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# Refined Strategies: Luxury extends its reach across China

CONSUMER MARKETS

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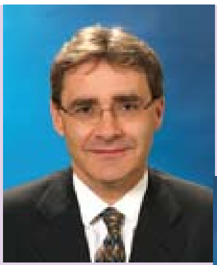
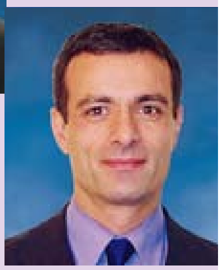
# Introduction





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Much has changed since our previous report on China's luxury market in 2008 and we face a markedly different global economic landscape. As in many other aspects of the global economic crisis, China is bucking a global trend in luxury consumption: with sales falling by up to 8 percent across the globe in 2009, China saw estimated sales growth of 12 percent.[1] By some measures, China is now the second largest luxury market in the world, after Japan.[2]

With decreased business travel expectations, China's mainland luxury stores may be in a position to capture a greater proportion of Chinese consumers' luxury spending. Whichever way you look at it, China's relatively confident consumers are now a key factor for the global luxury market.

In particular, the "super rich" segment has continued to grow despite the recent global economic turbulence. While younger professionals and other aspiring consumers may have struggled to command higher salaries over the past year, privately-owned enterprises are increasingly surpassing the former state-owned enterprises as generators of wealth, creating a new consuming elite. The October 2009 launch of ChiNex, China's Nasdaq-style second board in Shenzhen, is an illustration of this, effectively creating dozens of yuan billionaires overnight.[3]

Our latest survey shows Chinese luxury consumers maintaining reasonable confidence about their economic situation, as well as being comfortable with the idea of paying large sums of money, and ever more discerning and sophisticated in the retail choices they make. On the back of our 2008 report's focus on different city tiers, it is clearer than ever that China is not simply one luxury market, as it has a wide range of influences, drivers and perspectives in different segments across the country.

Despite the relative optimism about the Chinese luxury market, many respondents expected to decrease their spending on luxuries in 2010. Retailers will need to remain alert to potential downward shifts in certain product sectors.

There continues to be huge potential for growth and opportunities across China – not merely in the more well-known major cities of Beijing, Shanghai and Guangzhou. To that end, we have highlighted a number of tier-two and three cities that, while not having the same global fame, have large and increasing numbers of wealthy households.

There is also clear scope for greater use of technology in communicating with customers. With the ubiquity of mobile phone usage in China, and the advent of 3G technology expanding what can be done through mobile communications, there are plenty of options for engaging customers on an ongoing, personal basis. While the importance of the in-store experience continues to trump ideas of major online luxury retailing, customers are looking to the web to research different brands. Luxury companies looking to connect with the public should be making the most of the interactive media available to them.

Opportunities continue to abound in the China luxury sector, and the rewards are potentially huge. If you are interested in further discussing the issues and suggestions raised in this report, KPMG China's dedicated Consumer Markets team would be delighted to share their knowledge and insights with you.

1 "Luxury Goods Worldwide Market" study, Bain & Company, October 2009
2 China becomes world's 2nd largest luxury market, People's Daily, 27 July 2009
3 Stocks sizzle as China debuts start-ups market, Reuters, 30 October 2009

# Key findings

## Effect of the downturn

- Thirty-eight percent of respondents expect to spend less on luxuries due to the economic downturn. However, 44 percent say they will spend either the same amount or more.

- Most of those who are expecting to spend less say they would rather spend less on higher-level brands than switch to cheaper brands.

- Brands can consider responding to this environment with more closely-managed working capital strategies.

## Luxury drivers

- Personal reward and pampering rank as the main motivators for luxury spending, closely followed by formal use – clearly demonstrating luxury's psychological, as well as physical, function.

- The in-store experience remains an important driver of the "specialness" of luxury, highlighting the importance of impressive retail spaces and attentive, well-trained service staff.

## City tiers

- Despite some hesitancy from respondents in tier-two and tier-three cities, retailers report bullish expansion plans across China.

- Companies looking to extend their footprint to new cities should consider the pros and cons of franchising, direct investment and partnership to enhance their chances of success.

## Technology

- Though respondents were generally positive about paying for general retail purchases by mobile phone, there appears to be less interest in paying for luxury goods this way, highlighting the continued importance of the direct luxury retail experience.

- Companies may nevertheless be able to explore mobile marketing communications: 57 percent of respondents would be interested in receiving updates on new arrivals or limited editions by SMS; while 64 percent would be interested in validating the genuineness of their purchases using their mobile phone or device.

## Tax and customs issues for the luxury sector

- The downturn has increased pressure on nations' tax bases, and Chinese tax authorities are becoming increasingly stringent in their transfer pricing requirements and monitoring.

- Luxury retailers should pay particular attention to opportunities for customs savings in their treatment of items such as royalty payments and marketing expenditure.

# About the survey

TNS conducted their survey of luxury consumers in the third quarter of 2009. They conducted interviews with 927 consumers, all of them between 20 and 44 years of age.

To qualify, respondents in Beijing, Shanghai, Guangzhou and Shenzhen needed to earn RMB 6,500 or above. In other cities, it was RMB 4,500 or above. These other cities included Fuzhou, Hangzhou, Nanjing, Dalian, Harbin, Shenyang, Tianjin, Wuhan, Xi'an, Chongqing and Chengdu.

The female: male ratio was 51:49 and 71 percent of respondents were educated to college/university level or above.

The consumer research was supported by qualitative research, involving 12 in-depth interviews with high-earning consumers.

Unless stated otherwise, statistics referred to in this report are based on TNS research.

# Effect of the downturn: China's consumers emerge confident from 2009

In the aftermath of the financial crisis of late 2008, it was not immediately clear how deeply China would be affected. Overall, China rebounded better than many other nations, with GDP growth of 8.7 percent in 2009.[4] However, the downturn could not help but have an effect on China's generally confident luxury consumers. TNS survey respondents indicate that their spending plans were affected by the crisis, though confidence rose as the Chinese economy seemed to bear up strongly in the global recession. Luxury retailers in China were further protected by the continuing confidence of their highest earning clientele and their intentions not to cut back on their spending.[5]

## Impact of the crisis

Most respondents (72 percent) reported that the downturn had had little or no impact on them. An even higher proportion (84 percent) expect a similar level of impact (not at all or only slightly) for 2010. However, in the export-dependent south, 31 percent said the downturn had had a significant impact on them, compared to just 20 percent in central and northern areas, and 21 percent in the east.

A brief rocky period during 2009 has been followed by an increasingly positive outlook for 2010. While confidence dropped in 2009, TNS's most recent polling suggests that fewer respondents feel that the crisis will affect them significantly; a few more believe they will be untouched by the crisis; and 84 percent feel the impact will be slight at worst.

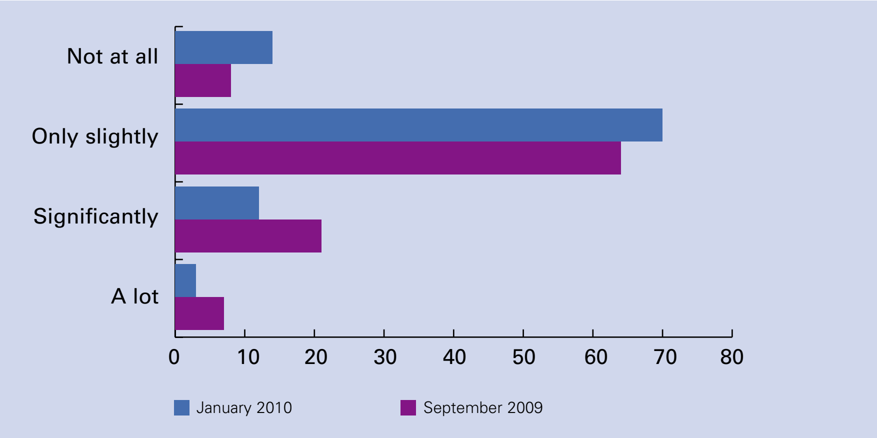
During the course of 2009, consumer expectations were notably affected by lower salary and bonus payments for the year, with nearly 46 percent feeling that their incomes would actually decrease in 2009. However, confidence seems to have returned, with 59 percent expecting their incomes to increase in 2010.

## Effect on spending

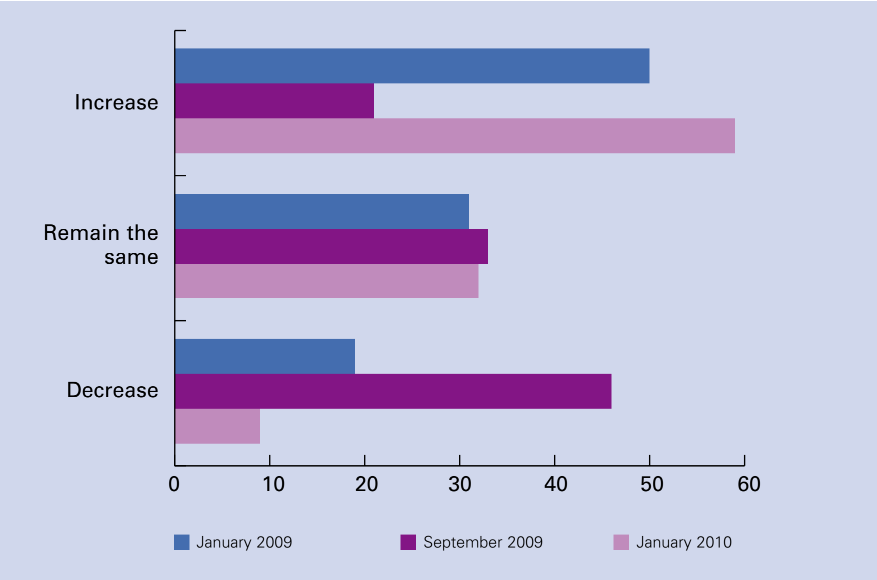
As a further sign of this relative confidence, 44 percent of respondents to our survey said that despite the downturn, they expected to spend the same or more on luxuries. This sentiment was particularly strong in Shanghai, with 27 percent expecting to increase their luxury spending, and 29 percent of 25-29 year olds expecting to spend more on luxuries.

4 National Bureau of Statistics
5 TNS qualitative study focus group

### Q: To what extent do you expect the global financial crisis to affect you in 2010?




### Q: How do you expect your income to change this year compared with last year?




This confidence appeared particularly strong in early 2010, as Sandy Chen, Research Director from TNS, notes: "During the recent Chinese New Year holiday, flights from Shanghai to Paris were fully booked out by Chinese tourists, many of them looking to make luxury purchases. In Hong Kong, high-end shopping streets were packed with Chinese tourists. Several stores such as Louis Vuitton had Chinese visitors lined outside the entrance as they struggled to cope with the level of interest."

This is not to ignore, however, that 38 percent of respondents said they expected to cut back their luxury spending because of the economic situation, with respondents in tier-two cities seeming less confident than those in tier-one. Given that the overall desire for luxury has increased, there seems to be a clear link to the downturn, and evidence of basic economising rather than a turn away from luxuries. Luxury retailers, including several featured in this report, talk of continuing high demand in tier-two and even tier-three cities.

