Retail Practice

Patterns for value creation in apparel, fashion, and luxury

Performance in the fashion and luxury industries has turned lower, but leading companies haven't been deterred. Here's how they excel.

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What's been the highest-returning sector over the past 15 years? Many would guess technology or healthcare or even consumer staples. Yet the apparel, fashion, and luxury (AF&L) sector outperformed them all: total returns to shareholders (TRS) rose by 11 percent annually—faster than tech (6 percent), pharma (4 percent), or consumer basics (6 percent).

In recent years, however, the sector's strength has started to wane. Pressure has come from all angles: a new breed of competitors (Amazon and other digital-native brands), heightened consumer expectations (for convenience, engagement, and shared values), alternative modes of ownership (resale and rental), and the continued decline of traditional brick-and-mortar retailing. From 2013 to 2018, the sector added only 4 percent TRS, well below the S&P 500.

All of this took place before the latest and most severe challenge: the COVID-19 pandemic. The AF&L sector has suffered more than most from the outbreak's social and economic effects. Workers are frightened for their health—and their jobs. TRS for the sector have plunged, much lower than in the broader market.

In any crisis, even (or especially) one as severe as this, it is important to take a through-cycle view. On that measure, some companies outperform the sector. McKinsey's recent *The State of Fashion 2020* report identified one group that is having things all its own way: 20 "super winners" benefiting from scale and growth to capture more than 100 percent of the industry's total economic profit. Although that metric is an invaluable measure of absolute value creation in the past, investors' forward-looking expectations for value creation are important as well. Our new research looks at TRS for 180 AF&L companies over five years, 2013 to 2018, to measure the creation of shareholder value in companies of every size and to identify the up-and-comers that may challenge the super winners over time.

The results are stark: the spread between the best and worst value creators is much wider in AF&L than in the broader market. From 2013 to 2018, more than 60 percent of AF&L companies failed to generate any positive TRS. Just 23 percent generated TRS above 10 percent—the threshold for outstanding value creation. By contrast, over this period, nearly 80 percent of S&P 500 companies had a positive TRS, and nearly half were above 10 percent.

In 2015, we published our original findings on TRS in the AF&L sector. We found that the companies creating the most value adeptly managed both current performance and the perceptions of investors. Today, we find something similar—four areas in which the differences between creators and destroyers of value are most acute: business model, price positioning and product categories, balance sheets and cost management, and portfolio structure. In this article, we'll explain what the best value creators do differently in each. We'll close with some observations on the impact of the global pandemic and what it means for the sector.

Business model

The legacy business model is an overwhelming—and largely immovable—influence on performance. We categorized companies among one of five primary business models.[1] In the past five years, off-price retailers have been the top performers, followed by legacy wholesale brands (Exhibit 1). Department stores, specialty retailers, and vertical brands underperformed.

Each cohort starts from a similar place: baseline returns of 4 to 6 percent.[2] As Exhibit 2 shows, two management-influenced factors—sales growth and change in profit margins—separate winning business models from the rest. Off-price retailers and legacy wholesale brands, the top performers, delivered around 5 to 7 percent sales growth, with a negligible impact from changing profit margins. We see almost the reverse among the TRS laggards: sales growth

