China's Luxury Consumers: Moving up the curve

CONSUMER MARKETS

AUDIT ▪ TAX ▪ ADVISORY

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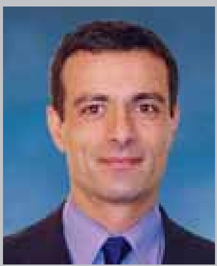
Nick Debnam



George Svinos

It is less than two years since KPMG China published its first study of the luxury market, but in that short time things have advanced dramatically. Where luxury brands were once focused on establishing highly visible (but often barely profitable) flagship stores in Beijing and Shanghai, many are now reaping the financial benefits of their brand-building strategies and taking their ambitious expansion plans to China's other major cities.

We recognised the need to take a fresh look at the luxury market and seek deeper insight into the habits, tastes and motivating factors that are driving its growth. While luxury goods are affordable to an increasingly wide segment of Chinese society, consumers are also being exposed to brands with an unrivalled intensity.

Many of the executives surveyed in this report acknowledged that while status and the "bling factor" lay behind much of the growth in luxury consumption, it was too simplistic to see the market solely in these terms. Our survey confirms this point: Chinese consumers are motivated by an increasingly complex range of factors and are becoming more interested in pursuing brands to experience their quality, to stand out from the crowd, or to reward themselves.

This report also delves closely into the travel habits of Chinese consumers. Twenty percent of our survey respondents travel overseas more than once per year. As a result of their exposure to international trends and more niche brands, we expect consumers to become even more discerning in the years ahead.

Globalisation, along with the increasing propensity of Chinese consumers to travel, is closing the gap between China and the Western world. Serious retailers must capture this opportunity and enter into the market early, otherwise they risk falling behind.

If you are in the luxury or retail business and have an interest in China, we hope you find this report useful. KPMG China has advised and assisted a number of leading luxury brand companies on their financial management and growth strategies in China. We would welcome the opportunity to discuss this report and its findings with you.

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About the survey

In early 2008, KPMG China commissioned TNS to survey middle-class Chinese consumers about their changing attitudes towards luxury brands. In total, TNS received 902 qualified responses to the survey. These respondents were based in 15 diverse cities and were between 20 and 44 years of age. All earned upward of RMB 3,500 per month, with a minimum income of RMB 5,000 in the larger cities of Beijing, Shanghai, Guangzhou and Shenzhen. Fifty-nine percent of respondents were educated to university level, with 11 percent educated to postgraduate level. Fifty-six percent of respondents were male and 44 percent were female.

TNS also conducted qualitative interview-based research with 14 higher-earning consumers to identify and corroborate the motivating factors behind their consumption of luxury brands.

This survey data is complemented by nine case studies with executives of luxury and retail companies. These are based on interviews conducted by KPMG China's Consumer Markets practice between December 2007 and March 2008.

Key findings

- As this report shows, China's luxury market has become measurably more crowded over the past two years. Consumers are becoming aware of an ever-growing number of luxury brands, becoming more discerning in their tastes and making greater efforts to understand the heritage of individual brands. This is creating even more pressure on new entrants to rapidly find their niche and establish their credibility.
- Chinese consumers are prolific shoppers when travelling overseas or to Hong Kong and Macau. However, the survey suggests that increased travel does not diminish the amount consumers spend on luxury when at home. Moreover, many people intentionally save or draw up a shopping list prior to travelling. This underscores the fact that it remains important to be on the ground and build brand recognition within mainland China.
- It is essential for luxury brands to have a clear strategy which takes into account the scope and extent of intended market penetration. A growing number of companies are investing directly into the China market by establishing wholly foreign-owned enterprises (WFOEs), but there are still many advantages to working with a joint venture partner or licensee.
- The choice of business model will also have tax implications, with China's tax authorities increasingly looking at the transfer pricing issues relating to management fees, royalties and other transfers of intellectual property.
- This year's survey reveals little change in the conservative attitudes towards credit, which suggests that the recent pace of growth in luxury consumption has not been driven by unsustainable patterns of credit-based consumption.

The passion for luxury

KPMG findings

- As China's luxury market grows in sophistication, differences in tastes and preferences are becoming more discernible between cities and demographic segments.
- The "bling factor" remains a key to the growth of luxury consumption, but Chinese consumers are also gaining greater appreciation of brand values and heritage.
- The market for accessories has continued to see stronger growth than apparel. One reason is that bags, jewellery and fashion accessories offer more versatility and visibility to consumers with a limited budget for luxury.

KPMG China's 2006 report *Luxury Brands in China* illustrated the extent to which China's middle classes have embraced luxury brands, while indicating the continued potential that exists in this growing and highly aspirational market.

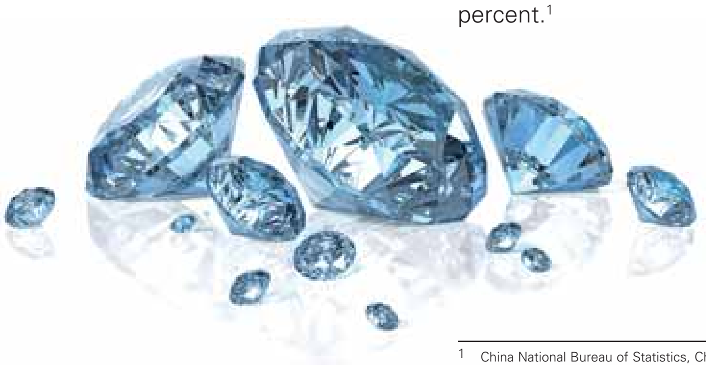
The report showed that China's middle class consumers strongly associate luxury products with success and good taste. This was particularly true among respondents in Beijing and tier-two cities. By contrast, very few respondents expressed negative opinions about luxury brands or owners of luxury goods.

Continued growth in consumption

Income and retail spending levels have continued to rise strongly since our last report. This has led even more international brands to reappraise their strategy in the China market.

In 2007, retail sales in China topped RMB 8.9 trillion (USD 975 billion), an increase of more than 17 percent from 2006. This amounts to a doubling of China's retail spending in the space of just six years.

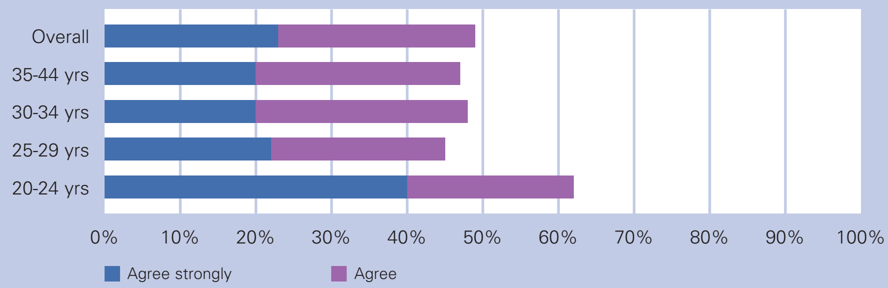
Income levels have also risen strongly, but remain low compared to more developed economies. Yearly disposable income per capita among urban households rose by 18 percent to RMB 13,876 in 2007, while per capita consumption expenditure stood at RMB 12,667, a year-on-year increase of 14.7 percent.[1]



1 China National Bureau of Statistics, China Biweekly Economic Statistics (中国经济统计快报), KPMG and TNS analysis.

While these income and expenditure levels represent an average, they are naturally far higher than this in many of China's coastal cities. Nevertheless, an income of RMB 5,000 per month is still modest by the standards of Europe or North America and as such a luxury purchase can represent a significant proportion of their disposable income. Forty-nine percent of respondents claimed they could not afford to buy luxury products now, but they aspired to own luxury products in the future. This figure rose to 62 percent among respondents aged 20 to 24. These statistics are modestly lower than in 2006 when they stood at 54 percent and 58 percent respectively.

"I long to buy luxury goods, but I cannot afford them right now"

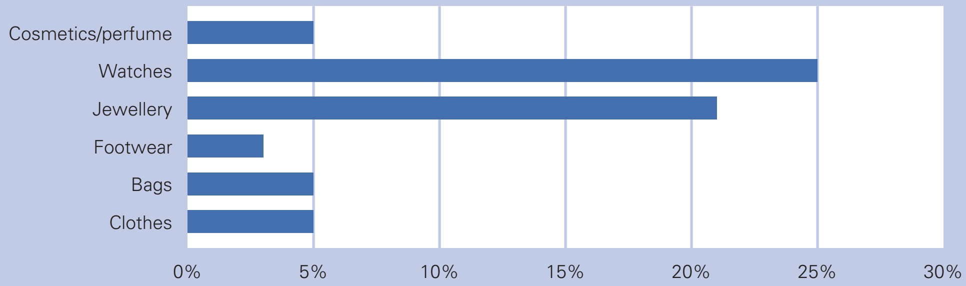


The economic realities facing Chinese consumers also dictate which product categories have been most successful, with many executives commenting that the market for accessories and jewellery has grown more strongly than apparel. Within apparel, several executives observed that brands need to carefully position themselves, citing examples where companies have been successful in the sales of premium casual wear, but struggled to retain the connection to their origins in more high-end couture and ready-to-wear.

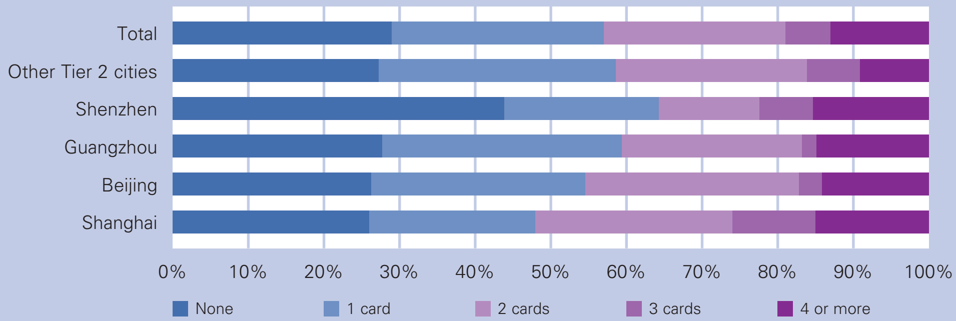
Chinese consumers remain cautious about credit. In most product categories fewer than 10 percent said they were willing to buy luxury items on credit. While the survey suggests no significant change in attitudes towards credit since our last survey in 2006, it shows that luxury consumption has the potential to sustain itself, or even to grow more strongly, in the future. Twenty-nine percent of respondents still do not own a credit card, while only 19 percent claim to own three or more cards.

