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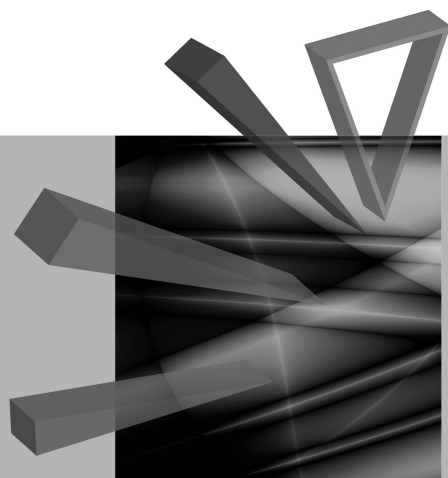
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# Clusters, Networks and Markets in the Asia-Pacific Region



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## CHINA'S LUXURY PRODUCTS MARKET

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**Abstract:** The article describes luxury products market in China. The author outlines how luxury products market should change till 2015. The article also presents how consumers have changed and what we can expect from this fast growing luxury products market in China.

**Keywords:** growth factors, globalization, GDP, luxury products market, China, USA, Europe.

### 1. Introduction

Growing at a pace far surpassing expectations, spending by Chinese consumers on luxury products now exceeds that of any other country. Having leapt past Japan's luxury market, which until recently was the world's largest one, China has become the paramount driver of growth in this sector, with purchases by Chinese both at home and abroad accounting for over one-quarter of the global total. China's current economic slowdown has caused the growth rate in the country's luxury spending to subside recently, and another factor leading some consumers to become more wary is heightened concern about corporate gifting to government officials. Even so, the nation's share of global luxury spending will continue to soar, to more than one-third by 2015.

Despite the cooling in the growth rate of Chinese luxury spending, a number of factors will ensure that demand remains relatively robust. These include the rising number of very wealthy consumers, who have a marked tendency to trade up to more expensive and more luxurious products. At the same time, new entrants into the luxury category – those just attaining the middle-class status – are increasing at an explosive rate as incomes head upward. Moreover, levels of financial confidence in China are astonishingly high; around three quarters of the country's affluent consumers believe their household incomes will increase significantly in the next five years. The rising purchasing power of women is yet another growth driver. And gifting by individuals shows every sign of staying strong or even increasing, while the decline in corporate gifting may well prove a temporary phenomenon related to the transition of the nation's leadership. A thriving economy, a growing middle class, and infrastructure investments are likely to continue pushing Chinese cities toward

a larger global presence. As expected, Beijing and Shanghai have the highest strength scores, and three other Chinese cities are grouped in a second tier.<sup>1</sup> Of all emerging cities worldwide, those in China may be the most likely to move up in future rankings.<sup>2</sup> One caveat, however, is that as China improves its small-particle pollution reporting, the outlook for Chinese cities could be impacted.<sup>3</sup> It is expected the 216 Chinese cities in the City 600 alone to contribute nearly 30% of global growth between 2007 and 2025 compared with 3% generated by cities in India.<sup>4</sup>

## 2. Changing luxury market

Glowing with optimism about their future, Chinese consumers have leapt into first place among the world's spenders on luxury goods. China's market for luxury was dwarfed by Japan's a few years ago, but Chinese spending on pricey and prestigious brands at home and abroad has grown at such a breathtaking pace, far exceeding expectations, that it now accounts for more than one quarter of the global total. This trend is only going to strengthen. Having already become the paramount driver of worldwide growth in the luxury sector, China will continue to gain importance in this market over the next several years, despite the nation's current economic slowdown. By 2015, barring some unforeseen events, more than one-third of the amount spent globally on high-end bags, shoes, watches, jewellery and ready-to-wear clothing will come from Chinese consumers, whether in the domestic market or outside the Mainland (Figure 1). But lucrative as this market may be, it is undergoing tumultuous changes that confront luxury-goods makers with formidable challenges. As the savviest brands have learned, simply building lots of stores in Chinese cities and offering merchandise emblazoned with famous logos is not nearly sufficient for reaping the rewards that this market offers.<sup>5</sup>

More and more Chinese spending on luxury – about half of the current total – takes place outside the Mainland. This is chiefly attributable to the growing ease and appeal of overseas travel for Chinese, and the high taxes that make luxury goods sold in domestic stores much more expensive than those sold abroad. Brands are therefore obliged to maintain consistency of excellence in their retail establishments around the world.