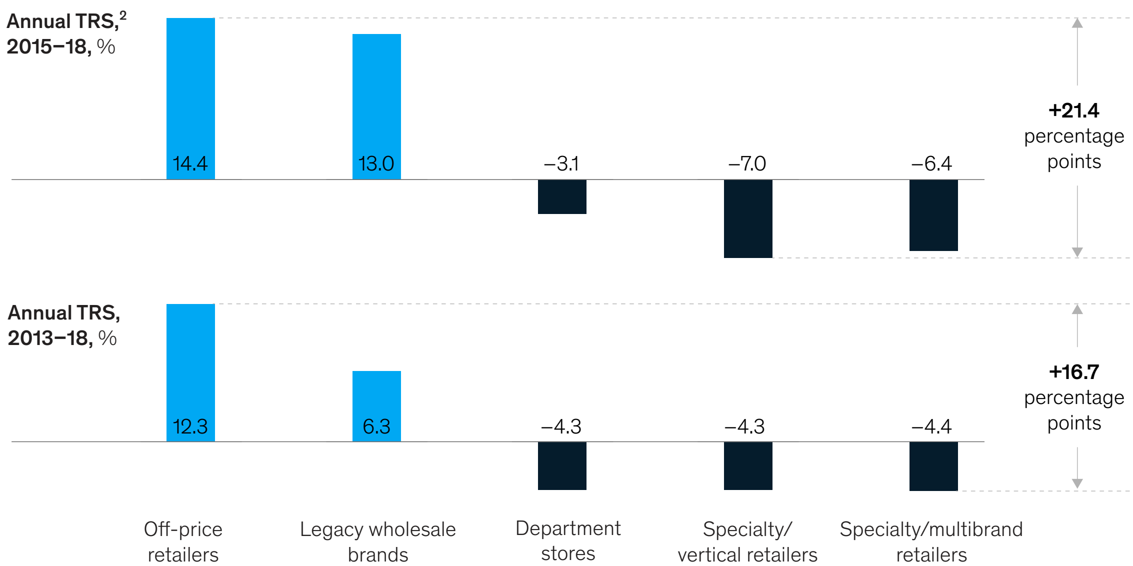
[1] Three kinds of multibrand retailers (*department stores*, such as Kohl's and Hudson's Bay; *specialty retailers*, such as Foot Locker and Urban Outfitters; and *off-price retailers*, such as Ross Stores and TJX), *vertical brands* that mostly sell direct to customers (such as Gap and H&M), and *legacy wholesale brands* that historically sold primarily through retail partners, although their sales are increasingly direct to consumer (such as adidas and Ralph Lauren).

[2] We call this the zero-growth return, defined as the inverse of the price-to-earnings multiple—the expected return if nothing else happens. For the apparel, fashion, and luxury industry, zero-growth returns in recent years have been around 4 percent.

Exhibit 1

Off-price and legacy wholesale brands outperformed other business models.

Brand performance by business model[1]



[1] Companies with brands across >1 type are categorized by their dominant business.
[2] Total returns to shareholders.

Source: S&P Capital Insights; Corporate Performance Analytics by McKinsey; McKinsey analysis

tracked inflation, while falling profit margins reduced TRS by around five percentage points. In essence, these companies have achieved modest growth, but only by sacrificing margins, typically through discounting.

Note also the powerful effect of investor expectations. The off-price retailers in our sample set have seen their operating-profit multiple[3] expand by 6.8 times, on average, while specialty retailers have seen theirs contract by 6.7 times. Investors believe in the off-price business model and are losing faith in specialty retailers. That is driving real changes in TRS.

For companies caught on the wrong side of the trend, fortune might favor the bold. AF&L incumbents continue to test new business models. American Eagle Outfitters, LOFT, Urban Outfitters, and Vince, among others, launched rental businesses in the past year or so. Legacy wholesale brands are doubling down on direct to consumer. Department stores continue to enlarge their off-price businesses, such as Nordstrom Rack. In an extreme postbankruptcy example, one department store is even quitting the business model entirely to become a vertical brand and licensor.

Category and price positioning

Consumer demand has surged for AF&L products at either end of the price spectrum: both luxury and value players delivered strong TRS over the five years we studied, while middle-market players struggled (Exhibit 3).