Consumers are most willing to buy big ticket items such as watches and jewellery on credit. While consumers in Beijing are often assumed to be more conservative in their habits, they expressed the greatest willingness to buy on credit in many product categories.

Willingness to purchase luxury goods on credit (2008)



Number of credit and debit cards owned



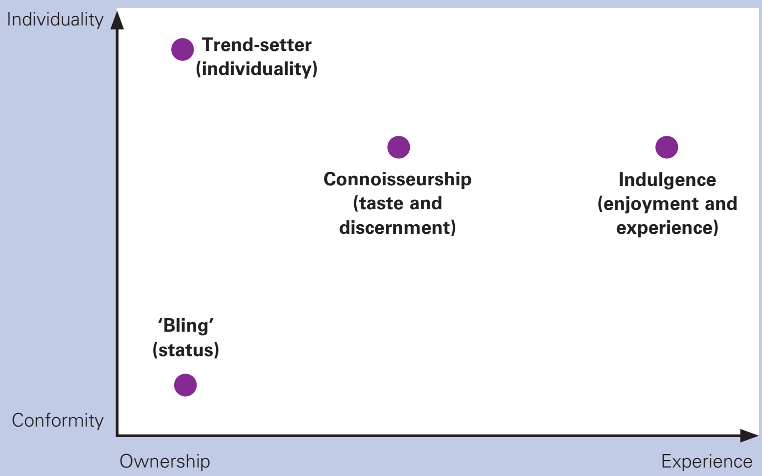
Segmenting the market

Luxury goods companies in China face several challenges in sustaining growth and developing their market position. Besides the enticements of status and prestige, companies need to consider what other emotional appeals can work with consumers as the market becomes increasingly crowded.

China is not a single, homogenous market for luxury and is showing increasing signs of segmentation and differentiation, with consumers motivated by more diverse factors and seeking satisfaction in different ways. Two important needs that are guiding the evolution of luxury are the need for individuality and the need for a rich and indulgent experience. Based on these dimensions it is possible to identify four broad segments, where these needs interact in different ways. These are status-seeking or the "bling" factor, connoisseurship, indulgence and trend setting.

This report includes nine case studies with executives in the luxury goods sector. Each has sought to position their company with a different combination of these emotional appeals.

Key drivers for luxury consumption

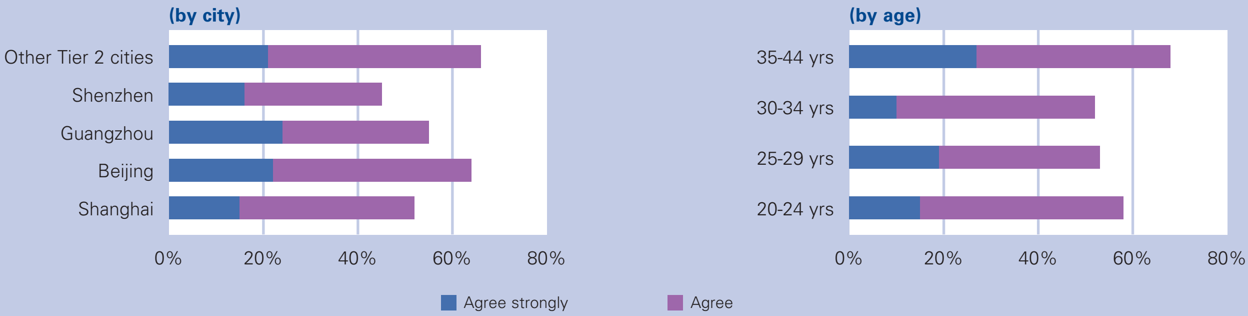


Source: *The Changing Face of Luxury*, TNS, 2007

The "bling" factor

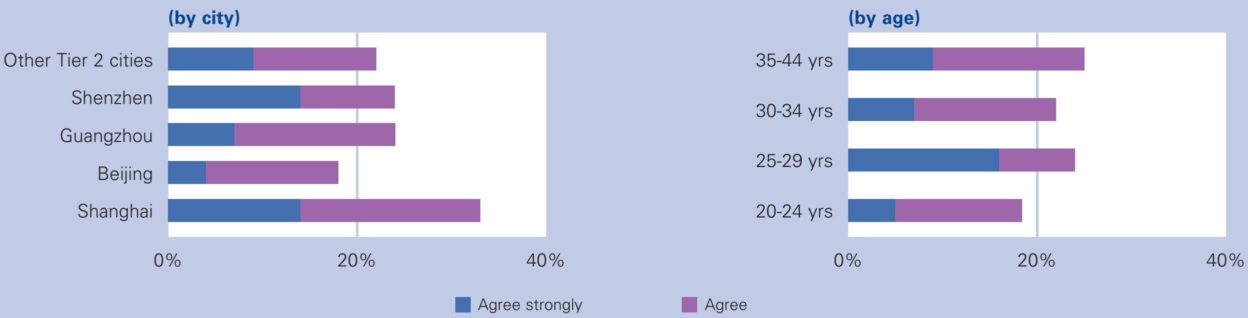
Conformity and status seeking are widely agreed to be key motivations for luxury consumption among China's emerging rich. This appears to be true across age ranges and locations. For example, 60 percent stated that they were willing to pay a premium for products that were popular or famous, with this proportion rising to 66 percent among tier-two city respondents. The fame and status of a brand are particularly strong factors among the youngest (20-24 years) and oldest (over 35 years) age brackets.

"I am willing to pay a premium for luxury goods that are popular or famous"



Exclusivity is an important factor for Chinese consumers, but they also seek status and recognition among their wider peer group. For example, a relatively low figure (23 percent) believed that goods could only be considered luxury if they were known and appreciated by the minority. The figure was particularly low for respondents from Beijing and among those in the 20-24 age bracket.

"Only those brands known and appreciated by the minority can be considered luxury goods"



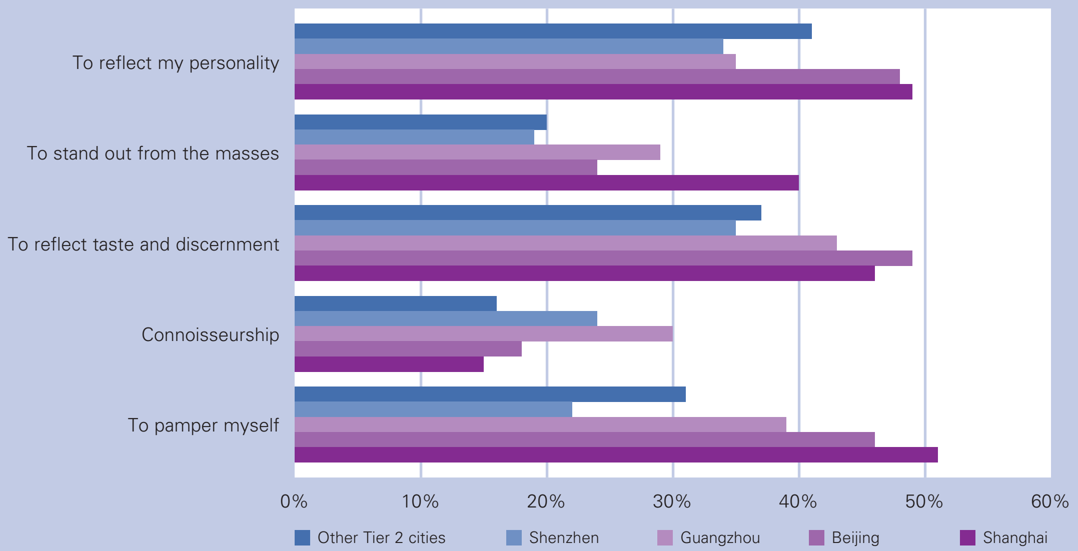
Connoisseurship

Connoisseurs and collectors are still a rare breed in China, but they are growing in number and can exhibit high spending power. TNS identifies these consumers as being typically over 35 years of age, male and based in first-tier cities. Their favourite collectible items include watches and expensive furniture. For female connoisseurs, their collections would also include bags and jewellery.

Connoisseurs are identifiable by their appreciation of uniqueness and heritage, and their expectations for a high level of craftsmanship. While undeniably seeking status, they also see themselves as opinion leaders among their peers and derive a high level of internal satisfaction from their luxury collections.

Connoisseurship was cited as a factor for luxury purchases for 30 percent of respondents in Guangzhou and 24 percent of respondents in Shanghai, while elsewhere it was lower, suggesting this is still not a critical motivation for most consumers. Outside of the super-rich segment, many people still do not have an environment in which to house their luxury collections. The growth of luxury housing and increased spending on homes may be a precursor to further growth in this segment.

Motivations for buying luxury goods



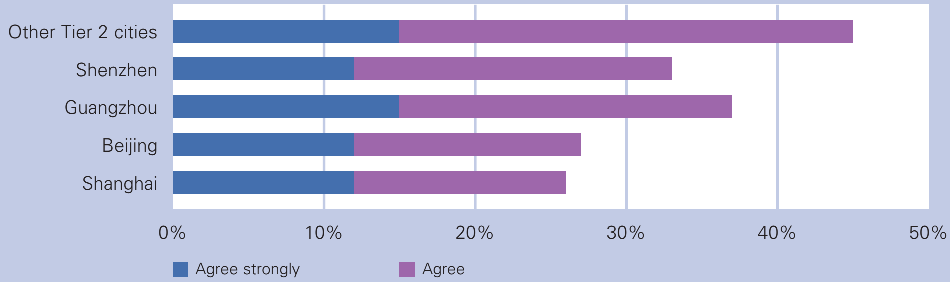
Indulgence

One of the strongest findings of the 2006 report was that over 70 percent of consumers bought luxury products as a form of self-reward. This suggests that the desire to spend money for indulgence, relaxation and enjoyment could become an even higher factor over time.

