MEISTERKREIS

ROLAND BERGER STRATEGY CONSULTANTS

# LUXURY IN CHINA

## A PRACTICAL GUIDE FOR THE HIGH-END-INDUSTRY

# LUXURY IN CHINA – A PRACTICAL GUIDE FOR THE HIGH-END INDUSTRY

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# PREFACE

## THE LUXURY MARKET IN CHINA IS GROWING FAST BUT REMAINS CHALLENGING

In the decades ahead, China will close the gap on the world's leading industrialized nations. According to a long-term forecast published by the Organisation for Economic Co-operation and Development (OECD), China will take over from the USA as the world's biggest economy as early as 2016. It is already the engine of growth in the global luxury goods market. In this segment, annual growth rates as high as 30% have given China third place in terms of market volume, trailing only the USA and Japan.

Yet China is anything but a straightforward market. Its sheer geographical dimensions, its substantial number of very large cities, its heterogeneous array of ethnic groups and wide gaps in economic development across different regions all point to the truth of this simple statement. And then there are the cultural idiosyncrasies of Chinese consumers, whose habits and preferences differ – significantly in some cases – from those in Europe and the USA.

There is no shortage of studies, articles and surveys that concern themselves with the Chinese market, its consumers in general and consumers in the luxury context in particular. This publication aims to provide a structured overview of the findings and insights gained from these sources on the one hand and from the practical experience of the companies concerned on the other. This knowledge will give managers in high-end industries both a pragmatic tool and a useful reference to help them assess and develop the Chinese market. "Luxury in China" was commissioned by the MEISTERKREIS, which brings together individuals, companies and institutions that shape and craft culture, creativity and outstanding quality in and from Germany. The MEISTERKREIS promotes awareness of this diverse industry, commits itself to upholding valued traditions and highlights the economic and cultural significance of this sector. It represents a branch of industry that creates value totaling more than EUR 60 billion and gives highly qualified work to over 160,000 people.

The MEISTERKREIS has more than 60 members in the creative and cultural industries such as Brenner's Park Hotel, Bechstein, Comtesse, Dornbracht, Faber-Castell, Gaggenau, Glashütte Original, Leica, Lufthansa First Class/Private Jet, Meissen, Montblanc, Nymphenburg, Porsche, Rena Lange, Weingut Robert Weil, Talbot Runhof, Thonet, Walter Knoll and Weingut van Volxem.

The MEISTERKREIS is a member of the European Cultural and Creative Industries Alliance (ECCIA), which comprises Europe's five major high-end industry associations: Circulo Fortuny (Spain), Comité Colbert (France), Fondazione Altagamma (Italy) and Walpole (UK). The members of the ECCIA represent the interests of about 400 leading European brands, which together account for more than 70% of the global market.

The Asia Work Group gives the members of the MEISTERKREIS a platform on which to bundle their expertise relating to the key export markets on the Earth's largest continent. The following organizations currently participate in the Asia Work Group: Bechstein, Comtesse, Leica, Lufthansa First Class/Private Jet, Porsche, Porzellan Manufaktur Nymphenburg, Excelsior Hotel Ernst, Schloss Johannisberg, Walter Knoll and Roland Berger Strategy Consultants. The MEISTERKREIS has already instigated a number of multi-brand collaborative ventures in China on behalf of these participants. Together, these companies have devised the "Routing Program" travel format that will give ultra-high-net-worth individuals from China an exceptional experience in Germany. In collaboration with the German Ministry of Foreign Affairs, the MEISTERKREIS has also organized a roadshow with a powerful high-end artistic appeal – entitled "Kunst. Kunsthandwerk. Handwerkskunst." ("Arts, Crafts & Craftsmanship") – that has already visited venues such as Shanghai. In addition, the MEISTERKREIS cooperates with the Asian Campus of the Shanghai-based EMLYON Business School.

For more information about the MEISTERKREIS and the activities of the Asia Work Group, please visit:

**www.meisterkreis-deutschland.com**

# THE CHINESE MARKET: EXPANSIVE, DYNAMIC AND DIVERSE

China will soon be the world's biggest economy, with roughly 1.3 billion inhabitants

Economic growth is driving purchasing power and, hence, domestic demand

There are still considerable differences in regional development levels – Purchasing power is strongest in tier-1 and tier-2 cities

The biggest threats to ongoing development are inflation and an aging society

## CHINA IS DEVELOPING INTO THE BIGGEST NATIONAL ECONOMY

**Economy**
A gross domestic product (GDP) of around EUR 3,700 billion puts China behind the USA and only just behind Japan as the world's third-largest economy. The last ten years of mostly double-digit growth have done a tremendous amount to enhance the global importance of the Chinese economy. China's growth is rooted in very strong export performance, but also in the development of its domestic economy. Rapidly increasing prosperity levels among the Chinese population are fueling growth in domestic demand – a fact reflected in the importance China has already attained as a sales market for foreign companies. However, one negative consequence of this dizzying upturn is a high rate of inflation, which has been well over 6% at times in recent years. With considerable success to date, the Chinese government is using state intervention as a tool to try to rein in inflation without halting the dynamics of growth.

**Regions**
Around 1.3 billion currently live in China, the most populous nation on Earth. The past ten years in particular have brought far-reaching changes to this sprawling country, which has evolved from being the Western world's extended workbench (thanks to extremely low wages) to a flourishing economy in its own right. One phenomenon that has accompanied this transition is an extremely wide gulf in the level of economic development from region to region.

The coastal regions of eastern China have benefited particularly handsomely from the upswing, while the country's central and western provinces remain on a comparatively low level. One crucial factor in this divergence is a rural exodus from the poorer parts of the country. Millions of workers have added to the imbalance by leaving home to seek gainful employment in the booming industrial regions and the robust economies of the country's megacities (tier-1 cities). The highly developed infrastructure and forceful economic prowess of these gigantic cities continues to attract more and more national and international companies and, as a result, opens up optimal income and career prospects.

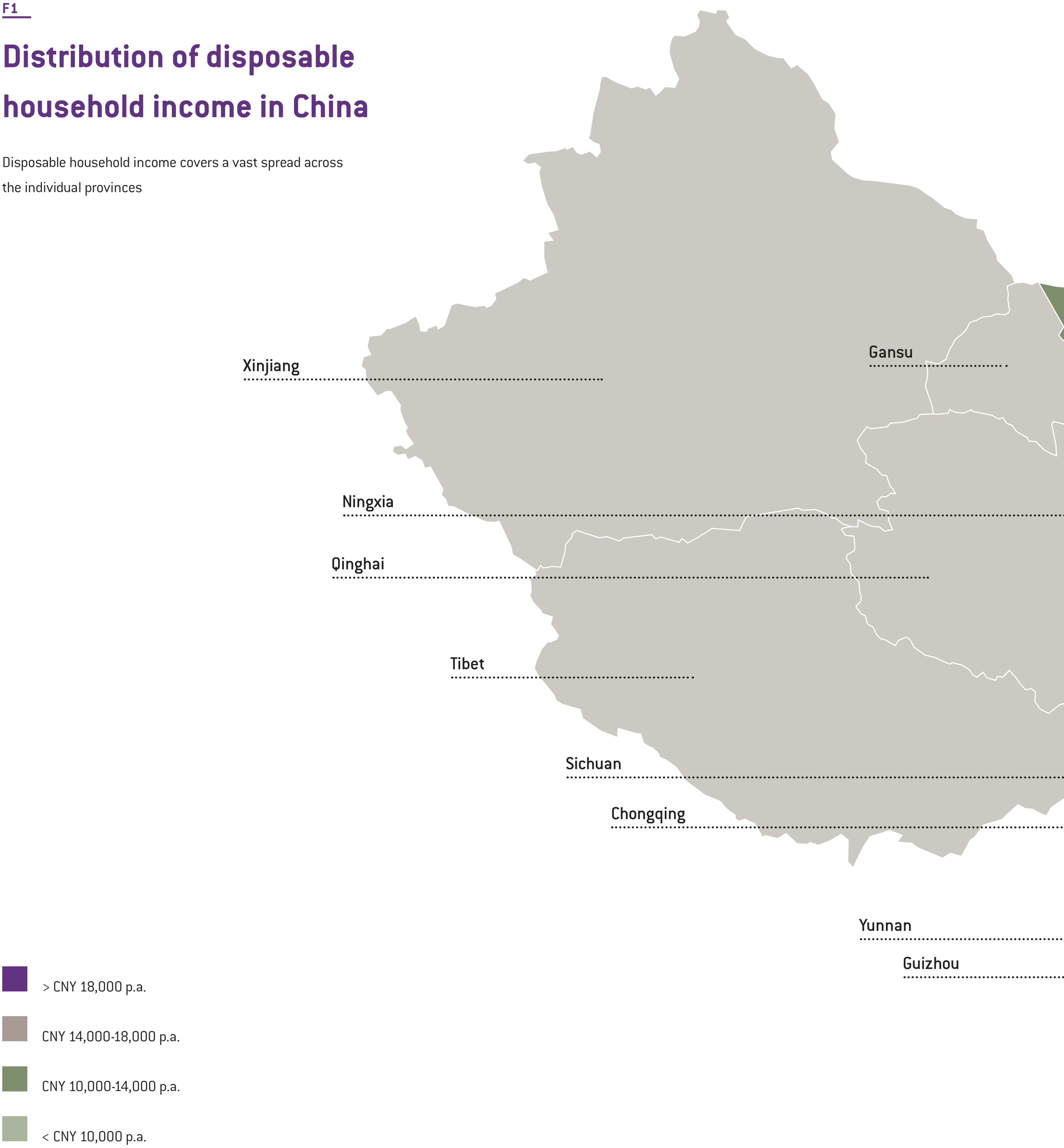
As a consequence of this development, disposable household income covers a vast spread across the individual provinces. The average in the wealthy regions is nearly twice that of China's poor regions.

F1 **Cities**
China has far more megacities and large cities (of more than a million people) than Europe. Differences in the level of economic development and, hence, in purchasing power and the average standard of living make it expedient to classify these cities. Distinctions are commonly drawn between the following four types of cities.

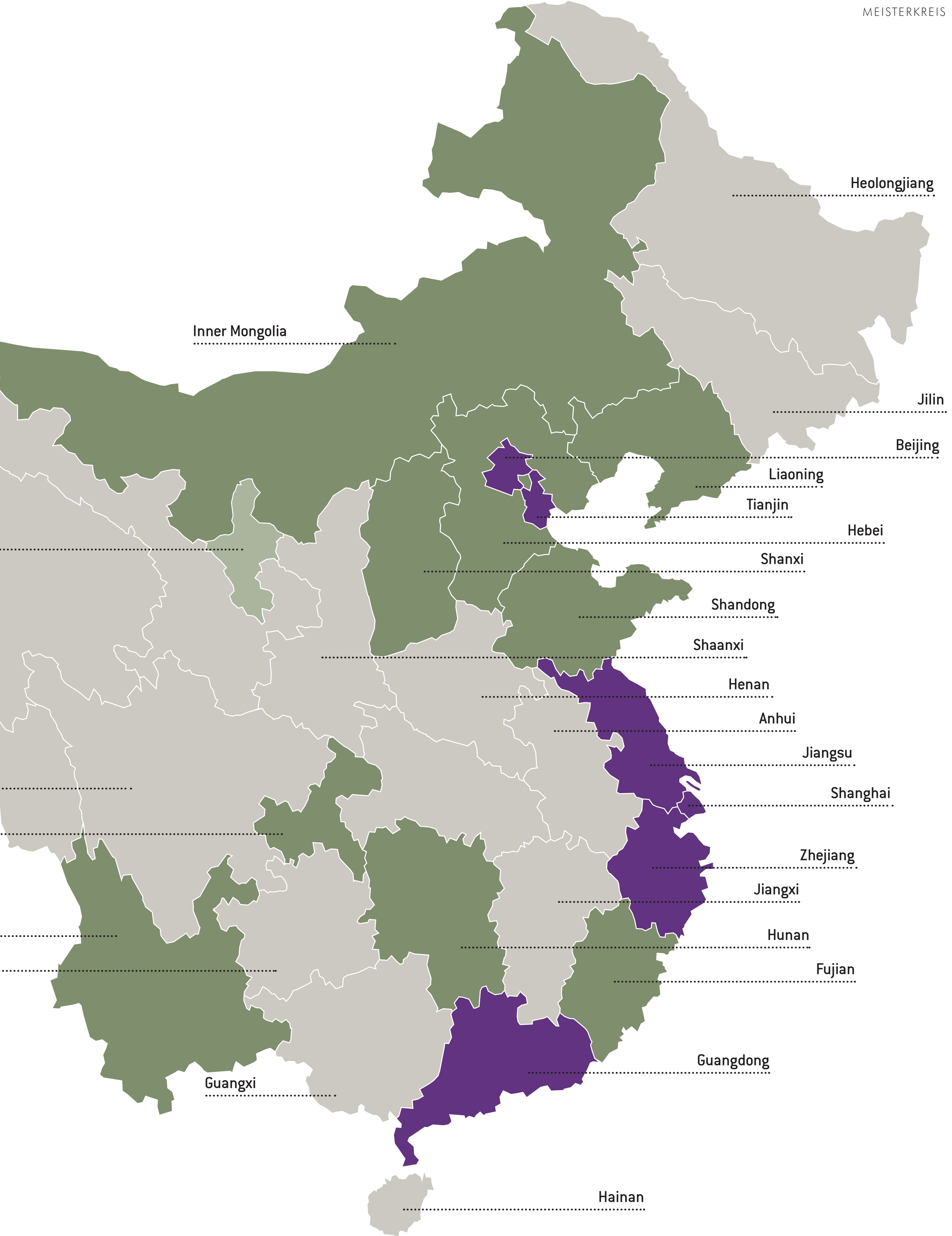
F1

# Distribution of disposable household income in China

Disposable household income covers a vast spread across the individual provinces




Source: United Nations Human Development Report China 2008


Heolongjiang
Inner Mongolia
Jilin
Beijing
Liaoning
Tianjin
Hebei
Shanxi
Shandong
Shaanxi
Henan
Anhui
Jiangsu
Shanghai
Zhejiang
Jiangxi
Hunan
Fujian
Guangdong
Guangxi
Hainan

Tier-1 cities are the most important centers of trading and finance. These are the cities with the highest income levels, the densest populations and the highest per capita GDP on the Chinese mainland. Four cities – Shanghai, Beijing, Guangzhou and Shenzhen – currently fall into this category, their total population of around 62 million people averaging out at around 15 million per city.

Tier-2 cities (still) trail the tier-1 cities in terms of population, income levels and economic development. The tier-2 cluster currently consists of 29 cities (including Chengdu and Tianjin), each of which has more than 5 million inhabitants. The total population figure for all 29 cities is 160 million. All these cities are experiencing above-average economic growth, rising incomes and a rapidly improving standard of living.

The 108 tier-3 cities (such as Urumqi and Kunming) average more than 2 million inhabitants and together add up to around 250 million urban dwellers. Their economic development lags behind that of the tier-1 and tier-2 cities, and their purchasing power is limited. The projected development of these cities nevertheless points to substantial potential for luxury brands in the years ahead.

At present, the tier-4 category comprises 147 cities whose population averages about 1 million and totals around 160 million. These are cities such as Changping (in the province of Beijing) and Dongsheng. Most of them are still in the very early days of their economic development.

