

## Part 4. How the Luxury Goods sector is faring during covid-19 with Vihari Ross, Head of Research and Portfolio Manager

### Video Transcript (May 2020)

#### Vihari Ross, Head of Research and Portfolio Manager Jennifer Herbert, Key Account Manager - Listed Funds

**Jennifer Herbert:**

Hello and welcome to our investment insights series, Magellan Minutes, in which our investment team dissects the markets and takes a deeper look into sectors and stocks in our global portfolios. My name is Jennifer Herbert, Key Account Manager at Magellan, and over the next 10 minutes, I'll be talking to Magellan's Head of Research, Vihari Ross, about our current luxury goods exposure. Thanks for joining us, Vihari.

**Vihari Ross:**

Thanks, Jen. It's a pleasure.

**Jennifer Herbert:**

Vihari, the Magellan Global Fund includes two luxury companies, which are LVMH from France and Estée Lauder from the US. It's a very interesting time for luxury. How have these stocks fared?

**Vihari Ross:**

It's been an interesting time and quite an unprecedented time for investors in terms of not only the lockdown but the recession that we'll find ourselves in when we come out of our houses eventually. The prospects for Estée and LVMH have been very much linked to the China story. And so their share prices actually started to turn in mid-January when murmurs of the virus first hit the newsreels and we had much less inkling about how bad covid-19 would turn out to be. And so the companies, compared with the rest of the market, actually started turning down a month prior. And so since that middle of January to middle of March, which was sort of the most recent bottom, both Estée Lauder and LVMH fell by 34%. Since then, we've had about a 20% rally in both. And they're both down about 23% today.

**Jennifer Herbert:**

And what's been [inaudible 00:01:45] into that, do you think?

**Vihari Ross:**

Well, Jen, what it really reflects is the Chinese consumer being so important, but also the importance of travel to the luxury industry. So 40% of luxury spend actually takes place when people are travelling overseas and 10% to 15% of that spend actually happens in the airports themselves. So for Estée Lauder, 23% of their global sales happen within an airport. Then you've got limitations in manufacturing in Italy being closed. You've got the reduced wealth effect, the feel-good factor. The share markets falling and things like that are impacting the sector.

So we've had this rally, that I described thanks to that sugar hit, from monetary stimulus and fiscal stimulus that's been thrown at the problem. But the reality is that the impacts of both the shutdown, the impact on travel and the recession that will follow really does have an outsized impact on these businesses.

**Jennifer Herbert:**

We're assuming a significant change in consumer behaviour post covid-19. What do you expect the recovery to look like for these businesses?

**Vihari Ross:**

This is a really interesting question. It's important to separate out the impact of the lockdown versus the impact of the inevitable recession that's going to follow. And currently our view is that the recovery in developed markets won't be a V – it'll take longer than that. And how long it's going to take is really uncertain. And no one really knows yet what it's going to look like. But when we do think about the recovery, there are a few important things to think about and note.

The first is that the Chinese growth story still exists, given what the government can do, mandatory tracing apps, mandatory lockdowns, etc. The recovery there is likely going to be sooner and stronger, in our view, than the rest of the world. And that is super important for Estée Lauder and LVMH because one-third of everything they sell is to the Chinese consumer. And that is said to grow, to being more than half of their sales in the coming years. So that tailwind of urbanisation, that tailwind of the growing affluent class and rising disposable incomes, will still be there following the pandemic.

The second thing is that this pandemic is really accelerating a lot of the things and trends that were already in place around the world before this virus started. So here I'm talking about things like the increasing portion of sales coming from the Chinese consumer, the Chinese spending more of their money at home rather than abroad. The rise of digital sales, selling stuff online, is becoming increasingly important. And so businesses like Sephora, which is owned by LVMH as well as Estée Lauder's substantial business that they have on Alibaba's Tmall platform has put them in very good stead in this crisis.

And in the same breath, there's this demise of the department store; the wholesale channel for luxury is really accelerating. And that's 45% of Estée Lauder's business in the US. So that decline is accelerating as well. It makes sense for a brand that has closed all of its stores around the world to rethink which ones do it wants to reopen again. And that's especially in the context of the online business increasing, in some cases at triple-digit rates.

The other trends that might accelerate are things like casualisation, which means wearing athletic wear and sneakers. The self-care trend, so people are buying more skincare while they're in quarantine and also sustainability, so more eco-conscious consumption. And in that saying the resale market, in luxury, is seeing a lot of interest at the moment as well. So you might expect brands to try and reclaim control of that sector for themselves in future.

And the third thing to think about in terms of a recovery, and what we're looking out for – is the desire still going to be there? This is something that people want, not need. These are brands that have lasted the test of time and it's human nature to desire these products. And what you've seen in the past downturns is that the best brands tend to win in that environment because people want to buy things that will truly last the test of time rather than something that's more fashion-oriented or edgy in its environment.

**Jennifer Herbert:**

Vihari, what signs have you seen in terms of consumer demand?

**Vihari Ross:**

Obviously the thing that's missing right at the moment is the occasion; no one is able to go out anyway. But despite that, what you've seen, for example, is quite substantial demand percolating in parts of the world. There were news reports that when the Hermès store reopened in Shenzhen recently that it made \$3 million worth of sales on its first day. And that's almost 20% of its typical stores' annual takings in one day.

We've seen companies like Vestiaire Collective, which is a community of second-hand buyers and sellers of luxury, see 20% to 30% growth year over year despite the existence of covid-19 and those anecdotes, along with other data that we look at, give me a lot of comfort because you can see that the consumer demand, underlying all of this uncertainty in the short term, is still there. And that's a key factor in really working out what the recovery does look like for these companies. But the thing to remember is despite these examples and the fact that people will ultimately come back to some form of spending on luxury, you do need to temper that a bit because you don't necessarily make up the sales that you lost today. And by that, I mean just because you don't buy a new dress or lipstick this year, that doesn't necessarily mean that you will go and buy two of them the following year. The sales that would've happened this year are simply lost to those companies.

**Jennifer Herbert:**

Both companies have now reported. Can you give us some colour on the valuation and price?

**Vihari Ross:**

The results over the past quarter were largely as we expected them to be, given how economically sensitive they are. But of course the worst is yet to come, in the period after the one that we've just seen. Which is this April, May, June period where most of the world was locked down.

January was really strong, which was pre the virus hitting. February was hurt by China because that's when it was hit by the virus. And then we had severe declines outside of China in March, with stores closed, travel stopping. So we ended up with a sales decline of 9% for Estée Lauder and 17% for LVMH in that first quarter. But even Coca-Cola had a 25% volume decline over that quarter. So it really has been quite indiscriminate in terms of the impact. And both Vuitton and Estée have seen a real exhilaration in their Chinese consumers' spend at home.

It's still negative overall because people aren't travelling. But LVMH said, for example, that its sales within China for its largest brands were up 50% in April, year over year. So there's that pent-up demand story again. And ecommerce is really showing itself to be a big driver of that acceleration.

So the shares have rallied. There's a bunch of bad news still to come; the cost of getting supplies out there and fulfilling online orders is going up. So there's an incredible short-term uncertainty to contend with and questions around how long this is all going to take to recover, but we remain confident in the quality of these businesses. And beyond that their management capability, the demand for their products and the importance of China to that growth story as well, so pulling all of that together, despite the obvious short-term risks, we do see value in these stocks today.

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