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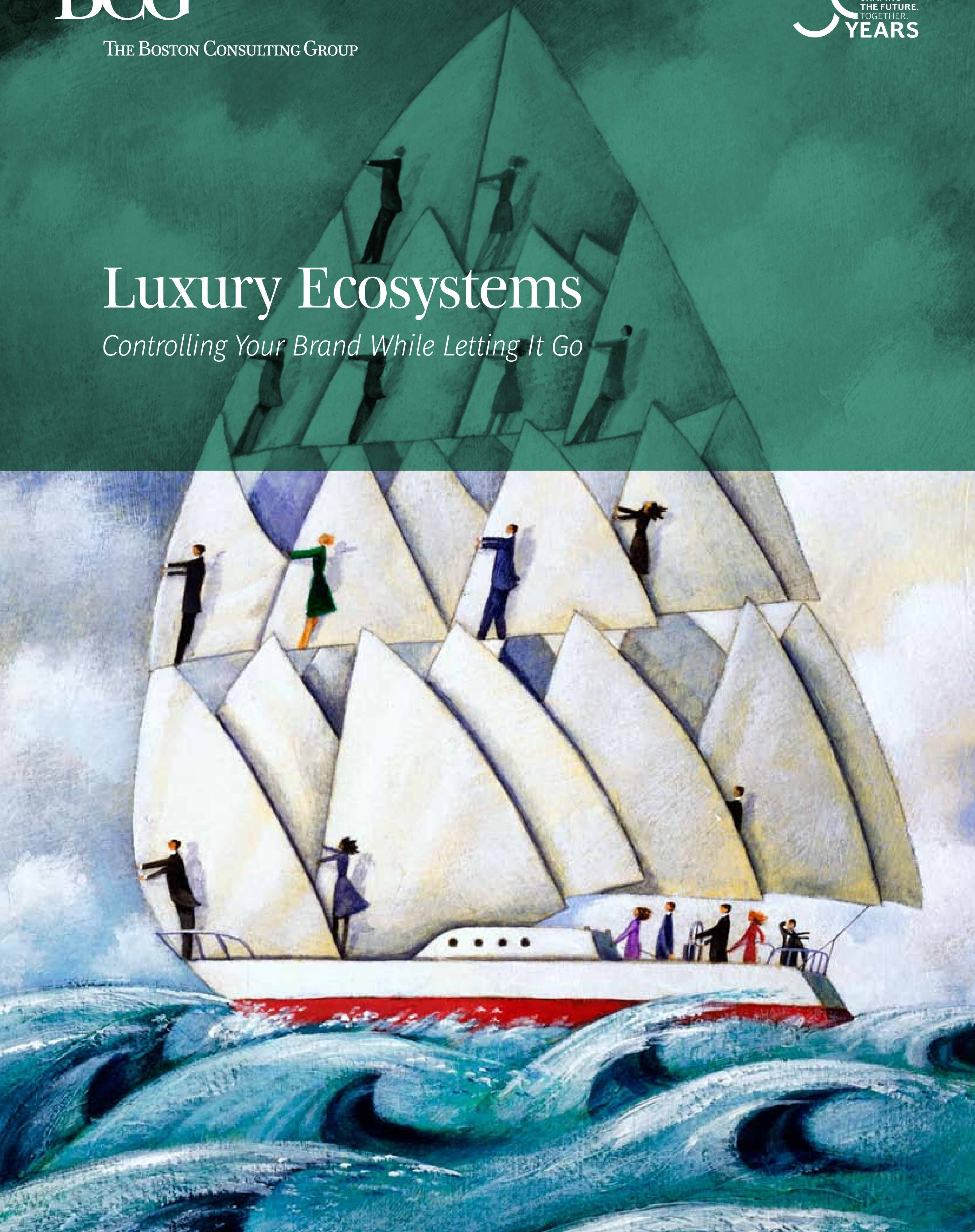
Luxury Ecosystems

Controlling Your Brand While Letting It Go



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Luxury Ecosystems

Controlling Your Brand While Letting It Go

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AT A GLANCE

Luxury brands cannot assume that the business models they have used so far will enable them to continue capturing new opportunities in the future. They must evaluate ecosystem models, which would let them keep control of their brands while forming partnerships that provide new competencies, channels, markets, and products.

