



cutting through complexity

CONSUMER MARKETS

Global Reach of China Luxury

A KPMG study

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Case Studies

Christies

Clarins

Estée Lauder

Ferrari

5Lux

Glamour Sales

LVMH

Montblanc

Oriental Watch Company

Peninsula

Qeelin

Scheme

Trinity

About the survey:

In mid-2012 KPMG China commissioned market research firm TNS to conduct a survey of Chinese middle class consumers on their spending patterns for luxury brands. TNS received 1,200 qualified responses to the survey. They were based across 24 cities and were between 20 and 44 years of age.

The survey data is complemented by thirteen case study interviews with senior executives of luxury and retail companies, conducted by KPMG China's Consumer Markets Practice between October and December 2012.



Introduction

Despite the global economic slowdown and its subsequent impact on the luxury sector, China's consumer sector continues to grow and also account for an increasing share of global sales for some of the world's largest luxury brands.

The demand for luxury goods in China is booming as incomes continue to rise. Domestic consumption has also been highlighted as a strategic focus for China's leadership, which also presents opportunities for luxury players to further establish operations across the country.

This year's key highlights include the increased impact of the travelling Chinese consumer. Our survey notes the number of Mainland Chinese travelling overseas has increased to 71 percent of survey participants in 2012, from 53 percent in 2008, a significant change. Overseas luxury brands with a presence in China are benefitting from this trend, as are some of the domestic Chinese brands that have or are planning to establish overseas operations. As the numbers of travelling Chinese consumers continues to rise, brands need to measure the impact of their business strategies both in Mainland China and the travel segment.

The survey also analyses the role of digital media and the extent to which it is being used as a tool to engage Chinese high-end consumers. Chinese consumers are engaging using online forums to discuss and research luxury brands. Our data shows that around 70 percent of potential consumers search for luxury brands on the internet at least once a month. We see a rise in popularity of experiential luxury consumption, as well as stronger status motivation for luxury goods. There are also increasing signs of changing consumption patterns in China.

Brand recognition continues to rise as consumers become more discerning and seek experiential luxury as well as unique one-of-a-kind luxury brands and products. Women are an important target market for luxury players, as their purchasing power rises and as they start to seek a wider range of products.

However, China is not without its challenges and brands need to be aware of the hurdles to market entry. Competition for example is increasing as consumers increasingly travel further overseas and broaden their knowledge of products and therefore expectations of better consumer service and sales experience. Brands therefore need to maintain their image and have synergies in their marketing and product selections both in China and also overseas, in order to cater for those travelling consumers. In addition, some brands have concerns about over exposure in the market, while others are looking to strengthen their branding and marketing strategies and to tailor them to the China market.

But we do see continued success in this market and a focus on placing China centre stage in terms of branding strategy and investment. In fact, many of the major luxury brands are continuing with their current investments, despite the ongoing global economic slowdown, to the extent of holding their biggest global marketing events in China. We also see interesting trends in terms of domestic luxury start-ups experimenting and developing their own brands. Some home grown brands are hiring in overseas talent in order to help them develop their business. Others are acquiring struggling overseas brands and investing in them.

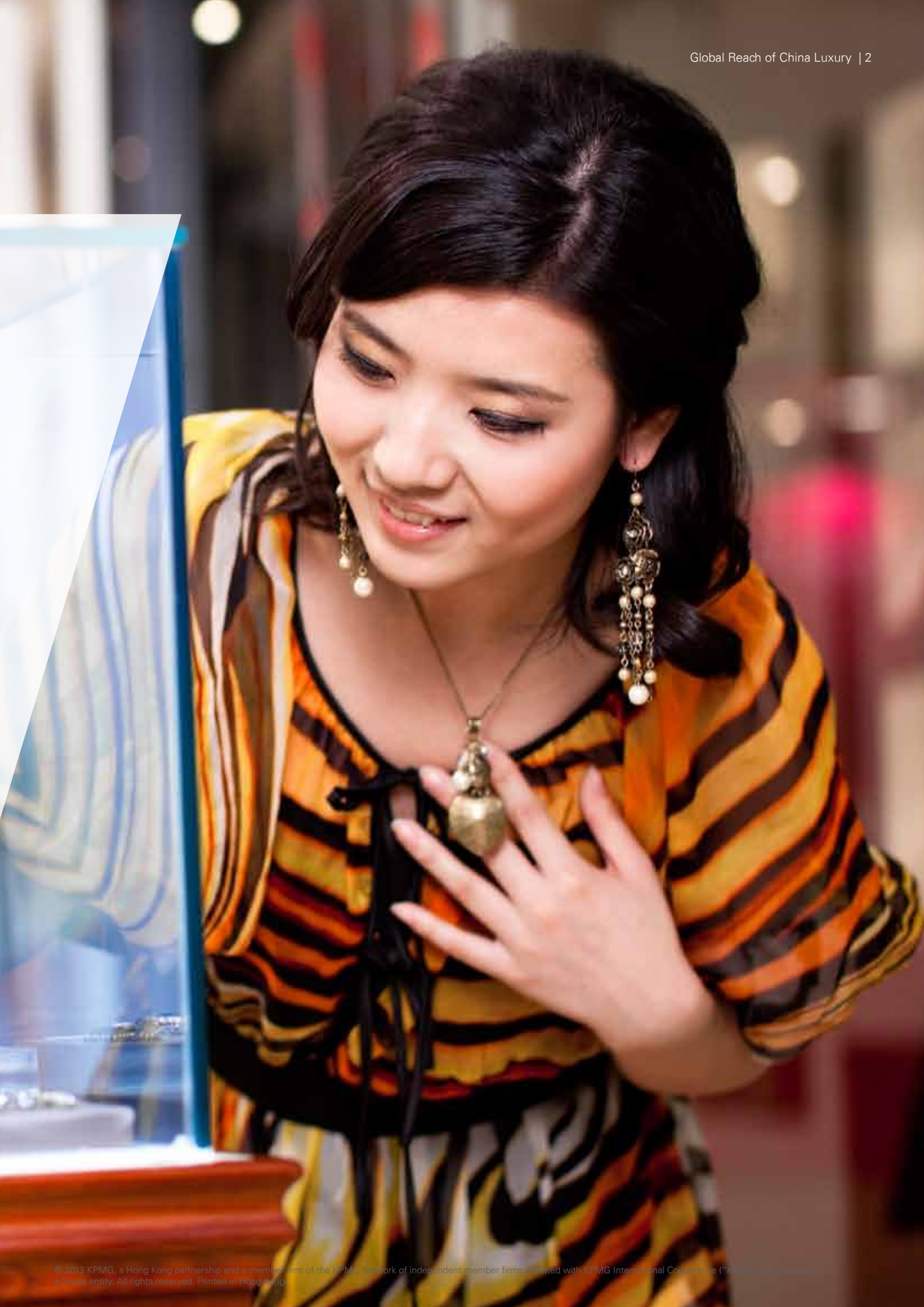
Our survey themes also resonate with the thirteen case studies featured, which comprise a selection of prestigious brands with a strong footprint in China. We would like to thank all the executives who took the time to share their insights with us.



Nick Debnam
Asia Pacific Chair
Consumer Markets
KPMG China



Jessie Qian
Partner in Charge
Consumer Markets
KPMG China



Executive Summary – Key Findings

- A key highlight of this year's survey is the increased impact of the travelling Chinese consumer. Our survey notes the number of Mainland Chinese respondents travelling overseas has increased to 71 percent in 2012, from 53 percent in 2008, a significant change.
- A majority of survey respondents (72 percent) said they purchase luxury items during overseas trips, with cosmetics, watches and bags winning the top spots.
- For purchases of cosmetics and perfumes, a majority (60 percent) of respondents said Hong Kong, Taiwan and Macau were their top locations; this is a significant increase from 43 percent in 2009. Mainland China was voted their second choice, whilst Europe also saw a marked increase due to the rising number of travelling Chinese, up from 3 percent in 2009, to 20 percent in 2012.
- Chinese consumers are increasingly engaging via online forums in discussions around luxury brands; our data shows that around 70 percent of potential consumers search for luxury brands on the internet at least once a month. Additionally, it also notes a surge in online shopping intentions, with 40 percent of respondents indicating they are interested in purchasing luxury goods on the internet, a substantial increase from 22 percent in 2011.
- We see a continued rise in popularity of experiential luxury consumption, as well as stronger status motivation for luxury goods. There are increasing signs of changing consumption patterns in China and the rise of digital and social media has also helped to increase exposure for luxury brands.
- Brand recognition continues to increase. This year's respondents said they recognize 59 luxury brands, a figure that continues to rise over our successive annual surveys. Meanwhile, 56 percent of survey respondents said they prefer to purchase well known luxury brands, whilst 69 percent separately indicated they would pay a premium for well known, popular luxury brands.
- Chinese consumers also distinguish among countries of origin and associate certain countries with particular products. As you would expect, Switzerland came top for luxury watches, while France scored highest for cosmetics and perfumes, clothes and bags and Germany for automobiles. There continues to be a strong association towards European heritage brands in these categories.
- We see rising discernment amongst Chinese high end consumers; as our survey notes, 88 percent of respondents indicated they would be willing to pay a premium for luxury brands that display high quality and durability; 80 percent indicated exclusivity and uniqueness as key factors, while 72 percent said the heritage of the brand plays a significant role.



The travelling Chinese Consumer

One of the key findings of our 2013 report is the increased impact of the travelling Chinese consumer, as overseas travel is expected to see further growth in the coming years. Luxury brands with a presence in China are benefitting from this trend, as are some of the domestic Chinese brands that have or are planning to establish overseas operations.

Our survey finds that the number of Mainland Chinese consumers travelling overseas has jumped from 53 percent in 2008, to 71 percent in 2012. This is a significant increase and one that luxury brands should take note of, in terms of opportunities to market to these travelling high-end consumers.



Travel spending represents a significant proportion of global luxury goods spending. Mainland Chinese are the biggest single group of tax-free shoppers in the world accounting for a rising chunk of global sales. Statistics from Global Blue, a tax-free shopping company, showed that Tax Free Shopping by Chinese global shoppers rose by 58 percent in the third quarter of 2012 (July – September) in comparison to the same period in 2011. Overall China accounted for 26 percent of total tax free shopping between April and November 2012.



MADE TO MEASURE:

- China has always been strong in menswear and this will be an area to watch
- A high proportion of menswear designers are focused on the China market and this is a particular sector of growth
- One area that could see rapid growth in the years ahead is the emergence of Savile Row tailors providing more custom type services to the Ultra High Net Worth Individuals (UHNWIs) in Mainland China
- Those tailors are now focused on serving more of those Chinese UHNWIs with the type of cut and fabric

Guy Salter, Deputy Chairman, Walpole

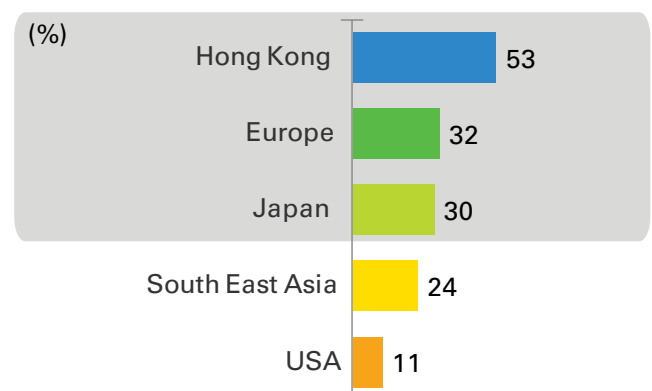
While top tier luxury brands have and continue to open flagship stores across China, particularly in Beijing and Shanghai, many survey respondents indicated they prefer to buy overseas, where they have access to broader and sometimes newer selections.

And as consumers seek better prices and product knowledge, visiting some of the major luxury brands located in places like Savile Row, Bond Street and Avenue des Champs-Élysées is therefore becoming increasingly popular.

In terms of top destinations, our survey shows that Hong Kong remains the number one choice for Mainland Chinese consumers, followed by Europe and Japan. A low tax and VAT environment is one of the factors that plays to its advantage.

Guy Salter, Deputy Chairman, Walpole (An organisation representing the UK luxury industry) explains: "Hong Kong plays a vital role as a window to the world and a sophisticated market for the Chinese consumers from the Mainland. In terms of travelling further overseas, we see the travelling Chinese having a significant impact in Paris and Continental Europe compared to the UK. This is also partly due to easier visa arrangements."

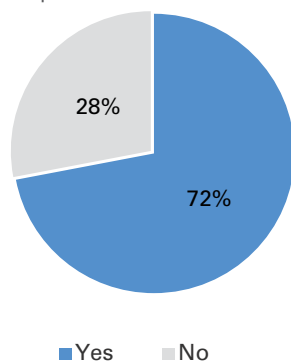
Figure 2: Which overseas countries or regions did you travel to for leisure in the past 1 year (Year 2012)





A majority of survey respondents (72 percent) said they purchase luxury items during overseas trips, with cosmetics, watches and bags winning the top spot. The survey also notes that buying habits don't change much with travel type, i.e. whether it is a business or a leisure trip.

Figure 3: Did you purchase luxury items on your latest overseas trips?



Share of spend on luxury purchases during your overseas trip

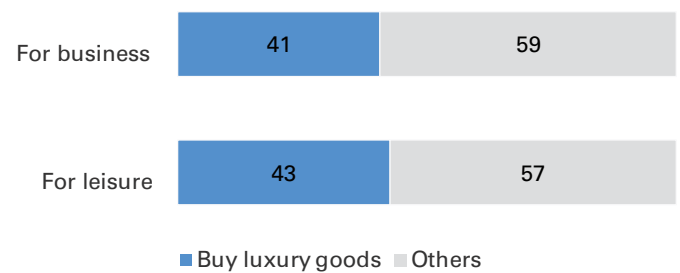


Figure 4: Which luxury items did you purchase when overseas?