The wealthiest consumers are becoming increasingly familiar with the luxury of five-star hotels, spas and high-end restaurants and constantly craving new forms of gratification. Many join luxury brand clubs not for the exclusivity but because they are regular consumers of luxury experiences and privileges and expect a consistent level of service or additional "perks".

The survey reveals some interesting discrepancies between cities and regions. Thirty-six percent of respondents say they buy luxury goods to pamper themselves, with that figure rising to 51 percent among respondents in Shanghai. Respondents in Guangzhou, Shenzhen and tier-two cities showing a stronger preference for luxury experiences over purchases of luxury items such as bags and clothes.

"Compared to buying luxury goods such as bags and clothes, I prefer to pay for luxury experiences"



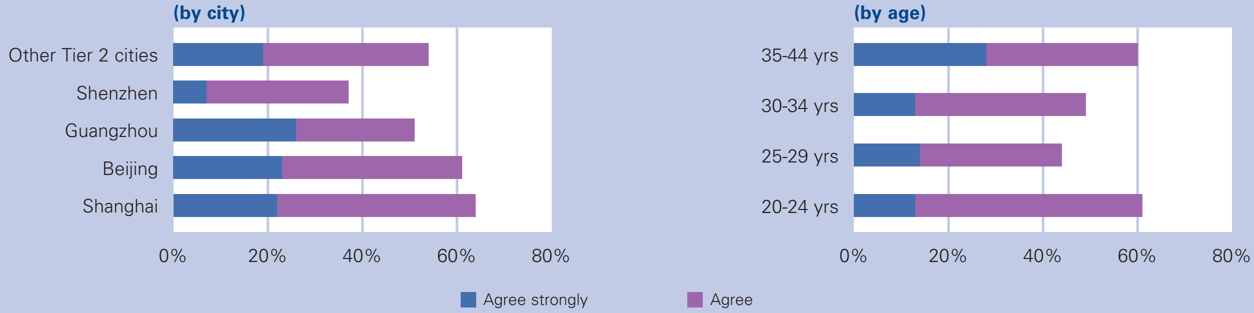
Trend setting

A small but growing segment of Chinese consumers no longer wishes to use luxury brands as a badge. These consumers use brands more creatively to express their identity and individuality. They would be the early adopters of new or niche brands, but may still mix these purchases with more well-known brands.

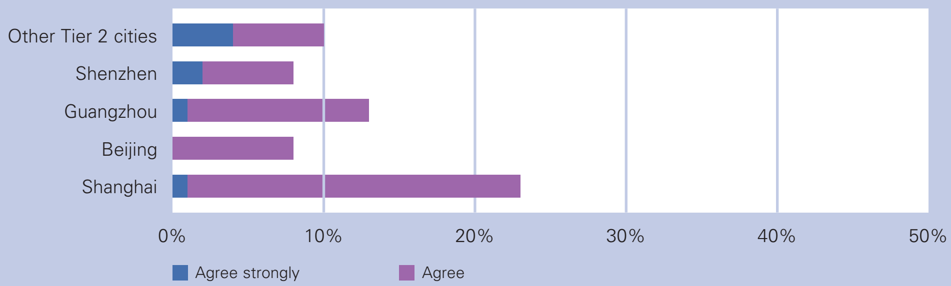
The survey reflects some marked differences in attitudes in this area, with respondents in Beijing and Shanghai most willing to pay a premium for fashionable goods and brands. TNS believes this trend-setter segment is typically younger than average, working in white collar roles and well-educated. However, fashion was also seen as relatively more important among the over-35 age group. These consumers exist in every city, not just the first tier.

Celebrity endorsements are not seen as an important factor for most consumers, although they were appreciated more highly in Shanghai.

"I am willing to pay a premium for goods that are fashionable"



"I believe celebrity endorsements are a good reference when choosing a brand"



Clear-cut appeal

Sandra Shek and Allison Pyrah, Swarovski

Swarovski, the Austrian producer of high-end lead crystal, has found China to be a receptive market for its gifts and fashion jewellery. With more than 110 retail outlets in 35 cities, China will soon be its third-biggest market worldwide.

"We were an early entrant to China, but even today we have few direct competitors," says Sandra Shek, executive director for Swarovski in China. "This has allowed us to expand steadily and confidently, over more than 15 years."

At the outset, Swarovski worked to clearly define its brand and establish firm control over distribution and service. The company developed campaigns to educate the Chinese market about fashion jewellery, still a relatively new concept in the 1990s. It also worked with a limited number of partners in order to efficiently get its products into the best department stores and outlets.

In hindsight, Shek believes this proved to be a cost-effective strategy that laid a good foundation for the company's subsequent growth, particularly as consumers became more appreciative of the quality and consistency that Swarovski embodies.

Most Chinese consumers are still not considered wealthy by western standards, but as their disposable income rises Shek believes they are looking for accessible and affordable ways to get a taste of the luxury lifestyle. This makes accessorising attractive. "Accessories offer flexibility, they can be used in different environments whereas a designer garment is something you can only wear on certain occasions," says Shek. "For that reason, many luxury brands are all seeing stronger sales in accessories than in apparel."

Swarovski's view of the market also corresponds to the profiles built up by TNS. Shek indicated that while most consumers were middle class females, she saw a clear difference in the target market between different cities. In tier-one cities, the customer is typically a female executive in a large organisation or the civil service. In tier two cities, where career opportunities can be more limited, the customers are more often independent business owners or wealthy housewives.

Swarovski is mindful not to disregard the male demographic, who often buy larger-value individual items, either for their partner, or as corporate gifts. While fashion jewellery can account for 80 percent of sales for most of the year, those larger luxury gift items could rise to between 30 and 40 percent of sales during the peak period, running from Christmas until Chinese New Year. While the collectibles market remains relatively small compared to other markets, it is another area which the company expects will continue growing.

Allison Pyrah, vice president of operations for Greater China, joined Swarovski in 1998, at a time when sales in China were less than 10 percent of those in Hong Kong. Today, mainland China retail sales are almost double, although sales in Hong Kong have also grown strongly, supported in part by the purchases of mainland visitors.

"In the early years, our customers in China were like blank canvases, with no preconceptions about our brand," says Pyrah. "Today we have a loyal base of customers and collectors. Our range of products and price points means we appeal to all ages. We recently conducted research on all our markets globally and Chinese customers came out on top for loyalty, emotional attachment and brand recommendation."

Being a single brand — as opposed to being part of a larger retail or luxury group — can be a challenge when it comes to securing prime retail space or negotiating rents. Rental costs have risen five-fold in the space of a few years and are now as much as USD 10 per square metre in some locations. While Pyrah is proud that Swarovski has maintained strong sales on a per-unit basis in recent years, utilisation will remain a key consideration.

Defining China's cities

For administrative purposes, China is divided into many cities, counties, towns and townships. According to the 2007 China Statistical Yearbook, China has 656 cities, which are sub-divided into 2,860 county level regions. In turn, these are divided into 41,040 towns or townships. The 656 cities are classified by the government as either municipalities (直辖市 – *zhi xia shi*), namely Beijing, Chongqing, Shanghai and Tianjin, province level cities (副省级市 – *fu sheng ji shi*), prefecture level cities (地级市 – *di ji shi*) and county level cities (县级市 – *xian ji shi*).

In China, a city is an administrative unit and may in fact comprise numerous towns and villages. Many companies use these administrative tiers as a starting point when devising their marketing strategy, but many also devise their own tiering or ranking based on economic and commercial indicators.

Understandably, the luxury goods market in China is for the most part confined to larger and more affluent cities at present. This report is based on research covering 15 of the largest first and second-tier cities.

- **Tier one:** This comprises Beijing, Shanghai, Guangzhou and Shenzhen. These are the four most important cities in China based on the size of their middle income to affluent population (defined as those with a monthly household income of RMB 5,000 and above). On average, each of these cities is home to around 3 million adults from households with a monthly income of RMB 5,000 and above.

- **Tier two:** In this group we have studied the next 11 markets in terms of their population of affluent and middle class consumers. Given that income levels and costs of living are typically lower in these cities, the survey applies a lower cut-off of monthly household income of RMB 3,500. Each of these cities has a relevant urban population (middle or upper income adults) of over 350,000 people.

Collectively the 15 cities studied have an adult population of 66 million people, of whom some 30 percent come from middle class households.

The following map show that China's four largest cities are clearly distinguished by the size of their middle class populations. However, there are still significant numbers of frequent travelers originating from all of these tier-two cities.