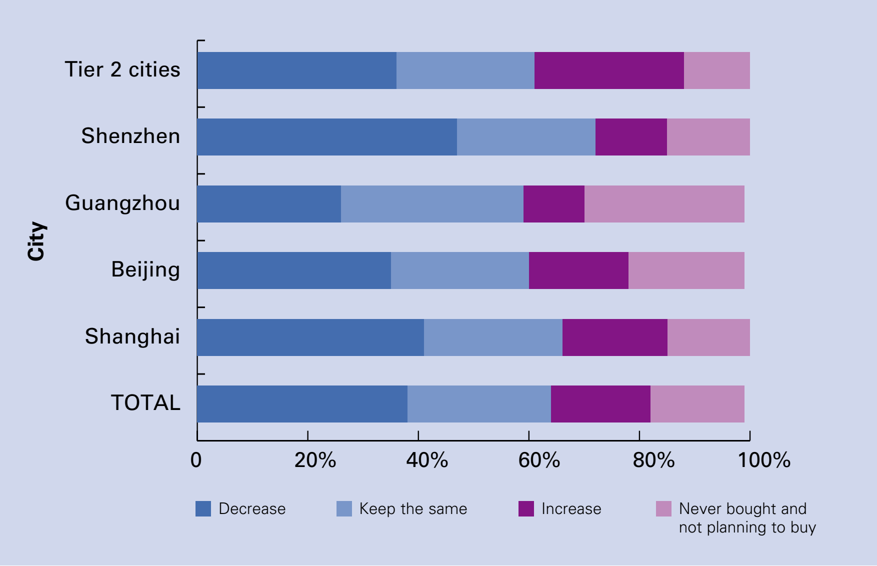
While remaining confident of medium- and long-term growth, retailers may need to maintain flexibility in their operations in order to deal with potentially unpredictable spending trends while the economic situation plays out over the coming year or so.

## Some things can wait – others can't

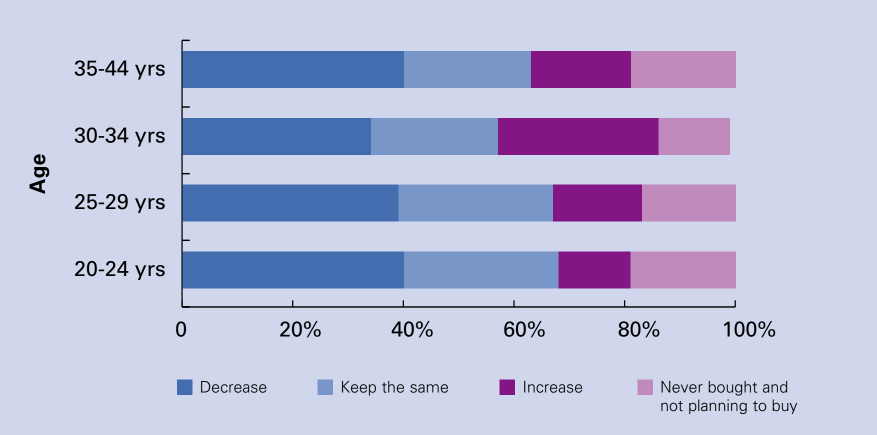
Looking through the responses, certain categories appear to face greater pressure than others, particularly those involving relatively high-cost, infrequent purchases. For example, many respondents said they would cut back spending on watches, jewellery, and luxury eyewear. People are more likely to either abandon or at least delay such rare purchases until their economic situation appears more positive.

Demand for 2008's most popular category, bags, appears to have weakened in this year's survey, with 37 percent of respondents reporting they expected to cut back spending on bags. Either they are happy to make do with what they have already or they would rather put their money towards other luxury purchases.

**How do you expect your spending on luxury to change?**




**How do you expect your spending on luxury to change?**

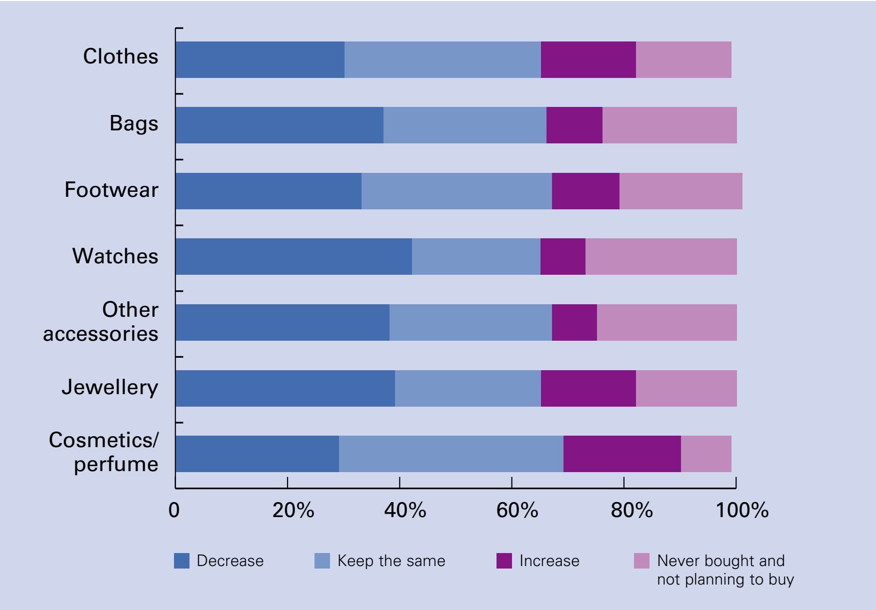



Respondents were noticeably less willing to cut back on cosmetics and perfume, with women showing a particularly strong desire to maintain or increase their luxury spending in this category. Sixty-one percent reported that they expected to spend the same or more on cosmetics items, the highest such rating across all the categories. This is mirrored in the responses on buying intentions, with 51 percent of women reporting they would probably or definitely buy cosmetics/perfume in the coming year – the highest positive rating in any category.

*"Millionaires are 15 years younger than their counterparts outside of China, and their wealth is growing more rapidly."*

*- Rupert Hoogewerf, Hurun Report*

**How has your demand for different product categories changed?**




## Connoisseurship trumps economising

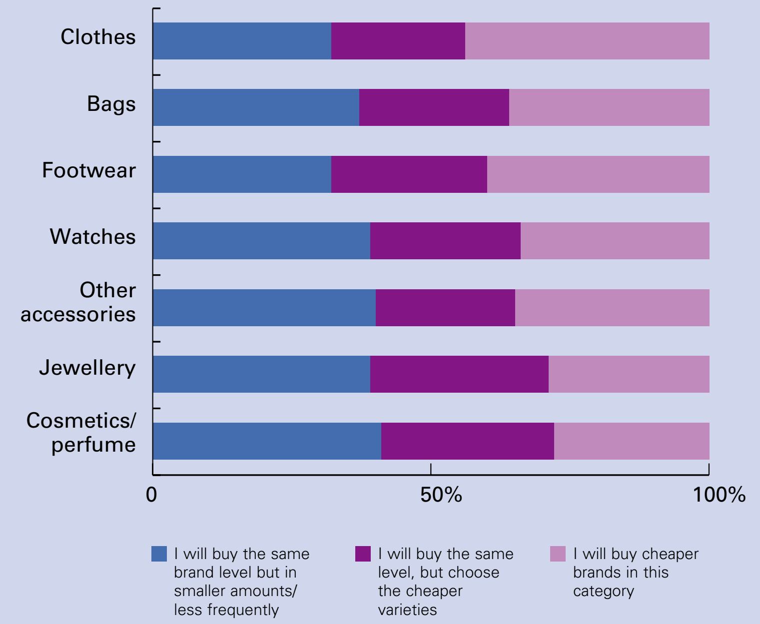
Consumers who have decided to spend less on luxuries face a number of options in reducing their spending. They could choose a cheaper brand or brand level for the goods they wish to buy, or they could stick with the same brand but simply buy less, buy less frequently or buy cheaper alternatives within the same brand level.

Across categories, those surveyed responded overwhelmingly that they would rather stay with the same brand level than switch to a cheaper one, suggesting that Chinese consumers have become accustomed to their higher level, higher quality brands and are not willing to accept cheaper substitutes.

This trend was particularly marked in cosmetics/perfume and jewellery, with 72 percent and 71 percent reporting they would not switch to a cheaper brand level. As more frequently purchased consumables, brand loyalty in these categories can prove incredibly valuable.

This marks an important stage in developing a luxury consciousness. The appreciation of a brand's quality, prestige and value – connoisseurship – is now more important than simple economic concerns. In 2008, we noted that many Chinese consumers were meticulous in the way they researched and selected luxury goods. This year's findings suggest that once customers have decided

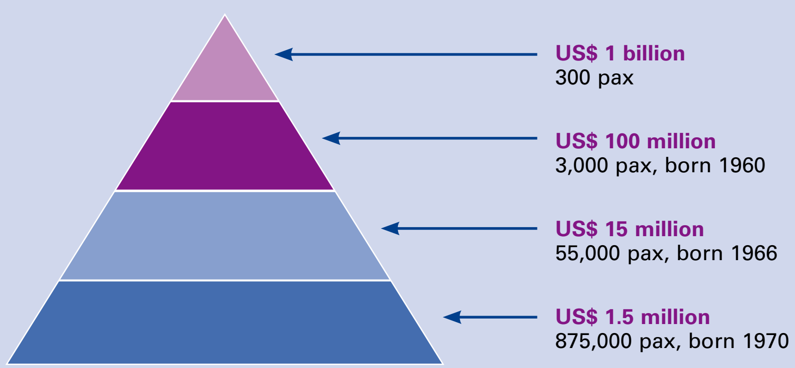
### Changing purchasing habits in light of the downturn (by product)




on their brand preferences, they commit to them and are not easily swayed by cheaper alternatives, even when they feel they have to cut back a little. Time and effort spent educating and persuading China's middle class about the heritage, quality and uniqueness of the brand can pay handsome dividends in brand loyalty and attachment.

The expanding number of millionaires and billionaires suggests that connoisseurship will continue to grow in importance. "The number of Chinese millionaires rose by 6.1 percent last year," says Rupert Hoogewerf, founder of the Hurun Report. "This has been driven by a rise in property prices, the recovery of the stock market and a generally strong Chinese economy. These individuals are, on average, 15 years younger than their counterparts outside of China, and their wealth is growing more rapidly. The male-female ratio is seven to three."

### Size of market – China's rich & super-rich




Source: 2010 Hurun Research Institute

# Building beyond first base

## Tim King, Alfred Dunhill Ltd.

A quintessentially British brand with a presence in Asia stretching back to the 1960s, Dunhill has found a receptive market in China. This can be largely attributed to its focus on men's apparel and accessories, supported by a strong brand story emphasising heritage and connoisseurship. Dunhill has sought to tap this enthusiasm for connoisseurship through its marketing efforts, most notably through its "home" store located in a 1920s villa in the old French district of Shanghai. The store (owned by parent company Richemont) is fitted out with high-end products to showcase Dunhill's craftsmanship, heritage and quality.

Dunhill's reach extends well beyond Shanghai, however. "We officially entered the China market in 1993, with stores in Shanghai, Shenzhen and Guangzhou operating through franchise arrangements," says Tim King, regional managing director of Alfred Dunhill Ltd. "It was a slow steady build-up, but over time our attention shifted further north as we discovered a strong appetite for our leather and apparel products in cities such as Beijing, Shenyang, Harbin and Dalian."

For many years Dunhill thrived through this franchise arrangement, which brought together a Hong Kong investor, a PRC investor and another private individual investor with commercial experience in China. At a certain point, the company realised that it needed to take a share of the market with greater control over its products. Today Dunhill directly owns 42 stores across 14 cities, while a further 48 stores in 30 cities continue to operate through franchises.

"In China, it's either about retail, or franchise retail, which means heavy investment on distribution," says Mr. King. "There is much room to expand through this model, but I expect other approaches will become more important to us over time, such as consignment models using department stores or through partnering arrangements with specialist dealerships."

The balance between wholly-owned and franchise arrangements requires additional investment to ensure consistency in the retail experience. "The franchises are very receptive to our advice and in return they share valuable feedback on the trends in their local market. I think we have developed a good system to reward franchise partners that maintain and exceed our high standards. That helps us ensure that the product mix and retail experience is consistent across all our stores in China."

Mr. King is also keen to see some of these franchises expanding beyond their initial city of strength and targeting further second- and third-tier cities. Indeed, many have the financial means to expand and will come to the company with their own proposals to enter new markets, although quality of the retail environment remains a key consideration for Mr. King. In the past two years Dunhill has taken over ownership of the franchise outlets in certain cities including Tianjin, Chengdu, Hangzhou, Kunming and Chongqing.

