

The Luxury of Success

High-end retailers are hot investment prospects

By **Connie Robbins Gentry**

Financial analysts have turned even more bullish on Coach, raising the 12-month target price for the high-end leather-goods and accessories company from \$38-\$40 to a range of \$43-\$45. Jim Hurley, managing director and senior retail analyst of the luxury-goods sector at New York City-based Telsey Advisory Group, credits the success to a “golden triangle” of converging events.

Increased customer traffic, inspired largely by new merchandise moving through store windows every month, combined with an improved conversion rate and higher average-transaction rates complete the tricuspid effect.

“Because the brand is so desirable, Coach has pricing power,” explained Hurley. “The strength of the product, the monthly flow of newness and the fact that sales associates are trained well all contribute to the success.”

Like many luxury brands, Coach, which recorded sales of \$2.1 billion in fiscal 2006, has also honed a multi-generational appeal, offering a broader range of price points and infusing its designs with a fun and fashionable flair that attracts younger shoppers.

Additionally, Hurley described the management team at Coach as one of the best he’s ever seen.

“The company’s singularity of purpose and vision is outstanding; there is a very strong partnership between CEO Lew Frankfort and Reed Krakoff, president and executive creative director,” he said. “The management structure is very lean and mean, and the strength extends from the senior level to store-level managers. There’s a lot of bench strength at Coach.”

For privately owned retailers contemplating the launch of an IPO, Hurley said the two critical factors are a strong management team that can inspire confidence within the investment community and a clearly articulated, easily understood growth strategy. Coach achieved both, and since going public in October 2000, has consistently impressed Wall Street.

As a whole, the luxury retail sector is a good bet for investments, and Hurley anticipates additional IPOs to launch with continued growth and prosperity in this niche. Two European retailers to watch are Salvatore Ferragamo, which is expanding its U.S. presence, and Versace, which Hurley suggested will refurbish its small network of U.S. stores and roll out additional locations in high-profile markets.

“One of the interesting things about the U.S. is that there are pockets of wealth outside the major cities; luxury retailers are opening stores in cities like El Paso, Texas; South Bend, Ind.; Charlotte, N.C.; and Rogers, Ark.,” he noted. “There is vibrant consumer interest for luxury brands in these markets, and Coach and Tiffany are probably the most aggressive about pursuing stores in these settings.”

Another advantage of opening stores in these smaller cities is that the profit margins can be significantly higher than in the major metropolitan areas.

“It’s not just that the rents are lower,” explained Hurley. “The cost of operations and labor are also reduced and the stores can be much smaller, where the retailer can manage its

exposure and inventory with a very sharp assortment.”

Luxury retailers have also begun selling over the Internet, although even the most evolved e-commerce players are only seeing a modest 5% to 7% of their total sales generated online. Hurley suggested this is primarily because most luxury brands are global, and e-commerce remains most prevalent in the United States.

The luxury brands that might exhibit the highest stock performance in the coming months are Coach, Tiffany and Tod’s—an Italian shoe and handbag retailer that is focused on growth in the United States, noted Hurley.

“The growth strategies of these brands has been clearly articulated, and we also expect to continue to see improvements in their operating margins,” he added.

The product category among luxury brands that is perhaps the most sensitive is apparel, which he expects could be negatively impacted by the continued growth of fast-fashion retailers such as H & M and Zara.

“Apparel as a category is always more difficult than leather goods; however watches and fine jewelry are the most susceptible to shifts in the geopolitical environment,” Hurley said. “For example, if there was an escalation in war or terrorist activity, the climate would not be conducive to such highly discretionary products.”

A global trend that is benefiting luxury retailers is the fact that the weakened U.S. currency has prompted international tourists from emerging markets such as Russia and the Far East to travel and spend money on luxury items.

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