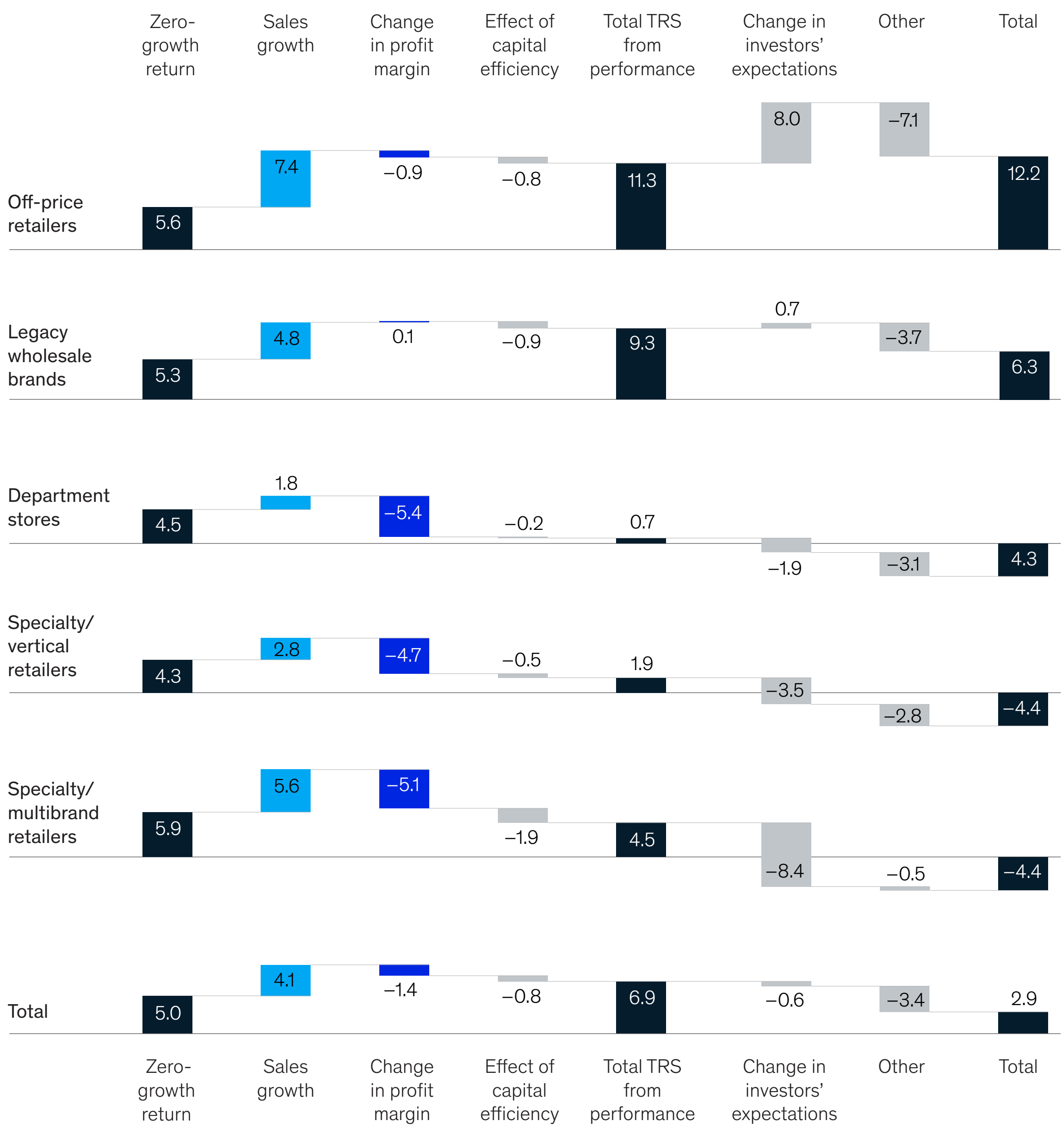
Category tailwinds can be found across AF&L. Soft accessories led the way: handbag and luggage players enjoyed 6 percent revenue growth and 11.2 percent annual TRS (Exhibit 4). Streetwear trends have fueled future-growth expectations in footwear, lifting valuation multiples and raising TRS by an average of 3.4 percentage points. Returns at hard-accessory companies—which market products such as jewelry, sunglasses, and watches—declined by around

[3] Enterprise value divided by net operating profit less adjusted taxes.

Exhibit 2

Two management levers have been critical to leaders' performance.

5-year TRS by business model and components, 2013–18, %[1]