Dunhill has not escaped the economic downturn but has seen business rebound strongly since the middle of 2009. "There was a tough six-month period for us from the 2008 Olympics through to March of 2009, but our sales have really bounced back since then," says Mr. King. "There has been some belt-tightening, which is highlighted by lower sales size per-transaction in the early part of the year."

Chinese consumers continue to travel and Dunhill makes a point of sharing information on purchasing trends among Chinese visitors to shopping centres such as Hong Kong as this can be a way of influencing the merchandising process for stores across the mainland. The information is also shared with Duty Free buyers, another increasingly important sales channel for the company.

# Prized and precious

**Kent Wong, Chow Tai Fook**


Chow Tai Fook (CTF) celebrated its 80th year by expanding its reach to 1,000 stores across China at the end of 2009. From its start back in 1929 in Guangzhou, CTF moved to Macau and then Hong Kong before expanding across the mainland in the late 20th century.

The mainland market has taken on increased importance for CTF, particularly as Hong Kong has suffered to a greater extent from the global downturn. Visits from mainland tourists continue to increase – as does their buying power and their appreciation of quality.

Kent Wong, Managing Director, recalls that not too long ago CTF's "fixed price" model met with significant resistance. "This has been a real change in mindset in tier-one and tier-two cities. Customers are no longer fixated on sale items and discounts - they recognise and appreciate the quality we provide and the appropriateness of the pricing structure." Mr. Wong is confident that this shows the power of branding and the potential to establish strong brand loyalty.

This model is holding up in the downturn. High gold prices have had an impact, but by contrast, diamond and jade have seen a surge in popularity. Mr. Wong freely acknowledges that watches and jewellery have taken a hit, but says that during the latter half of 2009 even these categories began to rebound encouragingly.

Mr. Wong believes CTF's strong growth owes a lot to its exclusive image, a position strengthened by its recent acquisition of "The Cullinan Heritage", a flawless, 507-carat diamond bought for HKD 275 million. CTF balances this prestige exclusivity with a diverse offering to target different customers: "We've got our flagship gem stores and our jewellery focus in department stores; but we've also expanded to specialist 'concept' stores to target younger consumers seeking 'trendier' items. Tastes are always evolving and we need to reflect that."

This extends to further alternative marketing channels. "We've recently opened our internet sites to direct sales" Mr. Wong explains. "Day to day, we see the massive importance of the shopping experience – our customers really enjoy being in the store – but with so many web users in China browsing, communicating, researching and shopping, we need to make sure we can connect with our customers wherever they are."

While maintaining ownership of the brand, CTF has adopted a franchise model for most of its operations. "Finding a good partner is crucial. Speaking of China as a single luxury market is naive – each city tier, each city itself has a different character, and even within a geographical boundary, we need to target our different segments carefully."

Cooperation with department stores has proved a useful source of market research to help monitor consumer trends and preferences. In addition to this, CTF's 20,000-strong VIP membership scheme enables it to keep up to date with its most loyal customer base. "Our customers are like family" says Mr. Wong," and we treat them as such."

But the customer relationship is crucial throughout the retail experience. "Training our staff is paramount – they are ambassadors for the company, its products and its culture. We strive to provide our customers with a personal, dedicated experience."

At present, 90 percent of CTF's management is localised. "It's a challenge to recruit and retain the best, but we have a strong brand culture in everything we do," explains Mr. Wong, "and we are delighted with the buy-in we've seen from our local staff."

Looking forward, Mr. Wong and CTF see great potential in central and western China. "Our initial focus was on the tier-one cities, but we're now fairly well spread across the mainland." With the development of mining and precious metals, Mr. Wong says western China is really opening up now. "We're seeing a market driven by domestic demand and domestic trends. China's luxury consumers are developing their own distinct identities, and our challenge is to meet their demands and expectations."

# Luxury consciousness in China

In our previous reports in 2006 and 2008, we highlighted the four main angles of luxury appreciation on an axis of conformity/individuality against ownership/experience: individuality; status; connoisseurship; and indulgence. This year's survey has shown consistent belief that luxury consumption can be a mark of high quality of life and good taste, while only 14 percent of the respondents said they saw luxury goods as a waste of money.

Nevertheless, with economic uncertainty in certain parts of the country during 2008-2009, luxury consumption needed to show its utility more than before – either functionally or emotively. Both are shown in the results of this year's survey: the functional drive of purchasing luxury "for important/formal occasions" continues to rank highly, while the emotive needs of self-reward and self-pampering have risen significantly. For men, using luxury to reward themselves has even surpassed the functional need "important/formal occasions" as the most important motivator. For women, the gratification needs of self-reward and pampering also rose far more than other needs.

### Male/female reasons for buying luxury goods

| | | Male | Female |
|---|---|---|---|
| 01: | To reward myself | 46% | 62% |
| 02: | To pamper myself, treat myself well | 27% | 62% |
| 03: | For formal occasions | 41% | 43% |
| 04: | To reflect my personality | 37% | 43% |
| 05: | To enhance my self confidence | 37% | 35% |
| 06: | To enjoy luxurious, high quality lifestyle | 38% | 31% |
| 07: | To reflect special taste and discernment | 36% | 31% |
| 08: | To pursue classics | 30% | 34% |
| 09: | To pursue fashion/trends | 27% | 35% |
| 10: | To represent social status and wealth | 33% | 29% |
| 11: | For value maintenance or appreciation | 28% | 29% |
| 12: | To stand out from the masses | 28% | 23% |
| 13: | Because of work necessities | 27% | 23% |
| 14: | To enjoy the ownership | 21% | 20% |
| 15: | For connoisseurship or collection | 20% | 18% |
| 16: | In order to fit in within social circles | 18% | 17% |

## Now it's personal

Though in some ways reacting cautiously to the downturn, with many set to rein in their spending a little, a clear flipside is that consumers appear to be more willing to pamper and reward themselves. As we go forward, it will be interesting to see whether this is a longer term trend or a "feel good" boost to counteract the current gloom surrounding the global economy.

While the desire to reward oneself was also the top answer in "reasons for buying luxury goods" in 2008, its response rate in 2009 went up from 44 percent to 54 percent. This rise was particularly strong in women (46 to 62 percent), highlighting the importance of female consumers in driving trends. The older group, 35-44 year olds, recorded a significant rise of 16 percentage points (from 36 to 52 percent), as did 25-29 year olds (from 40 percent to 56 percent).

A similar trend can be observed in the desire to pamper oneself – which jumped from 36 percent to 44 percent, with men and women registering 6 and 7 percentage point rises respectively. This saw pampering/treating oneself leap from sixth place to second in the overall ranking of purchase motives, making the top two all about being good to oneself.

This reaction suggests that luxury is providing both incentives and comfort for China's luxury consumers against a backdrop of economic uncertainty. Looking through the ranking of all purchase drivers, the top six (with the exception of important/formal occasions) are about personal choices and feelings. Back in 2008, consumers placed a high importance on reflecting taste and discernment (a relative, social value) and pursuing classics, with more personal/emotive motivators taking up only three of the top six places.

That is not to say these are no longer important – they clearly are, and the response figures are similar – but that they are currently taking a backseat to personal emotion and experience of luxury.

**Reason for purchasing luxury goods**

| 2009 | | Rank | 2008 | |
|---|---|---|---|---|
| To reward myself | 54% | 1 | To reward myself | 44% |
| To pamper myself, treat myself well | 44% | 2 | For some important/formal occasions | 43% |
| For formal occasions | 42% | 3 | To reflect my personality | 42% |
| To reflect my personality | 40% | 4 | To reflect special taste and discernment | 40% |
| To enhance my self confidence | 36% | 5 | To pursue classics | 38% |
| To enjoy luxurious, high quality lifestyle | 35% | 6 | To pamper myself, treat myself well | 36% |
| To reflect special taste and discernment | 33% | 7 | To enjoy luxurious, high quality lifestyle | 36% |
| To pursue classics | 32% | 8 | To enhance my self confidence | 32% |
| To represent social status and wealth | 31% | 9 | To pursue fashion/trends | 29% |
| To pursue fashion/trends | 31% | 10 | To represent social status and wealth | 25% |
| For value maintenance or appreciation | 28% | 11 | To stand out from the masses | 24% |
| Because of work necessities | 25% | 12 | Because of work necessities | 22% |
| To stand out from the masses | 25% | 13 | For value maintenance or appreciation | 22% |
| To enjoy the ownership | 21% | 14 | For connoisseurship or collection | 19% |
| For connoisseurship or collection | 19% | 15 | To enjoy the ownership | 19% |
| In order to fit in social circles | 18% | 16 | In order to fit in social circles | 13% |

In our previous studies, we explored the emergence of China's middle class luxury consciousness. This year, we can see these attitudes showing continuity and solidity. While there are interesting shifts in certain aspects, China's middle class consumers are beginning to show greater consistency in their attitudes to, and appreciation of, luxury.

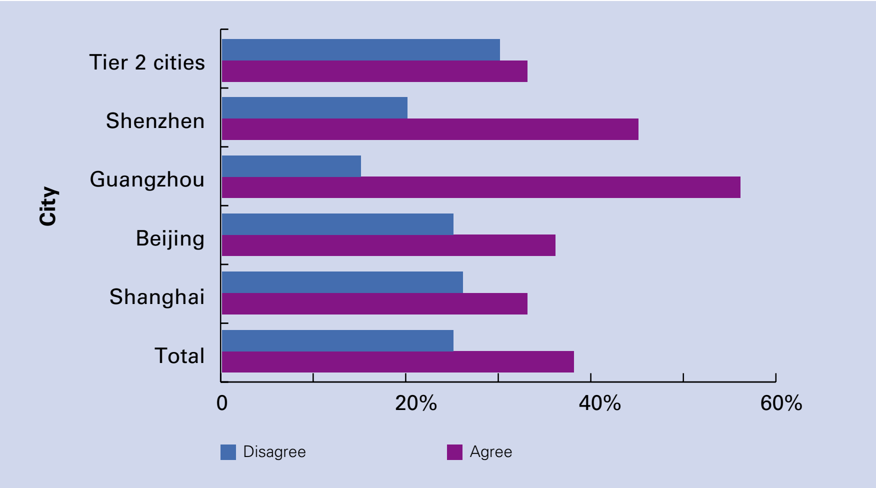
| Attitude | 2009 | 2008 |
|---|---|---|
| I appreciate the superior quality of luxurious brands, not simply the famous brand names | 64% | 69% |
| Luxury brands don't need to be recognised by the mass but should be appropriate for one's own personality | 63% | 69% |
| I long for luxury goods but I can't afford them now | 41% | 49% |
| Compared with purchasing luxury bags and clothes, I prefer to spend money on luxury experiences such as travelling abroad, playing golf, going to premium hotels to enjoy a spa, etc., etc. | 38% | 38% |
| I am practical and not willing to pay for the premium claimed by luxury goods | 35% | 31% |
| Only those brands of high awareness can be called luxury brands | 34% | 40% |
| I don't like to show off, so I would not buy any luxury goods | 27% | 23% |
| If I owned some luxury goods, I would be reluctant to use them because they are too expensive | 20% | 21% |
| Only those brands known and appreciated by the minority can be considered as luxury goods | 18% | 23% |
| The luxury goods used by celebrities are a good reference when making the decision to buy | 16% | 11% |

## Luxury is an experience

In our 2008 report, we noted the rise of the "indulgence" factor in China's consumer market. This is confirmed clearly in tier-one cities in this year's report, with rises in all four in terms of preferring to pay for luxury experiences rather than bags and clothes. Guangzhou saw a huge leap from 36 to 56 percent.