**Population**

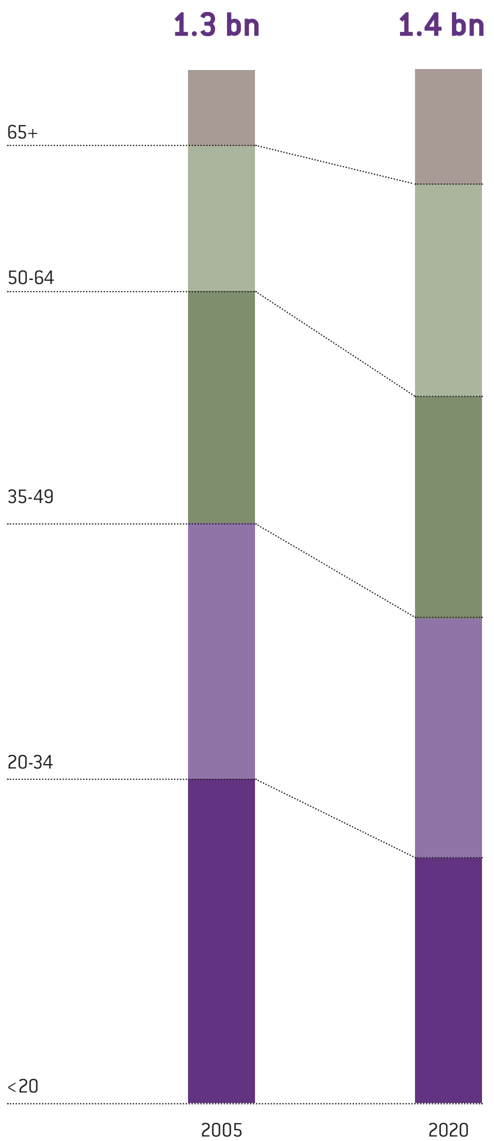
F2 The one-child policy imposed by the government to control population growth in this billion-strong country is having a visible and increasingly negative impact on the age structure of the population. The rapid decline in the number of people in the gainful employment age bracket and the resultant growth in pension liabilities are major challenges to which China must find solutions in the coming years.

A countertrend has nevertheless become apparent among wealthy Chinese in recent years. Among this group, having several children and putting up with the ensuing financial sanctions is increasingly becoming a status symbol. However, since this development is currently restricted solely to the upper-middle and upper classes, it is not widespread enough to correct ongoing shifts in the age

F2

**China's aging population**

Population by age bracket (%)




Source: The Brooklyn Institute, Roland Berger pyramid. Unless the Chinese government takes effective action, a rapidly aging society could seriously impair the country's economic performance within the next decade.

## CHINA'S LUXURY GOODS MARKET IS EXPERIENCING THE MOST DYNAMIC GROWTH IN THE WORLD

▶ China is the world's most dynamic luxury goods market, with annual growth rates of between 20% and 30%
▶ China's domestic market for personal luxury is worth EUR 15 billion and has nearly closed the gap to Japan
▶ Yet the overall market volume created by Chinese consumers in this segment is significantly greater: 60% of the sales volume generated by the Chinese happens abroad
▶ The market for "luxury experiences" is already worth around EUR 30 billion and is also growing fast
▶ For many luxury brands, the Chinese are already the single most important customer group

**F3** China has been and still is the biggest driver of growth in the global luxury goods market. This is essentially due to rising incomes on the back of China's potent economic development, resulting in the accumulation of personal wealth: More and more consumers now have the material means to buy luxury goods. The market for personal luxury goods (fashion, shoes, accessories, watches, jewelry, perfume/cosmetics) is already worth around EUR 15 billion in China. And by 2015, at the latest, China will have left even Japan in its wake. The figures that appear in most market statistics for China do not tell the whole story, however, because a large proportion of Chinese consumers' spending on luxury items – around 60%, in fact – takes place outside their home market. In other words, the total market volume generated by Chinese consumers is substantially higher. Travel agencies such as Affinity China, which specializes in organizing bespoke and group travel for the super-rich, live off this trend. Their arrangements range from yacht shows in Monaco to private visits to the ateliers of Salvatore Ferragamo in Florence. One key reason why such a large proportion of consumption is offshored from mainland China is that import duties, taxes and brand markups drive up price levels in the country (see the section on "Pricing"). Another reason is that, in the past, many Chinese feared that domestic boutiques for international luxury goods might not in fact be selling the original European products. While these fears have increasingly been dispelled in recent years, low taxes still enable cities such as Hong Kong and Macao to benefit from shopping tourism as consumers visit from the mainland. Something like 28 million Chinese a year visit Hong Kong, for example – many of them to purchase luxury goods.

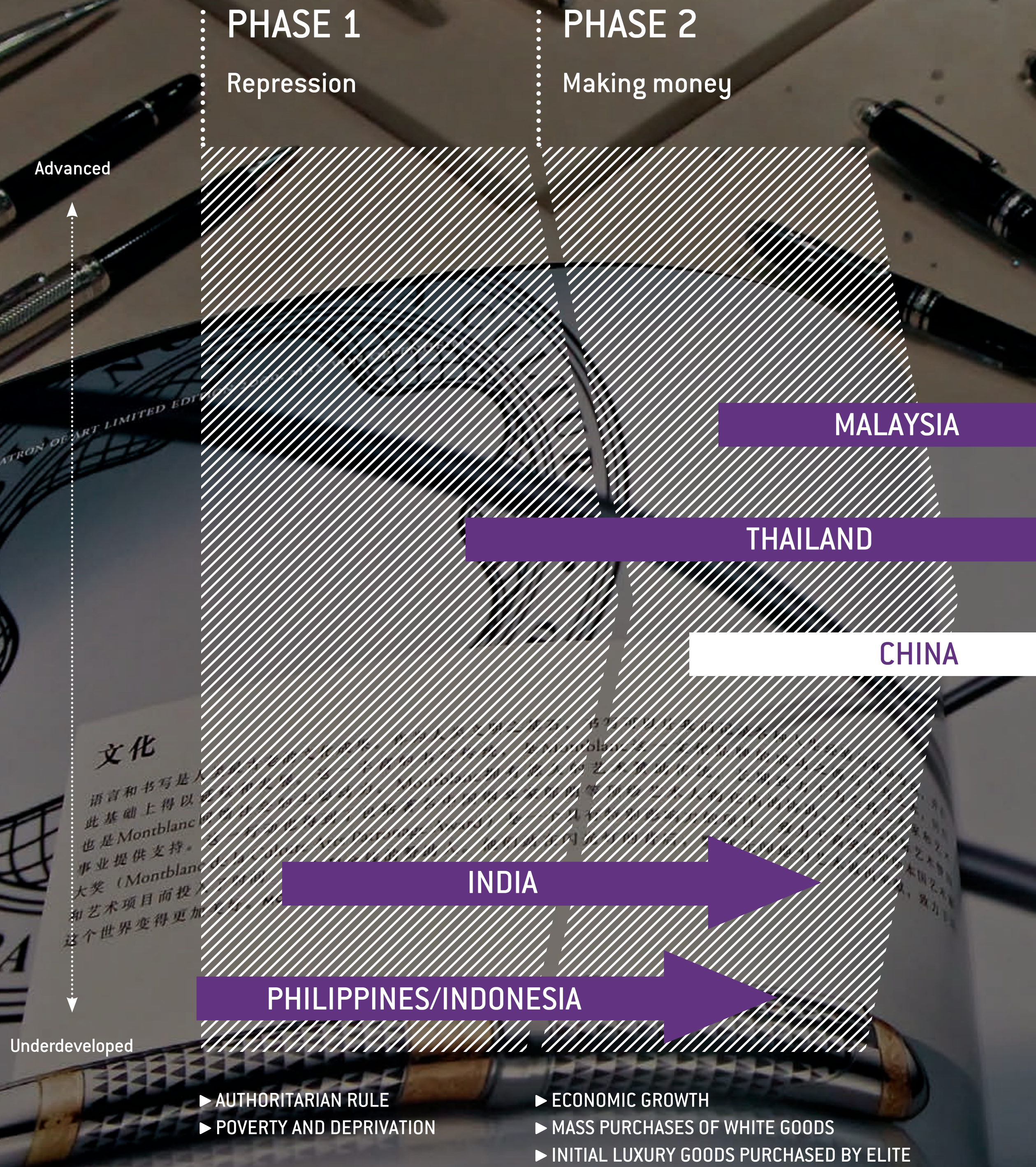
Alongside excursions to Hong Kong, Macao and Taiwan, more and more mainland Chinese are now traveling to and buying luxury goods in the non-Chinese world too. Shopping accounts for a large proportion of their spending when they travel. In Germany, for example, Chinese travelers are the second most important group of tourists in terms of tax-free revenues (after the Russians), and also spend more per capita than any other group. Frankfurt is the most popular shopping location for Chinese visitors, as many do their shopping here before flying home from Frankfurt Airport at the end of their European tours. Moreover, many of them make purchases not only for themselves, but also for friends, family and, increasingly, even unrelated third parties. The new term daigou – which roughly translates as "buying to order" – has indeed been coined in this context. Especially students in Western cities and Chinese airline personnel see this practice as a good way to supplement their income. As things stand, adding together their consumption at home and abroad already makes the Chinese the single most important customer group for many luxury brands. Above and beyond the personal luxury segment, manufacturers of luxury cars too are more than happy about developments in China, which has become the world's second-largest sales market for brands such as Porsche, Rolls-Royce and even Ferrari. The luxury experience segment (including hotels, gourmet cuisine, foodstuffs and beverages, for instance) is likewise growing very rapidly in China. Today, this segment already has a domestic volume of around EUR 30 billion. Wealthy consumers' penchant for travel is, for example, also driving fast growth in the domestic market for five-star hotels. China currently has around 700 hotels in this category, with a further 500 under construction or in planning. In the south Chinese holiday region of Sanya alone, around 40 new five-star establishments are slated to be built by 2015.

High-quality foods and beverages are likewise growing in importance. After the USA and the UK, China is now the foremost export market for the French wine industry – a fact attributable to constant growth in the number of top restaurants, not only in Beijing and Shanghai. Increasingly, exquisite restaurants offering a rich selection of wines can now also be found in China's tier-2 and tier-3 cities.

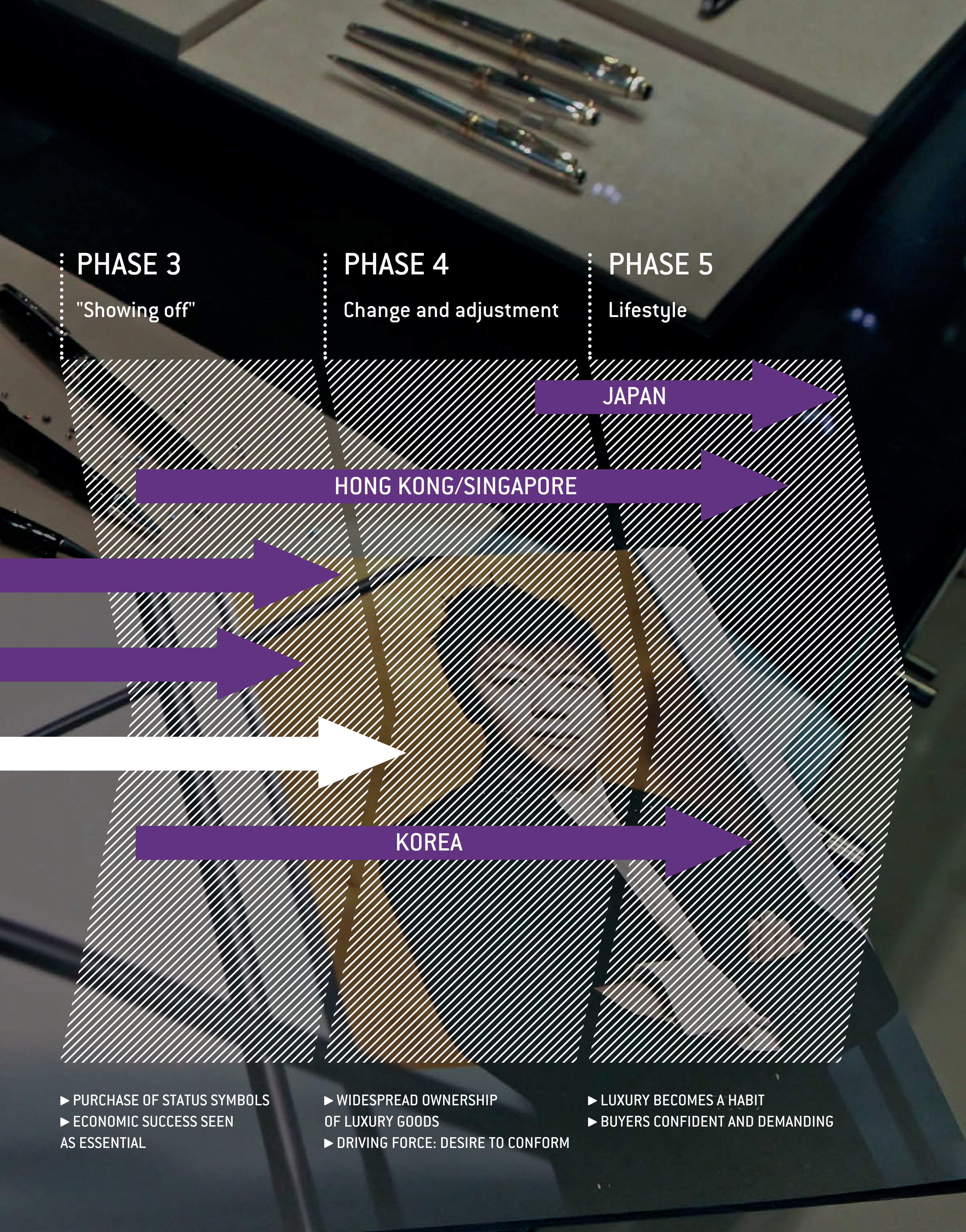
F3

## Multi-phase model in luxury markets

China's domestic market for personal luxury goods is already worth EUR 15 billion and will soon close the gap to Japan




Source: Ipsos, Roland Berger


PHASE 3
"Showing off"
PHASE 4
Change and adjustment
PHASE 5
Lifestyle
JAPAN
HONG KONG/SINGAPORE
KOREA
▶ PURCHASE OF STATUS SYMBOLS
▶ ECONOMIC SUCCESS SEEN AS ESSENTIAL
▶ WIDESPREAD OWNERSHIP OF LUXURY GOODS
▶ DRIVING FORCE: DESIRE TO CONFORM
▶ LUXURY BECOMES A HABIT
▶ BUYERS CONFIDENT AND DEMANDING

# THE CONSUMERS: LUXURY-ORIENTED AND BRAND-CONSCIOUS

**Chinese customers have a keen affinity for luxury – Luxury goods are widely accepted as symbols of success and good taste**

**Brands are critical – Customers prefer to buy what they know**

**Gifts are a primary driver of luxury purchases**

## CONSUMERS' ATTITUDES

Life in Asian cultures is still shaped by relatively strict rules. Though dress codes are no longer prescribed by law, many traditions continue to exert their influence, perhaps with minor, superficial adjustments. True, many old rules were gradually rescinded in Japan after the Meiji Restoration in 1868, and dress codes existed in China only until the imperial era came to an end in 1912. Yet neither fact can be taken to mean that fundamental cultural perceptions of social order have changed. To this day, clothes and accessories are still understood as the outward manifestation of a certain status in society, not merely as an indication of prosperity.

