



2023 Hainan Travel Retail Market Whitepaper

Resilience and reshaping,
amid risks



April 2023

By KPMG China and The Moodie Davitt Report



Foreword

It is our pleasure to present the 2023 Hainan Travel Retail Whitepaper in the 3rd China International Consumer Goods Expo, after the release of the 2nd edition in July 2022.

With the gradual easing of the national COVID-19 anti-pandemic policies in December 2022 and the reopening of the cross-border business and leisure travelling, Hainan, as one of the hotspots for domestic travel and spending, experienced a strong rebound in its travel retail performance at the beginning of 2023. The island's tourism infrastructure, from roads to hotels, from retail to restaurants, is undergoing significant investment and construction at a rapid pace, laying a solid foundation for creating more unique consumer experiences for clients. As witnessed by the opening of Haikou International Duty Free Shopping Complex and Wangfujing International Duty Free Harbor City in Wanning, heavy investment continues to be poured into the sector. This suggests a robust confidence in the future of the business. In March 2023, the new policy of " Guaranteed pick-up" and " Buy and pick-up" for offshore duty-free shopping further deepened the benign development of the Hainan offshore duty-free market.

With the planned seal-off coming in 2025, it is an exciting moment for consumer market on the island, with brands focusing intensively on the viability of their future business models, especially the impacts to stakeholders along the supply chain due to the new Sales Tax scheme. Brands are acutely aware of establishing proper Hainan structures and vehicles that will empower their commercial capabilities and allow synergy with the Greater Bay Area and the rest of mainland China. We believe that Hainan's duty-free shopping, as its "golden signature", will continue to achieve more impressive results in the future.





In this whitepaper, we will delve deep into key trends impacting the retail market in China, explore Chinese consumer buying behavior, and identify consumer personas. We will also examine how the upcoming operation of the free trade port and the closing of the borders will further promote the transformation of the game rules in the Hainan travel retail market. Our goal is to provide more professional insights for duty-free operators and brands competing in the Hainan travel retail market.

Through this paper, KPMG and The Moodie Davitt Report present insights on the Hainan travel retail market, with the goal of enabling duty free operators and brands to seize opportunities in this rapidly evolving landscape.

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01



Hainan travel retail business – where next?



Defining the travel retail and duty free sectors

'Travel retail' embraces a vast worldwide business sector focused, as the name suggests, on shopping by travellers (be they domestic or international). It is a sub-sector of two principle 'parent' industries – aviation and tourism – and therefore anything that impacts those sectors, positively or negatively, invariably has a knock-on impact to travel retail.

Travel retail is anchored by the duty-free channel – goods sold free of duty and tax, usually to international travellers. However, in three cases (Hainan Free Trade Port in China, Jeju in South Korea and Okinawa in Japan), duty-free rights exist for domestic travellers – so-called 'offshore duty-free'.

Duty-free sales take place at airports and seaports; certain downtown duty-free stores; onboard airlines, cruise ships and ferries; at land border crossings; in specialised stores serving diplomatic and military personnel; and online through established duty-free retailers.

Products that can be sold duty- and/or tax-free vary by country and jurisdiction (there is no duty-free between European Union member countries, for example). Goods bought under these rules can be brought into destination countries in varying quantities, called allowances. The Hainan Free Trade Port annual offshore duty-free allowance of RMB100,000 (approximately USD15,470) is the most generous (and we think far-sighted) in the world.

How the COVID-19 crisis impacted the sector 2020-2021

Until 2020, the duty-free industry, invented at Shannon Airport on the west coast of Ireland in 1947, was a vibrant and highly resilient business sector, historically bouncing back quickly from regional crises (natural disasters, recessions, currency fluctuations,, economic woes etc) and even international ones (SARS, two Gulf wars). But the COVID-19 pandemic changed all that. Being a global industry offered no protection from a global pandemic; conversely it exposed sector stakeholders to it on all fronts.

Global tourism suffered its worst year on record in 2020, with international arrivals dropping 74 percent year-on-year, according to the United Nations World Tourism Organization (UNWTO). Destinations worldwide welcomed 1 billion fewer international arrivals in 2020 (down to 409 million) than in the previous year due to the COVID-19 crisis, the related fall in demand and widespread travel restrictions.

With passenger traffic collapsing at most of the world's airports, travel retail was robbed of its bloodline through most of 2020 and to a lesser but still challenging extent in 2021 (a marginal increase to 454.8 million visitor arrivals).

The pandemic represented the most severe and sustained crisis in travel retail industry history. A global market that went into freefall with one remarkable regional exception, Hainan. More of that later in this paper.

And as outbound Chinese travel market normalizes,

will Hainan suffer as a result?

Market recovery 2022-2023 and beyond

As 2022 progressed, borders all around the world steadily opened. By the end of the year, international visitor arrivals had risen to 917 million, a comparatively modest -37% shortfall compared to 2019 – However, arrivals to Asia lagged badly at -77% compared to the pre-pandemic period, largely thanks to the tight border constraints in Mainland China, Taiwan, Hong Kong and Macau.

That all changed in early 2023 as Beijing lifted its COVID-19 and travel restraints with the Hong Kong and Macau Special Administrative Regions mirroring the response.

Based on UNWTO's forward-looking scenarios for 2023, international tourist arrivals could reach 80% to 95% of pre-pandemic levels this year, depending on the extent of the economic slowdown, the ongoing recovery of travel in Asia and the Pacific and the evolution of the crisis in Ukraine, among other factors.

Even more bullishy, in February 2023 the International Civil Aviation Organization (ICAO) predicted a “complete and sustainable recovery” in air travel this year, with volumes expected to surpass pre-pandemic levels. ICAO said that after a near-three year downturn, passenger traffic in 2023 is set to return to pre-pandemic levels on most routes by the first quarter, and to be +3% higher than 2019 levels by the end of the year.

The big question for the travel retail sector – internationally and in Hainan – is what will happen in terms of the outbound Chinese travel market. And as it normalises, will Hainan suffer as a result?

The following factors suggest not:

01 Passport ownership:

According to CGTN, around 10% of China's 1.4 billion population have passports. That means 90% of people can currently only travel – and shop duty free – domestically. Also, a significant number of citizens now hold expired passports and visas after such a lengthy suspension of issuances and renewals.

02 Traveller confidence:

When it comes to Chinese travel and spending, a global return to pre-pandemic numbers is going to take considerable time — especially considering the impact COVID had on consumer confidence about the safety of foreign travel. As capacity is ramped up, international flights remain expensive.

03 Big-picture dynamics:

In line with central government policy, the long-term trend towards repatriation of luxury spending from overseas is positive news for Hainan.

04 Natural and man-made attractions:

Hainan's attractions, both natural and man-made attractions are compelling. A pristine natural environment combined with numerous tourist attractions, fast-improving tourism infrastructure and serves on the one hand and world-class shopping (and, increasingly, dining and hotels) on the other. The latter is bolstered by the world's highest duty free allowance (CNY100,000 annually) and the habit of domestic duty free shopping that has formed since 2011 and accelerated through the pandemic.

05 Geographic proximity:

In an uncertain world, Hainan offers an easy and safe travel option with no linguistic or cultural barriers.

06 Hainan's Free Trade Port programme:

This extraordinarily ambitious long-term programme continues to attract investment and services to the island province. Tourism is a key tenet of the programme and within that sector duty free shopping is an integral element. As witnessed by the opening of CDF Haikou International Duty Free Shopping Complex and Wangfujing International Duty Free Harbour City in Wanning, heavy investment continues to be poured into the sector. This suggests a robust confidence in the future of the business.

07 Enhancements to the duty free shopping policy:

Continued enhancements of the offshore duty free pricing over recent years – most notably the big increase in the annual allowance and number of categories in July 2020 – have given the sector tremendous momentum. We expect continued favourable official treatment in the years ahead to help maintain the sector's competitive edge. This level of government support – unrivalled in the duty free industry worldwide – manifested itself again in March 2023 with crucial changes approved by the State Council to the duty free shopping pick-up policy. The enhanced policy is designed to make shopping easier and more immediate for consumers and ease logistical constraints for retailers. The two key principles of the new policy – 'Guaranteed pick-up' and 'Buy and pick-up' – will simultaneously boost shopping convenience and overall sales.

This report considers Hainan's prospects within that improving global context; examines how it has performed during the crisis; and evaluates its prospects in the years ahead.

All regions were adversely affected in 2020 and 2021. Except one.

Hainan

The global duty-free industry in numbers

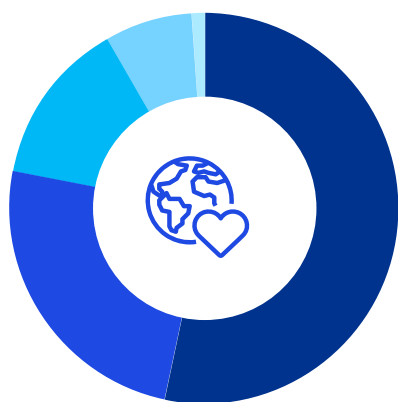
According to Generation Research, the global travel retail & duty-free industry was worth US\$86.4 billion in 2019, up +10% over 2018. The same source's 2020 and 2021 figures, though, reveal the brutal impact of the pandemic with worldwide sales collapsing by -47.6% to just US\$45.3 billion in 2020, followed by a +25.6% year-on-year rise from a low base in 2021 to US\$55.3 billion. 2022 figures are not yet available.

All regions were adversely affected in 2020 and 2021. Except one. Hainan, where sales rose +127% year-on-year in 2020 and, remarkably, by a further +84% in 2021.

For the purposes of assessing the industry's post-pandemic future, we believe 2019 serves as the appropriate global benchmark. We anticipate a strong year in 2023, with some retailers exceeding 2019 levels – notably Dubai Duty Free, historically the world's largest single airport retail operation. After exceeding targets in Q1 2023, Dubai Duty Free is projecting all-time high sales of US\$2.2 billion to US\$2.3 billion this year, well ahead of the 2019 record of US\$2 billion.

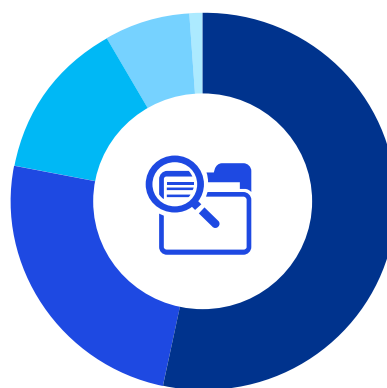
The charts below, courtesy of Generation Research, show the 2019 (pre-pandemic) and 2021 (mid-pandemic) breakdown of global duty-free sales by region and product category. They also paint a revealing picture of the impact of the pandemic.