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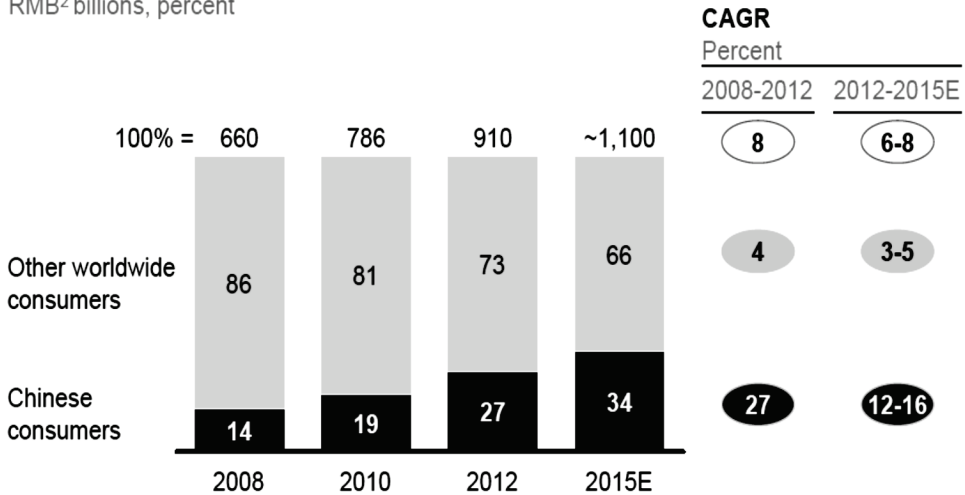
<sup>1</sup> R. Dobbs, S. Smit, J. Remes, J. Manyika, C. Roxburgh, A. Restrepo, *Urban World: Mapping the Economic Power of Cities*, McKinsey Global Institute, San Francisco 2011, p. 4.

<sup>2</sup> With a strengthening healthcare system, Beijing may be the likeliest of all.

<sup>3</sup> *2012 Global Cities Index and Emerging Cities Outlook*, A.T. Kearney Korea LLC, Korea 2012, p. 6.

<sup>4</sup> M. Jałowiecki, Asian cities as future potential financial centers of the world, [in:] P. Skulski (Ed.), *Competitiveness of Economies in the Asia-Pacific Region. Selected Problems*, Publishing House of Wrocław University of Economics, Wrocław 2011, p. 47.

<sup>5</sup> Y. Atsmon, D. Ducarme, M. Magni, C. Wu, *The McKinsey Chinese Luxury Consumer Survey Luxury Without Borders: China's New Class of Shoppers Take on the World*, McKinsey Insights China, Hong Kong 2012, p. 11.

RMB<sup>2</sup> billions, percent

<sup>1</sup> Luxury goods include fashion ready to wear, shoes, handbags, watches, and fine jewellery.

<sup>2</sup> 2012 real RMB. Fixed exchange rate 1 USD= 6.284378 RMB.

**Figure 1.** Luxury goods<sup>1</sup> consumption worldwide 2008–2015

Source: McKinsey Insights China – Luxury Consumer Studies (2008, 2010, 2012); literature search; experts interviews; HSBC report; Company financial report, [in:] Y. Atsmon. Ducarme et al., *op. cit.*, p. 11.

**Table 1.** 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

Source: *Global Reach of China Luxury – a KPMG study*, KPMG, Hong Kong 2013, p. 47.

Chinese government officials have been reviewing proposals to reduce some of the tax burden, with the goal of bringing more consumption back home. But the price gap is likely to remain substantial in the next two to three years, and assuming it does, Chinese spending on luxury goods will grow about as fast overseas as it will domestically. Because the wealth of so many consumers is rising so rapidly, many