F6 Luxury is very important to the Chinese consumer, much more so than in established markets such as Germany and France. The number of consumers of luxury goods in China has increased at a frantic pace in recent years as the economic boom has swelled the ranks of the middle and upper classes. A positive basic attitude toward luxury goods means that consumption thereof increases as a function of disposable income. And those who can afford luxury also like to show off their wealth. At the present time, the kind of conscious austerity with regard to luxury goods that is observable among well-heeled European consumers is visible only sporadically in China. In a status-oriented society where seeking to better oneself is a fundamental value, as is the case in China, the consumption of luxury goods does not provoke jealousy or ill-will on the part of less privileged consumers. On the contrary, it is regarded positively as a sign of financial prosperity and success, and as evidence of good taste. This way of thinking is naturally also reflected in the preferences of consumers of luxury goods: Alongside travel, which is itself often used to buy luxury goods, Chinese consumers have a very keen interest in "everyday luxuries", giving gifts and collecting. Recent years have seen a slight shift here, with children's education – often at foreign schools and universities – gaining in importance. The same goes for entertainment. Overall, however, wealthy individuals' propensity to spend on luxury product categories remains very high. Brands play a central part in the purchase decisions of customers who buy luxury goods in China. This customer group is not particularly open-minded, nor is it partial to experiments. More than 40% of individuals know what product of which brand they want to buy before they buy it. Similarly, well over half of the customers in this bracket never buy products of a brand they do not know. It follows that, for companies in the luxury goods segment that wish to succeed on the Chinese market, investing in brand building and brand awareness is indispensable. In addition to traditional marketing communication activities, dedicated stores and testimonials play an important role in this context too (see the section on "Marketing").

### Customer preferences are clear – "Made in China" is gaining ground

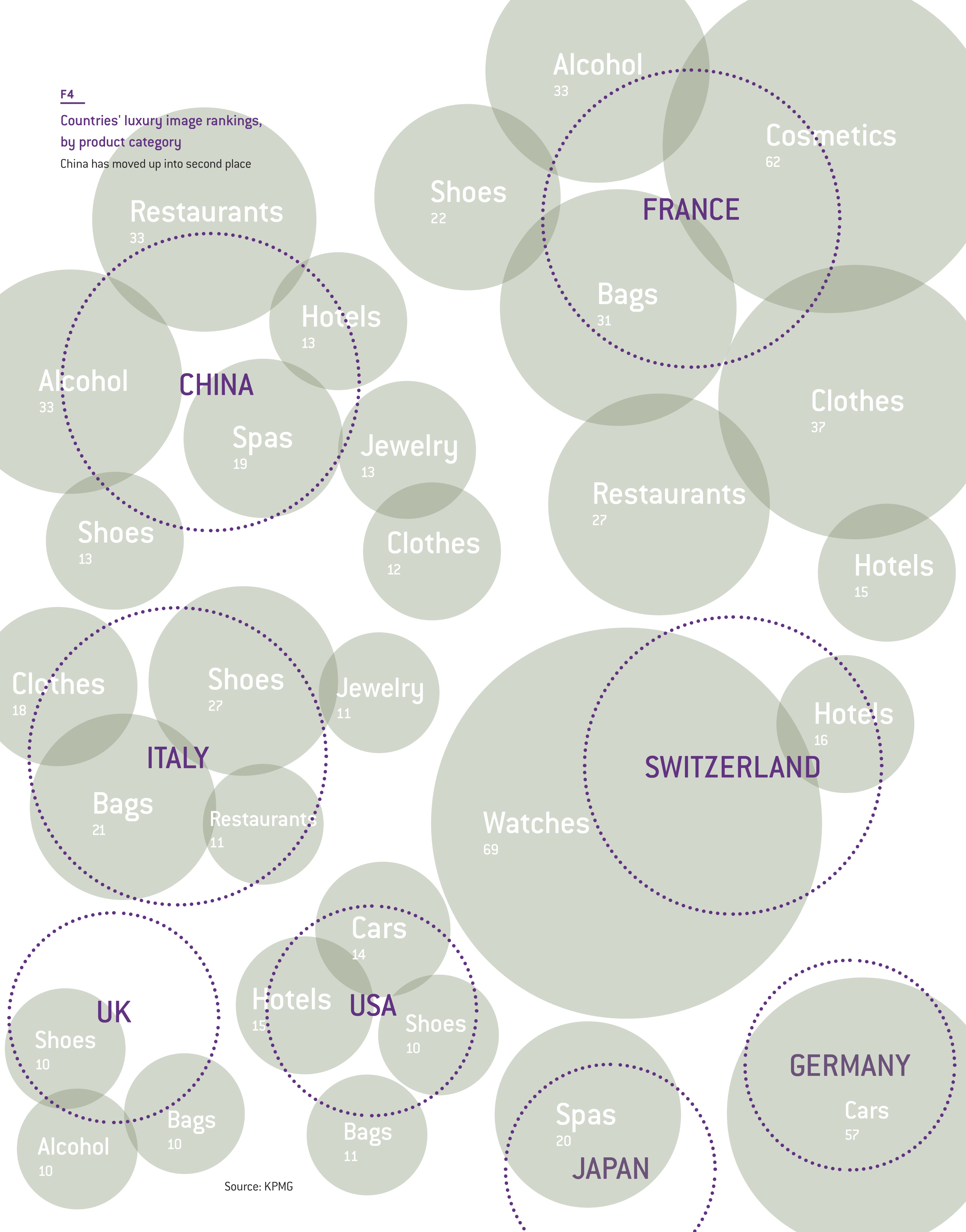
- ▶ "Made in China" was synonymous with superior quality and craftsmanship for several centuries
- ▶ Yet at the close of the 20th century, "Western stuff was hot, but Chinese stuff was not" – and the concept of luxury is still closely associated with Western culture
- ▶ Notwithstanding, the current trend is toward "sinofication": The Chinese are rediscovering their cultural heritage and are becoming increasingly open to Chinese luxury products
- ▶ Western luxury brands now face the challenge of remaining relevant and desirable to Chinese consumers in the future

Paradoxically, although China has evolved into what will soon be the world's foremost market for luxury goods in the space of just 20 years, it has so far brought forth very few luxury brands of its own. One major challenge to Chinese luxury brands appears to be the image problem China suffers from as a country of origin: Few people either in Europe or in China itself associate China with luxury goods. Chinese history tells a different story, however, and the country's rich tradition of consummate craftsmanship is the fertile soil in which Chinese luxury brands are now taking root.

F4

**Countries' luxury image rankings, by product category**

China has moved up into second place




Source: KPMG

Spas
23

Jewelry
25

Since the start of the 16th century, Western traders have traveled to China to swap European and American silver for Chinese luxury products. Unlike today, the label "Made in China" thus served for many centuries as a guarantee of superior quality and craftsmanship. The country's silk, ceramics, porcelain, cashmere, writing utensils and furniture in particular were highly prized.

F4 Yet at the close of the 20th century, Western stuff was definitely "hot" – and Chinese stuff was not. To this day, the concept of luxury is still strongly associated with Western culture, which explains why Western luxury brands are regarded as more valuable and more prestigious. Countries of origin such as France, Italy and Germany remain extremely important and are equated with tradition, quality and craftsmanship. However, this attitude is gradually changing in China, and the change is being championed above all by the young generation born since China opened up in 1978. This is the generation known as the "little emperors", because parents and grandparents alike concentrated all their attention and resources on these only children. They are easily the best-educated and most self-confident generation in China – but also the most egocentric and ambitious. They are the children of the economic miracle, children who have known nothing but almost magical growth. They are accordingly regarded as demanding, smart and hedonistic consumers. And they are the generation that will change the Chinese luxury market: Nouveau riche consumer habits will give way to a more refined and subtle style. As the country becomes an economic superpower with global leadership ambitions, the Chinese are once again holding their head high. The young generation in particular is cultivating an ever keener interest in its country's rich heritage of culture and craftsmanship.

This trend toward sinofication is favoring those Chinese makers of luxury goods that have touchpoints with local craft techniques, materials and design elements. The few Chinese luxury brands in existence today include the likes of fashion label NE Tiger, watch brand Longio and jewelry maker Zhaoyi ("The first luxury Chinese jade jewelry brand"). The trend naturally also comes at an opportune time for Shanghai Tang (now part of the Richemont Group), which is no longer targeting tourists alone, but increasingly also customers on the Chinese mainland. "We have to make it clear to our customers that it is okay both to enjoy luxury and to be Chinese," explains Raphael Le Masne de Chermont, Executive Chairman of Shanghai Tang. Accordingly, Shanghai Tang too is playing the tradition card with its Imperial Tailoring Collection, which is made to measure using traditional knowledge handed down from Shanghai's legendary tailoring trade. Many of these skills were lost during the Cultural Revolution and are now being revived and cultivated once again by Shanghai Tang. A recent study by KPMG found that Chinese consumers expect indigenous luxury brands to emerge primarily in the alcoholic beverages and services categories. Many entrepreneurs and designers in China dream of launching their own Chinese luxury brands. In many cases, previous successful launches have given them the funds they need. At the same time, they now have access to (almost) the same luxury network as European luxury brands, complete with consultants, designers, suppliers and advertising agencies.

For Western luxury brands, the trend toward sinofication poses a serious challenge. It is now up to them to find out how to remain relevant and desirable to Chinese consumers in the future – and how they can accommodate these consumers' desire for products that reflect their national identity. A comparable development to what has happened in Japan is the most likely scenario: When the Japanese began to consume luxury goods around 35 years ago, "Made in Japan" was still synonymous with "cheap and inferior". Today, however, the same label has come to epitomize superlative quality and modern design.

Western luxury brands can certainly expect guarantees of origin such as "Made in France" and "Made in Germany" to remain highly respected. However, they must also prepare for a scenario in which the likely resurgence of the "Made in China" label could erode some of their competitive edge. Europe's major luxury brands are increasingly demonstrating the value they attach to Chinese customers by producing special editions. In many cases, they use the animals in the Chinese zodiac, Chinese characters and/or traditional forms and patterns to do so. One brand that was quick to spot the potential in this approach is Chanel: As far back as 2009, this house of haute couture launched a dedicated China collection that drew heavily on the influence of traditional cheongsam or qipao dresses. Along similar lines, a series of luxury car manufacturers too have introduced eyebrow-raising models endowed with local motifs and handicraft techniques specially for the Chinese market. Porsche, for example, celebrated its tenth anniversary in China in 2011 by unveiling a gold-colored Porsche 911, "China 10th Anniversary Limited Edition".

Beyond these examples, Chinese tastes have already influenced the development of product ranges at many European luxury brands. The choice of colors is a very important consideration in China. Yellow, for instance, stands for happiness, harmony, fame, wisdom and the heights of culture. Yet yellow was also the color of imperial China and was thus reserved for the emperor's family. "Imperial yellow jackets" were therefore presented exclusively to high-ranking officials and the emperor's bodyguards as a sign of distinction. The color yellow was also often combined with red, which itself thus became increasingly popular among the Chinese as there were no restrictions on its use. To this day, luxury products often use a typical "China red", but also a "China green". Products in these colors do not adorn the window displays of luxury boutiques in China alone, however. In deference to Chinese luxury tourism, they can increasingly be found in European store windows too. Another factor is that many Chinese women prefer very small and compact, pocket-sized items. This preference as well has already very heavily influenced the global product ranges of a number of major brands.

**Consumer structure makes life hard for small and new brands**

▶ Customers for luxury goods no longer live in tier-1 cities
▶ Chinese luxury customers are very young and often still inexperienced
▶ Chinese men have a strong penchant for luxury and spend much more than their wives, even in segments such as clothing and shoes

Analysis of the historic development of luxury consumption in China shows that the domestic market was for a long time concentrated in the tier-1 cities and some of the tier-2 cities. This is where the customers with the highest purchasing power were to be found, and where a suitable infrastructure – in the shape of high-quality shopping malls – allowed brands to be showcased in a fitting environment. However, recent years have seen the luxury goods business increasingly spread to more tier-2 cities and a number of tier-3 cities. While the majority of luxury goods consumers still come from big cities such as Beijing, Shanghai and Shenzen, demand is growing faster in the country's booming smaller cities too. These cities are witnessing the emergence of new groups of customers who want to be serviced by bricks-and-mortar or online retail channels, but who as yet have relatively little knowledge or experience of products and brands. The section on "Distribution" discusses how this development will affect the luxury brands' point-of-sale structures.

A further key factor for the growth of the Chinese luxury products market is consumers' age structure: The country's growing prosperity means that many consumers, especially young people, are now in a position to purchase luxury goods. As discussed in the section on "Consumers' attitudes", image value – what owning luxury-brand products says about their social status – is very important to this group. This attitude itself thus powerfully reinforces the consumption of relevant brands. As a result, the customer base is becoming significantly broader year after year. In Germany, more than half of all consumers of luxury goods are over the age of 40. In China, however, the 20 to 39 age bracket accounts for 60% of these customers; and most of them as yet have little information and little experience. Hence the trust they place in big-name and prominent brands. By contrast, smaller or new brands tend to have a hard time impressing this customer group.

Chinese women outstrip Chinese men in terms of the total number of transactions. However, this picture is largely skewed by fast-moving product categories such as cosmetics and perfume, which are purchased predominantly by female consumers. In nearly all other product categories, Chinese males are out in front. This male affinity for luxury products constitutes a major difference to most European markets and mirrors the positive attitude toward luxury products discussed above. This becomes acutely apparent in the clothing segment, which is very definitely the domain of the female gender in Europe and the USA. Nor should the role of business gifts – especially watches, ties and other accessories – be underestimated, as they too are purchased mostly by men. Makers of luxury goods must factor the powerful role of male consumers into their considerations when looking at China. Neither the product range nor the associated marketing can afford to be too feminine if existing sales potential is to be tapped.

## CONSUMERS OF LUXURY GOODS BREAK DOWN INTO FOUR DIFFERENT TYPES

Chinese consumers of luxury goods who buy products for their own use (not to give away as gifts) can be split into four distinct categories, each of which can in turn be subdivided by age, education, income and regional distribution.

**Hardcore**

The single biggest customer group consists of the hardcore consumers, who account for around 45% of all luxury goods customers in China. The majority are between 20 and 35 years old, and most grew up in a context of luxury as the children of successful entrepreneurs or wealthy party officials. Many of them attend or have attended top universities in China or abroad, with their education and travels giving them a comparatively cosmopolitan outlook. Their experience and the time they have spent abroad also means that they know their way around the world's luxury brands much better than most other customers do. They are accordingly demanding. The majority of customers of this type live in tier-1 cities, where they are referred to as the "new emperors".

**Opinion leaders**

Opinion leaders are similarly accustomed to luxury and constitute a second important customer segment. This group makes up about 30% of all Chinese consumers of luxury goods. Most of these approximately nine million customers are either self-made entrepreneurs or the managers of large Chinese or international companies. The wives of these entrepreneurs and managers belong in the same bracket. The majority of opinion leaders are between 25 and 40 years old and live predominantly in the tier-1 cities. Like their hardcore peers, most are well educated and many have international experience. Their social status and the fact that they are readily conversant with luxury brands gives them an important role as opinion leaders in their given environment. They also purchase smaller, less well-known luxury brands.

**Middle-class climbers**

A third group of customers are known as middle-class climbers, who account for roughly 15% of Chinese luxury product customers. As the name suggests, they are social climbers who serve mostly as middle managers at national or international firms. The majority are aged between 25 and 35, and their career development has put them in a position to be able to consume luxury goods. However, less generous financial resources than either of the first two groups mean that they do this less frequently. Outward appearances are important to them, as are well-known brands and recognizable logos. China's economic upswing and the associated growth of the middle classes is expected to drive a considerable increase in the number of such customers.

**Fashion fanatics**

The last distinct customer type also includes the youngest customers, most of whom are between 20 and 30 years old. Around 10% of Chinese consumers of luxury goods share a pronounced weakness for luxury fashions and therefore fall into this category. Of the four different types, these customers have the least funds at their disposal and often save in order to buy certain products. Their purchase decisions are heavily influenced by celebrities, testimonials and the views of the opinion leaders described above. For them too, big and famous luxury brands are the first choice.

