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RETAIL

Luxury brands in China

CONSUMER MARKETS

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Contents

Introduction

China has experienced a relentless surge in consumer buying power since the 1990s. The Chinese consumer has become wealthier and more accepting of Western retail formats – with international supermarket chains, department stores and mass retailers paving the way for luxury retailers. Luxury brand companies have been investing in the Chinese market, with Louis Vuitton, Bally, Gucci and Ferragamo among the first wave of retailers to open outlets in China more than 10 years ago.[1] But now, with consumer spending power increasing and the loosening of government restrictions, foreign luxury brands face pressure to strengthen their commitment to the mainland or risk losing ground to their rivals.

Luxury is a constantly evolving and subjective concept, and not easy to define. But more often than not, the word is used to define an inessential but desirable item or a state of extreme comfort or indulgence. What sets luxury brands apart is that they command a premium without clear functional advantages over their counterparts. Yet consumers are willing to pay the significant price difference because they have a unique set of characteristics including premium quality, craftsmanship, recognisability, exclusivity and reputation.[2]

Luxury brands not only convey a standard of excellence, but act as social codes indicating access to the rare, exclusive and desirable.[3] This makes the luxury market a particularly interesting one because it represents consumption at its most hedonistic and seemingly irrational – purchasing for the personal pleasure it provides despite the financial cost.

1 "Luxe biz takes off in Chinese market", Footwear News, Vol 61 (17), 2005
2 "The mass marketing of luxury", Business Horizons, Vol 41 (6), 1998
3 Kapferer, J.N.: Reinventing the Brand, 2001

The luxury brands currently operating in China are largely of European origin and span across various retail sectors such as fashion apparel and accessories, footwear, perfume and cosmetics, jewellery, automotive, and liquor. In this report we profile the patterns of luxury consumption in China and explore some of the trends and challenges facing luxury brands, including the complexities of valuation and classification, which can have important tax and regulatory implications. The report includes some excellent primary research from TNS, which highlights how attitudes towards luxury brands vary within this huge and diverse country.

We would like to extend warm thanks to the Australian Centre for Retail Studies at Monash University and TNS in China for their efforts in researching and compiling this collaborative report.

Nick Debnam
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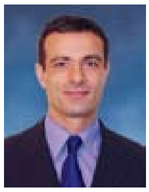

George Svinos
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Key findings from TNS

In October 2006 TNS surveyed more than 830 people across China on their attitudes and spending habits towards luxury brands. The respondents were identified by age and place of abode. All respondents were between 20 and 45 years of age and resided in first or second tier cities, earning a minimum of RMB 3,000 per month. Almost two-thirds of the respondents were married and 77 percent were educated to college or university level.

About TNS

TNS is one of the world's leading market research companies, providing custom research and analysis, political and social polling, consumer panel, media intelligence and TV and radio audience measurement services. TNS provides market measurement, analysis and insight through a global network of operating companies in 70 countries.

TNS' strategic goal is to be recognised as the global leader in delivering value added information and insights that help their clients to make more effective decisions. "TNS is the sixth sense of business".

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The survey shows that attitudes to luxury brands among China's aspiring middle class are overwhelmingly positive. For example:

- The majority of respondents regard owners of luxury brands as being successful and having good taste
- Fewer than 2 percent of respondents regard owners of luxury brands as "superficial"
- Over half of respondents said they longed to buy luxury goods, even if they could not afford them at present.

Figure 1: Attitudes to luxury brands

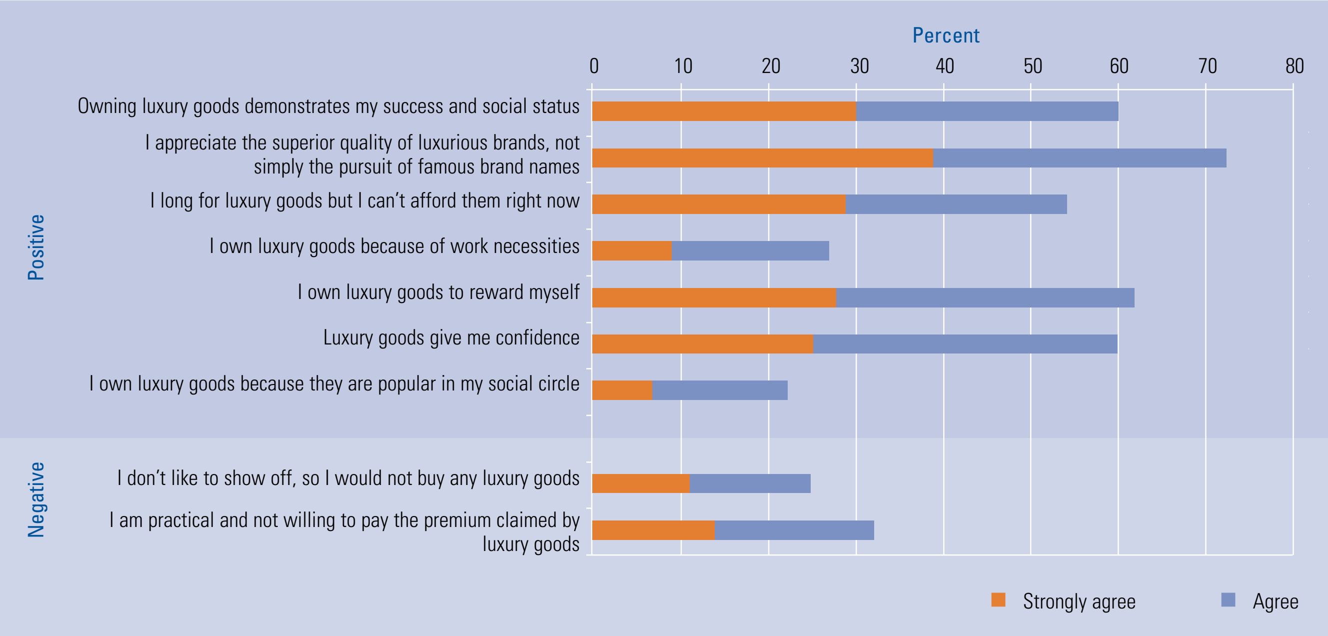
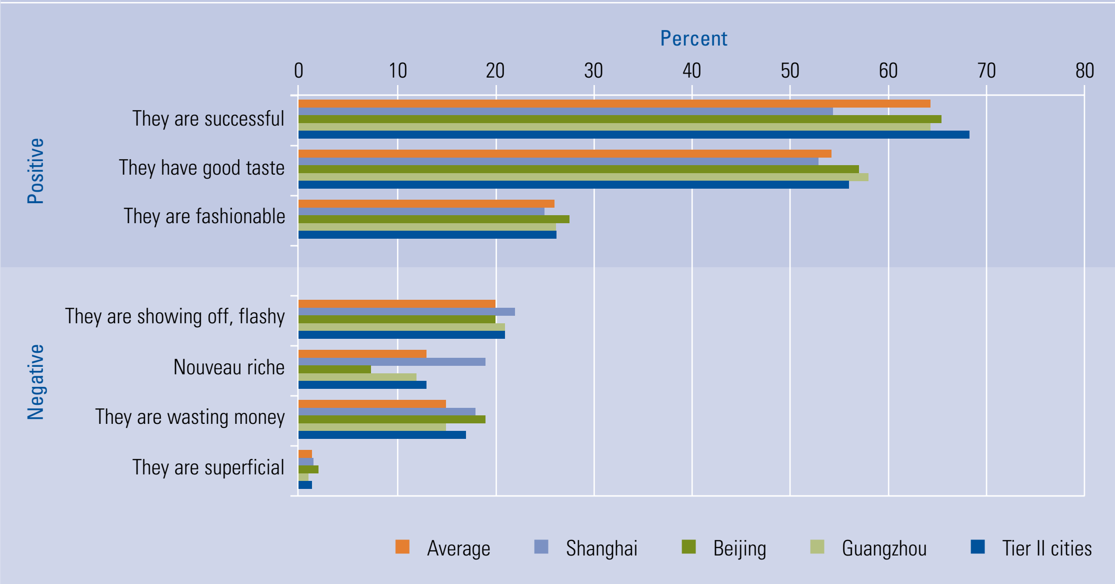


Figure 2: Attitudes towards people who own luxury brands



Attitudes towards luxury goods are equally positive among different age and income segments. However higher income consumers claim they are more likely to buy luxury goods as a means of self-reward.

