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CONSUMER MARKETS

Luxury experiences in China

A KPMG study

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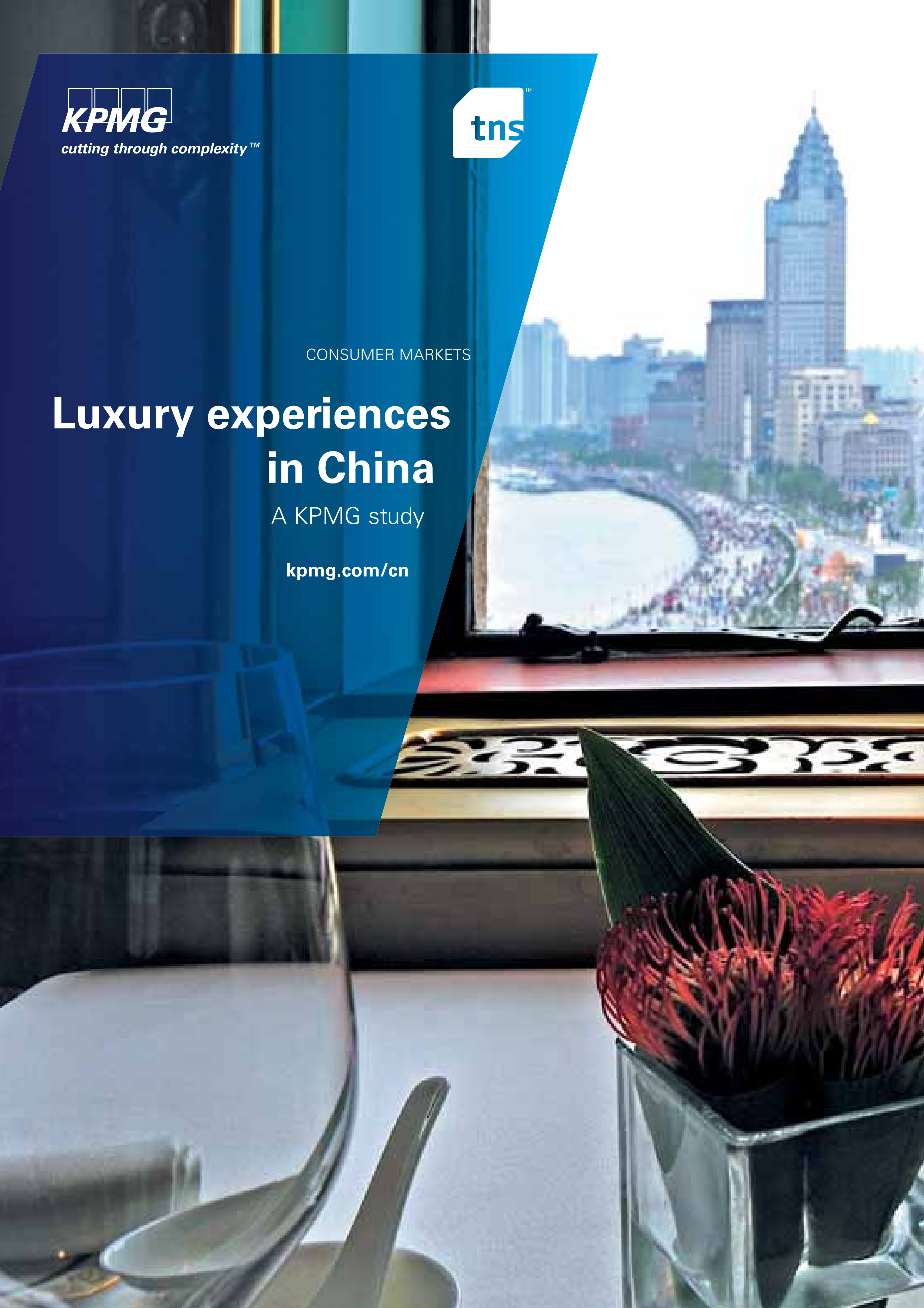

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China's role in the global luxury market is becoming more significant year by year. Many international brands are starting to see a recovery in their global sales after three very tough years, yet despite this China remains one of the brightest growth prospects.

Luxury companies are pursuing very different strategies according to the scale of their operations, and the scale of their ambitions. The traditional entry route for international companies has been through partnerships with local franchises and distributors. In recent years, as the business landscape has become more open and transparent, many companies have fully acquired their retail operations in China, at least in the most developed cities such as Shanghai, Beijing and Guangzhou. For some, local partners are still important in tier-two and tier-three cities where market conditions are less familiar. However some Western brands have entered these markets directly with a wholly foreign-owned enterprise (WFOE) model.

A long-held perception of luxury consumers in China is that they are driven by status seeking and overt demonstrations of wealth. Yet clearly in such a large and complex market this is a huge simplification. In many respects the white collar professionals and time-pressed executives in Beijing and Shanghai resemble their peers in other major capitals and financial centres as much as they do the wealthy business owners and entrepreneurs of second- and third-tier cities. If anything, it is in these cities that the greatest share of wealth (and disposable income) lies and it is here that we see consumption growing fastest.

