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An action plan for the hard-hit fashion industry

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Executive summary

For Western fashion companies, the last few years have provided a sobering reminder of the perils of making the wrong investments. Many companies in Europe and the U.S. increased their retail store space; others invested heavily in their e-commerce websites, believing that direct sales from their own branded stores would be essential to their success. Not all of these bets were right for every company, and companies that got it wrong have been penalized heavily. Many of them are struggling with the resulting high fixed costs and diminished retail store productivity.

The companies' challenges are evident in declining profits and sharply lower shareholder returns. Strategy&, PwC's strategy consulting business, analyzed 41 Western fashion companies (publicly listed European apparel manufacturers and retailers and U.S. fashion players with significant European business) and determined that they provided an average total shareholder return (TSR) of 5.8 percent on a compound annual basis from 2013 through 2015. That is a significantly lower TSR than most other consumer sectors achieved and represents a steep falloff from the fashion companies' returns just a few years earlier. Luxury fashion companies and middle-market fashion companies have deteriorated the most, Strategy&'s analysis shows. Two other fashion segments — sportswear and best value — have been more resilient from a TSR perspective thanks to their better fit with consumer trends.

This is an important time for fashion companies to make sure that their strategies are clear and differentiating. The companies' priorities should include making operations leaner and using any freed-up funds to push their organizations to be more entrepreneurial, more customer-centric, and more adept at connecting to outside partners through technology. The fashion companies that make these adaptations will be in the best position to prosper — and return more to their shareholders — in the years ahead.

Fashion's declining returns

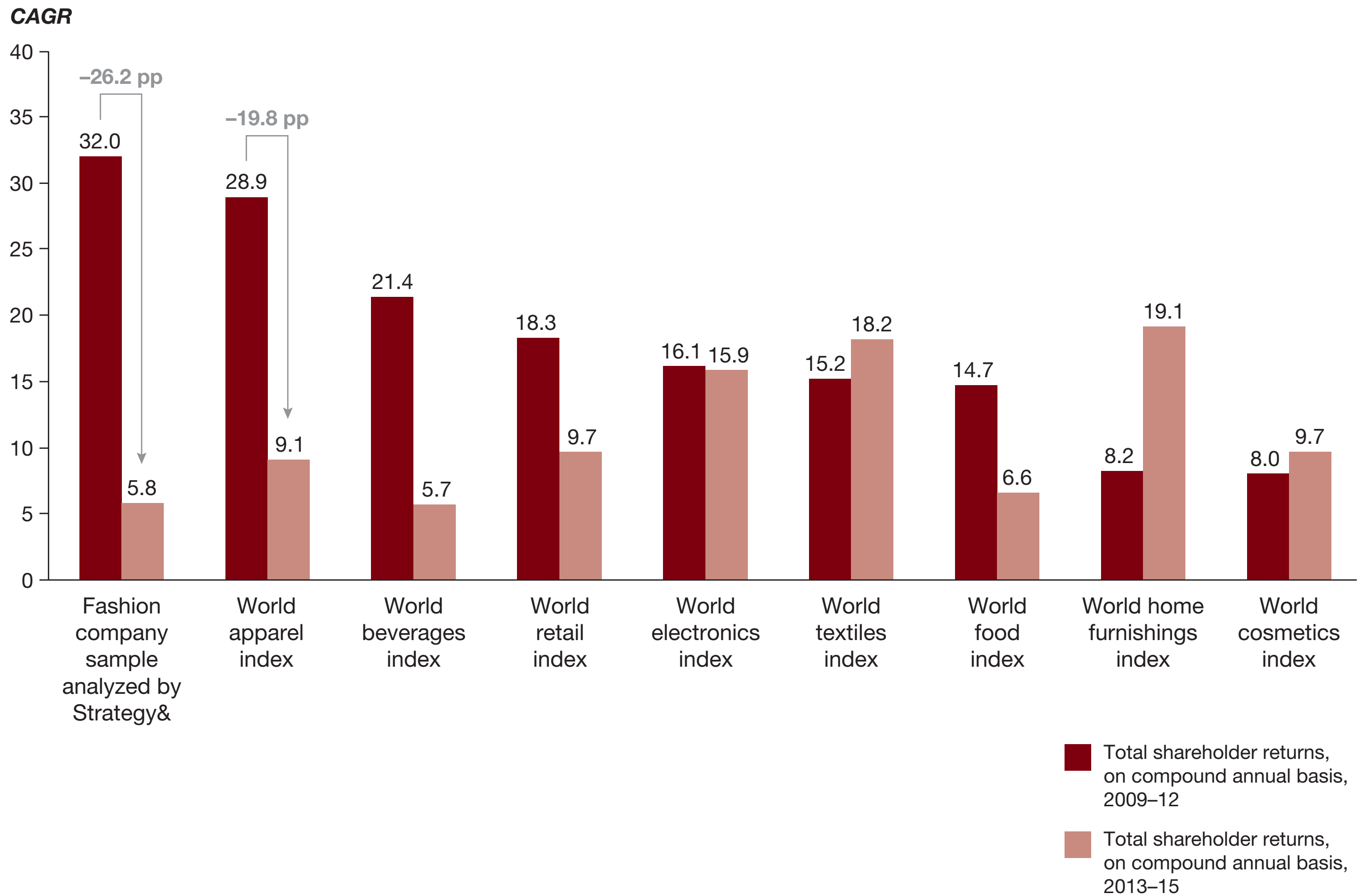
A few years after spending heavily to expand their traditional and online retail presence and build out aspects of their supply chains, some fashion companies are probably regretting those decisions. The resulting higher fixed costs have wreaked havoc on profitability in the fashion sector, causing shareholder returns to fall dramatically since 2013.