Respondents in Shanghai were, in many respects, the most cynical in their attitudes to luxury and the least likely to own luxury brands as a status symbol.

Figure 3: I own luxury goods to reward myself (by income)

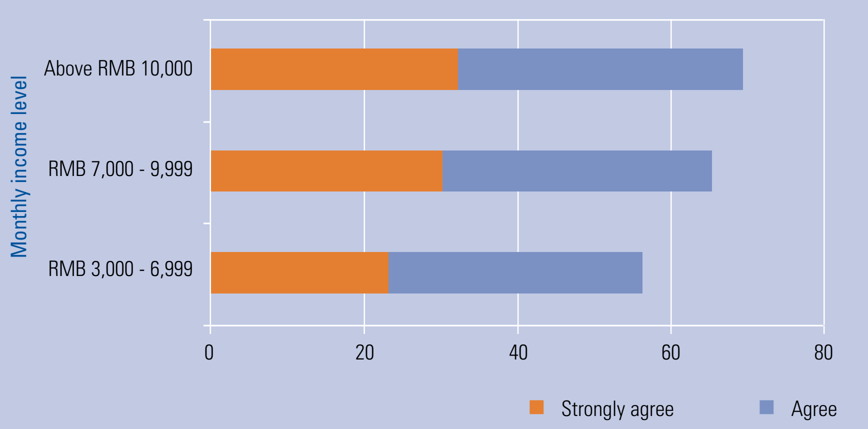
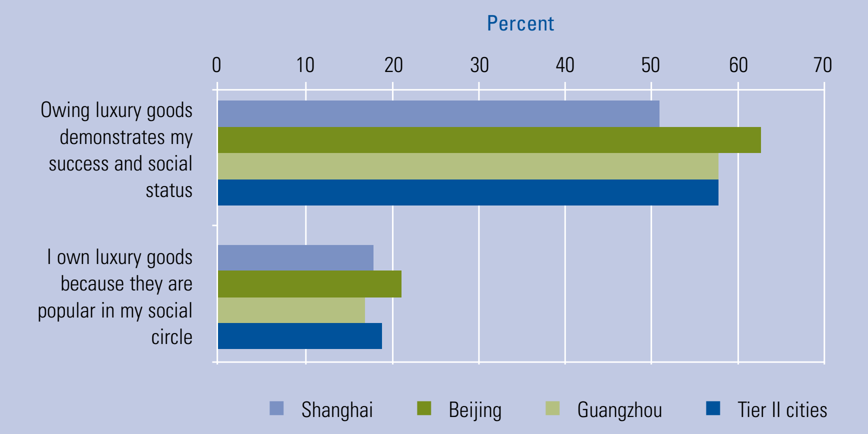


Figure 4: Attitudes positive in second tier cities



The outlook remains positive for luxury consumption in China. Consumers show a strong intention to purchase luxury products in the next 12 months, with the appetite for luxury goods relatively similar among the three largest cities and second tier cities.

The research from TNS confirms that attitudes towards credit among Chinese consumers are still somewhat conservative. The willingness to purchase luxury goods on credit is still low, the exception being for bigger-ticket items such as jewellery.

Figure 5: Intention to purchase luxury products in the next 12 months

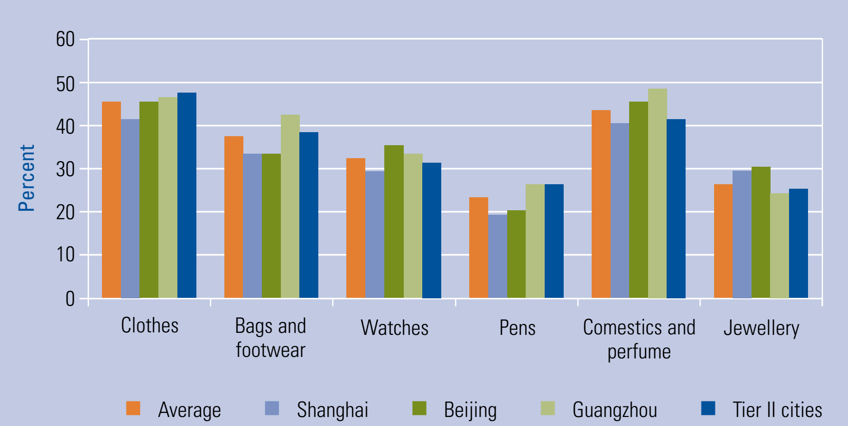
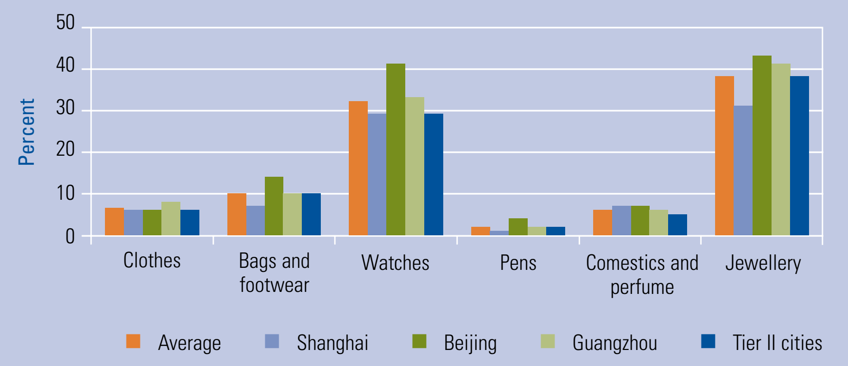


Figure 6: Willingness to purchase luxury items on credit



While most purchases were made domestically, in most product categories at least 30 percent of shoppers had made luxury purchases in Hong Kong, Macau or Taiwan. Shoppers proved more inclined to buy clothes, watches and jewellery in a branded store, but to buy accessories and cosmetics in a department store.