This year's report focuses on the rise of experiential luxury and how consumption is being driven by a desire for self-reward as well as status. The report also explores the role that the internet and digital media can play in brand building and considers whether more domestic Chinese brands may succeed in the luxury sector as tastes change. Finally, we draw out some of the tax and customs planning strategies for companies to consider as they grow or develop their strategy in China.

The themes from our survey are also very strongly validated in our ten case studies, which feature a selection of prestigious brands. We would like to thank the executives who took the time to share their insights with us.

Executive summary

1. China's luxury buyers are basing their purchasing decisions upon an increasingly wide range of factors. Emotive factors such as experience and self-reward have now emerged alongside status-seeking and needs-based factors as key drivers.

2. We see signs of a new wave of luxury collecting and connoisseurship which, although still less significant overall, is particularly evident among the wealthy in tier-two and even tier-three cities. While the past year has seen an explosion of interest in fine wine, our survey suggests that jewellery, fine art and antiques also have strong growth potential.

3. Luxury brands are spending more time developing digital media as part of their marketing strategies. Nearly 70 percent of survey respondents said they search for information about luxury brands on the internet at least once a month and 30 percent do so at least once a week.

4. While official websites can be an important means for validation and comparison of products, China has seen a growing number of blogs providing coverage of luxury goods and these can be more powerful in shifting or reinforcing brand perceptions.

5. Although becoming more open to online sales, consumers continue to show an overwhelming preference to purchase big ticket items such as watches in branded stores.

6. On average, Chinese consumers now recognise 57 luxury brands, a figure that has risen steadily over successive surveys. Respondents in tier-one cities recognise 61 brands, compared with an average of 53 in tier-two cities. The market is becoming ever-more crowded.

7. Chinese consumers also distinguish very clearly among countries of origin, and associate certain countries particularly strongly with certain products; for example Switzerland for watches, France for fashion, accessories and cosmetics, and Italy for footwear.

8. There continues to be an extremely strong association with European brands at the expense of brands from other regions, suggesting that brands of other origins need to consider how to distinguish themselves, or create a niche.

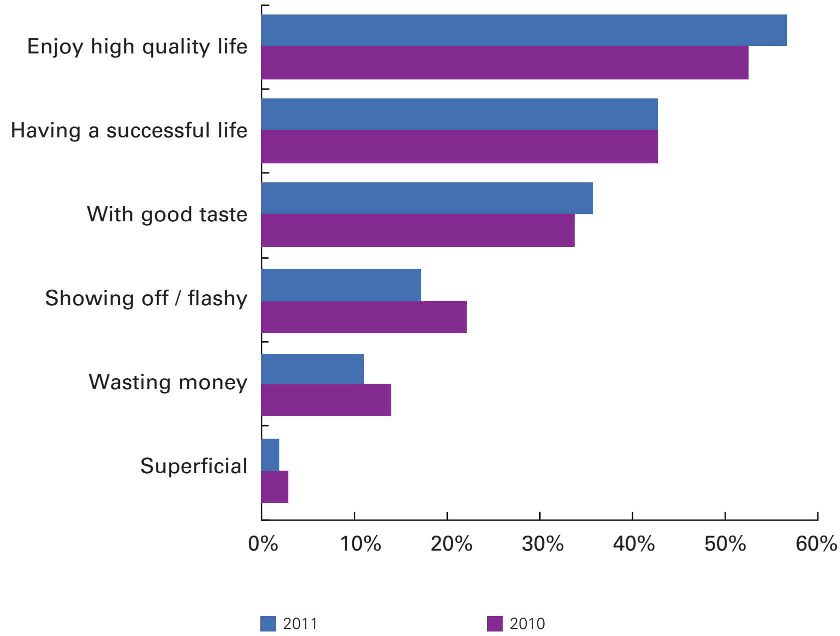
The luxury experience

Our latest survey confirms that China is continuing its march towards becoming the largest luxury market in the world, buoyed by extremely favourable attitudes towards brands (particularly those of Western origin), increasing levels of wealth in tier-two as well as tier-one cities, and a continued confidence in future economic prospects, which has been somewhat lacking in many Western markets since 2008.

For this year's report, TNS surveyed 1,200 middle class consumers based in 24 tier-one and tier-two cities across China. The survey was conducted using TNS's established online panels, with all respondents aged between 20 and 45 and earning a minimum of RMB 7,500 per month in tier-one cities and RMB 5,500 elsewhere.

While there is an aspirational element in some responses, it seems clear that many people now have direct experience of luxury. We have found no signs of a backlash against excessive consumption; indeed negative sentiment appears to be declining. The proportion of respondents equating luxury consumption with negative traits (for example showing off/flashy, wasting money, superficial) have fallen, while a large proportion of people continue to associate luxury with success, taste and the good things in life.

Fig. 1 Attitudes towards people who own luxury goods



Although emotive compensation needs are surging, luxury consumption continues to fulfil a strong status and social function need. Luxury executives may be reluctant to admit it openly, but many conceded that products with visible logos often sell more strongly, we believe for this reason. Other products with distinct features (for example the open-back watch which displays the movement) also continue to be sought after.