As China's ongoing economic boom increases disposable income, the number of middle-class climbers and fashion fanatics in particular is expected to rise substantially. This development is an essential driver of further growth in the Chinese luxury goods market. Above all, it will strengthen the position of the established and well-known international brands.

## Gifts are very important in China

**F5** Occasions for giving gifts [%]

Source: Hurun, 2012

## SMALL GIFTS NOURISH FRIENDSHIPS: LUXURY GIFT GIVING IN CHINA

▶ Giving gifts is a national pastime in China – Sheer prestige makes luxury products ideal for this purpose
▶ Luxury gift giving is deeply rooted in Chinese culture, for example in concepts such as mianzi (saving face), guanxi (networks of relationships) and the principle of reciprocity (give and take)
▶ Gifts account for a large proportion of luxury brand sales in China – The Chinese give away 76% of the luxury products they buy
▶ Wealthy Chinese spend about 10% of their annual income on gifts, and 80% of these are given in business contexts
▶ In the context of the current anti-corruption campaign, government institutions have been prohibited from buying luxury products as gifts – Some luxury brands are suffering painful losses in sales revenues as a result

Gifts are given in all cultures, all over the world. By Western standards, however, China's gift-giving culture is as pronounced as it is complicated. Anyone who has ever had private or business dealings with Chinese people knows the problem: When should you give a gift? What should you give? Who should receive which gift?

In China, gifts are essential to the development and nurturing of business relationships. Three quarters of all gifts relate directly to business purposes. The aim of giving gifts is always to build, cultivate, alter – or even put an end to – interpersonal relationships. In China much more so than in other cultures, giving gifts is "communication in a material form". Its importance can be seen at every turn: Even the tiniest Chinese supermarket, for example, will always reserve a sizeable chunk of its shelf space for gifts. Yet gifts such as knives or flowers are taboo, as they bear negative connotations in the Chinese mind. Flowers in large numbers are given only at funerals; and knives symbolize cutting off a friendship. Certain color codes must also be heeded when packaging gifts. Red stands for happiness and joy, but white is the color of grief and sadness. Nor should a selection of four wines ever be given, as the number four stands for death and misfortune.

Gifts are always given in line with the cultural calendar – at Chinese New Year celebrations, for example, and on private occasions such as birthdays and weddings. But they can also be given as spontaneous gestures. In recent years, the numerous official occasions, such as Qingming (to commemorate the dead), Zhongqiujie (the mid-autumn moon cake festival), Duanwu (the dragon boat festival) and China's national holiday have been supplemented by "imported" occasions such as Valentine's Day, Christmas, Father's Day and Mother's Day.

F5 In private contexts, gifts are given at births, when a newborn completes its first month and at deaths. But above and beyond all these official and private occasions, gifts are also given at virtually any and every meeting – business lunches, visits, or whatever.

Traditional gifts tend to be of a more functional nature, such as food (fruit baskets, milk or coffee) and the red envelopes containing money that are known and loved throughout China. In recent years, expensive liqueurs, jewelry and even watches, once a definite no-go as presents, have also emerged as popular gifts – a development reflected in the sales figures for many luxury brands. Products from well-known international luxury brands are coveted in particular. Recipients can readily assess their value, and can just as readily convert them to cash if necessary. More than that, however, gifts embody a clearly defined symbolism: Depending on their sentimental or financial value and whether they are more functional or more expressive, gifts reflect the status and/or value of a relationship. They reveal the level of mutual appreciation and how the giver and the recipient perceive themselves and each other. Given their prestigious standing, luxury products are thus especially well suited as gifts. The Chinese also attach considerable importance to elaborate packaging that makes a present appear even more valuable. Gifts are often given in connection with an implicit request or demand. Giving someone a belt, for example, indicates that the giver is very fond of the recipient and would like to "tie himself or herself" to him or her forever. Similarly, by accepting or rejecting the gift, the recipient can affirm or negate the implied request.

In principle, motives for giving range from the altruistic to pure self-interest. The former reflects a desire to maximize the recipient's joy and happiness. In China, this motive is encountered primarily in private contexts between family and friends. By contrast, self-interested givers see their giving as a means to an end in pursuit of their own agendas – for example with a view to calling in a favor in the future. In such cases, the giving of a gift places an implicit obligation on the recipient to return some form of consideration.

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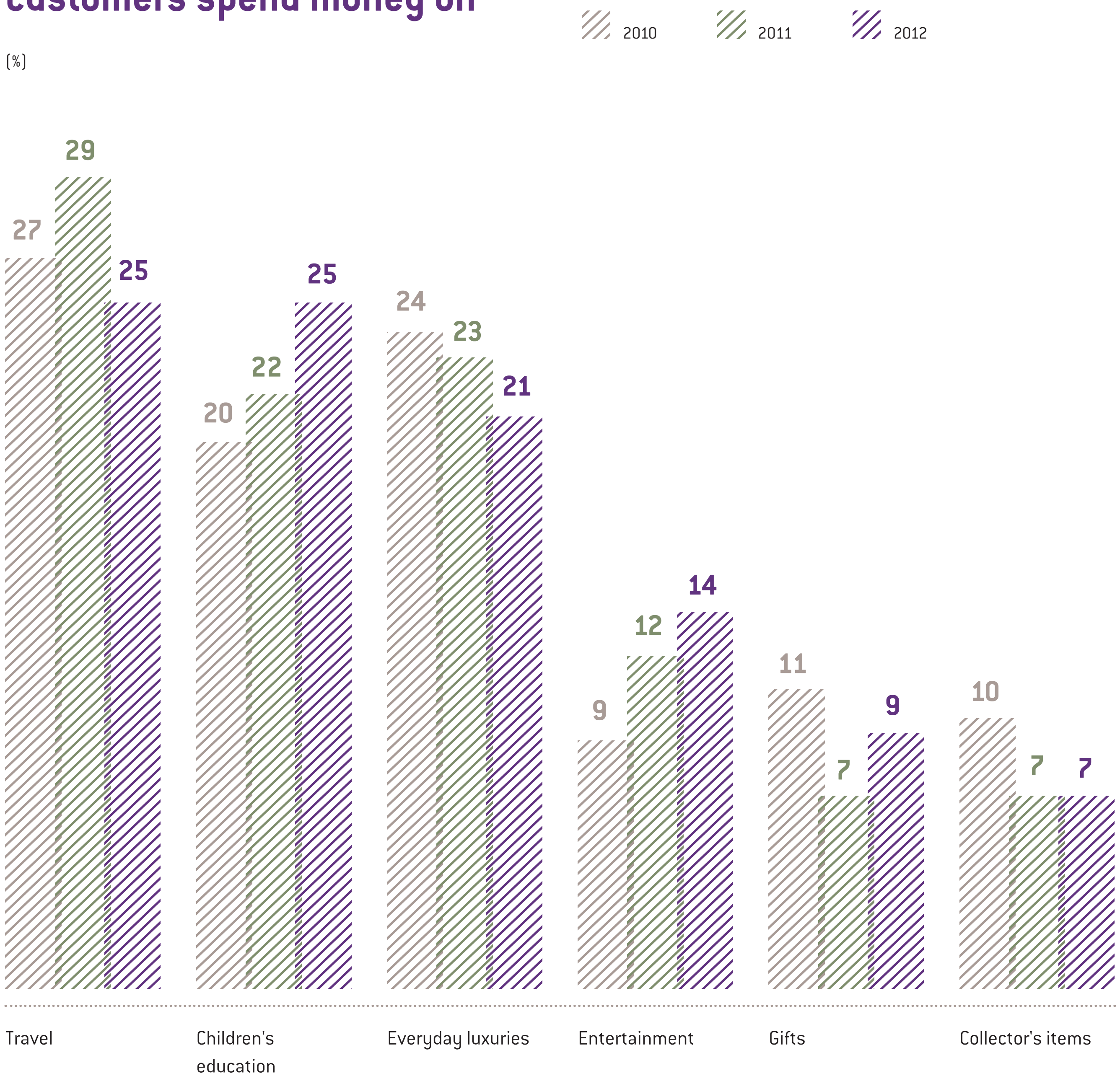
## What China's luxury product customers spend money on




Source: Hurun, 2012

The psychological background to these mechanisms is that the balance of interpersonal relationships is a keenly felt need in China. Achieving a healthy balance is vital to a person's happiness. If the balance is upset by a gift that is unexpected or too valuable, this creates an unpleasant tension on the part of the recipient. This tension can be released by giving a gift in return. And it is precisely here that the lines between giving gifts and bribery and corruption can become blurred.

Western business practices seldom involve the exchange of gifts. Accordingly, Western businesspeople are often very quick to see what they perceive as intensive gift giving in China as a form of bribery. But is this perception correct? Bearing in mind that wealthy Chinese spend 10% of their annual income on gifts, and that 80% of these gifts are given in business settings, recent developments come as no surprise.

After corruption scandals shook the highest echelons of the Communist Party in fall 2012, Xi Jinping, the party leader and successor to President Hu Jintao, has resolved to stamp out this tradition. Under the aegis of his anti-corruption campaign, government institutions have, for example, been banned from staging pompous banquets and buying luxury products to be used as gifts. The rules governing the acceptance of gifts have been tightened up too. In addition, the Chinese government has supported a large-scale press campaign by officially prohibiting radio and TV ads that advocate "gift giving". Not surprisingly, a number of luxury brands are currently suffering painful losses in terms of sales revenue. The effect of these government actions and what long-term influence they could have on growth in China's luxury goods market is not yet clear. Growth could definitely be inhibited in isolated categories, as experts believe that more than two thirds of the luxury products sold in China are given as gifts.

## THE CULTURAL FOUNDATIONS FOR LUXURY GIFT GIVING IN CHINA

So must everyone in China who accepts a gift now fear for their reputation? Do they have to avoid ever again proffering little gifts in the future? The situation is not as clear-cut as that: To understand the singular importance of gift giving in China, it is vital first to grasp something of the country's foremost cultural values. In China too, bribery is an illegal act that, in exceptionally grave circumstances, is punishable even by death.

Mianzi: Much more so than in Western cultures, giving gifts is deeply rooted in Chinese culture and values. This goes as far back as Confucius, whose teachings remain the cornerstones of Chinese life to this day. Contrary to individualistic cultures in which independence and decision-making autonomy are seen as desirable, the Chinese are much more given to collectivist modes of thought and action. And in collectivist cultures, the idea of saving face (mianzi) shapes many aspects of behavior. Mianzi compares with the Western concepts of reputation and standing, but goes much further and is much more tangible in everyday life. In China, mianzi can be saved (or indeed improved) in a variety of ways: through personal effort, hard work, great knowledge and prosperity, for example. However, a person's social status and their "face" is measured not only in terms of their personal performance, but also on the basis of their social network. The bigger a network and the more powerful the people (and their mianzi) in it, the greater is its guanxi (see below) – and the more its members will be noticed by others.

Guanxi: The most important social and business resource in China is guanxi. The word itself derives from the Chinese symbols guan and xi, meaning "gate" and "connection". Every Chinese is born into a guanxi network, but not every relationship automatically possesses guanxi – and above all not the same level or quality of it – from the outset. The guanxi within the family is stronger than that in a business relationship, for example. Nothing happens without guanxi in the world of Chinese business, which explains why so much energy, creativity and sophistication is invested in developing and nurturing it. Guanxi can be understood as a set of rules governing social norms and moral principles. Transactions that take place in the context of guanxi are based on trusting, long-term relationships that are primarily utilitarian in nature. Guanxi is rooted in renqing (roughly "human sentiment") and the principle of reciprocity. Gifts are social investments that lead to the hoped-for continuity in guanxi. The analogy of double-entry bookkeeping can be useful to illustrate the constant stream of reciprocal favors between parties that characterizes guanxi. If one party accepts a favor, the principle of reciprocity dictates that, to the Chinese mind, it would be morally reprehensible in the extreme not to return the compliment with a favor of at least equivalent value. Hence the following saying, attributed to Confucius: "He who fails to avenge himself is not a gentleman; he who fails to return a favor is not human."

The radical changes taking place in China – urbanization and privatization, for example, and the influence of Western firms, with their fundamentally different business practices – have also changed and weakened guanxi. It seems that the faster and easier way, the way of bribery, is all too often taking over from the more painstaking way of guanxi. Either way, the practice of giving gifts in China often walks a fine line between freewill giving and bribery – as long as no "red envelopes" change hands under the table.

## THE CHINESE CLUB CULTURE

For everything from sports to lunch gatherings to social get-togethers, private clubs are highly regarded and very important in China. All kinds of different clubs exist in Hong Kong and Shanghai in particular. The China Club, Kee Club and Hong Kong Club rank among the best-known and most exclusive clubs: Only members are allowed to eat together at these clubs, and membership is a coveted prize. The Hong Kong Club, for example, has a waiting list of up to seven years. Candidates then have to be recommended by two members and, assuming they are accepted, must pay a one-time entrance fee as well as a monthly membership fee. To become a member of the Hong Kong Golf Club or the Hong Kong Country Club, candidates can spend as long as 20 years on the waiting list. Here too, they must then be sponsored by existing members. However, since it is also possible to buy membership in these clubs, less patient would-be members can grace the fairway immediately for the equivalent of around EUR 1.5 million. Similar fast-track membership in the Country Club costs about EUR 500,000.

*Focus*

### High-net-worth individuals in China

**Rich and super-rich consumers are a potent customer group for luxury companies in all categories. Most studies list this clientele under the terms "high-net-worth individuals" (disposable income of more than CNY 6 million, around EUR 720,000) and "ultra-high-net-worth individuals" (disposable income of more than CNY 100 million, or about EUR 12 million). Just under one million Chinese currently fall into one of these two categories. A number of government officials and local politicians also satisfy the classification criteria but are not included in the official statistics.**

**The age structure of China's rich individuals is an interesting aspect, as they are significantly younger than their peers in Europe, the USA and industrialized Asian countries such as Japan. This is a consequence of China's rapid economic upswing over the past ten years, during which time many comparatively young people have accumulated considerable wealth. Their low average age also explains the pronounced and ostentatious propensity to consume that prevails in China, as opposed to the understated style one often finds among wealthy but older consumers in Europe in particular. China's rich individuals usually expect (and get) VIP treatment. Private shopping, invitations to exclusive events and sneak previews of new collections are par for the course, as far as they are concerned. However, many companies do not find it easy to always satisfy the demands of these customers. Cars are a good example, as having to wait for delivery of a new vehicle does not always go down well. Many brands employ special consultants for their rich clients and assign their sales staff to certain individuals. This gives each customer a permanent and regular point of contact.**

# MARKETING: DEMANDING CLIENTS EXPECT TO BE PAMPERED

International brands dominate the market, although indigenous brands too are becoming more widespread

Brand awareness is a crucial success factor – Word of mouth within the appropriate social environment (guanxi) is the most important channel

In the tier-1 cities, dedicated stores are the most powerful marketing tool for luxury brands

Top customers expect to receive personal care and attention

## THE ROLE OF THE BRAND

Chinese customers have an exceptionally strong affinity for brands. Since many of them have only scant experience with the luxury goods industry and are still rather uncertain, brands provide them with vital guidance as they make purchases. Brands also serve as indicators of the value of a product and, hence, of the social status of the buyer. As such, they are even more important here than in, say, the established markets of Western Europe.

