

You will present the way the author is defending the rational for no delocalization in the luxury sector. Questions associated with the case that should be addressed during the presentation

- Is luxury a special sector? On which aspects?
- Are those aspects pushing for no delocalization?
- Is luxury a special sector looking at the demand side?
- What are possible “hidden costs” associated with delocalization?  
What are possible solutions?



## Why Luxury Should not Delocalize

### A critique of a growing tendency

*By Jean-Noël Kapferer*

**M**any famous luxury brands have recently planned to delocalize their production. Many applaud luxury brands for closing production sites in their home countries, considering such cost optimization to be a rational evolution. But others claim that in doing so, luxury is losing its soul. This article reminds managers that any decision must be analyzed and evaluated within the context of a strategy. Luxury is a subjective concept but a luxury strategy is not: luxury's ability to sustain its high prices and profitability is governed by strict rules. What Prada and others are doing is, in reality, discontinuing their luxury strategy, in favor of a fashion strategy, without acknowledging this explicitly. In fact, the luxury strategy is a specific business model. Fashion is another, governed by a completely different set of working principles.

#### **From a well kept secret to overt announcement**

Conversations with executives at high-end labels have long confirmed the rumor of rising levels of production outsourcing. But high-end labels always refused to acknowledge these rumors officially. A product's country of production was often hidden by making the tag that specifies this information rather invisible on or in the product. For instance, it is very difficult to find any indication of the country of production within a

Lancel bag. The same is true for many Repetto shoes. Kenzo, a LVMH brand, moved the production of some clothes from Prouvy, France to Krakow, Poland, where workers' wages were one fifth of those paid in France (Korosylov, 2007). Nevertheless, the clothes were still priced as high as before. Armani Exchange cardigans are made in Egypt and Tunisia. In fact, the success of Dana Thomas's book (2007) is largely due to his journalistic work that unveiled the luxury sector's taboo about production delocalization.

Coach, however, has never hidden the fact that a large part of its production is delocalized. The same is true for Ralph Lauren Polo. More recently, Burberry's turn-around has been accompanied by the closure of its historical factory in Treorchy, Wales on the basis that having due to a belief that producing their clothes made in the UK was does not really create perceived value for a fashion brand. Hence, starting

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in 2006, Burberry delocalized all but its trench coat to China, Mexico, and other countries with low labor costs. In 2011, Prada, a very high-end fashion label, has decided not only to manufacture outside Italy (in China in fact), but also to announce this change publicly. This new communication strategy is most significant of a new era. Thus far, many Italian brands have used and abused the right to use the tag "made in Italy" as long as the product -although manufactured elsewhere- was « finalized » in Italy. Thus, the étiquette "made in Italy" does not at all guarantee that the product is actually made in Italy.

What then motivated the public announcement by Prada that "About 20 percent of Prada's collections — which range from bags and shoes to clothes for men and women — are made in China" (reported in the Wall Street Journal June 24th 2011)? This must be understood within Prada's financial context. It was pressed to seduce Asian investors, a few days before its IPO in Hong Kong on June 27, 2011.

Now, the real question remains: should luxury brands delocalize or not? Answering this question requires one to clarify what is meant by luxury.

### **Luxury : do not confuse the concept, the sector, and the business model**

Everyone implicitly understands what luxury is, when one talks about the concept. Certainly no two persons have the same definition of what is their own luxury, but the shared concept of luxury refers to "rare, hedonic, very high quality objects and services, sold at a price far beyond what their functional value would command, source of self reward and of image lift vis à vis some relevant others" (Kapferer, 1998). In fact, as shown by G. Bataille (1991), it is by sacrificing a high sum of money to pay more than

the functional benefits are worth that the buyer demonstrates his/her status and reinforces his/her own self concept.

However, the word "luxury" also has a second meaning. It can be used to refer to an economic sector. When Bain & Co. value the world luxury market at around 1.7 billion euros, they perform this calculation by summing the revenues of companies regarded as luxury, not by the public at large, but by syndicated organizations. For instance, in France, Comité Colbert acts like a self-appointed Club: only those allowed to register in this Club are regarded as luxury companies.

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There is also a third meaning of the word "luxury". It can be used to refer to a unique business model, a specific strategy with exacting and stringent rules to be followed (Kapferer, Bastien, 2009). This latter acceptance is interesting, because any company may enact a luxury strategy, even if this company is totally outside the common understanding of the kind of companies that comprise the luxury sector (fragrance, clothing, leather, watches, jewelry, accessories...). For instance, Apple, MINI, Nespresso, and even Lacoste follow, more or less, a luxury strategy, even though these companies are not perceived as "luxurious" by the general public.

