

# CHINA'S LUXURY MARKET

## LOSING SHEEN?



Thematic Report By

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## IS CHINA'S SLOWDOWN TAKING THE SHEEN OFF LUXURY GOODS?

Wealthy consumers in China have significantly slowed the pace of purchasing luxury handbags and watches in the mainland, raising concerns that China's love for luxury may be cooling.

China's current economic slowdown has dragged the growth rate of the country's millionaire club. The number of millionaires grew a mere 3.8% in 2014, sharply slower than the 9.7% growth recorded in 2011.

President Xi Jinping's vast anti-corruption campaign and heavy public scrutiny are quashing the country's graft-by-gift-giving culture.

The Chinese yuan's surprise devaluation is expected to dull sales of luxury goods further.

However, the crackdown and the devaluation have not entirely discouraged spending.

Chinese consumers are now purchasing more luxury goods abroad, with more than ~70% of their luxury goods purchases outside of the country.

Hefty import tariffs and consumption taxes, and growing sophistication, along with Chinese consumers' penchant for overseas travel, are driving luxury goods sales abroad. In response, luxury brands are slowing down their expansion plans in China, with Louis Vuitton announcing store closures (November 2015) in an attempt to avoid overexposure. A trend fast catching up in China is purchasing affordable or accessible luxury.

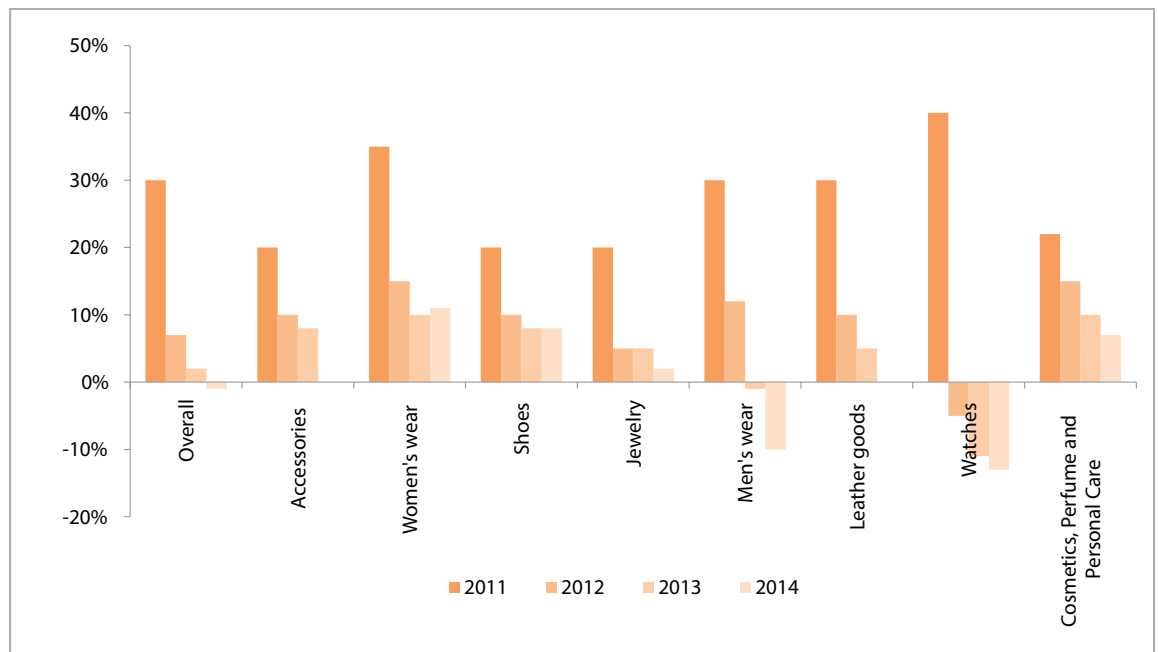
The rise of the category is driven by burgeoning middle classes as well as high income individuals looking for understated merchandise. Overall, the heady days of 20% growth may be over, but China's affinity to luxury merchandise persists.

## China's Domestic Luxury Market is Losing its Luster

The aspirations of China's rapidly increasing high net worth individuals and their unbridled spending capacity ensured swift growth in the consumption of luxury goods in the country over the past decade. Increasing urbanization and a fast-emerging middle class beyond China's largest cities created new geographic markets, adding new consumers of luxury. The sudden spurt in the demand for luxury goods saw sales in China rise USD9.6 billion in the five years up to 2014. The rise is the second-highest worldwide, after the US, which registered an increase of USD18 billion.

However, the impressive headline growth masks waning momentum over the last two years. A 2015 study by Bain & Company shows that China's luxury market contracted about 1% in 2014, after slowing down to a growth rate of around 2% in 2013 from 7% in 2012. The firm expects the market to shrink another 2% at constant currency rates in 2015. To fairly assess what lies ahead for the Chinese luxury market, we look at the reasons behind the recent slowdown in growth.