European brands rank highly in the favor of consumers across almost all product categories. French and Italian brands lead the way in apparel and accessories, with Swiss brands out in front for timepieces. For Chinese customers, these brands symbolize style, tradition and the promise of originality. Yet German brands too are very popular in China. The Chinese have a very positive basic attitude toward Germany, and products with the label "Made in Germany" command an excellent reputation, especially with regard to quality and technical innovation. This is evidenced in the automotive sector in particular, where German manufacturers clearly dominate the luxury segment. A Digital Luxury Group study of the brands that attract the most Internet searches gave all three top slots to German manufacturers: Audi, BMW and Mercedes. In other segments too, such as high-quality writing implements, musical instruments, furniture and even handbags and porcelain, Germans need fear no comparison with brands from France and Italy, the traditional exporters of luxury goods.

To date, Chinese brands have only very occasionally found their way into the leading group in the personal luxury segment. Unlike in the hospitality and food industries, they are yet to become such a compelling proposition for customers as their European counterparts. This picture is gradually beginning to change, however. Chinese design elements – especially the materials used and the techniques with which garments are crafted – set the Shanghai Tang brand apart. Shanghai Tang serves both Chinese and international customers and has been part of the Richemont Group since 1998. Hermès has likewise launched a Chinese label: Shang Xia. Both the brand and the product range are created by a local team and marketed as "made by Chinese for Chinese". In terms of pricing, Shang Xia is marked down significantly relative to the main brand. Alongside stores in Shanghai and Beijing, an outlet in Paris has been opened end of 2013. In China itself, these prominent examples have in recent years been accompanied by the emergence of other local luxury brands. And in the years ahead, the latter will undoubtedly take the fight for market share to the international brands.

## IMPLICATIONS FOR MARKETING

In light of the characteristics of Chinese customers for luxury goods described in the section on "Consumers", brand awareness plays a pivotal role in the success of brands in China. The primary goal for all luxury brands that want to succeed in China is therefore to get themselves recognized and, depending on the product category, they use every conceivable channel to do so. Fashion labels, for example, mainly use magazines to selectively target a wealthy clientele, whereas TV and radio ads are unusual. These media are reserved more for "gift segments" such as watches,

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## Price levels for luxury products are exceptionally high in China


Source: World Luxury Association 2012

jewelry and cosmetics. Since the corruption scandal in the Communist Party, however, China's State Administration of Radio, Film and Television (SARFT) has imposed numerous restrictions on precisely these segments.

China is a very heterogeneous market with a broad spectrum of widely differing agglomerations and regions, so standardized marketing has little chance of success. On the contrary, the critical factor is to align communication and product policies with the specific regions and customer segments. The use companies make of different media and the effectiveness of the media mix varies considerably, for example. While point-of-sale and print media have the greatest impact in the bigger cities, TV ads and social networks tend to be more effective in smaller cities.

**The example of Porsche**

Exclusive events can help raise brand awareness among certain target groups, while at the same time exploiting a special sales channel. Porsche, for instance, unveiled the Porsche 918 Spyder at an exclusive event at the Shanghai International Circuit (SCI) in May 2013. Wealthy Chinese clients take such events for granted. Private shopping, invitations to exclusive happenings and sneak previews of innovative products are no more than they expect. Against the unique backdrop of a Formula 1 race track, Porsche gave potential customers the chance to experience the car firsthand, configure models, talk to experts and, ultimately, place an order on the spot.

This exclusive event provided Chinese customers with a number of benefits. They were given an introduction to the product and how to use it; and their attention was drawn specifically to certain feature configurations. The occasion also gave Chinese nationals who do not have the option of traveling to Germany access to exclusive products. The Chinese are very appreciative when experts travel from Germany to attend such an event.

One aspect that must always be borne in mind when dealing with Chinese consumers is the role of personal networks (guanxi). An individual's personal environment is instrumental in shaping their values, attitudes and opinions. Logically, therefore, word of mouth and personal recommendations by friends and family often carry far more weight in China than in most Western countries. Collective opinions are more important than individually held ones, and that is why word of mouth is the most incisive marketing channel for luxury companies, as it is for other firms. This is especially true in smaller cities whose inhabitants frequently have less experience with the luxury segment.

As things stand, the Internet does not yet command pole position – neither in terms of luxury companies' advertising spend nor in terms of channel effectiveness. However, given the Chinese people's strong affinity for online channels, this will change markedly in the coming years, as outlined in the "Online" section.

For manufacturers of luxury goods all over the world, dedicated retail outlets are a central element of the marketing mix. Tasteful and well-situated stores are a direct sales driver. At the same time, they are an important tool for boosting brand awareness and strengthening a company's reputation. This is especially true in China, where brand awareness lays the foundation for the consumption of foreign products by indigenous customers. The major brands therefore have no choice but to operate more elaborately designed stores than they would in most countries, at least in the tier-1 cities and selected tier-2 cities. As a result, some of the world's biggest and most spectacular stores can today be found in China. They are more than just selling space: They also tell the brand story and give an insight into production methods.

However, smaller companies and/or newcomers to the Chinese market are well advised to adopt a strategic approach when choosing store locations. Especially in the tier-1 cities, it is equally important to pick locations in the right market environment. In order to deliver the brand experience described above in such a high-class environment and bring customers closer to the brand, a further necessary step is often to invest much more in store fittings and design than would normally be the case in Europe.

Still another critical factor in raising awareness of a luxury brand in China and establishing it as part of the "relevant set" – putting it on customers' mental shortlist when they are considering buying a particular product – are testimonials. Young target groups with comparatively little experience with luxury products tend to copy the purchasing patterns of celebrities. The latter's behavior is closely monitored in an array of journals, online magazines and blogs. Brand and product preferences are carefully documented. Deploying the right "brand ambassadors" therefore pays dividends for most luxury goods companies and has become a widespread practice. High sympathy and credibility ratings among the relevant target groups must be factored into the selection process. One successful example is the naming of Chinese superstar Li Bing Bing as the face of Gucci in China.

The more established and experienced a brand's customers become, the more importance is attached to what are known as below-the-line activities: store events, fashion shows, products tests and even private shopping, for instance. Many brands package such offerings together to form VIP programs that – in return for appropriate sales – open the door to exclusive services and experiences. Within the relevant strata, being a part of these programs is very prestigious and is a regular topic of conversation. Here again, guanxi – recommendations and opinion sharing within personal social networks – plays a key role.

Another way to increase brand awareness and give customers a greater knowledge of the brand's history and story is to engage in "cultural marketing" in the form of exhibitions. These can be hosted either in-store, at museums or in other cultural institutions. Chanel, for example, exhibited around 400 handpicked collector's items at the National Art Museum in 2011, flanking the event with a print and POS campaign.

## PRICING: LUXURY COMES AT A PRICE

▶ The prices of luxury goods in China are the highest in the world
▶ Alongside customers' pronounced willingness to pay, taxes and customs duties are additional price drivers
▶ However, high prices encourage Chinese customers to boost their consumption abroad
▶ Special editions and suitable investment in stores and service can justify the price premium in China

F7 There are few countries where luxury goods are as expensive as in China. The prices of clothes and accessories, for example are at least 30% higher on average than those in Europe. For cars and watches, the price differentials are even greater – considerably so. This hefty markup is attributable in part to how much luxury-crazed Chinese nationals are willing to pay, but also to the heavy taxes and import duties that are levied on many luxury items.

Price levels are a key factor influencing the degree to which Chinese consumers perceive – and covet – certain brands. Brands that are felt to be "too cheap" see their attraction eroded and fail to reach the target customer groups. When calculating selling prices for the Chinese market, it is therefore important not simply to translate the prices used on domestic European markets into the local currency and adjust for taxes and duties. Careful analysis of the competition for a given product should instead identify a corridor within which the selling price should be defined. Adopting this kind of strategy has helped some premium-segment brands – such as Hugo Boss – to successfully position themselves as luxury brands in China and, hence, to command appropriate prices.

At the same time, the scale of international price differentials is increasingly causing Chinese consumers to go shopping abroad. Around 60% of Chinese spending on luxury goods is already done in other countries. Watches, jewelry, clothes and leather goods are especially coveted. As a result, some brands are already considering raising their prices in Europe to reduce the price differential. In August 2012, a Prada spokesman was quoted in the Wall Street Journal as saying: "In order to reduce the price gap with China, the company may consider increasing prices as much as 10% in Europe if the Euro continues to stay so weak, of course without increasing prices in China."

It is questionable whether such a strategy could indeed be realized successfully without jeopardizing sales in established markets. Another way to keep prices high while also keeping sales onshore could, for example, be to produce special limited editions that are available only in China. Delivering a superior in-store brand experience in combination with excellent service is likewise a useful tool to defend price premiums.

## PRODUCT RANGES SHOULD HAVE A STRONG CHINESE AND MALE ORIENTATION

▶ Chinese customers are growing increasingly proud of their cultural heritage – Demand is growing for products that explicitly reference China
▶ Men are important customers for luxury goods – a fact that must be remembered when designing product ranges

F8 In the past, most Chinese customers in the luxury segment have only wanted to buy products from international ranges, none of which had any obvious point of reference to China. Many customers questioned whether the quality of the materials and workmanship in Chinese editions genuinely delivered on the brand promise – or whether they were not in fact just "cheap imitations made in China". This uncertainty has largely been allayed, however. Indeed, a turnaround in attitudes has been witnessed to some extent. China's emergence as an economic superpower with a claim to global leadership has seen its people rediscover their self-confidence and assertiveness. Young and wealthy consumers in particular are proud of their country's rich cultural and artisanal legacy, and they like to see these traditions honored in the products marketed by international brands.

Another significant consideration when putting together a product range for the Chinese market is that men play a more predominant role here than in Europe – as direct consumers on the one hand, but also as the buyers and recipients of gifts. In traditional markets for luxury goods, it tends to be the more technology product categories (such as watches, cars and audiovisual products) that have a pronounced male orientation. In China, however, fashion and accessory ranges too need to make more provision "for him" if they are to satisfy demand. Relevant brands with a strong commitment to China should bear this in mind as early as the collection or product development phase to enable them to offer male customers a sufficiently broad spectrum.

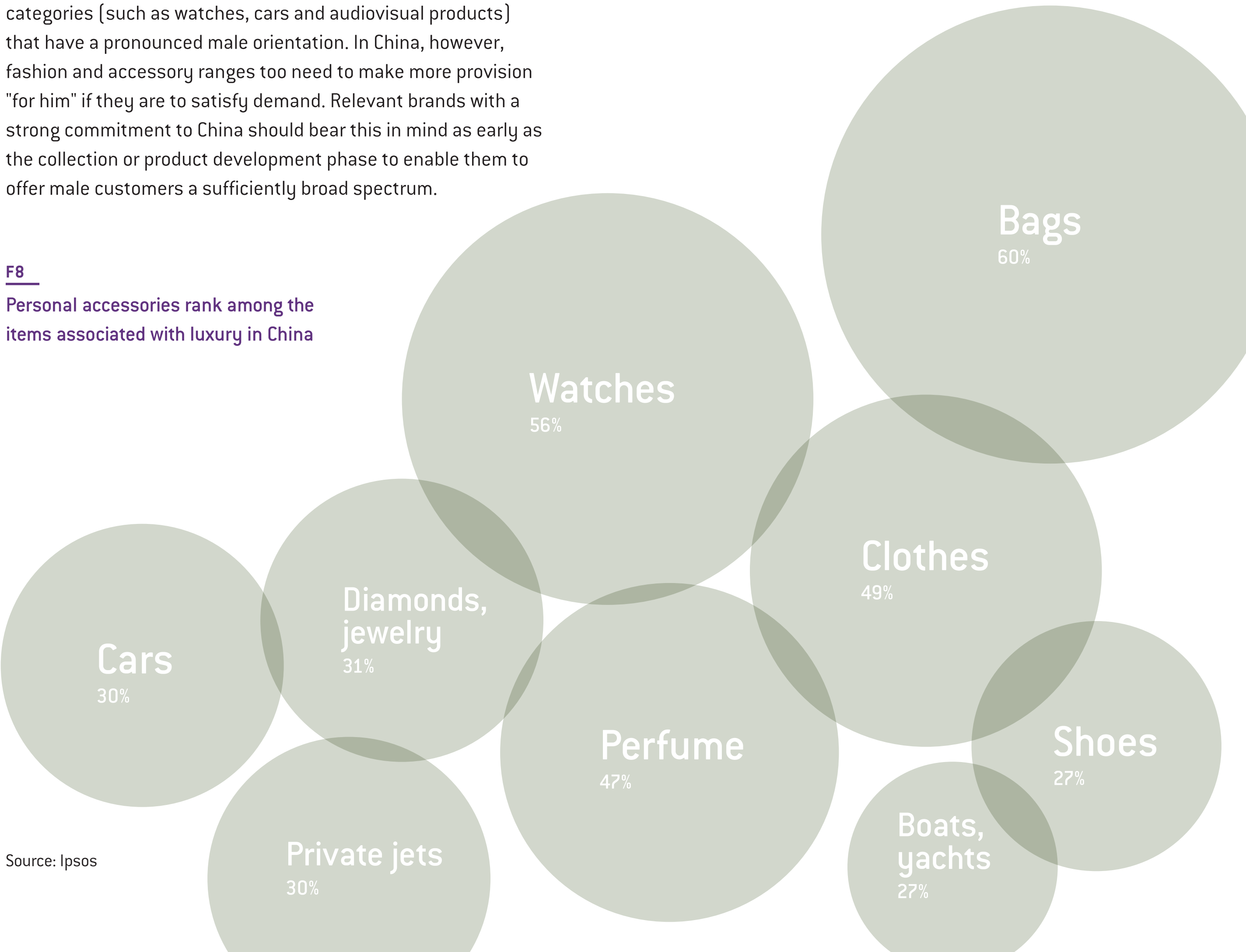
*Focus*

**Brand names**

A good image presupposes a suitable brand name. Most Chinese can make neither head nor tail of Western advertising in Latin script. Yet 50,000 nuanced characters that are rich in meaning and whose pronunciation varies from dialect to dialect make translation a difficult task. Mercedes (ben-shi: "fast and safe driving") and BMW (bao-ma: "precious horse") appear to have taken this hurdle successfully. Cultural associations also mean that the symbolism and color of the logo must likewise be carefully considered. White, for example, is the color of grieving in China, while blue stands for evil and orange for fortune or happiness.

**F8**

Personal accessories rank among the items associated with luxury in China




Source: Ipsos

# ONLINE: ANYTIME, ANYWHERE

The Internet is growing increasingly important in China, both as a way to source information and for e-commerce

Due to the (written) language barrier, companies should prepare Chinese websites whose content and presentation meet the needs of indigenous customers

Social media is very important to Chinese luxury consumers and should be an integral part of every marketing strategy

## THE ONLINE MARKET IS GROWING IN IMPORTANCE

China is going online. Expectations that the number of Chinese Internet users will increase by 40% – from 540 million today to 750 million by 2015 – bears impressive testimony to the vast potential of this market. According to a Techin Asia study, only just under 40% of Chinese "netizens" have so far made regular use of e commerce offerings. On the other hand, sharing information and experience via blogs and microblogs plays a comparatively important part, much more so than in Western Europe. Social networks (or at least indigenous Chinese ones) likewise play an influential role. Here we once again encounter the principle of guanxi, the practice of sharing with a social peer group and forming collective opinions.

Whatever the case, sales in China's online market have lately jumped by close to 50% per annum, from EUR 12 billion in 2009 to EUR 60 billion in 2012. Annual growth of roughly 30% is projected between now and 2015, which would result in a market volume of just under EUR 180 billion. According to China Daily Online, luxury goods currently account for only 2% of online shopping transactions, the equivalent of around EUR 1.2 billion. However, experts believe that this segment could double its share of online sales to 4% in the years ahead. More than 20% of Chinese Internet users already profess to be interested in buying luxury items online. This development would push online sales of luxury goods up to around EUR 7 billion by 2015. The potential for online business is believed to be highest especially in smaller cities in which the relevant brands do not yet have a bricks-and-mortar presence.