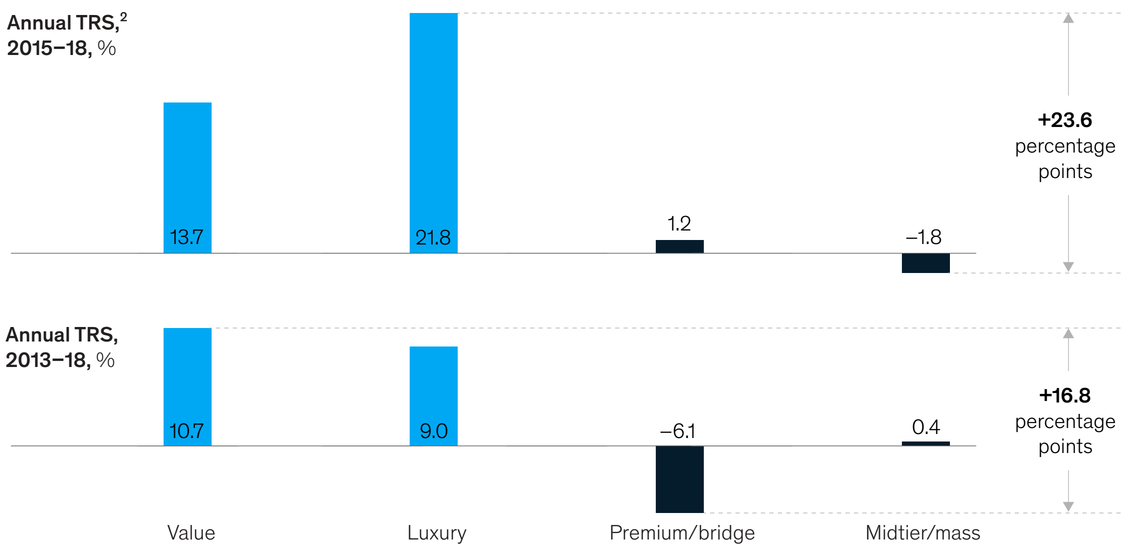
Note: Figures may not sum to totals listed, because of rounding.
[1]TRS = total returns to shareholders. Companies with brands across <1 type are categorized by their dominant business.

Source: S&P Capital IQ; Corporate Performance Analytics by McKinsey; McKinsey analysis

Exhibit 3

Value and luxury brands outperformed; midrange brands and retailers trailed.

Brand performance by price position[1]



[1]Companies with brands across >1 type are categorized by their dominant business.
[2]Total returns to shareholders.

Source: S&P Capital Insights; Corporate Performance Analytics by McKinsey; McKinsey analysis

4 percent. But strength may be returning to the sector, if LVMH's $16.2 billion purchase of Tiffany is any indication.

Several improvement levers are available for nonvalue, nonluxury companies and for companies underperforming in these segments. An evaluation of the product assortment and some targeted experimentation, for example, can reveal the path to value. The most promising strategies involve burgeoning resale marketplaces, where brands can begin to build consumer relationships at unconventional entry points in the customer journey. These operational changes can have a clear impact on value—and on the critical lever of perceptions too.

Financial management

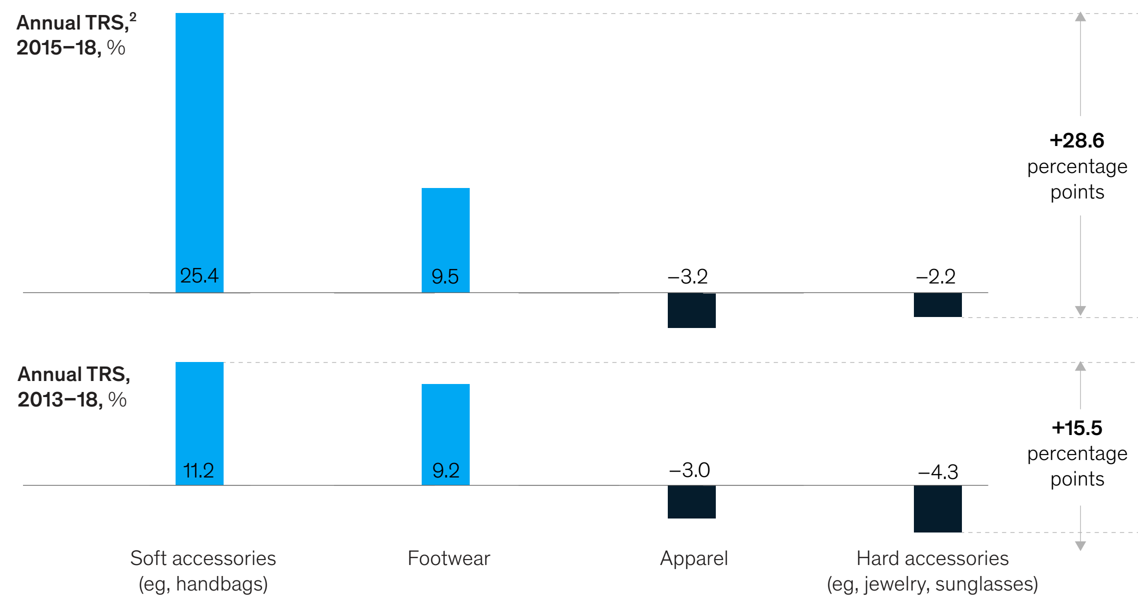
It is perhaps no surprise that in a retail-oriented business, prudent cost and capital management are essential. Our analysis shows that the winners are doing more with less: fewer doors, fewer and more efficient fixed assets, and less debt—not to mention balanced selling, general, and administrative (SG&A) costs (Exhibit 5). Both companies that have not been able to manage costs and companies that have cut SG&A costs by underinvesting in growth have underperformed the broader market. For SG&A costs, we see outperformers deploying classic levers (such as better demand management and reduced organizational spans and layers) alongside next-gen ones (for instance, use of automation and advanced analytics to keep spending ratios stable).