Figure 7: Location of luxury purchases in past year

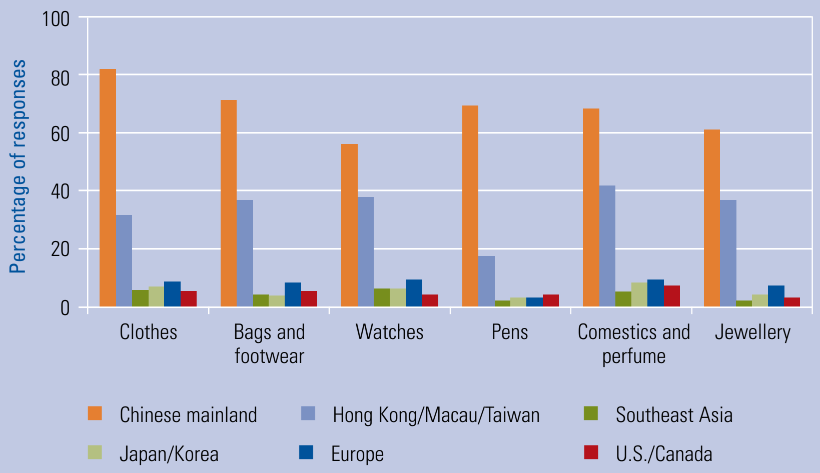
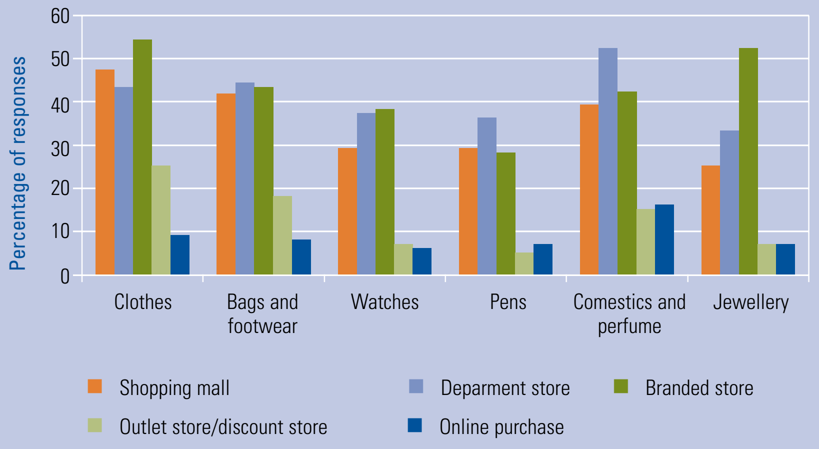


Figure 8: Choice of retail format for luxury purchases



Luxury brands and the retail sector in China

Foreign companies share a growing interest in tapping into China's luxury market. Statistics show not only that the number of wealthy people is growing fast in China, but that their willingness to spend on big-ticket items is also on the rise, driven by an appetite for status as well as the comforts and trappings of luxury products.

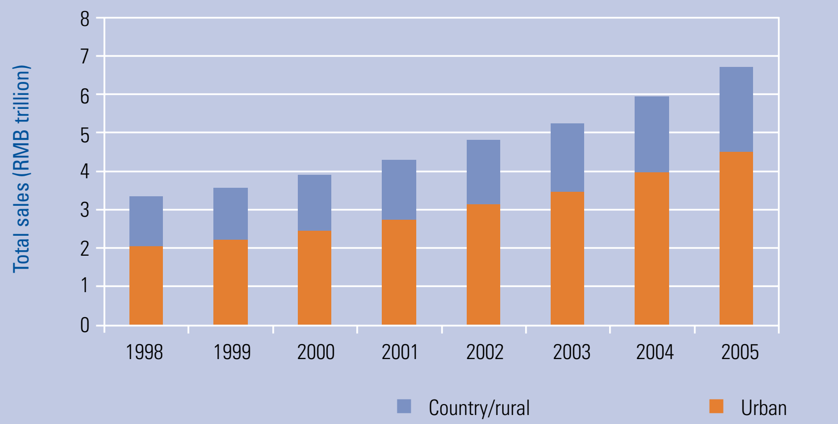
China's economy grew 10.3 percent in the first quarter of 2006 from the year earlier, overtaking the United Kingdom to become the world's fourth largest economy. According to a preliminary estimation by the National Bureau of Statistics in China, the GDP of China in the first half of 2006 was RMB 9.144 trillion, a year-on-year increase of 10.9 percent. Total retail sales of consumer goods for the first half of 2006 also experienced significant growth, reaching RMB 3.644 trillion, a year-on-year rise of 13.3 percent. Overall, China's retail sales have been rising at their fastest pace as increasing incomes spur spending on cars, furniture and electronics.[4]

Retail sales have been rising alongside disposable income. According to the National Bureau of Statistics of China, per capita disposable income of urban households stood at RMB 5,997 in 2005, an increase of 11.6 percent over the previous year, and a real increase of 10.2 percent after deducting price factors. The per capita consumption expenditure stood at RMB 4,228, a year-on-year increase of 9.4 percent, and a real growth of 8.0 percent. Cities are home to

4 "What's in store in the luxury department", Women's Wear Daily, 13 June 2006

some 40 percent of China's population, and average incomes in urban areas are often more than three times those in the countryside.[5] In June 2006 retail sales of urban consumer goods was RMB 2.462 trillion, a year-on-year increase of 14.0 percent; that of rural areas was RMB 1.183 trillion, increasing 12.0 percent.[6]

China's retail market, 1998-2005



Source: National Bureau of Statistics of China

Demand for luxury brands

Asia is the largest target market for luxury brands, accounting for more sales than any other region, including Europe and the United States. For instance, half of Switzerland's USD 8 billion annual watch exports go to Asia. France's LVMH, the world's largest luxury goods company, claims that 40 percent of world sales are generated in Asia while for its rival, Gucci, the figure is 45 percent.[7]

According to one of the world's leading financial groups, Goldman Sachs, consumption of luxury goods in China, except private jets and luxury yachts, reached USD 6 billion in 2004, making up 12 percent of the global total consumption on the goods — up from 1 percent just five years previously. According to their findings China has turned into the third largest consumer of luxury goods in the world.[8] Its share of the luxury market is only superseded by Japan with 41 percent and the U.S. at 17 percent. It is expected to grow 20 percent annually until 2008 and then 10 percent annually until 2015, when sales are expected to exceed USD 11.5 billion.[9]

Of course, only a tiny fraction of China's huge population can afford to spend several thousand renminbi on a bag or a pair of shoes. But many experts argue that China can become the world's largest luxury market with a comparatively

5 "China's retail sales rise more than expected", Bloomberg, 13 June 2006
6 National Bureau of Statistics of China; www.stats.gov.cn/english/
7 "Growing economy lifts demand for international brands", China Daily, 4 December 2004
8 "China said to be biggest luxury consumption market by 2015", SinoCast China Business Daily News, 12 February 2006
9 "Mainland taste for expensive grows", South China Morning Post, 20 May 2005

low purchasing rate because of its 1.3 billion population. While luxury-buying wealth is still spread extremely thin, the number of rich Chinese is rising fast. In 1999 you needed just USD 6 million to be among Forbes Magazine's 50 richest people in China, while last year you needed USD 140 million to rank in the richest 100.[10] Accordingly in 2006 it was reported that were around 300,000 U.S. dollar millionaires among China's more than one billion inhabitants.[11]

Market performance

Sales of luxury goods are booming across the world as the strength of the global economy helps to forge a new class of wealthy consumers in Asia, the Middle East and Eastern Europe. Whether it is yachts, premium car brands, haute couture fashion, high-priced liquor or designer perfumes and hand-crafted watches, reports from companies making high-end products have been pointing to a robust 2006 for their industry after a solid start to the year.