Motivators

Nevertheless, there has been a continued rise in experiential and connoisseurship-based behaviours. Connoisseurship and self-reward are becoming stronger motivators and when compared to the findings from our 2008 study, this is largely at the expense of status seeking.

The strongest single motivation cited by consumers remains self reward, with over 40 percent also stating that they consumed luxury "to pamper themselves" or to "enjoy the luxury experience".

With increased opportunities for mainland Chinese to travel overseas, and many people now investing in more luxurious residential properties, there are a wider range of environments in which people can choose to consume, and experience, luxury.

Fig. 2 Connoisseurship and self-reward growing while status declining

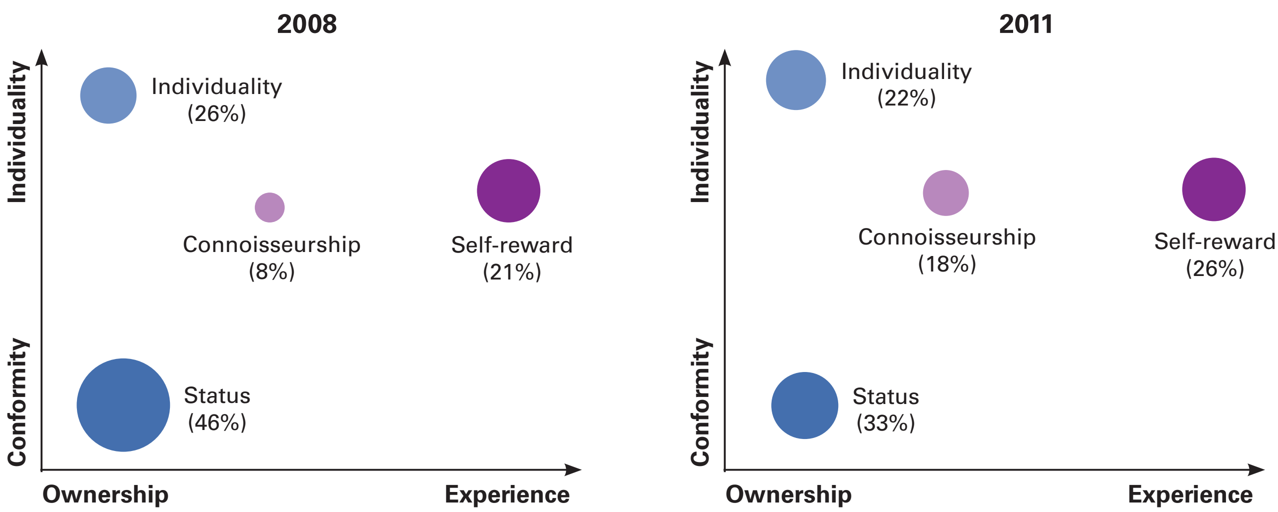
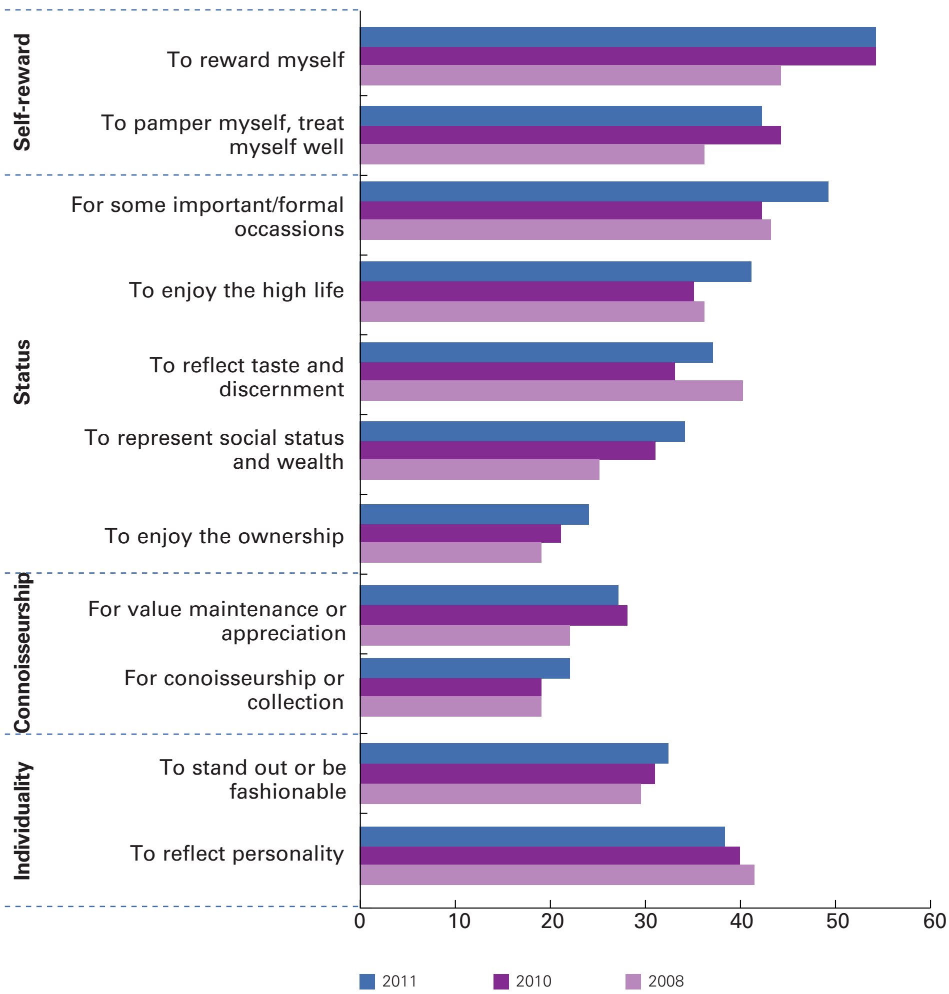


