Luxury business: responding to the crisis

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Executive summary

Many luxury goods companies are in the grip of a double crisis. A declining economy has hit sales, while a financial credit crisis has made debt difficult and costly to raise and service. The result is that many luxury companies find themselves in a liquidity crisis that requires urgent remedial action to survive.

During the first two quarters of 2009 stock markets have staged a partial recovery, and the rate of decline in property prices and in unemployment has moderated. Yet the corporate credit crisis has not gone away. Most companies in financial distress will still need to revisit their market positioning, their cost cutting strategies and their investment plans, and above all improve their cash management, if they are to survive.

In mid-2009 companies continue to enter financial crisis. The signs of approaching distress include missed budget targets, falling margins, worsening working capital and increased reliance on trade credit, while supplier conditions tighten.

Companies faced with these conditions should follow four 'golden rules' of survival.

- **Revise market positioning.** Companies faced with falling sales often persist for far too long with extended product portfolios or business lines that no longer make sense: rapid repositioning is vital.
- **Cut costs intelligently.** Cutting the right costs is difficult. While continuous cost reduction may be required for survival, it has to be achieved without reducing quality or effective marketing spend.
- **Maintain strategic investment.** Fear of increasing indebtedness in a debt-adverse market is leading some companies to freeze investment. That may keep stock market investors happy in the short term, but eventually it can undermine a company's competitive position.
- **Manage liquidity.** Although liquidity has become the leading issue for CFOs, cash management in many companies remains weak. Luxury companies, accustomed to a focus on product and sales, may be weaker than most. Acting to improve liquidity must therefore be at the top of the agenda.

Liquidity forecasting must play a key part in avoiding financial crisis: according to the 2008 Cash & Working Capital Survey, carried out by KPMG in the U.K., but also covering U.S. and Europe, many companies have a very poor record of forecasting what cash they will have, and where and when they will have it.

- KPMG's Advisory practice recommends that companies establish a task force dedicated to cash flow improvement, setting targets and paying bonuses on results, and running a 13-week rolling forecast reviewed daily.
- In the case of distressed companies with an international network and different IT systems, a move to centralized cash pooling may be necessary, as well as moving to cut operations that are burning cash, prioritizing solvent clients with discounts, implementing factoring to reduce payment times, and considering more sale and leaseback of assets.

Significant improvements are often achieved quickly, but making results sustainable requires the adoption of a 'liquidity mindset.' The opportunity is to achieve improvements over the medium-and long-term; the challenge is to make cash management become a natural part of everyday life for everyone in the company.

Luxury business: responding to the crisis

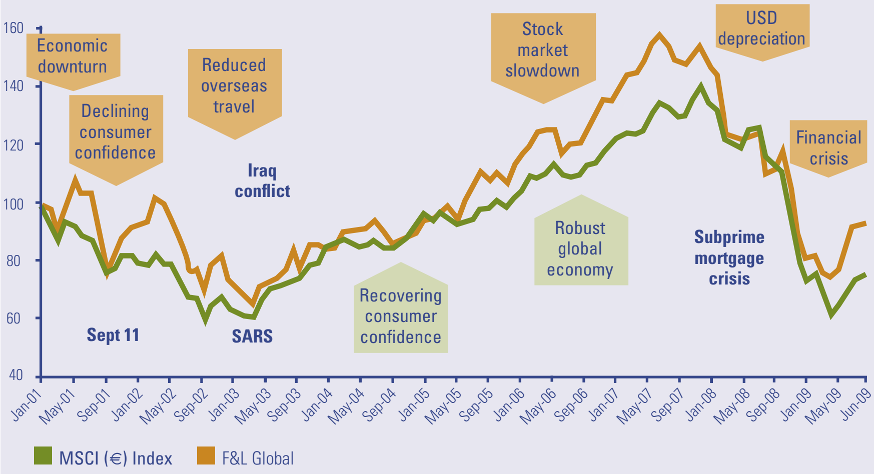
The credit crisis that has engulfed businesses of all kinds has hit luxury companies particularly hard. Many well-known names have been driven to the brink of insolvency. KPMG believes that for many more, survival will require a drastic re-appraisal of the way they do business.