Demand for luxury and fashion products has traditionally been regarded as fickle and highly susceptible to swings in economic sentiment. However luxury brands have now enjoyed many successive years of growth. According to Bain & Co., worldwide sales of luxury goods are expected to grow at an average of about 6 percent up to the end of the decade, with the sector growing by as much as 9 percent in Asia.[12] According to the Economic Research Institute in China, earnings from stock and property speculation have also contributed to the booming sales of luxury goods.[13]

The above-average growth in Asia is attributable in large part to China. Goldman Sachs has predicted that China will consume about 29 percent of the world's total luxury goods in 2015, surpassing Japan as the world's top luxury brands market. Their studies predict that the demand for luxury goods in China will grow by 25 percent annually between 2006 and 2010, exceeding Japan's expected 28 percent share at that time.[14] A similar prediction is made by Merrill Lynch, which expects that extravagant offshore spending will see Chinese consumers likely to account for almost a quarter of global luxury goods purchases by 2014.[15]

Luxury car brands also predict significant growth in the coming years. For example, luxury German car group Audi said in May 2006 that sales in China had almost doubled in the space of five months. Mercedes-Benz said sales rose more than 20 percent year on year, while BMW AG began the year by posting the best total quarterly sales in the auto group's history.[16]

Sales of certain luxury goods have been given a further boost by the progressive reduction of tariffs on imported luxury goods since 2005 in accordance with China's commitments to the World Trade Organization. For example, the 28 percent to 40 percent tariff that was levied on imported watches until the end of the year 2004 was cut to 12.5 percent and will be further reduced to 11 percent by the end of 2006.

10 " Retailers eye untapped market", The Australian, 16 April 2005
11 "China's increasing demand for high-end bling", The Luxury Institute, 14 June 2006
12 "Conspicuous consumption makes a comeback as luxury goods boom", China Daily, 10 June 2006
13 "High stakes for high-end goods", China Daily (North American ed.), 27 January 2005
14 "Luxury brands seeking more chance in China", Chinaview, 9 November 2004
15 "China luxury goods expected to surge", Women's Wear Daily, 4 October 2005
16 "Conspicuous consumption makes a comeback as luxury goods boom", China Daily, 10 June 2006

Counterfeiting

While the Chinese luxury goods market is growing rapidly, an equally fast-growing segment of local industry has been counterfeiting. Just as China has become the world's leading assembler and exporter of manufactured goods, it is likewise said to be dominating the underground trade in luxury fakes. The U.S. and EU assert that the majority of fakes seized at their borders are made in China. Mainland Chinese counterfeit exports to the U.S. accounted for 69 percent of total seizures last year, or about USD 64 million worth, according to U.S. customs.The problem is perhaps most pervasive in China because counterfeit operations are secretive, resilient and geographically dispersed.[17]

While government authorities are concerned that a proportion of profits from counterfeit goods are going to organised crime, companies are busy assessing the extent to which counterfeiting is undermining their brand value. Ultimately, despite the opportunities created by emerging markets like China, India and Russia, luxury brands are fighting battles on multiple fronts – and some say luxury brands are fighting to hold on to their identity. For them, the name denotes a guarantee of quality and with counterfeits the guarantee of quality offered by luxury brands is being undermined. Others suggest that the situation is a double-edged sword. Some believe that the availability of counterfeits has helped to make the genuine product more sought-after, as well as increasing general awareness of luxury names.[18]

17 "Fake luxury goods have sinister tag", China Daily, 21 May 2005
18 "The complex trade in luxurious fakes", The Financial Express, 30 April 2006

Source: ACRS

Profiling the Chinese consumer

While hard work and plain living have been revered virtues of the Chinese people for generations, there has been a growth in demand for foreign-branded or imported goods.[19] But running counter to the growing habit of consumption in China is the traditional propensity to save. Though luxury consumption is growing, for most the dominant social idea is still prudent consumption and undertaking no more than you can perform.[20]

Research suggests that while the emerging middle class will continue to save heavily, they will also spend increasing amounts of money.[21] This is consistent with trends that suggest that China's younger generation of teenagers and twenty-somethings show less of the caution of their parents and grandparents, and far more inclination to spend than to save.

The Chinese mainland luxury market is still in its formative stage. As Chinese consumers turn toward luxury goods as a means of rewarding themselves for their success or as a token advertising their wealth, analysts believe growth in the world's most populous country could boost Asia's share of world luxury sales to 60 percent.[22] China may however prove to be quite unlike any other developing market. Rapid change has become the norm, and as such, the past may be a poor predictor of future trends.

19 "Controversial consumption of luxuries", China Daily (North American ed.), 6 August 2005
20 ibid
21 "The Value of China's Emerging Middle Class", McKinsey Quarterly, 2006 Special Edition
22 "Luxury foreign products make inroads", China Daily, 14 November 2004

China's unique characteristics

- **Brand awareness**

The arrival of international retailers over the last decade has signalled a dramatic change in the psyche of the Chinese. China indeed has huge potential as a luxury market, given its massive urban population and the younger generation's affinity for designer goods. However, while the Chinese are very fast to take to luxury products, they still have trouble differentiating within the sector and distinguishing between the various strata of the luxury market; the country's big spenders are often only aware of the most popular luxury labels.

- **Perception of beauty**

While beauty in the West is often transformational and edgy with consumers less afraid to stand out from the crowd, studies suggest that Chinese women seek a more accessible, inclusive form of beauty. Features that stick out are not generally perceived as attainable or attractive. As such, in advertising, Chinese prefer to see Chinese faces, although a truly iconic foreign celebrity will also work because Chinese admire expertise, power and status.[23]

- **Counterfeit goods**

Most newly wealthy Chinese still want authentic products, but as a rule the Chinese are far more price-conscious for example than the Japanese and younger consumers have shown a willingness to mix cheap fakes with genuine products.[24] Studies suggest that people in Hong Kong are becoming more discerning when it comes to buying genuine clothing brands, accessories and electrical goods, despite the ready availability of fake goods.[25] Luxury brands will be hoping that a similar change in attitudes occurs, over time, on the mainland.

- **Shopping for pleasure**

"Mall culture" has arrived in China and shopping is increasingly being adopted as a leisure activity. Retail Asia magazine predicts that by 2020 China will be home to the seven of the world's ten largest malls.[26] This growing popularity of malls should help to increase the market size for luxury products, by strengthening brand awareness and aspiration.

- **Travel**

Chinese nationals have shown a strong preference for purchasing luxury products overseas for two reasons. First, shopping at the designer boutiques in Europe guarantees that the goods they buy are not counterfeit, something they can not be sure of when shopping in some malls in China.[27] Second, higher taxes and duties mean that mainland prices can be 30 percent more than elsewhere. Chinese citizens are travelling more and spending more abroad, as travel restrictions continue to be lifted and Chinese tourists have become some of the main buyers of prestigious brands from Europe. The French Tourist Board found that Chinese travellers to France already spend more than people arriving from the U.S. or other European countries.[28] The Economist Intelligence Unit predicts

23 Doctoroff, T.: Billions: Selling to the New Chinese Consumer, 2006
24 "Luxury's new empire", The Economist, Vol 371 (8380) 2004
25 "Buyers spurn fakes in big ticket items", Media Asia, 22 April 2005
26 Retail Asia magazine, 2005
27 "Western firms venturing further a field", The Wall Street Journal, 15 June 2005
28 "What's in store in the luxury department", Women's Wear Daily, Vol 191 (60) 2005

that by 2008, the number of Chinese overseas tourists will rise to 49 million. The World Trade Organization further forecasts that about 100 million Chinese people will tour abroad in 2020.[29]

- **Motivations: Aspiration and self-reward**

The reasons why Chinese consumers purchase luxury brands bear similarities to those in other countries. But the research of TNS found that status and self-reward are two particularly strong motivations in China. Among those surveyed, attitudes towards brands were overwhelmingly positive. For example:

- More than 70 percent saw luxury brands as a way to demonstrate their status and success
- Less than 30 percent objected to paying a premium for a luxury brand
- Just over 60 percent of respondents bought luxury goods as a way to reward themselves for their hard work and success.

