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China: The New Lap of Luxury

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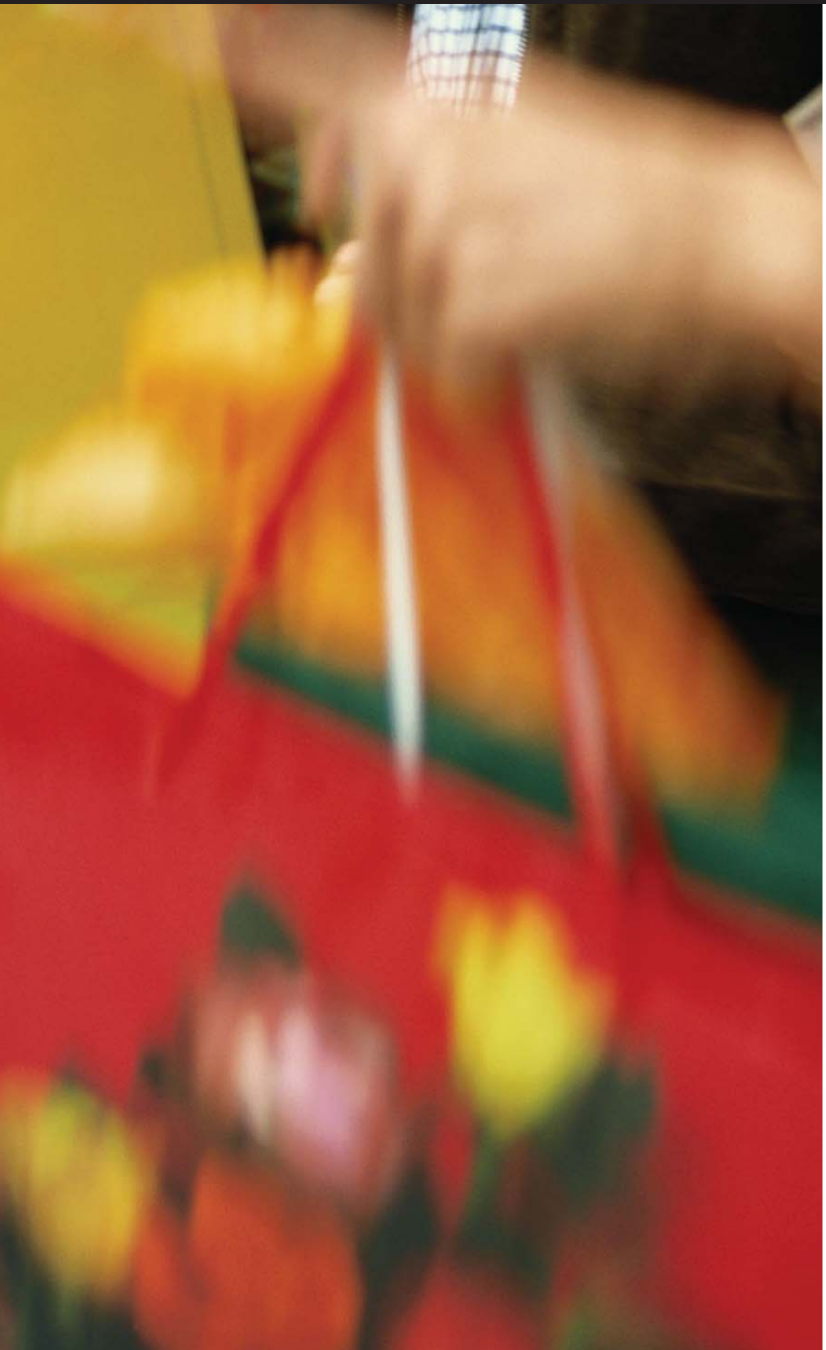

Overview

China is the world's third-[1] largest consumer of high-end fashions, accessories and other luxury goods. Luxury goods, broadly defined, refer to goods that communicate to consumers an elegant and refined way of living, focused on style and quality and especially targeted at the high-end and middle/high-end market. It accounts for an estimated 12 %[2] of global sales, dominating a significant share of the global luxury market when compared with Japan, 41%,[3] the United States., 17%;[4] and the European countries, 16%.[5]