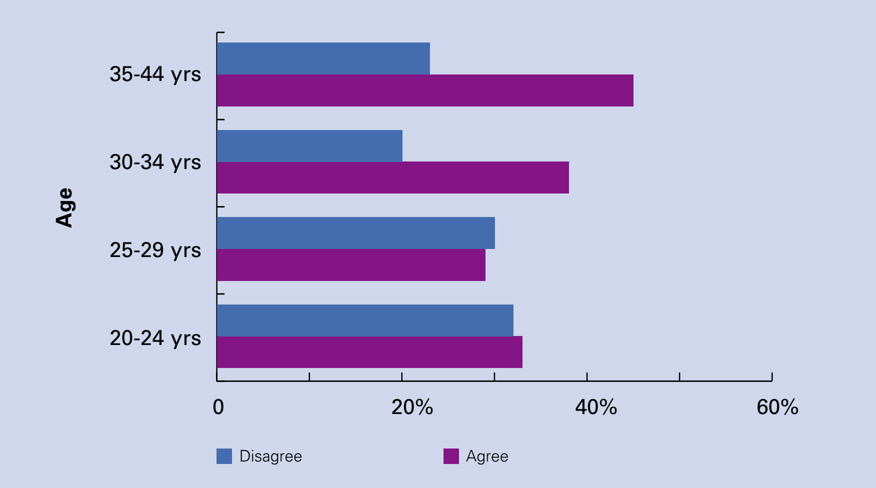
"China's super-rich are looking for one-of-a-kind experiences, and luxury offerings are increasingly stepping up to meet this demand," says Kunal Sinha, executive director with Ogilvy and Mather in Shanghai. "This is evident across hospitality, entertainment and recreational sectors. In the run-up to the 2010 Shanghai Expo, some 11 luxury hotels with over 3,250 rooms will open their doors. In addition, boutique hotels, and exclusive, themed tours and clubs are emerging to offer truly unique experiences, adding a further dimension to the luxury market."

**"Compared to simply buying goods, I prefer to pay for luxury experiences"**



There is a marked difference between older (30-44 year-old) and younger (20-29 year-old) segments, in terms of preferring to pay for luxury experiences. This again conforms to the luxury consumer scale we defined in 2008: as consumers

**"Compared to simply buying goods, I prefer to pay for luxury experiences"**




move along the curve from conformity to individuality, luxury experiences offer greater potential for unique, personal enjoyment. Older consumers are more likely to have fulfilled lower order "belonging" needs such as conformity, moving into higher order, individualistic fulfilment rather than mere accumulation of physical products.

*"China's super-rich are looking for one-of-a-kind experiences... This is evident across hospitality, entertainment and recreational sectors."*

*- Kunal Sinha, Ogilvy and Mather*

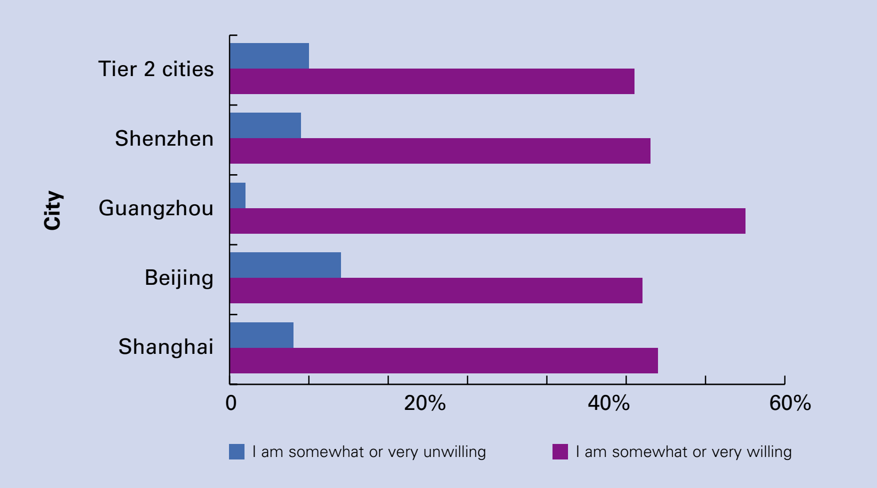
This premium accorded to experience is not limited to buying luxury holidays or outings; it is a fundamental part of making a luxury purchase. In drivers for paying a premium price for luxuries, a good shopping environment ranks more highly than it did last year, though its percentage is similar. It now ranks even more highly than "Exclusive image" – a further reflection of greater emphasis on the personal experience of luxury rather than something defined simply as different from the masses.

Combined with the continued high importance of after-sales service, this highlights the importance of recruiting, training and retaining the customer service staff that can not only meet but exceed the expectations of their discerning and demanding customers. This also has an impact on the continued importance of prestigious flagship stores, despite some rising interest in outlets (see page 26).

High quality continues to be the top-ranking factor in paying the luxury premium – brands cannot trade on their name alone, they must back it up with quality, duration and the confidence/promise of an extended warranty. Consumers are not simply interested in having luxury goods as trinkets to be admired, they want them to be able to stand up to repeated use and to last.

There is still considerable interest in paying a premium for goods that are fashionable, popular and famous, but these figures show a geographic change from our 2008 report. At that time, respondents in Shanghai and Beijing were more willing to pay for fashionable items. The importance of celebrity endorsements ranked surprisingly low. In this year's report, respondents in

**Willingness to pay a premium for goods that are fashionable**




| Drivers for paying a premium | | | | |
|---|---|---|---|---|
| 2009 | | Rank | 2008 | |
| High quality and long duration | 83% | 1 | High quality and long duration | 86% |
| Very good after sales service | 77% | 2 | Very good after sales service | 79% |
| Long warranty | 75% | 3 | High uniqueness | 75% |
| High uniqueness | 71% | 4 | Long warranty | 72% |
| Very good shopping environment and service | 65% | 5 | Long heritage | 67% |
| Environmentally friendly product | 64% | 6 | Exclusive image | 67% |
| Company's social responsibility | 63% | 7 | Environmentally friendly product | 64% |
| Long heritage | 63% | 8 | Company's social responsibility | 64% |
| Exclusive image | 63% | 9 | Very good shopping environment and service | 63% |
| Very popular and famous | 58% | 10 | Very popular and famous | 60% |
| Very fashionable | 54% | 11 | Very fashionable | 55% |
| European origin | 30% | 12 | European origin | 31% |
| Celebrities as spokespersons | 25% | 13 | Celebrities as spokespersons | 19% |
| American origin | 22% | 14 | American origin | 19% |

Guangzhou now appear most willing – a jump from 52 to 65 percent; there was a similarly large rise in positive responses in Shenzhen. By contrast, Shanghai, Beijing and tier-two cities have all seen slips in the rates of respondents citing fashionability as a driver for buying luxury goods. It remains a driver, but brands need to appeal to consumers' individual ideas and appreciation rather than simply building a "fashionable" image.

Environmental and ethical concepts continue to be important emotional drivers for luxury consumers in estimating the brands to which they aspire. This echoes general trends in increasing consumer consciousness and concerns of the environmental and CSR issues in China. With the Chinese government making some bold green commitments and environmental issues rising in the public consciousness, luxury brands can enhance their image by making the most of their environmental credentials.

## Branding luxury in China

China's economic growth and development has been accompanied by an increasing appreciation of and pride in aspects of Chinese culture. In this context, it is natural to wonder whether – and if so, to what extent – luxury brands need to localise their offering and branding.

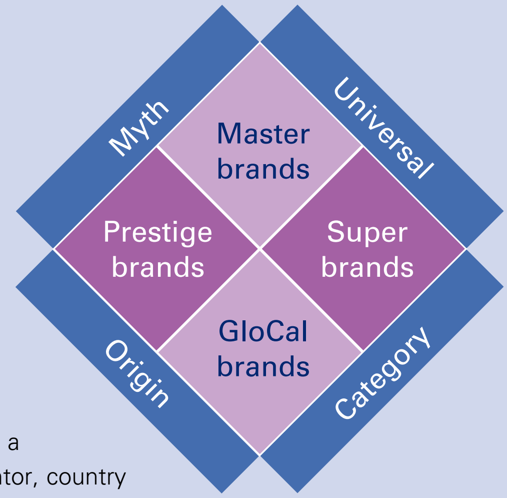
TNS divides brands and their attractions into four groups:

1) Master brands

2) Prestige brands

3) Super brands

4) GloCal brands




**First axis: Universal - Origin**

Some brands are perceived as universal: truly global and not related to a country of origin, while for others, the origin - the brand's source/inventor, country or home market - is especially important.

**Second axis: Myth - Category**

With this axis, some brand positions are based on a signature Myth or narrative; while at the opposite end are brands that are more defined by the rules of the category of product or service in which they operate.

From these positionings, consumers develop different expectations of how each type of brand should make a connection at the local level.

Luxury Brands such as Chanel, BMW, Rolex and Gucci are Prestige brands, with a strong appeal built on their cultural origin or provenance. For example, the quality perceptions of a brand like Mercedes are underpinned by pervasive beliefs about German design and engineering excellence.

- These brands are nearly always in strong display categories with high aspirational value.
- They embody the "best buy" in the category.
- They are associated with status and power.
- Affinity is built on heritage, innovation, and prestige.

Such "Prestige" brands need the least degree of localisation – their appeal is anchored in their origin and the quality perceptions that come with it. Translation and adaptation for local markets could even decrease their appeal. As such, these luxury brands may be best advised to avoid overt localisation in their design in order to better maintain their defining international myth.

**A Chinese luxury brand?**

Given this, can we expect to see major Chinese luxury brands emerge in the near future? While there is no stand-out international Chinese luxury brand as yet, premium brands from China, such as Shanghai Tang, are finding increasing popularity.

With most Chinese brands, their relatively short lives means that none of them have yet developed to the extent that they could be classified as "Prestige" brands based on a classic heritage. Nor do they have the provenance or myth to try to enter this elite group. The idea of a Chinese luxury brand, though entirely conceivable, thus remains some distance away. However, there is a much greater possibility for "Prestige" branding in areas associated with Chinese culture and history – for instance, there already are some strong premium *baijiu* (Chinese white spirit) brands in China.

# The China segment

## Allison Pyrah, Swarovski

If Allison Pyrah at Swarovski had one word to describe the change in the China market over the last two years, it would be confidence. "The self-confidence of Chinese consumers has now really come through, in their awareness of different products and how to put them together to define their own style," she says. "China is now a top-tier market, a major segment that is shaping the strategy for Swarovski globally. The product mix we need for China is also moving up-market."

Swarovski expanded its footprint to over 150 stores around China during 2009 and has continued growing despite feeling some effects of the global downturn. "We had a slightly tougher time of it in 2009, but we have been less affected than many companies because we have so many price points," Ms. Pyrah says. "Our spread across China also helped. Many cities were completely unaffected, while our stores in Hong Kong were to some extent carried through by the continued buying of mainland visitors."

Chinese consumers are travelling so much now that Swarovski is building its brand in order to enhance sales across all locations, not only within China. Chinese tourists are having an increasingly significant impact on sales in many other parts of the world.

Another recent development for the company is the launch of a range of watches, with Chinese supermodel Zhang Zi Lin brought on board as a brand ambassador. For Ms. Pyrah, this was significant in many ways; "This is the first time we have brought on a celebrity endorsement specifically to promote our watch line," she explains. "The fact that this is the only market where we have a local brand ambassador shows just how seriously we now take China."

In a crowded market, Swarovski has continued to enjoy a very well-defined brand position. Nevertheless Ms. Pyrah has seen some competing fashion jewellery brands coming into China. She observes that consumers still have a preference for European brands, but she is under no illusions about the potential for that to change rapidly. "A number of Chinese and Asian designers have made it big in New York or Europe and they are now coming back to Asia and gaining popularity. Maybe it is because they understand a certain aesthetic, but in any case I see this as a trend; it could be the start of the rise of domestic luxury brands," she says.