Therefore, in China the consumption of luxury goods is very much item-driven, meaning consumers search for the latest collection or products. At present in China consumption tends to concentrate on personal accessories such as cosmetics, perfume and watches – smaller items that can be justified as rewards. This is different to more developed markets where consumers tend to seek experiences or products more catered to their personal tastes.

The luxury consumer: Key segments

Urban migration, paired with a wealthier overall population, has led to the emergence of new luxury customers in China. These comprise a diverse group from youth to the middle-aged, from business executives and white-collar employees to the lowly educated, and from actors and actresses to the nouveau riche.

- **The traditional business elite**

The traditional luxury shopper is typically male and over 35. They most likely hold a senior position with a domestic company or a government agency and are typically well-connected. These luxury shoppers can be more advanced then other luxury shoppers in China. Because they have been consuming luxury products for a longer period then other segments of the market their tastes are, in some respects, more sophisticated than those of other luxury shoppers.[30]

While other buyers are only beginning to buy luxury products, the traditional shopper has moved on to luxury experiences and more niche luxurious products which are not necessarily so conspicuous. They are demanding more value for money and are choosing to not only indulge themselves but also their family.[31]

- **The new luxury shopper**

Modern luxury shoppers represent a range of different customers including entrepreneurs, business people and celebrities. What sets them apart is the fact that they are newly rich – very often the first generation in their family who

29 "The Gucci killers", Fast Company, Vol 102 2006
30 "Luxury's Chinese puzzle", Women's Wear Daily, Vol 189 (126) 2005
31 "Luxury foreign brands make inroads", China Daily, 14 November 2004

can afford luxury products – and tend to be younger than the traditional luxury shoppers. Surveys have shown that the majority of Chinese consumers of luxury products are now aged between 20 and 40. They are considerably younger than those in the U.S. and Europe, aged between their 40s and 70s. Although younger does not mean richer, this segment is, unlike other Chinese consumer segments, willing to spend a greater proportion of their income on luxury goods than those in the U.S. and Europe. With an optimistic view of the future, these relatively younger Chinese consumers seem to be less concerned about saving for their old age. This has a major effect on their spending habits – they prefer buying the most expensive items they can afford to suit their lifestyle.[32]

The modern luxury shopper has a mindset that is quite different from their parents' in their willingness to spend and in their awareness of what is available in other consumer markets. These educated consumers can tell the difference between fakes and real design, even if the garment is manufactured in China.[33]

- **Empowered women**

Until recently 90 percent of all luxury spending in China was dictated by men. Today, women in China are starting to gain economic independence and are reaching a point where they have money of their own to spend on luxury products. Young Chinese women are now supplanting businessmen over 35 as the main Chinese buyers of luxury goods as they grow in social and economic independence.[34] The modern female luxury shopper includes the business woman, the celebrity and the newly independent rich wife.[35]

The move to more women purchasing luxury goods is consistent with global trends identified by the Luxury Institute.[37] The Institute reported that the rise in the buying power of wealthy women is being driven by baby boomer women who have achieved independence and economic power, and are outliving their partners. They further predict that their buying power will continue to rise as women outperform men in academic achievement, career progression, and business start-ups in fields that have previously been the exclusive province of men.

- **Little emperors**

The most brand conscious of all China's consumers are the "little emperors," only-children now entering their teen years and early adulthood. This generation (the result of the one-child policy) is particularly evident in the larger urban centres where the policy was most strictly enforced. What is particularly different with these children compared to only children in the West is that they typically have six sources of disposable income with parents and grandparents all contributing to meet this one child's every need. Studies estimate that half a typical urban Chinese family's disposable income is spent on, or by, its youngest member.[36]

Combined with an increased opening up of media, the advent of the Internet and the increasing availability of Western brands, the result is a new breed of brand-savvy, luxury-conscious, and in some cases rather spoiled children, who know what they want, expect the best and are not shy about demanding it.

32 "High stakes for high-end goods", China Daily (North American ed.), 27 January 2005
33 "Decoding China's luxury market", Women's Wear Daily, Vol 191 (104) 2006
34 "Retailers eye untapped market", The Australian, 16 April 2005
35 The Luxury Institute; www.luxuryinstitute.com
36 "The emperors' new designer clothes", Bangkok Post Business, 18 January 2006

Source: ACRS

Strategies for luxury brands

For certain luxury brands, China has already outstripped both Japan and Hong Kong as the largest single market in Asia Pacific.[37] But the growing presence of luxury brands in China is bringing with it greater competition. The country's busiest streets, such as Nanjing Road in Shanghai, are witnessing fierce competition among the world's luxury brands. While some have warned that the China market is becoming saturated,[38] for the time being the environment is still a positive one for potential entrants.

- **Marketing**

As most Chinese consumers have low levels of brand awareness, they also have low levels of brand loyalty. However this also means that sales staff can be an extremely powerful tool – with the ability to not only inform consumers of the benefits of their brand, but sway them towards making a purchase. Luxury brands are investing large sums of money in heavy marketing to not just promote their brand and products but also to inform Chinese consumers about "luxury" and why they should pay a premium for products offered by luxury brands.

Brand building is occurring on a massive scale, not only through print and television advertising, but also through luxury events and shows and customised lifestyle publications. Indeed, word-of-mouth luxury promotion and advertising through low circulation print media has not proved effective in China. Luxury events are held with increasing frequency in Beijing and Shanghai and many people attend simply as onlookers. The willingness of the Chinese media to publicise promotional events featuring celebrities means they have proved

37 "High stakes for high-end goods", China Daily (North American ed.), 27 January 2005
38 "China's retail market saturated", The Financial Times, 28 April 2006

effective in reaching both aspirational and dedicated luxury purchasers. It is a chance to experience a so-called "luxury lifestyle" and to see products that are not available in the stores yet. Organisers may even welcome window shoppers as they expect that in the near future these middle-class shoppers will see their disposable income rise.[39]

- **Diffusion strategies**

Luxury brands are bringing many of the strategies that have worked in more developed markets to China. These include product diffusion lines which entice the less affluent and raise brand recognition among aspiring young shoppers. As China is developing, such strategies are not yet central to their success, but as the market becomes more mature and competition intensifies, more luxury brands in China may consider this approach.

- **Local lines**

Some luxury brands operating in China are seeking a local relevance, creating products that are specifically tailored towards or centred around Chinese consumers. For example, Louis Vuitton offered a range of Lantern Charm accessories based on the traditional Chinese lantern to celebrate the opening of the new Beijing store.[40] Luxury carmakers have also taken the lead in developing models specifically for the Chinese market.

- **Local manufacturing**

While companies are often wary of the "made in China" tag, companies such as Coach, Paul Smith and Armani have shifted some of their manufacturing to China in recent years.[41] Other luxury brands are boosting their presence in China to take advantage of cheaper local manufacturing. In addition to its retailing operations, Zegna bought a 50 percent stake in SharMoon in 2003, a Wenzhou-based company that produces men's suits, and have invested in production units outside Italy.[42] French luxury house Hermès has also planned for investment into local production facilities as part of a broader strategy to double sales in mainland China over the next few years.