A Luxury Ecosystem Defined

A luxury ecosystem describes a confederation of partners assembled by a luxury brand and united over the long term by a shared vision of the future. The brand is effectively the gravitational center; it orchestrates many of the partners' actions and works to build and maintain trust among all parties.

The Advantages of Forming a Luxury Ecosystem

Increasingly, companies benefit by bringing in ideas and expertise from the outside. A luxury ecosystem helps reduce the risks and costs of innovation because many more sources are contributing to the pool of new concepts. And it helps companies overcome the challenges of scale that affect many luxury brands today. It also provides an unmatchable advantage: agility.

NOT SO LONG AGO, Nokia was a powerhouse in the mobile-phone business—arguably the industry's dominant brand worldwide, with a market capitalization that had made the company one of the largest blue chips in Europe.

Then along came Apple.

The iPhone shattered the prevailing ideas of value creation in personal mobile communications. Apple was not just making and selling a product, it was bringing together a range of attractive offerings from a whole universe of partners, large and small. Yet despite the size and diversity of this universe, the offerings were tightly integrated: Apple was guaranteeing a homogenous and pleasing experience for the customer—a crucial factor in its success.

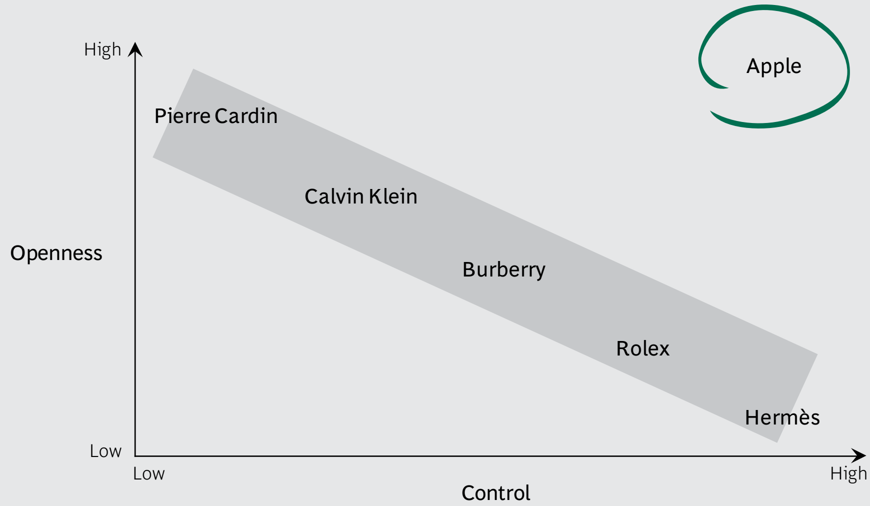
For Nokia, there was worse to come. The company began losing ground to manufacturers of phones using the Android operating system—in particular, the attractive, feature-rich handsets from Samsung. When Nokia's new chief executive sent out an internal wake-up memo, he described the company's challenges this way: "Our competitors are not taking our market share with devices; they are taking our market share with an entire ecosystem."

There is a powerful message here for CEOs in the luxury goods and services sector. By assembling such a powerful coalition, Apple did a very unusual thing: it established a balance between control and openness—two historically incompatible ways of managing a brand. (See Exhibit 1.) Apple had long been famous for its tightly controlled, or closed, business model. Yet the company had opened itself up to a host of partners, from giant telecom companies to independent contractors.

In today's "wiki world" of increasing openness, companies benefit by bringing in ideas and expertise from the outside.

More and more luxury houses will have to master that balancing act. Because most luxury companies feel strongly about maintaining control of their brands, they have been reluctant to work with partners on strategic projects and have retained most aspects of their value chains in-house. But that approach is rapidly being challenged by market circumstances. In today's "wiki world" of increasing openness—between customers and suppliers and between shoppers and brands, and where the lines between competition and cooperation have begun to blur—companies increasingly benefit by bringing in ideas and expertise from the outside. That is especially so in the luxury world, where future growth for many companies will depend on success in new market categories, locations, and channels—and where partnerships, when thoughtfully and carefully orchestrated, can make the difference between success and failure.

Exhibit 1 | Companies That Find a Compromise Between Control and Openness Will Gain a Competitive Edge



Source: BCG analysis.