Xi'an

Adult population: 2.61 million

0.61 million with household income of over RMB 3,500 per month

10 percent travel overseas once or more per year

Beijing

Adult population: 8.41 million

2.78 million with household income of over RMB 5,000 per month

34 percent travel overseas once or more per year

Tianjin

Adult population: 4.50 million

0.63 million with household income of over RMB 3,500 per month

24 percent travel overseas once or more per year

Shenyang

Adult population: 4.11 million

0.38 million with household income of over RMB 3,500 per month

35 percent travel overseas once or more per year

Harbin

Adult population: 3.23 million

0.40 million with household income of over RMB 3,500 per month

24 percent travel overseas once or more per year

Chengdu

Adult population: 3.30 million

0.74 million with household income of over RMB 3,500 per month

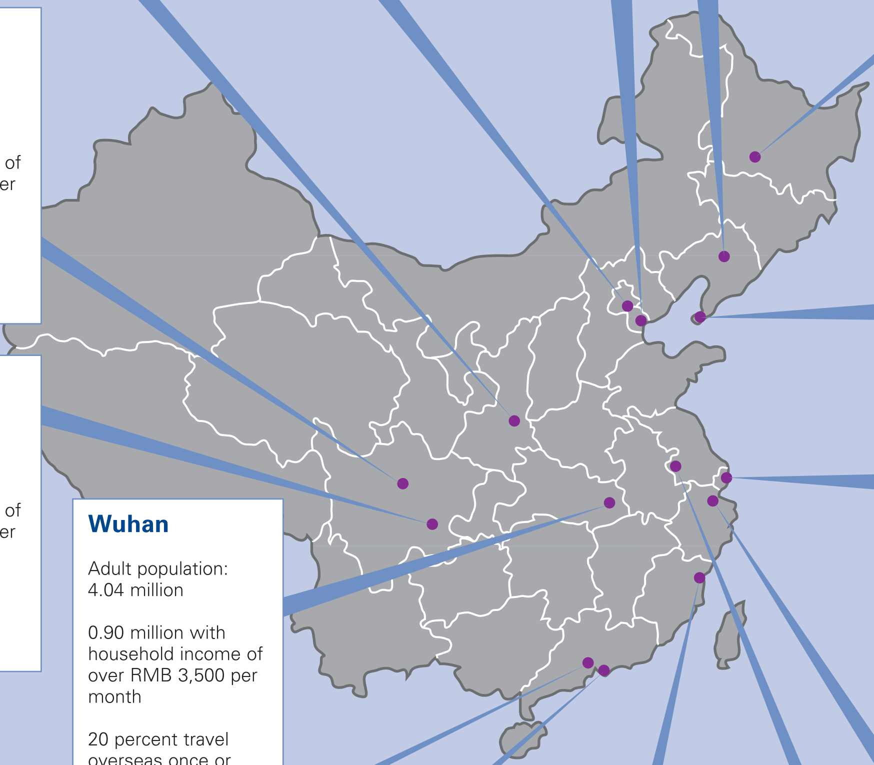
19 percent travel overseas once or more per year

Dalian

Adult population: 2.69 million

0.60 million with household income of over RMB 3,500 per month

12 percent travel overseas once or more per year



Chongqing

Adult population: 4.34 million

0.54 million with household income of over RMB 3,500 per month

22 percent travel overseas once or more per year

Wuhan

Adult population: 4.04 million

0.90 million with household income of over RMB 3,500 per month

20 percent travel overseas once or more per year

Shanghai

Adult population: 10.27 million

2.98 million with household income of over RMB 5,000 per month

41 percent travel overseas once or more per year

Hangzhou

Adult population: 2.06 million

1.42 million with household income of over RMB 3,500 per month

23 percent travel overseas once or more per year

Guangzhou

Adult population: 6.58 million

1.58 million with household income of over RMB 5,000 per month

63 percent travel overseas once or more per year

Shenzhen

Adult population: 5.46 million

3.04 million with household income of over RMB 5,000 per month

48 percent travel overseas once or more per year

Fuzhou

Adult population: 1.62 million

0.53 million with household income of over RMB 3,500 per month

12 percent travel overseas once or more per year

Nanjing

Adult population: 3.09 million

1.87 million with household income of over RMB 3,500 per month

22 percent travel overseas once or more per year

Source: TNS. Traveling percentages are based on survey responses.

Intelligent design

Jeremy Hobbins, LiFung Trinity Management Ltd.

Li & Fung, the Hong Kong-based trading conglomerate is over one hundred years old, however it has recently stepped up its involvement in the luxury retail sector in China, following its acquisition of the Trinity Group of companies two years ago.

Trinity operates the retail licences for six brands across Asia Pacific, including the British bespoke tailor Gieves & Hawkes and the Italian garment producer Cerruti 1881. Separately it also has a longstanding partnership which manages the retail operations for Salvatore Ferragamo in Korea and Southeast Asia.

"Li & Fung acquired Trinity because we saw it was a wonderful business model," says Group Managing Director, Jeremy Hobbins, "however we realised we could enhance that model further by expanding the retail network, restructuring the back office and installing a professional management team to restructure the company."

The main thrust of these efforts has been to establish a brand-focused management structure. This fits well with Trinity's approach, which has always been strictly focused on mono-brand retailing. Underpinning the brand management approach, a country management structure operates in each market to handle landlord relationships and secure access to prime retail space; in China branch operations are required to cover the extensive geography.

This remains a key consideration for any serious retailer and Jeremy Hobbins advises that "a premier location is absolutely key to any brand conveying a premium or luxury image." Through its landlord relationships, Trinity keeps a close watch on new retail developments, particularly in China's tier-two cities. "Opening up at the right moment is critical and establishing the right team to manage this takes time," says Jeremy, "but we have an advantage in being able to bring in people from other parts of the Li & Fung group."

This is no idle boast from an organisation that employs over 25,000 staff in more than 40 different countries. Trinity alone has more than 300 stores across Asia Pacific, of which 230 are in China. Almost 100 of these stores have been added within the last year.

"We are very clear that a common focus for our licenced brands is the menswear sector", says Jeremy. "Our target is the emerging businessman, who is increasingly conscious of his appearance and appreciative of superior brands. Our consumers are most definitely driven by status, but more in a professional sense than in a flashy way."

Maintaining quality is therefore "a fundamental criteria" as far as Trinity is concerned and many of the brands offer a high level of service, most notably Gieves and Hawkes. Personal tailoring and fitting occurs in Asia and goods are then custom-made in England. With a history stretching back to 1776, three Royal Warrants and the most recognised address in the world of tailoring, Number One, Savile Row, London, the company has a proud heritage to take to the market.

Mass market advertising has not been the main focus for Trinity's brands. Instead the company sponsors high-end or professional events, seeks publicity through luxury magazines and authenticates the history and value of the brands through "a high level of personal and VIP contact."

An example was when Trinity re-opened the Cerruti 1881 store in Hong Kong's Harbour City recently. "We brought Nino Cerruti over from Italy to celebrate the opening," says Jeremy. "This created a lot of advertorial interest, particularly in the Hong Kong and Chinese luxury media, while also allowing us to bring loyal customers closer to the heart of this longstanding brand."

In addition, Trinity has a number of other brands in the China market, which have a long history and clear market positioning such as Kent and Curwen which has a more sporting British heritage, and also D'urban, which has a strong Japanese heritage with a continental design theme.

Jeremy states that "the clear positioning for different brands, a strong customer focus, and an extensive retail platform" are amongst the key factors which enable the Trinity management team to operate successfully in this competitive retail marketplace.

Thriving on originality

Lawrence Lam and Edoardo Tocco, Diesel

"Consumers in China are just like anywhere else in the world," says Edoardo Tocco, General Manager for Diesel in China. "They have the same aspirations, and increasingly, the same tastes."

This is a view expressed by many of the people that feature in this report, but it is particularly remarkable coming from a rebellious, innovative brand such as Diesel. Conventional luxury in China is well established, but it takes another leap of faith for a Chinese consumer to justify spending several thousand renminbi on a pair of jeans. Nevertheless, Diesel has become a familiar brand in the high end malls of Beijing and Shanghai, and the second tier cities are firmly in Diesel's sights for the coming years.

Advertising is a crucial consideration for Edoardo, as he seeks to keep the Diesel profile high. "The advertising market here is very cluttered, but in some respects it is starting to become more defined," he says. "We have tended to work with international fashion and lifestyle magazines. However, we are now expanding into a number of purely local magazines and newspapers as well."

Diesel's understanding of the Chinese consumer has become more sophisticated. Its advertising campaigns have always been conceptual and contemporary, and that's not something that Diesel is willing to change in China, even if local consumers do not always fully grasp the meaning behind the campaigns. An example of this, Edoardo explains, is that the medium for branding and advertising remains English.

Diesel's target market is the upcoming middle class and generation-Y consumers, as opposed to the super rich, as Lawrence Lam, Diesel's Hong Kong-based regional CEO explains. Japan has been a successful market for the company, thanks to a growth in young middle class income levels and high brand awareness. Lawrence believes the same potential exists in China.

The real battleground therefore lies in the non-conventional media and communications space. This includes marketing strategies at point of sale, PR activities and events. "We make sure all our events have a distinctive Diesel twist that makes them quirky, conceptual or highly creative," he says. "But most importantly we want to make sure that both our events and the shopping experience at our points of sale are outstanding and memorable."

The challenges of brand perception are another consideration for Diesel. Lawrence is confident that Chinese consumers will gradually come to understand the brand and what it stands for. "Ultimately, this is more of an interesting challenge for us than the need to grow and open new points of sales," he says.

Lawrence and Edoardo view the competitive landscape at two levels. They consider Diesel a premium casual brand, a true alternative to the luxury world, so in this respect competition comes from other youth and quality casual brands as well as the diffusion or casual lines of more established global luxury companies. "We know that a person who is interested in Diesel will have a certain profile or outlook," says Edoardo. "But at the same time we don't want to second guess what other items our customers are spending their money on. We all compete for a share of the shopper's mind and for a share of their wallet, so in that respect all contemporary and luxury brands are competitors. That means we have to keep a bigger perspective as well."

The years ahead are sure to be exciting, with the opening of new flagship stores and the launch in the fall and winter of 2008 of a new premium collection called Diesel Black Gold. As the name suggests, this new collection is designed to appeal to more refined consumers that are motivated by trend-setting and connoisseurship rather than status. "We have to be brave in everything we do and rise to the mark by responding to increasingly sophisticated and fashion-conscious consumers," says Edoardo. "If we are committed to that ethos, we will continue to grow in popularity."

Choice and brand visibility

KPMG findings

- The luxury advertising market in China is highly competitive, particularly in terms of access to advertising and high-quality retail space.
- On average, the Chinese consumer recognises over 60 different luxury brands. Chinese consumers are becoming more discerning and understanding of the heritage of different brands.
- While many brands still see conventional advertising as the only route to achieve brand awareness, some companies are turning to alternative channels and more targeted marketing.