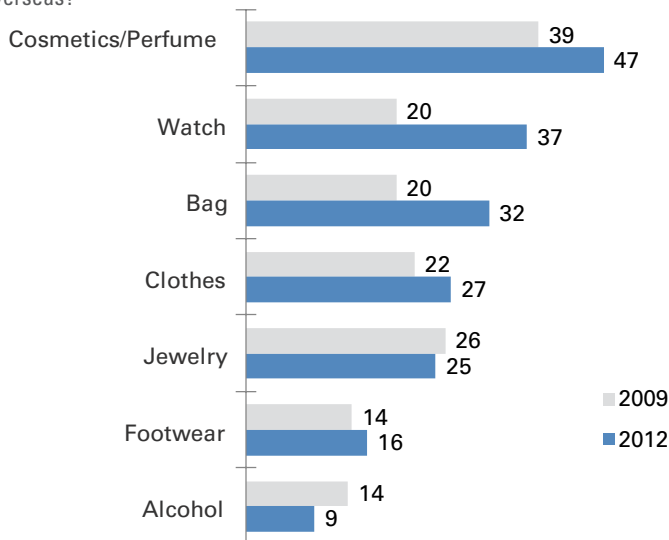


Figure 5: Share of spend on individual luxury products purchased overseas (2012)

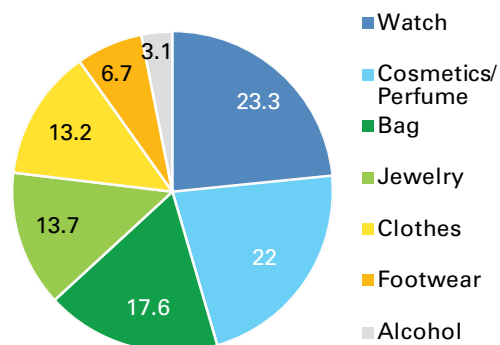


Figure 6: Where did you purchase your cosmetics in the last 12 months?

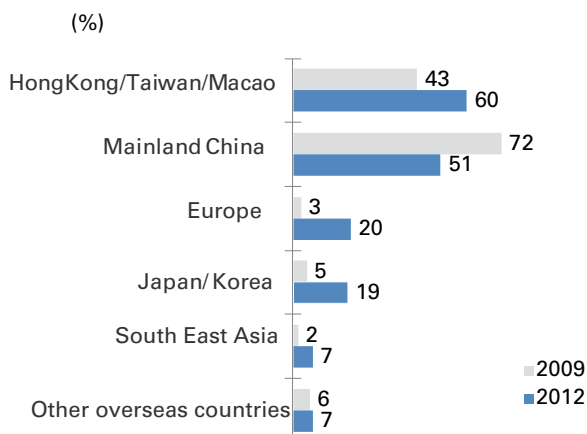


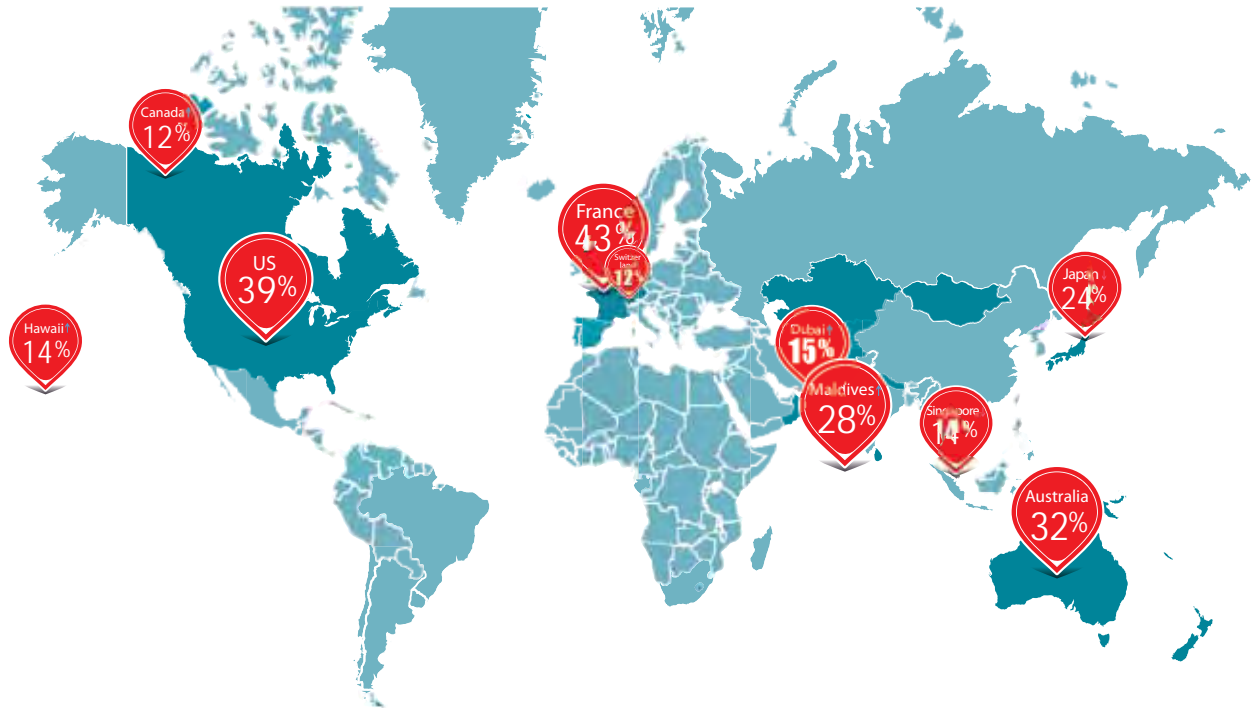
Figure 4 illustrates the demand for cosmetics and perfumes; a majority of respondents said that Hong Kong, Taiwan and Macau are the number one choice in terms of where consumers make their purchases, at 60 percent, compared to 43 percent in 2009. Mainland China came second whilst Europe saw a marked increase, due to the rising number of travelling Chinese, up from 3 percent in 2009 to 20 percent in 2012.

Hong Kong remains the top spot for watches, with 51 percent of watch buyers indicating they purchase their watches here, up from 41 percent in 2009. Mainland China was the second option, although it has lost a significant amount of share to Europe.





Preferred International Travel Destination-Top 10 (%) (High Net Worth Individuals)



Source: Hurun Report, Chinese Luxury Consumer Survey 2012

In response to the rise in Chinese travelers, global luxury brands are adapting to better serve Chinese consumers. Stand alone duty free shops overseas have seen sales rise, particularly in the case of cosmetics and perfumes.

With increased opportunities for Mainland Chinese to travel overseas and with rising discernment and individualism, this signals significant potential for global luxury brands.

TIME TRAVELS

In terms of where Chinese consumers are buying watches, Europe saw an increase from 5 percent in 2009 to 25 percent in 2012, as a result of increased travel to the region.

Alain Lam, Director and Company Secretary, the Oriental Watch Company, which has a flagship store in central Hong Kong, says: "Over 50 percent of our clients in Hong Kong are from Mainland China, as increasing numbers travel overseas. With a growing middle class in China, Hong Kong is going to continue to benefit in the long term, particularly because of the VAT price differentials which still make it an attractive shopping destination."

The Chinese market for watches in turn is also becoming a lot more sophisticated. Sam Hines, Head of the Watches Department for Christies Asia, explains: "The Chinese market is becoming more sophisticated in terms of its watch purchases. In 2002, our world-wide sales were USD8million, while in 2011 this increased to USD116 million. In ten years, the watch category has grown significantly, because of the strength of the market and people wanting to sell here. We see a trophy market being formed and a shift in terms of tastes."

Figure 7: Which channels did you use when purchasing your watch overseas? (%)

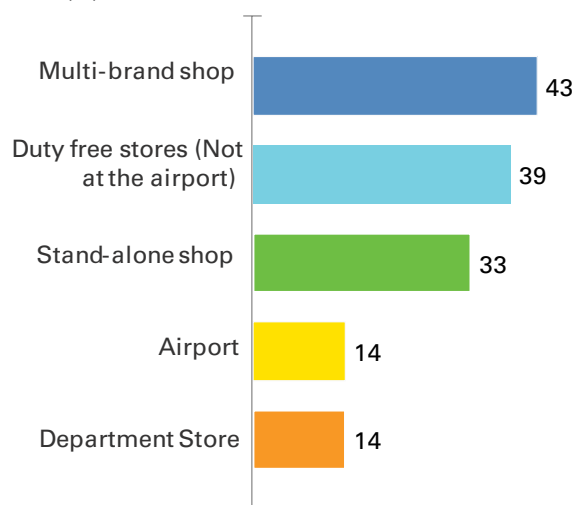


Figure 8: Share of spend by channel (%)

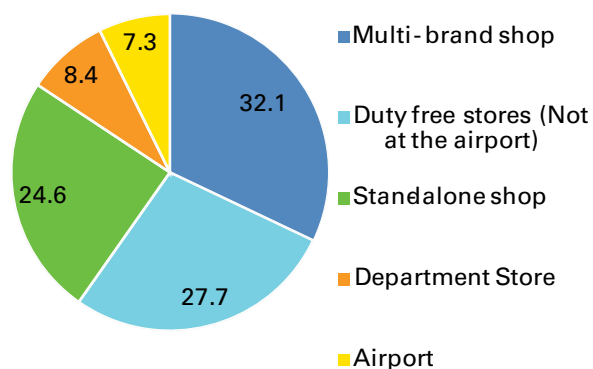
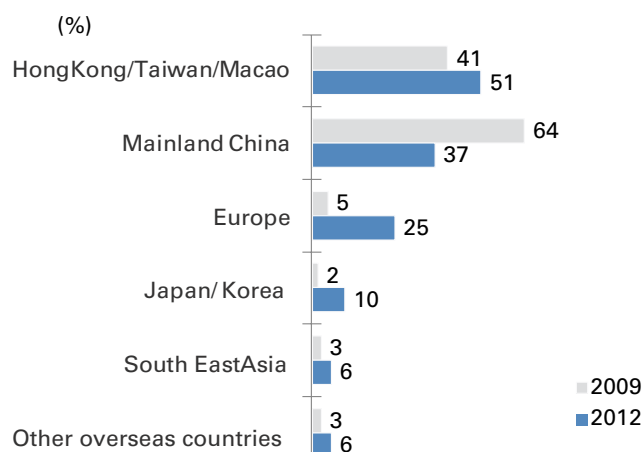


Figure 9: Where did you buy your watches from in the last 12 months?



DID YOU KNOW

- Tax Free Shopping by Chinese global shoppers rose by 58 percent in the third quarter of 2012 (July – September) in comparison to the same period in 2011
Source: Global Blue
- Overall China accounted for 26 percent of total Tax Free Shopping between April and November 2012
Source: Global Blue



Sunny Wong, Managing Director, Trinity

Hong Kong-listed Trinity is a key luxury brand owner in both China and globally, having snapped up two flagship UK men's tailoring brands – Gieves & Hawkes and Kent & Curwen and the Paris based brand Cerruti.

The key driver for its success has been high growth in China, which accounts for 55 percent of the group's total sales in the first six months of this year. Additionally, 60 percent of the group's business in Hong Kong is driven by Mainland Chinese tourists.

Sunny Wong, Managing Director at Trinity, explains: "We had the foresight to see that luxury would do very well in China. The richness of history and heritage fascinates the Mainland Chinese consumers. We spent several years transforming our original export business into a high-end retailer operation. To do this, we exited our profitable export business which included disposing of factories in China, in order to focus on our key brands."

Trinity currently operates almost 100 Gieves & Hawkes stores (One of the UK's oldest tailors, with a flagship shop at No 1 Savile Row in London) across China, as well as owning the Kent & Curwen and Cerruti 1881 brands. The group plans to expand both labels further in China.

"We had a big push in China by establishing infrastructure across the country and opening about 100 shops a year for two years," explains Sunny. "In terms of our presence, we are divided by five regions and we will also open a branch in the North East region of China later this year. All our branches are run regionally and autonomously by each brand."



Looking outbound, the group also plans to take advantage of the rising numbers of travelling Mainland Chinese. "One of the reasons is that the Mainland Chinese consumers travel and see us on number 1 Savile Row. We currently have a substantial operation in the UK and France. Later this year we will introduce Kent & Curwen to the US, with plans to be present in department stores mainly in NYC," says Sunny.

"We have had a reverse journey compared to most luxury businesses, as we have been successful in China to start with and have then gone out to buy the brands' parent companies in the UK and France. Trinity is therefore shifting from being a China business to a global player," he adds.

Sunny notes success of his products in China has been driven by the quality, fits and styles of tailored suits made available to consumers in this market. He explains: "When we started in China, we had an advantage because our ready-made tailored suits sold very well. We offer both ready-

made and bespoke suits in both European and Chinese fits and style. We will also be introducing a Chinese fit to our Savile Row establishment in order to cater to our overseas Chinese clientele."

In terms of catering to clientele in China, Sunny points out some unique consumer characteristics. "Menswear relies mainly on repeat business therefore we offer our loyal customers discounts and VIP service. We notice that our male customers in China tend to shop in groups – this is for a number of reasons, including gifting, use of their VIP cards and perhaps also an element of showing off. Many of our shops in Mainland China therefore have comfortable sitting areas where our customers can relax and take their time trying on and purchasing."

In terms of further expansion plans in China, the group has established a presence in the major tier 1 to tier 4 cities. Sunny adds: "Our expansion in China is being driven by where the wealth is located and the availability of suitable shop spaces. We have almost 400 shops across four brands but the pace of growth is a lot less in the market because of an economic slowdown. "



A strong foundation in China

Kenneth Wong, Managing Director, Estée Lauder Companies, Hong Kong

Hong Kong plays a pivotal role for cosmetics group Estée Lauder Companies Inc., which makes popular brands like MAC, Estée Lauder, Clinique and Bobbi Brown.

The group sells 11 of its 28 cosmetics brands in Mainland China, and sees over 50 percent of total sales of the top five skincare brands in Hong Kong, mainly driven by tourists from Mainland China.

Kenneth Wong, Managing Director, Estée Lauder Companies, Hong Kong, says: "Sales for our skin care products in Hong Kong are mainly driven by price differentials, especially when compared to Mainland China. The percentage of sales depends on the maturity of the individual brands and its ranking in the Mainland. We see that brands that don't capture the Chinese consumer are losing overall market share in Hong Kong. This means they are also being disadvantaged in terms of competing for mall positioning."

Estée Lauder plans to build on its success by cementing China as the group's second home market and has set up an internal "China 2020" working group to make that a reality. China is currently its third-largest market after the United States and the UK, with a turnover of USD500 million in the 2012 fiscal year that ended June 30. This year China also overtook Japan as the company's biggest sales region in Asia. Estée Lauder products are currently sold in around 60 Chinese cities and in



addition to expanding in tier one cities such as Beijing and Shanghai, the group it is also looking to expand in second- and third-tier cities across China.