The Chinese luxury market currently generates more than US$2 billion[6] in sales a year. It is expected to grow 20%,[7] annually until 2008 and then 10%[8] annually until 2015, when sales are expected to exceed US$11.5 billion. By 2010, China is expected to have a quarter-billion consumers who can afford luxury products, nearly 17 times[9] the present number. By 2015, Chinese consumers could be as influential as the Japanese and account for 29%[10] of all global luxury goods purchases. The fact that a population of 1.3 billion potential consumers with an average annual per capita urban income of RMB9,422[11] (US$ 1,163) and an annual per capital rural income of RMB2,936[12] (US$362), is able to create such a ripple in the world's luxury goods market reflects the hunger that Chinese consumers have for luxury goods.

China's Luxury Market

The Chinese Luxury Goods Consumer

In 2004, China's economy grew 9.5%[13] to RMB13.7 trillion[14] (US$1.7 trillion) and it is expected to grow more than 9%[15] this year. China's booming economy, coupled with a substantial increase in the number of buyers of luxury goods, has fueled the growth of the Chinese luxury market, which has enormous potential for further growth.

According to the China Association of Branding Strategy (CABS),[16] 175 million or 13.5% of Chinese consumers can afford a variety of luxury brands. Of this group, an estimated 10 to 13 million[17] are active purchasers of luxury goods, primarily personal accessories such as watches, wallets, cosmetics, clothes and jewels. CABS estimates that this group earns as much as RMB240,000[18] (US$29,630) annually and has between RMB300,000 to RMB500,000[19] (US$37,037 to US$61,728) in savings. The association expects this segment of the population to increase to 250 million[20] by 2010. Additional growth will come from the 200-300 million[21] Chinese who are expected to move in the coming years from the countryside to cities, where the supply of luxury goods is greater.

In general, China's luxury goods consumers are in two categories. One group is comprised of wealthy consumers who are crowd averse, seek personalized services, and frequently visit luxury retail outlets for the newest and most fashionable products offerings—without concern for price. The second group consists of white-collar employees, typically employed by a foreign company, who will spend an entire month's salary on a single purchase. Surveys have shown that most of these Chinese consumers are between the ages of 20 and 40, considerably younger than buyers of luxury goods in the United States and Europe, who are between the ages of 40 and 70. These Chinese consumers travel frequently and have buying habits similar to the Japanese, who began going abroad in large numbers in the 1980s.

Men have been the traditional buyers of luxury goods in China—just four years ago, only 25%[22] of all consumers were women. As women achieve greater social and economic independence, they are accounting for a larger share of the luxury market.

Chinese consumers tend to buy luxury products without much study or research, whereas consumers in Russia and Europe tend to focus on the real value of what they purchase. Japanese luxury goods consumers tend to be more discrete in their purchases than Chinese consumers, who often view the purchase of luxury goods as a manifestation of their social status and financial success. Many of these noveaux riche consumers use their material affluence to impress their friends, family and colleagues as well as to distinguish themselves from the masses. Chinese luxury goods consumers also have a "spend now and worry later" mentality when buying luxury goods. They prefer to purchase the most expensive items they can afford to indulge their new-found Yuppie lifestyle.

The Advent of the Mighty Chinese Tourists

Due to rising affluence and a relaxation of visa restrictions on Chinese travelers by the Chinese government, more than 28 million[23] Chinese traveled overseas in 2004, according to statistics from the China Academy of Social Sciences (CASS). Chinese travel is expected to accelerate over the next ten years. According to the Economist Intelligence Unit (EIU),[24] the number of Chinese travelers is expected to rise to 49 million annually by 2008, to 60 million by 2010 and to 100 million by 2015. This is in line with estimates by the World Travel Organization, which projects the number of Chinese travelers will reach 100 million[25] by 2020.