As the world's third-biggest economy, China is a country that international retailers and consumer brands cannot afford to ignore. Any company with a presence in the five largest global economies would have access to a potential market representing 57 percent of the world's GDP. China now ranks ninth among all countries in terms of penetration of international retailers.[2]

Luxury companies have been at the forefront of this move, as their high margin — low volume business model has been relatively easy to establish. However, the intensity of competition in China's luxury market has created challenges for brands looking to deepen their penetration or attract new aspirational consumers to their products.

The intensive brand building activity of recent years is already paying off on the streets of Shanghai and Beijing. On average, the survey participants recognised 64 different luxury brands, compared to 52 in the 2006 survey. In Shanghai this rose to 73 brands, while in tier-two cities it stood at 62 brands. The respondents recognised a higher number of brands in each main category, with the largest increase occurring in bag and footwear brands.

2 How Global is the Business of Retail?, published by *CB Richard Ellis*, 2008.

Brand recognition levels

		Clothes	Bags and shoes	Watches	Jewellery	Import cars	Others*	Total
2006 survey	Average number of brands recognised	9.3	4.7	7.6	2.5	10.1	17.5	**51.7**
	As a percentage of brands listed	26%	31%	30%	28%	60%	26%	
2008 survey	Average number of brands recognised	10.5	12.4	8.2	3.5	11.1	18.2	**63.9**
	As a percentage of brands listed	28%	37%	34%	32%	65%	24%	

*Others includes other accessories (for example pens and eyewear), cosmetics and alcohol. The list of brands used in the 2008 survey was longer, as some additional brands were included.

Brand recognition by city

	Shanghai	Beijing	Guangzhou	Shenzhen	Other Tier 2 cities
Average number of brands recognised (2008)	73.3	70.5	67.5	46.7	61. 8

To date, a key channel for raising brand awareness has been directly through the retail experience. Fifty-nine percent of men and 67 percent of women are prepared to pay a premium for luxury products in return for a positive retail experience and good service.

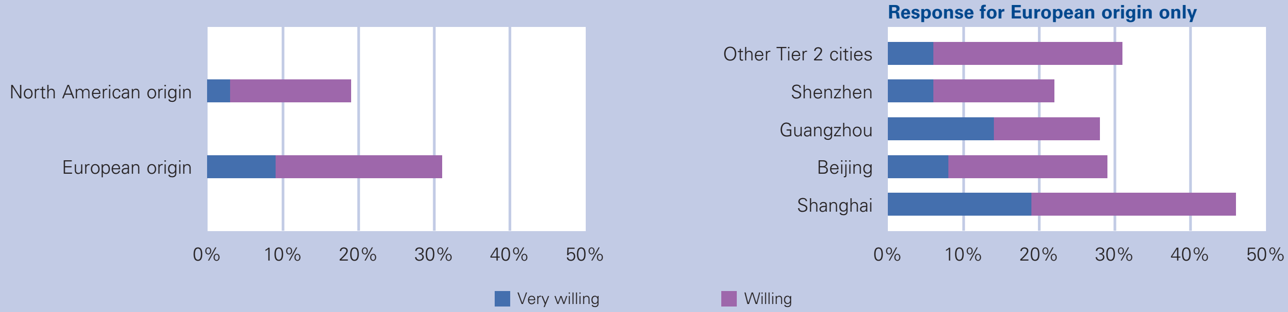
This has been regarded as a major challenge by many of the executives featured in this report. On the one hand, accessing high-quality retail space can be difficult, particularly as the largest luxury brands expand their footprint and command the best locations within new malls and retail districts. On the other hand, training and retaining sales staff can be a challenge as people are constantly head-hunted for new stores. Many of the leading luxury brand companies have made an express commitment to raise the standard of the sales experience in China to the same level as their stores in Europe or America.

"I am willing to pay a premium for a positive retail experience"

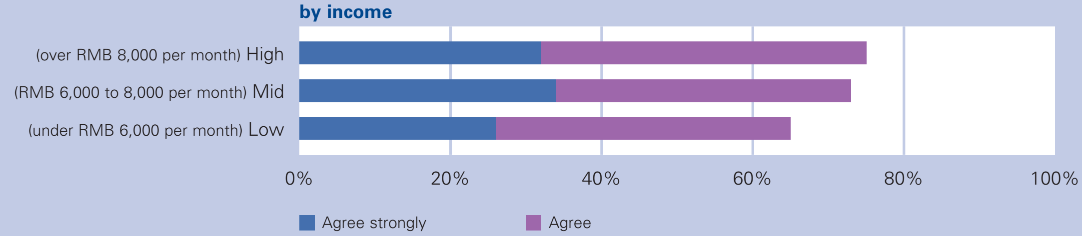
The intensity of competition is also felt by companies seeking access to advertising space, whether in print media or external locations. The growing sophistication of China's consumers and the emergence of distinct motivations such as connoisseurship and trend-setting are forcing companies to consider alternative marketing strategies, including exhibitions, events and sponsorships. These can be a more effective way to educate the market and reinforce certain values, such as heritage and prestige.

The origin of luxury brands is something that consumers are increasingly aware of, with respondents in all cities showing a preference for European brands over North American brands. Forty-six percent of respondents in Shanghai said they were willing to pay a premium for luxury goods of European origin. This compares with 29 percent in Beijing and 28 percent in Guangzhou.

"I am willing to pay a premium for goods of European or North American origin"



"I am willing to pay a premium for luxury goods with a long heritage"



The impressionable market

Denise Lo, Chanel

Denise Lo is a Hong Kong based executive with many years of experience working in the luxury and retail business. As general manager for watches and fine jewellery at Chanel, she has seen a steady change in attitudes towards mainland Chinese shoppers. "Hong Kong people recognise the power that mainland Chinese consumers now exert in their market," she says. "It's also visible when you go to Macau, as there are thousands of visitors there every day. Macau has become a principal stage for luxury brand marketing in its own right."

Denise came to Chanel from the Swiss trading and logistics conglomerate DKSH. Before that, she learned her business as an intellectual property lawyer with a large international law firm in Hong Kong. She developed a longstanding interest in luxury retail after seeing first-hand the forays of her family's business into China's retail market during the 1990s.

This background has given Denise a clear appreciation of the values and qualities exhibited by different brands. "Clearly there are tiers of what we can define as luxury, from the really high-end through to products that are of good quality but with wider appeal," she says. "All brands have to establish their standing afresh in China, so the considerations from a logistics and marketing perspective have to be thought through. The approaches to handling tax and customs may be completely different according to the volume and the value of the goods you are shipping."

Denise sees China as an exciting and impressionable market, where clear trends are emerging. People are becoming more confident in the way they match their clothes and accessories; this is particularly true in Shanghai. Beijing, by contrast, is "where the real money is," but it is also a place where tastes are more subtle and where "people are less inclined to stand out for all sorts of reasons."

Nevertheless, Lo agrees that many Chinese consumers are preoccupied with using luxury goods, especially accessories, to display their status. "That first encounter with luxury is total bliss," she remarks, "so people naturally want everyone to know about their luxury purchase."

"I also find it a bit ironic that so many fake goods are actually being bought by tourists and foreigners." she adds. "By contrast, the Chinese will seek out the genuine article, or travel to Shanghai or Hong Kong for that luxury retail experience."

Chinese people are traveling overseas in increasing numbers, and as they do they will continue to develop their own styles. However, Denise believes that Hong Kong remains a key window for Chinese luxury consumers. "The language barrier makes it difficult for many to look further afield to track trends in New York, London, Paris or Milan," she says, adding "many Hong Kong celebrities have a very positive image in mainland China and are often not too closely identified with one single brand."

The potential for growth may be exceptional, but there are challenges in the timing of market entry and developing the local workforce. "The talent pool within China is still developing and this creates a lot of challenges in managing growth," says Denise. "Looking to tier two cities, the potential is huge. People are pushing to get into those markets early to get the best positioning, but there are risks attached as well, if you arrive on the scene too soon."

The traveling consumer

KPMG findings

- Chinese consumers are increasingly able to travel overseas thanks to reduced restrictions and the appreciation of the renminbi.
- Among those consumers that have traveled overseas, ninety percent buy luxury goods, with almost half either specifically saving money or planning their intended purchases prior to their departure.
- Over half of respondents will buy luxury goods as gifts for others when traveling.

In 2006, mainland Chinese tourists made 34.5 million outbound journeys, compared with just 12.1 million journeys in 2001. By comparison, the total number of foreign visitor arrivals into China in 2006 (excluding visitors from Hong Kong and other "overnight" visitors) stood at 26.6 million.[3]

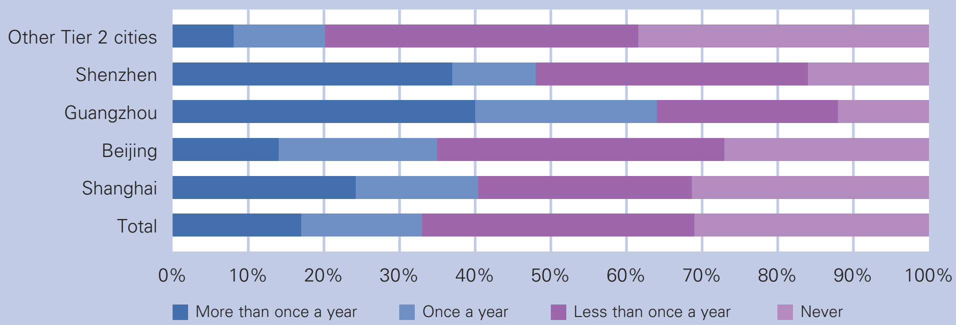
The increasing propensity of Chinese consumers to travel is having dramatic implications for the marketing of luxury goods.

Among the survey respondents, 33 percent travel overseas once or more a year, with that figure rising to 40 percent among respondents in Shanghai and 64 percent among respondents in Guangzhou. Seventeen percent of all respondents travel overseas (including to Hong Kong and Macau) more than once a year.

Those respondents earning more than RMB 8,000 per month travel overseas an average 2.3 times per year.

China's consumers have proved particularly willing to buy overseas, partly because the high levels of duty and value-added tax within China mean that products are often significantly cheaper, but also for the shopping experience of visiting boutique or flagship stores.