### Growth in China's Luxury Market by Category in 2014



Source: Bain & Company's report titled "2014 China Luxury Market Study – Priming Brands for Redefinition"

## China Creates Fewer Millionaires as the Economy Decelerates

China's economic growth faded to a 25 year low of 6.9% in 2015, well short of 7.3% registered in 2014 as Communist Party leaders try to re-balance the economy by pushing for consumer spending and away from the over-reliance on trade and investment.

Waning economic growth and the government's clampdown on corruption is slowing the upsurge in China's millionaire club, which contributes the bulk to luxury goods sales. As per the Hurun Research Institute,

the number of millionaires in China rose by 3.8% y/y, or 40,000, in 2014, to 1.09 million. The growth rate is a slight improvement from 3% in 2013; however, it stands at just about half the pace of growth in 2010 and 2011. Slower rise in wealth, among other reasons, is weighing on China's luxury goods sector, which is expected to grow marginally after contracting for the first time in a decade in 2014.



## "Gifting Luxury" Takes a Hit From Crackdown on Corruption

The Communist Party's crackdown on corruption beginning late 2012 has hurt luxury sales on the Mainland. Bain & Company states that the mainland's luxury market contracted 1% to CNY115 billion in 2014. This is in stark contrast to buoyant retail sales, which rose 12% in 2014.

The efforts to eliminate corruption have particularly struck "gifting luxury", which essentially includes watches and menswear. The gifting category accounted for ~30% of total sales in the past when growth was

healthy. As per Bain, watch sales dropped 5% in 2012, 11% in 2013 and 13% in 2014, after surging 40% in 2011. Sales of cognac and expensive wines, traditional presents, have also taken a hit. LVMH witnessed a 3% drop in its wines and spirits division in full-year 2014, while French alcoholic beverage company Remy Cointreau saw sales fall 3.2% in Q2 2015 (following a 9.0% drop in the first quarter) due to weaker demand for its flagship Remy Martin cognac in China.

## Yuan Devaluation Weighs on Luxury Spending

China's surprise currency devaluation is the newest threat to luxury brands in the country.

The effect of devaluation on luxury goods is expected to be two-pronged. While imported goods would

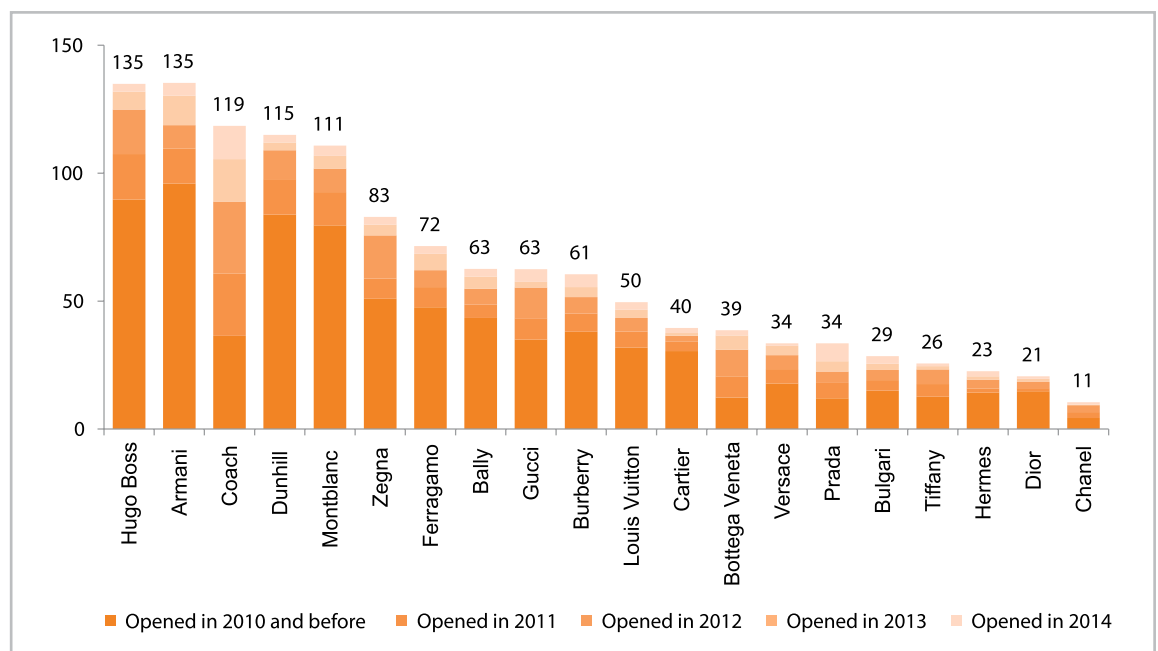
become dearer for Chinese consumers, the weaker currency will likely curtail Chinese tourism to expensive locales such as South Korea and Japan, which also double as shopping destinations for buyers of imported luxury goods.