2019 regional breakdown



● Asia Pacific	53.6%
● Europe	24.5%
● Americas	13.6%
● Middle East	7.3%
● Africa	1.0%

2021 regional breakdown



● Asia Pacific	68.2%
● Europe	16.0%
● Americas	8.4%
● Middle East	6.6%
● Africa	0.8%

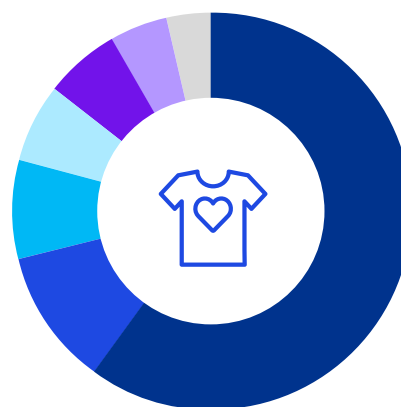
Source: Generation Research

2019 category breakdown



● Fragrances & cosmetics	43.7%
● Wines & spirits	14.8%
● Fashion & accessories	13.3%
● Tobacco goods	8.6%
● Watches, jewellery & fine writing	7.4%
● Electronics, gifts & other	6.5%
● Confectionery & fine food	5.8%

2021 category breakdown



● Fragrances & cosmetics	57.0%
● Wines & spirits	11.2%
● Fashion & accessories	10.6%
● Tobacco goods	6.5%
● Watches, jewellery & fine writing	6.1%
● Electronics, gifts & other	5.1%
● Confectionery & fine food	3.5%

Source: Generation Research (Contact@Generation.se)

Duty free & travel retail sales by region 2009–2021 (in US\$ millions)

Region	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Asia Pacific	10,295.2	13,000.2	16,665.6	19,902.2	22,317.9	24,729.4	25,294.4	27,375.3	30,827.3	38,831.9	46,370.4	32,285.2	37,723.3
Europe	16,176.1	16,758.8	18,910.4	19,272.3	20,139.3	20,581.9	18,856.7	18,732.9	20,060.7	20,802.7	21,174.8	6,437.3	8,861.5
Americas	7,605.2	8,702.7	10,280.8	10,855.7	11,162.5	11,725.3	11,276.4	10,853.4	11,655.2	11,799.8	11,728.0	4,048.7	4,632.1
Middle East	3,466.4	4,026.9	4,446.1	5,005.8	5,560.6	5,867.3	5,810.8	5,573.3	5,982.7	6,362.8	6,290.9	2,174.7	3,665.2
Africa	657.2	711.3	697.0	764.0	819.7	848.4	761.7	778.1	786.9	808.6	879.4	316.4	450.3
World total	38,200.0	43,200.0	51,000.0	55,800.0	60,000.0	63,752.3	62,000.0	63,313.0	69,312.9	78,605.7	86,443.5	45,262.3	55,332.4

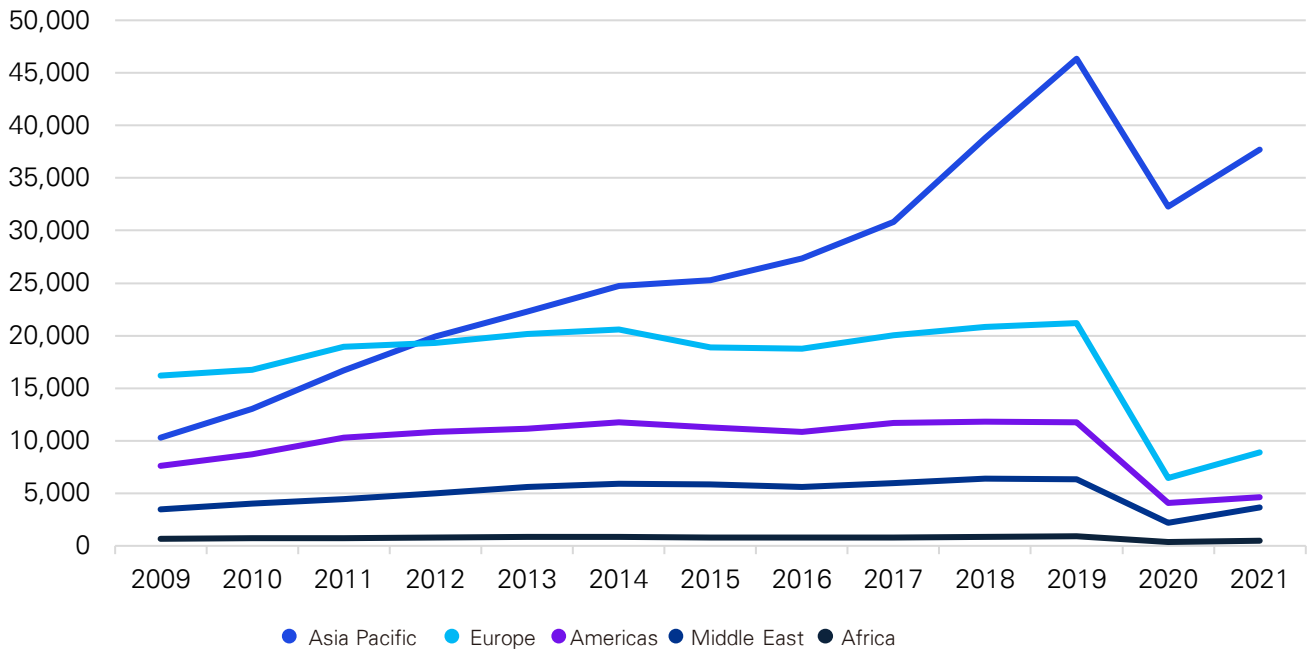
Source: Generation Research (Contact@Generation.se)

Duty free & travel retail sales by product category 2009–2021 (in US\$ millions)

Category	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Fragrances & cosmetics	10,708.0	12,060.1	14,344.1	15,793.7	17,260.3	19,289.5	19,763.5	21,464.4	25,605.9	31,324.1	37,769.9	27,173.3	31,513.1
Wines & spirits	6,681.9	7,367.8	8,432.6	9,091.0	9,862.3	10,437.0	10,150.7	10,463.3	11,350.7	12,165.8	12,769.7	3,662.5	5,882.4
Fashion & accessories	4,761.5	5,792.2	7,007.4	7,955.7	8,755.2	9,272.9	8,998.3	9,128.9	9,540.9	10,806.2	11,459.3	5,042.2	6,211.5
Tobacco goods	6,006.0	6,416.1	7,300.9	7,626.8	7,851.8	7,908.9	7,353.7	7,228.8	7,229.6	7,827.1	7,453.5	2,649.9	3,352.2
Watches, jewellery & fine writing	3,589.2	4,073.3	5,139.2	5,767.8	6,210.8	6,601.8	5,933.9	5,435.4	5,672.1	6,022.7	6,355.5	2,958.3	3,620.1
Confectionery & fine food	3,167.1	3,503.6	3,941.7	4,376.6	4,745.1	5,079.6	4,875.3	4,791.5	4,993.4	5,129.3	5,056.2	1,606.7	1,920.0
Electronics, gifts & other	3,286.3	3,987.3	4,834.1	5,188.5	5,314.6	5,162.6	4,924.7	4,800.8	4,920.2	5,330.4	5,579.4	2,169.4	2,833.1
World total	38,200.0	43,200.0	51,000.0	55,800.0	60,000.0	63,752.3	62,000.0	63,313.0	69,312.9	78,605.7	86,443.5	45,262.3	55,332.4

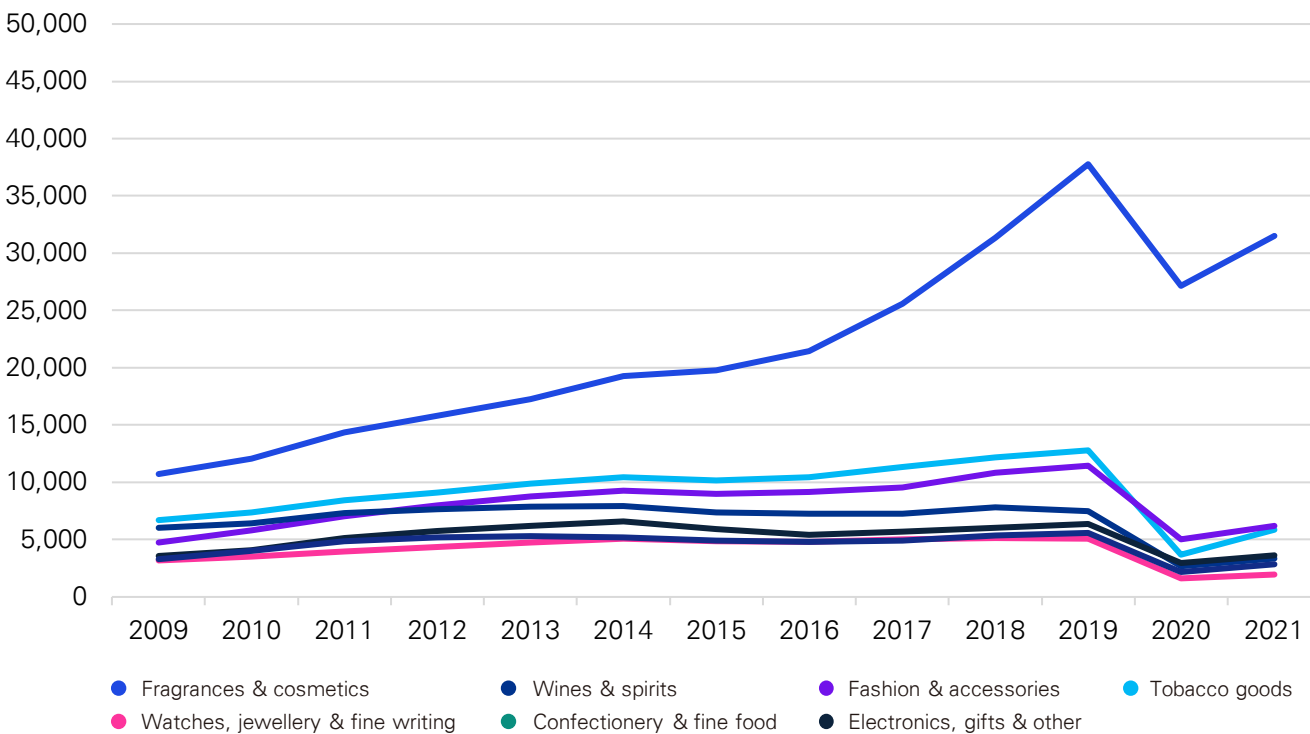
Source: Generation Research (Contact@Generation.se)

Duty free & travel retail sales by region 2009–2021 (in US\$ millions)



Source: Generation Research (Contact@Generation.se)

Duty free & travel retail sales by product category 2009–2021 (in US\$ millions)



Source: Generation Research (Contact@Generation.se)

By 2021, Asia Pacific accounted for 68.2% of worldwide sales – up sharply from 53.6% in pre-pandemic 2019. With much of the duty free world in hiatus, this transformation was driven dominantly by the Hainan offshore duty-free sector, referred to as ‘the lighthouse of travel retail’ by The Moodie Davitt Report.