The surge in Chinese travelers overseas is good news for the luxury brands segment. Chinese consumers have shown a high propensity to spend when traveling, and traveling also helps to enhance their awareness of brands. More Chinese travelers are shopping for luxury goods abroad because the variety of luxury commodities available in China is still somewhat limited. Moreover, prices of luxury goods can be at least 20-30%[26] higher in the Mainland than in Hong Kong or Europe because of the Mainland's high import tariffs and consumption taxes. Europe has attracted a large number of Chinese shoppers, providing a much-needed boost to luxury sales, particularly in Italy and France. China's overseas tourists spent US$25 billion[27] in 2004. The EIU expects this to rise to US$30.5 billion[28] by 2008.

Hong Kong is expected to continue attracting most of the overseas spending of Chinese Yuan on luxury goods due to its proximity to the Mainland and its attractive pricing. Travel from the Mainland to Hong Kong has been bolstered by three main factors: (1) The passing of two Closer Economic Partnership Agreements (CEPA) in January 2004 and August 2004, which gave Mainland residents unprecedented individual visa access to Hong Kong; (2) The easing of restrictions on the amount of cash that Mainland visitors could bring into Hong Kong: and (3) The easing of restrictions on Yuan-denominated credit cards. These measures have helped to revitalize the Hong Kong retail market: an estimated 11 million[29] Mainland tourists are expected to visit Hong Kong this year alone.

Impact of Yuan Revaluation

The Chinese Yuan, following its long-awaited revaluation in mid-2005, is no longer pegged against the dollar, but against a basket of foreign currencies. The Yuan's 2.1% increase against the dollar likely will increase demand for luxury goods while pushing up the costs for companies that currently source goods from China. A stronger Chinese currency will help to strengthen most Asian currencies and will likely spur long-term spending in the region as well as outbound travel from China.

Companies that sell luxury goods in Asia may see a gain in sales from converting their revenue in Yuan and other Asian currencies into dollars, Euros or other European currencies. Conversely, companies that sell goods whose costs are denominated in weaker currencies such as the dollar are likely to benefit from a growth in their sales volume and profit margins. However, China's efforts to relieve its currency pressures are expected to be gradual, allowing both consumers and companies that sell luxury goods to plan for the long term, i.e., in budgeting for purchases or in planning imports or exports.

Counterfeits—A Contentious Issue

Counterfeiting is the biggest problem for sellers of luxury brands. This is especially true in China, which is the acknowledged counterfeit capital of the world. According to European customs figures, China accounted for 60%[30] of the 92 million[31] counterfeit articles seized at EU borders in 2003. Counterfeit goods currently account for 10%[32] of world luxury goods trade, which is double the percentage for 2000.

Sales of counterfeit articles in China are growing as rapidly as sales of originals and are eroding the profits of brand manufacturers. The quality of counterfeits has improved so much so that it has become increasingly difficult to distinguish counterfeit items from the genuine products.

Chinese-made brands, in a related move, are masquerading as Western-brand products by using similar names, logos and goods. These brands have less impact on the luxury goods sector in China because they are lesser known and mainly limit their operations within the domestic market. Chinese consumers also are able to distinguish among these labels, further diminishing their threat to Western brands.

Some industry watchers believe that the wide availability of counterfeits in China should not impede makers of luxury goods firms from investing in China because counterfeit goods help to build brand perception and consumers are likely to upgrade to the real thing when they can afford it.

China's government has reiterated its commitment to eradicate counterfeiting. Efforts by luxury goods firms to co-operate with government officials to remove counterfeit goods from the marketplace have little effect in stopping these illicit activities. One way for luxury goods firms to counter this problem may be to refresh their designs quickly and launch new collections every season so that counterfeits are not able to keep up with the new designs.

China vs. Developed Luxury Markets

China's relatively new luxury goods segment is growing faster than that of France, Italy and the rest of Europe, the United States and other developed markets.

One of the marked differences between China and more mature markets is the type of luxury goods consumption taking place. In China the consumption of luxury goods is still very much item driven, meaning consumers search for the latest collection or product. In more developed markets consumers tend to seek experiences that pamper them, such as a luxury holiday or a service that helps lessen the time spent doing a task, e.g., home delivery of groceries.