- **Store formats**

Most Western luxury brands have made the choice to not alter their formats when operating in China as they believed that even minor adaptations could seriously damage the parent company's brand and global positioning. In China this has been working as Chinese shoppers are embracing international retail concepts. Luxury brands are operating mega-store formats (often the largest stores for the brand) with large ranges that have been shown to educate consumers about a brand and fuel an appetite for spending.[43]

As the market expands some luxury brands are moving out of smaller stand-alone outlets and out of hotels to expand and introduce even larger store formats. In the West Gate Mall Shanghai on the west section of Nanjing Road, a landmark boutique of 'Dior Cosmetic' opened in 2003, which was designated as the most luxurious Dior boutique, and made China the third country to have such

39 "China set to become luxury hub", Shanghai Daily, 20 May 2006
40 "Luxury cars target China's new rich", Peoples Daily, June 2004
41 "Luxury's new empire", The Economist, Vol 371 (8380) 2004
42 Consumer Goods & Retailing: Country Report: China, 2004
43 "Luxury's new empire", The Economist, Vol 371 (8380) 2004

a Dior boutique. Prior to its upgrading, annual sales of Dior in West Gate Mall were RMB 11 million (about USD 1.4 million). The new boutique was expected to surpass RMB 15 million (about USD 1.8 million).[44] Similarly, Louis Vuitton's expanded, three-storey China World store, with an overall area of almost 18,000 square feet and a sales area of 8,470 square feet, is the largest of the brand's stores in China.[45]

- **Rapid expansion**

Most of the world's leading luxury brands are rapidly expanding their China operations. That push is now extending to smaller Chinese cities such as Qingdao, a northern resort town and Chengdu in Sichuan province. Many of the brands active in China's luxury market have plans to expand with boutiques in second and third tier cities.[46] Generally, the path for luxury brands is to set up shop in the primary "cluster cities" of Beijing, Shanghai, and Guangzhou, and

44 ""City gets a taste of highlife with luxury goods", China Daily, 14 October 2005
45 "China's luxury rush: Expanding Vuitton shows market's growth", Women's Wear Daily®, Vol 190 (137) 2005
46 "China's hunger for luxury goods grows", Globe Correspondent, 21 March 2006

Primary and second tier cities in China

from there steadily expand. The research of TNS shows that brand awareness and willingness to spend in many second-tier cities is already close to the levels seen in the three primary cities.

- **Using local partners**

For a well-known name such as Louis Vuitton, entrance to the Chinese market has been aided by access to significant financial resources through its parent, LVMH. However, for smaller or more independent brands, the move to China can entail risk and require immense patience.

Many luxury brands are finding a local or regional partner or adviser to help navigate the market.[47] For example, U.S. watch retailer Tourneau has formed a partnership with Hong Kong's Peace Mark Limited and International Watch Group to open stores in China. Under the brand name Tourneau, the new joint company, Peace Mark Tourneau Holdings Ltd., will open high-end stores in mainland China, Hong Kong, Taiwan and Macau. The first two stores will be in Shanghai, with a third in Beijing. Overall, 30 Tourneau stores are set to open in China within the next five years.[48]

Another large company that acts as an agent for brands in China is Hong Kong's Dickson Concepts. It represents such brands as Polo Ralph Lauren, Brooks Brothers and ST DuPont.

47 "Homegrown brands battle for marketshare", Women's Wear Daily, Vol 191 (60) 2006
48 "Torneau, Peace Mark join to open 30 stores in China", National Jeweler, Vol 100 (10) 2006

A stylish city: The story of Hangzhou

Although relatively small, Hangzhou is a disproportionately wealthy city, and attracts shoppers from all over Zhejiang, one of China's most prosperous provinces. Tourism is also Hangzhou's primary industry, attracting about 30 million visitors from all over the world every year. As such, Hangzhou has witnessed an economic growth rate of 15 to 20 percent over the last two to three years. And, according to the Hangzhou Statistics Bureau, Hangzhou's total economic output in 2003 grew 15 percent to USD 23.26 billion, or USD 3,930 per capita, and average disposable income was USD 1,558. The area's affluence stems in part from its proximity to, and cultural affinity with, Shanghai. The individual prosperity of Hangzhou can be seen on its streets, where Jaguars and BMWs are becoming more common, compared with Shanghai where such items are rarely seen outside of showrooms.

A key attraction to Hangzhou is that it is among the first places in China to allow direct foreign ownership of businesses. But legal progressiveness is only a small part of the region's appeal. International luxury brands that have chosen to open stores in the area are enjoying a steady stream of shoppers. Hangzhounese are known to be very fashion-conscious, but also fairly conservative, and thus easily lured by international labels. Hangzhounese are exceptional because they are among the few Chinese who spend more on fashion than on food. The city generated retail sales of USD 7.09 billion in 2003, up 12.4 percent from 2002.

Hangzhou Tower is the city's main venue for luxury retail, although it now faces competition from Euro Street and the adjacent Lane Crawford store. It opened in 1998, featuring only domestic brands until Dunhill was added in 1999. A Louis Vuitton flagship store opened soon after in 2001. Hangzhou Tower consistently ranks among the most profitable department stores in China. It sees foot traffic of 30,000 to 40,000 people a day during the week, a number that jumps to 50,000 on weekends and holidays. Most customers are upper-level executives at banks and private businesses, as well as the government, with the majority in their thirties and forties. In 2004 alone, Hangzhou Tower recorded total sales of USD 217 million. These days, Hangzhou Tower hosts around 40 luxury brands including Dior, Cartier, Ferragamo, Escada, Zegna, Burberry, Hugo Boss, Chanel, Hermès and Armani. The Lane Crawford department store is also a main venue for luxury retail, with brands such as Gucci, Versace and Burberry.

Source: Movius 2005

Domestic luxury brands

In the past few years, local Chinese brands, once fragmented and backward, have been evolving rapidly. Local brands in China have been quick to pick up successful retail strategies from foreign entrants, establishing themselves in good locations and growing at a rapid pace. And, while most Chinese brands have yet to gain global visibility, within China itself, home-grown brands are becoming a source of pride and a badge of the country's emerging self-confidence.[49]

Despite the recent success of Chinese consumer brands, very few local luxury brands have yet emerged. There are some brands which are perceived as being luxury on a local scale – and have succeeded in portraying themselves as being international even though their main market is a domestic one. Such brands include Goldlion (a once exclusive brand which has become more accessible in recent years), and jewellery brands Chow Tai Fook and Tse Sui Luen. Growing design talent and increased government support mean that many more Chinese luxury brands could emerge in the next few years.

One international brand which set up its headquarters in China is Ports International. Ports International's move to China has given the brand a significant advantage in developing its brand and market share in the China market. Originally a Canadian company, it relaunched in the Chinese town of Xiamen and has expanded its product line throughout Asia and North America. Ports clothing has won publicity in fashion magazines such as Elle and In Style. In 2005 the brand was included in TIME magazine's "best products for 2005" alongside well-known names such as Tod's, Louis Vuitton and Chanel. It now boasts retail outlets and franchises across Hong Kong and mainland China, Japan, Dubai, Canada and the US.