Also note the sharp rise in category market share for cosmetics and perfumes, up from 43.7% in 2019 to 56.9% in 2021. This is a direct reflection of Hainan’s influence where cosmetics generally and skincare specifically are the dominant category {given the rapidly growing Chinese interest in perfume, we also expect to see Hainan account for a growing share of that category in the future}.

Preliminary Top 3 Travel Retailer rankings 2021 (By turnover, € million)



Source: The Moodie Davitt Report
 Note: Figures translated from local currency to Euros at 31 December 2021 exchange rates.



Hainan's offshore duty free sector rose by +127% and +84% respectively through 2020 and 2021 – in both cases from an all-time record high base.

The Hainan success story

Despite its 2022 challenges due to the COVID-19 situation, Hainan's offshore duty free sector ranks as the global travel retail sector's singular success story of the 21st century.

Although now ranking as the number one duty free market for many leading beauty houses, it should be remembered that the business is little more than a decade old. It has grown from small beginnings – a single shop in Sanya – to a multi-billion dollar industry featuring some of the world's finest (and certainly biggest) duty free stores.

As mentioned, Hainan's offshore duty free sector rose by +127% and +84% respectively through 2020 and 2021 – in both cases from an all-time record high base.

Despite a COVID-driven slowdown in late 2022, when stores in Sanya were closed for several weeks and those in Haikou were also affected, the market has rebounded strongly in early 2023 following the lifting of COVID-related travel constraints and central government's successful handling of the crisis.

The whole sector has benefited time and again since 2011 from supportive government policies, most notably on July 1, 2020 when the annual offshore duty-free shopping allowance was tripled to RMB100,000. Simultaneously, the number of categories was extended from 38 to 45 (including cell phones and alcohol, the latter with a 1.5 litre per trip allowance); the previous single purchase limit of RMB8,000 (USD1,250) was removed; and the limit on cosmetics skus (or stockkeeping units) raised from 12 to 30.

As we noted in last year's report, any chronicling of travel retail industry history, that policy decision will surely rank as one of the most far-sighted, consumer-friendly, business-supporting measures of all time. The financial results have been plain to see.

That support has manifested itself in the arrival of several new licence-holders since late 2020. There are 12 duty-free shops in Hainan covering Sanya, Haikou, Qionghai and Wanning. The business area of offshore duty-free shops across Hainan exceeds 500,000 m², and the number of brands settled in exceeds 1,500.

In one of the biggest changes to the offshore duty free shopping policy, major changes were made to the pick-up policy for duty free purchases in March, which will be taken effect since 1 April 2023. Previously, consumers could only order their shopping and retailers had to package and deliver to the airport, seaport or designated self-collection point before the consumer left the island.

The improvements, designed to bring much greater convenience to shopping on the island, are broadly categorised into two key areas – 'Guaranteed pick-up' and 'Buy and pick-up'. The measures are also certain to increase the conversion rate of visitors to shoppers and reduce logistics costs.

'Guaranteed pick-up' – strictly regulated in terms of inspection at departure – is expected to boost sales of top luxury items such as watches & jewellery. While with the implementation of the immediate buy and pick-up policy, tourists can directly purchase [duty free] a limited amount of fragrances, bags, clothing, silk scarves, sunglasses, belts, sporting goods and other products every time they leave the island.

Government support for the offshore duty free industry is once again being underlined by the hosting of the third annual China International Consumer Products Expo (Hainan Expo) on April 11-15. The Expo, already established as one of Asia's premier exhibitions, recognises that offshore duty-free is a key component of Hainan's Free Trade Platform programme. The programme, considered of key national importance, will see an island-wide Free Trade Port system focused on trade and investment liberalisation created in the Hainan FTP by 2025 (with full maturity by 2035).

This hugely ambitious event offers international brands and service companies a crucial opportunity to showcase their wares in China and, conversely, for national and local Chinese brands to promote themselves to an influential global audience.

The offshore duty free industry is a symbol of the Chinese government's ambition to retain travelling spend inside the country and to boost domestic consumption. As a market Hainan has its own rules, its own unique customer base (predominantly Chinese) and is an integral component of a "mega-trend" – to maximise Chinese consumption at home. Hainan offshore duty free plays a dual role for brands – it is a big volume and value channel in its own right, but it also offers an incalculably priceless showcase to consumers across the vast Chinese nation. As such, the Hainan success story seems set to run and run.

Battle of the giants: Hainan vs Korea

Hainan's burgeoning offshore duty free sector success of recent years presents an interesting comparative case study with the world's biggest duty free market – the Republic of Korea. The prolonged COVID-19 crisis affected both markets at various times in various ways.

Whereas Hainan flourished during 2020 and 2021 as Chinese citizens, unable to travel overseas, flocked to the island province, South Korea was robbed of its commercial bloodline of recent years – the travelling China. With Korean nationals being unable to travel, Korean duty free became overwhelmingly (90%+) about selling to large-scale daigou traders, a reliance that has left the sector worryingly vulnerable after Korea Customs Service (KCS) moved in late 2022 to curb excessive commission payments to travel agents facilitating the daigou business.

Hainan offshore duty free stores generated sales of CNY60.17 billion (US\$9.47 billion) in 2021, an +84% increase year-on-year. The results include duty free sales of CNY50.49 billion (US\$7.94 billion), up +83% year-on-year, with the balance being accounted for by tax paid sales.

In 2022, affected by the sporadic COVID-19 outbreaks on the Mainland – and at one point in Hainan – the offshore duty free sector was hit hard and did not complete the projected target.

However in 2023, Hainan's expected target is to surpass CNY80 billion in sales – up by a third on the record 2021 results. In the first five days of this year's Spring Festival holiday (January 21-25), the province's 12 off-island duty-free stores recorded total sales of CNY1.685 billion, up +20.03% over the first five days of the Spring Festival in 2022 and by +325% over the first five days of the pre-pandemic Spring Festival in 2019.

In South Korea the duty free market was flat in 2022, easing by -0.6% year-on-year in 2022 to KRW17.67 trillion (US\$13.62 billion). The performance represents a -24.12% deficit compared with the record pre-pandemic year of 2019.

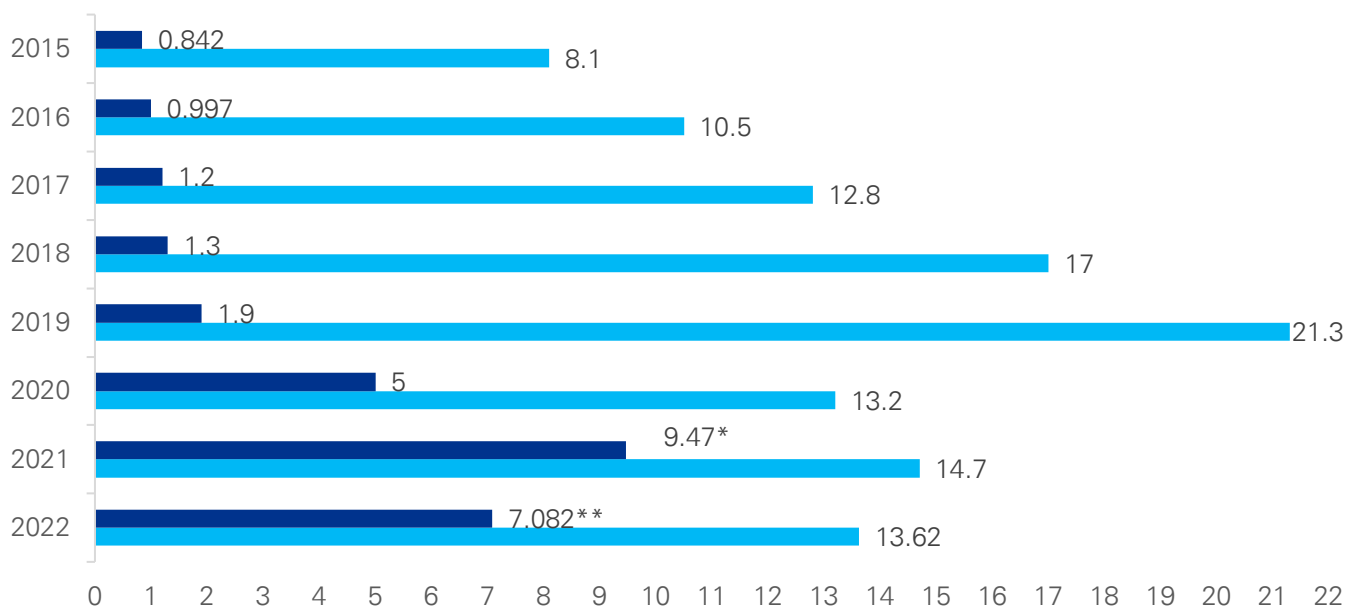
As a result of the KCS warning about perceived excessive commissions paid to travel agencies, Korean duty free sales in January 2023 slumped by -30% year-on-year to KRW797.4 billion (US\$603.6 million). The figures from the Korea Duty Free Association show a -41% decline month-on-month from December 2022. The impact has been particularly severe in the key cosmetics category, which accounted for more than 70% of total Korean duty free market sales last year.

While February sales rebounded by almost +37% month-on-month to KRW1.09 trillion (US\$838.9 million) in February, driven by a rebound in the daigou spend (the KCS view is not – yet at least – enshrined in law), many informed observers believe some form of control over the daigou business will be introduced. The February figures show a drop in total shopper numbers but a rise in spending volume, implying a sharp increase in sales to daigou resellers.

As noted in the *2022 Hainan Travel Retail Market White Paper: A Powerhouse of the New Retail*, Korea has largely become a Chinese market of sorts – a one-nationality dependence that has Korean travel retailers deeply concerned and seeking means to diversify. The return of outbound travel – and therefore outbound shopping – by Koreans will help normalise the sector but great uncertainty lingers over a market that for so long reigned supreme globally.

In contrast, as memories of the COVID-19 crisis recede, Hainan offshore duty free's future looks very positive. Over the past five years the sector has generated extraordinary sales of some CNY130+ billion and the industry has a lot of growth potential yet.

