Saks Upends Luxury Market With Strategy to Slash Prices

By VANESSA O'CONNELL and RACHEL DODES

When Saks Fifth Avenue slashed prices by 70% on designer clothes before the holiday season even began, shoppers stampeded. "It was like the running of the bulls," says Kathryn Finney, who says she was knocked to the floor in New York's flagship store by someone lunging for a pair of $535 Manolo Blahnik shoes going for $160.

Saks's deep, mid-November markdowns were the first tug on a thread that's now unraveling long-established rules of the luxury-goods industry. The changes are bankrupting some firms, toppling longstanding agreements on pricing and distribution, and destroying the very air of exclusivity that designers are trying to sell.

The problem Saks faced last November is one that haunts the U.S. economy as a whole: From car makers to home builders, companies are stuck with inventories that are far too fat. (See related article.)

Saks's risky price-cut strategy was to be one of the first to discount deeply, rather than one of the last. Managing high-fashion inventory is tricky. Clothing can go out of style in just months, so stores don't want to keep it around. But cut prices too soon or too deeply, and shoppers start to expect it.

Stephen I. Sadove, Saks's chief executive, says his action helped his company avoid massive losses, or worse. "These herculean things," including slashing inventories, were done to "make sure that the company survives," Mr. Sadove said in an interview.

Pressured by Saks, and hit by the worst holiday season in almost 40 years, rivals including Neiman Marcus Group Inc. and Barneys New York, a unit of Istithmar World of Dubai, slashed prices, too. They cut much more deeply and aggressively than usual, starting as early as late November -- with shopping season barely under way.

That, in turn, clobbered smaller boutiques. "It didn't seem logical to continue," says Linda Dresner, owner of a Park Avenue shop that for a quarter-century specialized in procuring unusual items favored by the fashion cognoscenti, like $1,000 dresses by Japanese label Comme des Garçons. She closed her doors in December, unable to keep up with the price-cutting.

Retailers are still feeling pain. Last Thursday, Saks said January sales fell nearly 24%. Neiman Marcus expects its first quarterly loss in a holiday shopping period that anyone at the retailer can remember.

Last year, luxury goods had become especially important to retailers because sales of these
so-called “star” brands such as Prada, Gucci and Dolce & Gabbana -- which sell in department stores as well as their own boutiques -- stayed strong into mid-2008, even though retailing overall was sinking by then.

By mid-November, there were already a few signs of trouble. Five days before Saks slashed its prices, Neiman Marcus had cut its own by 40%. And designers themselves were quietly trying to drum up cash by selling current fashions at fire-sale prices (to 90% off) at private "sample sales," often tucked away in industrial buildings in New York.

But Saks's maneuver marked an open abandonment of the longstanding unwritten pact between retailers and designers over when, and to what extent, to cut prices. Those old rules boiled down to this: Leave the goods at full price at least two months, and don’t do markdowns until the very end of the season.

That worked fine in the good times. Demand was high, and so were everyone’s profit margins.

But Saks’s surprise discounting forced companies and brands that have their own retail operations -- including Prada SpA, PPR SA’s Bottega Veneta and LVMH Moët Hennessy Louis Vuitton SA’s Marc Jacobs unit, which had opened hundreds of their own stores in the past decade -- to follow suit or forfeit sales.

Giving designers a heads-up wasn’t an option, Saks says, without risking that rival department stores get wind of its strategy. “We live in a competitive environment,” says Ron Frasch, Saks’s chief merchandising officer. “Also, who do you tell and who don’t you tell?”

Perhaps the biggest consequence is that customers are now questioning the entire premise of luxury goods: Why pay top dollar today if big markdowns could be coming tomorrow?

“Shopping has changed as an experience for me” because of all the discounting, says Roz Silbershatz of New York. Over the holidays she bought, among other things, a $1,000 Badgley Mischka gown for $290.

Previously, the 29-year-old communications executive had paid full price for items including a $2,500 Jimmy Choo handbag. “I am so shocked that I ever did pay full price,” she says. “I could never do that again.”

Designers are starting to fight back. Discounting “is the way of spoiling everything,” says Gianni Castiglioni, president of Milan-based designer label Marni SRL, known for $2,000 dresses made from innovative materials such as polyvinyl chloride (the "PVC" in household pipes) that are favored by the art-gallery set.

