PRODUCT

“Future Vertical Integration in the Luxury Segment.”
1.) ABSTRACT

The aim of this article is to gain some understanding of the areas in which we may see luxury vertical integration deals take place in the future. Making use of the insight that was learnt in the research report, it was possible to first consider the types of segments where vertical integration deals have taken place in the past. These segments were traditional know-how and artisanal skills, leather and exotic skins, cosmetic and perfume supplies, and jewellery and watches. Thereafter, by looking at the state of each industry, combined with the motives given by brands for these acquisitions, viable reasons for why a luxury brand may decide to vertically integrate were determined. These were: to preserve and develop know-how, to curb rising costs, unstable supplies, and diminishing quality, to ensure clear product provenance, and to elevate the level of perceived exclusivity. Thereafter, future forecasts and predictions became the focus. Analyst reports and predictions of industry experts were studied, and a clear consensus determined. The trend of vertical integration by luxury brands will continue growing in the coming years. The most likely areas of investment are the watches and jewellery, and leather segments. Furthermore, brands will look into investing in their supply chain when there is a threat to the quality or supply of their product, or if raw materials prices are rising rapidly. Furthermore, luxury brands will look into making investments into companies with strong heritage and craftsmanship backgrounds, and exclusive luxury goods offerings thereby further establishing their positions in the elitist segment.
2.) INTRODUCTION

My research report was based on the recently accelerated trend of upward vertical integration among luxury brands. Facing the decline of physiological raw materials and the declining amount of artisanal skills, luxury leaders in fashion, cosmetics, and jewellery are now competing for the procurement of these resources. The goal of the report was to find out the reasons behind this trend, by looking into what type of luxury brands are investing and which segments they are investing in, as well as looking into the motives given by brands and industry experts for the recent acquisitions of their suppliers, thereby leading to a set of more concrete and legitimate reasons why vertical integration may take place within the luxury sector.

The investigation made use of literature research and corporate interviews in order to discover the main sectors of investment, and the advantages of securing these resources. Firstly, the active brands in the segment were analysed, with some of the main brands who have been investing in their supply chains coming to fruition. After studying the various deals that took place between luxury brands and their suppliers, it was possible to conclude the main areas of investment, which were artisans know-how and traditional skills, the leather and exotic skins segment, the supply of cosmetics and perfume ingredients, and the jewellery and watch industry. Thereafter, the motives given by each brand for their investment were studied. Using the findings on areas of investment and the brand motives, as well as literature about supply chain management, it was possible to determine the main possible benefits that could be incentives for luxury brands to integrate their supply chains. The main benefits that were established were placed into the categories of: product provenance, control of quality and supply, prevention of counterfeit goods, pricing & cost reduction, craftsmanship, heritage and innovation, competitive advantage, and economies of scale. Each category makes use of various examples and theories to explain why vertical integration would be beneficial to a luxury brand.

With the current areas of investments having been determined and the main reasons for investments outlined, the insights gained from the research report can thus be used as a basis to explore the areas where we may see vertical integration investments in the future.

3.) METHODOLOGY

The motivation of this product was based on the findings of the research report, therefore the research foundation was taken from there, and combined with additional research that is more specifically linked to the topic. The main methods of research were:

- International literature was analysed and constantly monitored, especially in regards to the examined companies and in relation to the resources and skilled labor within the luxury industry (mainly media and press releases). Furthermore, analyst reports were examined.
- Interviews were conducted as a means to explore the opinions of industry experts, including Mario Ortelli, a senior research analyst at Sanford C. Bernstein, Franck Delpal, an economics teacher at IFM whose PhD thesis was written on the subject of vertical integration among luxury brands.

4.) RESULTS

In order to determine the areas where future vertical integration may occur, three aspects where considered. Firstly, vertical integration deals that took place in the past were studied. Secondly, the reasons why these deals may have occurred were reviewed. And lastly, future investment predictions by industry experts were studied.

4.1) Past Vertical Integration Deals

To understand why vertical integration in the luxury segment takes place, it is necessary to review historical acquisition deals that have occurred and the reasons behind them. The research report made use of recent articles to shed some light on the main luxury companies that can be seen investing in their supply chains. Studying each company and its various acquisitions enables the possibility to determine the focus areas of their investments. Four segments emerged from the research report as focal points of investment: skilled labor and traditional know-how, leather and exotic skins, cosmetics and perfume supplies, and jewellery and watches.