Hainan offshore duty free sales v South Korea duty free sales 2015-2022 (in US\$ billions)



Source: The Moodie Davitt Report

Notes: *Includes US\$1.53 billion tax/duty paid

** At prevailing exchange rate, includes US\$2.008 billion tax/duty paid,

■ Hainan ■ South Korea

To the future: Opportunities and challenges

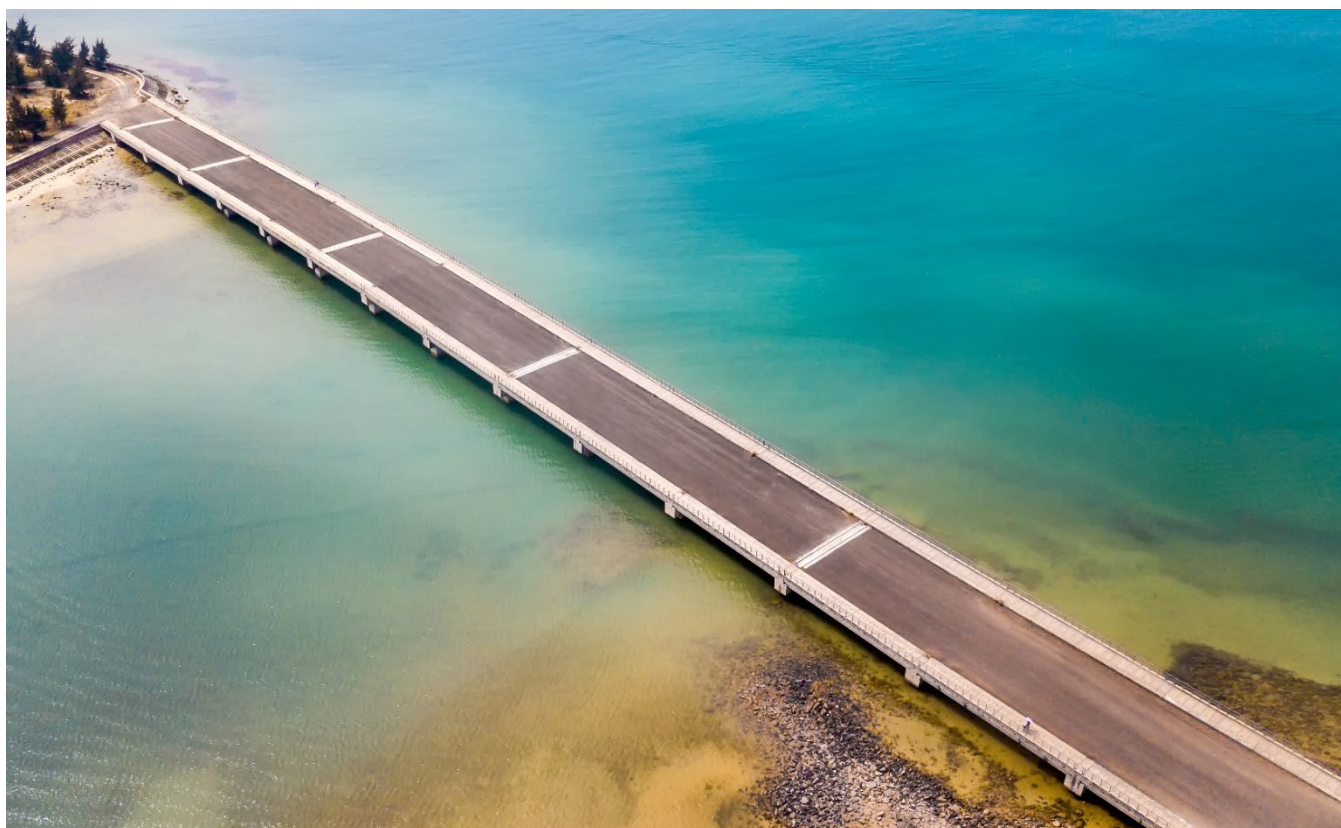
In this White Paper, we have addressed the likely impact on Hainan's offshore duty free sector as Chinese nationals begin again to travel freely to international destinations. Our conclusion is clear, Hainan duty free will continue to grow both in the short and long term.

As noted last year, the Hainan government and its duty free retailers have used the pandemic well. Outstanding tourism, investment and business promotion by fine organisations such as the Hainan Provincial Bureau of International Economic Development (Hainan IEDB), complemented by the top-class work of media houses such as Hainan Hinews Media Co and others, mean that the virtues of shopping duty free in Hainan are well-known throughout China.

Last year we predicted more preferential policies to further boost the island's duty free industry and we were proven right, notably by the far-sighted March 2023 introduction of the enhanced 'Guaranteed pick-up' and 'Buy and pick-up' policies.

Heavy investment in tourism infrastructure on the island is happening at pace – from highways to hotels, retail to restaurant. The 'culture + business + tourism' formula is surely the key to Hainan's future success as Chinese consumers increasingly seeks experiential rather than simply transactional encounters.

We believe therefore that in line with President Xi's description of international tourism is an important "business card" for Hainan Free Trade Port, the offshore duty free sector has a golden future.



02 

Evolution of China consumers in the post- pandemic era



The core trends currently impacting China's high-end goods spendings

Currently, China's high-end product market is impacted by economic growth, the COVID-19 pandemic, sustainability, and technological advancements and so on.

01

Slowing economic growth and stimulation policies

- Moving towards sustainable rates after decades of exponential growth
- “Dual circulation” economy policy encourages exports
- Local duty free sales come to rescue during the pandemic

02

The impact of the COVID-19 pandemic

- Drop in consumer confident levels during the spread of Omicron variant in 2022
- Growing consumer demand for high quality, uniqueness and speciality products and services
- Consumers “live in the moment”, likelihood for more impromptu purchases

03

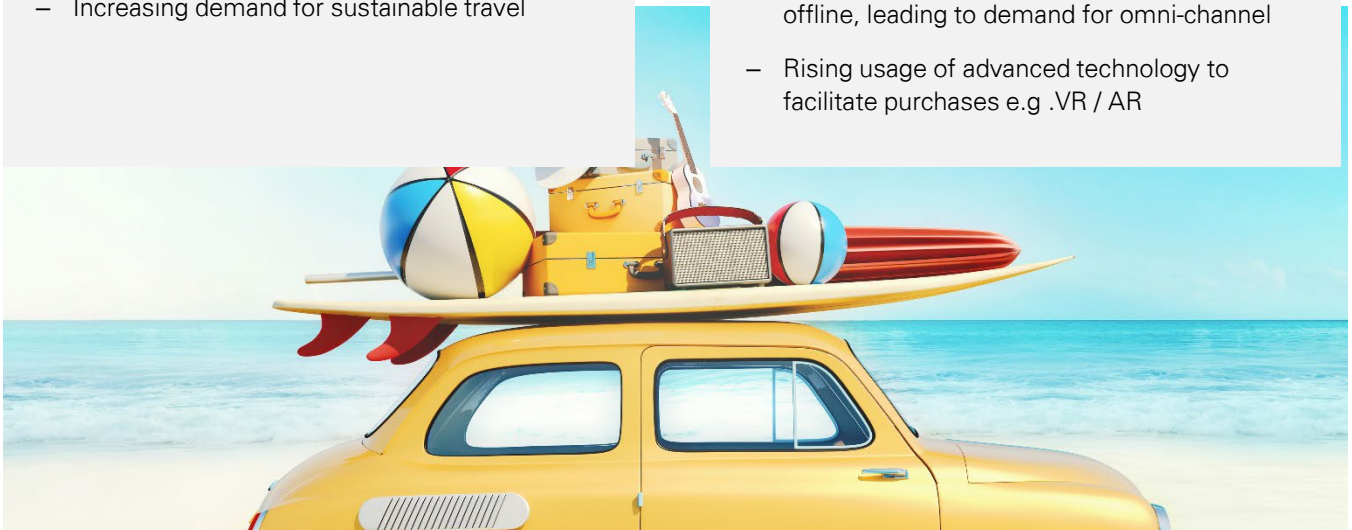
Increased awareness of sustainability

- Policy push from the government to encourage sustainability / “green” topics
- Rise of second-hand clothing market in China
- Increasing demand for sustainable travel

04

Digital technology has underpinned China's rise

- Increasing adoption of internet and social media
- Blurring boundaries between online and offline, leading to demand for omni-channel
- Rising usage of advanced technology to facilitate purchases e.g .VR / AR



Where to buy

Hainan, Hong Kong and Macau remain popular travel destinations for Chinese travelers pre & post pandemic

Based on recent surveys and outbound travel patterns since the lift of travel bans, in 2023, Chinese tourists are most interested in similar destinations as those in 2019 (pre pandemic) 1

- Mainland travellers made up 80% of total number of inbound tourists in Hong Kong & Macau, 40% of South Korea and Japan respectively²
- Number of Mainland tourists arriving at Hong Kong & Macau accounted for 46% of total departures in China³
- Benefiting from unique tourism resources and the rapid development of duty free market since 2020, Hainan is estimated to be a hot travel destination even after the border is open
- Milan, Hainan, and Hong Kong are Chinese luxury consumers most preferred destinations for traveling and purchasing luxury items (in no particular order).

Note:

(1) 2019 data is leveraged since recent surveys found that the travel destinations in 2023 is highly similar to those in 2019;

(2) (2) Gen-MZ refers to a pairing of two population groups: Millennials (born 1981-1995) and Generation Z (born 1996-2005)

^{1,2,3}Source: Euromonitor, MasterCard and ctrip – China Cross border Travel Consumption Report 2019, Official government statistics, Tourmis.info, World Bank, KPMG analysis

Preferred travel destination by luxury consumers (displayed by frequency)



Source: Luxury Redefined – Building trust with Chinese consumers through authenticity and integrity, KPMG China, DLG, 2023 Feb, KPMG analysis

Who to buy

the major driving force of high-end products 'consumption is high-end shoppers' habit of luxury items purchase

According to TMI's 2021 survey on luxury consumers, 42% of China's luxury spending comes from the high-end consumer group whose net assets exceed 10 million yuan, accounting for only 0.3% of China's total population. The macro environment and the pandemic have had a minor impact on the purchasing behaviour of high-end consumers buying luxury items.

Impacts from COVID-19



Spending level

- Overall, total consumption of luxury is not affected by macro environment.