Among a sample of 41 publicly listed fashion companies either based in Europe or based in the U.S. but having significant European business, total shareholder returns (TSRs) were more than 26 percentage points lower from 2013 through 2015 than they had been in the four previous years, an analysis by Strategy& shows. Since 2013, the average 5.8 percent annual return that these companies have provided is essentially tied with that of beverage companies for the worst performance of any consumer goods sector (*see Exhibit 1, next page*).

Strategy&'s analysis of 41 publicly listed fashion companies comes at a time when the industry is facing conflicting pressures — to keep its costs down on the one hand, and to augment its digital capabilities and strengthen its brand appeal on the other. In the face of these pressures, only about one of every six Western fashion companies increased its TSR over the earlier period, from 2009 through 2012. (See "Understanding the TSR metric" for an explanation of total shareholder returns, page 14.)

From a financial perspective, the biggest challenge for the fashion industry is profitability. Margins for earnings before interest, taxes, depreciation, and amortization (EBITDA) fell by an average of about 4.5 percent annually between 2013 and 2015. Fashion companies are paying a price for investments that have not panned out, including in their supply chains or in new retail shops or flashy flagship stores, which in many cases have diverted resources and attention away from larger wholesale businesses. Their costs have simply been too high even for the seemingly healthy revenues the companies have been generating. Fashion companies' revenue rose by an average of 7.5 percent in each of

Exhibit 1
Fashion company returns have fallen sharply



Note: The Strategy& fashion sample is primarily a European and U.S. index. (The 41 companies in it are listed in Exhibit 4.) The world apparel index has more geographic breadth, including a large number of Asian companies.

Source: Bloomberg financial data; Strategy& analysis

the last three years, about the same growth rate as between 2009 and 2012 (*see Exhibit 2, next page*).

To get a better sense of where Western fashion companies are struggling, Strategy& broke the market into four broad categories: best-value companies, known for their low prices; luxury companies, which sell high-priced apparel and other goods, usually under prestigious brand names; middle-market companies, which occupy an in-between point on the price continuum; and sportswear companies.

The pain has not been felt equally. Middle-market and luxury companies have faced the greatest challenges. Best-value and sportswear companies have fared better.

Middle-market companies were among the fastest to expand their retail footprints in the period after the financial crisis; in the last three years, this segment's average EBITDA margin has undergone a sharp decline. As for the luxury companies, every component of TSR made a lower contribution in 2013–15 than in the previous period. Like the middle-market companies, luxury companies seem to have overinvested in retail space expansion. Luxury companies have also had to deal with sharp sales downturns in Russia and China, two regions rocked by economic trouble whose consumers were previously avid buyers of high-priced apparel.