people in the value category will have joined the mainstream one by 2020. Indeed, mainstream consumers will then account for 51% of the urban population. Their absolute level of wealth will remain quite low compared with that of consumers in developed countries.<sup>6</sup> Chinese demand for luxury is in a state of flux across income levels and social classes. Sophistication is taking hold with remarkable speed among tenured consumers – those who have been buying luxury for some time. Tenured Chinese consumers increasingly tend to shun flashy products in favour of ones with understated styles. To distinguish themselves from more common buyers, they enjoy discovering smaller brands, ever-more luxurious items, or rare offerings. At the same time, there is continued and even accelerating growth in the number of consumers who have just reached income levels at which designer labels become affordable. These recent entrants to the luxury market tend to crave products that clearly display their new-found status, often from brands that are widely recognizable. With both groups growing rapidly, the market is diversifying, and luxury-goods makers face complex choices about how to tailor their product portfolios. It is becoming increasingly difficult for them to achieve sales growth without risking their brands' exclusivity and cachet. The importance of the in-store experience for Chinese luxury consumers is becoming ever more evident.<sup>7</sup> The ultra-wealthy (those with liquid household assets above RMB 100 million), a fast-growing and increasingly crucial segment of brands' clientele, expect the most regal treatment – and they are often getting it, with their perks including personalized service from brands as well as private shopping areas and even expensive trips. But providing an ideal shopping environment is the key to winning all kinds of luxury consumers, not just the richest – one indication being that impulse purchases are rising sharply. Enhancing the in-store experience is becoming an increasingly expensive proposition; store rents and labour costs are also on a steep upward trajectory.<sup>8</sup> The result is that some brands are facing tough trade-offs between the number of shops they have and the quality of service they offer. To monitor their best customers and secure prime sales opportunities, luxury brands must develop and strengthen customer relationship management programmes – using data collected from a variety of consumer activities to determine who the high potential customers are, and maintaining one-on-one ties with them. At the same time, companies cannot ignore online commerce, a channel where a small but fast-growing amount of experimentation is occurring even in the purchase of designer products. The firms that can overcome these challenges will gain the riches flowing from a variety of forces that are enabling and impelling the Chinese to spend more on luxury.<sup>9</sup>

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<sup>6</sup> M. Jałowicki, China's consumer market by 2020, [in:] P. Skulski (Ed.), *Innovation as a Factor of the Development of the Asia-Pacific Region*, Publishing House of Wrocław University of Economics, Wrocław 2012, p. 177.

<sup>7</sup> *Global Reach...*, p. 25.

<sup>8</sup> See more on: [www.china-briefing.com/en/](http://www.china-briefing.com/en/).

<sup>9</sup> Y. Atsmon, D. Ducarme et al., *op. cit.*, p. 14.



### 3. China's luxury consumption

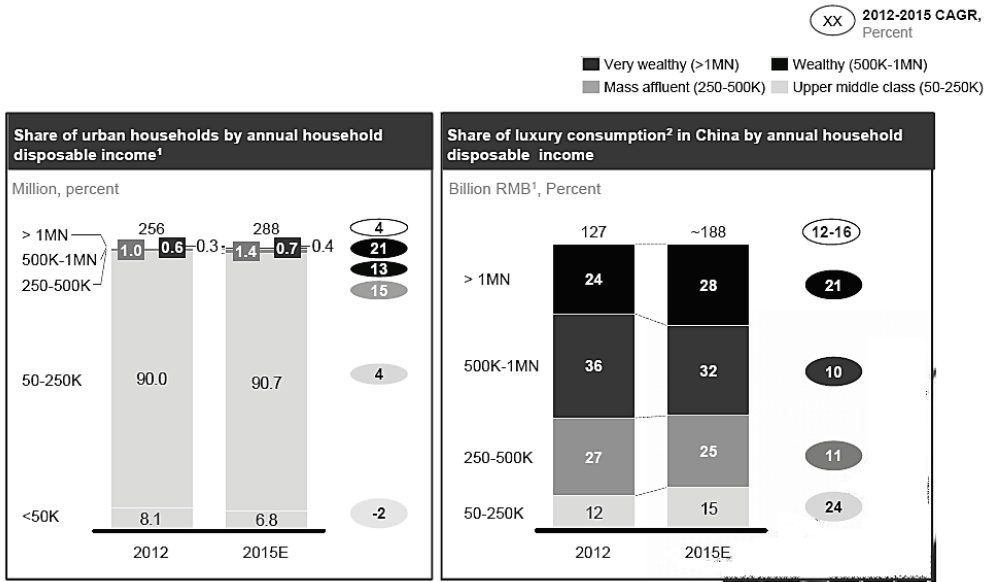
For the past four years, consumption of luxury goods in China's domestic market has surged at rates of between 16 and 20% per annum. That pace of growth is subsiding, to a projected annual rate in the 12 to 16% range between 2012 and 2015. In part, this is attributable simply to the rising tendency of Chinese to buy luxury goods overseas instead of at home, though it also stems from factors that are causing people to curb their overall purchases somewhat. One such factor is the concern that some consumers have about the nation's broader economic course. Another factor is tension over expensive gifting practices between businesses and government officials, combined with uncertainty related to the change in the nation's leadership, which has had a marked effect on such gifting. Even a 12% growth rate is much faster than that in other countries, however. As a result, the Chinese share of the global market – including spending by consumers outside the country – is certain to rise further in the next three years, to about 34%. Much of the growth in Chinese luxury purchases stems from the rising number of very wealthy households (i.e., those with annual disposable incomes above RMB 1 million). The number of very wealthy households will grow at over 20% annually in the coming 3 years. Not only are their ranks swelling; so is their tendency to trade up to more expensive and more luxurious products. This group will account for 28% of luxury consumption by 2015. At the same time, from a much lower end of the income scale, growth in luxury spending is coming from new entrants into the category – who mostly belong to China's mushrooming middle class (those with annual household disposable incomes in the RMB 50,000 to 250,000 range).<sup>10</sup> Even though each of these households spends much less than the typical wealthy household, their numbers are increasing so impressively that they will also make a major contribution to the additional luxury spending as projected to occur by 2015.

