The Wrap Up

Sharp Dressed Man

This week marks the beginning of New York Fashion week, one of the four major fashion weeks in the world. It is an event where designers show off their collections to the world, in the hopes of creating enough hype and awareness around what`s to come for the brand. Apparel is a big business which is why we are going to cover that topic today.

Whether we share an interest in fashion trends or not, it`s a designer world and we`re all living in it. Don`t believe me? Then take Miranda Priestly`s words from the 2006 film *The Devil Wears Prada* ``…You go to your closest and you select…that lumpy blue sweater, for instance, because you`re trying to tell the world that you take yourself too seriously to care about what you put on your back….that sweater is not just blue….it`s actually cerulean. And you`re also blithely unaware of the fact that in 2002, Oscar de la Renta did a collection of cerulean gowns….And then cerulean quickly showed up in the collection of eight different designers. And then it filtered down through department stores….However, that blue represents millions of dollars and countless jobs. And it`s sort of comical how you think that you`re made a choice that exempts you from the fashion industry when, in fact, you're wearing the sweater that was selected for you by the people in this room..``

Savage as she is, and based on the very real Anna Wintour, that quote carries a lot of weight. We start at the top of the pyramid with the ultra high end brands such as Louis Vuitton, Dior, Pucci, Fendi, Loro Piana, Off-White and then you realise that all these brands are owned by LVMH. Depending on the day, this luxury conglomerate is the largest company in Europe by market capitalisation, with their 2022 revenue reaching $84.7B and a net income of $15B. While they are the leaders of the industry, their model is not unique; Kering owns Gucci, Yves St Laurent, Brioni, Balenciaga and even Puma. In the last two decades, there has been a large wave of consolidation in luxury brands, especially amongst the leading fashion brands. What is most appealing about these

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businesses are their massive margins and relative insensitivity to the economic cycle.

Gross margins in the space often exceed 60% and can even approach 70% (that means your $1000 jacket likely cost $400 to make), which makes all all these high end brands appealing to investors and conglomerates. As a point of reference, a clothing brand like the Gap has gross profit margins closer to 38-40% while the more sporty Nike averages 43-44% margins. What makes the higher end luxury brands a little more recession proof than other retail brands is that they target wealthier clients whose spending patterns are less sensitive to a recession. That does not mean that their sales are impervious to economic downturns, after all, they also count the mass affluent market as their customers. Their sales and profits are less sensitive to brands to appeal to the mass market, however, as the middle class will change its spending habits more, during a recession.

While we highlight the high end, luxury fashion market and its appeal from a financial perspective, let`s pivot back to athleisure wear. Brands like Puma, Nike, Adidas and Lululemon have standalone appeal as investments as well. While their gross margins are not as high as their luxury counterparts, they are still very healthy and it is a space that has grown at a steady pace for the last 20 years. Based on forward projections, this segment of fashion is expected to grow its sales at a faster pace than most sectors of the economy. Nike, the largest company in the space, has had a difficult year on the stock market with a 16% dip, however, its 19% annualized return over the last 10 years beats the index by a healthy margin. To see how intertwined the Nike brand has become with culture, look no further than this year’s release of the movie *Air*, the story of how Nike and Michael Jordan created the most successful athlete endorsed brand (the Air Jordan brand, owned by Nike, with annual sales now at $5B).

Nike`s success has inspired other brands to expand into the space: Lululemon is often seen only as a yoga company but the truth of the matter is that it is much more than that. Over the last couple of years, it has expanded its collection to focus on every day wear, has introduced a running shoe line and is now targeting the golf and tennis markets. Like Nike, the company has had a strong run over the last 10 years; the stock has averaged 48% annualized growth over that time period. What is more impressive about Lululemon`s story is that this run up includes a 30% share price contraction in 2018, a high profile battle with company founder Chip Wilson and some controversies around the quality of the product. Over the next five years, Lululemon is expected to average annualized earnings growth in excess of 15%, including 20% growth this year (versus a flattish year for the broader S&P 500).

As we enter a period of economic uncertainty, due to the combination of high interest rates, high inflation and elevated debt levels, the apparel industry may experience some additional volatility. Especially in the case of companies whose shares overperformed over the last couple of years, a correction in the share price or a period of stagnation is possible. Our intention is to buy the leaders in the space on weakness; we`re not about to buy an entire position in a company, because of the aforementioned uncertainty, however we can start buying into these companies at the right price. LVMH`s recent 20% share price correction is appealing to us. We have begun to accumulate shares for some of our clients at this price but we also acknowledge that the share price can drop another 25% if it were to flirt with its 52 week low. As we`ve stated since the beginning of this year, we continue to remain cautious, which is why we will not immediately invest 2% of our portfolio in LVMH, but we will not be afraid to start buying at the right price. Such is my philosophy on fashion spending: buy great quality at great prices.

Healthy Distraction

Sticking to the fashion theme, we want to take a minute to appreciate the industry and all those who work in it. It starts with the designers who are expected to continually churn out new ideas and looks. Sometimes they can be a little too creative for our tastes but we so admire people who take risks and keep trying to move the needle forward in their space. Play it too conservative and critics will call you boring, too wild and you may alienate your customers. If they get it just right, however, they`re creating art.

We also want to recognize the work that goes into runway modeling; it may look easy but it comes with a lot of pressure. It takes a certain level of confidence to model and a special kind of courage to walk down the runway, with hundreds of camera flashing and where anything can go wrong.

Last but not least are those involved in the design, production, procurement and sales of the brands. In such a high profile industry, it can sometimes feel a little discouraging to take blame when something goes wrong but seldom get credit when things go right. Every person in the process is important even if they're not receiving the applause at the end of the show.

Have a great weekend!