The Elements and Benefits of a Luxury Ecosystem

A luxury ecosystem describes a confederation of partners assembled by a luxury brand and united over the long term by a shared vision of the future. The brand is effectively the gravitational center of the ecosystem; it orchestrates many of the actions taken by the partners and plays the leading role in building and maintaining trust among all parties. Companies that have established the right partnerships can benefit from cumulative expertise that would take years to build independently. At the same time, a luxury ecosystem ensures that the consumer perceives the brand as a unique, well-designed, and valued product or experience.

So how does this alliance differ from the many partnerships and license agreements that most luxury CEOs have already signed? The distinctions are subtle—more a matter of degree than substance—but their impact is far-reaching.

The partners in a luxury ecosystem may be tightly connected, through formal joint ventures or alliances, or loosely attached, through affiliations that bring mutual advantage from time to time. The partnerships may center on a wide variety of topic areas, such as new-product development, entry into new markets, or new channels through which the partners can reach to forge relationships with customers. The interactions between partners generally involve more integration and greater trust—key for achieving the compromise between control and openness—regardless of how tightly scripted a contract agreement might be; partners treat each other's teams as if they were their own. In addition, there is an exchange of give-and-take: each partner puts something at stake in expectation of greater gains later on, with economic incentives increasing for both sides as the ecosystem evolves. Effective ecosystems also share processes for monitoring progress and gauging results.

Specifically, luxury ecosystems provide competitive advantages that are not readily attained within the traditional confines of the industry. They help reduce the risks and costs of innovation because many more sources are contributing to the pool of new concepts. In a world where innovation in everything from new materials to new luxury experiences happens in much more open ways—and often follows quite unpredictable paths as a result—relying solely on an internal team can easily blind an organization to what's coming next. Furthermore, the luxury ecosystem model helps overcome the challenges of scale required to build a specific and distinctive competence. This point is all the more relevant given the extent to which luxury companies must demonstrate a wider range of competencies today, from digital to retail.

Luxury ecosystems deliver an unmatchable advantage—agility—even for brands that are largely immune to issues of scale or time to market. When a company must move more quickly and forcefully, a luxury ecosystem can amplify or accelerate the process. When circumstances dictate a slower, more measured approach, the ecosystem can be scaled back without hurting the core brand.

Luxury ecosystems deliver an unmatch-able advantage: agility.

Overall, a luxury ecosystem can create a stronger competitive advantage for a luxury brand because it requires more sophisticated modes of control, precisely calibrated processes, and carefully planned outcomes. Competitors can easily blunt any edge a company might gain by opening a larger, fancier flagship store. But it's not as easy for them to match the nuanced blend of hard and soft skills needed to successfully manage a luxury ecosystem centered on a brand. That innovation is far more difficult to decipher—let alone to replicate.

The Right Time for Ecosystems

Quite simply, the competencies and characteristics that got luxury brands this far cannot be relied upon to carry them forward in an increasingly volatile world. A greater proportion of the sector's growth will occur in new categories and territories: online sales will continue to power ahead, and consumers in nations with growing economies, such as China and Brazil, will begin to demonstrate increased appetites for luxury. BCG's calculations show that from 2011 through 2015, the traditional markets of Europe, Japan, and the U.S. will grow at a rate of only 2 to 6 percent per year, while new markets will soar at more than 15 to 20 percent year on year, and online markets will surge ahead more than 20 percent annually. The consequence: luxury brands' management teams must soon begin exploring other options.

Multiple factors are converging to make the ecosystem model critical for luxury brands' long-term success. To begin with, the sector is becoming more crowded, and brands need new ways to differentiate themselves and increase their visibility. At the same time, the industry remains very fragmented: BCG's data show that the top four players in personal luxury products have just 21 percent of the available market, whereas the top four in mobile-phone handsets command a 55 percent share, and the top four sports-equipment companies account for almost two-thirds of their market.