## ONLINE CHANNELS AT A GLANCE

**News sites and portals**

China has a broad array of online magazines that concern themselves with the lifestyles of celebrities. In recent years, these have been complemented by a series of portals devoted specifically to fashion and luxury themes, many of which address a female target group. Prominent examples of these sites include yoka.com and pclady.com.cn. Above all for fashion, accessories, watches and jewelry brands, these channels are very important for two main reasons. First, they help make brand names known and position them as desirable. Second, they can even stylize brands as "must-haves" by linking them to the right testimonials. The "ambassadors" who give these testimonials should therefore be chosen in such a way that they receive as much and as detailed coverage as possible in the relevant media.

Luxury navigation sites such as boogle.cn are another channel that is of great importance to luxury brands. Visitors to these sites find information, can search for specific brands and products, and are then linked to the appropriate web shops and brand websites. This channel helps brands (especially those that are as yet less prominent) to increase the volume of traffic on their websites and encourage potential customers to make direct purchases.

**Websites**

As in most markets throughout the world, websites serve as one of the most important embodiments for all brands in China too. Given the sheer expanse of the country and the still minimal presence of most luxury manufacturers in tier-3 and tier-4 cities, websites acquire an even greater significance in China than in, say, Western Europe, where the nearest brand store or multi-label dealer is usually within easy reach for most consumers. For luxury-conscious inhabitants of smaller Chinese cities, websites

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## Top 20 luxury brands by the amount of buzz they get on social networks

Unit: Posts

| | |
|---|---|
| Louis Vuitton | 66,659 |
| Chanel | 55,299 |
| Gucci | 40,029 |
| Coach | 39,651 |
| Prada | 28,162 |
| Dior | 26,973 |
| Cartier | 25,072 |
| Burberry | 24,514 |
| Hermès | 23,988 |
| IWC | 20,819 |
| Tiffany | 17,977 |
| Rolex | 16,783 |
| Miu Miu | 16,284 |
| Armani | 11,093 |
| Balenciaga | 9,715 |
| Bottega Veneta | 9,385 |
| Longines | 7,058 |
| Marni | 7,019 |
| Omega | 6,716 |
| Ferragamo | 6,511 |


Source: CIC luxury panel data, 2011

are the only way to get to know brands and engage in regular contact with them. Purchases are then made on journeys to bigger cities in China or abroad, or by placing orders online.

Yet websites are an important aspect of brand communication in the bigger tier-1 and tier-2 cites as well. In these cities, websites reinforce the brand image, increase loyalty and draw attention to new products and collections. The problem is that large swathes of the Chinese population cannot read English websites, a circumstance that leaves many of them rather disoriented on international sites. Chinese-language websites are therefore a must for all companies that want to experience lasting success on this market. But besides overcoming the language barrier, Western companies must also address cultural considerations, because the aesthetic standards of the Chinese differ – markedly in some cases – from those of the Western world. For example, homepages that are packed with information, glaring colors, animated effects and music are very popular among netizens in China. Yet such features often flatly contradict the luxury brands' regular corporate and brand identity. It is therefore important for a company either to recruit its own local experts to design and maintain a Chinese website, or to collaborate with suitable service providers who can reconcile the inherent tension between international brand presentations and the preferences of Chinese users, as well as professionally handling content management.

Another peculiarity of Chinese customers is the desire to be able to chat with brand representatives in order to obtain additional information about products, styling tips or details of product availability. Here again, well trained local staff are needed who can optimally exploit such dialogs in order to further cement customers' affinity for the brand.

For brands whose product range lends itself to online selling, integrating an online shop in the corporate website is one way to boost sales in China and, in particular, to reach those parts of the country that cannot yet be supplied via retail stores. In many cases, it is a good idea to recruit a local service partner to ensure that the entire ordering, delivery and returns process runs smoothly. For many brands, setting up their own operations on the ground in China is not (yet) worthwhile. This is because does not make sense to supply a Chinese web shop with goods from abroad, owing to customs duties, tax requirements and the logistical challenges involved.

For smaller brands and newcomers to the market, online multi-label dealers may also be a viable option. These dealers ensure an adequate traffic volume in the shop and "honor" a brand's products by including them in their assortment. Since we have already seen that Chinese customers tend to be reluctant to buy new brands with which they are unfamiliar, this arrangement makes it easier for them to arrive at a positive purchase decision. A number of online multi-label dealers already operate in the luxury goods market, with many of them specializing in certain segments. Companies that see this sales channel as an attractive option should analyze the formats actively used in their segment and check whether the brand portfolios offered by multi-label outlets are compatible with their own brands.

**The example of Burberry**

Burberry's Chinese website is aligned with local needs and focuses strongly on creating an emotional, interactive link between China-related content and commerce. In April 2011, the label streamed a live 3D hologram of a fashion show in Beijing and generated tremendous buzz. On the same website, Chinese customers can chat with a virtual consultant during the checkout phase to clarify issues such as availability and delivery lead times.

## SOCIAL MEDIA

The Chinese devote an average of 46 minutes a day to social media activities, making them some of the keenest users worldwide. Recommendations from friends and acquaintances (the guanxi principle again) are very important, which explains why social media has a more powerful influence on purchase decisions in China than anywhere else in the world. As international formats such as Facebook and Twitter are banned in China, local sites dominate the webscape (the main ones being Sina Weibo, Qzone, Renren and Tencent Weibo). In some areas, the rules and habits that govern communication via these sites deviate considerably from those that prevail in global social networks. For this reason, it is important in this context too to have brand communication experts for these channels who are at home in the Chinese market and thus have an understanding of the fine nuances of consumer opinion.

F9 For numerous brands such as Louis Vuitton, Gucci, Burberry and Chanel, social media has long been an integral part of their marketing strategy in China. Synchronized communication helps to extend the reach of these brands while giving them a deeper knowledge of their customers. The example of Dolce & Gabbana shows just how important the careful management of social media is to avoid risks to a company's reputation: In early 2012, the company's decision to prohibit photographs of the store in Hong Kong initially sparked of a wave of online protests. A physical blockade by around 1,000 people even forced the store to shut down temporarily. Had the company adopted a professional approach to social media channels, it would probably have spotted the danger at an early stage and could have swiftly taken corrective action. Some external service providers already permanently monitor social media offerings and can also analyze and edit the findings. For the Chinese, blogs in particular are extremely important as a way to express oneself and share one's views. This is equally true for customers who buy luxury products, 50% of whom use conventional blogs, while around 70% use microblogs such as Weibo (the Chinese equivalent of Twitter). In the personal luxury category, leather goods in general (and handbags in particular) are essentially the most hotly debated product group, as a study by Group M clearly shows. These discussions about the latest "it bags" are a powerful marketing tool for brand manufacturers and can give a massive boost to sales of individual products. A similar principle applies for shoes and jewelry.

Overall, a small number of opinion leaders exert a sizeable influence on the online luxury community: Around 20% of users are effectively responsible for 80% of published content. These multipliers primarily share their shopping highlights, brand knowledge and trend assessments – a self-presentation phenomenon referred to as shai. All brands need a solid command of shai, and need to be able to use it actively in their communication via social media channels. Some brands already go so far as to supply especially important opinion leaders with products at preferential rates or even free of charge. These individuals are also invited to brand events and store openings to establish them as true brand ambassadors. Professional agencies are often used to identify and approach these bloggers.

To date, product-specific shai – writing and disseminating opinions on one's purchases – is the most widespread form this phenomenon takes. However, as markets mature, the focus tends to shift more toward showcasing one's expertise and creativity ("True Man Show") or one's tastes (e.g. the "Shai lifestyle"), including street shots, hobbies, nightlife and travel. Today, the big international brands lead the field in terms of the "buzz volume" they generate on social networks. The top slots are occupied by brands primarily in the fashion and accessories categories. "Buzz leader" Louis Vuitton was the first international luxury brand to establish a microblog presence on Weibo.

The content of such microblogs nevertheless varies substantially from brand to brand. While fashion and accessories brands such as Burberry and Gucci tend to talk a lot about designers and celebrities who wear their brand, watch brands, for example, address noticeably more technical issues. Brands must recognize these different emphases in content and integrate them in their own social media marketing strategies.

# DISTRIBUTION AND PRODUCTION: MANY CHANNELS FOR THE ONE, FEWER OPTIONS FOR THE OTHER

There are a whole host of distribution models, some of which can be combined

Each brand must very carefully consider which is strategically the best option

Choosing the right partner is a critical success factor

## DISTRIBUTION MODELS

Especially when entering the Chinese market, a company's distribution model is a tremendously important success factor. Without the right connections and local knowledge, it is hard to be swift and agile and to maintain success in the long run. A variety of alternatives are open to help firms do business in China. And for every company, the choice of model is a strategic decision. It must be weighed carefully in light of company-specific criteria such as financial and human resources, the strength of the brand and past experience with internationalization. Over time, the model will often gravitate toward dedicated company-run operations as the firm gains experience and establishes its reputation on the Chinese market.

This section explores the various options and outlines some of their characteristic features. In the interests of brevity, however, we have to overlook certain segment-specific differences in our present context.

**Dedicated operations**
Running your Chinese business via your own local company (on the ground in China or Hong Kong) and operating your own stores is the option that maximizes a company's autonomy. It also has the potential to deliver the highest profits, as no fees have to be passed on to partners.

However, this model is also better suited to large, well-known brands that already do (or expect) a significant volume of business with China and that have sufficiently deep pockets, plenty of experience with this market and a solid network of contacts. This is important in order to optimize cooperation with the local authorities, but also to be able to acquire optimal store locations, for example. After several years in China, many companies switch their model from a partner-based solution to a dedicated group company.

**Joint ventures**
Joint ventures make it easier for new entrants or less well-known brands to gain a foothold in China. Working together with a local partner guarantees access to adequate knowledge of both the economic and cultural aspects of the market. Additionally, the local joint venture partner normally chooses the locations and negotiates the terms for stores, as well as helping to develop an effective communication strategy. Beyond that, the partner covers a portion of the set-up costs and the POS investment. Following a successful launch, many brands acquire the joint venture outright and transform it into a dedicated operation.

Choosing a joint venture partner is an important strategic decision, and candidates must be screened with great care. How well potential partners fit the brand, their financial resources, prior experience in the luxury industry and access to relevant market segments are all crucial criteria. On top of these issues, very detailed contracts must be formulated and all goals must be clearly defined in order to minimize any and all risks to the brand.

**Local distributors**
Distributors are autonomous companies that handle a brand's sales for the entire country or for individual regions (via mono-label stores and, where appropriate, wholesale outlets). Partly in deference to legal considerations, this model was especially prevalent in the boom years of the late 1990s and the first decade of the 21st century. This variant ties up few resources on the part of the brand itself. On the downside, the brand company can influence brand management, advertising and sales only to a limited extent. As a result of these drawbacks, this form of market delivery has seen its importance erode since the Chinese market was deregulated. Many luxury brands have since converted their contracts with distributors to joint ventures or brought the

whole of their Chinese business back in-house. Some firms nevertheless continue to work with distributors, albeit mostly with a focus on regions that are structurally weak or difficult to penetrate. As in the case of a joint venture, carefully choosing the right partner is a key success factor.

**Franchising**

The practice of franchising mono-label stores was fairly rare in the past, but has increasingly gained significance in recent years. Big mainstream companies such as adidas have pioneered the approach, and a growing number of luxury companies such as Bulgari are now also using the franchise model to expand or complement their existing store portfolios. Up to now, franchising has rarely been the sole sales model; and it tends to be better suited to brands that already play an active role on the Chinese market. In principle, this form of cooperation facilitates rapid market penetration in return for only limited financial risks as fixed costs are externalized. However, the contractual terms and in-store processes must be carefully coordinated and controlled to maintain a consistent brand image. Once again, choosing the right franchise partner is singularly important. It is also vital to rule out the option of subfranchising that would allow the franchise partner in turn to commission its own franchise partner. In most cases, any such arrangement makes it virtually impossible to control brand image presentation and smooth out operating process flows.

**Licenses**

Awarding licenses for the Chinese market is a practice seldom used by luxury goods companies, nor is it normally compatible with strict brand management. Under the terms of this model, a licensee acquires the brand rights for China, produces its own collections and handles both production and distribution. The licensor receives a fee in return. Although the model poses no immediate risk in financial terms, there are many cases in which it does indeed damage a brand's positioning and reputation. Licensed brands are often perceived as Chinese brands and are unable to command the same price levels as the "original" European products. The model is also often a source of irritation to customers who travel abroad and encounter different products in different price classes bearing the same brand logo.

## SALES CHANNELS

▶ In most segments, luxury goods companies must set up their own retail networks
▶ Top locations in tier-1 cities are the solution of choice to cultivate the brand's image
▶ Companies must assume that market entry will require a heavy initial outlay
▶ Tier-2 and tier-3 cities too hold plenty of potential for the future

Sales channels are a peculiarity of the Chinese market. Most segments of the luxury goods market have only a few multi-label retailers. It follows that mono-label stores are the most important sales channel for the majority of companies that operate in China's luxury goods segment. For brands that have little or no prior experience in operating their own retail network or whose assortments are not best suited to retail channels (due to a very low purchase frequency, for example), this presents a stiff challenge.

F10 In some cases, companies that occupy similar positions and whose product ranges complement each other (such as furniture and wallpaper providers) have joined forces and opened shared stores or showrooms. At the same time, the major international brands are currently in the process of sharply ramping up their store networks.

High-quality bricks-and-mortar stores are very important in China to give consumers firsthand access to the brand, achieve brand awareness and establish a lasting, recognized position. They are also instrumental in driving sales to Chinese customers abroad. As we saw earlier, this customer group primarily purchases brands that they already know and have accepted in their own "relevant set". Ultimately, this means that most luxury brands must shoulder a heavy initial investment to develop a store network and build their brand locally before they can realize a level of sales that covers these costs. This up-front investment phase can last for several years and must be taken into consideration when planning to do business in China.

**The example of Nymphenburg**

For instance, the Nymphenburg porcelain brand was a relatively unknown quantity in China. Opening a store in the prestigious Bund 18 in Shanghai nevertheless boosted its popularity, causing consumers to give it the benefit of the doubt. The elegant boutique in the luxury department store Bund 18 quickly earned a reputation as a stylistic milestone in China. Selected locations and addresses are very held in high regard in China and can thus make it easier for a comparatively unknown brand to enter the market.

The strategy commonly adopted by many luxury brands as they seek to gain a foothold and develop their business on the Chinese market is easier to understand in light of the above discussion. Their focus is first and foremost on the tier-1 cities and, possibly, on a few of the most attractive tier-2 cities. In these cities, most companies seek to give their flagship stores top locations in key shopping centers and in close proximity to established brands. In this way, they benefit from the spill-over effect from both the center as a whole and the immediate brand environment. The next step toward expansion is to further cultivate the brand's presence in these cities before moving to penetrate additional tier-2 cities and, where appropriate, tier-3 cities too.

**F11** As a result of this strategy, the smaller cities – especially those on tiers 3 and 4 – currently continue to experience a shortage of luxury points of sale. This in turn means that ample rollout potential still exists even for those brands that already service the tier-1 and key tier-2 cities. Louis Vuitton and Gucci, for example, have already begun to open stores in tier-3 cities. Many luxury automobile brands likewise already have a footprint here.

Yet there are always exceptions to the "rules" described above – exceptions that enable individual brands to be very successful. Max Mara, for instance, runs its biggest Chinese flagship store not in Shanghai or Beijing, but in tier-2 city Chengdu, where competition is not as fierce as it is in the megacities. Comme des Garçons has adopted yet another approach, opening a 19,000 $m^2$ multi-label store in Beijing in 2010 in order to immerse target customers in a 360-degree lifestyle experience.