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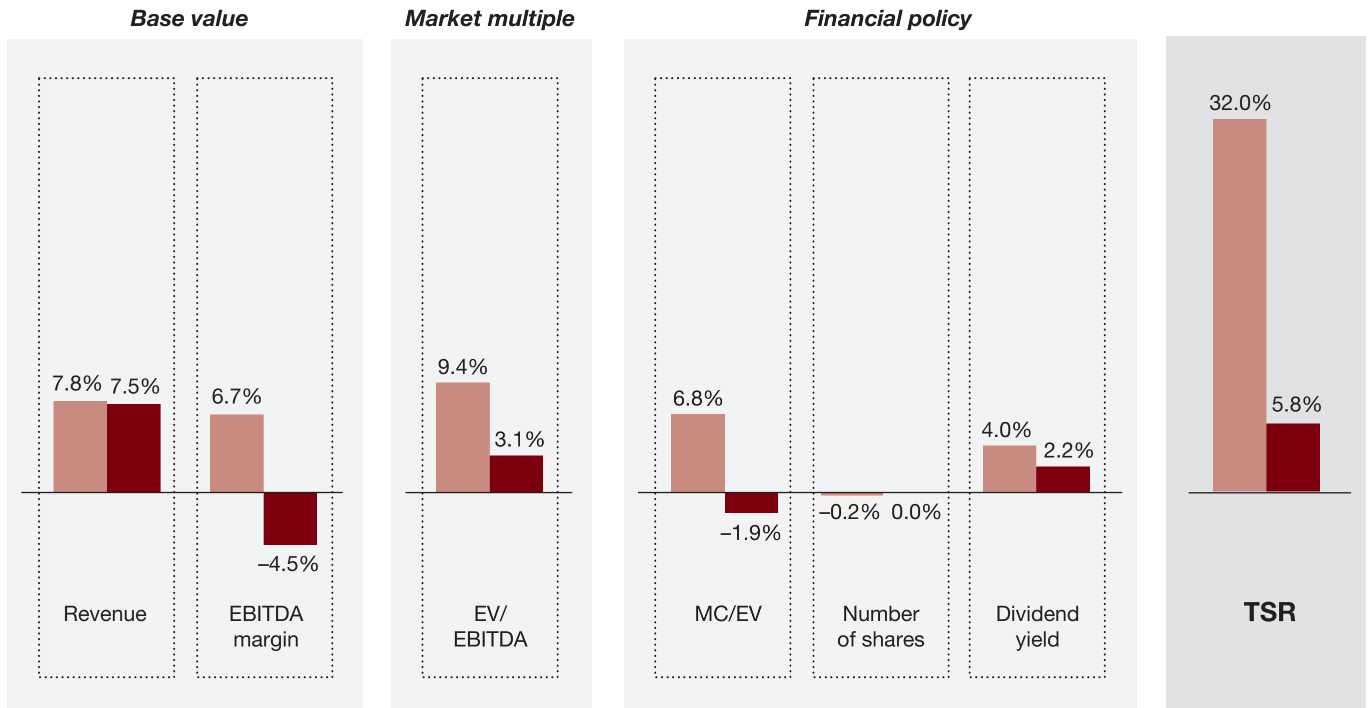
By contrast, the TSR results show there is a relatively high level of enthusiasm among investors for companies in the best-value fashion segment. Best-value companies have not been growing as quickly as they did from 2009 through 2012, and their profitability has declined, but the rise in market multiples suggests that investors remain optimistic about this sector's underlying strategy of offering apparel at significantly lower prices than other fashion companies.

Sportswear companies (whose returns were down by only some 4 percentage points in 2013–15 versus the earlier period) have also benefited from higher market multiples. And unlike best-value companies, the sports segment's growth has accelerated. Sports companies like Nike and Adidas have benefited from the increasing numbers of consumers who participate in athletics, who opt for sportswear as their everyday attire, and who view sportswear (including sneakers) as a fashion statement in its own right (*see Exhibit 3, page 9*).

The weak TSR performance of middle-market and luxury segments, and the better performance of sportswear and best-value fashion companies, can clearly be seen in a ranking of the 41 companies in our study (*see Exhibit 4, page 10*). Among the 10 worst TSR companies are six middle-market companies and three luxury companies. Sports and best-value

Exhibit 2
Breaking down TSRs in the fashion industry

Each component's annual contribution to TSR in the periods shown



Note: EV = enterprise value; MC = market capitalization. Because of some noncomparable periods, the averages are based on 39 companies in 2013–15 and 36 companies in 2009–12. Due to rounding, TSR percentages shown here may not add up precisely to the totals provided.

Source: Bloomberg financial data; Strategy& analysis

Exhibit 3
Return per fashion segment and what's driving it

Segment	2013–15, TSR CAGR in %	Key TSR driver		Description
Best-value market	27.5%	**Market multiple:**	+20.2%	Investor perception that market share of best-value companies will continue to go up
Sportswear market	24.1%	**Revenue:** **Market multiple:**	+10.4% +10.3%	Revenue growth and positive investor perception, especially of leading brands
Luxury market	2.7%	**EBITDA margin:** **Market multiple:**	–5.1% –1.2%	High investment in store expansion and e-commerce; less consumer buying of luxury goods
Middle market	–1.8%	**EBITDA margin:** **MC/EV:**	–5.9% –4.5%	Overinvestment in store expansion leading to declining store productivity; pricing pressure from other players and from powerful e-commerce gatekeepers

Note: EV = enterprise value; MC = market capitalization. Analysis of 39 companies. (Billabong and Esprit are excluded because of some noncomparable periods in their results.)