Shopping channel

- Daigou and travel retail overseas decrease
- Online channel slightly increases
- Domestic shopping mall is still important



Shopping behaviour

- More cautious in buying luxury products, consider whether the products are really in need before purchase



Product category

- Prefer value-preserving products
- Prefer classic ones

Reasons for domestic luxury consumption

01

Daily consumption is the main scenario

- Travel retail only accounts for small amount of luxury consumption

02

Urgency to get luxury products

- Luxury products are exclusive, some are limited editions that high-end shoppers want to buy immediately

03

Smaller price gap compared with overseas market

- The government has issued tax reduction policies on luxury products
- The development of Hainan duty-free market has also captured more consumption returns

Source: consumer research, KPMG analysis

Based on above data, we can see that, high-end shoppers have strong confidence on future economic environment, and their spending level will not be affected in short term. A large amount of luxury product consumption can retain domestically if local shopping malls can meet high-end shoppers expectations:

- Luxury product consumption will encounter a certain amount of outflow when the border reopens
- However, daily luxury consumption of high-end shopper may not be greatly affected
- High-end shoppers hope local malls can satisfy their needs on considerate service and quick access to new products

China's high-end shoppers become more favourable with online and offline omni channel integration for purchasing

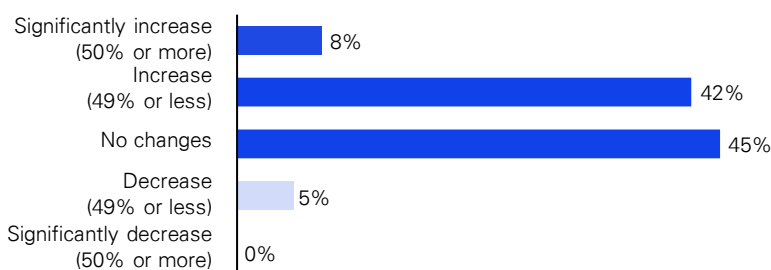
High-end shoppers are confident of future economic environment and their short-term consumption level remains unaffected

The travel restrictions and global supply chain disruptions during the pandemic have hindered Chinese consumers from purchasing high-end products abroad or through daigou channels. The purchasing behaviour of China's high-end shoppers has been affected and changed by the three-year-long pandemic. China's high-end shoppers become more favourable with online and offline omni channel integration for purchasing. China is expected to become the world's largest consumer market for personal luxury items in the future. In the current macroenvironment, Hainan is expected to cater to the trend of high-end product consumption returning to the domestic market, continuously releasing growth potential, and becoming the preferred destination for domestic high-end product spending.

Future luxury consumption change

How will your luxury spending level change in next 2-3 yrs?

N=38, single choice

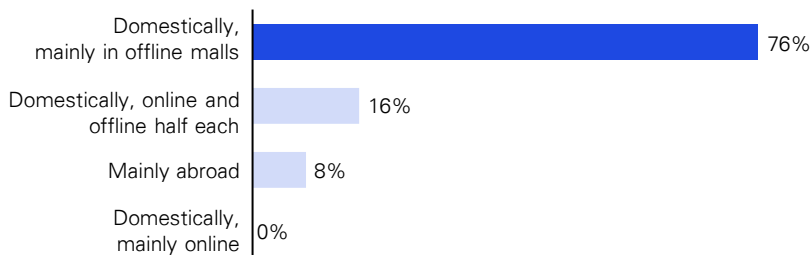


- High-end customers have **positive attitude** to economic environment after Covid restrictions lifted
- **Shopping desire increases** as high-end customers' **income level increases**

Luxury consumption channel

How will your luxury shopping channel change after the border reopens?

N=38, single choice

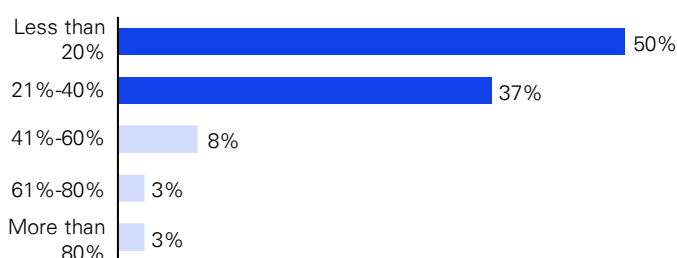


- Domestic shopping malls **provide convenience** and can fulfil **daily luxury consumption demand**
- During the epidemic, high-end shopping malls built **a certain connection** with consumers through **VIP program and close service**

Percentage of luxury consumption outflow

How much will your luxury consumption outflow after the border reopens?

N=38, single choice



- Luxury consumption outflow is mainly caused by **travel retail**
- Shoppers tend to buy luxury products in overseas mainly because of **price advantage** and **abundant product portfolios or stocks**

Source: consumer research, KPMG analysis

We categorised Chinese consumers into 5 clusters to explain their characteristics and behaviours, and identification of core and emerging luxury consumer "personas"

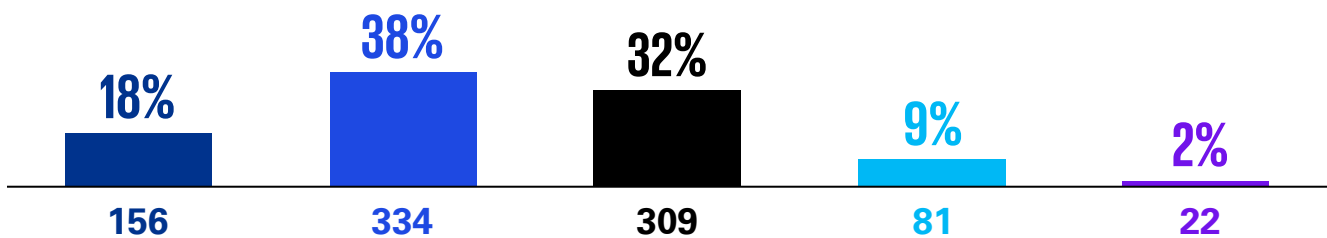
According to the KPMG China and DLC report *Luxury Redefined* published in February 2023, we categorised Chinese consumers into 5 clusters. The characteristics and demographics of each Chinese consumer group are as follows:

Understanding Chinese luxury consumers: The five clusters

	Cluster 1: Going global	Cluster 2: Look at me	Cluster 3: Fitting in	Cluster 4: Quality first	Cluster 5: Striving for the greater good
Characteristic	Value brand name and origin	Value conspicuous luxury clothing and accessories	Value quality life	Value sophistication	Value the 'greater good'
	Low understanding of brand nuance	Buy luxury products to display status	Share experiences on social media	Appreciate brand heritage, fabric and manufacturing	Choose companies that are sustainable
	Most prevalent among 45+ years old	Most prevalent among 25-34 years old	Most prevalent among 25-34 years old	Most prevalent among 45+ years old	Most prevalent among 18-24 years old
	Concentrated among Tier 2 cities	Concentrated among Tier 2 cities	Concentrated among Tier 1 cities and Hong Kong	Concentrated among Tier 1 cities	Concentrated among Tier 1 cities

Source: *Luxury Redefined*, KPMG China, DLG, 2023 Feb, KPMG analysis

Population % of population/ total population (millions)



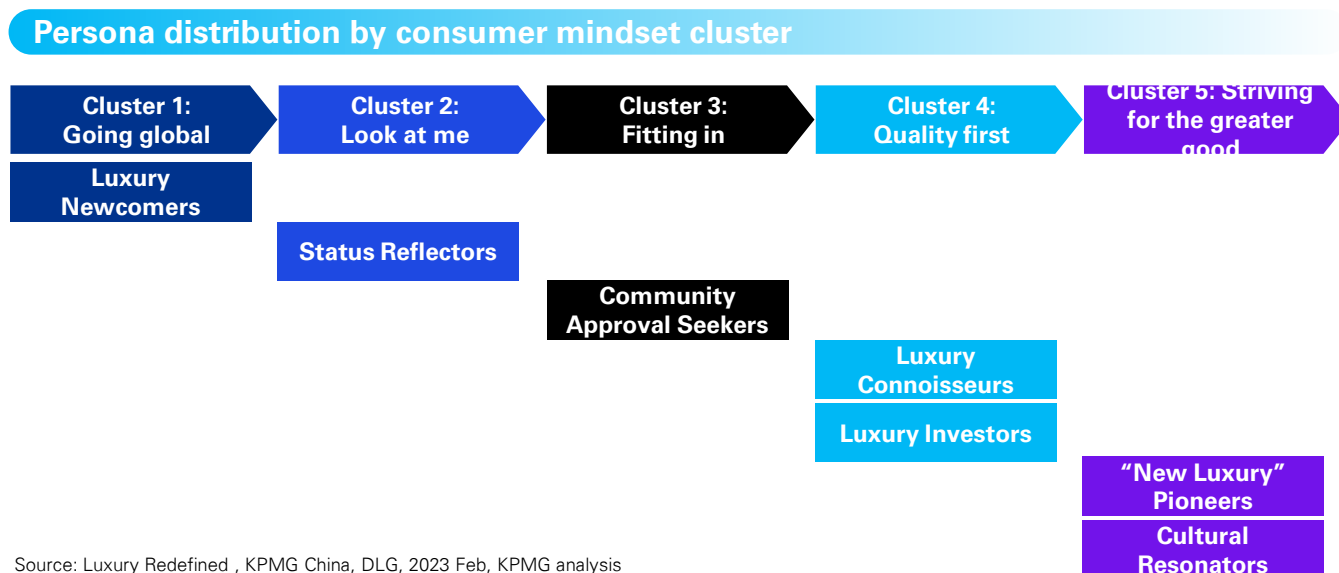
Source: *Luxury Redefined*, KPMG China, DLG, 2023 Feb, KPMG analysis

The clusters are not rigid, Chinese consumers move seamlessly from one cluster to another.

In China, consumers are multi-dimensional. This characteristic has amplified in previous years, due to:


- Rapid development of global perspective
- Easy accessibility information thanks to the advancement of the internet

We identified five core luxury consumer “personas” in China and two emerging personas with growing significance as the market matures:




- 01 Luxury Newcomers:** Luxury newcomers are those who recognise and favour foreign brands, They don't spend much time researching products and tend to buy well-known brands that are easy to recognize. They are easily influenced by brand advertising, reputation or spokesperson, and are more likely to accept promotions, discounts, direct sales from manufacturers, and duty-free shops.
- 02 Status Reflectors:** Status Reflectors value products and services with a good reputation and high brand visibility to reflect and showcase their status and wealth. They are likely to be influenced by information on mainstream social media and in advertisements, such as product placements on TV shows and in video games.
- 03 Community Approval Seekers:** Community Approval Seekers see luxury as a form of social currency that can give a sense of belonging. They are also keen trend watchers. To gain recognition from the community, luxury purchases are influenced by societal and peer pressure, and there is a heavy reliance on information from social media and key opinion leaders (KOLs).
- 04 Luxury Connoisseurs:** Luxury Connoisseurs value high-quality goods that can demonstrate their unique personality, and are prepared to pay a premium to get what they want. Consumers in this group have a relatively higher knowledge of luxury brands and an understanding of their differences. They are more likely to be influenced by social media, direct engagement from brands (e.g. newsletters, text messages, sales staff engagement), communities and their peers rather than advertisements. This persona has a higher acceptance of niche brands, while trends and influencers primarily dictate their purchasing decisions.
- 05 'New Luxury' Pioneers:** 'New Luxury' Pioneers are consumers who are attracted to new values and concepts, they are more open to brands that promote new ideas and advanced designs that make a contribution to society.
- 06 Cultural Resonators (two emerging personas):** Cultural Resonators are a young cohort of shoppers whose purchasing habits are driven by emotional connections to Chinese culture. Cultural Resonators see purchasing local brands as a sign of being an 'insider' and one that allows them to represent their heritage.
- 07 Luxury Investors (two emerging personas):** Luxury investors treating luxury products as an alternative investment vehicle. The products they buy are in high demand and are often limited editions or member-exclusive pieces.