While few truly domestic luxury brands exist, there are two brands which have emerged on a global scale and have been touted as being "luxury". These two brands, LaVie and Shanghai Tang, are set apart because they do not principally target local luxury consumers, but rather aim to tap into the tourism industry and consumers around the world who are keen to capture some of the trappings of 'Chinese luxury'. Designed and manufactured in China, LaVie has set up business in Shanghai's Bund area where many of the world's top luxury brands have gathered. Creator Ji Cheng, who studied at Marrogonni, a fashion design school in Milan, said her design idea was "Eastern concept and Western cutting." About 60 percent of LaVie's customers are foreigners.[50]

Similarly, Shanghai Tang has not specifically targeted local luxury consumers. It is unique in fusing old-China fashion with brave-new-world style and colour clothing. The popularity of the brand, and the fact that it is now partly-owned by the Swiss Richemont Group, helps to illustrate the fact that Chinese brands can emerge and succeed by tapping into a global market for Chinese-inspired luxury products.

49 "China said to be biggest luxury consumption market by 2015", SinoCast China Business Daily News, 12 February 2006
50 "In the lap of luxury", Beijing Review, 2 June 2005

The challenges ahead

Luxury retailing in China clearly presents tremendous opportunities, but also risks and challenges. In addition to heightening competition as is common among emerging markets, the most significant and relevant of challenges for luxury brands concern Intellectual Property Rights (IPR) regulations, the timeframe for a return on investment, low luxury brand awareness, booming Chinese tourism and limited retail infrastructure.

- **IPR regulations**

According to the U.S. Embassy in Beijing the piracy rate in China remains one of the highest in the world and, on average, 20 percent of consumer products are counterfeit. Even domestic companies are troubled by piracy, with a recent study by the Ministry of Information Industry finding that 37 percent of Chinese companies suffered from such problems.[51]

The Chinese government has made inroads in establishing an effective and complete law system regarding IPR protection and to strengthen the enforcement, supervision and inspection of such laws. However, the most serious issue relating to IPR lies in its enforcement and penalty at the local level because jurisdiction is diffused throughout many government agencies and offices.[52]

Chinese companies are now beginning to build up brands that need IPR protection and, as a result, they are also demanding better enforcement. Recent counterfeit cases have assisted in raising awareness among Chinese consumers

51 "China tries to kick the piracy habit". Fortune (Europe), Vol 155 (1) 2005
52 "The complex trade in luxurious fakes", The Financial Express, 30 April 2006

of the importance of brand authenticity. China's courts are busy chasing down firms that are counterfeiting luxury goods. In 2005 alone, over 13,000 cases were filed, a fifth more than the previous year, including many launched by foreign firms.[53]

- **Longer-term returns**

Despite the fact that luxury sales in China are on the rise, luxury brands should not expect a quick return on their investment. The costs of setting up, training staff and building brand awareness can be high, while demand remains limited in the short term. High import duties and consumption taxes will make it difficult to target market segments beyond the economic elite.[54] As a result, many luxury brand companies can expect to wait five to ten years to see a return on their Chinese investment. Thus far, only a handful of luxury brands, including LVMH and Prada, have reported making significant returns on the Chinese mainland.

- **Shortage of services providers**

Finding the right location poses a problem, as does the process of applying and being approved for a retail license. This is because China has yet to streamline such processes.[55] As with other sectors, the pace of change in China's retail industry has created bottlenecks and the need for new and professional services. There are still few credible local specialist developers of retail property on the mainland. More commonly developers have adopted easy solutions, either leasing property long term to a department store or hypermarket, or selling it in small units to investors and entrepreneurs. And, although this leads to a satisfactory outcome for the developer, it brings monotony for the shopper and a growing number of ailing retail centres. Chinese developers need to be able to work with retailers to create a much more attractive shopping experience for consumers.[56]

- **Ineffective advertising and media**

While luxury brands have been placing advertisements in internationally renowned magazines, they often find the message is lost. This can be attributed to Chinese newsstands, which are overflowing with advertisements to the extent that most readers barely notice a luxury newcomer. A breakdown in advertising messages is also a result of the size of the country. While a marketing effort in one city may yield results there, it will have little to no impact elsewhere. Many cities outside of the main commercial centres may have potential customers, but reaching them means doing something that they can see directly. This has led some high-end brands such as Cartier to break with their standard practices and advertise and promote their products more directly than they would in other markets. Cartier has not only gone to print, but also to television as the best choice for developing the Chinese market.[57] Media costs in China can however be very expensive, particularly in Beijing, Shanghai, Guangzhou and Shenzhen. Complemented by heavy clutter and difficulty in reaching targeted audiences, building brand equity can be a costly exercise.[58]

53 "Handbags at dawn", The Economist, April 212006
54 "Consumer Market Insights: China's willing upper class spenders", China Daily. (North American ed.), 10 June 2005
55 "Luxury goods slow to develop in China", Market Focus Asia Pacific, April 2005
56 "What's in store in the luxury department", Women's Wear Daily, 13 June 2006
57 "Luxury labels test marketing mix for virgin territory", Media Asia, 8 October 2004
58 Doctoroff, T.: Billions: Selling to the New Chinese Consumer, 2006

- **Staff shortages**

Some luxury retailers, initially attracted by the low cost of labour in China, have struggled because of a lack of local management talent. A good strategy here is to find trained staff or to train and develop staff once employed within an organisation. However, in some cities, there is also a clear shortage of trained staff in sales and service positions related to luxury goods. Luxury brands in China need to empower their employees to become brand ambassadors.

- **Brand positioning**

For those eager to expand in China, it is critical to take note that success in the Chinese market requires far more than opening many retail outlets. Product, presentation, packaging, promotion, distribution, merchandising and advertising should all contribute toward an essentially simple, unified purpose - delivering genuine brand value to customers. The most successful luxury brand firms began the process of building their brands long before they entered the market. This is a very important consideration for the Chinese market where consumers know little about luxury brands.

Moët Hennessy, one of the most successful luxury wines and spirits brands in China, and part of the LVMH group, is a prime example. Following the establishment of its Beijing office in 1996, the company spent nearly five years conducting market research on consumer psychology and behaviour, distribution channels and media advertising before its formal entry into the Chinese market in 2001. Heavily investing in marketing, public relations and retail networks, the company has a firm strategy of keeping balance between the enhancement of brand image and the expansion of distribution channels. Proud of its history, strong traditional values and uncompromising attitude towards quality, the company has endeavoured to perfect its brand image in all aspects. By 2005, Moet Hennessy had accelerated annual growth to about 15 to 20 percent, with stable development in 26 cities across China.[59]

- **Managing risks**

In an effort to leverage better distribution channels and the market knowledge of local dealers, as well as to lower operating costs, many foreign luxury companies choose to license to Chinese retailers. Unfortunately, this strategy has led to failure for many who subsequently found that distribution channels are not being adequately controlled, particularly with retailers selling counterfeit goods alongside genuine products. As such, more luxury brands in China are choosing to build dedicated retail outlets of their own, eliminating the concern for inappropriate licences, and focusing on the main stores. However, for smaller luxury brands this may not be feasible and using an intermediary may be essential. If this is the case, then it is important to monitor the franchisee closely so that the brand is protected and uncompromised at all times.

59 Xiao, S.: What are the critical success factors for luxury goods companies looking to expand in China?, 2006

- **Promoting a culture of luxury**

For luxury brands in China, the focus should not just be on selling products. Luxury brands need to seed their success through establishing a luxury culture in the Chinese market. Such culture will define the context in which luxury brands operate. Many Chinese customers have little sense of luxury culture with much of the nation still living in relative poverty, and while there is a growing cohort of rich Chinese most are yet to have a full understanding of and appreciation for the "luxury lifestyle". While the sudden jump in wealth among Chinese has resulted in a short-term boom in luxury buying, only through the cultivation of a luxury culture can luxury brands look forward to sustainable, healthy development in China over the long term. As has been evidenced, fashion shows, special events and other public relations efforts by luxury companies create a luxury culture environment, giving ample opportunities to Chinese customers to practice their taste for a luxury lifestyle and build emotional connections with the brands.