Great capital management is another trademark of value creators. How can underperformers make their balance sheets more efficient? Value creators are improving their store networks by applying advanced analytics to assess omnichannel performance, investing in their highest-quality locations, using design and digital capabilities to revolutionize the customer journey, and experimenting with short-term leases and innovative formats. Despite chatter about the "death of brick and mortar," certain brands have had great success reimagining ways to arm their stores to deliver a unique user experience. New marquee locations—

Exhibit 4

Soft accessories and footwear outperformed.

Brand performance by accessory type[1]

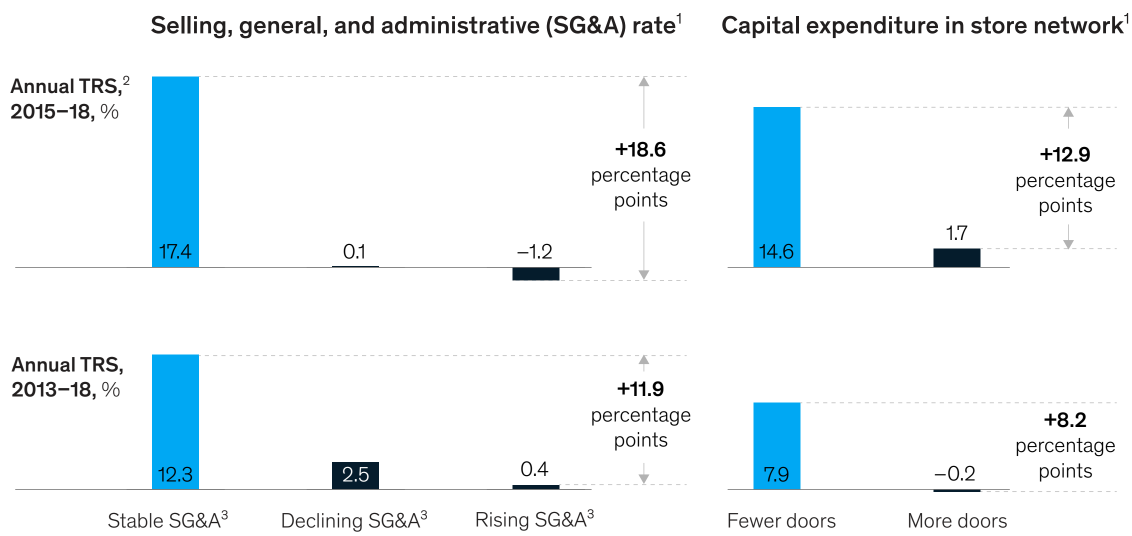


[1] Companies with brands across >1 type are categorized by their dominant business.
[2] Total returns to shareholders.

Source: S&P Capital Insights; Corporate Performance Analytics by McKinsey; McKinsey analysis

Exhibit 5

Stable selling, general, and administrative rate and fewer doors outperformed.



Note: Figures may not sum to listed totals, because of rounding.
[1] Companies with brands across >1 type are categorized by their dominant business.
[2] Total returns to shareholders.
[3] Selling, general, and administrative states defined by change in share of revenue: stable, change of <1 percentage point; declining, decrease of >1 percentage point; rising, increase of >1 percentage point. For 5-year total returns to shareholders, calculated as 3-year trailing average for 2013 vs 2018; for 3-year TRS, calculated as 2-year trailing average for 2015 vs 2018.