China's Tier 2 cities are where many of these new entrants are likely to live. Although about 60% of luxury spending will continue to take place in the nation's 12 largest and wealthiest cities, faster-paced growth will likely occur in smaller metropolises. Stoking the growth even further is the world-beating level of financial confidence among Chinese consumers, especially those in upper income groups. Asked whether they believe their household income will significantly increase in the next five years, 74% of affluent Chinese consumers (that is, those with annual household disposable income above RMB 250,000, or US \$40,000) expressed agreement or strong agreement, up from 68% two years ago. Among wealthy Americans (defined as those with household disposable incomes above \$150,000), only 46% said they expected their incomes to rise substantially in the next five years.<sup>11</sup>

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<sup>10</sup> M. Jałowiecki, *China's consumer...*, p. 176.

<sup>11</sup> Y. Atsmon, D. Ducarme et al., *op. cit.*, p. 16.

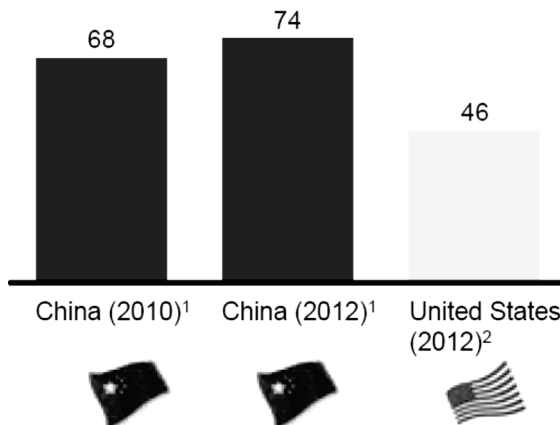


<sup>1</sup> 2012 RMB terms.

<sup>2</sup> Luxury goods include fashion ready to wear, leather goods/handbags, watches, and fine jewellery.

**Figure 2.** Growth in Mainland China luxury consumption 2012–2015

Source: McKinsey Insights China – Luxury Consumer Study (2012); team analysis, [in:] Y. Atsmon, D. Ducarme et al., *op. cit.*, p. 16.



<sup>1</sup> Consumers with annual household income above RMB 250K.

<sup>2</sup> Consumers with annual household income above USD 150K.

**Figure 3.** Percent of wealthy respondents who agree or strongly agree that household income will significantly increase in the next 5 years

Source: McKinsey Insights China – Luxury Consumer Studies (2010, 2012); Consumer Sentiment (2012), [in:] Y. Atsmon, D. Ducarme et al., *op. cit.*, p. 17.

