takes the creative director's ideas and manipulates them into something that the public will want to buy. That person needs to be able to stand up to the creative and if the creative ultimately holds the purse strings, then disaster is nigh.

Are things any different in a luxury services sector? Well, yes. First, the R&D costs are significantly less-you don't have to reinvent your product range every six months nor do they have a strict 'sell by' date. However, you do need to think carefully about what you are commissioning from a designer and how you might use their brand going forward.

Everything is generally fine while the hotelier and designer are seeing eye to eye but, as happened a while ago with Ian Schrager and Philippe Starck, if the 'partnership' terminates, it creates real issues. These will include whether the hotelier can continue to use the designer's name.

So, with all of these pitfalls, why bother considering an investment in this sector? For many families these investments provide an opportunity to create a business with a personality about which they can be passionate and the products of which they can enjoy. However, once the novelty of attending a fashion show, store opening or product launch has waned, it's about hard work and outsmarting the competition. People can make fortunes-we are all aware of the success of Jimmy Choo-but more investments prove not to be worthwhile. This is often because, in their enthusiasm for the product, investors forget some of the basic principles of investment.

Authors

Hugh Devlin

CONSULTANT | LONDON

Corporate

+44 20 7597 6018

hugh.devlin@withersworldwide.com