The group is also focusing on travel retail within China, and have subsequently increased their retail footprint and advertising at airports. The rising numbers of Chinese travelling overseas has also had a significant impact on sales outside of Mainland China. Kenneth notes: "For every dollar of business we do in China, we also have two dollars of sales from Chinese consumers outside China. Hong Kong has been a main beneficiary." The heritage aspect of the brand is key as is cultivating a more contemporary perspective/look and feel.

As a further step towards expanding its footprint across Asia, the group recently launched its own luxury skincare line, called Osiao. Developed

at the company's research and development laboratory in Shanghai and manufactured in Japan, researchers in China spent several years extensively researching different types of Asian skin. The product contains Chinese plants and herbs including Ginseng and cordyceps which is aimed at customers across the region. Launched in October 2012, Osiao is currently being sold in Hong Kong, with plans to expand its reach in time.

In terms of Estée Lauder's positioning and strategy, Kenneth says: "Some of our products have high loyalty with Mainland Chinese consumers. We do not see premium Chinese brands in the same market or with the same positioning. In Mainland China, we are placing a lot more advertising dollars to both digital and TV channels in order to extend our reach and to communicate the aspirational value of our products to existing and potential consumers."

The majority of the group's business in China is in the department stores, free standing stores and online channels. "We want to do more free standing stores because we can express the personality of the brand better and to meet the changing shopping preferences of the consumers," Kenneth concludes.



China drives our global strategy

Cyril Bedat, Regional Market Research Manager, LVMH Watch & Jewelry

Swiss Luxury Watchmaker TAG Heuer, part of LVMH Watch and Jewelry division, expects solid growth for this year, as it seeks to expand and consolidate the retail footprint.

Products from TAG Heuer are currently available at about 140 points of sale, including twenty boutiques in China.

Cyril Bedat, Regional Market Research Manager, LVMH Watch & Jewelry, says: "Retail distribution for luxury players is a sign of your positioning for consumers, a gauge of quality and premium.

Luxury malls and retail in general in China are therefore a very important focus for us. This explains why we are currently present in the main luxury malls in China, including Beijing SKP and Shanghai Plaza 66. You cannot establish your brand in China without having key premium locations."

A key finding to emerge from this year's survey is that watches continue to be amongst the top luxury purchases by Chinese consumers. Mainland China continues to play a significant role for TAG Heuer. Cyril adds: "Last year, China surpassed Japan in total luxury consumption. China therefore is at the centre of our global strategy. Moreover, actions and efforts we put in place in Mainland China have certainly had a huge impact outside Greater China (Hong Kong and Macao), and in travel retail. Luxury consumers are increasingly buying our timepieces



abroad, in Switzerland and also in France, UK, USA and Australia."

"We have seen more sales from Chinese consumers outside Mainland China and also outside Hong Kong. We believe that 50 percent of the market is in China and 50 percent is outside China (HK, Europe, USA and travel retail). Therefore we cannot measure the impact of our strategy only in mainland China, as we must include the travel segment."

In terms of differentiating themselves from competitors in China, Cyril explains: "We do this through our brand positioning: TAG Heuer for example, embodies the achieving spirit, it is a luxury watch brand inspired by the value of sports and innovation. We won the 2012 Grand Prix d'Horlogerie de Geneve for our Mikrogirder, The TAG Heuer Mikrogirder Chronograph is a dual-assortment, ultra high-frequency watch.

It is the first timepiece ever created with neither a balance wheel nor a hairspring, and is accurate to an unprecedented 5/10,000 or 1/2,000 of a second. This innovation and "forward looking" spirit is part of what we believe makes the difference for our brand."

TAG Heuer, one of the world's largest luxury watch players, aims to bolster its watch business in China, along with the rest of Asia, is its main target market. "Going forward, we plan to keep around 150 points of sale in China but with an increasing emphasis on our boutiques. We will make strong investments in communication in order to boost our brand awareness and we also plan to enter the women's luxury segment this year and develop this going forward," Cyril concludes.



Ahead of the times

Alain Lam, Director and Company Secretary, Oriental Watch Company

The Oriental Watch Company established in 1961, was the first watch retailer to list on the Hong Kong Stock Exchange and has since built a strong business as a retailer and distributor of a number of key luxury watch brands across the region.

The group distributes a large number of prestigious luxury watch brands, including Rolex, Tudor, Piaget, Vacheron Constantin, Audemars Piguet, IWC, Jaeger-LeCoultre, Girard Perregaux, Longines and Omega. It launched its watch retail business in Mainland China in 2004 and now operates over 40 outlets and brand boutiques in more than 20 cities including Shanghai, Beijing, Shenzhen, and Guangzhou, with 90 points of sales across the country.

In 2008, the company opened a two-storey 20,000 square foot flagship store in central Hong Kong. Alain Lam, Director and Company Secretary, points out: "Over 50 percent of our clients in Hong Kong are from Mainland China, as increasing numbers travel overseas. With a growing middle class in China, Hong Kong is going to continue to benefit in the long term, particularly because of the VAT price differentials which still make it an attractive shopping destination."

In addition, the group has also recently opened a new flagship Rolex free standing store on the Bund in Shanghai. At 8,000 square feet, it is the largest Rolex concept store in the world.



Alain adds: "We have a strong distribution network and this is important in China. Most of our business today is in the Northern region and we plan to open our next store there. Our strategy is to anchor with certain brand names in all of our stores. We see a growing number of high net worth individuals in China becoming big collectors. These individuals are moving up the value chain and have their own personal taste and individuality. For example, we see that consumers in China prefer to purchase the original western style watches, and Chinese inspired collections don't sell as well. Trends are changing and we see women increasingly viewing timepieces as a fashion accessory. Our focus therefore is on the aspirational middle class in China."

In terms of challenges, Alain says a growing issue on the global supply side is a lack of craftsmen and experienced watch makers. In China, one of the key issues is lack of experience within middle management. Operating costs are also rising in the tier one cities, so there is subsequent movement into T2-T3 cities. "There continues to be significant challenges in the watch sector with the entry barriers being so high as it is a capital intensive business. However, China has a more open door policy than many other geographies and this has benefitted a lot of international luxury brands," he concludes.

Digital Trends

The growth of e-commerce is on the rise in China and this offers new and additional opportunities for luxury players. Chinese consumers are rapidly interacting online, visiting online forums and are discussing and researching brands on the internet. Digital media therefore is playing an increasingly significant role, as it enables brands to interact with both existing and potential customers.

This year's survey shows that around 70 percent of potential consumers search for luxury brands on the internet at least once a month. Additionally, it also notes a surge in online shopping intentions, with 40 percent of respondents indicating they are interested in purchasing luxury goods on the internet, a substantial increase from 22 percent in 2011.

Search engines are also a significant source of traffic to luxury brand websites, but clicks from social networking sites are even more important.

Timothy Coghlan, Senior Manager, Luxury Retail at Savills China, says:

"E-commerce is one of the most exciting sectors in China and with the difficulties of opening stores, we are seeing more brands look at doing online business. Chinese consumers are having those conversations about the brands online and the social media trends are moving very fast. It is also increasingly proving a challenge to find the right people to 'blog' about your brand."

Figure 10: How often do you search luxury product information online?

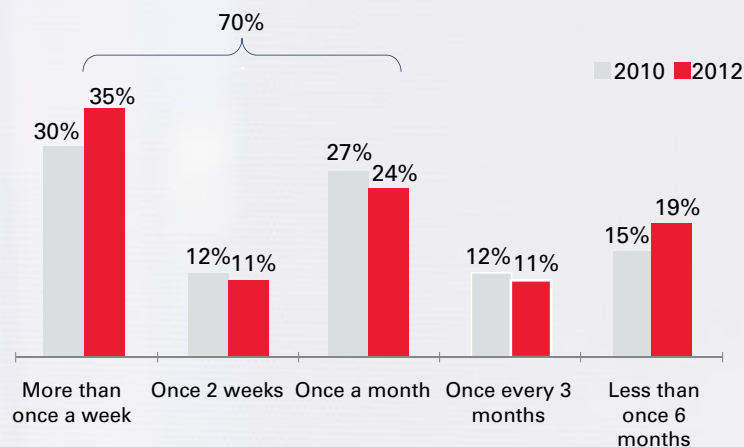
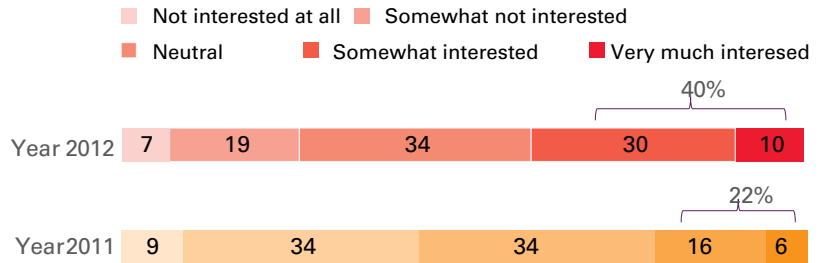




Figure 11: To what extent are you interested in purchasing luxury goods on the internet?



Survey respondents cited convenience as the main motivation to purchase online, while cost saving did not matter as much as a factor. In terms of barriers to online purchasing, they cited concerns over authenticity of products, payment safety concerns and lack of after-sales service. Online retailers increasingly face trust issues, as consumers to a large extent have voiced concerns about the authenticity of goods purchased via the internet.

Sun Yafei, CEO of 5lux.com, the online Chinese luxury retailer, points out: “As the e-commerce industry is currently not regulated, some consumers are concerned they may end up with counterfeit goods. Online sites therefore have to prove their credibility and building a strong reputation requires time and effort.”



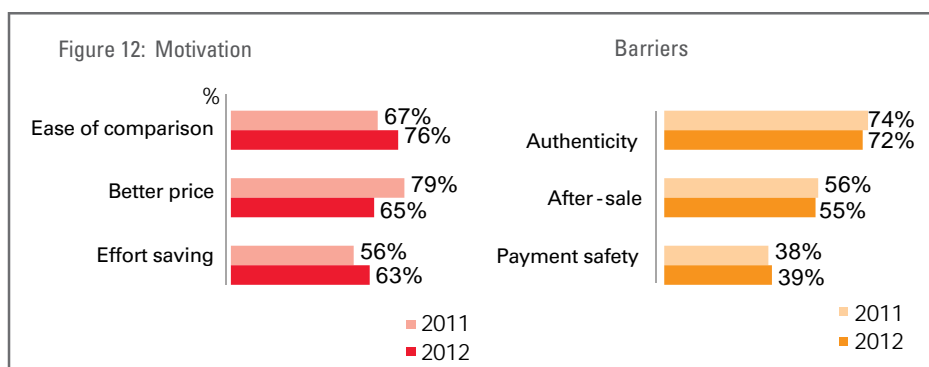


Figure 13 shows that the importance of digital media continues to rise for Chinese consumers, as the impact of conventional media channels such as brand stores, TV commercials and magazine adverts showed noticeable declines since last year's survey. Meanwhile digital media reach, such as the use of the brands' official websites, has increased since 2011.