Some, including Marc Jacobs and Derek Lam LLC, are thinking about splitting their product lines or withholding some top items from department stores in order to feature them in their own stores. And at New York Fashion Week, which starts Friday, some designers might offer retailers only their "pre-fall" collection, but not what they actually show on the runways, which would appear only in their own shops, according to one buyer for a Saks rival. This person declined to name the two brands weighing this strategy.

Saks executives aren’t in favor of that. It’s the runway collection that’s "setting the image and setting the tone" for a designer’s look, says Mr. Sadove.

Diane von Furstenberg, the designer and president of the U.S. fashion designers’ trade organization, says another solution might involve producers leasing space in department stores.

The idea appeals to brands because it gives them complete control over display and staffing. Department stores, however, have some issues. It diminishes control over their own department-store brand and can also get confusing for shoppers, if say a "store-wide" sale doesn’t apply to items bought in various leased-out areas of the shop floor.

Leasing is more common Europe and Asia but relatively rare in the U.S. Saks leases a slice of its space to Louis Vuitton and Fendi, among others.

From his corner office overlooking 49th Street, Mr. Sadove, 57, says he's working on damage control with designers. “If people’s feathers got ruffled, we want to unrouffle them.”
Saks has an incentive. “Almost everything we sell is ‘designer’ in one form or another,” Mr. Sadove says.

Still, he and Mr. Frasch, defend their actions, saying they needed to swiftly fix a big problem that no one saw coming.

When Saks started planning its 2008 holiday season a year ago, there were few clues that the six-year boom in luxury goods was about to flop. Although other retailers were starting to suffer, it appeared that Saks’s wealthy clientele -- its typical shopper has a $175,000 annual household income -- might help the chain buck the trend.

The Dow Jones Industrial Average was approaching 13000, and “our customer feels good,” Mr. Sadove said in November 2007, as Saks reported higher profits.

So, in February 2008, Mr. Sadove told his merchants to place orders accordingly when they jetted to Milan and Paris to buy for the fall season.

Then, September struck. Mr. Sadove was in Paris on Sept. 29, attending runway shows -- but his eyes were glued to his BlackBerry as he watched the Dow drop nearly 800 points in one day.

Next, he watched big spenders became penny-pinchers. That month, Saks’s same-store sales fell 11%. In October, they declined another 17%, the worst monthly drop since the 2001 terrorist attacks.

The change happened “over as short a period of time as you can possibly imagine,” Mr. Sadove says.

The result: a huge disconnect between Saks’s inventory and shoppers’ appetite. At Saks’s annual “private sale nights,” early-November events for top customers, the usual 40% discounts got no response.

After lunch on Nov. 10, Messrs. Sadove and Frasch gathered with other executives to strategize. The Thanksgiving kickoff to shopping season was still a few weeks away, and maybe people’s billfolds would loosen up by then. But Mr. Sadove was anxious.

So he floated the idea of deep price cuts.

Some colleagues urged drawing the line at 50%. But Mr. Frasch felt strongly that wouldn’t be enough.

“I felt, the sooner we react, the better,” he recalls. “I said, ‘Let’s not wait till December 26th’ " to do something dramatic.

Their decision: A 70%-off sale would be used, but only in a worst-case scenario, if sales kept declining and shoppers remained bored by less eye-popping 40% rollbacks.

Extreme discounting of luxury goods is perilous. Not only does it potentially leave your best customers feeling duped for paying full price, it also erases fat profit margins of 50% or more.

“We are going into a period of total unknown,” Mr. Frasch told the team.

As Thanksgiving approached, things still looked very bad. So the 70%-off signs went up.

On sale day, Tuesday, Nov. 25, a line of hundreds of women snaked out the entrance of Sako’s eighth-floor shoe department in New York to buy, among other things, $800 Christian Louboutin pumps price-chopped to $250.

Nationwide, boutique owners were blindsided. In Los Angeles, less than three miles from Saks’s Beverly Hills store, Tracey Ross, a well-known boutique owner there, decided not to match the cuts right away. So she was
stuck trying to sell $2,400 dresses and $1,400 handbags at full price when similar goods were in
the bargain bin, relatively speaking, just around the corner.

Ms. Ross says she phoned and pleaded with designers to take their merchandise back. They
were "in complete denial," she says. "They said, "You're Tracey Ross. You'll sell it.""