***Focus***

## Feng shui

**Many Western countries look at feng shui as some kind of esoteric art. In sharp contrast, it ranks in China as an important and integral component of the search for and design of premises. Feng shui is part of China's everyday culture, and it is taken for granted that someone with suitable expertise will be involved in planning construction and, later, in the interior design and fitting of a property.**

**Originally, the modern headquarters of HSBC in Hong Kong was planned to feature entrances that were questionable from a feng shui perspective, according to which evil spirits could enter the building unhindered. The construction plans were subsequently changed, giving the escalators in the lobby area a rather idiosyncratic, angled course.**

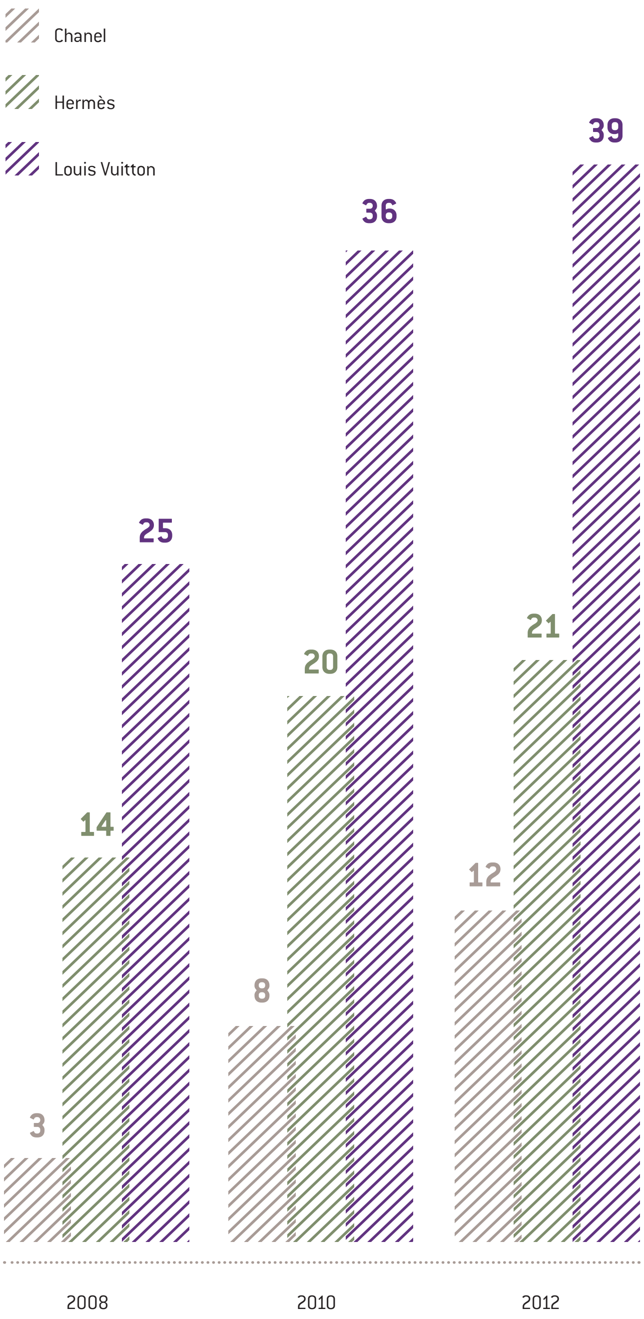
**Yet feng shui can also have a formative influence on the common practice of choosing rental space in a shopping center or wherever. For example, business premises situated opposite elevators and/or escalators are believed to be ill-fated. Experience shows that tenant churn is very high on such premises, and that only lower rents can usually be realized.**

Strong demand for top locations in the tier-1 and tier-2 cities generally exceeds supply despite the fact that new shopping centers are springing up constantly. One consequence of this situation is that rents are rising significantly, and this is visibly impacting the stores' profitability. Even so, companies should not shy away from renting very good space. The risks are usually containable, because coveted locations frequently have waiting lists. It is therefore usually not difficult to find a tenant to take over the space if the store's performance fails to live up to expectations.

**F10**

**Expansion of store networks in China**

Major brands are sharply ramping up their networks




Source: Roland Berger Research 2013

There are still considerable differences in average rents between tier-1 and tier-2 cities. Despite somewhat lower sales productivity per unit area, stores in tier-2 cities are therefore often highly profitable. Alongside its direct sales and brand presentation function, the point-of-sale in China is often important for another reason too: For complex products such as watches and high-quality musical instruments, stores also serve as maintenance and repair shops. Some brands even go so far as to train their staff in Europe to be able to ensure that top-quality advice and maintenance is provided.

## WHEN SMALL AND MID-SIZED LUXURY GOODS COMPANIES ENTER THE MARKET

- ▶ Until recently, only the leading luxury brands in a given product segment tended to meet with success in China. Today, some luxury goods consumers in China are ready to welcome brands known only to connoisseurs
- ▶ Even for small and mid-sized German companies in the luxury goods market that are looking to expand abroad, emerging countries such as China can represent an attractive alternative to their nearest geographical neighbors
- ▶ Operating your own showrooms in China is an expensive and risky business. One problem is nailing down store rents for the long term
- ▶ One alternative to in-house showrooms is the use of dedicated industry-specific distribution specialists. Another is to share a showroom with complementary luxury brands with which one enjoys a good relationship

As recently as the 1980s, luxury goods were almost totally absent from China. The first wave of big Western luxury brands washed over the country in around 1990. As famous as brands such as Louis Vuitton and Rolex had always been in the West, they were still utterly unknown in China at this time. The principal challenge for these "pioneers of luxury" was thus to cultivate brand awareness in this vast country. To achieve this goal, one of the tools they used was television advertising – something that, as a matter of principle, luxury brands in Western markets see as too vulgar and inappropriate. Since then, Chinese consumers have made up a lot of ground in the market for luxury goods.

The rule of thumb in China used to be "winner takes all": Only the leading luxury brands in a given product segment would ever meet with success here. Yet today, some luxury goods consumers in China are also ready to welcome brands known only to connoisseurs. Though the market is still relatively small, "connoisseur brands" such as Philippe Hurel are choosing precisely this time to go to market in China, building their networks now on the assumption that the market will mature noticeably over the next five years.

When small and mid-sized German companies in the luxury goods industry look to expand abroad, near neighbors such as France and the Netherlands are no longer automatically the most strategically sensible choice. On the contrary, this honor often goes to fast-growing emerging markets such as China. Many market players overlook the fact that, for very-high-priced luxury products such as surrounTec speakers (approx. EUR 200,000) and Welter wallpapers (up to EUR 10,000 per square meter), "mere millionaires" do not even belong to the target group. A study by Deloitte shows that Germany has more high-net-worth individuals than China, but also that China has far more "mid-tier millionaires" (between USD 5 million and USD 30 million) and ultra-high-net-worth individuals (over USD 30 million). Moreover, the number is growing all the time. To put that another way: Rich people in China are more often very rich. For this reason – and because of their powerful desire for luxury products – China is an attractive market for high-priced luxury products from Europe. This applies not only to the big-name luxury product companies, but also to some of the smaller and mid-sized players in this industry. For example, after Germany, China is already the second most important market for Welter's "haute coûture for walls" from Berlin.

Companies taking their first steps on the Chinese market traditionally encounter the problem that high-end resellers and luxury department stores, such as Bergdorf Goodman in New York and Harrods in London – where luxury products can be launched on the market with relatively little effort – are practically unheard of here. One option for many luxury brands is therefore to open their own showroom. For mid-sized companies in particular, though, the associated investment is heavy and the risks are high. Uncertainty about rents is one of the typical problems they run into, as it is almost impossible to set rents for the long term. A host of European luxury brands opened showrooms in Shanghai in recent years. Then, after one or two years, they found their landlords suddenly demanding horrifying increases in the rent, for example because the value of the surrounding environment had increased in the meantime. Plenty of other solvent tenants were thus ready and waiting. Other luxury brands saw their rental agreements terminated simply because the landlord had a better idea about what to do with the store space. Naturally, if a showroom has to be abandoned, the high expense of the initial fittings and furnishing quickly becomes a sunk cost.

Some luxury brands therefore try to cooperate with a Chinese partner that is in the business of letting its own store space and that is prepared to offer better rental terms in return for a stake in the business. Partnering with a Chinese distributor that possesses experience and good relationships in the given industry is another conceivable option. In defiance of their own cultural roots, however, Chinese partners often evidence a relatively short-term orientation, becoming impatient if the luxury brand does not start making a profit after two or three years. To keep them motivated over the longer term, it is advisable to seek Chinese partners that are prepared to take a financial interest in the business. In recent years, a number of industry-specific distribution specialists have also emerged. They include the likes of Oriental Watch Company and Frank & Label, both of which position themselves as "ambassadors of exceptional jewelry from Europe and America" and represent Western jewelry makers at trade shows and in their own stores in China. Another provider is the Sparkle Roll Group, which presents luxury watch brands known mainly to connoisseurs – such as Richard Mille and Parmigiani – at in-store boutiques in shopping malls (one example being The Sparkle Roll Luxury World in Beijing).

European luxury brands that are entering the Chinese market now tend to take more time to analyze the markets in order to avoid the mistakes made by their predecessors. It is possible for a company to have internal staff or commercial agents explore the market – and even realize initial sales successes – before a dedicated showroom is opened.

Some very expensive luxury furnishing products are in any case sold indirectly via interior designers and architects, who can naturally also be contacted before a company has its own showroom. The next step when seeking to penetrate the Chinese market is not necessarily to have your own showroom, but could also involve sharing a showroom with complementary luxury brands with which you enjoy a good relationship. More and more German brands in China's luxury goods community are now seeing this as an attractive strategy. For its Beijing showroom, high-end wallpaper provider Welter cooperates with a German partner that has many years' experience on the ground in China, as well as with other German brands such as Burmester, Koch & Bergfeld, KPM and glassmaker Theresienthal. Sharing a showroom reduces the cost and can even create added benefits, allowing the partners to stage events together and profit from each other's contacts and customers.

## PRODUCTION ON THE GROUND IN CHINA IS STILL SOME WAY OFF

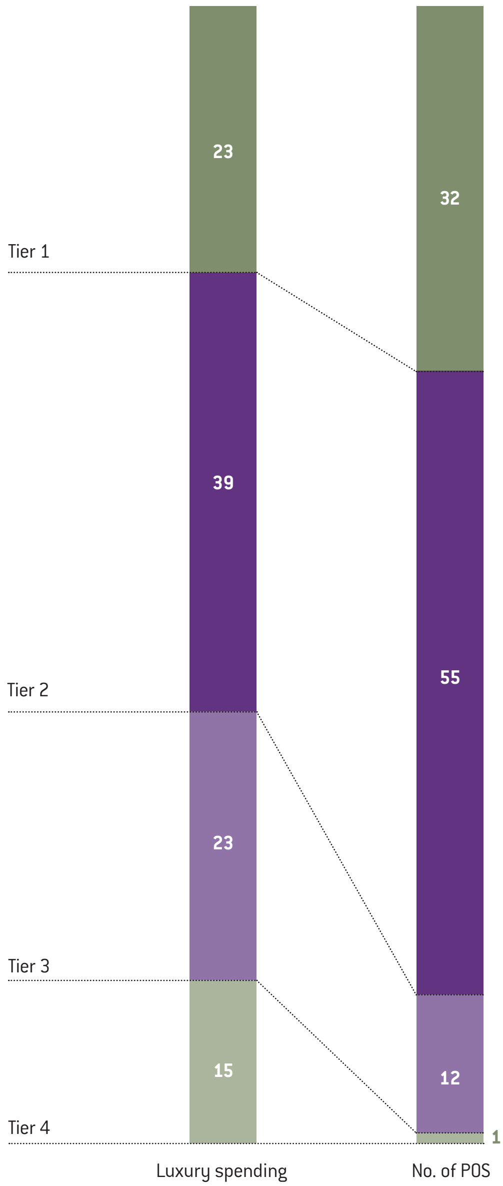
▶ As things stand, it is not advisable for European brands to produce their luxury goods in China on any large scale
▶ A few exceptions are beginning to appear, but proof of concept is still lacking
▶ Domestic luxury brands that reference traditional Chinese craftsmanship are increasingly winning consumers' favor

A number of Western luxury companies are responding to the trend toward sinofication – the growing attraction of indigenous brands – by establishing "Chinese" luxury brands of their own. Examples include Estée Lauder's new cosmetic brand Osiao, Hermès' design and craftsmanship brand Shang Xia and LVMH's Báijiǔ ("white alcohol") brand Wenjun. New brands of this kind open up new sales opportunities for Western luxury companies. At the same time, however, they also help improve the image of the "Made in China" label.

F11

**Spending on luxury goods versus the number of points of sale (POS)**

By size of city (%)




Source: Luxury in China Conference 2012, Roland Berger

One main driver of China's economic upswing has been and still is the country's role as an "extended workbench" for the Western world. Together with the obstacles to product imports raised by the Chinese authorities, this factor could make the option of producing luxury products on the ground in China appear eminently sensible. However, for genuinely high-end luxury products, manufacturing in China is not yet the way to go; nor is this likely to change in the next few years. It is therefore highly probable that Meissen porcelain will continue to come from the eastern German town of Meissen.

In the longer range, a better image can make China more attractive as a production base for luxury goods companies. A large proportion of Europe's luxury brands are in any case increasingly convinced that their brand image is stronger than the image of any given production venue. In other words, they assume that customers will trust brands such as Chanel and Prada to strictly control the entire production process irrespective of where it actually takes place. In recent years, luxury brands have understood that global competence clusters exist for specific product categories. For example, a Dior manager admitted in an interview that relocating jeans production to Turkey not only increases profits, but also facilitates quality assurance thanks to the expertise available in this region. Only recently, Chanel acquired Hawick Cashmere in Scotland – again because the region is known for producing high-quality cashmere products. Similarly, China itself has the potential to nurture competence clusters in high-end and creative industries in general, and the traditional Chinese industries referred to above in particular.

Even today for many European luxury brands, China is already more important as a manufacturing venue than many people realize. In some cases, almost-finished luxury products from Asia are effectively being exported to Europe for the final touches. Many of the high-end European carmakers already manufacture in China for the Chinese market. Additionally, a large number of luxury fashion groups have aspects of their entry-level product ranges manufactured in China in their entirety. Even parts of Prada bags come from China. Prada has acquired a roughly 5% stake in SITOY, a company traded on the Hong Kong Stock Exchange that, rather like Italy's eyewear specialist Luxottica, serves as an outsourcing partner for luxury brands in the leather goods and handbags segment.

The developments discussed in this section indicate that China's reputation as a production base will improve in the years ahead. German luxury brands would therefore do well not to rely too heavily on the "Made in Germany" label. Having said that, the rising tide of competition from China means that it is very definitely in their interests to defend the perception of quality that this label embodies – and also to position Germany as a production venue for luxury goods for Chinese consumers in particular. "Luxury made in Germany" still sounds nowhere near as compelling an argument as it should.