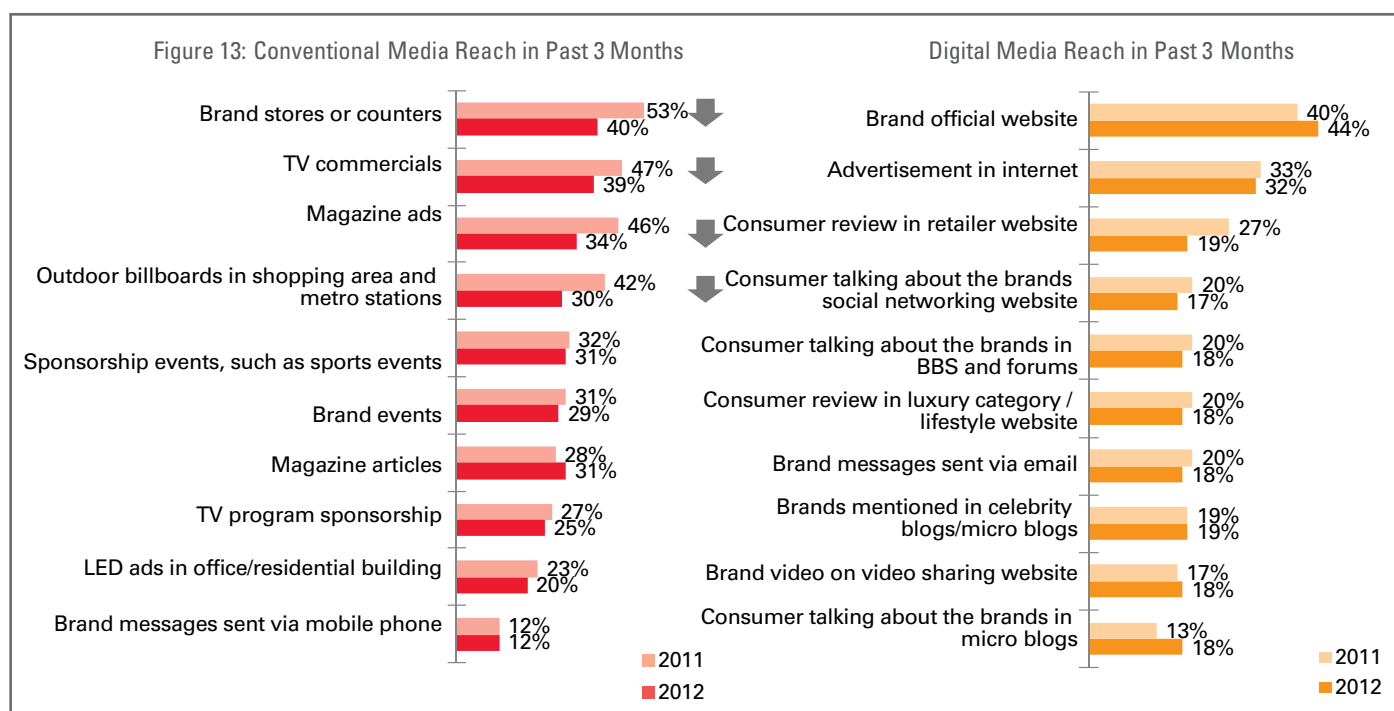
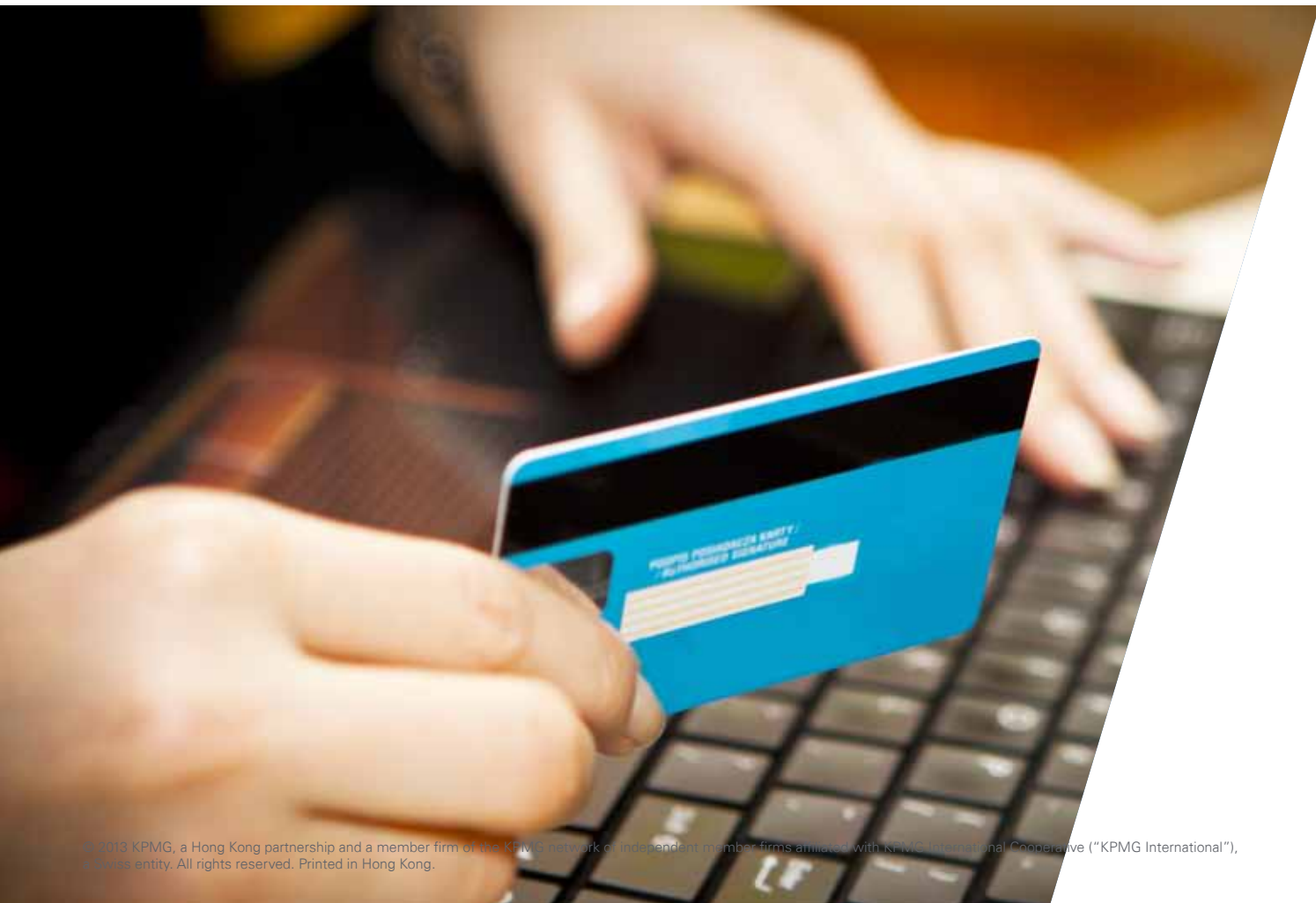
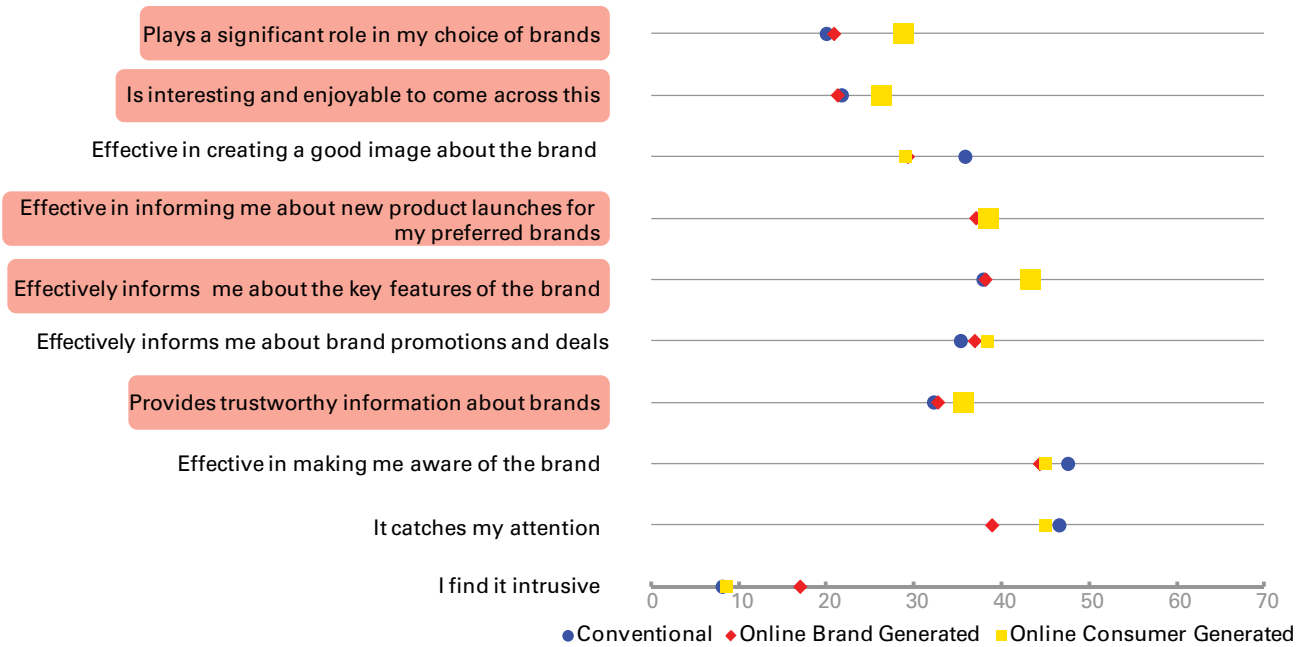


Figure 14: THE INTERNET ENABLES CONSUMERS TO LEARN MORE ABOUT LUXURY BRANDS





Respondents indicated that being able to browse luxury brands online enabled them to learn more about the individual brands and likewise, luxury brands were able to explore ways to get closer to their consumers via digital media. While many luxury brands prefer to wait and see how the ecommerce space evolves in China, many of the CEOs interviewed said that this is an area they are looking to tap into and introduce digital strategies.

Another key potential area for luxury brand advertisers is mobile applications. Luxury brands are keen to establish their presence in the mobile world and some now showcase their new collections using social media and mobile applications. However, ongoing challenges for retailers include inadequate infrastructure, particularly in the case of logistics, concerns over counterfeit products and online payment transactions. Online pricing strategies can also be a challenge and luxury brands tend to be concerned with regards to how their products are marketed online.

According to a recent KPMG global technology survey, Chinese consumers are seeing the highest take-up of e-commerce and new technologies. In fact, a larger number of Chinese consumers engage in online shopping, compared to consumers in the rest of the world. This is across a wide range of items, from household products to luxury products. Top items included CDs/DVDs/books and video games, as 79 percent of survey respondents said they preferred to purchase goods online, ahead of 65 percent of global respondents.

China has also seen exponential growth in the use of mobile devices for both purchases and payments and is leading the way in the mobile banking space, because of the rapid take-up of smartphones. The rapid adoption of the smartphone is playing a significant role in terms of customer experience in the retail space. Over 50 percent of Chinese consumers said they use their smartphones at retail outlets to access coupons and mobile gift cards (46 percent), whereas global respondents said they typically use their phone to research products and services or to locate the nearest stores.

A DIGITAL APPROACH TO CHINA

- Social media is having a huge impact
- Wealthy Chinese consumers are relatively younger compared to the West. It is therefore important to interact with them early on
- Keep messaging on your brand via online platforms
- We see M-Commerce taking off in China

Jason Beckley, Marketing Director, Alfred Dunhill



The Chinese marketplace is one of the most dynamic and competitive in the world. The Chinese consumer is also driving the use of payments online which has had a significant impact on purchasing patterns in China. Consumers here are becoming more technology savvy with an increased take up of smartphones, iPad-type technology, and personal computers.”

Egidio Zarrella,
Clients & Innovation Partner, KPMG China

DID YOU KNOW

- Around 70 percent of potential consumers search for luxury brands on the internet at least once a month (*Source: KPMG luxury survey 2013*)
- 40 percent of respondents indicate they are interested in purchasing luxury goods on the internet, a substantial increase from 22 percent in 2011 (*Source: KPMG luxury survey 2013*)
- As of end-June 2012 there were 538 million internet users in China (*Source: China's Internet Network Information Centre.*)
- A larger number of Chinese consumers engage in online shopping, compared to consumers in the rest of the world. A recent global KPMG technology survey found that 79 percent of Chinese respondents prefer to purchase goods online, ahead of 65 percent of global respondents.

An online strategy for luxury

Sun Yafei, CEO, 5lux.com

Launched in 2009, Fifth Avenue Luxury Network (5Lux.com) is an early mover to China's online luxury segment. The website was launched to capitalise on an increasingly sophisticated online consumer network in China.

Digital strategies are increasingly being adopted as a tool to engage high-end consumers and 5Lux has identified its typical consumer in China: Aged 30 with a bachelor's degree or above, earning around RMB10,000 per month and located mostly in tier one and two cities, such as Beijing and Shanghai, as well as the provincial capitals.

Sun Yafei, CEO, 5lux.com, says of her firm's strategy: "As an e-commerce business, our advantage is that we provide convenience to our consumers and enable them to compare products across the board. We have chosen to focus on middle to high-income consumers who tend to buy based on their choice of brand, product design and quality, rather than on price."

The site has attracted consumers via a variety of means, including through word of mouth advertising, online search engines and media outlets. It also uses traditional advertising as a means to attract attention.

Yafei says: "As an online platform, we can afford to experiment with various advertising media, as long as we make clear that we are a high-end luxury retailer. For example, in Beijing which is prone to traffic jams, we have opted to place adverts of our site on buses as they travel through the congested



streets. These adverts are targeting consumers on the roads and in their cars."

Despite the opportunities, there are also hurdles for the fledgling online luxury retail business in China, as many luxury brands are still adopting a wait-and-see approach in terms of online sales. Yafei however expects this to change in the near future. "In the next three to five years, many luxury brands will start to collaborate with online retailers, as the internet generation becomes the next potential consumer group with purchasing power. The offline brands will need to adapt to this trend."

Online retailers also face trust issues, as some consumers are concerned about the authenticity of goods purchased via the internet. She explains: "As the e-commerce industry is currently not regulated, some consumers are concerned they may end up with counterfeit goods. Online sites therefore

have to prove their credibility and building a strong reputation requires time and effort."

In terms of maintaining a successful online strategy, she notes that e-commerce will become an increasingly segmented industry and brands will need to adapt. "While integrated platforms have large site traffic and other advantages, being a specialized platform is crucial to our growth. Online retailers now face a conundrum – they are looking for scale and profits, and to do so without diluting their brand image. At 5Lux, we have very stringent criteria, and we will reject both international and domestic brands if we don't think they will appeal to our customer base. It is also important to manage the number of brands in your online portfolio and the related SKUs carried. We have also placed a lot of effort into negotiating with brand owners, distributors and suppliers and having a strong after-sales customer service experience."

In terms of future opportunities, Yafei notes an increasing shift in consumer spend on luxury goods, as they become more discerning and expand their brand knowledge.

"When we launched our website four years ago, our customers were mainly from Beijing and Shanghai. At that time, consumers wanted to purchase the traditional, well known brands. While these still sell very well and are also now popular amongst white collar workers from cities such as Chengdu and Chongqing, in Beijing however, consumers are becoming more individualistic and products that reflect this are now more easily sold on 5Lux. We see a shift from the logo fever culture as consumers start to look for unique and individual products," she says.

Establishing a China footprint

Linda Liu, Founder and Chairwoman, Sheme

Linda Liu, Founder and Chairwoman of Chinese luxury shoe brand Sheme (Pronounced “she” “me”) started the business with only USD600 and a determination to succeed in a market that has traditionally opted for heritage brands from Europe, with typically a 100-year history.

Enterprising and ambitious, Linda recognised the potential for developing a home-grown luxury brand in China, as consumers here become more discerning and as they seek greater variety. A native of Sichuan province, she launched a trading business in 1986 – selling shoes from her bicycle – and eventually branched into manufacturing shoes and selling both in China and overseas.

With 26 years experience working in the industry, starting with a small shoe shop in Chengdu, Linda now owns a business that employs 3,000 staff with a network of 40 stores across Mainland China, including Beijing, Shanghai and Chengdu (where the headquarters are located).

Linda spent ten years sourcing top global designers, craftsmen and artistic directors to create an international team in 2008. It includes former designers and artistic directors from top brands including Armani and Chloe and infuses a blend of east and west creativity into the shoe designs.



Linda says: “We are striving to meet the aspirations of today’s female Chinese consumer. The main characteristics of Sheme include our link to Chinese culture; we use Chinese craftsmanship as well as the best raw materials from around the world. We have embraced China’s unique cultural heritage in our designs, and apply high quality hand-crafted techniques. A lot of our shoes have hand embroidered elements to them and we also place a lot of importance on making our shoes comfortable to wear. A handful of shoes are made every day in order to maintain the quality, and it involves intricate handiwork, including detailed embroidery and Swarovski crystals.”

