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The worldwide expansion of luxury firms: forms, objectives and effects

Theme: Fashion beyond borders

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Abstract:

The globalization of the luxury market is not a recent phenomenon. However, the forms of this global presence have undergone significant changes during the last decades. While new markets have emerged, luxury companies have switched to a more integrated model of distribution developed their global presence and clearly become retailers.

First, we examine the various forms of distribution used by the companies to reach the foreign markets over time. We then show that if some external factors (conditions to establish subsidiaries, evolutions in the local distribution networks) influenced the modes of entry of luxury firms, strategic and economic reasons also explain this movement of integration and the increasing share of retailing in the companies' activity. We underpin these theoretical approaches by a series of French and Italian case studies to show the reasons provided by the companies themselves to justify this strategic evolution.

Eventually, we analyze the consequences of this general movement of downstream integration. This strategy has led to the setting of strong entry barriers at a sector level. In addition to their brand identity and in certain cases their specific know-how and assets, the “insiders” now have a bigger market power on their environment. Moreover, this strategy can partly explain the structure of the luxury industry for many consumer goods: a few big companies whose supremacy can with great difficulty be challenged by their smaller scale competitors.

Key-words: Luxury, France, Italy, Internationalization, Retail networks, Corporate strategy, Entry barriers.

1 / Luxury and Internationalization

a) A European specialization

Incontestably, the luxury sector is part of the economic identity of Europe. The history of our continent as well as the weight it occupies in the contemporary production of luxury goods justifies this assessment. More precisely, France and Italy concentrate the main part of the companies and employment related to this kind of products, even if Switzerland has significant position for watchmaking.

This specialization however does not have anything innate, and results in the case of France from a voluntarist strategy of imports substitution in sectors such as porcelain, silk or dyed cotton fabrics named “Indiennes” (Verley, 2006). The establishment of royal manufactures defended by Barthélémy de Laffemas and Henri IV then by Colbert and Louis XIV made it possible for France to become one of the leading vendors of luxury items for worldwide markets. The birth of the haute couture in Paris at the end of the 19th century was the second motive, supporting the development of a national industry for products of high quality and based on small productive units.

An international division of labor emerged during the 19th century between the United States and Asia on the one hand, strongly exporting primary products, and France and the United Kingdom on the other hand, specialized in products with higher added value. France and the United Kingdom specialized, one on artisanal productions thanks to its qualified labor force, the other on industrial manufacturing, because of stronger productivity.

b) European luxury on global markets

Whether for haute couture or high end craftsmanship, the US market has been the main destination for the French luxury companies. Central at the beginning of the 20th century, this market has suffered during the crisis of the 1930's, but has ensured the French couturiers a consequent development of their activity after the Second World War (Verley, 2006).

Luxury and internationalization go hand in hand systematically. Indeed, it is starting from the exchanges of luxury goods that the international trade was structured; in addition, the luxury companies are systematically strong exporters. These characteristics can be explained by the basic conditions of the luxury market:

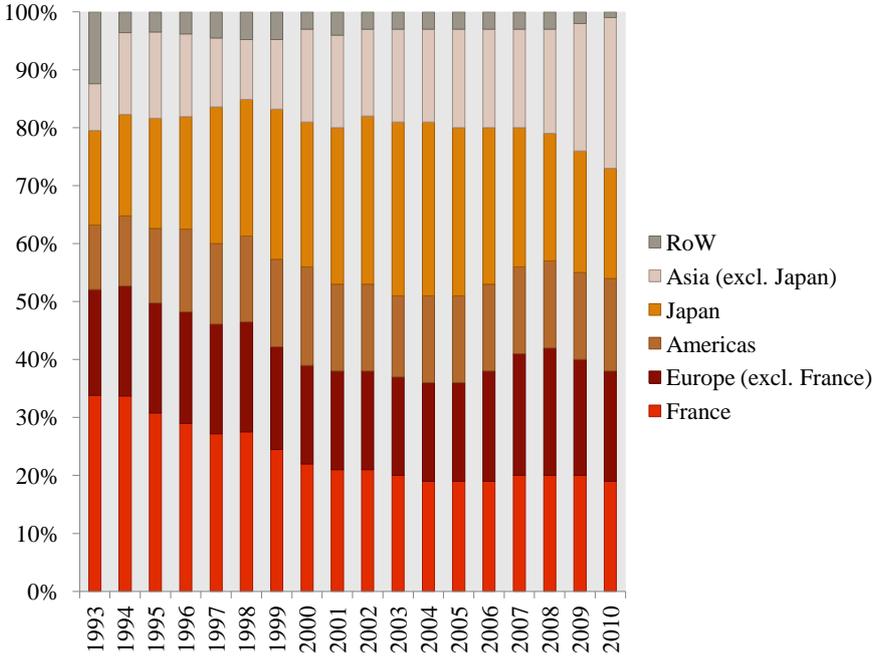
- In a context where transportation costs are substantial, only products enjoying an positive or constant price elasticity of their demand can be exported, which is the case for luxury items. Indeed, the cost overrun related to transport, included in the retail price, will not have a negative effect on the level of consumption. Traditional products, whose consumption decrease as the price increases, are on the contrary penalized and can't be exported when the transportation costs are significant.
- In addition, since luxury products are addressed to a negligible fraction of the population, the narrowness of the interior market can represent a handicap for the development of luxury companies, which are naturally export-oriented in order to find a wider clientele.
- Lastly, luxury items are carrying an identity linked to their manufacturers and their country of origin, and are strongly embedded in its culture. They have thus the ability to be exchanged because they do not have equivalents on the worldwide markets.