In the end, she says, she had to discount so steeply that she couldn't pay her designers. "I am
like, 'Do the math. I sold your $800 shoes for $50.'" She closed her store and filed for
bankruptcy protection on Christmas Eve.

Some designers also added to the pain by enforcing minimum-order agreements on boutiques.
In good times, hot brands had the power to set terms like these.

Some boutique owners were incredulous. "Could you imagine if I told my customer, shopping in
my store, 'Here is your budget?'' says Elyse Walker, who owns five boutiques in Pacific
Palisades in Southern California.

Her sales were down 5% for the year -- but profits fell 50% due to deep holiday discounting.

Meanwhile, in Milan, Mr. Castiglioni of the designer label Marni was at home in mid-November
when he received a call from the manager of his New York store saying customers were
suddenly walking in and demanding 50% to 70% off. "They were saying, 'Why should we pay full
price?' " Mr. Castiglioni recalls.

In New York, American designers started contacting Ms. von Furstenberg, the head of their
trade group, looking for advice. "I was very upset. Everyone was," the designer says. That level
of price-cutting "cannot happen again," she says.

Part of the problem is the designers' own fault. Over the past 15 years, their products have
become so ubiquitous -- Gucci is sold in airport, Hermes has mall shops -- it's undermining the
image of exclusivity. In a January survey of rich shoppers by the Luxury Institute, a research
firm, roughly half of high-net-worth consumers said luxury brands are becoming commoditized;
64% said they were overpriced.

"The luxury industry has to devise a new business model," says Arnold Aronson, a consultant
and former Saks chairman.

Among the designers rolling out separate lines for their own shops is Aeffe SpA, the Italian
parent company of Alberta Ferretti and Moschino. The company had just opened stores in New
York and West Hollywood, Calif., in August and September -- just in time to come under
discounting assault. Aeffe USA's president, Michelle Stein-Borgna, says shoppers' expectations
have already changed. A few days ago, one of her store managers informed her that "customers
are coming in and asking for discounts on spring merchandise right now."

Her response: "Absolutely not. It's a vicious cycle," she says. Aeffe is now thinking about cutting
back what it offers to department stores in areas where it has its own shops.

Similarly, New York design house Derek Lam, which is known for cocktail dresses that sell from
$1,200 to $3,500, is opening its own New York store next month. To protect itself against other
retailers' discounts, it's thinking about creating "special editions" of key items that wouldn't be
sold in Saks and other retailers.

Others are taking the opposite approach. In December, Sergio Rossi, the Italian shoe and
handbag designer, closed all three of its U.S. Sergio Rossi stores. Instead, the label, which is
owned by the Gucci Group unit of French company PPR, plans to stick with boutiques and
department stores.

A spokeswoman for Gucci Group says the store closures were a strategic decision unrelated to
discounting.

For emerging designers, the situation is more dire. "The department stores really hurt us," says
Philip Leeming, co-designer for Falls, a dress-designing duo.

Late last year, Saks informed Falls and other designers that they would be expected to cover
some of the cost of Saks's price-cut decisions. Saks says the designers weren't asked to
shoulder the full burden of its extreme discounting at year's end.

"It was horrendous," says Leong Ong, Mr. Leeming's business partner.

Last year, Falls shipped its own lines to 160 different retail customers. Today, it is drastically
cutting production and instead focusing on designing for retailers' private-label lines. "There's
less chance of them asking for returns" on unsold goods, Mr. Ong notes.
In hindsight, Saks executives say they may have cut too much in some areas. "We didn't need to do what we did in accessories," Mr. Frasch says. High-end shoes and handbags would probably have sold out, even at higher prices, because shoppers see them as more practical wardrobe updates than another new outfit.

The retailer is still not out of the woods. Saks shares were recently trading at $2.72, down from $22 in December 2007. In mid-January, it laid off 1,100 people, or 9% of its work force, and could close some stores.

This year, Saks is spending about 20% less on merchandise to keep inventories lower, but Mr. Frasch acknowledges the number is only a guess. The luxury-goods business is "absolutely flying blind," he says.

His boss, Mr. Sadove, agrees. "One of the big questions that people are asking," he says, is: "Will people ever buy at full price again?"

Write to Vanessa O'Connell at vanessa.o'connell@wsj.com and Rachel Dodes at rachel.dodes@wsj.com

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