With three factories under ownership in China, Sheme is currently focusing on building its high-end footprint in the country with plans to eventually establish stores in Europe, including Milan, Paris and London. In October 2012, Sheme opened a new store at the Bund in Shanghai.

Linda points out: “Every year we export over USD50 million worth of shoes to international markets, so this clearly an important part of the business for us. In Mainland China we currently have four high-end outlets. I plan to continue to focus on brand building and expanding my team of craftsmen and designers”

“We see that Mainland Chinese consumers have become a lot more sophisticated. Female consumers are moving up the value chain and rewarding themselves. Fashion has also changed considerably and I see more women selecting their shoes before deciding what to wear,” she adds.

The Evolving Chinese Consumer

We see rising sophistication amongst Mainland Chinese consumers, in terms of an increased interest in experiential luxury as well as seeking independent and unique brands.

Florian Craen, Regional Managing Director, Hermes, says: "China is a key market but it is Chinese customers that are changing our industry. We see consumer behavior patterns changing at a very rapid pace. Values linked to craftsmanship, selectivity in the distribution and scarcity of the product are becoming more important in the eyes of consumers in this market."

Brand recognition continues to increase, as our survey highlights. This year's respondents said they recognize 59 luxury brands, a figure that continues to rise over our successive annual surveys.

56 percent of survey respondents said they prefer to purchase well known luxury brands, whilst 69 percent separately indicated they would pay a premium for well known, popular luxury brands.

Timothy Coghlan, Senior Manager, Luxury Retail at Savills China, says: "We continue to see some of the major brands doing their biggest global marketing events in China, because one of the key strategies is to 'Think Big' in China and brands have got to have the wow factor."

Number of luxury brands recognised in China (percent):





BRICKS AND MORTAR STRATEGY

- Some brands have waited years for prime sites in T1 cities
- We are now seeing some brands 'reverse engineering' by going into T2-3 cities with a view to moving up the value chain
- Some of the niche brands need to impress landlords before obtaining prime sites
- One of the general trends is that of rising rental costs
- Another interesting observation is that brands are making bigger 'facades' but still only retaining single floor space.

Timothy Coghlan, Senior Manager, Luxury Retail at Savills China

Armando Branchini, Executive Director at Fondazione Altagamma, the Italian Luxury Association, adds: "Italian luxury brands have been in China for a long time and there will be more opportunities for 'niche' brands. I see a wave of new big Italian brands coming into China without the logo mania. Niche Italian brands are very sophisticated and Chinese consumers are looking for something different."

There are differing perceptions of luxury brands depending on which country they are from. In the figure below, Hong Kong has topped the Fashion segment, with 70 percent of respondents placing it in the number one spot. Meanwhile, 69 percent of respondents indicated Germany leads for industrial design, while 52 percent said France was in the top spot for luxury design.

Attitudes towards luxury

	Germany	Mainland China	Hong Kong	France	UK	Swiss	US	Japan	Italy
	%	%	%	%	%	%	%	%	%
Free	15	14	63	45	28	29	77	15	38
Fashion	15	13	70	58	28	29	46	28	43
Long history	46	80	13	40	58	45	15	18	44
Romantic	11	9	30	89	26	29	23	12	53
Precise	72	26	9	8	41	38	11	54	11
Famous for luxury design	16	6	30	52	24	39	23	9	45
Famous for fashion design	12	7	45	56	24	26	32	21	45
Famous for industry design	68	17	10	8	36	39	35	40	14
With culture heritage	38	69	19	43	51	41	16	21	44
Famous for arts	17	16	19	54	31	30	16	15	56
Total	310	257	307	452	346	345	293	237	393

DID YOU KNOW

59% Of respondents prefer high awareness luxury brands, compared with niche, low awareness luxury brands

69% Of respondents would pay a premium for a popular, well-known luxury brand

Luxury consumption is still viewed as a status symbol in China. Respondents said their perception of people who own luxury goods are that they tend to enjoy a high quality of life, are successful, fashionable and have good taste, all positive attributes.

Figure 15: What's your view of consumers who own luxury goods?

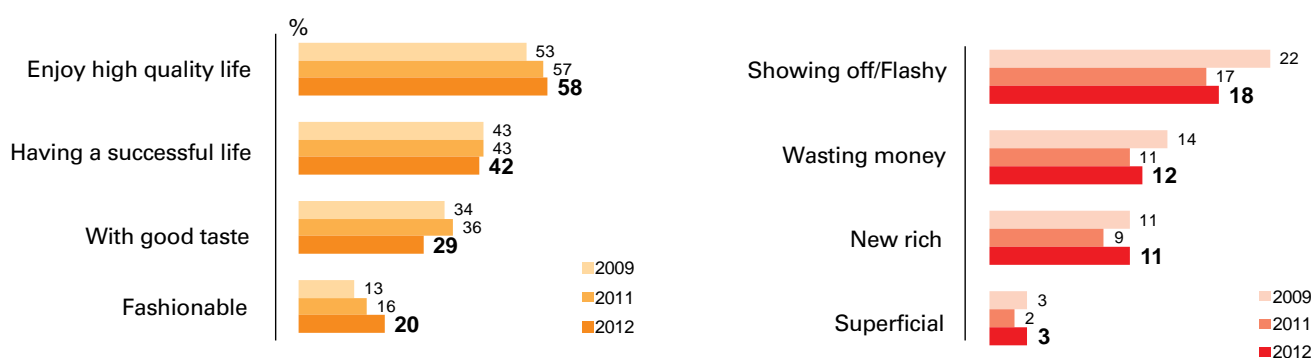


Figure 16:

Luxury Goods	Experiential Luxury	Collecting
To reward myself 51%	To enjoy high quality life 53%	As an investment 53%
For important, formal occasions 48%	To reward myself 50%	To reward myself 30%
To pamper myself 43%	To pamper myself 42%	To appreciate the quality, design, and history 29%

Figure 17 indicates that emotive compensation needs are important for all luxury categories. Respondents indicate status as a stronger motivator for tangible luxury products, while experiential is driven by a specific occasion and collecting by investment needs.

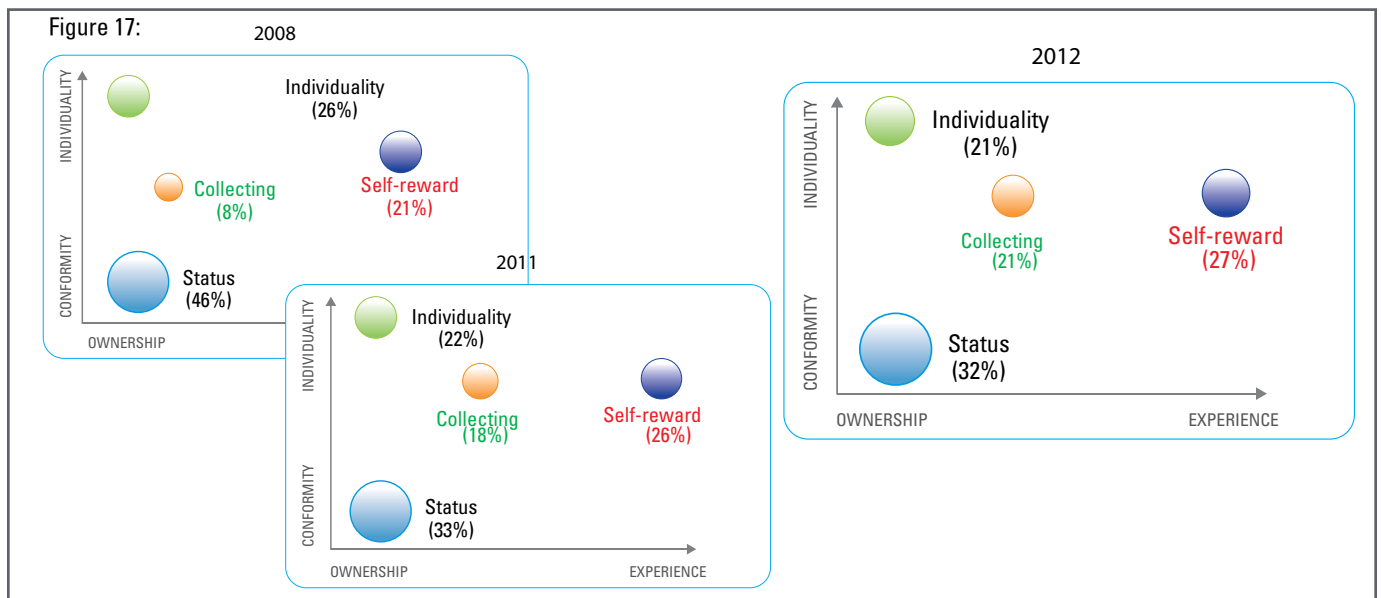
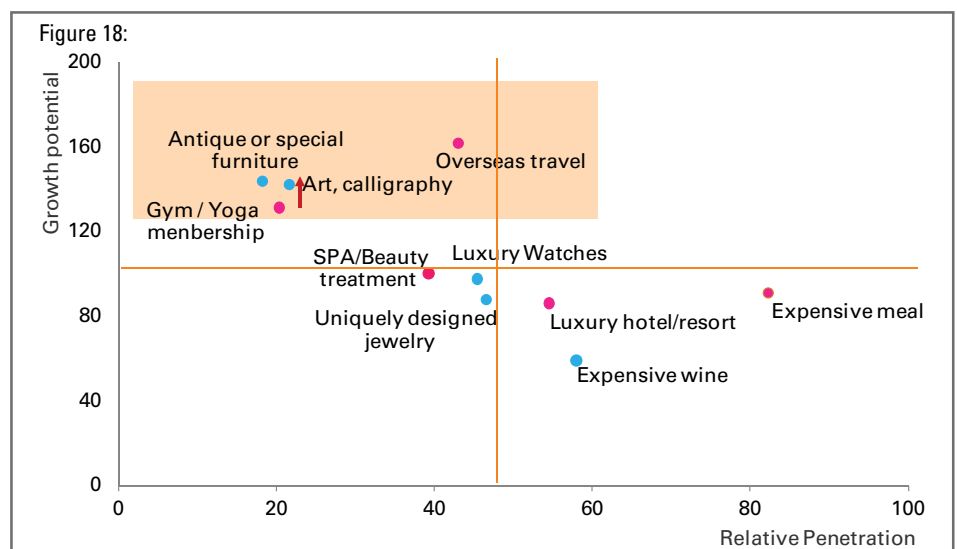


Figure 18 shows that overseas travel, antique purchases, spa treatments and gym and/or yoga memberships are on the rise and are likely to continue to do so. Luxury consumers increasingly indicate they want experiences that make them feel pampered and that are more memorable. As consumers seek more individuality, luxury experiences can offer greater potential for unique personal enjoyment. We therefore see a larger segment of consumers opting for luxury holidays, hotels and spa packages, both within China and overseas.

Morgan Ji, Deputy Secretary General, the China Luxury Industry Association (CLIA), says: “We have seen significant change in China over the last 30 years. There is much greater awareness of brands and also a thirst for knowledge. Consumers are keen to broaden their experiences of high-end prestige goods. We also see the rise of experiential luxury.”





DID YOU KNOW

- Brand recognition continues to increase, as our surveys highlight. This year's respondents said they recognize 59 luxury brands, a figure that continues to rise over our successive annual surveys. Respondents in tier-one cities recognized 61.9 brands, compared with an average of 56.4 in tier-two cities.
- 56 percent of respondents said they prefer to purchase well known luxury brands, whilst 69 percent separately indicated they would pay a premium for well known, popular luxury brands.



A luxurious experience

Clement Kwok, CEO, The Hongkong & Shanghai Hotels, Limited (HSH)

Affluent mainland Chinese are the second largest global clientele for The Peninsula Hong Kong, says Clement Kwok, Chief Executive of The Hongkong and Shanghai Hotels, Limited (HSH).

With a rising number of well heeled Chinese travelling overseas, the HSH group of Peninsula Hotels has seen a significant rise of this market throughout its hotels in Asia and the USA.

Incorporated in 1866 and listed on the Hong Kong stock exchange, HSH owns, develops and manages prestigious hotels and properties across Asia, US and Europe. Its hotel portfolio comprises The Peninsula Hotels in Hong Kong, Shanghai, Beijing, New York, Chicago, Beverly Hills, Tokyo, Bangkok, Manila, with a new hotel scheduled to open in Paris in 2013.

Clement stresses the importance of quality over quantity in his business. "We are a niche operator and only focus on owning and operating a small number of super luxury hotels. We don't do management contract hotels and we target independent high level discerning consumers who know what they want. The mainland China business therefore is very important for us - in China itself for domestic travellers, in Hong Kong and across the rest of Asia."

The Peninsula Shanghai, located on the riverside Bund in the heart of the city, attests to this point. Paying homage to Shanghai in the 1920s and 1930s, the hotel recreates the look and feel of this era. Many of the hotel's top suites are



occupied by affluent mainland Chinese clientele from neighbouring cities, including Shanghai itself, Beijing and other leading mainland cities. It has three restaurants serving authentic Cantonese dining and modern European cuisine. Its shopping arcade meanwhile hosts over 28 prestigious international brands.

"Shopping is a key factor in some of the travel patterns for the mainland Chinese consumers," Clement explains. "We also see increasingly sophisticated dining expectations. Our mainland Chinese clients are quite discerning about the level of service and the creativity of our menus; some, for example, want us to source special ingredients. Additionally, high net worth clients from Hong Kong are increasingly travelling or making Shanghai their second homes, so there is a lot more intermingling nowadays."

In terms of further expansion plans in mainland China, Clement says: "We are looking at other cities to source

development opportunities that we would commit to long term. Our strategy is to develop and hold hotel assets for a very long term play. Our product in China is defined by our unique hotel in Shanghai, and we want to ensure all our hotels measure up to the same standard."

Further afield, the Peninsula in Bangkok has seen an increase in mainland Chinese tourists and later this year HSH will open a Peninsula in Paris, by the Champs Elysees.

"The key is to understand the Chinese traveller," Clement adds. "All our collateral and menus are translated into Chinese and we have Chinese restaurants in seven out of our nine hotels. We run wine pairings with Chinese food and have a Chinese chef's table at our restaurants in Hong Kong and Shanghai. These are all important steps towards further establishing our brand in China."



Radiant growth in China

Laurent Lautier, President, Asia Pacific at Clarins

French cosmetics group Clarins is seeing strong growth in China, a market that is currently among its top five and is expected to take the number one spot in a few years.