This fragmentation bodes ill for luxury brands' ability to scale up—not in absolute terms but in terms of being able to add the right competencies when and where needed—and thus for their ability to grow as they expect. Many luxury houses are effectively "subscale," especially now that the bar is higher for what constitutes scale in the luxury business. A decade ago, producing annual revenues of around $500 million was enough for a typical global brand, whose clients would have been concentrated in a few large cities in traditional markets. The company also would have had consumer segments that were both fewer in number and more homogenous in terms of culture, earning power, social class, and retail buying patterns than those of companies today. The customer and market aspects of luxury brands now are very different; Chinese buyers alone account for as much as 40 percent of global sales of some key brands, for example. For a company to become a relevant global brand, it must achieve yearly sales revenues of at least $1 billion—preferably closer to $2 billion.

Concurrently, tastes in luxury are changing, especially among buyers from new markets. The art world, for instance, is undergoing a transformation, with new names quickly edging past the renowned artists who had been so sought after for much of the past century. (See Exhibit 2.)

Exhibit 2 | The Art Market Reveals the Extent of Change in Luxury Buying

2005		2011	
Artist	Value[1] ($millions)	Artist	Value[1] ($millions)
Pablo Picasso	153	Zhang Daqian	550
Andy Warhol	87	Qi Baishi	510
Claude Monet	62	Andy Warhol	325
Canaletto	55	Pablo Picasso	315
Mark Rothko	42	Xu Beihong	220
Marc Chagall	37	Wu Guanzhong	212
Willem de Kooning	37	Fu Baoshi	198
Fernand Léger	36	Gerhard Richter	175
Jean-Michel Basquiat	36	Francis Bacon	129
Lucian Freud	34	Li Keran	115
Total	**579**	**Total**	**2,749**

Sources: Berenberg Bank; BCG analysis.
[1]The value represents the cumulative value of works sold at auction.

Complexity follows the rapid growth of luxury markets everywhere, including in China, India, Indonesia, Russia, and Vietnam. Because each nation has its own culture, regulatory environment, political system, and retail network, luxury brands will need to acquire additional expertise and knowledge that are specific for their locales. New categories of luxury offer a host of fresh opportunities, all of which demand different capabilities. For instance, the growth numbers for experiential luxury—everything from spas to luxury kitchen installations—show that the category is expanding by more than 12 percent a year on average, compared with about half that for personal luxury products, such as watches and cosmetics. Meanwhile, the bar for what constitutes luxury continues to rise, as increasingly sophisticated consumers demand the best in everything. One small example is the clamor for Poltrona Frau leather seating in Bugatti and Maserati cars.

Technology is certainly playing a role, too, and not only in terms of Web presence and online shopping. In fact, it has expanded far beyond the digital: new raw materials, such as biomaterials and high-gravity plastics, are being explored by leading fashion houses, such as Gucci. And working with those materials will likely require skills that many of today's providers just do not have. Clearly, hiring a few IT-savvy graduates will no longer suffice.

Finally, there's the element of time. In today's fast-paced world, consumers and businesses alike place greater value on saving time. And increasing volatility both puts a premium on agility and spurs further scrutiny of the old ways of doing things.

Luxury brands will soon be unable to compete on products and brand equity alone.

For all of these reasons—a more volatile world, the rising importance of scale, the new capabilities required to grow successfully in fresh territories, technology's broader role, and tighter time constraints—it is crucial for luxury companies to be more open to partnerships of all kinds and to carefully consider how they might start to design and build their own luxury ecosystems.

Trading Control for Opportunity

We believe that luxury brands will soon be unable to compete on products and brand equity alone. They will need to be able to select, maintain, and manage the right partnerships across an ecosystem of committed players. Yet many luxury brands' management teams are far from ready to make that shift—and it's not because business leaders are slow to understand it. Rather, it's because they are firmly fixed on controlling their brands. Aware of the sorry stories of luxury goods providers whose brand values were diluted when they relinquished too much control, the diehards struggle to envision benefits that could outweigh what they think they would have to give up. They resist the cultural changes needed to transition to partner-led models. And very few are prepared for the process modifications and upgrades in skills and capabilities that they would need to succeed in the alternative model.

This "control credo" almost always rules, even when such companies make acquisitions. The emphasis on control usually translates into cultural homogeneity or separation of the acquired brand in order to maintain the distinctiveness of each brand rather than on bringing in fresh blood and new ideas—again, at the cost of limiting any useful synergies or transfusions of new capabilities.