The business landscape for all consumer companies has changed out of all recognition in the last 12 months. The global credit system has stopped functioning. Very large companies including many banks have come close to bankruptcy. Stock markets have fallen steeply, growth in mature and emerging markets has declined and in many cases turned negative. Commodity prices have fallen, and real interest rates have been reduced to near zero.

Adding to the sense of a crisis of confidence, the financial system that services the free market is broken. Where capital was formerly plentiful and cheap, now the financing needs of companies are getting more and more complex. Some companies have benefited from these changes. But most have suffered. Many good companies are at risk of bankruptcy.

Perhaps the most important aspect of this downturn – and the reason that so many companies are struggling – is that the broad economy is implicated. Whereas the last downturn that followed the dotcom bust was essentially the unwinding of a corporate investment bubble, in this downturn the consumer is over-leveraged. Consumer debt takes a long time to correct, and when final demand is so weak, the whole economy suffers.

KPMG's Fashion & Luxury Global Index 2001-2009



Source: KPMG analysis of Bloomberg data; Morgan Stanley Composite Index
Note: Updated: 22/05/09

Only a year ago many luxury companies believed that their brand power and the high net wealth of their customers meant that they were largely insulated from what happened in the broad economy. The idea was supported by the fact that luxury brand owners had delivered higher sales growth than other consumer companies since the end of the dotcom bust, and that their share prices had tended to hold up when other segments of the market faltered.

Events of the last year have shown that luxury companies are at least as vulnerable as other consumer companies in a recession. Middle-income consumers have reined in their discretionary spending sharply. The very rich have seen their net worth dramatically reduced by the fall in stock markets and property values, decimating demand for super-luxuries like yachts, cars and property-related purchases.

Luxury remains vulnerable
KPMG's Global Fashion & Luxury Index reveals the correlation of luxury business with the broad economy. The index tracks the share prices of 60 fashion and luxury companies on 10 different stock exchanges and in different market segments – from basic fashion, to high luxury, to top-end retailers.

The graph on page 2 shows the index performance versus a broad global stock market index, since 2001. It suggests that there is indeed a correlation between the luxury index and measures like economic growth, currency fluctuations and consumer confidence. It shows that in times of growth, luxury has performed somewhat better than the average, shown by the Morgan Stanley Composite Index. But it is also clear that luxury companies feel what everyone else feels: when average performance falls, luxury falls.

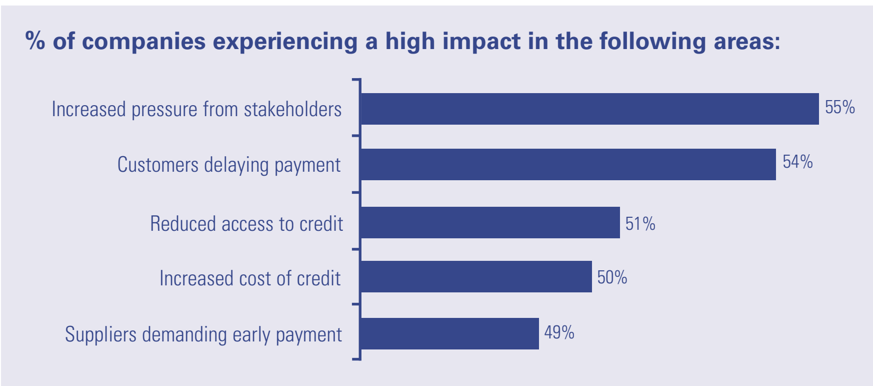
The credit crisis persists
During the first two quarters of 2009 stock markets have staged a partial recovery, and the rate of decline in property prices and in unemployment has moderated. Yet the credit crisis has not gone away: tight financial conditions and aversion to corporate debt are still restricting the ability of companies to raise new money and service their existing debts. At the same time cash flow is being squeezed by customers lengthening payment terms and suppliers tightening credit terms.

The bar chart to the right shows some results from the latest KPMG Cash & Working Capital Survey of more than 550 companies worldwide in 17 business sectors. Over half of those companies (55 percent) are experiencing increasing financial pressure from their stakeholders and say it is getting more and more difficult to get credit.