Source: S&P Capital Insights; Corporate Performance Analytics by McKinsey; McKinsey analysis such as the Nike NYC House of Innovation/000 or the Modern Retail Collective store of the future (with McKinsey as a proud partner) at the Mall of America—are delivering immersive, reactive retail experiences at one-of-a-kind destinations.

Portfolio structure

In a trend-driven business, moderate diversification is a virtue. One of the clearest ways for AF&L brands to differentiate their performance would be to take a portfolio approach. The TRS gap for multibrand portfolios has widened over the past three years. Even more dramatically, the TRS gap between companies active in M&A (completing more than one M&A deal a year, on average) and those that aren't widened to 10.8 percentage points, from 5.7 (Exhibit 6). We see this across industries: companies that are active, committed stewards of their portfolios consistently outperform their less dynamic peers. In M&A, a programmatic approach—multiple smaller bets over a few years—outperforms any other strategy across all industries.

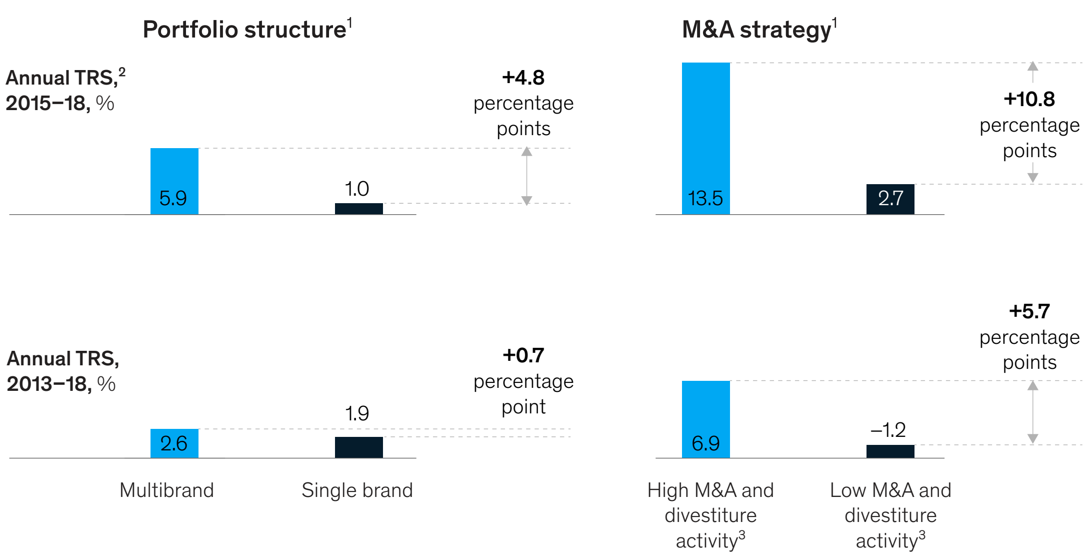
M&A is no cure-all, however; it is difficult to execute, particularly in AF&L. Nonetheless, a well-implemented inorganic-growth strategy that exploits a company's core source of competitive advantage can often be the first step in a transformation from laggard into category-defining giant. LVMH rigorously uses its global branding, marketing, and product-development expertise across luxury categories such as apparel, beverages, footwear, and even hotels. Divestitures, too, are an important part of portfolio shaping: VF, for instance, has willingly parted with brands that no longer fit its strategy—as it did when it spun off its denim portfolio into Kontoor Brands—reinforcing the growth story and keeping VF near the top of the TRS rankings.

The substantial disruption from COVID-19

Social distancing and shutdowns of nonessential businesses in major markets around the world have hit the AF&L sector hard. In 2020, shares through March 17 are down 32 percent, ten points worse than the S&P 500. All but three companies in our data set are down at least 15 percent year to date, and a third are down more than 50 percent. There are a few bright spots: diversified companies,

Exhibit 6

Multibrand structures and programmatic M&A strategies outperformed.