The fact that "luxury" can have each of these three meanings is a source of much confusion. Since the word "luxury" is fashionable, its use is largely abused, especially by companies that do not in fact follow the rules of the luxury

strategy. Coach, for instance, introduces its home page with a bold headline, "The look of luxury," thereby acknowledging that, although it has an appearance of luxury, it is not a real luxury product. Going one step further, one can say that it is because luxury is a sector, driven by obligations of growth and profitability, that many of its co-opted members have no other choice than to delocalize their production. They rationalize it by invoking the excellent quality of the work now done in China, but the real reason for this delocalization is that they cannot grow and increase their profitability by raising their retail prices. Instead, they are increasing their profitability by reducing their cost of goods. In the luxury business model, one grows by continuously raising the average price. This is the only way for a brand to keep on being the dream of the wealthy and of all those consumers who, although not as wealthy, want to buy a part of the former's life style. But this business model is exacting. Many companies cannot follow it anymore and prefer to discontinue a luxury strategy, without saying it explicitly, in favor of another business model, for instance that of fashion or that of premium brands.

### **Luxury brand building is about building incomparability**

The luxury business model aims at creating incomparability, which grants freedom to set one's own prices. In contrast, in all other business models, prices are set while taking the competition's prices into account.

How does one create incomparability and the price insensitivity that follows? Incomparability is created by moving away from tangible elements of comparison and focusing on concepts such as art and religion - intangibles that elevate people.

Certainly, incomparability should also

have a rational basis. Luxury brands put forth their rare ingredients, rare production, the unique talents of the brand's craftsmen, the time it takes one person to sew a Kelly bag, or the time a Royal Salute whisky stays in the barrel (21 years minimum). But the economics of singularities (Karpik and Scott, 2010) that apply to famous Bordeaux Chateaux wines as well as to Management Consultancy prices are mostly due to the uniqueness and desire created by intangibles. The two major intangibles are time and provenance. That date of birth, heritage, and legend are one essence of luxury is acknowledged by the relentless attempt by many recent brands to simulate it. Thus, Ralph Lauren is very successful in making everybody forget that it is a recently-invented life style brand (1968), the fruit of a business genius named Ralph Lifshitz. The whole atmosphere within Ralph Lauren's flagship stores and the many black and white photographs on the walls are designed to create the illusion of a brand that already existed at the time of the Great Gatsby, Cary Grant, and the early Hollywood golden era. This halo of privileged life is leveraged to sell the Ralph Lauren Polo line at a premium price, even though much of it is made in China at low cost. Nevertheless, these products are sold in flagship stores that look like mansions in the hearts of the world's capital cities.

Provenance is the second strong intangible pillar of luxury desire, for it builds uniqueness, mystery, magic, and non-comparability, and adds cachet. One should not forget that luxury is the by-product of art. Gifts are an important part of the luxury market. This is remotely reminiscent of the exchange of objects of art between the Emperor of China and the Kings of France and Italy. Luxury was the ambassador of the country from which it came.

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An exception to the rule of provenance is when the homeland is not linked to an added value, or to a specific perceived skill. This is why Chanel or Louis Vuitton watches are made in Switzerland, but in their own exclusive factory. They are not outsourced or made under license. Similarly, if Hermès wants to launch a new shawl in rare cashmere wool, it might rely on the unique skills of the craftsmen themselves living in Kashmir. It already has such arrangements with Touaregs of the Sahara desert, Indians in Brazil, and artisans of Madagascar. This agreements are not aimed at reducing costs, but rather at sustaining some rare local arts and savoir-faire.

### **Do not confuse luxury, fashion, and premium business models**

Luxury is a subjective concept. Many of us may disagree when

interviewed about the perceived luxuriousness of a given brand. However, luxury as a business model has quite precise managerial implications. What are all the elements of the luxury business model? (see Kapferer & Bastien, 2009).

- full control of the value chain
- full control of the retail experience
- highly selective distribution
- one-to-one relationship with clients at retail level
- high level of personalized services
- high level of craftsmanship
- exceptional level of quality
- no licenses
- no super-sales, no promotions
- developing brand awareness well beyond the core target
- always increasing average prices
- strong involvement with arts
- beware of celebrities

This business model was empirically invented by those luxury brands which today are icons of the world's desire (Vuitton, Hermès, Chanel, Ferrari, etc.). These brands grow by continually launching higher products - higher in creativity, quality, and price. Porsche's turn around in the 1980s was achieved by the deletion of the many accessible lines (920, 924, 928). Remember, products are perceived as luxury specifically because some people cannot access them. Products for which this rule is not met should not be called luxury products, but rather premium stylish products, for instance, or designer brands, or mass-prestige.