Source: KPMG analysis of Bloomberg data; Morgan Stanley Composite Index

For some luxury companies the pressure has come from the combination of falling sales at a time of rising finance costs. Many family owned luxury brand owners began to sell stakes to private equity investors in recent years as part of a search for expansion capital, taking on large amounts of debt in the process. The credit crisis has dramatically increased the cost of servicing or rolling over this debt, and in some cases the combined rise in finance costs and fall in sales has pushed companies close to collapse.

And the transition from apparent health to extreme financial distress can be very rapid. During 2009 KPMG has worked with a number of companies that in just a few months have gone from growth to crisis.



Source: KPMG Cash & Working Capital Management Survey 2008 in US, UK and Europe

Yet many of the early warning signs of approaching distress are there to see, for anyone who is watching the company's liquidity position closely.

Budget targets are suddenly missed; margins fall, working capital increases and companies become increasingly reliant on trade credit, while supplier conditions are likely to be tightening, and banks and clients are likely to ask the company for much more detailed financial data.

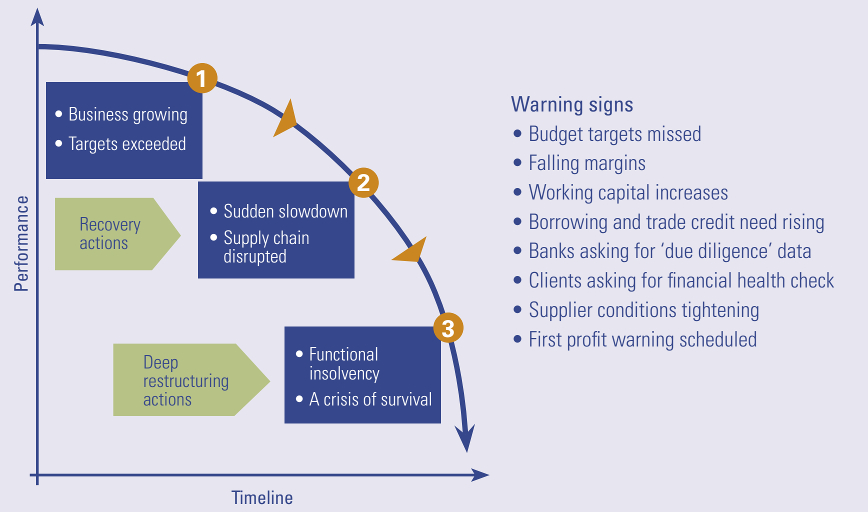
This process continues today: in mid-2009 KPMG sees companies, particularly medium-sized companies, continuing to enter the rapid crisis cycle from a position of apparent health. In most cases the core problem is one of liquidity.

How should these companies respond to such a crisis? There is a roadmap that luxury businesses can follow, according to Maurizio Castello of KPMG's Advisory Practice in Italy, an industry specialist who has been advising crisis-hit luxury companies on strategies and financing issues. "The key to surviving now and prospering in the future is for companies to realise how drastically and rapidly they need to improve their operational performance," says Mr Castello.

The 'golden rules'

"Companies approaching a financial crisis can be tempted to cut everything they can just to stay solvent," says Maurizio Castello. "That might be a mistake; if they are going to cut they need to cut intelligently, while still investing for recovery." He adds that KPMG's advisory experience with luxury companies during 2009 suggests that there are four 'golden rules' that luxury companies should bear in mind when planning for survival and recovery.