The good news is that a handful of leading luxury brands *are* seeing the value of an ecosystem approach, and they are beginning to experiment assertively as a result. For instance, high-end audio-equipment maker Bang & Olufsen has teamed with Lutron Electronics in an imaginative venture that creates alluring lighting and sound ambiences. Giorgio Armani and PPR now use the YOOX Group's Yoox.com site to manage many of their Web-shopping sites. (See Exhibit 3.) And *maison* manager Richemont and Ralph Lauren have established a successful, long-term joint venture—in which each partner has an equal share—to design and create luxury

EXHIBIT 3 | Armani Gains Tangible Benefits in Partnering with YOOX Group

YOOX manages Giorgio Armani's e-commerce end to end

Armani gives to YOOX:

- Complete management of Armani's e-commerce channel
- The right to sell the Emporio Armani second-line brand from the year 2006 and all Armani Group brands from the year 2010

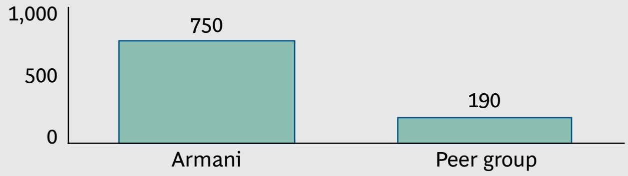
YOOX gives to Armani:

- End-to-end channel management
- Physical inventory management
- The ability to choose the online assortment of offerings, set prices, and determine promotions
- Management of all unsold items on Yoox.com

The partnership provides tangible benefits for both

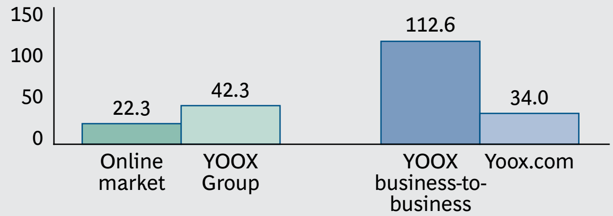
Benefits for Armani: online penetration that is higher than that of the company's peer group[1]

Number of unique visitors per year (thousands)



Benefits for YOOX: business-to-business operations are growing faster than Yoox.com

CAGR, 2007–2011 (%)



Source: BCG analysis.

[1]The peer group comprises Hermès, Marc Jacobs, Calvin Klein, Hugo Boss, Donna Karan, Paul Smith, Belstaff, and Eres.

watches priced at up to $27,000, as well as fine jewelry. The co-owned company designs, develops, manufactures, and distributes the products through Ralph Lauren boutiques and other high-end independent jewelry and luxury-watch retailers. It is Richemont's first such joint venture with a luxury fashion designer and Ralph Lauren's first foray into the precious-jewelry and luxury-watch businesses.

The joint venture seems to be a success: not only has the new company grown rapidly, with annual revenues of more than $100 million, but at least half of its customers are new to Ralph Lauren. The partnership has helped both Richemont and Ralph Lauren overcome the tradeoffs typical of conventional licensing agreements, in which the luxury brand often feels that the producer fails to uphold the consistent quality standards required to support the brand, while the producer expects that the luxury brand will bear all the responsibility for marketing the product.

Candidly, though, it is too early to say whether any one luxury company or partnership perfectly exemplifies the ecosystem model. However, providers that are already open to dealing and integrating with others—such as Luxottica Group, whose core business involves third-party licensing—are primed for success.

BCG projects that the proportion of the world's luxury brands that are tightly controlled by one corporate entity will drop from today's figure of approximately 80 percent to about 60 percent within ten years. The remainder are likely either to be managed or influenced by a leading partner online or through a brand extension, or they will be focused on developing a market in a specific location. We are confident that there will indeed be many more partnerships, and many more experiments in new territories, like the ones described above.

How to Create a Healthy Ecosystem

Shifting to an ecosystem approach is less a disruption than a progression. There is no one business process or organizational element that must be entirely rethought; much depends on where along the value chain a partnership can have the most impact—for instance in product design, production, retail channel, or online. (See the sidebar "The Elements of an Ecosystem Advantage.")

THE ELEMENTS OF AN ECOSYSTEM ADVANTAGE

BCG has identified several factors that can help luxury brands master the concept of a luxury ecosystem.