## Global Brands Lie Low on China

The decline in luxury spending has brought to halt global brands' plans to aggressively expand in the world's most populous market. New store openings slowed down significantly in 2014. Most brands are conservative about future expansion and are focusing more on store renovation, relocation and operational improvement. Global luxury brands opened 97 new stores in 2014, compared with 160

new openings in 2012 and more than 100 openings in 2013. Furthermore, luxury brands are also seen closing under performing stores in order to avoid overexposure as the market becomes more mature and fragmented. Overall, global luxury companies closed down 23 stores in 2014 in China, primarily in the men's categories.

### Store Count of Luxury Brands in December 2014



Source: Bain & Company's report titled "2014 China Luxury Market Study – Priming Brands for Redefinition"

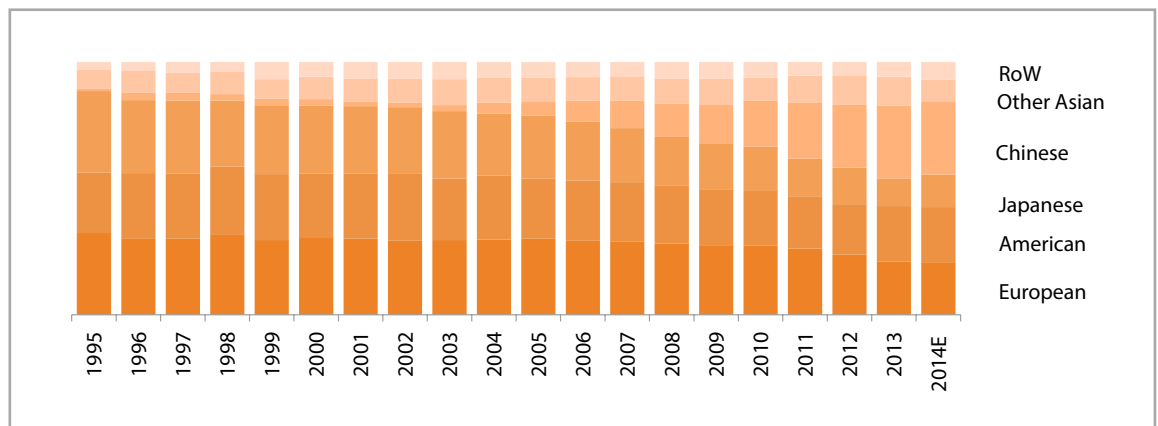
## Chinese Buyers Continue to Rule the Luxury World

Despite the slowdown in luxury sales in China, mainland shoppers continued to be the world's biggest spenders in the global luxury market in 2014. Luxury consumption by the Chinese, including those from Hong Kong and Macau, reached CNY380 billion (USD59 billion) in 2014, or ~30% of the global total. This shows that Chinese consumers' voracious appetite for status symbols, regardless of the cost, has stayed on. Overall, about two-thirds of Chinese consumers' luxury spending in 2014 was outside China.

Growing foreign travel by Chinese is an important reason for this trend. As per the UN World Tourism Organization, Chinese travelers form about 10% of international tourists worldwide. The country saw 117m outward-bound trips in 2014, up 19.2% y/y, 50% of which were for leisure. Chinese tourists are also the

highest spenders. They are expected to clock-about USD229 billion in 2015, up 23% y/y, followed by the Americans, who logged overseas spend of ~USD86 billion in 2014. Further, more than 80% tourists stated that shopping forms a major part of their trips, compared with just 56% of Middle Eastern tourists and 48% of Russians. Additionally, China's tourism shopping tax refund firm Global Blue estimated that an average Chinese tourist allocates a staggering 60-70% of total trip expenditure toward luxury goods shopping. In fact, a survey by hotels.com also revealed that Chinese tourists' spend on hotel rooms is at the lower end of the scale when compared to tourists from other countries, indicating that a majority of Chinese shoppers opt for budget accommodation while splurging on luxury goods.