China presents some familiar challenges as well, such as in training and retaining staff. For Ms. Pyrah, the key to this is rising expectations. Employees' expectations are rising, along with the customer's expectations for a high-quality retail experience. The result is that the cost of fitting out retail outlets continues to rise. Ms. Pyrah believes the quality of retail experience has to be aligned across all cities. "The quality of retail properties in second- and third-tier cities has improved vastly with fabulous landscaping, decor and infrastructure so there are no excuses," she says. "On our part we need to use our best quality fittings in our stores, regardless of location."

Swarovski has been in China for many years and continues to develop a loyal following. Ms. Pyrah has been fascinated to watch this following develop a virtual presence through websites and dedicated blogs. "We don't necessarily harness or participate in these sites ourselves, but we do have to think about how we respond and how we keep track of what our customers are saying about our brand," she says.

This growing community of awareness, facilitated by the web, all seems to be contributing to that growing sense of confidence among Chinese consumers.

# Speed dial

## Helmuth Hennig, Jebsen & Co.

"For many global luxury companies, there is a sense of relief that China exists right now," says Helmuth Hennig, managing director of Jebsen & Co. in Hong Kong. "There was a bit of a stumble in early 2009 in China, but consumption has generally held up thanks to the stimulus measures and continued liquidity."

This is good news for Jebsen, the Hong Kong-based company which has grown from its origins as a shipping concern into a major distributor and importer of industrial products and consumer goods. The company acts as distributor for Porsche in China and also imports luxury yachts, carries numerous watch brands including Raymond Weil, and separately runs a major wine importing business, Jebsen Wine. These industrial and luxury products have an important feature in common: they all need to be imported in compliance with exacting regulations, and also require attentive and technical levels of after-sales service.

"Consumer markets that have taken a generation to develop elsewhere are emerging in a matter of a years in China; it is like these consumers are on speed-dial," says Mr. Hennig. "Take the market for luxury boats. There is an enormous amount of real estate development underway on Hainan Island in the south of China that is being accompanied by the development of several marinas. All of a sudden, wealthy consumers are looking for new ways to spend their money and enjoy their leisure time. For wealthy people in Beijing or Shanghai, this southern region of China is going to be the equivalent of the Cote D'Azur in Europe or the Caribbean in the United States. For our Porsche business, sales have really taken off, from just 40 units in 2002 to over 3,500 units in 2009."

Jebsen's watch business has evolved over a longer period and there have been some interesting learning points. A key dynamic is the continued importance of Hong Kong, due to its duty-free status. Hong Kong has always had a profusion of watch and jewellery brands for this reason, but now it is completely inter-linked with the mainland. Brand-building activity in China helps to strengthen sales in Hong Kong and vice-versa, so marketing strategies need to be aligned between the markets, as well as more widely across the globe. Mr. Hennig sees a 60:40 ratio in Jebsen's sales to China and Hong Kong, but even then a high proportion of the 40 percent in Hong Kong are sales to mainland shoppers.

Mr. Hennig sees Jebsen's position in the chain running from supply through to consumer. "We work with suppliers that need an outsourced partner for distribution and marketing," he explains. "We help to develop the entry opportunities and put complementary products together. We have very focused teams on the front end who understand the products and the branding, but behind that we have a shared, scaleable back end for logistics and invoicing."

The problems of logistics from a few years ago are no longer such concerns, in Mr. Hennig's view, due to the pace of infrastructure development. "It is now quite easy to run your business from selected distribution points," he says. "It is also getting easier to profile customers. The real challenge is that it is a very crowded market and consumers have to choose between a lot of brands which, from their perspective, are all quite new."

The logical extension would be to move more into retail and Jebsen is already doing so in some areas, for example, working with Porsche to develop a boutique Porsche Design store in Shanghai. "We don't ever intend to be a retailer as such," says Mr. Hennig. "We will continue to focus on our strengths in nation-wide distribution, building networks and understanding what brands need to succeed, and then helping them achieve that."

This is expertise that may continue to set Jebsen apart. "China will always set its own rules, whether it is in tax and customs regulation or in specific areas of product regulation such as labeling. One of our strengths is our understanding of how to navigate these issues in a country-wide distribution strategy. We can see recognition within China of a move away from reliance on the export-oriented economy and we have no doubts about the potential for growth in its consumer markets," Mr. Hennig concludes.

# Wealthy Chinese cities: Beyond the first tier

With its massive population and fast-paced development, China is home to a growing number of wealthy cities beyond the well-known, tier-one cities of Shanghai, Beijing, Guangzhou and Shenzhen. The 12 introduced below form only a small selection, but give an impression of the scope of growing spending power across China's cities, with wealth driven from manufacturing, real estate, high-tech, finance, trade, and freight industries, amongst others.

### Zhengzhou

Adult population: 2.05 million

Population with monthly household income above RMB3,500: 0.99 million

Number of RMB millionaires: 15,200 (total for province)

Capital of Henan province; major transportation hub for central China; strong in manufacturing, textiles and agriculture; home to one of China's three futures exchanges

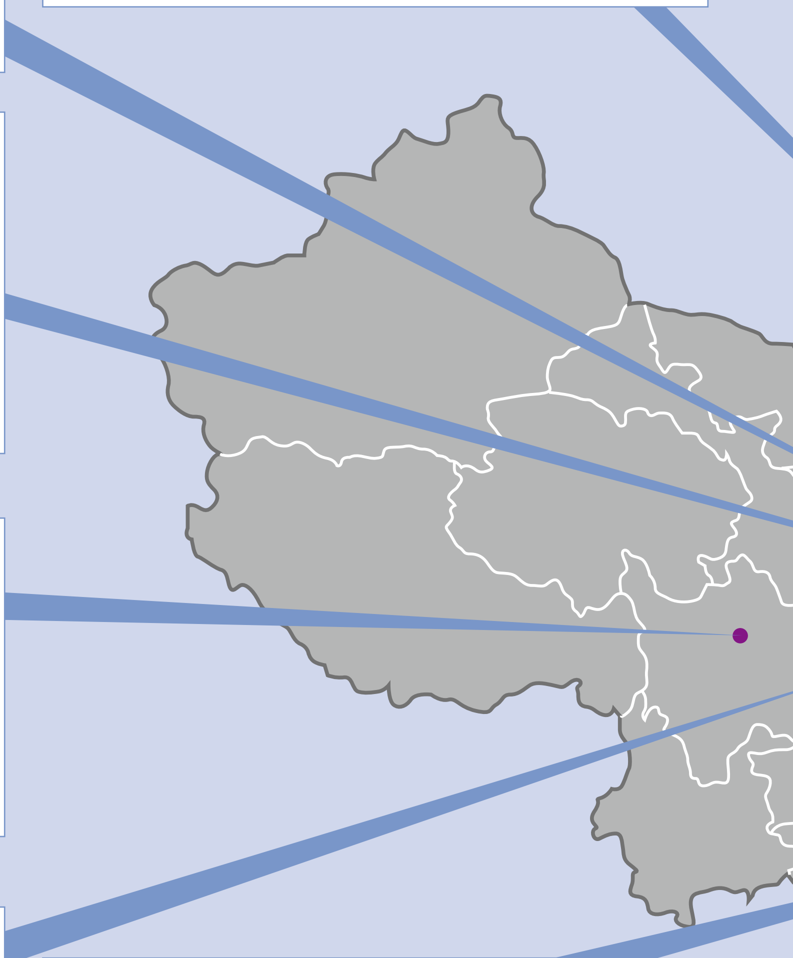
### Tianjin

Adult population: 4.55 million

Population with monthly household income above RMB3,500: 2.14 million

Number of RMB millionaires: 14,500

One of four provincial-level municipalities (with Beijing, Shanghai and Chongqing); an international port; strong manufacturing, including petrochemicals linked to nearby Dagang oilfields.



### Nanjing

Adult population: 3.15 million

Population with monthly household income above RMB3,500: 2.45 million

Number of RMB millionaires: 22,100

Capital of Jiangsu province, capital of China in previous eras; modern economy built on electronics, automotive, petrochemical and iron & steel, with a resurgent financial sector.

### Chengdu

Adult population: 3.32 million

Population with monthly household income above RMB3,500: 1.07 million

Number of RMB millionaires: 13,500

Chengdu is a popular gateway to the country's western regions, a regional financial centre and an increasingly notable hub for hi-tech industries.

### Chongqing

Adult population: 5.07 million

Population with monthly household income above RMB3,500: 2.02 million

Number of RMB millionaires: 9,700

The largest of the four provincial-level municipalities, and western China's largest inland port; well developed industrial base, especially in metals, minerals and petrochemicals.

### Xiamen

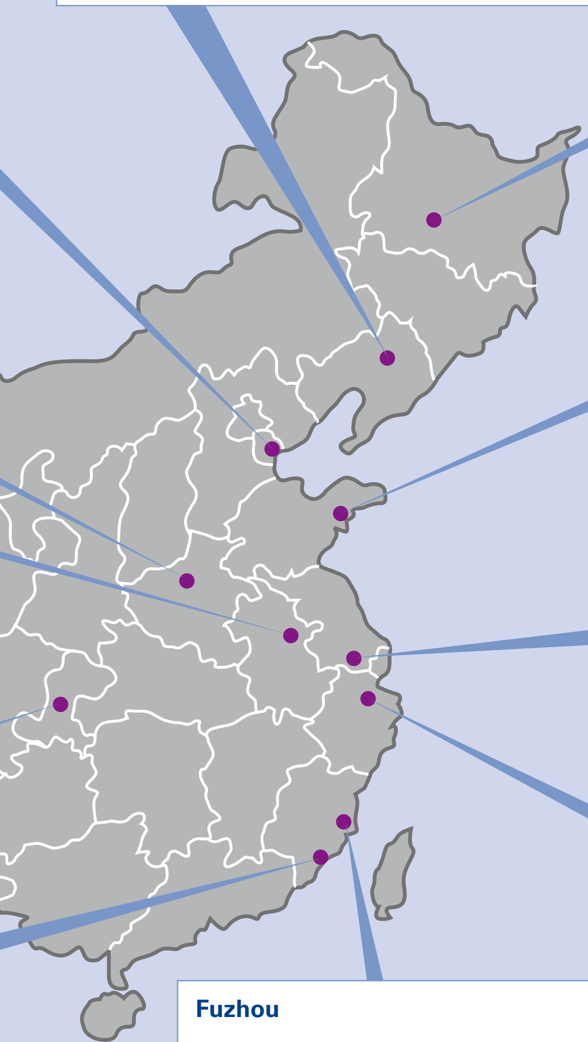
Adult population: 1.78 million

Population with monthly household income above RMB3,500: 1.14 million

Number of RMB millionaires: 11,500

One of the first five special economic zones established; a coastal port city looking out on the Taiwan Strait; consistently ranks one of the top 10 "most liveable" cities in China.

Source: TNS and KPMG research. Millionaire statistics provided by Hurun Report



### Shenyang

Adult population: 4.19 million

Population with monthly household income above RMB3,500: 1.47 million

Number of RMB millionaires: 7,660

Capital of Liaoning province; a trade and logistics hub for Northeast Asia, with direct rail links to North Korea and Russia; particularly strong in automobiles, aviation and energy.

### Harbin

Adult population: 3.23 million

Population with monthly household income above RMB3,500: 1.38 million

Number of RMB millionaires: 5,790

China's 10th largest city; a gateway to Russia and home to new and high-tech development zones; renowned for its winter ice-sculpture festival and multicultural architecture.

### Qingdao

Adult population: 2.25 million

Population with monthly household income above RMB3,500: 1.01 million

Number of RMB millionaires: 11,100

A major port and naval city, facing Korea and Japan across the Yellow Sea; home to the popular "Tsingtao" beer brand; host city for the Olympic sailing competition in 2008.

### Suzhou

Adult population: 1.17 million

Population with monthly household income above RMB3,500: 0.96 million

Number of RMB millionaires: 15,600

A popular tourist destination for its traditional-style architecture and UNESCO-listed gardens; historically renowned for its silk, now also a base for the hi-tech and pharmaceutical industries.