Not all purchases of luxury goods by Chinese involve items that they keep for themselves. Indeed, the practice of social gifting has been, and will remain, yet another major reason that the luxury sector is expanding. Some analysts expect this trend to wane because the press – and government investigators – are devoting more scrutiny than ever to powerful people receiving lavish gifts such as watches and jewellery. No doubt, gifting by companies has dropped in response to such attention. But this dip is probably just temporary, and in any case corporate gifting should not be confused with gifting by individuals. The social gifting culture is embedded in Chinese society; it is a faithfully-observed feature of holidays and celebrations because it is seen as a way of nurturing and maintaining relationships – so it is not about to diminish in importance anytime soon. From among luxury shoppers, asked what will happen to the proportion of their luxury spending devoted to social gifting in the coming year, 39% said they expected it to increase, 58% said they expected it to remain the same, and only 3% predicted it to decrease.<sup>12</sup> Finally, changing lifestyles are also contributing to the luxury boom. Upper-class Chinese are spending more time with other wealthy friends at social occasions such as fancy dinners and parties, which gives them new opportunities to show off their collections of clothing, shoes, jewellery, and bags.<sup>13</sup>

#### **4. The implications of the above findings for purveyors of luxury goods**

Achieving growth while remaining exclusive, and appealing to more consumers without losing cachet, may be a tougher balancing act in China than in any other market, according to some top executives in the luxury-goods sector. Even as new entrants flock to a popular brand, the loyalty of more tenured consumers may weaken because they are seeking to differentiate themselves and achieve a sense of specialness with a smaller, niche product. In the worst case, new entrants may even follow the trend set by tenured consumers into alternative products – leaving the once fashionable brand abandoned by both ends of the market. Now that Chinese luxury shoppers have become more sophisticated, and can sense when a brand is trying to be everything to everyone, brands must focus on their core strengths. A brand needs to continue building on its heritage – highlighting the skill of its craftsmen, for example, or the length of its history – to strengthen the brand's appeal. This does not mean that brands should completely avoid expanding into new categories; rather, they should do so in a way that enhances their key narrative. Thus a leather goods firm may readily benefit from adding accessories to its product portfolio, but expanding into watches and jewellery might confuse consumers unless such an

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<sup>12</sup> Y. Atsmon, M. Magni, L. Li, W. Liao, *Meet the 2020 Chinese Consumer*, McKinsey & Company, Hong Kong 2012, p. 15.

<sup>13</sup> See more on: [www.tnsglobal.com](http://www.tnsglobal.com).

expansion relates to the firm's core products. Advertising should be used to drive core brand equity with a single message focused on iconic categories and products rather than spreading marketing investment across all categories. And the core product category must include sufficient variety and novelty to allow consumers to trade up.<sup>14</sup>

Price is a major signal in China. It drives perception of worth, and products that drive aspiration should not go on discount. Assuring consumers that everyone pays full price will bolster a brand's prestige. This is particularly true for iconic products – those aimed at brand building – for which prices should remain fixed, though for other items companies may need to adjust price levels so that inventories do not rise excessively. Wide gaps between domestic Chinese prices and overseas prices may lead customers to delay purchases, so a balance should be struck to keep domestic prices at reasonable levels relative to those abroad. And for some brands that are trying to broaden their reach as they develop new channels of distribution, such as outlet stores or web sites, there may be opportunities to attract more price-driven market segments and move some goods at lower prices.<sup>15</sup> To the extent promotions are offered, they should be limited to VIPs – either making the process fully transparent or eliminating promotions altogether. In general, iconic categories and products that never go on sale should be kept distinct from those that might. Strike the right balance between store numbers and quality: Having increased their numbers of stores at a very fast clip in recent years, most luxury goods makers should now seek optimality in their footprint coverage and bolster the productivity of their existing stores. Some brands have traded off their store locations and sizes to achieve maximum expansion, and opening a store in a non-exclusive location can actually hurt brand image. It is therefore advisable to refurbish and upgrade current outlets, with the aim of ensuring that sites are prominent and stores globally consistent in terms of look and feel. Expanding selectively in a few untapped lower-tier cities may be desirable. Successful brands are in the process of adopting this approach; some told us they are planning to slow down expansion and perform better in their core Tier 1 city locations. For instance, one leading luxury brand has opened its largest store in China, at over 1,200 square meters, situated in one of Beijing's ritziest malls.<sup>16</sup>

Maintaining a consistent image in stores and products in all countries is especially essential now that Chinese travellers are becoming so ubiquitous. Retail locations should be chosen for maximum appeal to Chinese tourists, and Chinese-speaking sales representatives should be available at such outlets. Travel retail outlets, such as duty-free airport boutiques, are of growing importance for reaching Chinese shoppers, so brands should ensure that they also staff those stores with properly-

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<sup>14</sup> Y. Atsmon, D. Ducarme et al., *op. cit.*, p. 31.