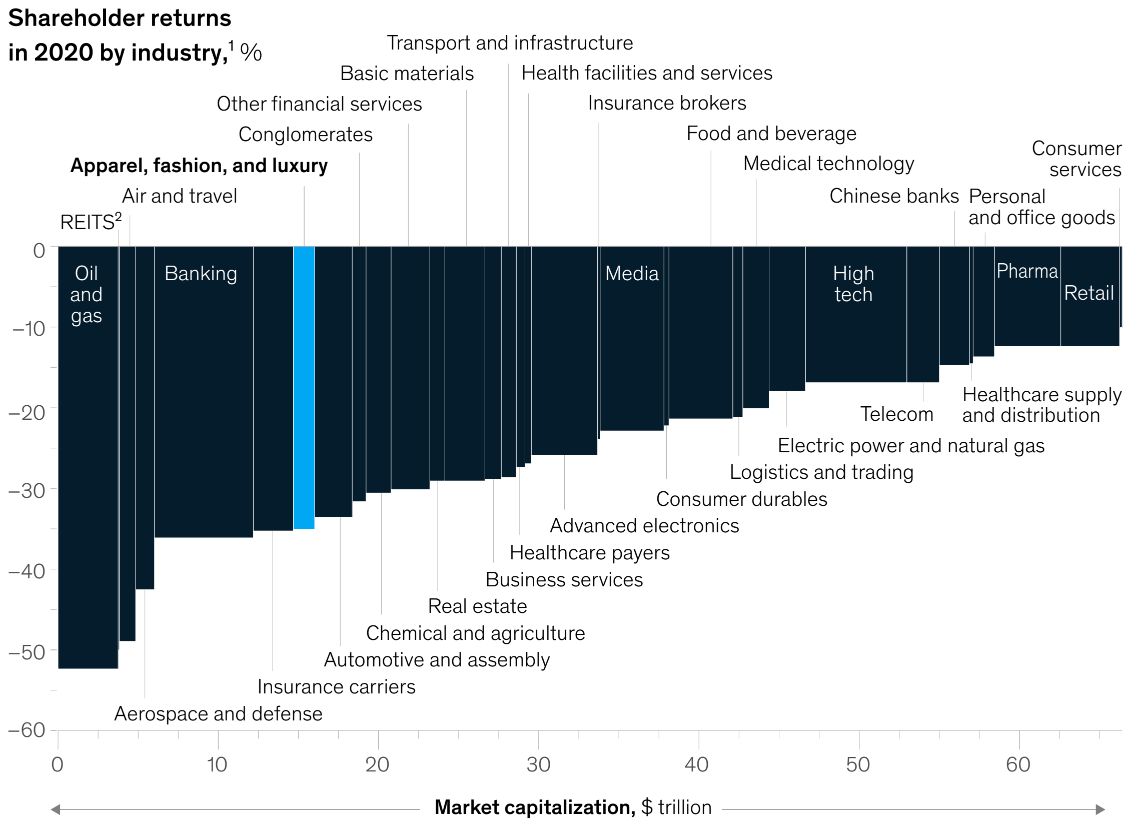


Note: Figures may not sum to listed totals, because of rounding.
[1]Companies with brands across >1 type are categorized by their dominant business. Excludes beauty companies.
[2]Total returns to shareholders.
[3]Activity defined by number of acquisitions or divestitures in past 5 years (includes deals of all sizes; excludes real-estate transactions): high, ≥6; low, ≤5.

Source: S&P Capital IQ; Corporate Performance Analytics by McKinsey; McKinsey analysis

Exhibit 7

Apparel, fashion, and luxury is among the worst-affected sectors.



[1]As of March 18, 2020. Adjusted for currency. Data set includes global top 3,000 companies by market cap in 2019, excluding some subsidiaries, holding companies, and companies that have delisted since.
[2]Real-estate investment trust.

Source: S&P; McKinsey analysis

including those with multiple brands, varied distribution channels, or active M&A, are slightly outperforming their peers; retailers that have shrunk their footprints are 11 points ahead of store growers; and companies based in regions where the pandemic has not yet had significant impact (Latin America) or has possibly peaked (Asia) are now outperforming those in Europe and North America (Exhibit 7).

Despite the massive uncertainty, two clear truths are already emerging. Companies must take decisive action, even in the face of ambiguity. And a clean balance sheet with plenty of liquidity has never been more critical to survival.

The AF&L sector has tremendous value at stake for companies that can make not only the right choices but also, in many cases, bold moves, which our colleagues' research has shown to be essential for companies that want to vault from the middle of the pack or from good to great. Across the industry, in every segment and every category, the gap between the haves and the have-nots is stark. Although the ideas involved in value creation may be straightforward—improve performance and win over investors—the tactics involved are anything but. By understanding the drivers of under- and overperformance, companies can steer their own fate.

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