Fig. 3 Motivations for luxury consumption (%)



For experiential luxury, the feeling of self reward and self pampering is overwhelmingly important. The implication for experiential luxury marketers is to deliver on this emotive cue to customers rather than being preoccupied with exclusivity and discernment.

Connoisseurship needs are on the rise based on our analysis of the market over the past year. As the market grows in sophistication, Chinese consumers also move from pure ownership of a product to being able to appreciate the meanings and history of a luxury brand. In addition to serving as a practical means of investment/value maintenance, collecting unique artefacts are also a great way of reflecting personal taste and discernment – something which could also be defined as a status need.

Our survey explored current and future penetration of different forms of experiential and connoisseur-based luxury. To mitigate the likely risk of over-response to certain questions, these have been compared on a relative penetration basis (in relation to the total consumption of experiential or connoisseurship luxury).

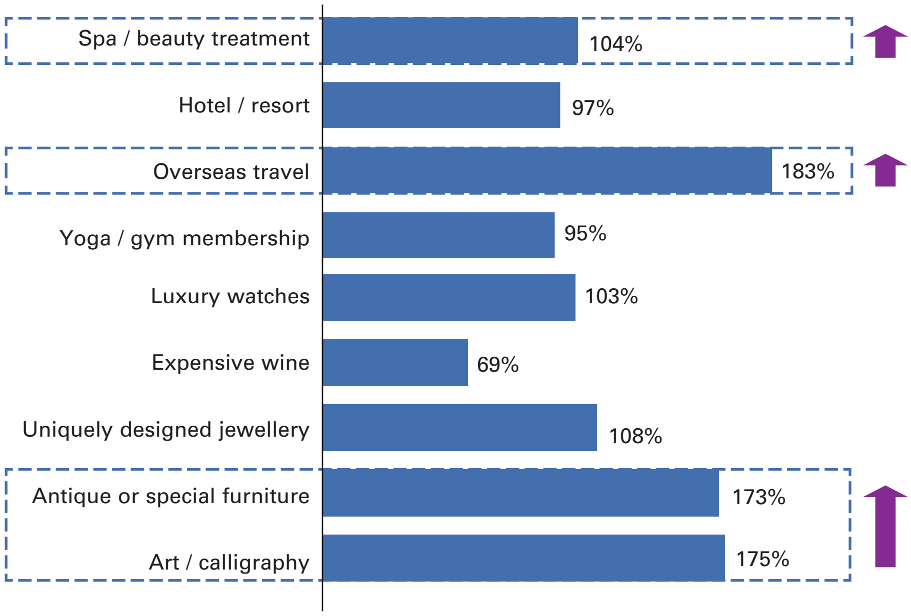
While existing levels of penetration are generally higher in tier-one cities, it is close in connoisseurship categories such as fine wine and is even slightly higher in tier-two cities for fine art. Our questions on planned luxury consumption reveal that we are likely to see even higher levels of overseas travel in the years ahead, while lifestyle expenditure on health and beauty treatments is also rising.

Fig. 4 Penetration of different forms of experiential and connoisseurship-based luxury (%)

Relative penetration	Total	Tier 1	Tier 2	Male	Female
Experience					
Spa / beauty treatment	30	37	24	27	34
Hotel / resort	43	51	35	51	35
Overseas travel	31	39	22	39	25
Yoga / gym membership	25	28	23	27	25
Connoisseurship					
Luxury watches	48	54	41	53	50
Expensive wine	62	62	59	67	63
Uniquely designed jewellery	53	57	51	46	72
Antique or special furniture	19	20	18	21	20
Art / calligraphy	21	18	24	25	20

Figure 4 shows the penetration of certain luxury products and "experiences" while figure 5 measures future propensity to consume equating the number of people who are planning to consume each product in the next 12 months against the number of people who claim to have consumed that product previously. Perhaps for this very reason, some of the products with a higher existing penetration level (for example luxury resorts and fine wine) tend to score lower on the future propensity measure; although there are some exceptions, most notably overseas travel which scores highly on both counts. Coming from a relatively low level of current penetration, consumption of art and antiques appears to have some of the strongest growth potential.