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THE AUSTRALIAN CENTRE FOR RETAIL STUDIES

The Australian Centre for Retail Studies is a commercial centre within Monash University's Business and Economics Faculty and Department of Marketing. It provides knowledge leadership to those involved in the retail sector through broad-based research and information generation, management education programs and the promotion of retailing as a career.

The centre engages in the following areas of activity throughout Australia, New Zealand and Asia:

- Management development programs
- Presentations, conferences and seminars
- Retail research, reports and publications
- Study tours.

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Tax and regulatory issues

The process of importing, distributing and selling luxury goods in China raises further challenges for companies, including a number of difficult questions regarding tax treatment, customs duty, logistics and the transfer of intellectual property.

Customs duty, import VAT and consumption tax can all be charged on luxury goods imported into China. The ability of brands to mark up their goods at dramatic premiums can also prove difficult to explain to tax authorities when the time comes to file income tax returns. Companies producing or trading luxury items need to understand how to avoid unnecessary or overlapping burden of tax and other duties. For example, VAT and business tax should in theory be mutually exclusive, since both are turnover taxes.

Customs

One of the first issues facing an importer of luxury goods concerns customs duties. Importers typically pay customs duty on the declared import value, but should be mindful that if there is a separate royalty agreement and the royalty payment is connected to the imported goods, they may be required to pay duty on the royalty too. If confirmed that this royalty should be subject to customs duty, this royalty will be incorporated as part of the dutiable value and be taxed at the rate applicable to the imported goods.

A second issue is customs valuation. Customs officials manage their own database of pricing information based on past customs filings. The authorities may base their considerations on this database before they turn to the importer with a pricing enquiry.

It is therefore highly advisable for importers to file customs declarations based on the genuine terms and conditions of the transaction and to make necessary adjustments to the transaction value, according to the customs valuation code. Any discussion or uncertainty over valuation could entail delays or even cause shipments to be withheld.

A less common consideration for luxury brands, but one which will affect certain goods, is classification. Customs may wish to classify certain goods which arrive as component parts as finished goods, entailing different dutiable treatment. One way to avoid this uncertainty, which is also encouraged by the Customs authority, is to reach an Advance Classification Ruling on the goods to be imported. This includes filing an application, and providing samples and specification information on materials used and processing methods involved.

In reaching an agreement with Customs, such a classification would be good for a period of two years and can then be renewed provided major changes have not been made to the goods under discussion. A similar arrangement called Advance Customs Valuation has also been introduced to reduce the uncertainty on customs valuation upon importation. But this is usually for large amount recurrent imports.

Finally, Customs recently published a list of goods which cannot be imported under processing trade, including exports under toll manufacturing arrangements and buy-sell arrangements. It means that customs duty and import VAT (import taxes) would be payable upon importation of these goods, even if they are imported for export use. This recent change in policy will increase the cost of production for those operations which have been importing these materials as bonded goods under processing trade arrangements in the past. These operations may have to consider varying their mode of operation in China to reduce their tax burdens.

Special zones

Free Trade Zones (FTZs) and Bonded Logistics Parks (BLPs) are located in major coastal cities such as Dalian, Shanghai, Shenzhen, and Guangzhou and have been used to plan the distribution of imported goods within China. As these special tariff areas are regarded as outside of China for customs purposes, goods can generally be stored here and not subject to import taxes until they are shipped into China's domestic market for free circulation. In such cases, the warehouses inside these zones take on a role as regional distribution centres. Warehousing and distribution activities are allowed but substantial manufacturing activities are not encouraged.

On the other hand, if the goods need to undergo final processing procedures for export sales after entering China, an Export Processing Zone (EPZ) could be a good option to set up a processing facility, especially if some of the final products will again be shipped out of China for international sales.

VAT considerations

China's VAT regime requires luxury brand companies to carefully consider the turnover tax consequences of their activities. First and foremost, a company's tax requirements will depend on whether it registers as a general VAT taxpayer or a small-scale VAT taxpayer. This classification will determine the way it can compute VAT payments and its eligibility to procure and issue VAT invoices.

Retailers and wholesalers typically require anticipated annual sales of RMB 1.8 million, a fixed place of operation and procession of physical goods in order to apply for general VAT taxpayer status. An applicant company must be able to prove that it has a reliable accounting system, good internal controls and the capability to correctly compute its VAT burden. The quality of the management/staff and the effectiveness of the system on tax accounting are key areas for inspection.

It is also worth pointing out that exports of goods from China will be subject to a positive VAT charge, unless the VAT export refund rate for the export products is 17 percent. The lower the VAT export refund rate, the higher is the exporter's VAT burden.

Transfer pricing

China's enforcement of transfer pricing regulations is a growing area of concern for companies involved in transfers of IP and other intangible assets. A key concern for companies is how to compensate the brand or IP owner adequately and fairly. The tax authorities are presently very concerned by the tax implications of inbound IP transfer and are particularly aware how far prices can be marked up. This is especially evident when they see the price luxury brands can charge compared to similar counterfeited goods.

Luxury brands may not yet be a sufficiently profitable business to have fully caught the attention of China's tax authorities. Indeed, after profits have been allocated to other steps in the value chain, there may be little left to allocate to IP. Companies opening up new luxury market segments in China can face heavy losses early on, when marketing and advertising costs are high. Even brands which are well known overseas may not generate premium profits in China in a reasonable time. The tax authorities often use this as a reason for doubting any value attributed to the IP. In their view, if the IP were valuable, it would generate profit – how can a company with poor financial performance pay royalties on an apparently unsuccessful business?

Ironically, the time when the tax authorities might deem the company's IP worthless is also the time when it is most at risk from competitors. Subsequent market entrants can not only learn from the first-mover's mistakes, but also piggyback off the brand-building that is being put in place, exacerbating IP leakage.

Luxury companies can therefore face many challenges in explaining their pricing policies. While certain companies (for example an importer and distributor) see each other as arm's length partners, they may find it difficult to explain and verify that relationship to the authorities. Also, in a market where brand awareness is low, a premium value may be harder to charge or to justify for tax purposes. By aligning its transfer pricing policy with IP strategy, a company will find it easier to defend its tax position in front of the authorities.

A Hong Kong perspective

It has become a common practice for international brands to establish a distribution centre in Hong Kong, due to the territory's high quality logistics infrastructure and the existence of a sizeable domestic market of its own. However such a strategy throws up its own tax and regulatory considerations. If the purchase price or other fees attributable to the goods are too high, it may be argued that the amount paid is incurred for a purpose other than for the derivation of assessable profits.

It is usual for retailers in Hong Kong to pay lease incentives (in particular for prime retail leasing locations) and to incur expenditure on advertising signage. Considerations should be given to the determination of these expenses as being revenue or capital in nature so as to avoid tax-inefficiency.

In addition, staff may be hired by Hong Kong companies to conduct sourcing or selling activities regionally. The activities of these staff may create a taxable presence and/or tax reporting obligations for the Hong Kong companies in the overseas jurisdictions.

KPMG's experienced professionals can assist companies to manage a range of tax and Customs considerations relating to the importation, production, marketing and distribution of luxury goods in China.

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