Founded in 1954, the brand has been present in Asia since 1996. Laurent Lautier, President Asia Pacific at Clarins, says: "We have products that have existed for around 50 years. In Asia, we are the challengers, having arrived after our competitors. Across Asia we have rebuilt the story of the group from the very beginning leveraging the "institute expertise" of our brand and the experience in skin care. It is the reason why we focus on skin care products. Five years ago we entered China via a distributor and we established a joint venture structure 18 months ago with a majority stake. We own the brand and control the strategy. Our strength in this market is our position as market leader in the body skin-care line and the success of Clarins' unique products like Shaping Facial Lift."

Clarins products that are proving a success in China include the Shaping Facial Lift, a special serum which provides Asian consumers the perfect V-shaped contours from every angle and White Plus, a product franchise which reveals the best fair skin of every woman. The company also re-launched Double Serum, a dual-phase serum combining the strength of two powerful anti-aging serums created from 20 botanical extracts. The product was



designed with a lighter texture to cater to the needs of Asian women.

Laurent explains: "We researched the Shaping Facial Lift product in France in our laboratory, with the objective to deliver an answer for woman in Asia: how to enhance the shape of their face. We worked closely with consumers in Asia. This product is a fantastic success and helps us to build credibility in face care. We are also establishing an anti-aging product line, which is currently the biggest skin care market in China. We are following the same methodology: listening and understanding Asian consumers."

"In order to bring the best Clarins experience to Chinese consumers, we have also built a number of skin spas, two in Shanghai and two in Beijing. It is also for us the best way to remain close to Chinese female consumers and to better analyze their expectations," he adds.

Laurent also notes a significant impact from rising numbers of travelling Chinese: "We have Chinese speaking sales, training and marketing teams in many countries like in France, in shops such as Galeries Lafayette but also in our offices. For example, in the months of March and April, when consumers are looking for whitening products, we are providing all the whitening products Chinese consumers want to buy and not only in Asia, but also in all overseas locations where they tend to shop."

In Hong Kong meanwhile, around 50 percent of the group's business is driven by Mainland Chinese consumers.

Clarins aims to continue to expand its presence in Mainland China. It currently has over 100 points of sale across the country and is set to establish an R&D centre in the coming months, most likely in Shanghai. Laurent concludes: "China amounts to around 20-25 percent of our business and is the fastest growing and largest market for us in Asia. The brand is growing very fast in China and 2012 was a very good year for us, as we have gained a significant percentage of market-share."

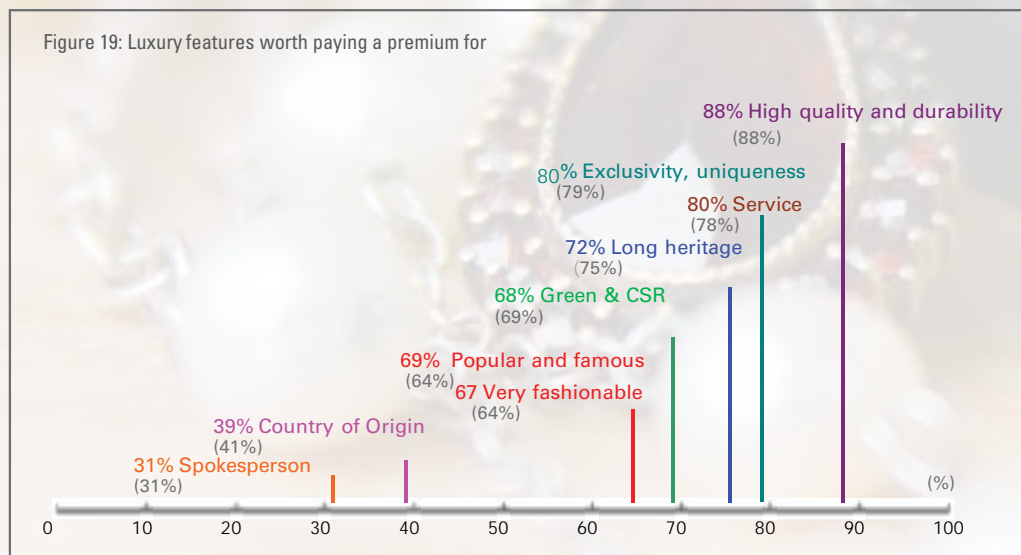
The Luxury Landscape

China continues to play a very important role for global luxury brands. As Chinese consumers increasingly travel further afield, their tastes and knowledge of products continues to widen.

It is therefore increasingly important for luxury players to maintain a strong brand image and synergies in their marketing and product selections both in China and also overseas, in order to cater for those travelling consumers. Additionally, incomes across China are rising and an ever growing middle class also represents significant domestic opportunities for luxury brands, as they expand their footprint across the country.

Figure 19 shows that 88 percent of respondents indicated they would be willing to pay a premium for luxury brands that display high quality and durability; 80 percent indicated exclusivity and uniqueness as key factors, while 72 percent said the heritage of the brand plays a significant role.

Figure 19: Luxury features worth paying a premium for





Consumers in China also distinguish among countries of origin and associate certain countries with particular products. As you would expect, Switzerland came top for luxury watches, while France scored highest for cosmetics and perfumes, clothes and bags and Germany for automobiles. There continues to be a strong association towards European heritage brands in these categories.

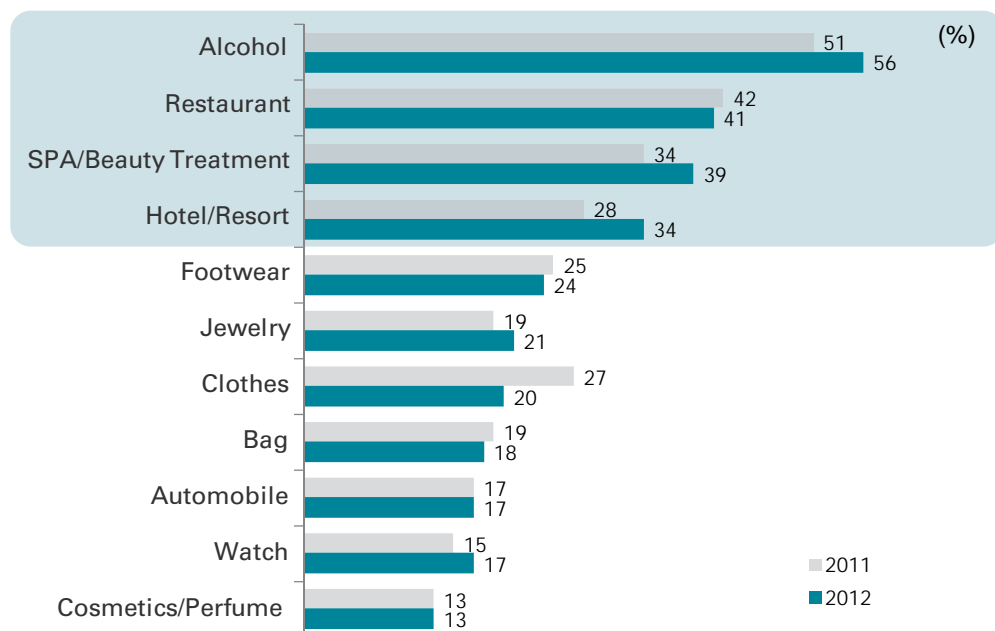
While we see an increase in the number of homegrown Chinese brands, they face tough competition from older European luxury brands that have hundreds of years of history and heritage behind them. Therefore they need to think carefully about how they position and differentiate themselves in this market.

Figure 20: Strong sense of country of origin by category

	Mainland China	Hong Kong	France	UK	Switzerland	US	Japan	Italy	Germany	Spain
Clothes	12	9	37	7	2	8	4	18	2	1
Bag	9	5	31	10	5	11	2	21	5	1
Footwear	13	6	22	10	2	10	2	27	5	1
Watch	7	3	6	4	69	3	1	2	5	0
Jewelry	13	21	25	8	9	7	1	11	3	1
Cosmetics/Perfume	7	6	62	5	2	7	4	3	2	1
Alcohol	33	2	33	10	3	6	0	5	3	3
Automobile	8	1	4	7	1	14	4	4	57	0
SPA/Beauty Treatment	19	11	23	6	5	6	20	2	3	2
Hotel/Resort	15	10	15	8	16	15	7	6	2	3
Restaurant	33	8	27	6	3	5	3	11	2	2



Figure 21: From which categories will we see Chinese brands emerging?

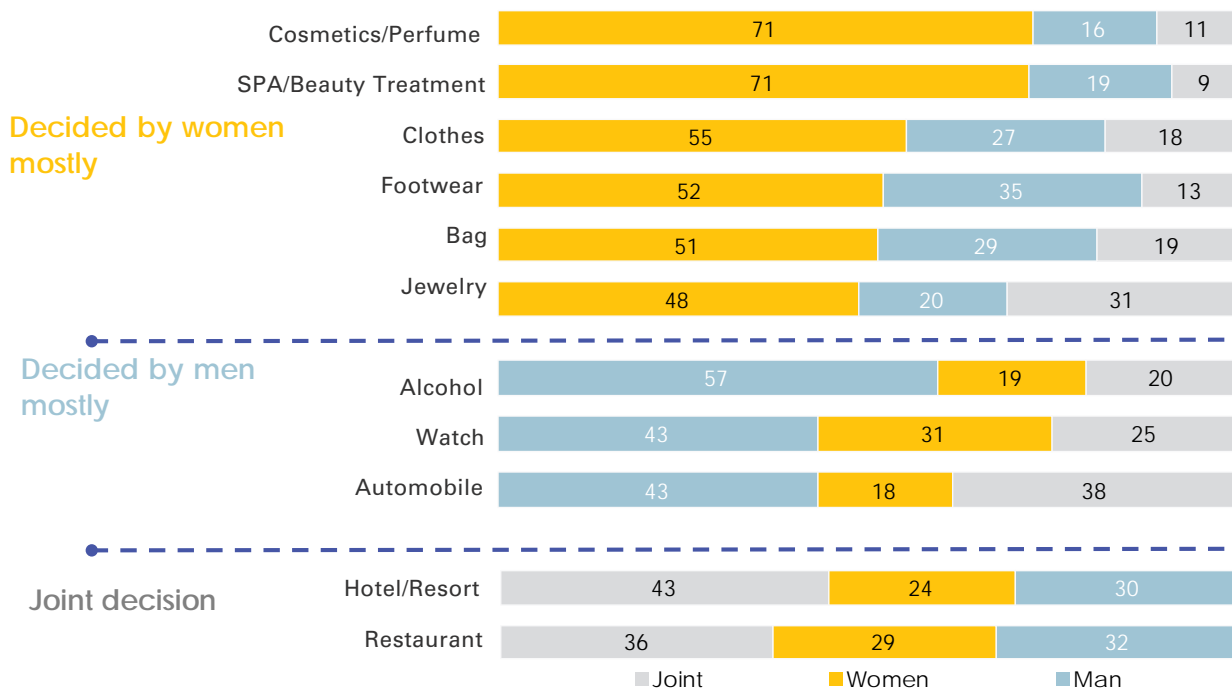


Interestingly, our respondents also indicated that they expect domestic Chinese luxury brands to increasingly compete in the experiential space, the top categories being alcohol, restaurants, spas, hotels and resorts. This suggests that domestic Chinese brands are perhaps more likely to capture this niche of the market, as it's not an area that requires heritage or history considerations, which other European luxury products such as watches, bags and jewelry tend to be associated with.

As Dennis Chan, Chairman of luxury firm Qeelin points out: "We have always expected that Chinese consumers would develop a growing awareness of their roots and believed that in time, those consumers would seek out brands that express their own values."



Figure 22: Men and women luxury consumers (%)

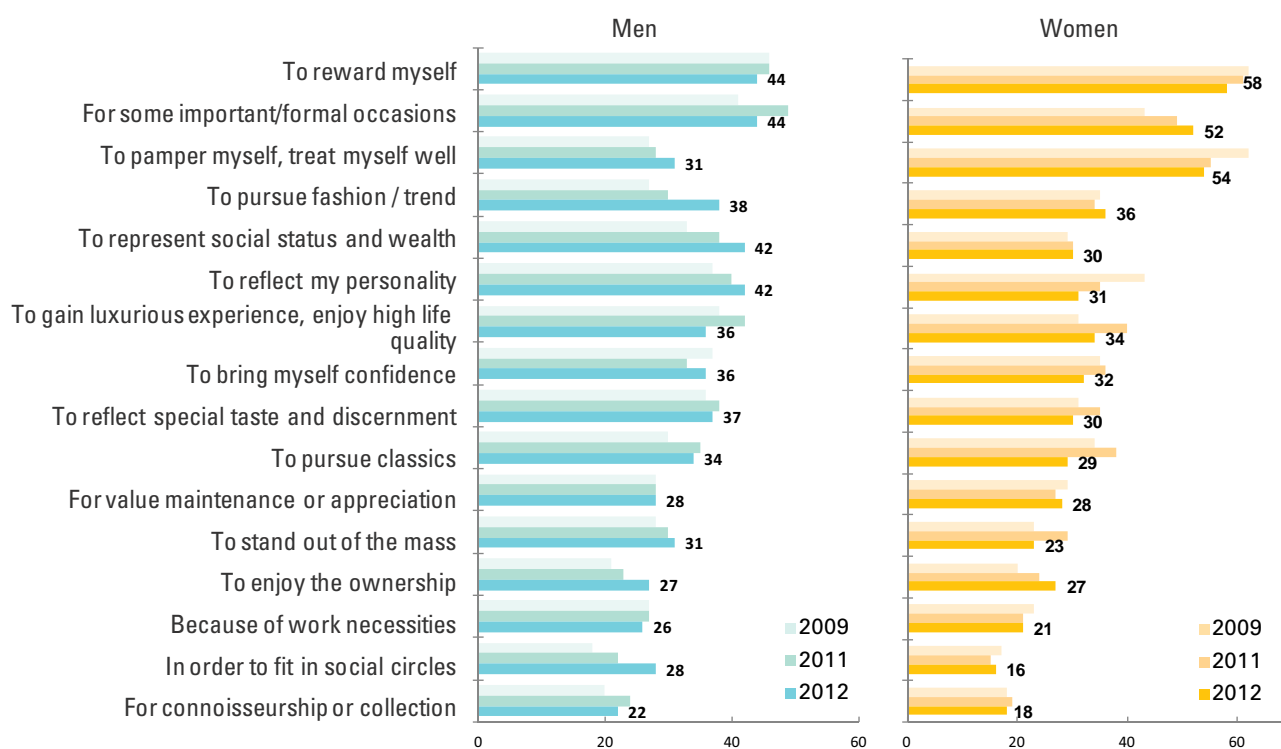


Our survey also indicated that women tend to make purchasing decisions around cosmetics, perfumes, spa treatments, clothes, footwear, bags and jewelry. Men on the other hand mostly decide on purchases related to alcohol, watches and automobiles. Joint decisions are made on hotels, resorts and restaurants. While there are some similarities in terms of motivation, women appear far more likely to buy luxury as a form of self-reward and pampering, whereas men are traditionally driven by status.