### Store Count of Luxury Brands in December 2014

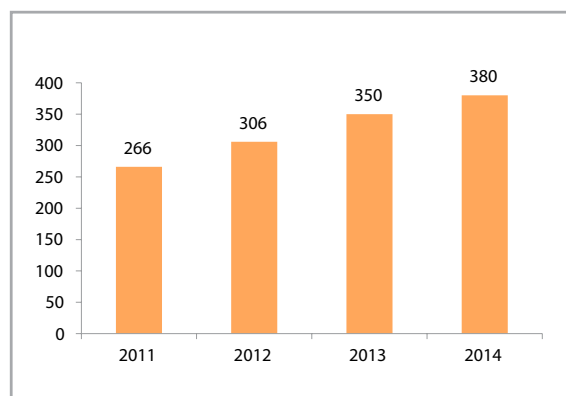


Source: Bain & Company's report titled "2014 China Luxury Market Study – Priming Brands for Redefinition"

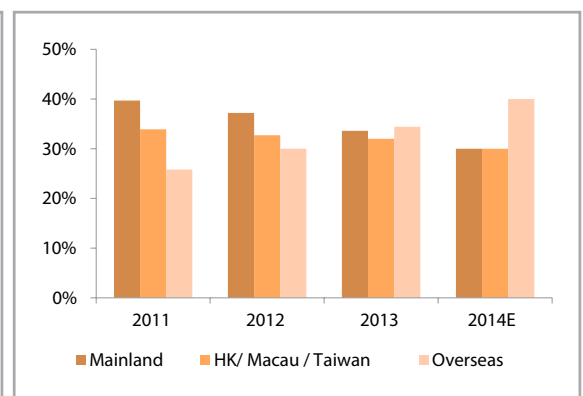
Chinese luxury shoppers rank Hong Kong and Macau among their favored shopping destinations due to their proximity to the mainland; however, Europe is also gaining popularity quickly. Chinese tourists prefer buying luxury goods abroad for reasons like:

- › High price differential due to China's stiff luxury tax
- › Changing taste and sophistication levels
- › Relaxation in visa requirements for Chinese tourists travelling overseas

### Total Mainland China's Luxury Spending (RMB Billion)



### Mainland China's Luxury Spending Pattern



Source: Bain & Company's report titled "2014 China Luxury Market Study – Priming Brands for Redefinition"

## Beating the Price Differential

Chinese consumers prefer shopping for luxury goods abroad primarily due to the attractive price savings. As per estimates from the Chinese Ministry of Commerce, the average price of luxury products purchased in China is around 45%, 51% and 72% higher

than Hong Kong, the US and France, respectively. LVMH estimates that a Louis Vuitton handbag would cost 30% more in Beijing as compared to Paris. The higher prices are attributed to tax imposed in the form of import duties, consumption tax and value added tax (VAT).

**Import Duties** range from 10-25% for general luxury products, and can go up to 35-60% for luxury cosmetic products.

**VAT** is typically charged at around 17%.

**Consumption Tax** of up to 30% is levied on purchases.

### Category-Wise Taxes on Luxury Goods in China

| Taxes/Tariffs   | Cosmetics | Jeweler/<br>Stones | Luxury<br>Watches | Automobiles | Yachts | Golf<br>Equipment |
|-----------------|-----------|--------------------|-------------------|-------------|--------|-------------------|
| Consumption Tax | 30%       | 5%-10%             | 20%               | 1%-40%      | 10%    | 10%               |
| Import Duties   | 6.5-150%  | 0-130%             | 11-100%           | 25-270%     | 8-30%  | 12-50%            |

Source: Fung Business Intelligence Center's report titled "Luxury Market in China (April 2013)"

## Changing Tastes, Rising Sophistication

Growing exposure to luxury goods through the internet, personal experience and overseas travel is making Chinese shoppers more discerning. While bling is still fashionable for newer consumers in smaller cities, wealthy individuals from larger cities are returning from their travels well-informed. These consumers are gradually moving from "aspirational luxury", where bling reigns, to "absolute luxury", which

characterizes the desire to be seen as both wealthy and sophisticated. Thus, well-heeled shoppers are increasingly critical of products that are commonplace, such as a monogrammed Louis Vuitton handbag, irrespective of the price tag. They seek understated and exclusive merchandise à la Chanel or Hermes.

## Relaxation in Visa Processes

Chinese consumers also prefer shopping abroad due to a relatively easy process to obtain a visa to travel across main shopping destinations such as Europe and the US.

Apart from these reasons, Chinese consumers buy merchandise overseas to ensure authenticity of goods.

China is infamous for counterfeit luxury products and consumers prefer buying luxury goods overseas to be sure that they are genuine. Shopping at upmarket destinations such as France and Italy also lends the shopper significantly higher bragging rights.

## The Way Forward

While high end luxury sales have been the focus area of Chinese consumption over the last decade, affordable luxury brands have risen to the top of the list of the most desired and acquired merchandise among Chinese consumers in recent times. The concept of “affordable or accessible luxury” has hit it off extremely well. These brands have experienced remarkable growth, supported by speedy and profitable retail expansion, strength in online sales and a growing flow of new middle-class customers. Besides, the segment is also witnessing renewed interest from more affluent customers. The desire for affordable luxury has grown to an extent that traditional ultra-premium brands are also designing new products at comparable price points to compete in the category. The affordable luxury sector would undeniably be a huge driver of consumption in China in the years to come.

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