Fig. 5 Propensity to consume experiential and connoisseurship-based luxury



China's wealthiest provinces

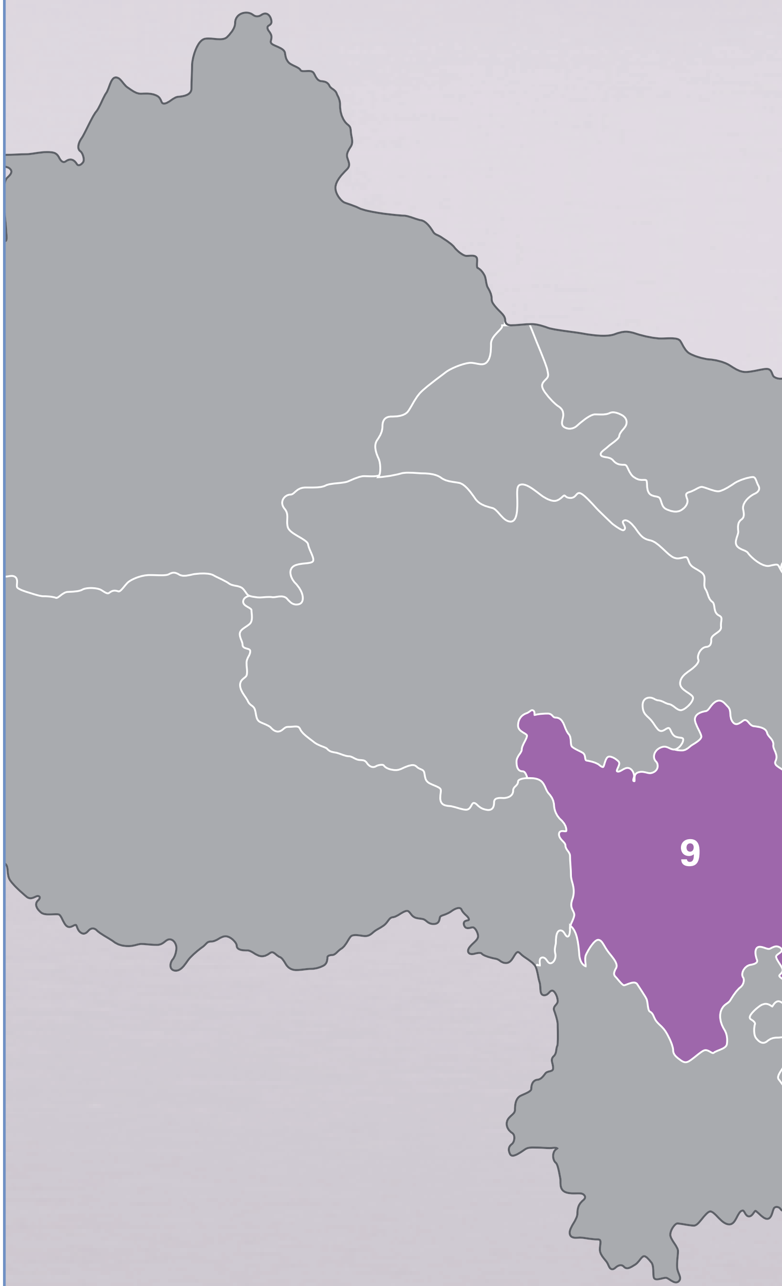
"There are now more than 960,000 people with wealth of over RMB 10 million and 60,000 people with wealth exceeding RMB 100 million," explains Rupert Hoogewerf, founder of the *Hurun Report*, China's annual rich list. "Although it is starting to change, the primary source of wealth has been real estate and manufacturing. Over half have derived their wealth from their private business. This is reflected in the fact that the wealthy are most concentrated in the coastal provinces, from Liaoning in the north, to Guangdong in the south."