The exportations of luxury products were, until in the 1970's, primarily directed the United States and Europe. Soavi (1999) shows thus that in 1921, the European markets weigh for 45% in French exports of luxury items, the United States for 27%. From the 1970's, the strong economic development operated by Japan is at the origin of a new phase of growth for the French luxury companies, in particular for fashion and leather goods. (Jacomet and Delpal, 2011)

Since the middle of the 2000's, the Asia-Pacific zone, consisting in China, India and many other countries experiencing strong economic growth (Singapore, Taiwan...), clearly took

over and represents the principal pool of growth for the years to come. By way of an example, the following graph shows the evolution of the respective weight of the different areas in Hermès' turnover. Dynamism of the Asian markets (except Japan) unrelentingly made decrease the share of the markets known as mature (United States, Japan, Europe), although the sales in those always post a solid growth.

Chart 1 – Hermès sales breakdown by area (1993-2010)



Source: Annual reports

The swing of the European companies towards the Asian markets constitutes over the long period a new upheaval of the luxury market. This change was in addition accompanied by a radical modification in the forms of presence of the companies on these markets.

2 / Internationalization and Retail

For about twenty years, an abundant literature has been devoted to the relationship between internationalization and distribution on the one hand, and to the choice of entry mode by the firms on the international markets.

1) Theoretical approaches

The theoretical works exploring the process of internationalization of firms are organized around three main themes (Melin, 1992):

- The way in which the companies penetrate the worldwide markets. These approaches analyze the choice between integration and outsourcing for the management of a foreign branch.
- The nature of the international exchanges within the organizations (transfer pricing, transaction costs...) or between institutions.
- Coordination processes (monitoring systems, relations with the local government...).

Concerning the first topic, which interests us particularly, various models describing the stages of internationalization exist. A first approach was to decline Vernon's model of the product lifecycle, but this one applies better to a macroeconomic level than on the level of a company in particular. In addition, it is more relevant for products with long life cycles than for those whose obsolescence is fast. One of the most recognized models was developed by Johansson and Vahlne (1977) and is called Internationalization Process Model or Uppsala model. These authors explain the worldwide development of firms by their need to limit the psychic distance with their markets of establishment. They will enter in priority on the markets which they understand best, in general the countries bordering, before penetrating the more distant markets once the psychic distance with those will have decreased thanks to the better knowledge and improved competences of the company on international presence. This model has been criticized because of its deterministic conclusions. Moreover, it is more adapted to explain the first phases of internationalization than for already well-established firms with a global presence. Lastly, a third kind of models, gathered under the name of "eclectic paradigm" (Dunning, 1988), explains the nature of the internationalization of the firms by three types of variables: ownership-specific advantages, internalization advantages and location advantages. The ownership-specific advantages relate to the assets a company has generated from its possession of certain specific features (international experience, marketing skills, trademarks, unique know-how...); the internalization advantages are related to the theory of transaction costs and explain the global presence of companies by the existence of market imperfections which makes the hierarchy more efficient than the use of the market; finally, the location advantages are related on the potential of the host market and

the reduction of risks inherent in a direct presence of the company. This model was based on an analysis of manufacturers and was later adapted to the retail sector (Park and Sternquist, 2007). The main critics that it faced were its static character: this model is adapted for a descriptive approach but doesn't explain the way in which the companies generate little by little these advantages by themselves.