Source: Bloomberg financial data; Strategy& analysis

Exhibit 4
Ranking fashion companies by shareholder return

#	Company	Segment	TSR 2013–15	Δ TSR 2009–12
1	Under Armour	Sports	49.2%	7.2%
2	Nike*	Sports	35.4%	14.7%
3	Adler	Best value	32.5%	n/a
4	ABF*	Best value	30.1%	7.2%
5	Foot Locker	Sports	28.2%	–19.2%
6	IC Group*	Middle	26.7%	–9.3%
7	Luxottica	Luxury	26.6%	=
8	Columbia Sportswear	Sports	23.6%	10.5%
9	VF Corp.	Middle	20.2%	–10.8%
10	TJX	Best value	19.8%	–23.9%
11	Inditex	Middle	16.2%	–21.0%
12	Hennes & Mauritz (H&M)*	Middle	13.8%	–0.3%
13	Christian Dior*	Luxury	13.1%	–22.7%
14	Hermès	Luxury	12.8%	–11.2%
15	Adidas	Sports	11.9%	–14.9%
16	Calida	Middle	10.7%	–14.2%
17	Asos*	Middle	8.6%	–73.0%
18	Brunello Cucinelli	Luxury	7.6%	n/a
19	LVMH	Luxury	7.1%	–25.4%
20	Kering	Luxury	6.9%	–28.0%
21	Hudson’s Bay	Middle	4.0%	n/a
22	Hugo Boss	Luxury	2.8%	–47.0%
23	Ludwig Beck	Middle	2.2%	–32.6%
24	Richemont Group	Luxury	2.1%	–35.6%
25	Burberry	Luxury	2.1%	–53.8%
26	Wolford*	Middle	0.1%	–21.2%
27	Puma	Sports	–3.8%	–17.3%
28	Gap	Middle	–4.6%	–29.7%
29	Ahlers*	Middle	–6.1%	–27.3%
30	American Eagle Outfitters	Middle	–6.3%	–33.3%
31	Esprit*	Middle	–7.0%	14.9%
32	Ralph Lauren	Luxury	–8.0%	–43.4%
33	Billabong*	Sports	–10.8%	14.2%
34	PVH Corp.	Middle	–12.6%	–66.1%
35	Coach*	Luxury	–12.9%	–42.2%
36	Giordano	Middle	–14.5%	–58.7%
37	Abercrombie & Fitch	Middle	–15.1%	–36.9%
38	Charles Voegele	Middle	–18.2%	–7.5%
39	Gerry Weber*	Middle	–25.6%	–64.7%
40	Prada	Luxury	–28.4%	n/a
41	Tom Tailor	Middle	–31.4%	n/a

* A company whose fiscal year doesn’t coincide with a calendar year and that hasn’t yet reported its 2015 results.

Source: Bloomberg financial data; Strategy& analysis

fashion companies occupy seven of the top 10 slots on our list, with particularly strong performances by number one performer Under Armour (TSR of 49 percent from 2013 through 2015) and second-place performer Nike (35 percent TSR).

As a whole, the ranking shows how hard it has been for fashion companies to eke out a gain in TSR performance during the more recent period studied. While 26 fashion companies had positive TSRs (that is, TSRs above zero) from 2013 through 2015, only six companies in the sample had TSRs higher than they were in the 2009–12 period. Almost all of the companies with TSRs above zero (25 of the 26) got their biggest performance boost either from higher revenue or from a higher market multiple, a measure of a company's stock price in relation to its earnings. Roughly half of the companies with negative TSRs were primarily hurt by a decrease in their EBITDA margins, underscoring the damage to companies that overestimated the benefit they would get from retail space expansion, website investments, verticalization of the supply chain, and other investments.

Imperatives in the next few years

We believe that Western fashion companies need to concentrate on three areas if they are to stabilize and improve their shareholder returns. The first is to focus on branding, positioning, and strategy; the second is to home in on digital opportunities; the third is to transform to be more customer- and product-centric.

Focus on branding, positioning, and strategy

Strengthening their brands requires companies to be clear on what is differentiating in their market position, on who their customers are, and on how they are going to reach those customers. This clarity should determine all of a fashion company's activities — both online and offline — and should result in a consistent presentation of the company's brand profile in physical stores, online, and over social media.