***Focus***

## Barriers to imports

**The Chinese authorities often make it difficult for foreign companies to export their products to China. All products slated for import must pass a series of tests, including some that destroy the tested products. On top of this, all components and a barrage of technical specifications must be reported to government institutions. Especially in the case of innovative technical products, this is certainly not in the interests of manufacturing companies. In some cases, the authorities go so far as to inspect the production facilities and processes at locations in Europe. However, the support of Europe's politicians will be needed if this practice is to be curbed. At present, individual companies have no choice but to bow to these stipulations.**

# HUMAN RESOURCES POLICY AND LOCAL LAWS: A CONSTANT CHALLENGE

The scarcity of talent on the Chinese market makes human resources policy a key challenge for companies

Intensive competition for the best people on the market is driving salaries sharply upward

Long-term personal incentive systems are increasingly needed to cement the loyalty of employees

Administrative obstacles often force companies to work together with local manpower agencies

## HR POLICY – A SUCCESS FACTOR FOR ALL LUXURY BRANDS

Finding suitable people with suitable training and education is a pivotal success factor for all luxury brands, and that is no different on the Chinese market. Especially in sales, companies need genuine brand ambassadors whose talent for selling things is complemented by a credible embodiment of the brand values. They also have to be a good match for the demanding clientele that frequents such stores. In China, personnel management is tricky on three counts in particular: recruiting, the length of time people stay with the company and contract design.

*"HR is the biggest challenge for foreign companies doing business in China."*
(Watson Wyatt/EU SME 2012)

**Recruiting**
Recruiting the right employees is a major challenge for luxury product companies in China. Alongside the expatriates who usually work in senior management positions and are seconded to China from Western countries, it is becoming increasingly important to also take on local employees (especially in sales) and managers to establish the brand on this market.

Attracting highly qualified and multilingual Chinese staff is no easy task, though. One reason is the steadily growing demand on the corporate side, while another is the exacting demands placed by candidates themselves. The government's one-child policy and the resultant aging of society is making the situation all the worse. Access to suitably qualified people is thus largely contingent on the attractiveness of the employer brand, although this fact often makes life easier for big-name Western firms than for local operations. For their part, candidates demand attractive salary packages, working conditions and career opportunities. Companies must adopt a proactive stance, rise to this challenge and present both their brand and their employment offerings at universities. Many firms also call in local human resources consultants to secure reliable access to the best potential employees on the market; and these consultants are also in a position to carefully examine the application folders. Counterfeit applications are a regular occurrence but are difficult for non-Chinese to spot. Where companies do not already cooperate with Chinese partners, HR consultants and agencies can be helpful with regard to the employment relationship too.

Sales staff who come across as authentic and who credibly represent the brand values are likewise hard to find. To solve this problem, many brands have taken to observing the sales personnel in the stores of their competitors or other luxury brands, and then – directly or indirectly – offering good candidates the chance to join them. Brands that collaborate with a Chinese partner (in a joint venture, for example) should choose a partner that has good contacts on the labor market and, ideally, that can itself supply a talented pool of sales staff.

Porsche has reported a trend whereby well-educated Chinese staff are using employment at reputable international companies in China as a springboard to further develop their career at these companies' head offices outside China. On the other hand, there is an observable trend for suitably qualified German staff to find the prospect of being employed at a subsidiary in China less and less attractive. A poor quality of life (due in part to issues such as smog) is one of several reasons for this phenomenon. In some large Chinese cities, apps that show current smog levels are used more frequently than weather apps.

**Salaries**
Fierce competition for the best talents on the market has caused salaries in China to more than double in the past five years. Unlike in Western Europe, even marginal differences in pay packages make changing employers an attractive proposition, especially for sales personnel. Companies should therefore try to keep employees not only via the salary, but also by developing tailor-made, long-term incentive systems. Again unlike in Europe, employees on the Chinese market seldom develop a close relationship to the employer brand itself. They tend instead to feel a strong sense of loyalty toward their superior. This circumstance should be borne in mind when selecting and managing management staff in particular.

**Qualifications/training**
Over and above personal and job-specific qualifications, employees should receive further training from their employers. This is especially important for sales advisers, who are called on to reconcile the inherent tensions between Chinese culture, its social and communication peculiarities and the requirements of a top international brand. Numerous large brands have responded by developing special training programs for China. This issue is equally important for smaller brands too, however, and should be factored into HR management planning right from the outset. A further challenge concerns technically sophisticated products such as watches and high-quality musical instruments that require care and maintenance. German piano manufacturer Bechstein, for example, trains employees from China at its headquarters in Germany so that it can guarantee an outstanding quality of advice and service in China too. Some high-end watchmakers adopt a similar approach.

**Contracts**
As we saw earlier, foreign companies operating in China have a number of administrative hurdles to overcome. Foreign firms are often not allowed to employ Chinese staff directly. Instead, the latter must be taken on in complex and circuitous ways by a Chinese temporary employment agency. Contracts must be made out in the local language and are governed strictly by Chinese labor law. For these reasons, using local HR consultants and agencies is imperative for most companies.

## LAWS AND REGULATIONS ARE COMPLEX AND OPAQUE

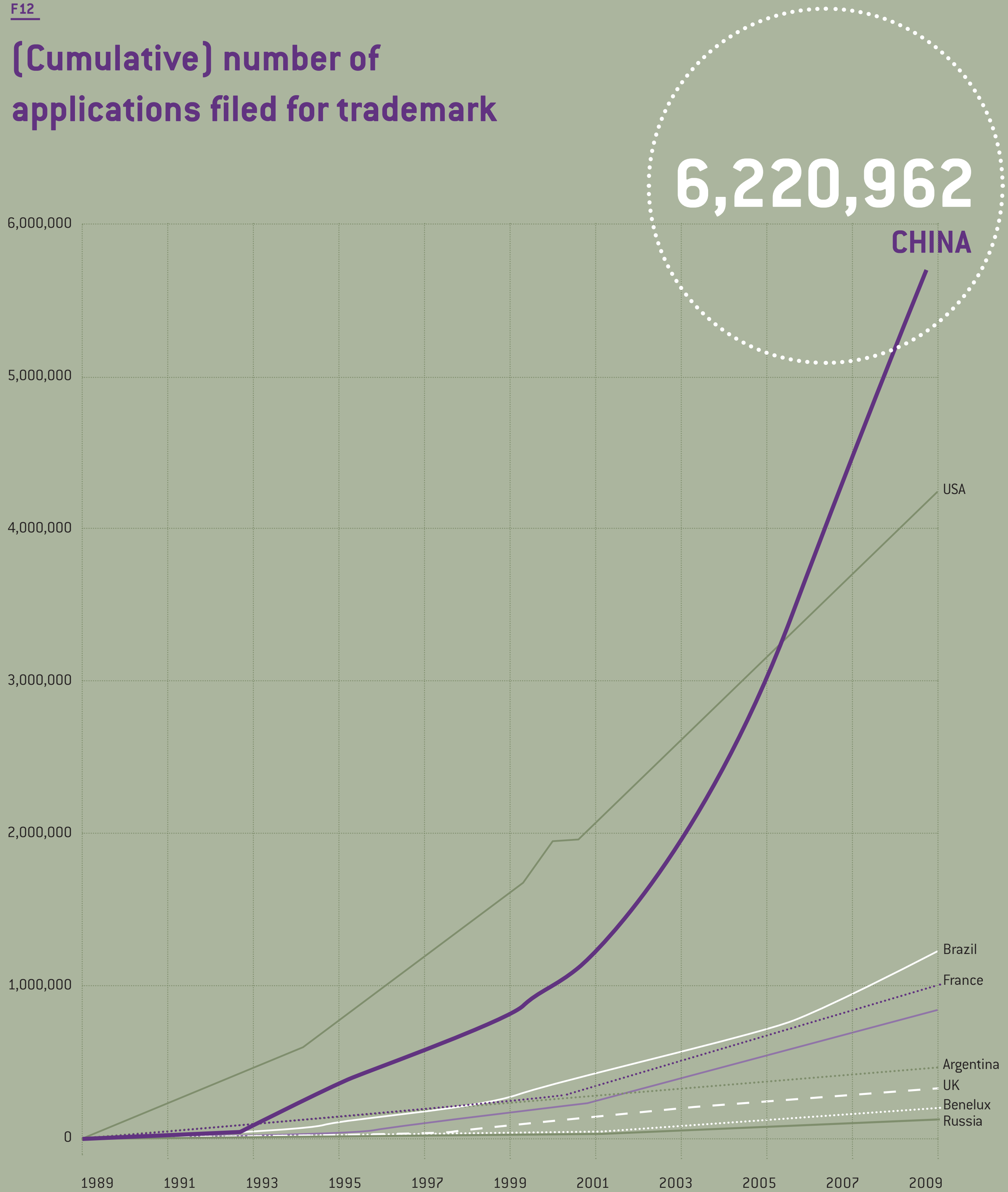
- ▶ Chinese laws and regulations are often complex and can only be properly assessed by local experts
- ▶ Trademark protection in particular is essential in China, and provision must be made for the peculiarities of Chinese law
- ▶ Each company must carefully consider the most suitable legal form and head office location – and should regularly review these decisions
- ▶ Import duties and taxes are high in China, but experts can find all kinds of ways to reduce the burden

A solid legal basis is vital if a company is to achieve lasting success on a foreign market. Especially when compared to Western Europe and the USA, China evidences an array of peculiarities in this regard, some of which are outlined in this section. However, it is not possible to provide concrete solutions or instructions on how to act in this publication. Collaboration with local and international legal experts, tax advisers and auditors is needed and guarantees access to knowledge of the latest status of all the constantly changing rules and regulations.

F12 **Trademarks and trademark protection**
Trademark protection is one of the most important topics for companies that operate in China. Yet examples of pirate stores for brands such as Apple show that this is not an easy issue to deal with, as do the countless pirate products that are on sale on markets in Chinese cities. When applications are submitted for trademarks in China, the first-to-file principle applies in most cases: The company that files the name first is granted the trademark rights. Market players are also permitted to file trademarks that differ only slightly from other brand names. Examples include Armani Polo, Zegna DF Puma and Lu-Gucci. Beyond that, Chinese trademark law is highly complex: There are 45 classes of trademark applications, each with further subdivisions – a situation that has, in recent years, caused the number of applications to skyrocket.

F12

# (Cumulative) number of applications filed for trademark




Source: Thomson Reuters, 2011

# Use of brand name variants (distribution)

F13

Example: Burberry


Unlike in other parts of the world, Western brands will discover that versions other than the official brand name are often used in China. The point is illustrated by the variations on the "Burberry" theme that are commonly used by Chinese speakers.

76%

Unofficial Chinese name

Source: Digital Luxury Group, 2012

F13 For foreign companies in particular, it is difficult to verify and prosecute violations of patent law as little or no support can be expected from the authorities. Companies also face the challenge that, in some cases, the authorities are still working off a two- to three-year backlog of applications. In the course of their contact with consumers, companies run into the problem that the latter use different variants of the brand name (the international name, the official Chinese name and the colloquial version). And even these versions vary again from region to region due to different dialects. Where necessary, all these naming variants should also be filed to guard against problems under trademark law. In light of the above idiosyncrasies of the Chinese market, there are a host of implications for trademark protection:

- Companies should be quick to file trademarks – and also to check and file related classes of trademarks
- Different language variants should likewise be filed to take account of regional differences. Collaboration with local (language) experts is essential in this area
- The market must be monitored constantly to quickly identify any potential imitators and swiftly take corrective action. LVMH, for example, has its own dedicated counterfeiting team. The attention of consumers is also drawn to such copycats and pirate copies in order to diminish the attraction of these products
- Another alternative would be to file all existing (European) brands on the basis of the Madrid Agreement (the minimum required). International filings are a possibility, although this would necessitate an extensive investigation of local rights. Companies are also urgently recommended to file their brands specifically in China

**Starting a business and choosing a legal form**

The legal form a company should take when entering the Chinese market must be considered very carefully, as the various forms involve different rights and obligations (which is indeed the case all over the world).

Foreign companies operating with no local partners tend to find their hands tied. They cannot search for or employ their own staff, nor can they sign their own rental agreements. Workarounds can be found by adopting a different model, such as a joint venture or a Chinese representative office. A presence in Hong Kong, which goes hand in hand with more generous rights, is another alternative. Once the choice has been made, an application to file the selected legal form can be completed relatively quickly. Companies must critically assess the available set of options and identify which one makes the most economic and strategic sense for them. This evaluation should be repeated at regular intervals in order to adjust the adopted model as internal and/or external parameters change and evolve.

**Choosing a location for the headquarters**

Closely linked to the question of the legal form is the issue of where the headquarters should be. Corporation tax in mainland China is currently higher (25%) than it is in Hong Kong (16.5%) for example. Successful examples exist in both places, so decisions must be made on a case-by-case basis.

Representative offices in China are not normally regarded as legal Chinese institutions and are therefore not authorized to engage in business for profit. Cooperation in the form of a joint venture or with a local partner, for example, is required for this to be the case.

**Taxes and customs duties**

In addition to the standard corporation tax, import duties and excise taxes too have a significant influence on sales of luxury goods in China as they translate into higher prices. Chinese tax and customs law is complex and difficult for non-experts to fathom. A product's tax classification depends on its physical form, for example. Nor is it easy to interpret the precise classification, which can lead to disputes with the authorities.

Imports are also subject to a number of rules and regulations. Each importer pays license fees that must be declared to customs, for example. Costs that are not taxable can mitigate tax payments. To some extent, these tax breaks can be generated by providing after-sales or post-production services in China (such as training, assembly and maintenance work and warranty services). It may therefore make sense to manufacture at least some products in China. The trade-off against the risk to the brand image must be weighed carefully in each case.

Additionally, optimal use of the over 100 regional and bilateral free trade agreements that exist can significantly reduce the burden of taxes and other charges.

**Rental agreements**
In this context, foreign companies need to be aware that their authority to rent property hinges on the legal form their Chinese business takes (via a joint venture or local partner, for example). Companies must also apply for rental permission from the Chinese authorities.

Normally, two parties are free to agree their own terms for rental contracts. Shanghai is the only exception to this rule: Here, a standard document must be used that leaves less flexibility for contract design. All contracts should be examined by local experts.

*Focus*
## Legal forms at a glance

The most common legal form is the wholly foreign-owned enterprise (WFOE). Under this form, a foreign limited-liability company bears the financial cost of setting the company up in China.

The second most common form is the equity joint venture (EJV). A limited-liability company is set up here too, albeit in this case by a foreign investor and a Chinese partner. The two parties share both management responsibilities and liability, depending on either's stake in the joint venture. The Chinese government recently simplified both the process of launching a joint venture and the operational management of this form of company.

Other corporate forms include cooperative joint ventures (CJVs), joint stock corporations and a branch office.

# CONCLUSION

China has delivered impressive economic growth in recent decades. Sprawling cities and agglomerations have taken shape, underpinning the country's sustained upswing. This economic boom has also had a lasting impact on the financial capabilities and consumption patterns of many Chinese, fueling enormous demand for luxury products. In a short space of time, China's luxury goods market has thus become one of the biggest in the world and has already acquired huge importance for the industry.

International manufacturers of luxury items are now called on to respond to these changes: Despite an excellent market climate, it is still far from easy to attain lasting profitability and success in China. These goals will be achieved only by companies that understand the culture, the customers and both the social and political frameworks in this vast and populous country.

We trust that this publication will provide players in the high-end industry with important and useful insights that can help pave the way to a successful business experience in China.

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# ACKNOWLEDGMENTS

We are especially grateful to all members of the MEISTERKREIS, whose energy and commitment within the framework of the Asia Work Group breathed life into this publication. We look forward to working with them together again in the future.

Karl Schulze, C. Bechstein
Andreas Mann, Comtesse
Helmut Heier, Leica
Sabine Dörflinger, Lufthansa First Class/Private Jet
Hans-Jörg Lenz, Porsche
Patrick Mayer, Porsche Design
Thomas Anders, Porzellanmanufaktur Nymphenburg
Alexander Gaus, Roland Berger Strategy Consultants
Professor Dr. Klaus Heine, EMLYON Business School, Shanghai
Markus Benz, Walter Knoll

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