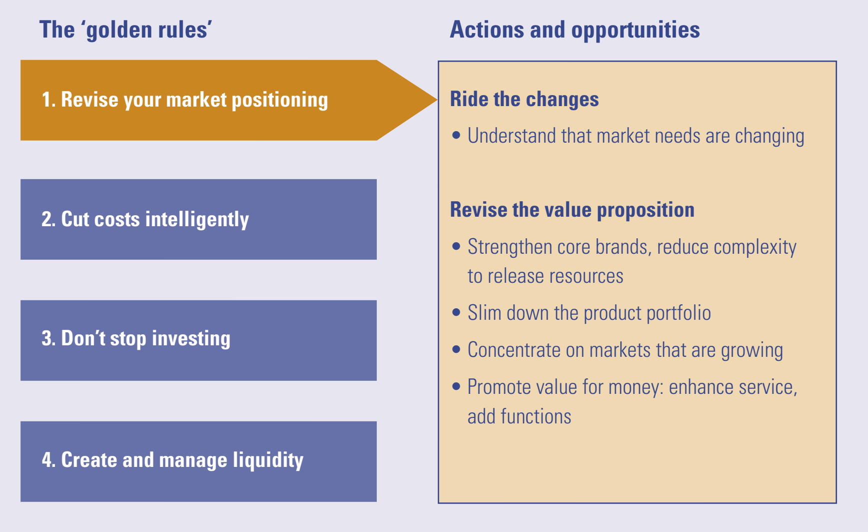
Crisis lifecycle is ultra-rapid



- **Revise market positioning.** Companies faced with falling sales often persist for far too long with extended product portfolios or business lines that no longer make sense: rapid repositioning is vital.

The problem may be particularly acute for luxury companies that have become accustomed to profiting from the power of their brands. KPMG recommends that instead of relying just on brand power, companies should refocus on those markets or segments that are most likely to sustain revenues. Companies should also consider whether they are delivering the right value and the correct service level: luxury based just on brand but not on value is unlikely to succeed in current conditions. Unprofitable business lines that are not part of the core business should be disposed of, to focus financial and managerial resources on primary products or more promising business areas.

Revise your market positioning



- **Cut costs intelligently.** Cutting the right costs is difficult. While continuous cost reduction may be required for survival, it has to be achieved without reducing quality or marketing spend.

Many companies reduce marketing budgets across the board, although the evidence is that weeding out underperforming marketing expenses while increasing spending on well-targeted marketing will get better results. Companies that stop communicating their message through marketing could rapidly lose market share and undermine their brands. Cutting jobs is also an easy win that can be costly in the longer-term: luxury companies frequently have large amounts of human capital embodied in the skills of employees, which once lost are usually gone forever, making a business re-launch in the recovery period very difficult. KPMG recommends alternative ways of reducing HR costs without firing the best skilled staff such as salary sacrifice, overtime banks and rationalising benefits.

"Above all you have to resist the temptation to cut quality," says Maurizio Castello. "Quality is intrinsic to the whole concept of luxury, and there can be no compromise on that. But what companies can do is cut out useless product accessories, or aesthetic details that cannot be perceived even by an experienced client but which may be very expensive to produce."

Cut costs intelligently

The 'golden rules'

1. Revise your market positioning
2. Cut costs intelligently
3. Don't stop investing
4. Create and manage liquidity

Actions and opportunities

Cost control must be strategic

- Do not reduce quality
- Support marketing and sales budgets
- Maintain investment in innovation and product development
- Invest in human capital
- Aim cost control at product profitability

- **Maintain strategic investment.** Fear of increasing indebtedness in a debt-adverse market is leading some companies to freeze investment. That may keep stock market investors happy in the short term, but eventually it could undermine a company's competitive position.

Luxury companies typically need to invest intensively in retail network development and intellectual property. Now is also when luxury companies should be maintaining investment in IT: "new technology can help to reduce product development and operations costs, provide real-time sales data from the store network, and can also support the development of alternative routes to clients such as e-commerce," says Maurizio Castello. Now is also a favourable time for the acquisition of distressed assets that may allow retail expansion or the securing of strategic supplies. "To finance such investments you have to re-think the way you access capital," says Maurizio Castello. "It is now much more important to communicate your strategy to banks and other providers of capital. You may have to explain your business plans in more detail, and give full information about short and medium-term management of the business. Banks are very afraid of getting involved in anything that might not pay. It is only when they have a really good understanding of your plans and the actions you are going to take that they can help you sustain your business."

- **Manage liquidity.** Although liquidity has become the leading issue for CFOs, cash management in many companies remains weak. Luxury companies, accustomed to a focus on product and sales, may be weaker than most. Acting to improve liquidity must therefore be at the top of the agenda.

Liquidity forecasting must play a key part in avoiding financial crisis, but it is not easy to forecast which important clients will pay on time, or to decide which strategic suppliers must be paid in turn, especially if the company has many foreign subsidiaries which trap cash. Maurizio Castello says that "accurate forecasting is vital in reducing an organization's exposure to financial risk, but many companies have a very poor record of forecasting what cash they will have, and where and when they will have it. They keep missing their targets and end up with pools of hidden cash doing nothing when it could be contributing to the business."