Examples of supply chain based acquisitions in each category include:

Skilled Labor & Traditional Know-How:
- LVMH: ArteCad, a Swiss watch supplier of mechanical movements, dials, cases and straps, and top cashmere maker Loro Piana. (Wendlandt, 2013).
- Bulgari: Dial producer Cadrans Design, metal watch straps specialists Prestige d’Or, high end watch case specialist Finger, and suppliers Gerald Genta, Daniel Roth and Manufacture de Haute Horlogerie (Reedy, 2009).

Leather & Exotic Skins:
- Chanel: Lamb hide provider Bodin-Joyeaux (Wendlandt and Denis, 2013).

**Cosmetic & Perfume Supplies:**
- Chanel: Purchased land near Grasse, France’s perfume capital, dedicated to the cultivation of jasmine and roses, re-introduced Florentine Iris to the area, and set up partnerships with sandalwood growers in New Caledonia (Wendlandt, 2013).

**Watches & Jewellery:**
- LVMH: ArteCad, a Swiss watch supplier of mechanical movements, dials, cases and straps, and top cashmere maker Loro Piana. (Wendlandt, 2013).
- Bulgari: Dial producer Cadrans Design, purchased intellectual property and machineries related to watch components from Leschot, metal watch straps specialists Prestige d’Or, high end watch case specialist Finger, and suppliers Gerald Genta, Daniel Roth and Manufacture de Haute Horlogerie (Reedy, 2009).

### 4.2) Motives Behind Vertical Integration Deals

Now that the acquisitions that took place in each segment have been outlined into categories, the motives behind the various acquisitions need to be determined. Using articles that highlight some of the reasons given by luxury brands for their various acquisitions, as well as articles pertaining to the current state of each segment, the reasons behind the various vertical integration deals can be determined and categorized.

**Skilled Labor & Traditional Know-How:**

In regards to the state of this segment, it is clear that there is cause for concern. In the 1920s, there were approximately 10,000 couture-level embroiderers in France, today there only around 200 (Reedy, 2009), this means that the demand for these ateliers services has decreased dramatically. Moreover, since the 80s, Swiss watch making technicians have had to face the
advance of Asian competition, and the emergence of quartz technology, and they are still in jeopardy today as the market for high-end timepieces is on the decline (Reedy, 2009). If the demand for the skilled labor that these companies provide continues to decrease, the companies will be sure to die out. The knowledge and skills of these manufactures is an integral part of many luxury brands product offerings and their customers expect products of an exceptional quality and high level of craftsmanship. The reasons given by brands for their acquisitions in this segment have therefore been mainly focused on the preservation and development of knowledge and skills. Senior press officer for the Maisons d’Arts, Nathalie Vibert claims that the acquisitions of French ateliers by Chanel:

“amount to a genuine wager on creativity, which, beyond preserving unique archives and know-how, allows such craftsmanship to grow and bloom in full independence. The aim is clear: it is not for Chanel to grab exclusive suppliers, but to nourish a craft which is the quintessence of Paris couture.” (Reedy, 2009).

Furthermore, after the purchase of Barrie Knitwear, Chanel's fashion president Bruno Pavlovsky explained that this acquisition was made as a way for Chanel to reaffirm their commitment to traditional expertise and craftsmanship, with the aim of safeguarding their future and supporting their development. (BBC News, 2012). Therefore, it can be established that the need to preserve and develop traditional knowledge and artisanal skills is a viable reason for why a luxury brand would vertically integrate.

Leather & Exotic Skins:

Research has shown that there is also reason to worry in regard to the leather and exotic skins industry. The first issue is that due to the demand of the luxury sector, the prices of exotics, Spanish entrefino, and French calf leather have been rising sharply, with the barrier of $100 a hide being broken last year (FNA, 2013). This can be attributed to the fact that overall slaughter numbers have decreased due to the trend of more people becoming vegan and vegetarian (Daneshkhu, 2013). Meat traders are responding to a drop in consumer demand for veal, therefore fewer animals are being reared and slaughtered, however the demand for luxury leather goods is still growing, and the prices are therefore rising by 20-30% per year (Daneshkhu, 2013). The second issue is the stability of the supply of exotic skins. The alligator and exotic skin industry in Louisiana is dealing with an unstable inventory of exotic skins, with a surplus of 840,000 hides waiting to be sold, while only about 275,000 hides are sold nationally in the US each year, which results in a threat to the stability of the sourcing of skins (Reedy, 2009). This could be attributed to a very bad market, as farmers are hugely dependent on luxury watch sales which were off by as much as 25 percent (Lariviere, 2009). Almost 10% of the total revenue from handbag sales is
from exotic animal skins, and according to Bain & Co the luxury accessories market was worth €57 billion last year (Bloomberg, 2013). Furthermore, the number of tanneries is decreasing as well; fewer than 20 tanneries still operate in France compared with more than 60 in the 1980s, according to France’s National Leather Council (Masidlover, 2013). The third issue is the ability to source the highest quality of skins. Deputy chief executive for strategic development and corporate image at Hermès, Patrick Albaladejo explained that:

“good quality calf skin depends on the breeding of the animal; if it is not raised in good conditions – in freedom and eating grass – it will not have a good life and the skin will not be at the quality required. Unfortunately, the quality of breeding is not necessarily going up these days." (Daneshkhu, 2013).