Keep customers' interests front and center at all times. Stay alert to how customers want to engage and interact, how they might assume control of your brand—whether knowingly or unwittingly—and what they seem to expect over the long term.

Know your own organization. Make sure you are familiar with not only your company's strengths and capabilities but also its limits and the capabilities and cultural attributes that it needs to succeed. With that knowledge, you can proceed to a clear performance-gap assessment.

Learn and develop first-rate capabilities for screening potential partners. While staying open-minded about types of partners is crucial, it's equally essential to set up and use clear, consistent screening criteria.

Define clear rules for working and operating within an ecosystem. Develop and communicate definitive governance rules and specifications for the give-and-take between partners. It is important to be unequivocal about what can never change and what might well benefit from a partner's creativity.

Engineer a culture of openness. Externally, treat your ecosystem partners as equal members of your team. Internally, find ways to communicate the idea that control and openness are not mutually exclusive. Reward all senior managers who demonstrate that they accept and nurture both dimensions.

Ensure face-to-face sharing of ideas and knowledge between partners. Don't rely solely on video conferencing and e-mail. Collocate key professionals wherever and whenever possible.

Build long-lasting trust. Building solid trust in each brand, the partnerships, and the collaboration model will help all the partners act for the good of the whole ecosystem.

Align incentives as much as possible. If full alignment is not possible, at least recognize any diverging incentives and potential conflicts of interest and address them.

Take controlled risks. Launch a range of ecosystem experiments. Pilot new products and services, test them rigorously, and learn from the failures as well as the successes.

Partnerships per se do not require actual organizational changes, of course. But they are likely to lead to flatter organization structures as luxury companies increase their outsourcing and confer the requisite authority on executives who manage the partner relationships. But partnering arrangements almost always call for new business processes, capabilities, and cultural modes. BCG envisions the necessary approach in three key categories: creating a system for building and maintaining an ecosystem advantage, maintaining adaptability, and extracting value. (See Exhibit 4.)

Exhibit 4 | The Key Principles of Building and Maintaining a Luxury Ecosystem

Creating a system	Ensure minimal barriers to entry and rewards sufficient for motivating participation
	Establish common standards to enable frequent, low-cost interactions
	Foster trust among participants
Maintaining adaptability	Facilitate diversity within the system
	Preserve redundancy
	Ensure tight feedback loops
	Cultivate flexibility in the system
Extracting value	Limit the portability of value beyond the system
	Determine what to structure and when to relax control
	Ensure a seamless experience for customers across the system

Source: BCG analysis.

Some of these elements merit closer examination. Consumers are an essential part of any luxury ecosystem, and examining how their roles and expectations will change is critical. Consumers are very active in today's Web-enabled world; they seek a high level of engagement with the brands they buy. Since this is especially true in luxury markets, companies must continually reevaluate their customer-engagement models, looking beyond straightforward purchase transactions to review the type of relationship that consumers want and expect.

The importance of this point extends far beyond tactics such as inviting select customers to special events. For example, consider Pinterest, the popular social-media site where users "pin" photos and illustrations of favorite things. The Pinterest phenomenon hints at how luxury companies need to think and act differently about their customers' roles in the ecosystem. Many organizations do not want images of their brands to be pinned because they cannot control the outcomes. A customer who uses a mobile phone to take photos of a product in a magazine, for instance, may publish images of inferior quality that don't flatter the product. In such circumstances, luxury companies will have to reevaluate the benefits of control versus the opportunities that openness affords.

At the same time, luxury companies will have to develop new skills for identifying and selecting partners, orchestrating highly effective partner networks, managing relationships, ensuring that all partners are fully and rewardingly engaged, and practicing good governance. The goals are to make sure that the roles and responsibilities for all partners are properly defined and communicated and that points of integration between and among partners are made clear.

The world is too volatile, complex, and fast moving for companies to continue controlling every aspect of every brand from beginning to end. CEOs of luxury brands must adopt a partnership mindset and recognize that success today requires creating an ecosystem of partners united over the long term by a shared vision of the future. They must also develop partnering structures, governance modes, skills, and competencies to turn that mindset into a practical, agile, growth-oriented business model—and, of course, choose partners whose complementary strengths can bring the new model to life.

Companies that embrace this new mindset and are ready and willing to work across traditional corporate boundaries will have the edge over competitors that cling to control.

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