The EU is a partnership involving 28 countries. Since it began, the EU has grown to become a ‘single market,’ allowing goods and people within the EU to move freely, as though the member states were one country. The media has raised concerns that Brexit negotiations could result in the UK giving up full access to the EU single market and free movement of labor. Should this occur, the UK would be left with the mammoth task of negotiating new trade agreements with each of its current trading partners and re-assessing EU citizens’ right to work in Britain. Additionally, businesses could be subject to higher customs tariffs for goods and services traded between the UK and the EU, dubbed a “hard Brexit” by the media. In the wake of Brexit, the UK economy began to waver due to investors’ panic and a severe drop in the British pound, which fell in October 2016 to its lowest rate since 1985. The USD-GBP exchange rate is currently stable at around $1.2; however, the pound has fallen almost 20% since the EU referendum.

What have been Brexit's effects thus far on the UK luxury market?
As a result of currency fluctuations, the UK has become one of the least expensive luxury markets in the world. A majority of luxury goods are now cheaper in the UK than anywhere else in the world. On the first day post-Brexit, the stock price of the British luxury fashion house, Burberry, dropped over 3%, but despite this immediate set-back, the company reported a 40% increase in UK sales in the quarter ending December 31, 2016. The immediate effects of Brexit have clearly been beneficial to the British luxury brand’s top line. Business of Fashion reported in August 2016 that “a classic Burberry trench coat retails at £1,495 or about $1,995 at current exchange. In China, the same coat is priced 32 percent higher at ¥17,500 or about $2,639.”

As consumers do not like to pay more for the same product, the drop in the pound has shifted tourist spending power to the UK. However, if the cost structure i.e., manufacturing and shipping costs, is mainly in foreign currency, the increase in sales may not be enough to offset the higher costs.

It also will be increasingly difficult to analyze the trends in the UK luxury industry and whether the upturn in the market is a result of organic growth or the ‘Brexit effect.’

Why does the ‘Brexit effect’ matter to the US luxury market?
In November 2016, the website VisitBritain reported a 2% overall increase in visits to the UK and an 8% increase in visits from North America. The results of the EU referendum have led to a surge of tourists flocking to the UK. Some large US luxury brands rely on foreign shoppers for a significant portion of their sales. Historically, travelers have purchased luxury goods in the US, as goods were traditionally cheaper here.

The Brexit effect is already putting additional pressure on US luxury brands’ earnings. US luxury brands with a strong UK presence may experience approximately 10%-15% decrease in consolidated sales value. This earnings decrease may put pressure on other markets, such as Europe or China, to reduce the gap.

For US luxury companies with a strong international presence, determining the impact of Brexit on worldwide sales will be a challenge. The industry already faces domestic concerns with the increasing decline in mall traffic and the shift of consumer spending to online platforms.

In its latest 10k filing, Tiffany & Co. disclosed that “A continued strengthening of the U.S. dollar against foreign currencies would require the Company to raise its retail prices in order to maintain its worldwide
relative pricing structure.” Traditionally, slumps in exchange rates trigger companies to reassess the retail price of goods in foreign markets to avoid large fluctuations in consolidated reported sales.

On the other hand, if the UK is a growth market for a US luxury brand, the cost of investment in the UK is now up to 25% less than it was before the result of the referendum, so companies may want to consider making capital investments now.

Is the price disparity around the world exploitable?

Sharp drops in exchange rates, such as the pound’s current situation, increase the risk of goods entering the grey market—the trade of authentic goods through distribution channels unintended by the original manufacturer. There is an incentive to buy goods in a cheaper market and resell them in countries where the retail price is higher, resulting in lower profits for the original manufacturer.

Monitoring the grey market can be challenging. Companies must have the ability to trace the location where each of their products originally entered the market place. This can be both expensive and difficult to manage. The complexity of the business model can also have an effect. For a business-to-consumer model, grey-market goods are more easily identifiable, as each point of sale location belongs to the company. For business-to-business models, the distribution chain can be more complex. Multiple parties in the distribution chain could affect the brand’s visibility on the market price and require renegotiation of the terms and relationships among the parties.

The grey market can damage price positioning and a brand’s reputation. A traditional way to protect a brand against the grey market has been to realign retail prices worldwide to discourage these practices.

To curb the grey market, should luxury brands amend retail prices in the UK to promote price harmonization across the globe?

The obvious resolution for the worldwide luxury market is to increase prices in UK boutiques to restore market norms in consumer purchasing and maintain profit levels worldwide. An increase in retail price of 10%, at most, would help alleviate the situation. However, companies must be mindful that the price increase remains within a reasonable price corridor. If the price increase in the UK is too high, UK customers may be lost.

Additionally, international luxury brands must ensure that an increase in retail price does not fall outside their current transfer pricing structure.

Historically, price repositioning to control the grey market has proved successful. Brands such as Russian jeweler Fabergé and Swiss watchmaker Rolex have already increased their retail prices in Britain by 10% in an attempt to offset the fluctuations in currency values. In 2014, some products in Chanel boutiques in Europe were 40% cheaper than in China. In May 2015, Chanel announced the objective to maintain worldwide prices not fluctuating more than 10% above and below the global Euro benchmark. As a result, Chanel lowered its prices in China by 20%. Chanel reported in May 2016 that despite its challenges in China’s luxury industry, Chanel was seeing signs of success against the grey market in China.

Luxury brands need to continue developing their global pricing strategy to minimize the effects of Brexit on the brand, its consumers and relationships with its trading partners.

It is clear that Brexit’s impact on the global luxury market is evolving and may not come to fruition for a couple of years. The UK will soon begin to negotiate its exit from the EU and assess the impact on trade relationships with other countries. In the US, there have been recent discussions on potential renegotiation of current trade agreements, as well as consideration of border tax on imports, which was eventually shelved ahead of the release of tax reform plan. In this context, luxury companies’ global pricing strategies will prove valuable to manage such level of uncertainty in the market.

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