Chan Kim and Hwang (1992) for their part proposed an eclectic model based on three types of variables: strategic variables of the industry (global concentration, strategic synergies and motivations), variables linked with the environment of the companies (country risk, uncertainty of demand, intensity of competition...) and transaction-specific variables (level of firm-specific know-how, tacit nature of know-how). This approach shows that companies tend to proceed to integration of their subsidiaries when 1/ the country risk is weak, 2/ they have experiment in the country, 3/ global synergies and concentration are strong and finally 4/ when its know-how is of tacit nature, i.e. inarticulable and not transmissible. They add that integration has as a virtue to reduce the transaction costs which can arise from an opportunist behavior on behalf of the partner of the company, which can use the assets of this one (know-how, brand...) in an inappropriate way. The principal limit of this approach is that it explains internationalization on a global level but doesn't really explain the development process of companies on worldwide markets.

This economic approach was also developed by Horstmann and Markusen (1987), which propose a model offering the choice to a company between giving a license for its products to a foreign partner and investing itself on this market, in a context of imperfect information of the consumer on quality. The authors show that to guarantee its reputation, the company will be encouraged to ensure itself its activity abroad, more especially if its products are high quality products. This result is completely relevant to understand the strategy of fashion and luxury companies, such as Gucci, Christian Dior or Yves Saint Laurent which have given up in the 1990's the massive use of the licenses which they made hitherto.

More specifically, a whole side of the theoretical literature relates to the activities of retail (for a survey over the last twenty years, see Alexander and Doherty, 2010). The explored sets of themes are more or less the same ones as in the generic models of internationalization. Subjects such as the motives for internationalization, the selection of the target markets, the choice of entry mode or the strategies of setting in market (standardization *vs.* adaptation) are thus listed (Swoboda and *al.*, 2009).

Lu, Karpova and Fiore (2011) have analyzed the factors influencing the entry mode chosen by fashion retailers. After having defined the four degrees of presence on an exterior market (export, franchise, joint venture and wholly owned subsidiary), they list the conditions under which must be exerted a precise control on its distribution by a company. Some concern the company itself (existence of specific assets, significant brand equity, required financial capacities, strong international experience), other its environment (weak country risk, cultural proximity, weak governmental restrictions), others finally its market (strong potential of market, small degree of competition). Wigley and Moore (2007) match these explanatory factors of three critical success factors: complete consistence between the brand management at a global scale, the distribution channel choice and between the imagery of the brand and its incarnations (shops, staff...).

Doherty, Moore and Doyle (2010) were specifically interested in the strategy of luxury companies to use their flagship stores as modes of entry on new markets. This new kind of entry mode has to be added to the five types already defined by Dawson (1994): internal expansion (the company opens individual shops using in-company resources), merger or takeover, standard franchise agreements, joint ventures (in-stores concessions), exchange without controlling interest. Flagship stores must be distinguished from the traditional boutiques both by their physical or tangible features (their size, their installation, their localization and their cost) and the functions which are assigned to them. Beyond the basic commercial role, the authors show that flagship stores are also used to establish the reputation of the company and its brand on the market, as supports of communication and reception for the press and the business partners (franchisee, external distributors), to accommodate consumers in search for a greater exclusiveness in products and services. This kind of shops is logically systematically managed directly by luxury companies, because of their cost and of the control required on all the plans.

2) Cases of luxury companies

Our approach consists in confronting the approaches we have just presented to the evolution of the practices of a selection of luxury companies. Due to their seniority and available testimonials over long period, we will particularly focus on the companies Louis Vuitton, Hermès and Gucci.

Table 1 - Sales breakdown by area (2010)

| | Europe | Americas | Japan | Asia-Pacific | RoW | Total |
|------------------------------|--------|----------|-------|--------------|-----|-------|
| LVMH Fashion & Leather goods | 29% | 18% | 16% | 30% | 7% | 100% |
| Gucci | 30% | 18% | 12% | 36% | 4% | 100% |
| Hermès | 38% | 16% | 19% | 26% | 1% | 100% |

Source: Annual reports

Nowadays, the necessity to tightly control their distribution makes consensus among all the researchers (see Moore et al., 2005, 2007, 2010) and managers of luxury companies. It is however advisable to remind that only a few decades ago, in the 1980's, these companies did not at all have such an international visibility nor exclusive control of their distribution.