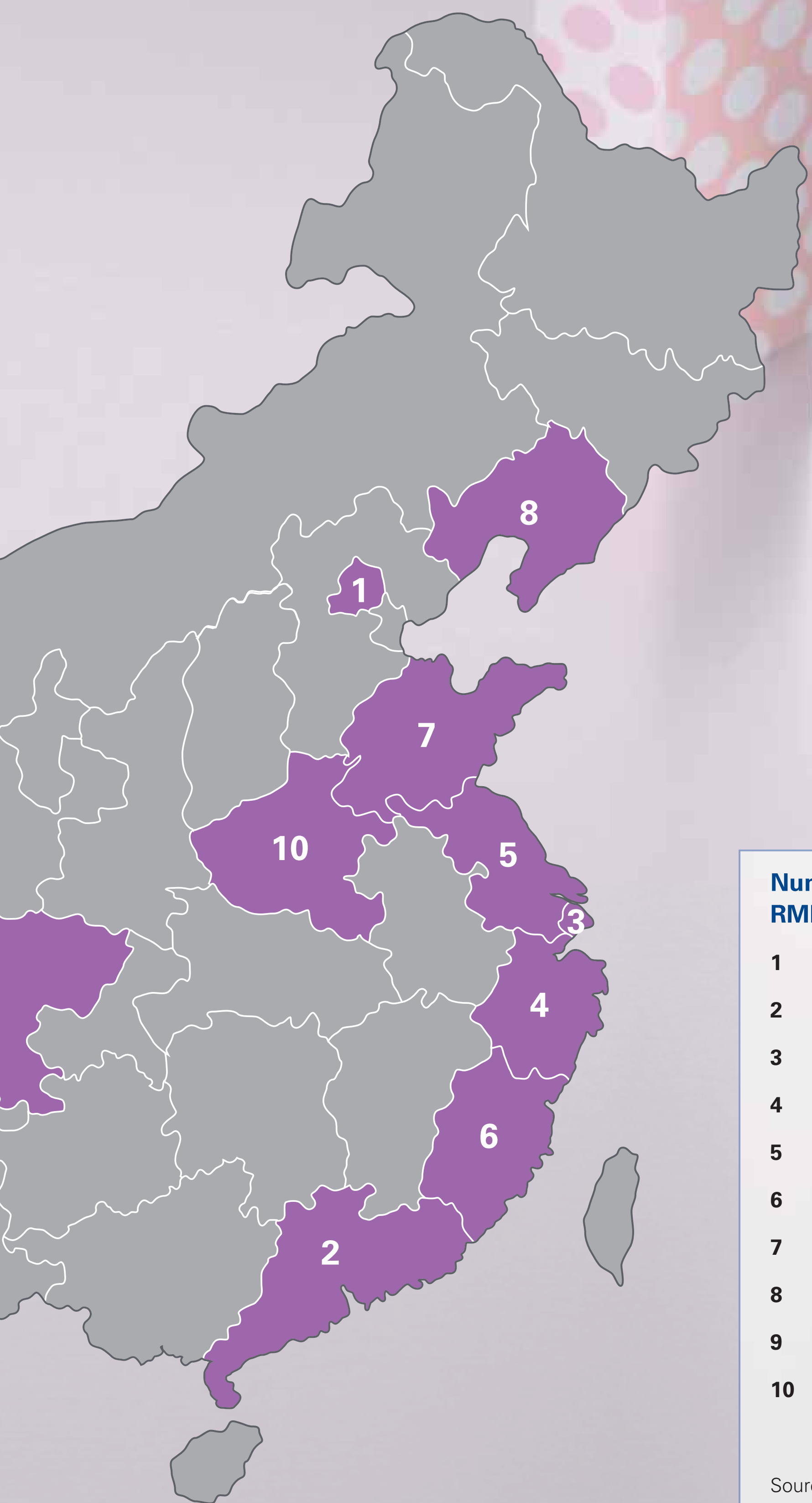
Hurun's research shows that Beijing municipality is once again the wealthiest province in China. While Shanghai municipality only comes third, its neighbouring provinces Zhejiang (home to cities such as Hangzhou, Wenzhou and Ningbo) and Jiangsu (home to Nanjing and Suzhou) also figure prominently.

The only inland provinces to make the top ten are heavily-populated Sichuan and Henan.

The average age of a multimillionaire is 39 years old and the average billionaire is 43 years old. Male millionaires outnumber their female counterparts by a ratio of 7:3.

Mr Hoogewerf believes many of China's wealthiest citizens remain hidden from view. "We have identified over 1,300 people with wealth in excess of RMB 1 billion, but in such a fast moving economy we estimate that there may be twice as many with hidden wealth exceeding that amount," he adds.





Number of residents with wealth of over RMB 10 million

1	Beijing Municipality	170,000
2	Guangdong	157,000
3	Shanghai Municipality	132,000
4	Zhejiang	126,000
5	Jiangsu	68,000
6	Fujian	36,000
7	Shandong	33,000
8	Liaoning	29,000
9	Sichuan	24,000
10	Henan	16,500
	Other	168,500

Source: Hurun Report 2011

Determined to endure

Bernard Fornas, President and CEO, Cartier International

As a leading global brand in both the watch and jewellery segments, Cartier has been building up its retail presence in China over the past decade and today operates 37 boutiques in 22 cities across the country.

Bernard Fornas, Cartier's global CEO and President, has been heading and driving the Maison for almost 10 years and contributing to Cartier's steady growth during that time. This experience makes him well positioned to see the opportunities and the challenges now presented by China and how this emerging market can fit into the company's global strategy.

Mr. Fornas outlines Cartier's ambitions for growth, which include expanding its network of high quality boutiques to as many as 50 locations across China within the next three years. "Our objective is not to be present everywhere, but to be strategically well placed and to establish ourselves as a successful brand over the long term," he explains.

Another critical aspect of the strategy is showing a commitment to develop local talent and capabilities, while espousing the highest standards of service quality. The company's China entity is managed primarily by highly talented Chinese employees, some of whom are trained in France. In addition, to ensure the brand's DNA is upheld, several key management positions have been staffed by French employees as well, and Mr. Fornas himself is an increasingly frequent traveller to China, remarking that in recent years he has been visiting "on an almost monthly basis."