Don't stop investing

The 'golden rules'

1. Revise your market positioning
2. Cut costs intelligently
3. Don't stop investing
4. Create and manage liquidity

Actions and opportunities

If capital is available, invest

- Invest in new technologies to support sales and client experience
- Invest in e-commerce channels
- Invest in IT to improve quality and productivity and reduce time-to-market
- Invest in distressed assets

If capital is short, redefine the banking relationship

- Lower leverage wherever possible
- Communicate your survival strategy, share the business plan in detail

Create and manage liquidity

The 'golden rules'

1. Revise your market positioning
2. Cut costs intelligently
3. Don't stop investing
4. Create and manage liquidity

Actions and opportunities

Control cash in and cash out

- Stop burning cash: cut product lines, and cash consuming projects
- Involve clients & suppliers to redesign supply chain for better cash management
- Control the solvency of the client base, allow discounts to speed payments
- Introduce credit factoring
- Tighter control of order-to-cash and purchase-to-pay procedures
- Introduce sale & leaseback of strategic assets
- Sell non-strategic assets

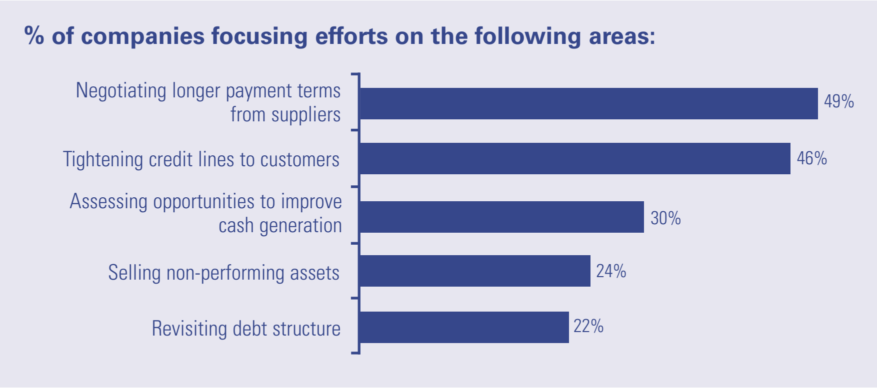
Cash flow forecasts are weak

For some years KPMG has been tracking how companies interpret their cash flows, through the KPMG Cash & Working Capital Surveys. The results from a panel of 552 companies in 17 industries, including luxury, show that while almost all companies produce regular cash flow forecasts, only 14 percent of companies find their forecasts accurate and over 80 percent of companies have seen their working capital position worsen in the last year.

The latest Survey shows that many CFOs are now focusing on the first line of liquidity improvement: negotiating longer terms, tightening credit lines, and selling non-performing assets. The challenge now is to achieve real benefits from these measures, make them sustainable in the medium-term and not to miss potential savings.

Making improvements in liquidity management sustainable in the medium-term requires more than a mere adjustment of existing processes, says Maurizio Castello. "To reach your targets what is needed here is a change of mindset," he says. "It is no good trying to deal with a liquidity crisis if you are stuck in a revenue and margin mindset. You need to focus on liquidity."

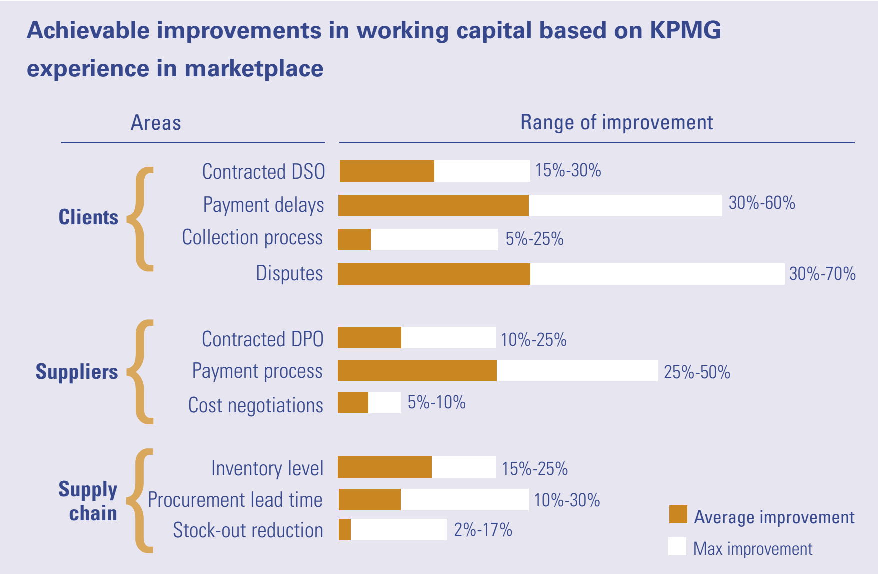
Significant results are often achieved quickly. Companies can achieve rapid results on receivables, on payables and on inventory, by acting to create a strategic segmentation of clients and suppliers, by managing customers proactively, and by introducing new payment term models, inventory classifications and stockholding strategies – that means clear policies on what to stock and where to hold it – and sharing forecasts with strategic customers and suppliers.