<sup>15</sup> See more on: [www.tnsglobal.com](http://www.tnsglobal.com).

<sup>16</sup> *Global Reach...*, p. 50.

trained salespeople and provide Chinese-oriented merchandise. Trends showing the most popular foreign destinations for Chinese merit careful monitoring, now that more Chinese are traveling to places such as nearby Asian countries or Europe rather than just Hong Kong and Macau. CRM programs should be globally-oriented, not just focused on China, though privacy regulations in some countries may make it difficult to manage fully-global customer databases. More broadly, companies' organizational structures should reflect the importance of the Chinese market by including clear processes for generating direct communication between headquarters and local operations in China, the aim being to allow instant feedback on the market's latest developments and trends.<sup>17</sup>

## 5. Conclusions

Despite all the forces fostering growth and increasing sales, this market is also changing fast, in ways that make it harder and more expensive for luxury brands to win over the nation's consumers. A rapidly-growing share of Chinese luxury shoppers are doing their purchasing abroad – and although Hong Kong and Macau rank among their favoured shopping destinations, Europe is also rising quickly in popularity. Increasing foreign travel by Chinese is one important reason for this trend; so is the fact that luxury goods are not nearly as expensive overseas as they are in the Mainland, where the government imposes stiff taxes on such goods. About half of Chinese luxury spending currently takes place abroad. This phenomenon raises the danger that a brand may lose consumers' trust if its stores or products fail to present a consistent image both in China and elsewhere in the world. Furthermore, Chinese consumers' tastes in luxury products are maturing with surprising speed. Shoppers with just a few years' experience as buyers of such products increasingly prefer low-key and understated goods to ones that are emblazoned with popular logos. Yet the market is splintering, because the fast growing numbers of new entrants still favour widely-recognizable brands that show off their status. As tempting as it may be for firms to try satisfying all kinds of consumers, doing so risks diluting their brands' cachet. Finally, the in-store experience is proving increasingly important in this market as the key touch point for consumers making decisions about buying luxury. Consumers heavily attributed their choices to a variety of aspects concerning the experiences they had in luxury boutiques. A rapidly-growing number of them reported buying on impulse, or after only brief consideration, highlighting the crucially of the in-store factor. For ultra-wealthy consumers, providing a VIP shopping experience, with private rooms and dedicated salespeople, is essential, as is establishing effective customer relationship management programs. As for online commerce, which is exploding for many consumer products in China, the amount in the luxury sector is still small, but experimentation is taking place and this channel cannot be ignored. Successfully implementing the above strategies will be neither

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<sup>17</sup> Y. Atsmon, D. Ducarme et al., *op. cit.*, p. 34.

easy nor cheap. But for luxury companies, it is imperative to address the challenges – the globalization of Chinese luxury shopping, the rising sophistication of the country's consumers, and the changing ways in which those consumers make purchases. Even if the market is slowing, the outlook is robust, and there is no denying that the Chinese have become the world's most important luxury buyers. The firms serving that market will need to adapt accordingly.

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## RYNEK DÓBR LUKSUSOWYCH W CHINACH

**Streszczenie:** W artykule opisano główne zmiany na rynku dóbr luksusowych w Chinach w porównaniu do pozostałej światowej konsumpcji. Autor opisuje, jak rynek ten powinien się zmienić do 2015 r. Opracowanie przedstawia również zmiany, jakie zaszły wśród konsumentów oraz jakie decyzje będą podejmować konsumenci na rynku dóbr luksusowych do 2015 r. mimo spowolnienia w Chinach. Wymieniono główne produkty, które będą chętnie kupowane przez konsumentów w Chinach. Pokazano stawki podatków od dóbr luksusowych oraz jak zmiany zachowań konsumentów mogą wpłynąć na rynek dóbr luksusowych w Chinach.

**Słowa kluczowe:** czynniki wzrostu, globalizacja, rynek dóbr luksusowych, Chiny, USA, Europa.