Today, everyone can see the multiplication of accessible goods sold by so-called luxury brands. It is normal for a luxury brand to create an access door to its universe, to induce the consumers to trade-up (Silverstein, et al., 2008). The problem arises when the so-called luxury brand can only grow and be profitable by selling accessories, mostly licenses. It means that the brand has, in fact, discontinued the luxury business model, while continuing to leverage its halo of luxury image (inherited from a past fame) to sell fashionable accessories, produced at low cost in some emerging country.

Let's now turn to the fashion business model. It is totally different for one very good reason. What does fashion sell? Just being... fashionable. This simple insight commands the entire fashion production, distribution, and marketing strategy. After two or three months, today's fashion won't be fashionable anymore. As a result, the prices will need to be slashed so that the shops get rid of their inventory and can be ready to showcase the forthcoming collection. In order to maintain high margins despite the necessity to engage in sales, followed by super sales in factory outlets, there is only one solution: to lower the cost of production as much as possible and try to sell at the highest possible prices at the beginning of the season. In any case, once a cloth is out of fashion it is not used anymore. It does not need lasting quality (unlike that of luxury since luxury is here to last). This is why Coach has always acknowledged being made in China. The goal is

to maximize the gross margin, by manufacturing the products at the lowest possible cost. This is normal. In the fashion business model, one lives in a fragile time: being fashionable does not last. Thus, the past, the heritage, and the legends are not important. Nor is the country of origin. However, the designer is, or the strong values held and promoted by the brand.

The *premium* business model is based on the manufacturing of best-in-class products, with an image of style. An example is the skincare sector, in which the ever-increasing claims of skin protection and rejuvenation made in the advertising of new creams and elixirs must legally be justified by scientific evidence. In this business model, time, heritage, and even provenance are not important. Proof is.

To summarize the argument, Muccia Prada recently said (WSJ, June 24th, 2011), "brands need to economise and look for manufacturing territories that offer the best deal, but to also weigh up the consumer response to a luxury brand's source and place of origin." This is a clear statement, admitting that the Prada brand now defines its strategy according to consumers' own trade-offs, just as a mass market brand. But, in fact, what do consumers think about this?

### The consumer opinion on delocalization

Asia is the future of the luxury market, because of its booming economies. It is, therefore, interesting to look at recent research undertaken in the BRIC countries as well as in Japan, which was the former number one market for luxury and is still very high. In interviews with 1,500 luxury buyers in Japan in 2009, McKinsey asked whether they agreed with the following sentence: "I do not care whether luxury goods are made in low cost countries such as China, India, Vietnam, so long as they are genuinely from luxury brands." Only 14% agreed. This means that 86% of Japanese luxury buyers think that luxury brands should not delocalize to countries with low labor costs.

Ipsos, a global market research company, asked another question of luxury buyers in six so-called emerging countries in 2010: "A brand fits more with my idea of a luxury when it is made in my country vs in a western country." The answers ranged from 1 (my country) to 6 (it is a western brand) with intermediate grades corresponding to mixed or in-between opinions. The average answers by country are as follows: Russia 6, South Korea 5.8, Brazil 5.4, China 5.4, Hong Kong 5.3, and India 3.8. Interestingly, in five cases out of six, luxury immediately evokes a product from another country, and specifically from western countries (France, Italy, Germany for cars too).

One should not overlook the role of travel in the growth of the luxury market. In 2010, according to Bain & Co.<sup>8</sup>, total luxury sales inside all of China were smaller than total luxury sales in New York city alone. However, purchases made by Chinese travelling abroad represent as much as Chinese internal market luxury sales. When they travel to Paris, for instance, they visit the Eiffel Tower and The Louvre Museum and then rush to Louis Vuitton's flagship store on the Champs

Elysées. They will bring back a luxury gift from that famous brand, bought in the Parisian store (which increases the perceived value of the gift), like a trophy. They cannot imagine buying in Paris something that is in reality made next door to them, in China, by somebody like them.

Luxury is special. It is the highest form of consumption, in which all the sources of added value are mobilized to produce the desire of something that is not necessary, making it compulsory: both tangible and intangible added values. Behind the luxury brand there is the country cachet and culture. This is why on the basis of ethics as well as of the long-term sustainability of their price, luxury brands should not delocalize, and should remain that for which they are bought: the finest objects and services a country can produce, with the additional unique cachet of being "made in..."