Frequency of overseas travel



3 "Development of Tourism," *China Statistical Yearbook 2007*, published by the National Bureau of Statistics.

The increase in the spending power of Chinese consumers overseas has been further strengthened by the appreciation of renminbi and the increased ease with which people can make purchases. For example, the China Unionpay network is now increasingly prevalent in Hong Kong and also further afield in Japan, Korea, Southeast Asia, Australia and many parts of Europe.

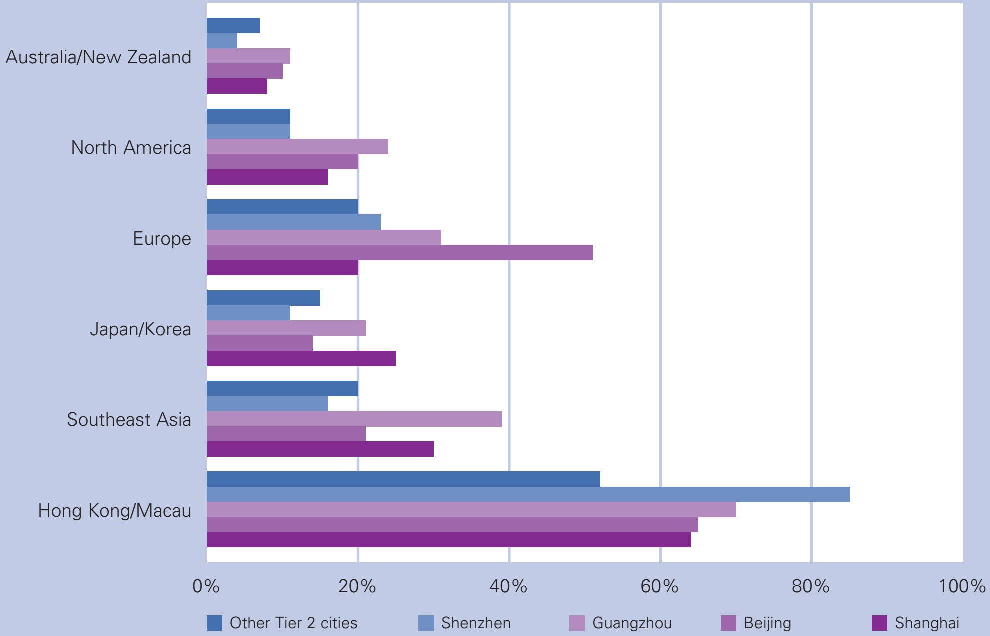
Frequency of travel per year, by income range (%)

	Total	Low (under RMB 6,000 per month)	Mid (RMB 6,000 to 8,000 per month)	High (over RMB 8,000 per month)
Once a month or more	2	0	3	5
Once every 3 months	5	3	4	11
Once every 6 months	10	5	13	15
Once a year	15	9	17	23
Once every 2 years	11	13	10	11
Less than once every 2 years	25	29	25	17
Never	30	42	27	15
Mean times per year	1.08	0.43	1.13	2.3

Hong Kong and Macau are the most popular destinations among those traveling, followed by Southeast Asia and Europe. However there are some notable discrepancies between cities, with respondents in Beijing more likely to travel to Europe, while respondents in Shanghai go to Korea or Japan. Naturally respondents in southern cities such as Shenzhen and Guangzhou were the most frequent travelers to the neighbouring regions of Hong Kong and Macau.

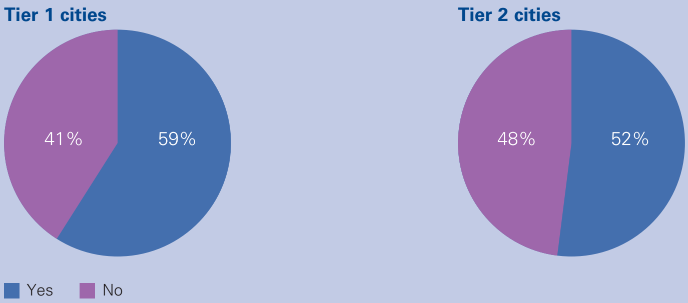
Among those who have traveled overseas, the overwhelming majority say they have bought luxury products. The majority did not save specifically for these purchases, but many did make a list, including buying items as gifts for friends or family. Chinese consumers are particularly willing to buy cosmetics and accessories such as bags, pens and eyewear, when traveling.

Planned destinations for Chinese travelers



Shopping patterns while traveling

Willingness to buy luxury gifts for others when traveling:



Even the most frequent travellers continue to purchase luxury goods in China. Among those traveling more than once a year, 86 percent said they would buy luxury goods domestically as well. There is no evidence of an inverse correlation whereby increased travel might diminish the sales potential for luxury goods within the country.

As a result, it would seem important for luxury brands to build brand awareness with Chinese consumers both inside the country and also overseas. On the one hand, many consumers will actively write up a shopping list of their intended purchases before travelling and this will inevitably be influenced by their exposure to brands in the home market. On the other hand, China's travelling consumers are typically higher earning individuals and more likely to act as trend-setters or "champions" for a new brand.

The sheer number of Chinese tourists traveling overseas in the years ahead should ensure that marketing and branding activities in international locations (for example in airports, large tourist attractions and large international cities such as Hong Kong) are increasingly targeted towards a Chinese audience.

Respondents purchasing luxury goods domestically and overseas

Purchase location	Total	More than once a year	Once a year	Once every 2 years	Less than once every 2 years
Mainland China	93%	93%	95%	94%	90%
Overseas (incl. Hong Kong and Macau)	43%	86%	64%	39%	36%

Note: Percentages are based on weighted numbers of respondents

The next step to success

Giovanni Di Salvo, StraBranding

"China's luxury market is more navigable than a few years ago," says Giovanni Di Salvo, partner of StraBranding in Hong Kong. "However, it's still an extremely challenging market and achieving success requires experience and on-the-ground knowledge."

These are qualities that Giovanni clearly possesses, having spent eight years with Prada Group, most recently as general manager of Prada Asia Pacific, before joining Valentino Group as CEO for Asia Pacific, based in Hong Kong in 2005.

Giovanni recalls his time at Prada being particularly exciting, as it coincided with a period of rapid growth, a number of acquisitions and the formation of joint ventures throughout the region. By the end of his tenure, Prada had over 70 stores around the region, employing over 800 staff. Of those 70 stores, 11 were located in China.

In 2007, Giovanni joined strategic branding and business development consultancy StraBranding, as partner in Hong Kong. The company advises clients, many of them new entrants to the China market, on partnering strategies, locations, distribution, pricing, product mix and merchandising.

"We are advising many new entrants, but we also see opportunities to work with companies that have been established in China for a number of years and that need to reposition the brand or reformulate their operational strategies," he says.

Prada took a direct approach to opening and operating stores and Giovanni believes the more successful brands have often taken this approach. "Ten years ago people would typically just license their products rather than going in directly. The operational and regulatory issues are clearer now, but it still takes commitment as well as clear planning. The challenges start as soon as you set up the company in terms of sticking to a clear business plan, declaring and managing your working capital requirements and anticipating your requirements in areas such as logistics and HR management."

The upside of this is that direct ownership allows the brand to gather more feedback on tastes and preferences. "Education and communication around a brand is especially important in a young, growing market such as China," he says. "That communication process needs to occur in both directions."

So, even for brands which base their distribution strategy on a franchising network, opening direct stores in the first tier cities is important. Giovanni pursued this strategy with Valentino. Another Italian brand, Armani, has followed the same approach by operating Giorgio Armani flagship stores in Beijing and Shanghai.

Giovanni sees the China market growing in sophistication. "Status is still the primary motivation for consumers across China," Giovanni remarks, "But there are interesting differences in tastes. My experience has been that consumers in Beijing are particularly interested in understanding what is behind a brand, its history and heritage. So in Beijing a brand archive exhibition might be the most effective channel to promote a luxury brand, whereas in Shanghai a glamorous event, such a fashion show or a party, might work better."

Giovanni also sees potential for StraBranding to work with Chinese brands that are seeking to raise their profile or sell products to other markets such as Europe and US. "There is some high quality Chinese couture emerging," he says. "The process of transforming that raw talent into identifiable brands cannot occur overnight, but I have no doubt it will happen. We are already witnessing a profound transition in Asia Pacific, from simply manufacturing to creating."

Pushing the right buttons

Lars Hundborg, B&W Asia Ltd.

Lars Hundborg is the CEO of B&W Asia, a British luxury sound equipment company that is gaining a new following in Asia. Lars' story sheds some interesting light on the dramatic rise of luxury consumers, while his products — beautifully crafted speakers that can cost up to RMB 600,000 (USD 80,000) per set — are truly capable of turning heads.

Lars has a clear understanding of his customers and how he wants to position his products. "Quite simply, our target customers are people who are successful and who want the best in life," says Lars. "Around one-third of our customers in China are what you might call 'hi-fi freaks' who are collectors or connoisseurs of our products. But that connoisseurship is becoming less important, as we try to appeal to people at a more fundamental level. We want to give people a luxury experience and to excite them with our state-of-the-art design."

The China market may be in its formative stages, but it has already proved to be a rewarding one for B&W. In 2007, Lars notes, the company saw its strongest sales at the mid- and high- end of its product range. This was reflected in the fact that the value of each container it shipped into China almost doubled, as compared to 2005.

"To grow, you have to be seen, and that's difficult in China because people are bombarded by brands," says Lars. "We have looked to non-traditional channels to gain that visibility and to establish that connection to luxury living."

B&W recently set up their first representative office in Shanghai. Lars describes this as "an important step in representing our brand in China on our own terms," but he is also proud to note that most of the sales people he has employed in this office come from a non-audio background. He is looking for people with the skills to sell products based on their lifestyle-enhancing appeal.