The widespread availability of luxury goods, frequently referred to as "the democratization of luxury" is increasingly common in developed markets such as the United States, where even supermarkets offer luxury products such as gourmet foods. Unlike China, where purchases indicate wealth and social status, it is difficult in the United States or Europe to determine wealth based on purchases because almost everyone has access to some kind of luxury product. It will take many years for China's luxury goods market to reach an equivalent stage.

Another difference between developed markets and China is in the approach of many global luxury firms to the Chinese market. Many international firms have taken the unconventional route of working with local partners to establish their brands in China, a route they would not have taken in more developed markets where the business landscape for doing business is comparatively well-structured.

Many luxury goods firms have found that brand advertising and promotion is more complex in China than in other markets. For example, although China is larger than the continental United States, its communications system is comparatively primitive, and advertising opportunities are limited. Given these limitations, companies that sell luxury brands have to use their storefronts to connect with Chinese consumers, which increase the importance of new store locations. In addition to storefronts, some firms have found success in promoting their brands at large events, cocktail parties, and through direct mail and personal invitations to prospective customers. Firms also have found that the Chinese press is willing to help promote products, which usually is not the case in other countries.

Elements to Success—Overcoming Challenges

Looking Beyond the Short Term

Luxury goods firms entering the Chinese market need to take a long term view as it likely will take time to meet their expected return on investment. Despite such challenges, many firms have indicated that they expect to continue investing in China over the next three to four years even though it may take longer for them to meet their profit goals.

Luxury goods firms entering or expanding in China's vast market have encountered high location rental or purchase/build costs, distribution and logistics issues and differences with cultural communications and personnel training. These issues often require experience and time to overcome and make short term success in China unlikely.

Pitching Business on a Local Level

It is essential that manufacturers and distributors of luxury goods understand the cultural differences among consumers in the countries where they market their products. As outlined in *"The Path to Success for Retailers and Consumer Brands in China"*, [33] China is made up of many regional markets. Retailers, including the luxury goods segment, need to customize their business operations to each local market.

An understanding of local markets in China is even more critical for luxury firms as they move from the more populous and relatively westernized coastal cities of Shanghai, Beijing and Guangzhou to second- and third-tier cities such as Dalian, Hangzhou, Shenzhen and Chengdu. Management decisions, strategic plans and even product offerings will need to be tailored to each local consumer sector.

Location, Location, Location

Many of the leading luxury goods firms have already expanded into China. Their challenge, and a challenge for those planning to enter this market, is to secure prime locations before they are all taken. This is especially critical for firms expanding into untapped second- and third-tier cities. Unlike fast food retail outlets in China, luxury firms can establish outlets in only a few, select localities if they are to maintain the perception of exclusivity. This makes it even more important for retailers to adopt a cautious approach in selecting retail locations. Brands can very easily be tarnished if they are in the wrong environment, such as a shop located within a department store that targets low-end consumers.

Partnerships and Joint Ventures—A Possible Solution

Luxury firms new to China may want to consider entering into a local partnership or joint venture to help ease their transition into this complicated market. This strategy may be necessary for selected lines or brands of goods that may require local expertise to be successful.

Such ventures can ease the difficulty of entering a new and relatively complicated market such as China. Local partners can help entrants to understand the local market and address issues such as attaining business and retail licenses and navigating often-complicated rules and regulations. However, firms will need to be cautious in choosing credible Chinese partners, including local producers, distributors, retail stores and personnel. Before selecting a partner, global luxury goods firms should engage in comprehensive, on-the-ground research to understand the market.

Local firms in China also benefit from joint ventures with foreign firms. For example, such partnerships give Chinese companies a more global perspective on doing business and help them improve their existing operations. Properly structured, such ventures can be a win for both domestic and foreign partners.

The Future

Government Endorsement

China's government is keen to develop China's retail sector, especially the nascent luxury goods sector. For example, according to sources at the Economic Commission of Shanghai Municipal People's Government, Shanghai's regulator for trade and commerce, Shanghai's government has earmarked specific areas of the city, both existing and new retail sites, for the development of the luxury goods retail niche. Officials also have indicated they are eager to attract high caliber luxury goods retailers to expand the city's retail market.