### Hangzhou

Adult population: 2.08 million

Population with monthly household income above RMB3,500: 1.88 million

Number of RMB millionaires: 47,300

Capital of Zhejiang province; strong in light industry, textiles, chemicals and hi-tech; just over an hour from Shanghai by train, with a faster Maglev line planned; its West Lake is a popular holiday spot.

### Fuzhou

Adult population: 1.62 million

Population with monthly household income above RMB3,500: 0.97 million

Number of RMB millionaires: 10,200

Capital of Fujian province; opened to foreign investment in 1984; a centre for chemicals and a port city on the Min river; nicknamed "Spa City" for its hot springs and famed for its lacquer products.

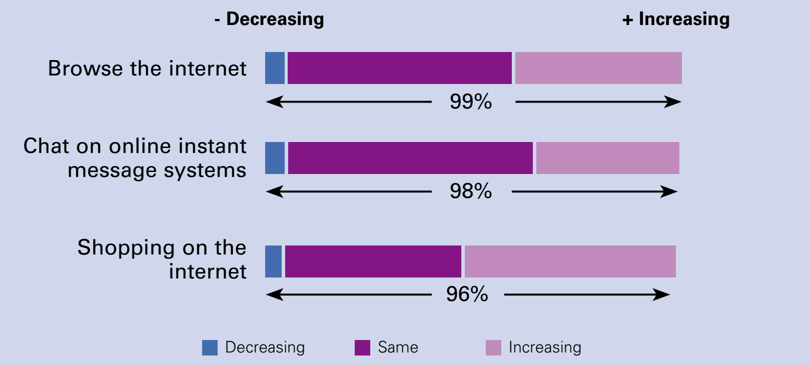
# Technology: Can mass media be exclusive?

While online luxury sales continue to rise globally[6], the continuing prime importance of the in-store experience as a driver for luxury in China means e-commerce may not be a pressing priority at present. However, our survey suggests there is scope to utilise mobile technology to personalise customer relationships, shape brand awareness and build customer profiles.

Technology has had a huge impact on retailing as a whole – in a 2008 study, KPMG International found that Asia scored highest for respondents feeling comfortable with using their mobile phones to make financial transactions – 64 percent were at least somewhat comfortable, compared with an overall level of 52 percent.

This increasing comfort with using technology for purchases is mirrored to some extent in our findings, with 43 percent of respondents saying they would be happy paying for general retail goods by mobile phone. However, for luxury products, this drops to 28 percent. With 39 percent registering little or no interest at all in paying for luxury by phone, the continuing importance of the retail experience in justifying the luxury premium is clear. Sixty-four percent of respondents rated the retail experience as a significant factor in their willingness to pay a premium for luxury goods. Plush, prestigious stores with attentive,

**Q: In 2010, what will you do more, and what will you do less?**




Note: The length of the bars above represent the proportion of consumers who undertook or plan to undertake that activity in either 2009 or 2010

6 "Luxury Goods Worldwide Market" study, Bain & Company, October 2009

knowledgeable sales assistants give shoppers a genuine sense that they are participating in something special. Consumers are pampered and enter a world of reserved, peaceful exclusivity that, they feel, gives them value for the money they pay.

But there is more to the impact of technology on luxury retailing than simply purchasing. As at 31 December 2009 there were 384 million internet users in China – more than the entire population of the United States. The depth of their usage and particularly the use of social media is also growing rapidly, with an estimated 46 percent of China's internet users active on social networks[7].

This social networking can be an important tool for luxury retailers in guiding and managing consumer sentiment about their brands. For instance, one in five Chinese consumers aged 18-44 will not purchase a product or service without first researching it online[8], suggesting companies not only need to ensure their own online presence boosts their brand, but also that they are managing their brand effectively to ensure that people are talking positively about it.

*"Consumers are looking for a seamless brand experience across multiple channels."*

*- Yolanda Wang, IBM*

A survey carried out by IBM showed that 78 percent of respondents said they would follow a favoured retail brand on a social networking site[9], offering scope to engage and encourage consumers on an ongoing basis. China's unique internet situation, where local offerings such as QQ, Renren and Sina dwarf more internationally recognised social networking names, will require international brands to develop a new vision of how to manage collaborative, web strategies.

Yolanda Wang, China Leader in IBM's Retail Centre of Competence, believes a strong, multi-media brand presence is an essential component of any consumer-focused campaign: "Our findings suggest consumers are looking for a seamless brand experience across multiple channels. For luxury retailers, this could mean using their online spaces to enhance the prestigious heritage value of their brands, whilst also offering retail scope for experienced consumers who already know what they like and want, as well as a quick-to-market reach to the newly rich in further flung parts of China."

Not only does this offer a more cost- and risk-effective approach than heavy capital investment, but in a fast-changing competitive environment, a direct online presence also allows luxury brands to closely control and assure the quality, content and exclusivity of an authentic brand positioning.

With the pervasive impact of communications technology in China – it tops the world for mobile phone and internet users – mobile devices offer great potential for fast-paced, interactive communications with customers. Besides simply information gathering, the application of mobile technology appears most focused on practical aspects; for example, 65 percent of consumers surveyed are positive about using SMS to make reservations and book tickets. This practical approach extends to receiving messages, with 57 percent registering their interest in receiving updates regarding new arrivals or limited editions by SMS. Such a service may be particularly useful for the most fashion-conscious (54 percent rate fashionability as a driver for buying luxury goods) and those who prize exclusivity in their purchases (63 percent of luxury consumers rate exclusivity highly).

7 *25th Statistical Survey Report on the Internet Development in China*, China Internet Network Information Centre, January 2010.
8 China's internet obsession, McKinsey, March 2010.
9 *Meeting the demands of the smarter consumer*, IBM Global Business Services, December 2009.

A common concern – also seen in responses regarding outlet stores – is authenticity. It is not surprising to see that 64 percent of respondents would be interested in validating the genuineness of their purchase through a simple, efficient SMS process. China's more than 702.65 million mobile phone subscribers sent 63.79 billion SMS in the first half of 2009,[10] suggesting a familiarity that would make such a procedure swift and easy.

**Online to in line**

Online marketing – especially the viral kind, quickly shared and spread via video-sharing sites and blogs – can play a significant role in driving up interest and demand, especially for special events or limited edition items. In 2008, Diesel Jeans launched an online marketing campaign to promote their 30th anniversary "Dirty Thirty xXx", including a world series of Diesel parties linked online.

This proved almost too successful in China, with one store in Beijing being so overwhelmed with eager customers for the limited edition jeans that police had to be called to manage the crowds.[11]

10 http://www.digitimes.com/news/a20090903PR200.html
11 Limited Diesel sale tamer than Beijing stampede, *South China Morning Post*, 13 October 2008

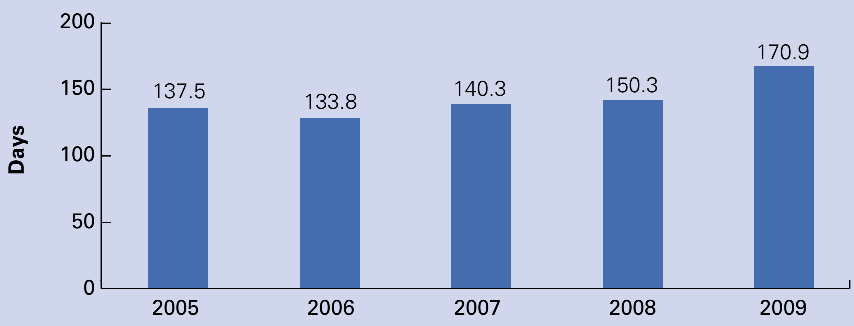
# Working capital challenges for luxury businesses

This year's survey reveals that even in a downturn luxury customers may be reluctant to trade down and purchase cheaper products or brands, and in many cases would prefer to just buy fewer or lower-cost goods from their preferred brands. This has implications for brands attempting to manage working capital, a challenge further complicated by the fact that many are still bullishly looking to expand in tier-two and tier-three cities.

Luxury companies, accustomed to focusing on products and sales, can tend to have weaker cash management systems than companies in other industries. In light of the global economic uncertainty, there is a risk of product over-supply either draining cash resources or impacting brand value. Many companies have become more cautious about working capital. Some have been quite clear in placing cash and working capital as their top priority, even at the risk of losing some sales.

This continues to be a difficult strategy to navigate in a fast-growing market like China and there are signs that companies have become less efficient in managing their inventory over the past two years. An illustration of this is the Days Inventory Outstanding for listed luxury retail companies in Hong Kong and China, which rose from 150 to 171 in 2009.

**Average Days Inventory Outstanding**




Source: Based on financial statements of listed companies in Hong Kong and China (on the Stock Exchange of Hong Kong Ltd., Shenzhen Stock Exchange and Shanghai Stock Exchange), as reported by Capital IQ.

The challenge for luxury retailers in China is how to continue to expand their product range and maintain strategic investment growth whilst efficiently managing their cash and working capital. It is clear that some companies have found themselves overstocked and have had to grapple with the dilemma of using private sales and outlets, or destroying stock.

## Outlets: Out of town, not out of mind

Out-of-town outlet malls have long been a staple of the American shopping experience – giving shoppers the chance to pick up relatively inexpensive brand name items, albeit possibly out of season or with a limited range or choice of size. By contrast, outlets are comparatively new to China, with major centres such as Shanghai Outlet and Foxtown in Shanghai and Scitech Premium Outlet Mall in Beijing still establishing their image and brand range.

In the course of researching this paper, some luxury retailers contacted indicated that outlets did not at present form a significant part of their plans for China. However, others saw them as a cost-effective means of disposing of over-stocked merchandise and generating cash.

From our survey, China's middle classes appear interested in outlets, but have not had much experience with them. Only 25 percent of respondents had ever visited an outlet store. Unsurprisingly, the highest figures came from Shanghai and Beijing, where the major outlet centres in mainland China are currently based.

There is a balance to the apparent low popularity of outlets in China. With many luxury retailers still trying to establish their brands as high-end exclusive offerings, the "discount outlet" option can undercut this prestigious image. This is supported by our survey respondents' high ratings for connoisseurship, quality, and high levels of service. Luxury needs to feel special, and prestigious flagship stores and higher-end department store locations are likely to remain the dominant shopping choice. This is further boosted by the fact that a solid 16 percent are certain they would be highly unlikely to ever shop at an outlet.

The reasons why Chinese consumers do not wish to shop at outlets gives an insight into what they value most in purchasing luxuries. The fashion-conscious are put off by the out of season products (39 percent), while almost one-third are concerned about the authenticity of products sold in outlets. Whether this is a fair reflection on the outlets is not as important as the fact that it points to the continued prestige accorded to the major stores, which remain important markers for the luxury market in China.

Despite all this, the attraction of outlets for consumers is obvious: price. In times of relative economic uncertainty, this can be a compelling message – 64 percent of those surveyed said they would be interested in shopping in outlets, while 20 percent said they would do most of their luxury shopping in outlets.

From a luxury retailer's point of view, outlets offer a useful way of turning out of season or over-stocked inventory into cash. This flexibility is more compelling in times of relative economic uncertainty, such as we saw during 2009. In addition, for certain product categories, the potentially un-refundable customs and VAT costs incurred in importing goods to China may make shipping unsold items back out to other markets expensive by comparison. Having an established presence in outlets provides a quick, convenient way of making the most of a company's stock, while also extending its reach to other areas of the market.

## Clear strategic management linked to cash and working capital is key

Cash and working capital management is a discipline that makes company leaders think about products. It makes them think about the cost and complexity in their product ranges and in their production processes. It also raises questions about supply chain design – and it is often rare to find a supply chain that cannot enhance a company's cash generating ability.

With this in mind, luxury market participants should consider the following points for managing their cash and working capital more efficiently.