Source: KPMG Cash & Working Capital Management Survey 2008 in US, UK and Europe

However, for sustainable improvements companies may need to re-organize the financial function. If a business has an international network of subsidiaries – typical of a luxury company – with a lot of different IT systems, it may be time to move to centralized cash pooling. That gives financial managers access to overall available liquidity, and it may be the only way to make cash flow visible.

Focusing on liquidity can bring results. The chart below shows the ranges of improvements KPMG finds that companies can achieve.



Source: Data based on a set of working capital improvement projects in multinational companies

Conclusion

A roadmap for survival

"Don't try to do everything at once," counsels Maurizio Castello. He adds "yes, you need to go quickly – but still you need to go step by step."

"First, plan and control the cash. Second, use that control to reduce your working capital in a sustainable and lasting way. Then move on to other things that may generate additional cash – cash pooling, tax optimization, and vacant properties are just some examples."

In the end companies should recognise that optimal cash management is not just a fix for a temporary problem. It is about seeing liquidity as part of your strategic decision-making process.

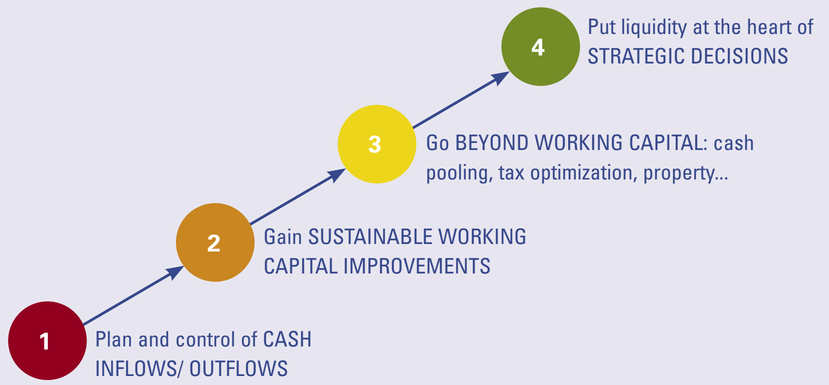
KPMG believes that cash management is a discipline. It makes company leaders think about products. It makes them think about the cost of complexity in their product ranges and in their production processes. It also raises questions about supply chain design – and it is very rare to find a supply chain that cannot be better optimized for cash generation.

Luxury companies do not need to be told how big a challenge they face today. But challenges are always opportunities. The opportunity is to achieve sustainable improvements over the long term, and the challenge is to make cash management a natural part of everyday life for everyone in the company.

Engendering a liquidity mindset is not just a crisis strategy. Cash and working capital are set to remain high on the corporate agenda. Winning companies can release cash from their businesses to provide financial flexibility. They can use today's opportunity to embed cash into their culture, and that can maintain a healthy balance between cash and earnings when economic prosperity returns.

The route to excellence in liquidity

KPMG Cash & Working Capital Framework



Liquidity is now strategic

All industrial processes and marketing decisions impact on liquidity

Product	Supply chain	Clients and markets
Complexity of range	Complexity of range	Complexity of range
Manufacturing complexity	Manufacturing complexity	Manufacturing complexity
Product lifecycle	Product lifecycle	Product lifecycle

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