Efforts to Develop Local Talent

China is becoming increasingly significant to the world's fashion industry, according to Fudan Management School,[34] one of China's premier institutions. With many luxury brand stores in Shanghai currently managed by retailers from Taiwan, Hong Kong or other places, the government has recognized a need to train retail managers and employees from the domestic population.

To promote such training, China's Fudan University has teamed up with universities in Italy and France to offer training programs specifically tailored for managers in the luxury fashion industry. As part of this program, students have the opportunity to gain hands-on experience at world-renowned fashion houses. Fudan University also plans to launch a fashion and luxury MBA program to promote research into the Chinese fashion world. Similar talent development programs can be expected as China's luxury goods industry expands.

Growth of Domestic Luxury Brands

Over the next five to ten years, China's homegrown luxury brands may grow in popularity, particularly among the post-revolution generation. Chinese brands are expected to expand into the global arena, taking the lead from Shanghai Tang, a Hong Kong based retail company that successfully entered the global market.

Production in China—A Viable Alternative?

China's well-organized and low-cost workshops may become a draw to the global luxury goods industry, though few luxury houses have made known their views about manufacturing in China. Over the years, Europe's luxury houses have created the perception that European craftsmanship and materials make their products superior. Relocation to a low-cost manufacturing area such as China could be risky for a luxury goods manufacturer. These firms are concerned that their brands may lose some of their allure, which contributes to their desirability and price.

Some retailers also believe that Chinese factories lack the craftsmanship and experience to make luxury goods. Moreover, these retailers insist that European houses will dominate the luxury goods business for the foreseeable future because of Chinese consumer's desire to emulate the sophisticated European lifestyle.

Firms may possibly minimize the potential damage of outsourcing by using the firm's brand name as a pledge of manufacturing quality and design, replacing a "Made in Italy" label with a "Made by luxury brand X" label. A well thought out and implemented strategy may help to alleviate some of the cost pressures for international luxury firms that have been grappling with rising costs that have eroded margins.

China as a Springboard to the Rest of Asia

The focus for many luxury goods firms is on China, but many also are looking to expand operations strategically throughout Asia and the Pacific, including Japan, Taiwan, Malaysia, Australia and Hong Kong. Firms will be wise to use China as a spring board to reach other emerging markets in Asia. China can be seen as a catalyst for development in the region, driving much of the growth for the rest of Asia.

Conclusions

- China's luxury market is expected to undergo immense growth in the coming years.
- Chinese consumers have started to mature and demand a wider range of luxury goods. Chinese travelers also have begun to flaunt their purchasing power overseas, greatly boosting the luxury goods sector in foreign markets.
- Luxury firms need to understand the nuances of China's local markets to succeed. They should consider pitching different brand names and offering different products to meet varying consumer preferences.
- Luxury firms will need to look beyond short-term gains to secure market position for the long term.
- Partnerships and joint ventures may help foreign entrants navigate the complexities and challenges of the Chinese luxury segment.

Ernst & Young Can Help

Ernst & Young has operated in China since 1981. We have worked extensively with leaders in Chinese government and business and have played a role in assimilating Western companies and technologies into the Chinese economy. These seasoned relationships enable us to expedite time consuming procedures and reduce uncertainty for our clients. Ernst & Young is a valuable knowledge resource for client decision makers as they:

- Assess the competitive landscape for retail and consumer product companies from both a national and regional perspective.
- Assess the opportunities and risks China represents for their business models.
- Deliberate on and establish the optimal business model in China.
- Select the best location in which to do business in China.
- Apply for new, or change existing, licenses and permits to commence operations.
- Conduct negotiations with Chinese governmental authorities.
- Conduct negotiations with joint venture or business alliance partner(s).

Auditing, Tax and Transaction Support—Ernst & Young can assist clients with auditing, tax and transaction issues as they:

- Contemplate wholly owned foreign enterprise (WOFE), joint ventures, or other ownership structures.
- Conduct financial and tax due diligence reviews of acquisition or joint venture targets.
- Determine a business-appropriate and tax-efficient organizational structure.
- Review the effects of China's post-WTO changes to accounting, auditing, and tax regulations on foreign-owned businesses in China.
- Quantify and evaluate merits of various tax holidays, rebates, refunds, and other investment incentives offered by Chinese authorities as part of the site-selection process.
- Devise tax structures and transfer pricing plans.