**Gain visibility and control of cash flow:** Plan and control cash flow and understand fully the impact that different products, supply chains and distribution channels can have on cash flow. Use this control to make sustainable working capital improvement, exploiting the capabilities of technology.

**Work with, not against, suppliers:** The best companies that manage cash are those that work closely with their suppliers to optimise the delivery and settlement process. In some cases, they are working with their "at risk" suppliers to offer quicker payment terms in return for steeper discounts.

**Continue to invest, but be prepared:** Stress-testing cash flow forecasts and balance sheets can help a company fully understand the liquidity and financing requirements of new operations and its impact on the existing business.

**Corporate structure:** Consider a centralised cash management structure. Luxury groups tend to follow a decentralised operating structure, which can inhibit their visibility and control over cash. This is a particular concern in China as cash pooling is limited, meaning there can be a failure to optimise the group's liquidity.

# One to watch

## Denise Lo, Richard Mille Asia

China offers opportunities for genuinely niche brands, but in such a vast country, it is a wonder where to start marketing your products. Richard Mille is a Swiss watch manufacturer that produces barely 2,000 timepieces a year, with prices starting from RMB 400,000 per item. Already one-third of those timepieces are sold in Asia Pacific, with China and Hong Kong combined representing one of the largest markets.

Denise Lo is Managing Director North Asia for Richard Mille and has overseen the brand's breakthrough into China over the past year. Her company also carries the franchise of the Boucheron jewellery brand in Hong Kong and operates in China through a franchise arrangement with a partner.

"Our products are incredibly technical and exacting," explains Ms. Lo. "This has become a hallmark of Richard Mille. It is a testament to our exclusivity and high standards that we were recently invited to participate in the SIHH *(Salon International de la Haute Horlogerie)*, arguably Switzerland's most exclusive, invite-only watch fair."

The brand has opened two outlets in China. The first, in Plaza 66 in Shanghai, opened two years ago and a second opened at the Legendale (a recently opened five-star hotel) in Beijing in June 2009. Richard Mille stores typically have just four or five highly-trained staff but, as Ms. Lo explains, Beijing is something of a flagship and in total there are 12 people employed there.

The visibility associated with these locations is of course a great starting point, but Ms. Lo confides that interest in Richard Mille watches was gathering momentum even before these outlets opened in early 2009. "Word began to spread at high-society events and building awareness informally like this is also important for us," Ms. Lo notes.

Ms. Lo believes that demand for luxury products at the very high end has held up well over the past year. The numbers of millionaires and billionaires in China continues to multiply and the process of endorsing high-end products continues to cascade down through society. "In mainland China, there is a sense of peer pressure among the emerging elite," says Ms. Lo. "People want to be on a par with their contemporaries and display their good taste. Our consumers in Hong Kong tend to be a little more private. They are more like connoisseurs, and tend not to display their wealth on a day-to-day basis. Maybe that is an indication of the way things will develop in China, but I think it'll take time."

Richard Mille, the man behind the brand, is highly-regarded in the watch business, having left his previous company to set up his new brand only 10 years ago. This also presents an interesting challenge for Ms. Lo as Chinese consumers may look for heritage and a long track record as they seek to establish that sense of connoisseurship. The good news is while Richard Mille may be a young brand, the watches have held their value recently in watch auctions and Ms. Lo sees signs of a strong and loyal following.

Another attribute of Richard Mille is a strong association with Formula One motor racing, and the brand is endorsed by the Brazilian racing driver Felipe Massa. However, Ms. Lo feels the impact of such an endorsement may have limited appeal within China for now. For Ms. Lo, the challenge is to get the name out in the right circles and extend awareness in China's second tier cities. "Many second-tier cities have more than their share of millionaires," she says. "We cannot justify opening boutiques in all these cities so we have to find other ways of going on the road with exclusive events to present our products."

Appetite in China is growing, but for Ms. Lo the expectations are now dauntingly high. "For almost any brand globally, the next five years are going to be all about China," she remarks.

# Luxury destination

## Mark Lettenbichler, Ritz Carlton Group Hotels

Ritz Carlton Group began their China journey in 1998, and their progress since has been steady, focusing on the right deal, the right investor and the right location. Operating on a strict, 100 percent management basis, choosing the right partners in the right locations is even more important to building lasting success.

Mark Lettenbichler, Vice President, Area General Manager, Ritz Carlton Beijing, believes the brand has succeeded in establishing a strong connection to luxury living and he sees significant scope remaining in enticing local customers who are new to the luxury hotel experience. "Chinese consumers are aspirational. Many of them have never experienced luxury before, so we enjoy the challenge of surprising them with something unforgettable." Flexibility is therefore important here as well; "There's no one menu to fit everyone," he adds.

The global financial crisis has had an impact on Ritz Carlton's corporate business in China and that makes it even more important to target the domestic luxury consumer. The travel and entertainment budgets of multinationals have been hit, and the demand from Chinese corporate clients is not yet strong enough to make up for this shortfall. There are signs from global contacts and colleagues that this is slowly turning around, but the numbers for the turn of the year 2009-2010 will be a more obvious marker.

There are signs of increasing demand from Chinese corporations, however. Behaviour is already changing as competition drives up demand for luxury as an incentive for staff and customers, as well as a sign of prestige.

As a result, Ritz Carlton makes sure it focuses its offering to the local market, particularly as there is a strong willingness in Asian markets to use hotels for special events from weddings and birthdays to major delegations.

Customer profiling is tricky in an experience-based environment, especially since everyone enters Ritz Carlton hotels with a different level of expectations. "We collect 'guest preferences' so we know what our customers enjoy, and we try to isolate some common themes to guide our response," says Mr. Lettenbichler. "But ultimately, we want our customers' experiences to be unique, so we're always looking to go above and beyond."

Ritz Carlton sees its reputation in China as being an exclusive, prestigious global luxury brand. Its sales and marketing teams are focused on driving up awareness with Chinese customers and travellers. "This is a great time to do so," says Mark. "Not only is China an increasingly popular travel destination – a new Ritz Carlton Shanghai Pudong is opening in June 2010, just in time for the Expo in 2010 – but we're seeing a marked increase in appreciation for fine dining and fine wines. There's a groundswell towards greater luxury appreciation all over."

This growth brings its own challenges, and Mark recognises that there is growing competition, particularly in Beijing in the wake of the 2008 Olympics. "Everyone wants to make a big entry in China right now, so it's becoming a crowded market temporarily. In some ways that's good – it helps develop a 'luxury destination' feel, but it's important to do your homework before making investments. We're happy to take the time to select the right locations and partners."

Getting known beyond the big cities is a challenge. Ritz Carlton appears most well known in Shanghai, but the sheer size of the China market can complicate things, despite the wealth of opportunities it offers. "Some clients don't realise yet that we have a presence in other big cities, such as Guangzhou," Mark adds. Such is Ritz Carlton's confidence in the future of the China market, they are already looking at second- and third-tier cities. "It hasn't been easy to enter certain cities, but these developing cities will be the key emerging markets in the near future."

# Strategies in a strengthened transfer pricing environment

In building up their brand images in the emerging market in China, luxury goods companies have engaged in extensive advertising, marketing and promotional activities. These activities have attracted the attention of the Chinese tax authorities.

Brand-building promotional expenses are often associated with the creation of marketing intangibles. The definitive meaning of marketing intangibles is not always clear; however the term can include brands, trademarks, the local market position of a company or its products, distribution channels and customer relationships. With many luxury brands operating in China not yet profitable, the value of these intangibles is further clouded.

The tax environment facing luxury brands in China has recently changed dramatically with the introduction of new tax and transfer pricing regulations. To deal with these new challenges in transfer pricing, luxury brands will need to establish a clear and proactive strategy. Any such strategy will have to clearly define and validate the transfer of royalty payments, possibly using either a Cost Sharing Agreement or Advance Pricing Arrangement as a tool to mitigate taxpayer risk.

## Royalty payments in China's luxury sector

Royalty arrangements, where a licensor provides an established trademark or brand name for use in the conduct of a business to the licensee in return for a fee, can be economically and commercially justifiable depending on the particular circumstances of the financial relationship and brand usage. Even when royalty payments force a local entity into losses during its initial entry into the market, it may still be possible to justify these payments.

A circular released by the Chinese tax authorities in 2009[12] clarified the SAT's interpretation of royalty payments for proprietary knowledge. It defines a royalty payment for proprietary technology as involving "a technology licensor who agrees to license unpublicised technology to another party for free use, in which case the technology licensor usually does not participate in the specific implementation of the licensed technology by the technology licensee and does not guarantee the result of the implementation." This approach is similar to recommendations in Article 12 on royalty payments in the OECD Model Tax Convention.

12 Guoshuihuan Number 507, issued by the State Administration of Taxation

Chinese tax officials appear to be particularly concerned about the value of the royalties Chinese entities are paying to foreign affiliates for intangibles in the luxury goods market. Local tax officials assert that local operations should realise immediate profits if the recently-introduced brand name has value. Otherwise, they argue, Chinese affiliates may be overpaying for brand licensing. The tax authorities question whether these fees are often too high given the lack of luxury brand name recognition during the early phases of market entry in China.

As a result, China's tax authorities have intensified transfer pricing audits in terms of intangible asset transactions in recent years, especially regarding overseas royalty and licence fee payments. Recent transfer pricing circulars issued by tax authorities have also confirmed that they expect at least minimal profits to be earned by any single-function manufacturer, distributor, or retailer. For luxury goods companies dealing with continuing uncertainty from the financial crisis, this raises several additional considerations: single-function companies are not expected to share group losses in recessionary times, and a minimal routine profit is expected to be earned by Chinese affiliates to reflect their simple functional and risk profile.

In addition, China continues to discourage the payment of related-party management fees and has repeatedly challenged taxpayers on the validity of these charges. Many taxpayers have faced non-deductibility issues as a result. Companies with multiple related-party transactions occurring in multiple directions must interact with each other at arm's-length, and due to a lack of legislation allowing for consolidation for Chinese tax purposes, any significant related-party royalty payments and service payments may trigger further scrutiny and the potential for double taxation.

In all of these situations, the Chinese tax authorities put the burden of proof onto the domestic taxpayer. To help ensure that royalty payments are being priced properly, Chinese taxpayers are required to document their related-party transactions contemporaneously and demonstrate compliance with the arm's-length principle. This documentation is then used by Chinese tax officials to monitor and assess Chinese taxpayers in terms of congruity with China's transfer pricing regulations.

## Marketing intangibles

Issues related to marketing intangibles and the affiliated royalty payments for luxury goods companies operating in China have also been of heightened interest to Chinese tax officials. In particular, officials are concerned about whether multinationals are applying a consistent approach in their local and global pricing policies. To this end, the authorities have been demanding that Chinese affiliates substantiate all related-party royalty payments by producing evidence of an economically-reasonable pricing basis, as well as supporting material that proves third parties are conducting comparable transactions at similar pricing levels and on similar terms.

The situation is further complicated when local distributors or retailers of luxury products develop their own marketing intangibles to satisfy the unique characteristics and size of the Chinese market. For example, many luxury brands establish flagship stores in China as a visible and significant marketing channel. The costs incurred in setting up such a store for marketing purposes may be viewed as an investment in local brand awareness (or even global brand awareness at the expense of local operations depending on the cost recognition approach of the company) and, as a result, Chinese tax authorities may require that more income be allocated to Chinese affiliates of foreign companies as a contribution from the brand owner to expanding its market share within China.

## Mitigating luxury sector taxpayers' risk

New Chinese transfer pricing requirements, enacted this year but retroactive from 1 January 2009, mandate that short-term analyses be updated on a contemporaneous basis. Due to the complexity of their transactions, luxury companies may also consider two long-term alternatives offered by the Chinese tax authorities: Cost Sharing Agreements (CSAs), and Advance Pricing Arrangements (APAs).