Louis Vuitton

The case of Louis Vuitton is emblematic with many regards. Kyojiro Hata, former president of the Japanese subsidiary of Louis Vuitton, described in detail the situation at the time (Hata, 2004). In 1977, the company had only two fully owned shops in France (in Paris and Nice) and secured a presence on the US and Japanese markets through trade agreements. In the United States, the company had a license with Saks Fifth Avenue. And for Japan, Louis Vuitton treated with the importer Mitsui & Co and the wholesaler Sann Frères. In spite of that, many Japanese customers went to the Parisian shop and bought products in great quantity. The company thus ordered a study which highlighted the presence of its products in many Japanese shops that it had not selected, which clarified the existence of reseller networks based in Paris and selling their goods in Japan with profit (the price change was then substantial between the French and Japanese shops). This led the company to limit the sales to the Japanese customers. The study carried out by Mr. Hata also explored the methods of establishment used by luxury companies in Japan, highlighting the need for inventing a new and original model. This one took the shape of a double contract between on the one hand Louis Vuitton France and the Japanese department stores (distribution contract) on the one hand, and between Louis Vuitton France and Louis Vuitton Japan on the other hand (management contract). Indeed, recent changes in the legislation authorized the foreign companies to establish themselves in Japan without any local partner, which was little known

by many Western businessmen at that time. Moreover, Louis Vuitton and its future representative in Japan had a critical point of view on joint ventures, which were seen as sources of conflicts and consequently of bad management.

Initially, the Japanese subsidiary had essential mission of ensuring a policy of distribution and communication in conformity with the requirements of the House. Even though the shops and the salespersons belonged to the department stores, the company wanted to behave as a retailer and soon became one. Starting from 1981, the subsidiary was turned into in private company having for additional missions the importation of products and the distribution through wholesale. In parallel, the company organized the multiplication of the retail stores directly controlled by Louis Vuitton. From the middle of the 1990's, the company reinforced its implication on this market by replacing the department stores salespersons by its own employees. Since, the will of Louis Vuitton is to have a direct presence on every market, except those presenting legal constraints to foreign installation or very strong specificities.

The motivations to internationalization are in this case at the same time offensive and defensive. Offensive because the surge of Japanese customers in France testified of their noteworthy appetite for Vuitton products and thus the strong potential this market represented. Defensive because retail stores opening in Japan also aimed to counter the presence of resellers (in particular through the reduction of price differences between France and Japan) and to preserve the company image.

Hermès

Created in 1837, Hermès faced major evolutions carried by each successive generation which directed the company (Guerrand, 1988). Thierry Hermès, the founder, sold through wholesale harnesses and saddles. His son Charles opened the first shop and started retailing. The third generation, incarnated by Emile Hermès, understood the nearest end of horse transport and diversified the company towards leather goods, fashion, silk... He also started to lead the company on the worldwide markets. In the first times, the company did not open shops but employed "travelers" who where selling saddles, harness, covers for horses all around the world. The first subsidiaries were created in France in first half of the 20th century in order to follow the high net worth customers in her vacation resorts (Vittel, Deauville, Le Touquet, Biarritz, Cannes). As for the European distribution, the company first privileged representatives for the main French cities (franchisees are named "concessionnaires" by Hermès) whom were chosen on strict criteria: to conduct an extremely detailed market study

on the potential of the cities and sites, to have a lease in a promising city, three years of rent and two years of business expenses in bank. This distribution through “concessionaires” was primarily structured after the Second World War, with the increasing complexity of the international trade. This system showed some limits, in particular the matter of the price change between France and the other countries: *“So that our representatives can make some benefit without practicing excessive prices, we were obliged to increase our retail prices to be able to make them a rebate. Obviously, if people had to spend 50 to 80% more abroad than in Paris, they would have taken a plane and our agents would not have had a raison d’être”* (Guerrand, 1988). Then, the passage of a system of representatives to sales in directly operated stores is relatively recent, since it dates from the 1990’s.