Jack Zhou
周博宇
Luxury Newcomer



Age: 45+
Marital status: Married with no or 1 child

Education Level:



81% college educated


Location:

- 9% Tier 1 cities
- 10% Tier 2 cities
- 10% Hong Kong

Luxury spending:
As a % of annual household income


No spending	21%
<5%	26%
5%-15%	24%
16%-25%	18%
26%-35%	6%
36%-45%	2%
46%-55%	2%
>55%	1%

Audrey Lau
刘子君
Status Reflector



Age: 25-34
Marital status: Married with 1 child

Education Level:



93% college educated


Location:

- 12% Tier 1 cities
- 13% Tier 2 cities
- 16% Hong Kong

Luxury spending:
As a % of annual household income


No spending	10%
<5%	15%
5%-15%	24%
16%-25%	30%
26%-35%	14%
36%-45%	4%
46%-55%	3%
>55%	0%

Robin Lin
林迪
Community Approval Seeker



Age: 18-24
Marital status: Single

Education Level:



86% college educated


Location:

- 11% Tier 1 cities
- 8% Tier 2 cities
- 15% Hong Kong

Luxury spending:
As a % of annual household income


No spending	28%
<5%	31%
5%-15%	16%
16%-25%	14%
26%-35%	7%
36%-45%	1%
46%-55%	2%
>55%	1%

Rebecca Lee
李羽希
Luxury Connoisseur



Age: 18-34
Marital status: Single

Education Level:



93% college educated

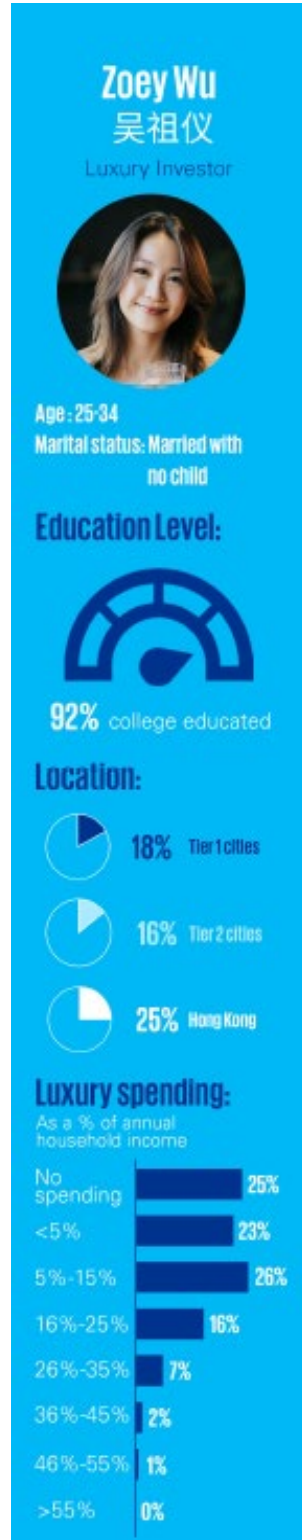
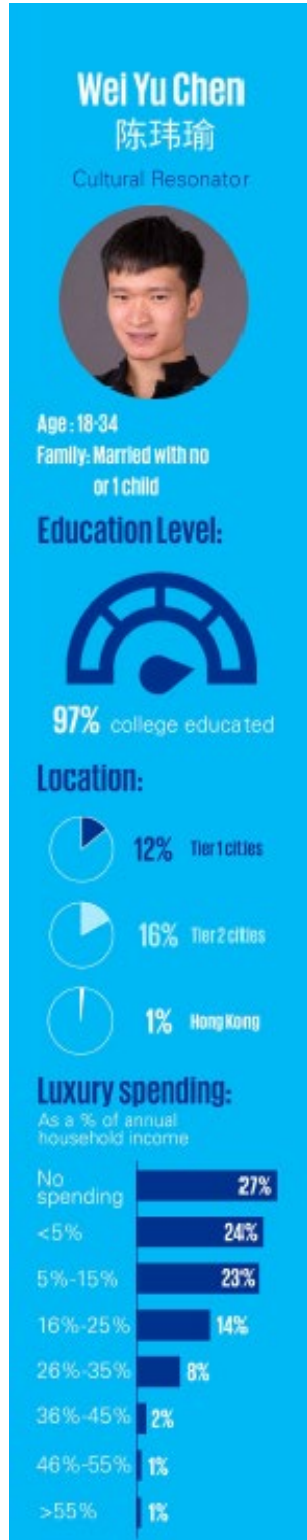
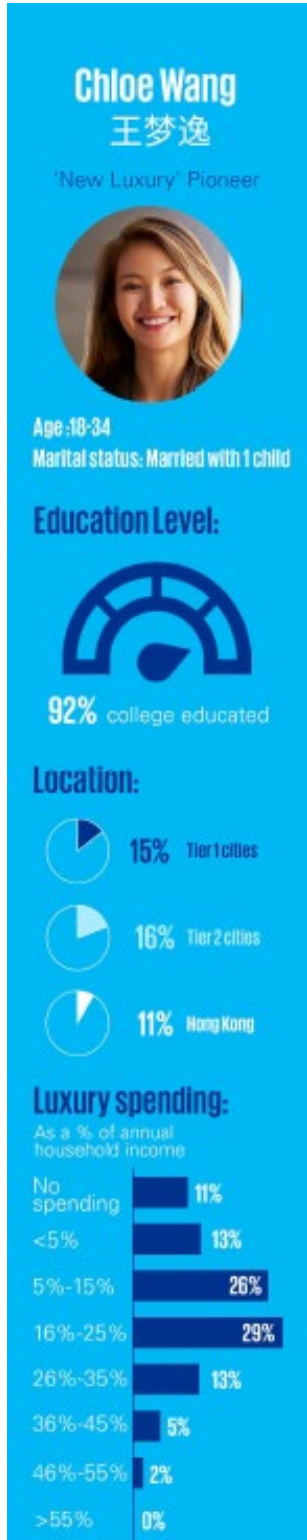
Location:

- 23% Tier 1 cities
- 21% Tier 2 cities
- 20% Hong Kong

Luxury spending:
As a % of annual household income

No spending	18%
<5%	29%
5%-15%	28%
16%-25%	16%
26%-35%	6%
36%-45%	2%
46%-55%	0%
>55%	1%

Source: Luxury Redefined , KPMG China, DLG, 2023 Feb, KPMG analysis



As the Chinese market matures, the importance of cultural resonators and luxury items investors is expected to increase. However, consumer behaviour is constantly changing, and they may exhibit characteristics of multiple consumer profiles at the same time.

According to a survey of seven consumer profiles, Milan, Hainan, and Hong Kong are their preferred destinations for traveling and purchasing luxury items (in no particular order) .

Source: Luxury Redefined , KPMG China, DLG, 2023 Feb, KPMG analysis

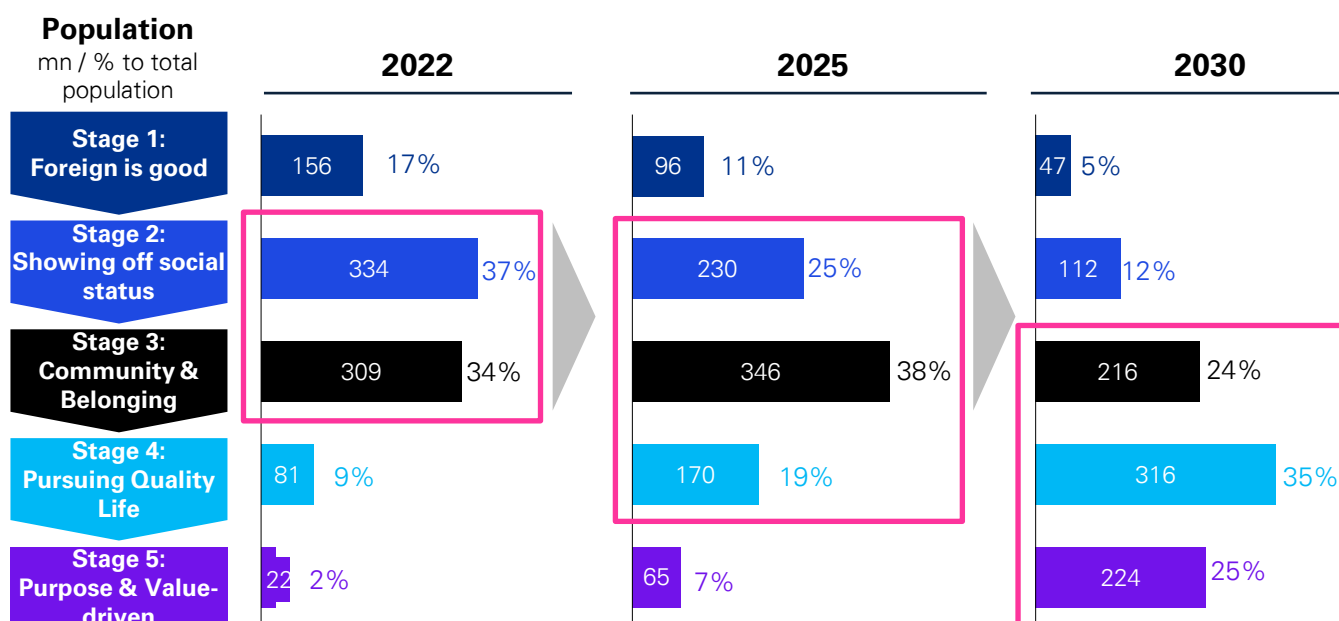
We estimate that Chinese consumers will gradually evolve and dominate in relatively mature consumer clusters by 2030

Based on the survey analysis, purchasing power is a critical factor in the ability to buy luxury items, which drives the development of consumer mentality, and affects the future development of Chinese consumers. When consumers are no longer limited by their purchasing power, they have a certain degree of freedom to expand their purchasing scope from low-level needs to high-level pursuits. Using GDP forecasts, we can assess the consumption patterns of Chinese consumers and estimate how they will change in the future according to the trends observed in other countries.

According to the KPMG research report *Luxury Redefined* published in February 2023, Chinese consumers generally are in cluster 2 ('Look at me') and 3 ('Fitting in'), while consumers' attitudes in most Tier 1 cities are in the fourth cluster ('Quality first') or at least approaching it (Figure 15). Most consumers in Tier 2 cities fit into the second and third clusters, with increased income and economic development allowing for greater purchasing power and thus a growing appetite for luxury items.

China's GDP per capita (adjusted by purchasing power parity) is currently one-third of that of the United States (Figure 16). Yet, if broken down by city class, China's GDP per capita for Tier 1 cities is lower than the United States by just 30 percent, and it is ahead of developed countries such as Japan and South Korea. Through forecasts based purely on past economic performance, the GDP of Tier 1 cities could catch up with the US's current level in 2030, implying that most residents in these cities will have a consumer mindset in clusters 4 and 5 by 2030.