Figure 23: Luxury goods purchase motivator differ by men & women (%)



Understanding Taxes for Luxury firms

Customs issues

China continues to play an important role as a large and expanding market for luxury brands. However, its complicated customs environment adds additional challenges to its already complex local tax system.

Most luxury goods are still subject to moderately high customs duty rates ranging from 0 percent to 65 percent, on top of consumption taxes which range from 0 percent to 45 percent. Lilly Li, KPMG's Asia Pacific Leader for Trade & Customs, says: "Overlooking the potential impact of customs duties and consumption taxes on luxury products can easily affect product marketability and bottom lines."

Regardless of whether goods are imported into or manufactured in China, luxury firms should carefully consider the potential customs implications of their business models.



DID YOU KNOW

- **Royalties** – Many luxury products carry brand names and intangibles for which royalties or license fees are paid. China Customs often takes a default view that all royalty payments that are remitted to offshore intellectual property holders are subject to customs duties. However, if properly structured, these royalty payments may be excluded legitimately from the customs value, resulting in significant savings.
- **VAT reform** – Prior to Value Added Tax (VAT) reform, royalty payments could be subject to three types of irrecoverable taxes – customs duties, business tax, and consumption taxes. However, due to the reforms piloted in Shanghai and rolled-out to a number of provinces this year, business tax has been replaced by recoverable VAT. This brings down the irrecoverable tax categories for royalties to two which eases the tax burden for companies paying royalties and license fees to foreign entities on their imported products.
- **Free Trade Agreements** – China has entered into nine free trade agreements (FTAs) offering reduced duty rates for qualifying products from 17 different countries/territories. These FTAs are still heavily underutilized and afford a significant opportunity for companies to plan and realize customs and tax savings. Unlike before, more FTAs now accommodate principal / re-invoicing and centralized regional distribution structures.
- **Special Customs Supervision Areas** – Luxury companies planning to partly or fully manufacture their products in China may consider a variety of special Customs supervision areas offering tax and customs incentives depending on the type of products to be manufactured, its raw material sources, the manufacturing process to be undertaken, and target market. Care must be exercised in selecting the appropriate location. If an inappropriate site is chosen, any incentives offered could be eroded by significant tax burdens on exports (irrecoverable export VAT) and local sales (customs duties).

Transfer Pricing trends

The transfer pricing environment in China has proven to be particularly dynamic for the luxury industry over the past few years. As many luxury goods players have enjoyed very strong growth and profitability in the China market, the question on how these profits should be allocated across various jurisdictions who are participating in the value chain has gained increasing importance. Not surprisingly, China has actively started to foster views according to which the majority of such profits should be taxed in China, due to unique characteristics of the Chinese market.

Kari Pahlman, KPMG's Asia Pacific Leader for Transfer Pricing, says: "Chinese tax authorities have actively used the luxury goods sector as an innovation platform to develop novel transfer pricing concepts all of which are designed to increase income allocation to China. It has become increasingly difficult for multinational luxury goods to avoid profit and cash traps in China and incurring substantial transfer pricing risks in their offshore (non-China) operations. Multinationals need to develop hybrid and proactive strategies to manage the inherent global transfer pricing risks pertaining to their China operations."



DID YOU KNOW

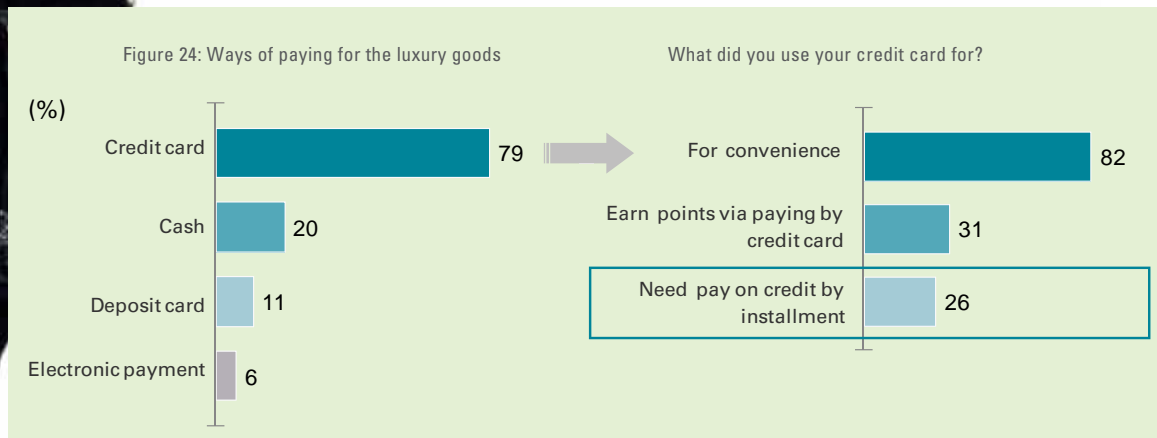
- **Profits Traps:** Multinational luxury goods groups frequently face challenges in ensuring that any excess profits and/or cash are not “trapped” in China. This is especially true in the case of luxury goods where intangibles such as brands play an integral role in the value chain. In such situations, multinational groups are often looking for ways to effectively transfer price excess profits from China, however, these attempts are frequently countered by Chinese tax authorities, who are constantly seeking to develop “innovative,” China favorable transfer pricing approaches.
- **Local marketing intangibles:** China tax authorities continue to strongly believe that local Chinese entities have developed “local marketing intangibles” via their marketing efforts and therefore commonly challenge mechanisms (such as royalties) for returning residual profits to the global brand owners. This may be particularly likely where the local Chinese entity appears to have “invested” in developing the China market, as evidenced by losses during the early years of operations. In this regard, consideration may be given to the implementation of support payments to the local Chinese entities to reduce risk of locally developed intangibles. These arrangements may also offer opportunities to utilize tax losses in other jurisdictions, therefore potentially improving the group’s overall tax efficiency.
- **Market premiums and location savings:** China tax authorities frequently argue that local Chinese entities are entitled to earn some or all of any “market premium” – i.e., any excess profit associated with the ability of some luxury goods to sell at a higher price in China vis-a-vis other markets – even if the local entity did not undertake any activities to create such market premium or to increase the value of the brand. China tax authorities also continue to take the position that local Chinese entities are entitled to capture a large share of any “location savings” that a multinational enterprise achieves by producing products in China. Pro-active multinational groups are responding by documenting offsetting factors, such as how these savings would be split between independent market participants in comparable situations and the extent to which any perceived location savings are actually passed on to the customers.
- **Advanced Pricing Agreements (APA):** Some APA negotiations in the luxury goods industry are currently struggling, largely due to the inflexible positions of the Chinese tax authorities regarding local marketing intangibles and local market premiums. However, on a longer term basis, managing actively relationships with the tax authorities across all levels of the tax administration and utilizing particularly bilateral APAs in a strategic manner continue to offer the best solutions to proactively manage the inherent transfer pricing risks in China for the luxury goods industry.

CUSTOMS AND CONSUMPTION TAX RATES ON LUXURY PRODUCTS IN CHINA

Product	Customs duty rate	Consumption tax rate
Jewellery	0%-35%	10%
Watches	11%-23%	20%
Clothing	14%-25%	n/a
Bags	10%-20%	n/a
Wine	0%-65%	5%-20%
Cosmetics	6.5%-15%	30%
Golf equipment	12%-14%	10%
Automobiles	25%	1%-40%
Yachts	8%-10.5%	10%

CREDIT CARDS:

In terms of payments, credit cards are increasingly used, however only a minority of respondents said they use installments as a means to clear payments.





In the fast lane

Edwin Fenech, Greater China President and CEO, Ferrari

When Ferrari founder Enzo Ferrari stated “always sell one car less than what the market requires” more than 50 years ago, little did he probably have the China of 2012 in mind. But as Edwin Fenech, Greater China President and CEO of Ferrari explains, scarcity of product is a keystone of the company’s business model and one that is helping steer the legendary brand to success in China:

“We are not here to sell volumes – if we sell a car, we have to sell it in the proper way and make people understand what they are buying: our heritage, our values and the technology that we have in our cars,” he says.

Ferrari, which sold its first car into China in 1992, established an official presence in 2004 with headquarters in Shanghai. This year it will open its 20th dealership in China. While Mr. Fenech says China could be the company’s largest market down the track (currently second behind the US), his focus is on nurturing an “evolution of the mindset of people,” branding and remaining true to the DNA of Ferrari.

He explains that Ferrari’s business model may be hard to digest for some of China’s wealthy – who might want goods immediately rather than waiting – but notes an emerging category of buyer that appreciates Ferrari’s unique proposal. “People want to differentiate themselves through different ways – the most-wealthy want unique products, that’s why I think a lot of brands in China are making limited editions.”



Ferrari produces just 7,000 cars a year from its production base in Maranello, Italy, with some 500 of those now arriving in China each year. A limited edition of twenty 458 Italia China models, marking the 20th anniversary of sales into China and the Year of the Dragon was released. The cars incorporate traditional Chinese ‘long-ma’ (dragon-horse) elements and craftsmanship such as calligraphy in the interior and golden dragon insignia adorning the bonnet. “Chinese want to rediscover their culture,” Mr. Fenech says. “It is very important to listen to what they want and the trends.”

Initiatives to distinguish the brand’s values in China have included a staff/dealership training centre in Shanghai and opening a Ferrari Myth exhibition in the former Shanghai Expo Italian pavilion – undertakings previously restricted to only within Italy. Customers can also join the Ferrari challenge series to race on an F1 circuit, take a course to become a race pilot, enjoy virtually unlimited customization options, take ownership of the specific car design patent

under a “one-off” programme, and benefit from 7-year’s maintenance or extended 10-year warranties. “These are all things that are quite unique to Ferrari,” says Mr. Fenech. “We sell the cars, but being present for the after-sale services is absolutely the key.”

Finding centrally located dealership locations remains a challenge for Ferrari given space requirements, technological needs and competition among luxury brands. Mr. Fenech adds that “the right location today is not necessarily the right location of tomorrow” and that assessing the evolution of each city in China is important.

Securing the right people, whether employees or partnering dealers, has also been difficult given Ferrari’s strong values. “In this booming situation in China where talented people are solicited by every other company – especially because Ferrari is a benchmark – retaining employees is a challenge,” Mr. Fenech explains.

Ferrari has also invested in a social media team dedicated to local applications, such as Weibo, with which Ferrari gained 320,000 followers in China in less than a year. “Especially now in China, social media has become a must,” he says, adding its speed and size means potentially serious repercussions if not managed openly and honestly.

Mr. Fenech says unlike in most countries, Ferrari cannot leverage on the main assets of the brand – particularly in less-developed tier 2, 3, or 4 cities – as some consumers have yet to differentiate between various high-end sports car manufacturers. “That’s why we are working on branding in order to create a difference, to put Ferrari in its deserved position, which is leadership,” he says.



Organic Growth in China

Jim Siano, President & CEO Asia Pacific, Montblanc

European luxury brand Montblanc shares a name with the highest peak in the region and is known for its high precision gold and diamond-encrusted pens, watches, jewelry and leather accessories.

Founded in 1906, and using a distinctive “White Star” logo, the company began producing up-market pens in Germany. Today Montblanc forms part of the Richemont group and its sister companies include luxury brands Cartier, Van Cleef & Arpels, Chloé, and Baume et Mercier.

Montblanc operates in 70 countries via 440 of its own boutiques and other retailers. Its biggest market is Mainland China, followed by the US and Hong Kong. The company, which entered China in 1992, has 102 points of sale in 53 cities.

Jim Siano, President & CEO Asia Pacific, Montblanc says: “When I joined the group, 60 percent of sales in this region were from Indonesia. In Mainland China, Montblanc tended to be positioned on the eighth floor of department stores next to the toy section, with a metre and a half sized counters. In the early days, it was difficult to get more prominent positioning in the tier one cities, so we established ourselves in the North-east region of China and started off on the ground floor of a department store in Harbin. We then expanded across the region and then went back to Shanghai and Beijing, with ground floor positioning.”



The brand has a strong European identity - its leather products are made in Italy, jewelry in Milan, pens in Germany (its headquarters) and watches in Switzerland. Montblanc watch prices range from RMB 30,000 to RMB 2.5 million.

“In China, we started with pens, leather and watches and took control of all the marketing, products and points of sale. We started with small stand-alone stores and enlarged them over time as we view retail as a profit making venture. In terms of building the image of the brand, we created the standalone store concept in China which all other brands emulated after seeing our success,” Jim adds.