Table 2 - Hermès – Evolution of the distribution network

| | 1995 | 1996 | 1999 | 2001 | 2004 | 2006 | 2008 | 2010 |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Nb of Directly operated stores | 67 | 77 | 98 | 109 | 133 | 145 | 166 | 193 |
| Nb of Franchisees (“Concessionnaires”) | 78 | 77 | 97 | 97 | 104 | 107 | 121 | 124 |

Source: Hermès Annual reports

The company first chose the closest markets to France (Swiss, Germany, Italy), in terms of culture and legal framework, before settling in the United States and Japan. Afterwards many problems and a long period of presence in department stores, a Hermès subsidiary was established in New York in 1983. Concerning the entry of the company on the Japanese market, it was first done through a representation contract with a chain of department stores. Ever since, the share of directly operated stores clearly surged, even if the number of franchisees also progressed.

It is also interesting to state that the share of franchisees in the network is greater in the nearest markets than in the far ones. In Europe, only 56% of the stores are directly operated by Hermès. This share is of 69% in the Americas, 64% in Asia and 78% in Oceania. In the Middle East, the company only relies on local partners. These figures show that the way Hermès enters foreign markets is more linked with the period it enters than the location of the

country. According to the Uppsala model, the company should have a greater control on its European stores network than in Asia, for instance, which is not the case.

The mode of entry seems more linked with the period Hermès entered the market than their cultural or geographical proximity with the company. When Hermès started to expand in the mature markets (Europe, USA, Japon), it used both subsidiaries and franchises; that's why the distribution networks in those countries are still mixed. Nowadays, for new locations such as China, it mostly uses subsidiaries.

Table 3 - Hermès – Directly Operated Stores and “Concessionnaires” by Area

| | Nb of Directly Operated Stores | Nb of “Concessionnaires” |
|------------------------|---------------------------------------|---------------------------------|
| Europe | 71 | 56 |
| <i>Of which France</i> | 15 | 20 |
| <i>Italy</i> | 11 | 11 |
| <i>Germany</i> | 10 | 8 |
| Americas | 34 | 15 |
| <i>Of which USA</i> | 25 | 9 |
| Asia | 81 | 45 |
| <i>Of which Japan</i> | 28 | 22 |
| <i>China</i> | 17 | 4 |
| Middle East | 0 | 6 |
| Oceania | 7 | 2 |
| Total | 193 | 124 |

Another interesting phenomenon described by J.R. Guerrand is that the opening of a shop abroad does not generate a decrease in the number of customers of this nationality in the French shops. On the contrary, the increase in the reputation of the brand thanks to its settlement in new countries tends to increase the frequentation of the other shops of the company by the tourists of those countries.

Gucci

Created in 1921, Gucci is from the start directed towards retailing. In 1951, it has three shops in Italy; the first boutique abroad is established in 1953 in New York. Until in the 1990's, the international distribution network increases, primarily through the use of franchise agreements. Thus, in the 1970's, Gucci signs a contract of agency with a specialized retailer to ensure its representation on the Japanese market. The arrival of a new team of leaders in 1995 (Domenico de Sole is named CEO this year) marked a turning in the distribution strategy of the company. This one, largely involved in debt, needed to increase its performances and to clarify its strategy. That passed in particular by the buying-back of licenses and the drastic reduction amongst franchises which were replaced by directly owned stores, as testifies the figures below.

Table 4 - Gucci – Evolution of the distribution network

| | 1996 | 1999 | 2002 | 2003 | 2004 | 2005 |
|---------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Nb of Directly operated stores | 69 | 130 | 173 | 187 | 198 | 207 |
| Nb of Franchisees | 111 | 51 | 32 | 31 | 32 | 33 |

Source : Mark Lee (2006)

How to justify this choice? Cristina Ventura, head of retail operations for Europe, quoted by Martinez Jerez, Corsi and Dessain (2010) explains: *“When a franchise becomes DOS, sales increase by 30%. This is due to a range of factors: DOS are more systematic in calling for the in-store events, the sales force is more service-oriented, and the stores carry more merchandise, as they put more weight on having the right handbag or the right jacket for their customers and less on the financial cost of the stock”*.

The only remaining franchises concern countries where the company believes not to have sufficient knowledge of the market or those whose legal framework does not allow the establishment of fully controlled shops.

These three cases show very well that the switch to a directly controlled internationalization is relatively recent for luxury companies. They also validate most of the previously detailed theoretical approaches.

In terms of ownership-specific and internalization advantages, this strong control was indeed supported by the existence of specific assets (high brand value, know-how, control of the productive process, exclusiveness...), as well as their will to ensure a deep internal control on the whole dimensions of product development, from creation to distribution. Moreover, concerning location advantages, the existence of strong potential markets and easier installation requirements created favorable conditions for this new strategy.