The investment in sales force training is clearly considerable and for many, the training process can last for up to two years. "China now represents one of the major markets for Cartier," Mr. Fornas stresses. "That means we are looking to employ Chinese personnel in our international boutique locations as well as within China. For example, at some of our biggest tourist stores such as Galleries Lafayette in Paris, or Dubai Mall in Dubai, in order to guarantee full service satisfaction, we now ensure a certain proportion of the sales personnel is of Chinese origin."

While Chinese consumers are travelling overseas in increasing numbers, and also travel to locations such as Hong Kong to make purchases, Cartier is doing everything it can to create the complete Cartier experience locally for its clients. The brand carries its full range of products in its boutiques in China, which Mr. Fornas believes contrasts with the approach taken by a number of other smaller brands.

With regards to Chinese customers' prime watch purchasing criteria, Mr. Fornas identifies the brand as the leading one, followed by its "Swiss made" heritage. Cartier has not been tempted to generate sales volume by producing lower value items to appeal to the larger part of the market. On the contrary, the noticeable change in the purchasing patterns of Chinese consumers in recent years is evidence to Mr. Fornas that market growth is principally assured by combining winning products and service excellence. Customers are showing a preference for more sophisticated watch and jewellery items, ones which also inevitably tend to be higher-priced.

"Cartier is adapting its business strategy in accordance with the current situation. It is not only based on long-term vision and anticipation, but also on concrete facts," Mr. Fornas explains. "China's market future is not certain, many things could happen, either politically or economically. The effects could be significant for all of us and this is why we have always spread our risks. Cartier is investing not only in China, but also in many other emerging markets. We have a long-term vision and we are determined to endure forever."

Nevertheless, Mr. Fornas believes that China, along with the entire Asia Pacific region, will continue to be a major growth prospect over the next five years. "Interestingly, our research shows that today branded jewellery only accounts for around 10 percent of the market — the rest is non-branded," he says, "For this reason, we are actually quite interested in the well-being of our competitors. If they do well, it can only help to develop the market segment, for jewellery as well as for watches. Cartier will only profit from that, even more so in a high potential market like China. And to remain a leading luxury brand, you must continue offering beautiful products and excellent service."

Entrepreneurial spirit

Con Constandis, Managing Director, Pernod Ricard China

Pernod Ricard carries dozens of prestigious brands, including the Scotch whisky labels Chivas Regal, Royal Salute, Ballantines and The Glenlivet, the cognac label Martell, and champagne labels Perrier-Jouët and Mumm. The company's portfolio appears well-suited to China given its strength in brown spirits and premium brands, but Con Constandis, managing director in China, believes he is only starting to make inroads into this huge market.

"We estimate that at the moment we are only talking to one-tenth of the potential luxury consumer base here in China," Mr. Constandis explains. "Bearing in mind the dominance of local products, total imported spirits only represent 1 percent of the domestic spirits market right now. For me, that makes it a really challenging but also exciting market."

With a background as a chartered accountant, Mr. Constandis has worked in CFO and senior management roles with Seagram in Canada and Europe, and subsequently with Allied Domecq prior to its acquisition by Pernod Ricard in 2005. He relocated to China in mid-2009 and set about building a foundation for the next stage of the company's growth in China. "I arrived here inheriting a business that was successful but which faced challenges in meeting the scale of future opportunities," he recalls. "I came with no baggage and I was looking ahead at the enormous potential for this market. We knew we needed to invest more and commit more, make some changes. The exciting thing I have found in China is that commitment is rewarded. Commit to people, and they will repay you and follow you. I really believe that whatever you are willing to give to China, you will get back, and more. That applies to people as well as business, so be willing to invest."

Despite all this untapped potential, China is already the group's second largest market in terms of profitability, behind the US. "We have over 50 percent market share in China for scotch whiskies, and we do see strong growth in cognac at the high end. We recently sold 1,000 bottles of an ultra prestige Royal Salute scotch whisky [which sells at over RMB 18,000 per bottle], and our VIP customers are asking for more," he says. "In regional terms, cognac has particularly strong demand in the south of the country. Whisky is popular in central regions but faces strong competition from premium baijiu and emerging categories, like champagne. In the north, wine and whisky are the preferred drinks, but cognac is growing fast."

Premiumisation continues to be critical to Pernod Ricard's strategy. This involves introducing higher-end products, justifying a value proposition and, as Mr. Constandis puts it, "creating a halo effect for the franchise as a whole." He sees the positioning of Chivas Regal whiskies as a good example of that process. "The high-end spirits account for 1 percent of the market by consumption, but already account for 20 percent by value," he adds.