Furthermore, Kering divulged that their reason for purchasing France Croco was to secure a sustainable supply of high quality crocodilian skins (Daneshkhu, 2013). Lastly, Mario Ortelli, an analyst at Sanford C.Bernstein in London, explained that by investing in leather and exotics skins products luxury brands are trying to elevate their level of perceived exclusivity. From these findings we can therefore determine that rising prices, unstable supply, and diminishing quality are factors that could cause a brand to vertically integrate. Furthermore, it is a way for brands to strengthen their image of exclusivity.

Cosmetic & Perfume Supplies:

There has not been much evidence to indicate any major cause concern in this sector. However, by reviewing the type of deals that took place we can speculate as to whether there may be issues to consider in regard to the supply of cosmetic and perfume ingredients. Chanel, Dior and Hermès have been setting up exclusive partnerships with plant growers in an effort to guarantee the supply of raw materials for their perfumes and cosmetics, and Chanel and Dior have both purchased land near Grasse, dedicated to the cultivation of jasmine and roses (Wendlandt, 2013). This would indicate that there may have been a problem with their supply. Furthermore, Edouard Mauvais-Jarvis, scientific communications director at Parfums Christian Dior stated that, ‘Our concern is ensuring continuity in the equity of the products we use and being able to trace them.’ (Wendlandt, 2013). Therefore, it would be reasonable to assume that there may be supply issues, as well as possible provenance issues that are causing luxury brands to invest in this sector.
Watches & Jewellery:

The concern for this segment can be linked back to the need to preserve know-how, and to guarantee supply of raw materials. Gem Palace has implemented a completely vertically-integrated manufacturing unit with the aim of reviving traditional skills that were nearly lost in history (Reedy, 2009). Furthermore, Guido Terreni, managing director of Bulgari, stated that: ‘Integration for us was born from a desire to master the know-how and increase the competence of the product and now it has become a precious manufacturing tool that allows us to excel in quality and ensure independence in the supply.’ (Brooke, 2014). Laurence Graff, London based jeweller, has focused on controlling access to raw materials. The company bought a minority stake in the Letseng-la-Terai mine in Lesotho in 2008, which is where the famous Lesotho Promise (the 15th largest rough diamond ever to be discovered) was found (Reedy, 2009). Laurence Graff believe that the highest quality will attract the best customers, and their access to coloured stones is therefore just as important to the company as their stone cutters and master jewellers (Reedy, 2009). Thus, the preservation of know-how and the ability to secure high quality supplies are re-established as motives for integrating the supply chain.

4.1) Expert Investment Predictions

Now that investment motives have been determined, it is interesting to try and gauge where possible future investments may take place. It is therefore beneficial to take current forecasts on the issue by industry experts into consideration. In the Blackbook report ‘The M&A Wave – All the Targets, Multiples and Possible Outcomes’ (Ortelli and Patel, 2014) various forecasts were made for which brands may consolidate in the coming years, and where these consolidations may take place.

- LVMH is expected to invest in fashion & leather goods, where the company has a strong expertise, or in watches & jewellery, to gain additional market share and expertise in the fast-growing hard luxury market.
- Swatch is predicted to invest in further vertical integration to acquire component producers and their skilled labor.
- Analysts forecast that Prada with vertically integrate further in order to secure the supply of raw materials for its products. The acquisition of small leather factories in Italy by Prada is seen as very likely, given the market is fragmented and suffering from the current gloomy backdrop; hence, there is potential for good deals.
- Additional vertical integration is predicted for Burberry, particularly to secure the supply of raw materials and manufacture its products.
- Analysts believe that Hermès will continue to vertically integrate businesses upward in the coming years to secure the supply of specific raw materials, such as leather and watch components.
A study done by Deloitte on the Swiss Watch Industry (Deloitte AG, 2013) highlighted that the majority of watch industry executives expect vertical integration activity to continue. The reason for this is because companies want to alleviate sourcing problems in parts and labour shortages. According to Michel Jeannot, Publisher at WtheJournal, the aim today for all high-end brands is to stand out from their competitors with their products, and to constantly highlight their differences or particularities. Enamel artwork, miniature paintings, lacquering, engraving, skeletonizing, guillochage and marquetry are all métiers and skills that are becoming popular again with watchmakers and a clientele in search of exclusive watches. And to offer these elements, watch companies will increasingly introduce more métiers in-house, to gain more independence and to master rare skills (Doran, 2014).