Lars sees an opportunity to sell B&W products to new luxury housing developments, so a key target group has been architects and interior designers that can recommend their products to their clients. "We are targeting the real high end of the market," says Lars. "Many of these people will never go anywhere near a downtown hi-fi retail outlet, so you have to approach them indirectly or through other channels, including clubs and luxury events."

Like other luxury brands, Lars seeks to sell an experience or an association, as he puts it by "telling stories and demonstrating the heritage of the brand." For example, B&W equipment has been used in the Abbey Road music studios since the 1970s and has also been used in the sound production of numerous hit movies, from Star Wars to Harry Potter. "Our consumers in China have really bought into these stories," Lars observes.

B&W continues to rely on distributors and has identified Beijing, Shanghai, Shenzhen, Dongguan, Guangzhou, Chengdu and Chongqing as its seven target markets. Lars recognises the challenges of working with distributors and has observed some competitors struggling through a lack of clear strategy. "You need to question whether distributors can follow your growth. Are they managing their cash flow, or could they create a bottleneck for you?"

Lars' conclusion is that he needs to "avoid getting preoccupied with the product, keep thinking about the business model." It is this approach that is helping B&W make the jump from a technical product to a luxury lifestyle product.

Changing business models

KPMG findings

- There is a growing willingness to invest directly in China's luxury and retail sectors, but distributors and joint venture partners can still play a valuable role in helping develop a brand's presence.
- Franchising or joint venture arrangements need to provide an adequate incentive to the licensee and clear terms for how the partner is compensated if the two parties agree to end the arrangement in the future.
- As Hong Kong and mainland China operations become more closely intertwined, companies will need to examine and define their functions more clearly for tax purposes.

Many luxury brand companies now see their presence in China as a key part of their global growth plans. This may be particularly true for publicly-listed luxury companies facing a slowdown in consumer spending in North America and Europe. Investors are increasingly interested in seeing international brands develop a strategy to succeed in China.

Since 2004, China has removed restrictions on the foreign ownership of retail and distribution businesses, so foreign companies no longer need to establish a joint venture to enter the luxury market.

The joint venture model still offers some advantages, allowing companies to benefit from the knowledge and resources of their local partners. Joint ventures continue to be used by large international retail, and food and beverage chains seeking rapid expansion. In many cases, several joint venture partners are needed to succeed in different markets. An alternative approach, favoured by many brands seeking even stronger penetration, has been to work with a distributor and establish local franchises.

Many executives admit that the challenge with these approaches, particularly in the luxury market, is to find a partner that shares the company's own high standards and values and can execute the branding effectively. Franchising or joint venture arrangements also need a clearly established timeframe and criteria that provide an adequate incentive to the licensee to develop the brand and clear terms for how the two parties might agree to end the arrangement in the future.

A number of companies in Hong Kong have succeeded in serving this licensee role, developing long-term relationships with a portfolio of international brands. While the opportunity now exists to invest directly, partnering with local or Hong Kong-based companies can still be extremely useful, particularly for the infrastructure they can provide to support expansion across many cities.

For luxury brands that want to retain strict control over management and intellectual property, and whose expansion plans might be less dramatic (in terms of actual numbers of outlets), operating directly through a wholly foreign-owned enterprise (WFOE) is an increasingly attractive and feasible option. This approach has been pursued by many of the largest and most high-profile retail brands and groups.

A number of brands have switched to this approach over the past four years, but doing so requires a greater commitment of financial resources and local knowledge of the market. The WFOE also needs to understand how customs declarations were handled under previous distributor arrangements, to ensure consistency.

Operating as a WFOE can still be easier in the larger cities where third party service providers are available to provide support, but can prove more challenging as companies expand more widely. As a result, some brands may set up a WFOE, but still opt for joint venture or franchising arrangements in certain cities.

One market or many?

The legal and regulatory requirements facing companies, as well as the characteristics of consumers, are quite different in Hong Kong and mainland China. However it is equally clear that significant differences exist between different parts of China, in terms of consumer tastes and the competitive and retail environment.

As a result, luxury brand companies increasingly view Hong Kong and the mainland of China as a single market. A large proportion of Chinese consumers see Hong Kong as a "window" for international trends. Indeed, a large proportion of retail sales in many of Hong Kong's malls are derived from visiting mainland Chinese.

Within a regional corporate structure, it is increasingly common for Hong Kong and China to be run by one management team. However, many brands still use Hong Kong as a distribution hub for sales in China, rather than selling directly into China. This can be advantageous given Hong Kong's lower corporate income tax levels, but the company also needs to consider the customs duty obligations of bringing goods through Hong Kong into China. The functions of the Hong Kong and mainland China offices need to be clearly distinguished for tax reporting purposes.

Some apparel and accessories companies are also using locations in China to handle certain manufacturing or processing functions. With China's domestic market growing, there are possibilities for these companies to reorganise their supply chain towards a more direct distribution model. This may simplify the tax and customs obligations, but entail more significant operational and logistical changes.

It will also change the profile of related-party transactions, a subject which is addressed in more detail in the next chapter.

M&A activity in the luxury sector

The consumer retail and wholesale sectors have been one of the hottest target areas for private equity investment in recent years. In 2006, private equity companies invested in 143 different companies in these sectors across Asia Pacific, representing total investment of USD 7.9 billion.[4]

While private equity interest has been particularly strong in the luxury sector, it could be dented by the tightening credit market and a slowdown in consumption in Europe and North America. Chinese companies are increasingly interested in acquiring international brands. In some cases these companies have already seen success in reinvigorating or repositioning these brands in the China market.

Valuation in China's luxury retail sector

Given the high growth and variety of operating structures in China's consumer sector, there are many parameters that can be used to value luxury companies.

The PEG ratio (the price/earnings ratio divided by the growth rate of earnings) shows that investors are reacting to the excellent growth prospects for the sector. While an average P/E ratio in the range of 25x to 30x might on the face of it seem like a high multiple of earnings, it is substantiated where the PEG ratio is close to a value of one. There are other considerations which are not reflected in the PEG ratio, such as the associated risk of achieving the forecasts or the sustainability of such earnings growth, but nonetheless it does provide a useful snapshot of relative value when considering similar companies.

Factors driving the performance of these companies include the income growth of the urban elite and the higher aspirations these bring, the high level of household savings, which is still growing after more than doubling in the past five years, and an urbanisation process which continues to swell the ranks of the middle classes, particularly in the key age bracket for discretionary spending of 20 to 35 years of age.

A further driver is the growing, economically independent female consumer group, whose education levels are catching up with their male counterparts, and whose typical jobs in the private sector services industries are booming.

4 Private Equity: Implications for Economic Growth in Asia Pacific, published by KPMG International (2007).

Adapting to growth and opportunities

Nelson Chan, Dickson Concepts

Nelson Chan, Executive Director of Dickson Concepts, sees a potential market of 200 to 300 million consumers in China that can afford imported products, although he is mindful that the demand for the most high-end luxury goods might be confined to a market of around 100 million people.

"Many of these consumers are still earning relatively low incomes by western standards, but the desire to elevate their status using luxury brands is undeniable," Nelson remarks. "Most Chinese consumers use cash and debit cards when making purchases. Credit cards are not widely used and when they are it is normally for convenience rather than because of the need for credit."

Dickson Concepts is well-placed to benefit from China's emergence into one of the world's biggest consumer markets. The Hong Kong listed company operates the Seibu department stores in Shenzhen, Chengdu and Shenyang, and acts as licensed distributor for famous international brands such as Ralph Lauren, Tommy Hilfiger, Brooks Brothers, S.T.Dupont and Tod's in more than 30 Chinese cities. The group also includes the Dickson Watch & Jewellery chain and carries famous watch brands such as Rolex, Tudor, Chopard, Blancpain, Glashütte, Girard Perregaux and Jaeger-LeCoultre.

Over the past two decades, the company has expanded from its base in Hong Kong into the retail markets of 25 provinces across mainland China, as well as other markets such as Taiwan, Singapore and Malaysia. "Our strength is that we can help meet the principal's needs in terms of product mix and positioning strategy," says Nelson. "We initially entered China in the early 1990s in a joint venture with the Jin Jiang Group in Shanghai, so we have a lot of local knowledge and can give our advice on how best to position a brand in the local context. We have been moving even more people into China since 2002, when we established our Shanghai office. We now run over 200 retail outlets across the country."

China may be growing dramatically, but there are often regulatory and logistical challenges that can be slow to resolve. This is where Nelson believes Dickson Concepts can really assist a brand to succeed.

"We are operating multiple brands, each with their own brand manager and merchandising team," Nelson continues. "But we use our group strength to take advantage of common back office functions. This includes not only supply chain logistics but also store set-up services including interior design. So in essence we have the advantage of combining brand independence with strong functional support."

Nelson sees tastes and preferences becoming more sophisticated in China, but the majority of consumers are still looking for a logo or a clearly identifiable product. He has also observed that consumers in tier-two and tier-three cities follow the trends in Shanghai more closely than those of Beijing.

The growth in China has been phenomenal, but it has been accompanied by intensifying competition. "With so many new brands coming in, the costs of operating are going up," says Nelson. "When rents increase significantly its tough, because we cannot increase our turnover at the same pace. The competitive environment is also intensifying among department stores, as many of our local competitors have really raised their game."

Transfer pricing issues affecting the luxury sector

China now represents a critical part of the global supply chain and retail operations for many luxury brands. As a result, luxury companies need to clearly understand the implications of recent changes to China's tax environment. In particular, they need to establish a clear strategy to handle transfer pricing issues.

Enforcement trends affecting the luxury market

China's new Unified Corporate Income Tax Law (CIT Law) came into effect at the beginning of 2008. It states the need for contemporaneous documentation of transfer pricing and indicates that companies need to proactively manage their transfer pricing risks. It may foreshadow a more active transfer pricing audit environment in China.

Since the introduction of the new CIT law, China's State Administration of Taxation (SAT), has indicated that the focus of transfer pricing audits will expand from purely manufacturing entities to target organisations with more complicated operations involving distribution, services, and transfer of intellectual property. As a consequence, luxury brands are likely to become more frequent targets for transfer pricing audits.