Footnotes

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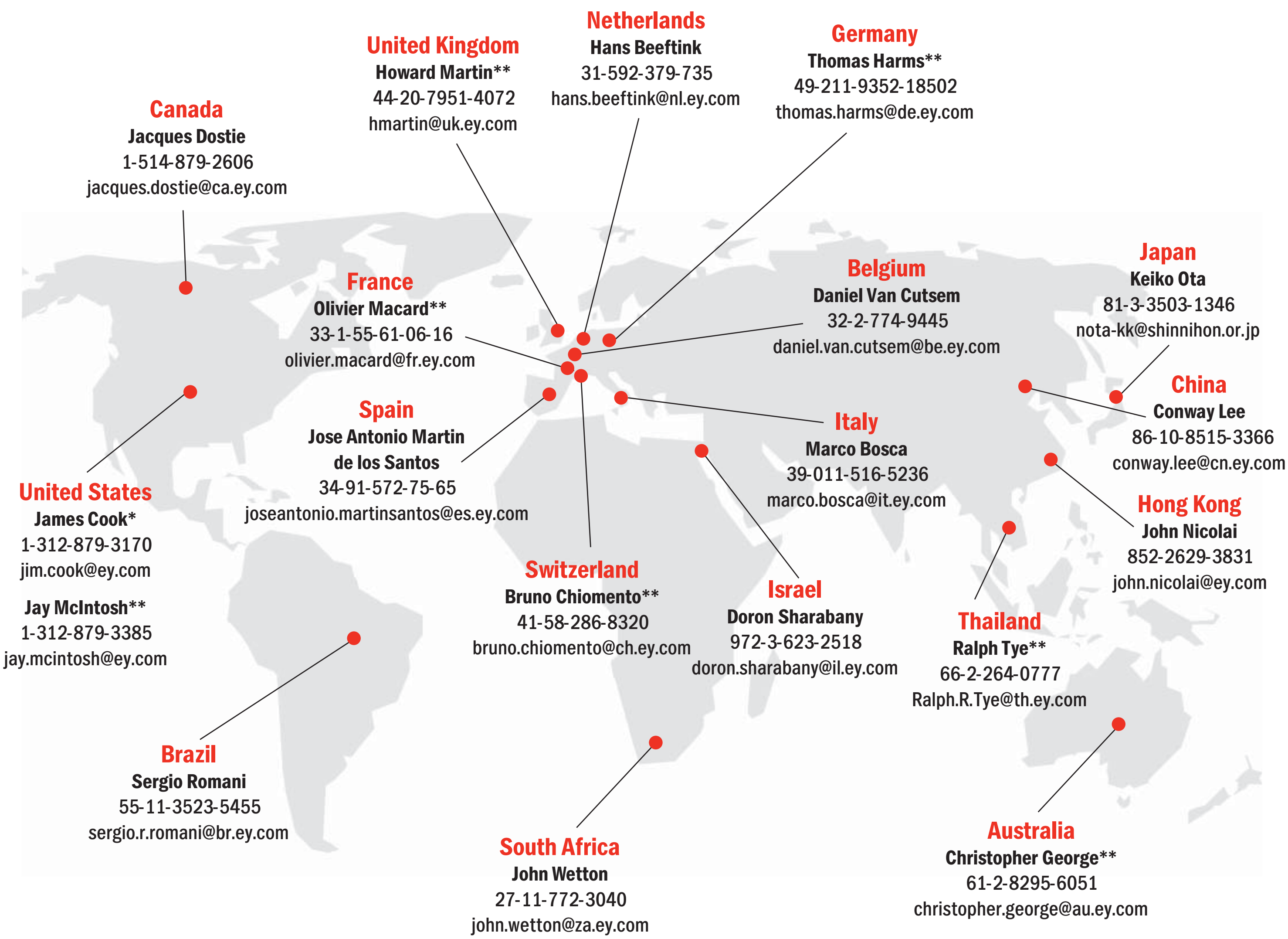
Global RCP Leadership



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