The opinions of industry experts were sought after during interviews conducted for the research report. When asked where he sees further integration in the future, Franck Delpal responded that, 'Leather is a main field of interest and it started with the manufacturers which are now all taken care of. The second step is the raw materials which is almost done as many brands have already invested in tanneries. Now the issue is the animal, so brands are already beginning to talk with the farmers about the best treatment of animals in order to help guarantee the highest quality of skins. So in the future we may see that luxury brands will even have their own farms for exotics like snakes for example. In textiles this is not really worth while.' To the same question Mario Ortelli commented that he thinks jewellery will be a main area of interest.
4.) RESULTS

From the first sub-section of the results, ‘Past Vertical Integration Deals’, four categories emerged as focal points of investment for luxury companies. These were skilled labor and traditional know-how, leather and exotic skins, cosmetics and perfume supplies, and jewellery and watches. However, just because acquisitions in these segments happened in the past, it does not mean that they will happen again. Therefore, second sub-section was introduced with the aim of determining the reasons given by luxury brands for their various acquisitions, as well as gauging the current state of each segment.

These findings established that there is considerable cause for concern in the sectors of skilled labor and traditional know-how as the number of artisans has decreased dramatically over the years, leather and exotic skins, where prices are rising rapidly, supplies are unstable and high quality products are difficult to source, and jewellery and watches, as companies need to ensure the survival of techniques and sources of raw materials. However, there was not much evidence to indicate that the supply of cosmetics and perfume supplies is a major issue.

Furthermore, this sub-section yielded the main reasons as to why a luxury company would vertically integrate. Firstly, to preserve and develop traditional knowledge and artisanal skills as these aspects are an integral part of a luxury brands product offering. Customers want products of the highest level of craftsmanship and skill, and expect the highest quality to validate the prices that they pay, and this would be put into jeopardy if a highly specialized supplier were to disappear. Secondly, to curb rising prices that bite into profit margins. Integration of the supply chain means brands are able to save costs by cutting out the middleman. Another reason is when brands are facing an unstable supply of their products. Vertical integration is a way from them to guarantee materials for themselves over competitors. Furthermore, brands may want to vertically integrate when the quality level of products is diminishing. Having control over the supply chain means that luxury companies can ensure that the highest standards are used to yield products. This could be done be by making sure that animals are bred in the best conditions to avoid scaring or disease, or by making sure that employees are focused on producing the best quality and not the fastest products. Lastly, brands use vertical integration to strengthen their image of exclusivity. For example, by aligning themselves with tanneries that have been established for many years, and offer a high end product, brands are also aligning themselves with the values of heritage and craftsmanship.

The last sub-section of research focused on forecasts and predictions by industry experts. While predictions into the future can not necessarily be considered as factual, it is still intriguing to explore the possibilities. However, most predictions that were found where quite specific, and therefore it is necessary to extract the main areas of investment, rather than focus on specific
company acquisitions. Analyst reports showed that vertical integration will continue to a main reason for vertical integration in the future, and that future acquisitions would most likely take place in the segments of leather, and watches and jewellery. Considering the state of these segments determine in the earlier section, this seems like a very possible prediction.

5.) CONCLUSION

From these findings, I can therefore make an assumption that the trend of vertical integration by luxury brands will continue growing in the years to come as the benefits of securing supply and know-how in the industry are an important focus for luxury brands and they have the availability of cash flow to pursue desired deals. The main areas of investment will most likely be in hard luxury sector of jewellery and watches, where the fashion cycle is not very fast and therefore, the brand heritage is more important, and in soft luxury sector, specifically in leather industry, where these segments have been a major point of concentration for high end companies. Vertical integration within the ready-to-wear segment is not likely to happen as there are a large number of suppliers to meet demands. Luxury brands are most likely to invest in their supply chain when there is a threat to the quality or supply of their product, or if raw materials prices are rising rapidly. Furthermore, luxury brands will look into making investments into companies with strong heritage and craftsmanship backgrounds, and exclusive luxury goods offerings thereby further establishing their positions in the elitist segment.
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