However, some external factors are also driving a change in consumer mindsets, such as relevant policies on ESG and brands' initiatives around consumer education. Some of these top-down actions are pushing consumers to think and act differently than they would have without this influence, leading to higher awareness and different purchasing behaviours. This will shorten the required time for consumers to transition from the status to the more advanced clusters 4 and 5 ('Striving for the greater good'). Therefore, it is thought that the mentality of consumers in Tier 1 cities in China may only be about three to five years behind the consumer mindsets seen in the US market, while the overall Chinese market could be about five to eight years behind.



Source: *Luxury Redefined*, KPMG China, DLG, 2023 Feb, KPMG analysis

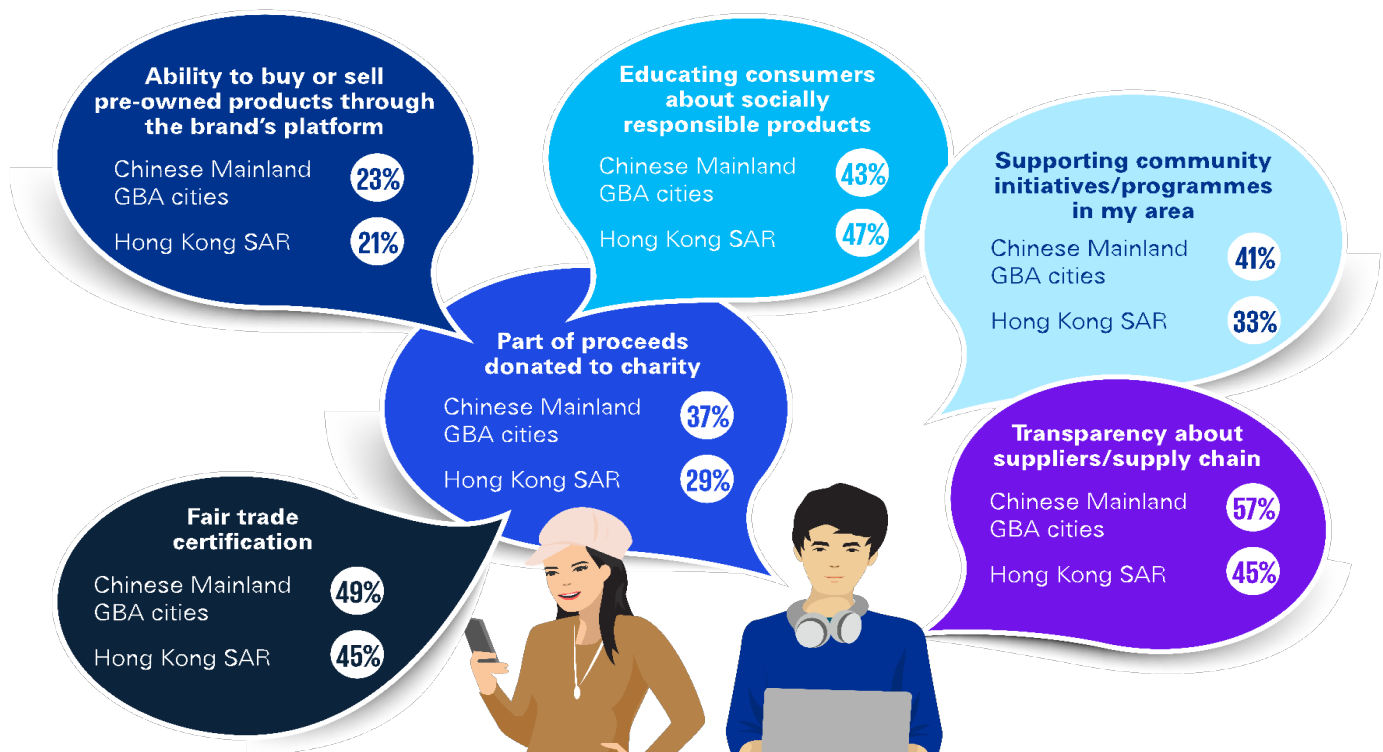
Buy from whom

Chinese consumers are expecting retailers with share more social responsibility

Leading socially responsibility actions consumers want to see from retailers.

Leading socially responsibility actions consumers want to see from retailers

Percentage of respondents who believe retailers should take the following actions



Source: Retail Recharged: Engaging consumers with technology, purpose and trust - 2022 Survey. KPMG China, GS1 Hong Kong, HSBC, KPMG analysis.

In summary, all operators in the Hainan travel retail market, whether they are duty-free operators or conventional retailers, should focus on the consumer profiles of Chinese consumers and the possible changes in their purchasing behaviours and habits in the future to prepare for the development of a more active and diversified Hainan travel retail market after seal-off.



03

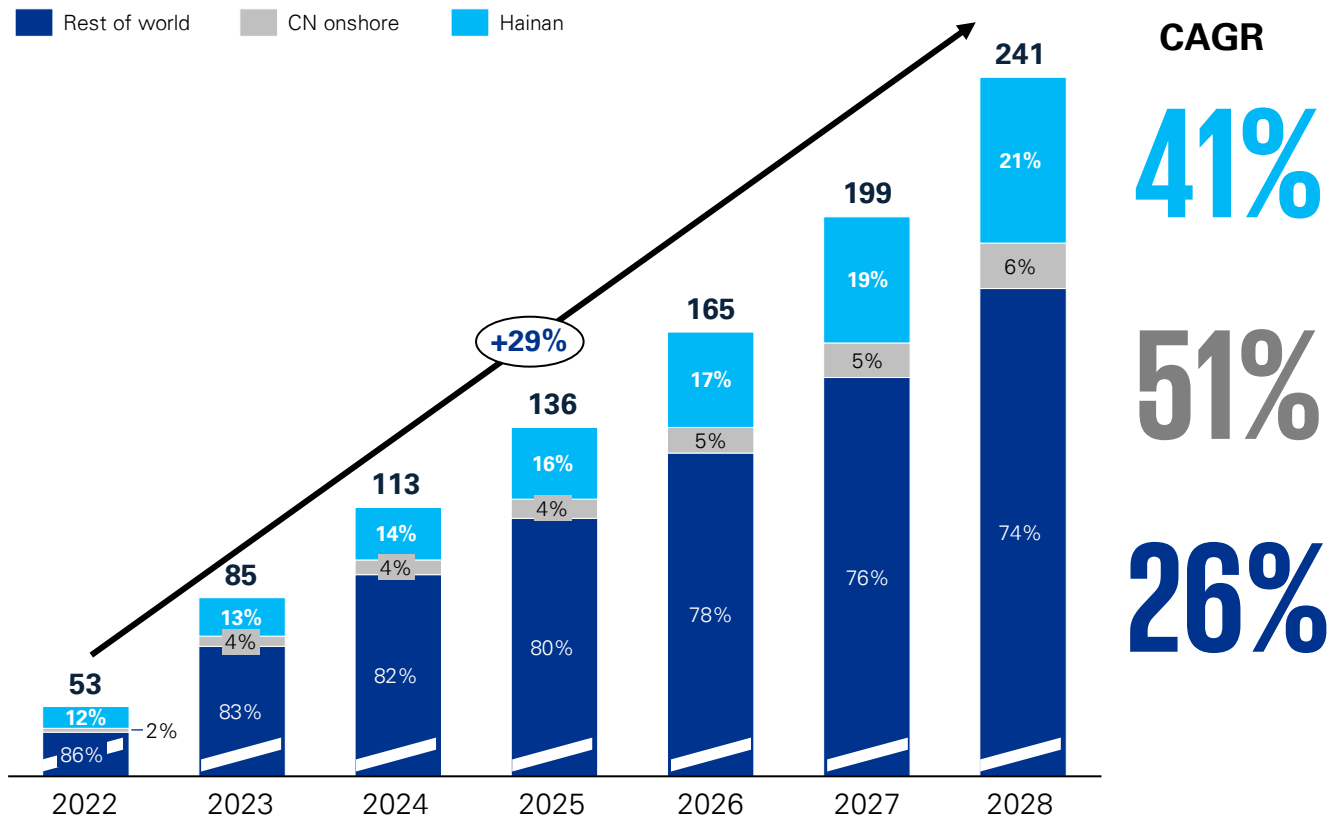
**2023 is the ideal time
when we set the
course for victory for
Hainan!**



Hainan plays a key role in the global travel retail market

As mentioned, with the continuous support and investment from the government, investors remain optimistic about Hainan's travel retail market. We believe that offshore duty-free industry can be considered as Hainan's "gilded signboard", will continue to achieve more impressive results in the future.

Breakdown of worldwide travel retail market ⁽¹⁾ (%, 2022-2028)



Note: (1) Assumed constant growth rate from 2026-2028; assumed Hainan's share of China DF to remain constant, taking up ~ 79-80% of China market
 Source: Booking.com – Travel Confidence Index Report 2022, HKEX, KPMG – Hainan Travel Retail Whitepaper, KPMG market model, Statista, Trip.com, KPMG analysis

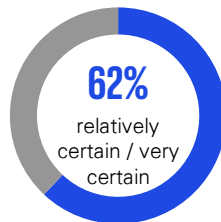
With the continuous investment in Hainan market, consumers' perception of Hainan market are constantly evolving and becoming more better

Consumer purchasing concepts are constantly evolving, and consumer behaviour is also constantly upgrading, from "overseas Shopping" to "Hainan Shopping."