Chinese tax officials have demonstrated a growing interest in the concept of marketing intangibles and royalty payments for luxury companies operating in China. This raises the possibility that the SAT will demand more income allocation to Chinese affiliates of foreign companies to cover their contribution in expanding market share within China.

This is different from the situation five or ten years ago. At that time, a Chinese affiliate not only had to invest heavily in developing the local customer base and brand loyalty, but also in the product itself. In those situations, Chinese affiliates may have seen little or no profits during the early stages of market entry. Local tax officials may also assert that there should be immediate profits if the recently introduced brand name has value; otherwise, the Chinese affiliate may be overpaying for brand licensing.

At the same time, some Chinese officials have questioned the value of royalties paid to foreign affiliates for intangibles and management fees, implying that the fees are too high given the lack of luxury brand name recognition during the early phase of market entry. Officials are demanding that the Chinese affiliate substantiate the royalty payments by producing evidence that third parties are paying similar licensing royalties.

China continues to discourage related party management fee charges by disallowing their deductibility. Due to lack of consolidation requirements, companies with multiple related party transactions occurring in multiple directions must deal with each other at arm's-length; any significant intra-group royalty payments and service payments may engender further scrutiny and potential double taxation.

Transfer pricing issues facing luxury companies in China

The enforcement of transfer pricing in China has produced some startling results, and a number of luxury companies have been subjected to tax scrutiny or transfer pricing audits. Since the burden of proof lies with the taxpayer, it has become increasingly important for luxury companies to develop their own sophisticated and proactive approaches. This may involve:

- determining appropriate transfer pricing between a Chinese retailing entity and overseas affiliates. This could include consideration of profit repatriation through royalties and inter-company charges, with a view to balancing import duty/taxes and corporate income tax liabilities

- determining an appropriate royalty charge between the intangible brand owner and retail stores in China

- considering whether a shared-service company should be established in China (for example, to centralise management, marketing and IT services)

- assessing the approach to recharging shared services costs to the Chinese retail outlets.

Approach to managing transfer pricing exposure for luxury companies in China

For luxury brands stepping into the Chinese consumer market, some marketing activities may not have an impact beyond the year in which they are performed, and so would be treated as current expenses rather than capitalised expenditures. The treatment of such activities is likely to be important in a functional analysis carried out to establish comparability for transfer pricing. In some cases, the cost of marketing activities and trading activities may need to be recovered by charging for associated luxury products and services. In other cases there may be an intangible property on which a royalty is separately charged. In some cases, it may be a combination of the two.

In either case, it is important to conduct functional analysis of marketing intangibles, especially if dealing with other jurisdictions where transfer pricing documentation requirements are still not fully clarified.

In the past three years, China has concluded several Advance Pricing Arrangements (APAs). With more currently under negotiation, it is clear that the SAT is becoming more sophisticated in its approach to transfer pricing issues.

APAs are viewed as beneficial to both taxpayers and the tax authorities because these arrangements are seen as enhancing the predictability and certainty of the taxation of related-party transactions. In this respect, where the amount of royalty payments becomes an arguable transfer pricing matter for luxury brand retailers, they have a tool to negotiate with the tax authorities to agree on a conclusive method to resolve ambiguities. Likewise, APAs can be applied to resolve issues involving the transfer price of management service fees. APAs can help taxpayers avoid costly and exhausting transfer pricing investigations and resolve issues in an amicable manner.

Article 41 of the new CIT law provides for cost-sharing arrangements. Under Article 112 of the CIT implementing rules, an enterprise may share common costs based on the principle that "the costs and expected benefits are matched."

A qualified cost-sharing agreement, which reduces the risk of challenges to outbound royalty payments or the sharing of service costs, while reducing business and withholding tax burdens, is likely to benefit taxpayers in several ways. It could be particularly advantageous to a company using a luxury brand originally owned and developed abroad, or that has made significant local marketing expenditures within China to adapt or maintain the value of the brand.

As China becomes increasingly interested in asserting the value created by local marketing activities, companies with local marketing expenditures that will create value for a brand will benefit from cost sharing as well.

The cost sharing agreements can be used in intellectual property or services-related arrangements. In the services area, limitations have been placed on what can be charged from abroad to the Chinese affiliates, so the cost sharing mechanism may provide an alternative. A company is more likely to benefit from cost-sharing arrangements than not because the royalty payment for using the luxury brands or allocated service costs will be deductible, and theoretically no additional business tax and withholding income tax should be levied.

Deep roots in the China market

Michelle Chen and Adrian Pick, Ports Design

China's consumers are bombarded by brands like never before. In such a crowded market, local experience and a demonstrable track record can be the key to success. Ports Design has adopted a unique strategy in China. Having built up a large presence on the ground, including more than 5,000 employees in retail, logistics and manufacturing functions, the company now has high levels of vertical integration. This proximity to the customer has allowed it to serve a vast network of retail outlets and quickly detect and react to changing tastes and trends.

Adrian Pick joined Ports in Canada and has spent the last five years based at the company's China headquarters in Xiamen as vice president for corporate development and communications. With over 360 outlets in 56 cities across the country, Pick witnessed one of the most dramatic phases in the company's history. Group turnover for 2007 reached RMB 1.355 billion, supported by a 28.9% percent increase in retail turnover.

"I came to China expecting to see mindless money spending, but I have been surprised by how stylish and tasteful Chinese consumers have become,' says Pick. "People really research and understand what they are buying. The history of the brand really does matter."

Ports' international profile has also helped in this respect. "We have seen strong growth in our North American market," says Marketing Director Michelle Chen. "We have achieved a high profile in the fashion media, having been seen adding glamour to influential movie stars such as Nicole Kidman and Reese Witherspoon. This is also having a spill-over effect on how we are perceived in China. The 1961 range was initially developed only for the US and Canada, as we considered it too avant garde for China. However, that range is now selling strongly here as well."

In 2007, Ports hosted Chinese actress Xu Jinglei at New York Fashion Week, a step which had a dual role in strengthening the brand in the China market and helping to build global awareness.

The challenges associated with growth go far beyond finding new shop locations and training new staff. Chen admits that the company has had to increase salaries to retain staff, particularly as new brands continue to enter the market and seek out skilled people.

The company keeps a close eye on maintaining and developing its existing outlets. It moved out of several locations which were felt to be moving down-market and relocated to more appropriate areas. "Our primary objective is to increase the average size and revenue, on a per-square metre basis, at our existing stores," comments Chen. "Therefore we don't dwell too much on the rate of store growth, but instead focus on the year-on-year sales and performance of individual stores. We are already ahead of our competitors in terms of our presence on the ground, so this is now more of a priority for us."

In 2007, Ports ranked as the second most desirable luxury clothing brand in a survey of *Vogue China* readers. The accolade suggests that the Ports brand has lost none of its lustre after so many years of growth.

Growing by the second

Stan Lee, Xinyu Hengdeli Group Ltd.

In such a young yet crowded market, China's luxury consumers can find it particularly hard to discern between different watch brands. Xinyu Hengdeli is a Hong Kong listed company that has helped many of the world's most prestigious watchmakers break into the China market. It manages a network of more than 160 stores and serves as authorised distributors for three of the world's leading watch groups: LVMH, Richemont and Swatch.

Building its own retail brand while carrying these other high-profile brands "[is] like a marriage," says Stan Lee, the company's vice-president. "Balancing expectations and keeping all parties satisfied is a challenge."

The company's approach in China has been to establish three separate retail lines while also housing certain prestigious brands only in flagship stores. The first of these chains, Elegant Watch, originated in Hong Kong and caters to those looking for the very highest of high-end watches. Prime Time, the second chain, carries a wider range of mid- to high-end brands. The third is Temptation, a network of stores focusing more on the women's market by offering more fashionable names.

With so many watchmakers to choose from, Stan believes people in China are only starting to appreciate the history and heritage of different brands. "Many of the watch brands are Swiss or French in origin, so they appear relatively similar at first glance," he says. "People are starting to compare and judge, and this will create new opportunities for us to help individual brands build an identity through their own retail outlets. However, at the moment, big spending on advertising is critical to ensure a company's products stand out."

Xinyu Hengdeli's four-pronged structure covers retail, wholesale, after-sales service and post-production services. Stan believes this approach has helped the company defend its market-leading position.

"Our business structure gives us a complete picture of the market, particularly as our wholesale division supplies many of our rival retail chains," he remarks. "That these leading brands are so happy to work with us in after-sales and post-production reflects the strength of our relationships. Most of our competitors simply don't have the capacity or the relationships to put all of those brands on the same table."

Stan believes Chinese consumers are looking for something new or unique when buying a watch, suggesting that trend setting is a strong motivating factor in their purchases. "This suggests that our Temptation retail line will continue to fare strongly, but also that there is a lot of potential for customers to upgrade to the really top-end brands," he says. "The watch market in China is still rather male-dominated, even compared to other parts of East Asia."

The growth of Xinyu Hengdeli retail outlets means customers no longer need to travel to Beijing or Shanghai to make their big purchase. "An increasing focus for our growth is tier-two cities, where our performance has been strong. In some cities we have been able to buy our own retail premises to consolidate our position," he adds.

Looking beyond its plans for retail expansion, Xinyu Hengdeli has also made some notable acquisitions. Most recently, it bought out a 90 percent controlling stake in OMAS, an Italian company producing hand-crafted writing instruments. The stake was bought from LVMH and the acquisition was seen as a way to cement the two companies' relationship. It may also portend a significant trend towards further acquisitions of European brands by Chinese companies.

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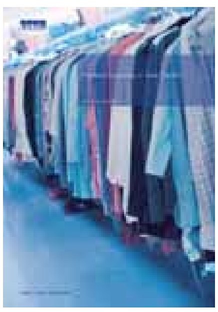

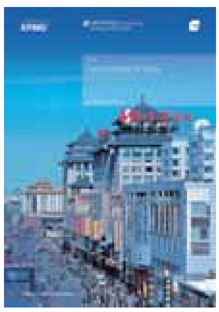

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