Article 41 of the new Corporate Income Tax (CIT) law introduces CSAs as an option for Chinese taxpayers. Under Article 112 of the CIT Implementation Rules, an enterprise may share common costs if the costs and expected benefits are matched. As Chinese tax authorities become increasingly insistent that local marketing activities create value for brands, companies with local marketing expenditures which create value for a brand may benefit from sharing these costs with overseas related parties. A company is more likely than not to benefit from a CSA because the royalty payment for using luxury brands or allocated service costs would be deductible, and theoretically no additional business tax and withholding tax should be levied. However, companies need to balance the risk that a portion of commercial ownership of valuable marketing intangibles would reside in China.

Another long-term planning option companies in the consumer market arena may benefit from is an APA. China has concluded several APAs within the last five years, and with more underway, the SAT is becoming increasingly sophisticated in proactively resolving transfer pricing issues. APAs provide luxury companies with a practical approach to reducing uncertainty about their related-party transactions. Another benefit of APAs, especially for luxury goods companies in turbulent economic conditions, is that they encourage stability by agreeing the structure for calculating revenues in advance.

## Conclusion

The key TP risk management strategy for a luxury goods company operating in China is determining which approach to use and how to successfully justify this to the Chinese tax authorities. Although the marketing of intangibles is by nature difficult to price, luxury goods companies have both short- and long-term planning tools at their disposal to help them mitigate their TP risks.

# Customs approaches for luxury companies

Despite falling international tariff rates, luxury goods often remain subject to high customs duties within China. This challenge demonstrates the importance of effectively and efficiently managing customs risks and opportunities for companies in the luxury sector.

Customs expenses are often mistakenly treated as unavoidable costs of doing business, when in fact customs offers many avenues for direct cost savings. A better understanding of the key customs issues can help companies in the luxury sector to identify customs risks and opportunities.

Developing an efficient customs programme can help to eliminate non-dutiable costs such as royalties, evaluate Free Trade Agreements (FTAs) and review tariff classifications. Additionally, China has many special trade zones and bonded areas which can be used to develop a duty-efficient supply chain. The incentives and regulations governing these areas change frequently, so monitoring efficiency and compliance is vital.

The inherent tension between customs and transfer pricing regimes worldwide means that considering the two areas together is fundamental to developing successful cross-border policies.

## Identifying non-dutiable costs

Under the World Trade Organisation valuation code, the final price actually paid or payable for goods by an importer is the value that must be declared to Customs. This includes universal additions to the price, such as royalties, as well as legal deductions. For example, certain cost elements included in the final price can be stripped out, thus lowering duty costs and, potentially, other indirect tax costs.

Non-dutiable cost elements include after-sales or post-implementation services such as training, assembly, maintenance and warranty services. Other cost elements such as finance charges, inspection fees, sales and marketing costs and certain types of commissions can also be deducted based on a review of the supplier agreements and payment structure.

## Royalties

Ensuring that royalties are treated appropriately for customs purposes remains of key importance for participants in the luxury goods industry. Many luxury goods are associated with well-known brand names which attract substantial royalty and/or licence charges.

Goods-related royalties form part of the dutiable cost of goods, regardless of the timing of the royalty payment in relation to the importation of the goods. Goods-related royalties can be defined as those which the importer must pay, either directly or indirectly, in order to be able to sell those goods. To the extent that such payments are not already included in the price paid by the importer, these additional payments must be added to the value of the goods declared for customs purposes. Establishing suitable information systems that track royalty payments and ensure they are, where appropriate, included in the customs value of imported goods is vital for full compliance with customs requirements.

Companies in the luxury goods industry should also consider whether any royalties paid are not 'goods-related' royalties. Removing such payments from the invoice price offers an avenue for reducing customs duty costs.

## Free Trade Agreements

There are over one hundred regional and bilateral FTAs offering preferential duty rates for trade between Asian states as well as global trade. The question is whether the benefits of these preferential duty rates outweigh the internal administrative costs of complying with the country-of-origin and documentation requirements.

Exploring the FTA landscape can reveal significant reductions in duties and import-related costs and, even if a company is already claiming FTA benefits, closer examination of practices and procedures may reveal that critical compliance requirements are not being met. Early identification of non-compliance can help companies to make the changes necessary to help avoid costly customs penalties.

## Tariff classification

Tariff classification, based on the physical form of the goods, determines the rate at which duty is payable on import. Therefore, changing the state in which goods are imported offers the potential to change the tariff classification of declared goods and reduce the associated duty cost. For example, breaking down fully assembled goods into components, sub-assemblies or individual parts could result in the goods being subject to a different tariff classification numbers which confer more favourable tariff rates.  There are certain restrictions on this type of tariff planning so it is important to pay close attention to the rules pertaining to specific industries and tariff heading when considering this opportunity.

## Special trade zones

Depending on relevant supply chain needs and the location of key markets, it may make business sense to shift assembly, manufacturing, or other assembly and manufacturing, or other hubbing activities to special customs zones or bonded parks within strategic locations within China. These types of programmes provide for deferment or avoidance of customs and indirect taxes for various types of business activities and could be leveraged to improve cash flow and/or reduce costs.

As the economic downturn forces companies to evaluate locations for manufacturing and other key operations, now is an excellent time to rethink supply chains and how to best use duty free zones and customs bonded areas.

## Transfer pricing interplay

Customs and transfer pricing both focus on cross-border transactions and adopt the arm's length principle, but the drivers for each regime differ considerably. Customs valuation focuses on ensuring goods are not undervalued such that duty is under collected while transfer pricing's focus centres on checking that tax deductions are not claimed for over valued goods purchases, thus reducing taxes payable. As such, complying with both regimes requires careful management and coordination.

As customs and transfer pricing authorities globally become increasingly integrated addressing the two areas in isolation is becoming progressively more unsound.  Companies need to consider implications of policies for one area on their practices in the other.

# Next stop China

## Andrew Yu, I.T Group

I.T Group was founded in Hong Kong 21 years ago by four siblings with a shared love of fashion. As a pioneer for the distribution of unheralded or upcoming fashion brands, I.T Group has expanded its store concept from Hong Kong across the mainland of China, bringing with it over 300 international brands. With its listing in 2005, it has ambitious growth plans and fearlessly hopes to achieve half its turnover from China within a few years.

"When you come to our stores you'll find a different proposition for how to define luxury," says Andrew Yu, Senior Corporate Finance Manager of I.T Group, based in Hong Kong. "We blend some well-known luxury and fashion brands with exciting new designers, to provide inspiration to our customers. With China's Generation Y and female consumers rising in affluence, we see plenty of uptake for our style of fashion retailing."

I.T Group made its first foray into China as part of a joint venture in 2004. A key step for the business was buying back the joint venture in 2007, leading to a renewed push into the mainland China market. "It gave us more room to bring foreign brands into China, it was easier for brands to approach us and it was easier for us to leverage our position and negotiate openly with those brands," Mr. Yu explains.

The company now has 120 self-run stores across China, although most of these are in either Beijing or Shanghai. The company has a further 40 franchises located in second- and third-tier cities. In addition to its own stores, I.T Group has been partnering with French Connection in Hong Kong and China for the past five years and has also helped the European company open its new Zadig & Voltaire stores in Hong Kong.

This suggests the downturn has not been too hard on I.T Group, particularly as around half the company's sales come from more modestly priced own-label lines. The company started producing these product lines in 1995, another milestone for the business. However, Mr. Yu notes that some of the more cutting-edge imported labels have continued selling very strongly, despite the economic pressures. "There are strong sales for some of our high-end lines, for example embroidered denim selling for up to RMB 10,000 per item. These are not just showpieces," he explains. "The Japanese labels that are popular here in Hong Kong are also popular on the mainland."

Mr. Yu believes I.T Group is in a good position to grow in a market that is characterised by growth opportunities and an evolving consumer appetite. "The multi-brand model is a good way for us to pursue growth, even as Hong Kong is becoming a mature market for us," he explains. "I wouldn't describe awareness of fashion in China as advanced yet, but consumers in China do know a lot and are learning fast. China has been resilient to the downturn and another feature of our business is that we can shift products more quickly if we offer modest discounts. This gives us flexibility. Some high-end luxury brands may have to discount deeply to keep selling in a downturn."

If there is a downside it is in achieving scale across such a vast and diverse market. "Our model means we have relatively high fixed costs, which will only get brought down as we achieve a larger scale around the overall business in China," says Mr. Yu.

I.T Group may be relatively new to China, but Mr. Yu is banking on experience and an original retail concept to help I.T Group grow. "Hong Kong is a crowded market for brands. If we can succeed here I don't think we have any reason to fear China either," he says.

# A 'Friendly Revolution'

## Raphael le Masne de Chermont, Shanghai Tang

"Proudly Made by Chinese" is the mantra created by entrepreneur Sir David Tang, who founded lifestyle brand Shanghai Tang in Hong Kong.

Established in 1994, Shanghai Tang started out as a chic Chinese emporium for visitors to Hong Kong. It has since developed into a lifestyle brand that blends modernity and tradition. This places it in the enviable position of being one of China's very first luxury brands, at a time when the country is rapidly becoming one of the world's most influential economies.

While the global financial downturn had some impact on the business, as it has on most luxury brands, the brand's strong presence in Hong Kong helped to act as a buffer. And as the global economy recovers, the focus for the brand is to continue to expand in mainland China.

"The good news is that we are now replicating our strong Hong Kong business strategy in both Shanghai and Beijing. We are also well established in travel retail in Asia and we have a fair business in Europe and the US," says Raphael le Masne de Chermont, the company's Executive Chairman.

Shanghai Tang has a network of boutiques, including Shanghai, New York, Paris, London, Tokyo and Madrid, as well as stores in Dubai and Macau. Hong Kong serves as the headquarters with nine stores, while China remains its main target for expansion plans. The brand currently has 12 boutiques located in tier-one and tier-two cities across mainland China, with plans to open four more this year.

"There is some reassurance for mainland Chinese consumers to see our shops in Paris, London and New York; it helps show we are a strong international brand. When it comes to brands in China, the most important word is not luxury, it is international," adds Mr. Chermont.

Three years ago, mainland Chinese consumers formed only 2 percent of Shanghai Tang's business, in contrast to 20 percent today. "In terms of location, we have to reinforce the message to Chinese consumers that we are a luxury brand and in order to do so, we need to be based in the shopping malls."

The 2008 Olympics in China helped to propel the brand's image amongst Chinese fashionistas. "The Olympics helped to instill a growing sense of national pride and greater awareness of China's cultural heritage. Chinese people increasing see themselves not only as a strong nation, but also as a creative nation. All the clichés about the Chinese label are now falling apart, as China fast becomes the engine of the global economy," Mr. Chermont explains.

Shanghai Tang is matching its strategy to tie in with this rising sense of pride. "Shanghai Tang is a relevant lifestyle brand which serves as a bridge between cultures, both East and West. We offer consumers a 'Friendly Revolution' – a new style of dressing and living which is modern and at the same time faithful to Chinese identity and culture."

The lifestyle brand is also due to launch Shanghai Tang Lounge, its first branded music disc this year. In January, its first 'own brand' cafe was opened in Xintiandi, a popular up-market retail zone in Shanghai. "We aim be a friendly, colourful ambassador of modern China, through all lifestyle elements," Mr. Chermont adds.

China is not without its challenges, particularly in administration and licensing. To tackle the challenge of copy-cat rivals, Shanghai Tang rolls out new collections every six months.

Mr. Chermont also believes there is a need to keep ahead of the fast growing e-commerce business in China, "China has its own equivalent of the major online portals. Rather than simply replicating your existing e-commerce website, you should create a new one, specific for your China business."

The main focus for global brands however, is to manage their reputation. Shanghai Tang has been proactive in launching an ethical luxury programme in China. Projects include working with minority groups in Yunan and Sichuan as well providing funding to help save China's rapidly diminishing tiger population.

"As we are the torch bearer of luxury in China, we want to endorse an ethical approach. We focus on minorities in China because their rich traditions and cultures are an incredible source of aesthetic inspiration," he concludes.

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