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### Sustaining "made in" as a real brand

Looking at luxury companies's own attitudes, there is a clear segmentation, based on their brand positioning and business model. A first group (such as Louis Vuitton, Hermès, Chanel) emphasize quality and heritage as the main sources of their incomparability. They are patriots. For them, a country of origin is a homeland, much like the soil in a vineyard – a miracle made of earth, nature, sun, rain, and sophisticated human labor, loaded with culture. For them, "made in..." tells a whole story, tying production to a long heritage.

A second group of companies emphasizes the creative style only, much inspired by the fashion business model. Thus Burberry CEO A. Ahrendts defended the company's decision to close its British factory as follows: being made in the UK is not a strategic factor to build consumer preference for the brand, which is mostly based on fashion and British style, not on a specific British manufacturing know-how, unlike some French and Italian luxury brands.

As a result, for this group of companies, the question of "made in" is an empirical one: if there is no difference in the look and feel of the product, consumers' satisfaction is then guaranteed in any case. Since it is less costly to manufacture in China, it is rational to delocalize, from a managerial standpoint. They are advocates of the intangible economy, following M. Porter's thesis on the competitive advantages of nations, in which the West would specialize in what it does best (creativity, design, and marketing), leaving production to emerging countries that will quickly learn how to match the quality level of former local producers of luxury brands. Taking Apple



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as a benchmark, although almost everything in an iPhone is made either in China or in South Korea, a label on every box reminds consumers that the product was "designed by Apple in California." In this manner, the Cupertino company harvests fame and profits by virtue of being the one who conceived and designed this wonder tool. Thus, this segment does not emphasize the phrase "made in," but rather "designed in" or "designed by brand X," or does not emphasize any such particular phrase at all. As one retailer has said, "when a consumer buys Chanel, he/she buys France in the meantime, so why add a tag on the cloth with 'made in France' written on it? To do so would be superfluous."

This raises a question of the specificity of luxury management. First, delocalization diffuses the, thus far, unique country know-how, thereby destroying levers of added value. More structurally, delocalization provides these western brands with access to higher volumes of production, and hence the ability to capture fast-growing consumer demand in Asia, Russia, and Brazil, without limits. Implicitly, this means that luxury is a business just like others, aimed at value creation and shareholder satisfaction (Kapferer, Tabatoni, 2011). We are very far from Hermès philosophy, epitomized by CEO Patrick Thomas: "When one of our products gets too successful, we stop it." This philosophy is surely not unrelated to the remarkable profitability of this luxury brand (its profit in 2010 was 27% of sales). The luxury dream is precisely based on the fact that it is another world, far from all the principles governing the success of global brands made everywhere in the world and selling just an image to as many people as possible: Nike, Adidas, and even Ralph Lauren, Hugo Boss, Tommy Hilfiger, Gant, etc... The latter are often called luxury, because the word "luxury" sells, but they are actually premium stylish brands, if words and business models are to mean something seriously.

The consequence of this latter vision is that "made in" must be defended. Otherwise, it will lose its value. A first consequence is legal. The bar must be set very high to allow the right to use the certification of origin ("made in"). Most importantly, defending the "made in" means that this phrase itself should be managed as a full brand, with both its tangible and intangible sources of added value.

### **The challenges of non delocalization**

To remain a true luxury brand, following the luxury business model, entails sticking to local production. This is not an easy task for many luxury brands. Those that comply must create the conditions that are necessary to sustain this production. This is why they often buy their local sub-contractants in case the latter go bankrupt, to be sure to keep alive a historical

know-how that might otherwise disappear. Another reason might be that the owners of these sub-contracting companies retire, but have no children willing to take their position. Thus, luxury brands play an institutional role in the sector by creating their own schools to encourage youth to enter these rare professions, often unknown amongst most youth, yet very rewarding. Many other brands would have just thrown in the towel and delocalized, happy to find low cost labor in emerging countries or even in Eastern Europe, thus providing a big bonus to the shareholders, since the retail price of the luxury product is exactly the same regardless of the country in which it is made. But are shareholders the managers of the luxury brands, as they are for most consumer goods or even mass prestige brands? Of course not. As long as they remain independent, non-listed, family companies, they have a long-term vision that precludes falling in the trap of short-term benefits. What is at stake is the ability for true luxury companies to remain so distinctive and the source of an exclusive, long-lasting desire.

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