Consumer perception evolution

Tourism in Hainan

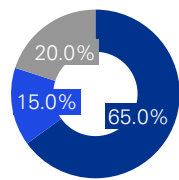
Q: Even if outbound tourism resumes, still plans to return to Hainan to shopping



"Overseas Shopping" to "Hainan Shopping"

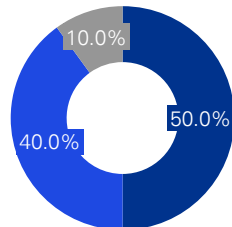
- The pandemic has accelerated the reversal of overseas shopping trends back to domestic tourism
- Driven by the new policies, brands, products categories, # of visitors and consumption has shown increasing trends in Hainan

Change in Hainan DF sales mix



2019

- Perfumes & Cosmetics
- Luxury goods
- Others



2025E

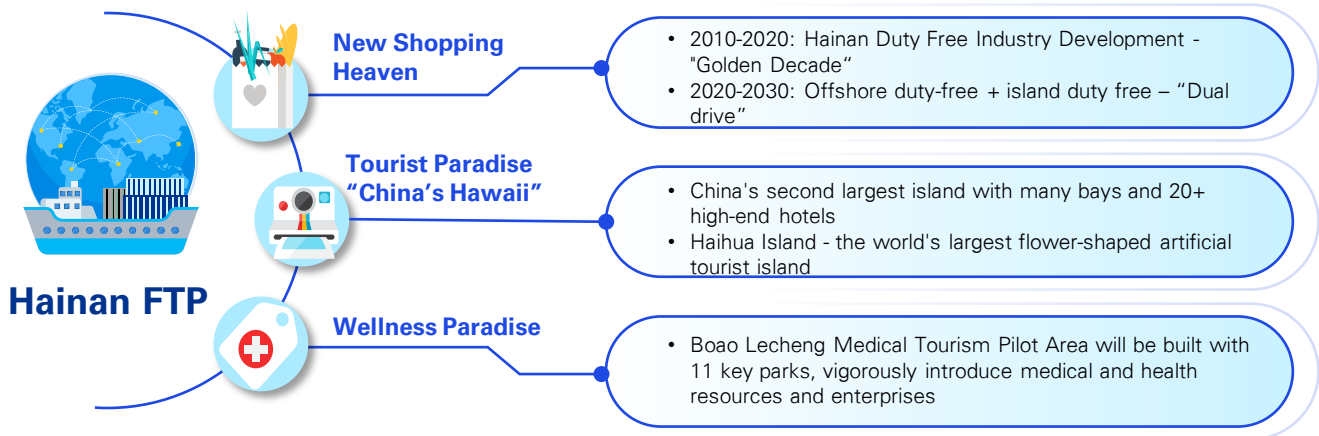
"Consumption upgrade"

- The removal of single-item DF allowance cap (RMB 8,000), and the increased per-visit purchase quantity limit drives the change of tourists' DF shopping behaviour
- Due to rising incomes, Chinese people have become more interested in buying high-end and luxury products

Source: UBS, GUOSEN SECURITIES, KPMG analysis






Market image in Chinese consumer



With the liberalisation of investment policy and more investment of foreign capitals, Chinese consumers increasingly believe that Hainan FTP is **High-end international tourism & shopping centre**

Tax incentives and favourable policies will attract more brands to start carrying out a Hainan long-term strategy

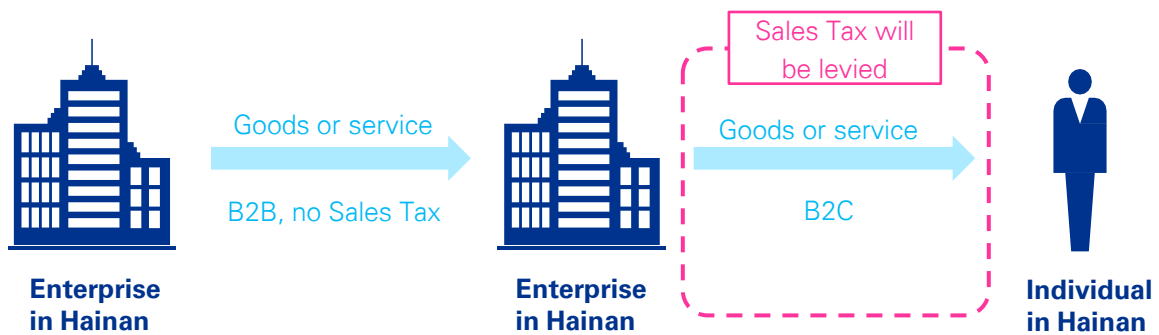
Key objectives — How we will achieve it

Key objectives	How we will achieve it
 <p>Take advantage of the 'seal-off' giving greater margin and more control on pricing</p>	<ul style="list-style-type: none"> ▪ Set up Hainan trading entity and bonded warehouse allowing; <ul style="list-style-type: none"> – Import duty exempted starting from seal off – Streamlines indirect tax into 'Sales Tax': ONLY B2C is levied with single-digit tax rate
 <p>Lower tax burden</p>	<ul style="list-style-type: none"> ▪ Hainan entity will enjoy 15% CIT due to the substance of our business; <ul style="list-style-type: none"> – Before seal-off, 15% Corporate Income Tax for encouraged industries with business substance – From the year of seal-off to 2035, 15% Corporate Income Tax applies to ALL sectors with business substance (except those on Negative List)
 <p>Attract more talent through lower tax</p>	<ul style="list-style-type: none"> ▪ Team members will enjoy reduced individual tax costs in Hainan; <ul style="list-style-type: none"> – Before 2025, 15% cap for Individual income Tax – Before 2035, it is levied at 3%, 10%, 15% for individuals residing in Hainan over 183 days per annum

The island seal-off will be the biggest driver of change towards Hainan's future as a leading retail destination

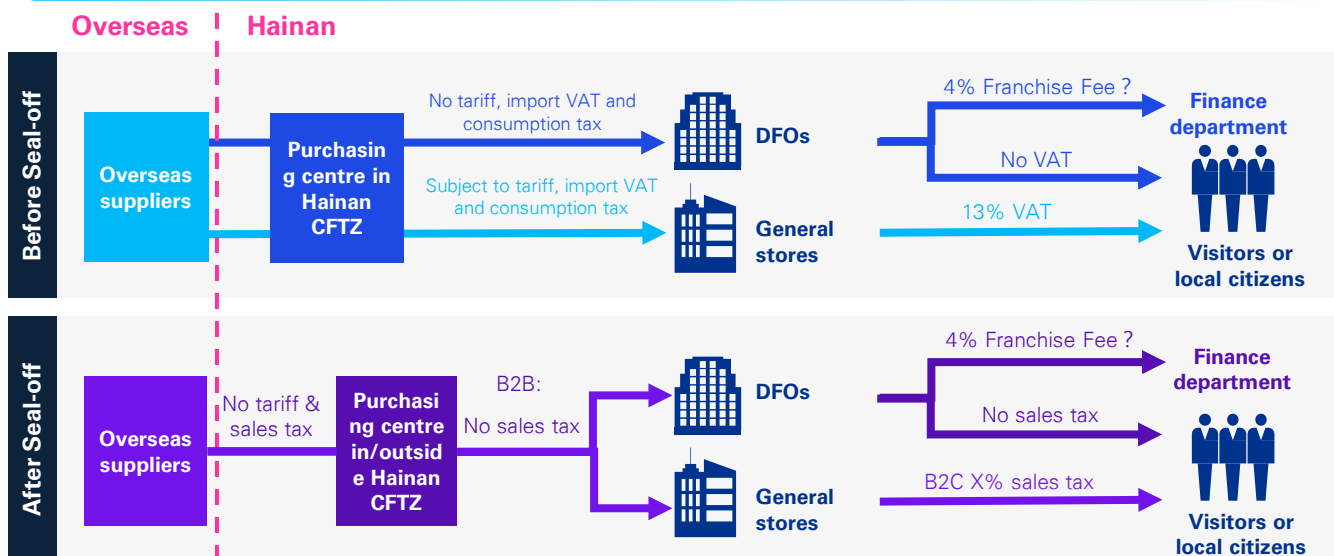
VAT and Consumption Tax to be simplified and streamlined into Sales Tax. According to the top-level design concept of Sales tax, it would be levied in the final B2C stage, meaning the prior B2B flows free of turnover tax. This could be a landmark driver of wholesale and retail business for those entering Hainan.

Sales Tax Scheme in Hainan after Seal-off



After seal-off, the streamlined tax policy may narrow the gap between conventional retailers and duty-free operators, allowing brands to have the opportunity to sell through conventional channels at a more comparable effective tax rate (with equal profits). Before and after seal-off, we expect the major tax effects on conventional retailers and duty-free operators to be as shown in the following figure:

Indirect tax treatment for wholesale and retail business in Hainan



**After seal-off,
the traditional duty
paid and duty free
market will be
integrated.**

**Brands should consider
how to benefit from Hainan
as an overall platform
coordinated with
effective resources**

For brands, this would create the opportunity to operate direct owned or consignment style stores at prices much closer to the DFOs (the main distinguishing factor as to why they are not able to effectively do this today). This will appeal to those luxury and premium brands, and those that want to get greater control over their end customers and management of their brands in the market.

Moreover, after seal-off, the traditional duty paid and duty free market will be integrated closely. Brands will need to further consider whether their operations will become a travel retail managed business or a local market managed business. This will likely be the most difficult question to face internally, however we have already seen the most strategic brands beginning to see how they can benefit from Hainan as an overall platform coordinated with effective resources which is not limited to being run by one unit or another.

For DFOs the key question is how they can position themselves. Will they remain in what is mostly a wholesale style relationship with their brands, or will they seek alternate models to attract specific brands and in turn drive greater traffic into their locations? Further, are their set-ups agile enough to work with these different models, and if not, what will they need to achieve this agility?

All of this needs to be considered against the backdrop of the general investment going into Hainan from other retailers and developers who now may offer alternate points of sale to traditional DFOs. This investment will bring greater overall benefit to the market and will offer more choice to brands and customers alike in their retail experience in Hainan.



2023 is the ideal time when we set the course for victory for Hainan!

With the development of Hainan's retail industry, we have not only seen a variety of duty-free retail models, but also witnessed the vigorous development of Hainan's travel retail market. The future is full of opportunities, and 2023 will be an important start step for travel retail market. So, how can we seize this opportunity and achieve success in this retail market?

01

Keep the dialogue open and transparent

- The government timely and promptly communicates the policy direction that the market is keen to know, managing market expectations for business models on the island after seal-off.
- Enterprises actively maintain good communication with key policy makers and professional intermediaries such as the central government, Hainan province and cities, and actively explore diversified business layout after seal-off.

02

Establish the keystone for post-seal-off retail models

- After seal-off, brands can establish their own duty-free stores without paying import duties. The cost of indirect tax has greatly decreased compared to that before seal-off, which puts brands on the same level playing field with duty-free operators.
- Enterprises can consider training local teams in advance, as well as the strengthening of local supply chain management, sales channels and pricing, government relations and other related capabilities.

03

Agile Operations to connect Hainan with Mainland Market

- Provide consistent loyalty programs, points that can be used universally, and information sharing on consumer profiles for Chinese consumers visiting Hainan.
- Balance the pricing, sales, employees, shared supply chain, demand planning, data operations, organization structure settings, and cooperation mechanisms for the two markets of travel retail and mainland retail market.

04

Digitalization Empowers Hainan to Create Seamless Omnichannel Consumer Experience

- Proactively respond to the changes in consumer behaviour in the post-pandemic era, with consumers prioritizing online channels to obtain product information, while physical stores remain a key bridge to experience brand culture and historical heritage.
- Leverage the advantage of Hainan's data flow policies and deploy a fully integrated online and offline omnichannel experience to meet consumer demand.

Final word

Ultimately the seal off will help to further change Hainan for the better and its why we have invested our time and capabilities to understand the key factors to be successful in the market. KPMG are the leading advisors in Hainan, working with the largest number of brands and DFOs on the most innovative business models. Contact us to help you:

- Analyse the current and near future development of Hainan policy and market
- Identify the applicability of policies to your business decisions in preparation for Hainan market entry
- Adopt an appropriate Hainan entry strategy, including holding structure, vehicle options (branches and companies) and business models (service, trading or mix function, etc.)
- Select the effective plan for implementation to achieve the strategy objectives
- Identify the appropriate growth strategy from POS type to location selection

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