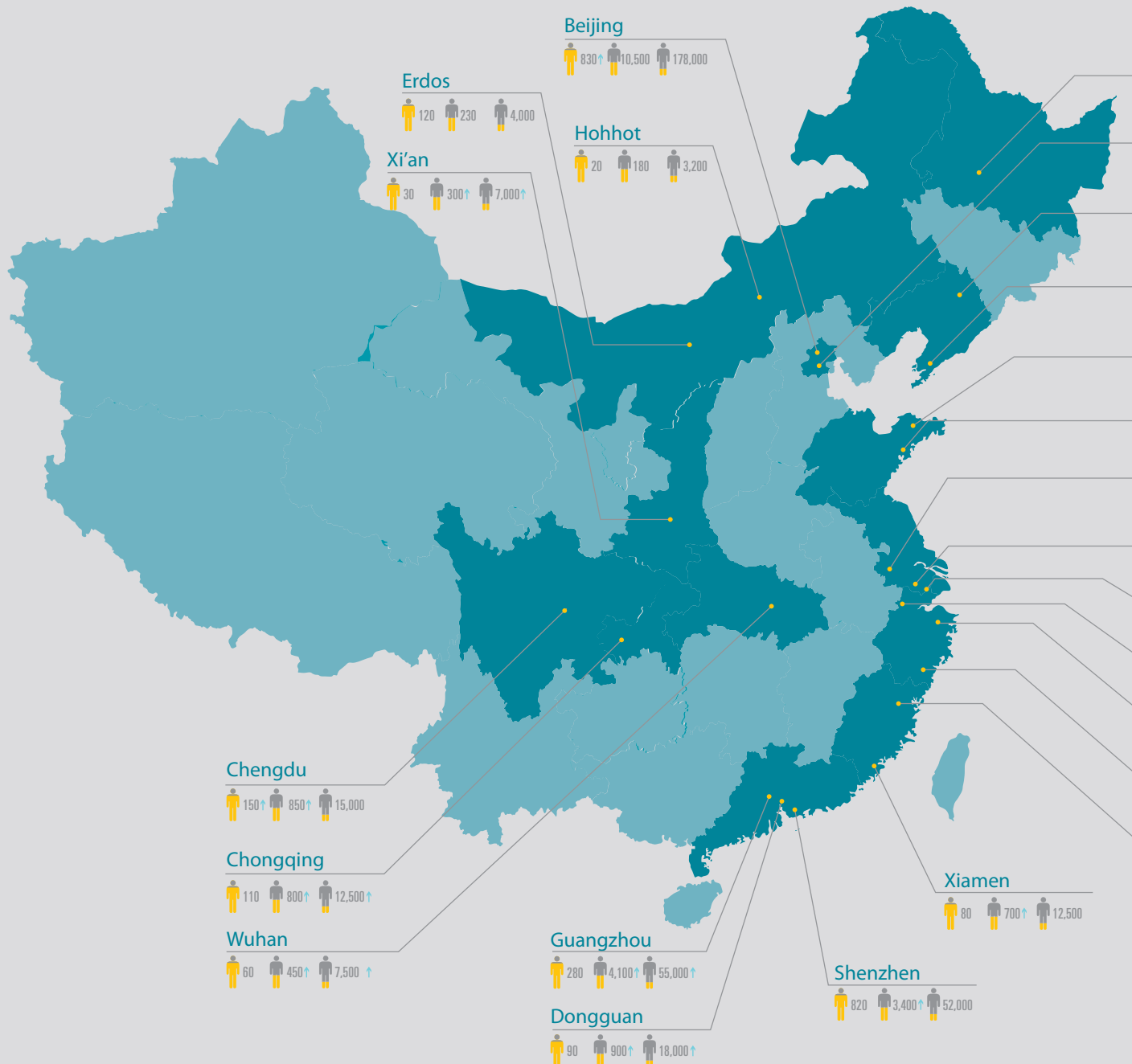
The travelling Mainland Chinese tourist is also contributing significantly to the group’s sales overseas, including Hong Kong where 80 percent of sales are driven by Mainland Chinese consumers.

In early 2012 the group opened its largest concept boutique yet in central Beijing, as it continues to remodel its existing stores and expand scale. “It is very important to have a dominant position in China in order to trigger sales in Europe and the US. China has moved on from conspicuous consumption to a more discerning consumer culture, one that is forward looking,” Jim notes.

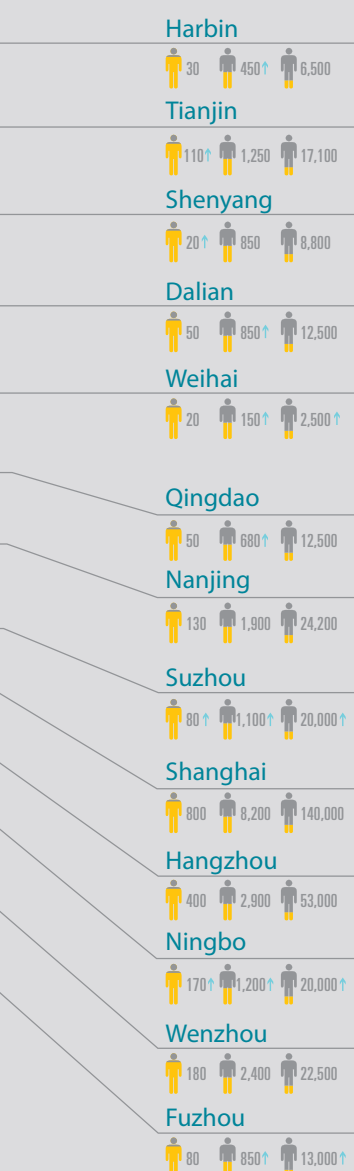
Pens continue to be an important segment of the business while watches have seen the fastest growth. “We are focusing on being in the right locations, with bigger stores and the right offerings for our customers, as we already have achieved a wide geographic coverage. We will focus on maintaining our strong brand image in China, with strong sales and positioning in the malls. We want to grow organically because that is the long term future for the brand,” he concludes.

Hurun Insights

Where Do Chinese Millionaires Live ?



Source: Hurun Report 2012



China's Wealthy Consumers

Chinese individuals with more than RMB10 million (equivalent to USD1.6 million) broke through the one million mark for the first time in 2012, reaching a record 1,020,000 individuals, an increase of 6.3 percent over the previous year, according to Rupert Hoogewerf, founder of the Hurun Report, a luxury magazine which publishes China's annual rich list. "China is also home to 63,500 super-rich, defined as individuals with RMB 100 million (equivalent to USD16 million), an increase of 5.8 percent from that of last year."


China is home to 7,500 individuals with RMB 1 billion (USD150 million) or more in total assets, up by 3,500 on last year. "We conservatively estimate that for every Chinese HNWI that the Hurun Research Institute identify, another two exist under the radar, thus there are 260 individuals with RMB 10 billion, of which 130 have "Known" wealth and the other 130 have "Hidden" wealth," Rupert adds.

Hurun's research shows that on average, millionaires are 39 years old, and 60 percent of them are male. They have two private bank accounts, three cars, 4.2 luxury watches, spend 8 days a month on business trips and go on 3 international trips per year.

85 percent of millionaires plan to send their children abroad for education, whilst among billionaires, this figure is 90 percent. One third of millionaires own investable assets overseas and account for 19 percent of millionaires' total assets.

Business Owners make up 50 percent of millionaires in China, followed closely by Professional Investors, accounting for 20 percent. Real Estate Investors and High Level Senior Executives each account for 15 percent of China's millionaires.

Meanwhile, property lost top spot to manufacturing as the key source of wealth for the Hurun China Rich List 2012, for the first time since records began in 1999. Although the super rich in China have seen their wealth shrink in the past year, it is important to realize that compared with as little as five years ago, they are still up 50 percent.

 RMB 1 billion (pax)

 RMB 100 million (pax)

 RMB 10 million (pax)

↑ Rose significantly compared to last year



Wines and watches on the block

Sam Hines, Head of the watches department for Christie's Asia and Simon Tam, Head of Wine, Christie's China

Wine and watch auction sales continue to be driven by rising demand from Mainland China, as consumers here become more discerning and collectors seek one-off pieces.

Sam Hines, Head of the watches department for Christie's Asia, says: "The Chinese market is becoming more sophisticated in terms of its watch purchases. In 2002, our world-wide sales were USD8million, while in 2011 this increased to USD116 million. In ten years, the watch category has grown significantly, because of the strength of the market and people wanting to sell here."

For example, an extremely rare Patek Philippe made in 2003, sold for more than USD1 million in the Christie's November 2012 auction in Hong Kong. The platinum wristwatch featured 12 complications including minute repeat, tourbillon, perpetual calendar, retrograde date, sky chart, moon phases, orbit display and side real time.

Sam explains: "Patek Philippe watches encompass heritage, history and the



philosophy of the brand and a lot of China collectors inspire to buy these. Patek has opened a flagship boutique store in Geneva and also in Shanghai, of almost the same size. A lot of the modern watches they make nowadays also show China influences, for example a preference for complicated and diamond set watches. Prices for pocket watches meanwhile have increased by as much as 1000 percent. Brands are also nowadays making enamel and cloisonné dials. The strength of the Chinese consumer therefore can be seen to be influencing brands."

A reflection of a changing market, Christie's is increasingly sourcing watches from collectors in Mainland China and across Asia. The travelling Chinese have also had an impact on sales. Sam notes: "A number of Chinese clients travelled to Geneva last year to participate in our auction. Typically they would buy yellow gold and pink gold but are now looking at other metals such as platinum and white gold. Glass backed and



skeletonised watches have become very popular and prices have subsequently increased."

"We see a trophy market being formed and a shift in terms of tastes," he concludes.

On the wine front, Hong Kong again emerged as the leading destination for wine in 2012, with over USD37 million in sales as China consumers

continue to play an important role. There is increased demand for rarer and difficult-to-source vintages in China. Burgundy wines for example are becoming more popular in a market that is traditionally attracted to first growth Bordeaux.

Simon Tam, Head of Wine, Christie's China, says: "Clients are becoming more sophisticated as they know the vintage years, when is it good to drink and when to store. Our 2010 catalogue for example hosted umpteen Bordeaux, however nowadays we have Spanish, Italian, Burgundy wines, as well as different vintages of Bordeaux. It is about knowledge, security and discovery. The enthusiasm for fine wines in China is being increasingly incorporated into consumers' lifestyles. However, the finest wines are still poorly distributed and their inaccessibility has meant that wine is generally perceived as a luxury product in this market."



A Rising Gem from the Far-East

Dennis Chan, Chairman and Guillaume Brochard, CEO, Qeelin

Inspired from ancient Chinese cultural history, Qeelin is a jewelry brand that blends Chinese aesthetics with contemporary craftsmanship and design.

Recently acquired by French luxury group PPR, the brand was co-founded by Chairman Dennis Chan and CEO Guillaume Brochard in 2004. Turning mythical Chinese symbols into luxury jewelry pieces, it was first launched in Paris and has since been launched in Hong Kong, Mainland China, London and Tokyo, with plans to further expand.

"I toyed with the idea of launching a unique brand with Chinese characteristics for a while. The turning point for me was a trip to Dunhuang in Gansu province, western China, in the middle of the Gobi desert. I visited the Caves of the Thousand Buddhas and I was inspired by the many cultural influences on the paintings in these caves. I then embarked on developing Qeelin, a jewelry brand using Chinese aesthetics and culture as an inspiration together with French craftsmanship. It took seven years to develop and launch the brand," explains Dennis.

"Our dream is to build a bridge between tradition and modernity. Our inspiration stems from ageless Chinese symbols that we aim at turning into contemporary jewelry icons. We wanted to create something original. We've always expected that Chinese



that in time, those consumers would seek out brands that express their own values," he adds.

Since its launch, the brand has now branched out into the high-end jewelry segment, using skilled craftsmen and stone setters to create a modern twist on traditional designs.

"Our consumers are elite. They are used to buying jewelry from international fine jewelry brands and they know how to benchmark different brands. We don't have specific products for any particular market but we see multicultural DNA between China, France and the UK. We have a mix of impulse buyers as well as a loyal following in Europe and China," adds Guillaume.

Current store locations in China include Beijing, Shanghai, Nanjing, Shenyang, and Tianjin. The brand's short term strategic focus is Greater China and

other markets such as the Middle East, Japan or the USA within a few years.

In terms of marketing, Qeelin has so far mainly relied on word-of-mouth. Its network of 14 boutiques located in prestigious locations such as Harrods (London), Prince's building (Hong Kong) or Yintai (Beijing) has also played a major role to ensure high visibility and position the brand within the international fine jewelry brands arena.

Guillaume concludes: "Current challenges to doing business in the region mainly relate to finding the right team and the right locations for our boutiques. Yet the brand unique DNA has meant it continues to see strong appeal from its network of high-end clientele."

New initiatives for China

Thibault Villet, CEO, Glamour Sales

Hong Kong based e-commerce company Glamour Sales Holding Ltd, saw luxury retailer Neiman Marcus take a strategic yet minority stake in 2012, as part of aims to tap into China's booming online retail market.

Launched in China in 2010, Glamour Sales' online platform provides brands with an outlet to clear their end of season stock. With two million members, the group has over 60 call centre staff and around 200 employees, and with 60 percent of its business now conducted in tier 2-4 cities across China.

Thibault Villet, CEO, Glamour Sales, says: "Consumers are evolving and we are now seeing segmentation online. Additionally, malls and outlets are now also appearing online, so there is greater variety. Additionally consumers are looking for products on the high streets and not being able to find them, so we fulfil their retail needs via our online platform."

Neiman Marcus, which operates a namesake chain and Bergdorf Goodman, plans to focus on wealthy Chinese consumers via its stake in Glamour Sales. Its online Mainland Chinese shop (www.neimanmarcus.com.cn) was launched in December 2012, with products for 34 luxury fashion designers currently available for sale on the site.

The site features a selection of merchandise from multiple designers, selected specifically for the Chinese market. The assortment focuses on



men's and women's ready-to-wear, shoes, handbags and accessories. Over the next several months, the group says its website will continue to expand with additional designers and new categories of merchandise, including jewelry and seasonal collections. Additionally, there will be around 80 designers on the website by the end of the year. All the merchandise will be sourced directly from the manufacturer, while the operations centre is based in Shanghai in order to guarantee speed of delivery throughout China.

Thibault adds: "We are able to offer a wider choice of products going forwards and will look at continuous knowledge transfer. We are also able to offer more high-end brands and continue to build trust with customers. Our latest research shows that customers are moving upwards in terms of their spending power and brand choices. The fastest growing online category has been apparel and this is a very

difficult segment to get right. We have always focused on authentic products and continue to work on new ways of innovation in the online e-commerce space."

He notes the focus on technology applications as a method to target online consumers. Having already launched iPhone applications in 2012, it continues to make progress in this space. "In Japan we already conduct 30 percent of business via Smartphones and tablets. In China, it is currently around ten percent and will continue to grow. You need local integration when you are dealing with social media offerings such as Weibo."

Glamour Sales recently launched a personalised newsletter for clients, based on visit history and navigation of their site. "We have been able to change category and league with the recent investment by Neiman Marcus, and we are looking to build the brand and take it to another level," Thibault concludes.



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