Strategically, companies must recognize the growing importance of digital ecosystems in their marketing — including services like Twitter and Facebook. As for digital channels, these cannot be ignored or resisted; instead, they should be embraced and developed. It is the rare fashion company that has the combination of brand strength, scale, and resources to do a significant amount of business selling directly to consumers online. Instead, most fashion companies should define their unique selling propositions and identify parts of the e-commerce value chain where they can be successful. A key question is deciding how to deal with fashion's immensely powerful gatekeepers — namely Amazon, Alibaba, Asos, JD.com, and Zalando.

Develop digital abilities and opportunities

To take advantage of the industry's fast-emerging digital ecosystems, fashion companies need to develop agile IT platforms. An agile approach to IT means greater flexibility and scalability and an ability to link to external partners and interfaces quickly. The real-time processing of internal and external data that will be enabled by these external linkages will significantly increase transparency and the accuracy of forecasting. It will also enable fashion companies to operate

more efficiently across their supply chains, making step changes in speed and flexibility at a cost that is justified by the benefit. As an example, leveraging real-time sell-out data from gatekeepers' websites helps to manage reorders and avoid out-of-stock situations.

The other capability, besides agility, that is needed as fashion companies move to fulfill their digital sales potential is a deep expertise in data analytics. Data analytics can help fashion companies figure out what happened, why, and what might work better, and make adjustments to their business. For instance, the U.K. fashion retailer Next, with £4.1 billion (US$5 billion) in annual revenue, uses Blue Yonder, an analytics software company, to help it find new customers. Data analytics can also be used to implement dynamic pricing, the on-the-fly adjustment of prices to capitalize on seasonal, time-of-day, and individual user dynamics. And a few players are pushing the boundaries of digitization even further. Google and Zalando recently showcased a pilot in which an artificial intelligence system creates a virtual design of a piece of clothing for consumers based on the consumers' input.

Reduce nonessential activities and become more entrepreneurial

From an organizational perspective, fashion companies need to adjust to the changes taking place externally. This has a couple of implications. First, it means moving to a leaner organizational structure. Looking at the reduction in manual steps as more sales happen digitally, a company may decide to streamline support functions. For that matter, a company may decide it can outsource certain activities altogether. Examples of functions that may be outsourced include fulfillment activities such as pick and pack and some aspects of online marketing. (In most cases, fashion companies should continue to manage their more differentiating e-commerce functions — such as pricing and visual merchandising — with in-house teams.) The determination of what may be outsourced or "leaned out" depends on an assessment of how core the activity or capability is to the company's future.

The second organizational adaptation is trickier. It involves transforming the company's culture so that managers and employees have more of an entrepreneurial mind-set and are more willing to take risks. Essentially, it is about realizing that disruption is inevitable and trying to trigger the disruption oneself rather than wait for someone else to do it. Recognizing the obstacles to this, some companies have created small, internal startup-like organizations and put them in charge of their digital strategies. The thinking is that if they hit on something big or that will make a difference, the innovation can be implemented company-wide. Over time, the startup teams and mentality will need to be reintegrated into the core organization and business.

Data analytics can be used to implement dynamic pricing.

Understanding the TSR metric

Total shareholder return (TSR) provides a picture of the value created by a company for its investors. In this report, we compare Western fashion company TSRs for two periods — the three years from 2013 through 2015 and the four years from 2009 through 2012. The numbers that result are directly comparable because the TSRs reflect compound annual growth rates — that is, the average total return that an investor has gotten in each year.

TSR (used in this report to get a macro-level view of the performance of the fashion industry and a micro-level view of individual companies) depends on several underlying factors. One is a company's base value, which is driven by revenue and its level of EBITDA. The second determinant of TSR is a company's market multiple, which reflects investor perceptions about future cash flows. And the third contributor to TSR is a company's financial policy, meaning its decisions about leverage, dividend payouts, and financial structure. By understanding these drivers, executives can take steps to improve returns for their shareholders.

Prerequisites to success

Companies, much like individuals, sometimes pay a price for being too exuberant in their investing. That partially explains what has happened to Western fashion companies in recent years.

When added to the ripple effect of changing consumer preferences, ill-conceived investing decisions have left many of these companies with asset or capability investments that have become hard to justify. They must now rethink these tactics and carefully consider whether their strategies will win going forward.

In a world in which customers want to engage with their favorite brands digitally, every traditional fashion company is going to have to make adjustments. To start with, such companies need a crisper brand position. They also will have to lay the groundwork for greater entrepreneurism in their organizations, and move toward IT systems that can easily connect with outside gatekeepers and other partners. Guiding this activity should be a clear, bold strategy that employees understand and that drives their daily — indeed hourly — decision making. Companies that show discipline about this will have the best chance of profitable growth and of rewarding their shareholders in the years ahead.

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