The increasing deregulation of the international trade and the global integration of economies facilitated a direct approach of the markets by the companies. Another significant element is the change in the distribution structures in the host countries. A Goldman Sachs study (2010) highlights a close link between the level of development of a country and its distribution structure. If the department stores had a central role in Japan in the 1970's and 1980's, it is not any more the case today. Same manner, in South Korea, after a domination of the market by the department stores, the specialized circuits emerged thereafter. Little by little, the foreign companies can enter these countries with their own shops.

Today, this development scheme is the dominant strategy of luxury brands, the only preserved territories being those where the foreign establishment is not fully authorized, where market conditions are not optimal or those where the companies did not wish to turn their network in Directly Operated Stores because of long relationships with a local partner.

3 / Retail and luxury

The evolution of most of the distribution networks under the mode of direct control constitutes a major strategic axis for luxury companies. This form of downstream integration finds its justifications in business strategy. We also will show starting from tools for industrial economy that these changes had consequences on the degree of competition within the luxury industry and constitutes one of the means used by the companies to organize a market foreclosure.

Porter (1982) enumerates four advantages suitable for integration towards distribution:

- 1) A better capacity to differentiate the product. The creation of an favorable environment for the products of the company, the presence of a trained staff, knowing the product perfectly, are significant ways to create value and to distinguish a company from its competitors.

2) Suppression of bargaining power of the purchaser. Facing customers, the company is in a better position to propose its offer than with a department store or a chain with higher market power.

3) The access to information concerning the market. The manufacturer can thus follow in real time the nature and the evolution of the tastes of the customers and answer them quickly.

4) The fixing of higher prices. The company cumulates the margins of wholesaler and retailer (who are added in certain cases to those of manufacturer and importer) which can reinforce its economic model. Free to fix its own prices, the company is not forced by a partner to practice sales or promotions. In addition, in the case of international distributors, the possibility of having a price policy on a worldwide scale also constitutes an advantage.

The justifications of vertical integration by the economic theory corroborate those proposed by the literature of management and strategy. Mahoney (1992) explains for instance the recourse to vertical integration by the existence of agency or transaction costs, which make the internalization of functions preferable. Other authors, such as Richardson (1996), also justify vertical integration by the need for giving a prompt response to the market, starting from the case of the fashion sector. McGuire and Staelin (1983) for their part studied the choices of distribution of two companies according to the degree of substitutability of their products. A small degree of substitutability is accompanied by a direct control of the distribution. The luxury companies, whose major strategic axis is to differentiate themselves from their competitors, chose their distribution mode suitably.

Lafontaine and Slade (1997) analyzed the issue of retail contracting and conclude that a firm will be likely to be downstream integrated if:

- The risk of market is weak,
- The retail formats are substantial,
- The cost of control of the agent by the principal is noteworthy.

In addition to its advantages in terms of efficiency for the company, it seems necessary to us to highlight that this increasing downstream integration by the companies also plays a part in their competing context. Indeed, the cost required by the existence of a distribution network and consequently the visibility of a luxury company at an international scale became prohibitory. As we showed, the direct presence of luxury companies in the various worldwide markets constitutes a pledge of credibility and acts positively on their reputation.

In addition to their strong brand identity and in certain cases their specific know-how and assets, the “insiders” now have a bigger market power on their environment. This will to be directly present on the markets can be seen as what Dixit (1982) named a strategic pre-commitment. He describes a market where are present an installed company and a potentially entering company. By a series of expenditure showing that it is strongly engaged and in an irreversible way, the installed firm will notify the potential entrant that its entry will cause a reaction and that it would be preferable that the entrant does not penetrate on its market. The rise in the cost of the entry generated by the firm installed thus constitutes a threat which, if it is credible, will prevent all new entry on the market.

It results from this race to downstream integration that the cost of entry on the luxury market became extremely heavy. It is partly what explains the relative fixity of the structures of this sector. The concentration of the turnover between a few big companies is very strong and there is a growing difference in terms of size and performances between the leaders of the luxury sector and their challengers. The main luxury firms profit indeed from the best exposure in terms of brand and product portfolio, of distribution networks (mainly through retail), and of markets (strong presence on the emerging markets with strong potential). They thus still will accentuate their advance on their competitors and will continue to affirm their domination on the market.

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