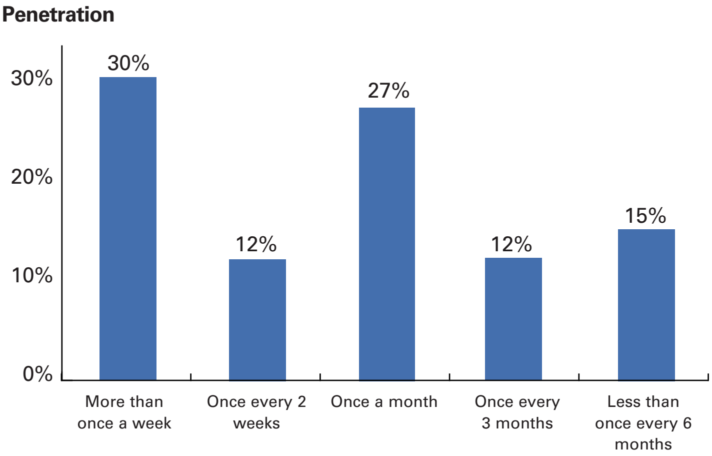
Mr. Constandis sees signs that the premium market is becoming more of a consumption market, although gifting remains a main driver. "Gifting is an important statement, particularly here in China," he observes. "The gift you receive denotes your status. In China, 80 percent of consumption occurs in a dining environment, which traditionally means large banquets. However, increasingly people are interested in entertaining at home as well. People are looking for a better balance in their lives: they want to enjoy themselves and escape from some of the pressures of their daily routines. Luxury consumption is one way to do that. They are also becoming more selective in their purchases and equating their purchase decisions more directly to their values and aspirations."

Digital strategies

No luxury brand can afford to dismiss the internet in its marketing and sales strategy. Nearly 70 percent of survey respondents said they search online for information on luxury brands at least once a month and 30 percent do so more than once a week. However, the survey responses show web channels, while effective as a way to communicate promotions and special offers, are less effective than many other media channels in overall brand building and as a means of influencing choice of brands.

Moreover, a relatively low number of respondents expressed interest in making purchases online. For watches, only 5 percent said the web would be their preferred channel for a purchase. Overall, just 6 percent said they would be "very interested"

Fig. 6 How often do you search for luxury brands on internet?



in purchasing luxury products online, with a further 16 percent saying they would be "somewhat interested". Those who expressed an interest cited price, convenience and the ability to compare products as the main benefits, while the main deterrents were due to concerns over authenticity (74 percent), after-sales service (56 percent) and payment security (38 percent).

Fig. 7 Preferred channel to buy luxury watch

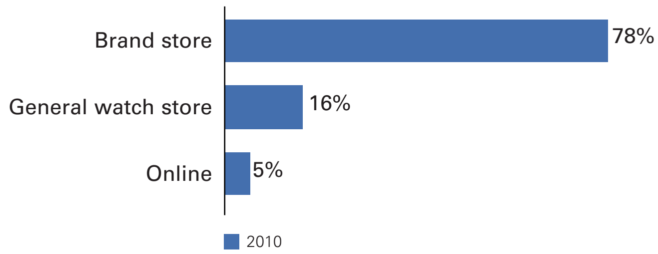
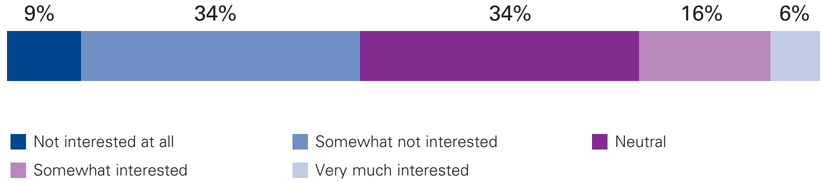


Fig. 8 Attitudes towards online shopping for luxury products

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



Main perceived benefits

Better deal, less expensive	79%
Easier for comparision among different items. e.g. product feature, price	67%
Less time consuming compared with offline shopping	56%

While the attitudes towards the web seem to be entrenched, technology can be a game-changer. The emergence of more innovative formats such as iPad apps are creating new possibilities for interaction with consumers. "In the past few years we have been surveying campaigns for a number of leading brands and we have seen some marked changes in user behaviour towards luxury brands," explains Philip Kuai, Director, Product & Strategy and Head of Mobile at AdChina. "In the internet age, it was very difficult for brands to occupy a user's desktop, but with apps it's different. They allow rich, eye-catching, interactive content and one-on-one communication between brands and their customers. This has been the turning point at which brands are spending far more on online marketing."

While the click rates for luxury are lower than for fast moving consumer goods or consumer electronics, online publishers are nonetheless "very luxury-focused," according to Mr. Kuai. He also believes the importance of opinion leaders has increased. "The premium brands are increasingly focused on seeking out these leaders," he adds.

Mr. Kuai notes that while luxury consumers most commonly browse the web for news or financial information, in certain categories there is a higher prevalence to visit luxury or lifestyle sites. "Among luxury alcohol consumers, we noticed far more tendency to browse luxury and beauty websites, compared to amongst other categories," he explains.

According to AdChina's tracking of web activity, white collar senior managers are less attracted to these luxury and beauty sites, but show a higher-than-average inclination to click on web ads for financial products, watches and hotels. "Perhaps surprisingly these senior managers spend relatively more time surfing these sites between 9am and 5pm compared to some other segments, where we see more web activity at night time," Mr. Kuai adds.

Citing AdChina's own research, Mr. Kuai believes 17 percent of consumers are using mobile apps to search for lifestyle-related information, although at present only 5 percent are using apps to make purchases.

Above and below the line

Our survey went into more detail to explore the attitudes towards different web channels as well as comparing the web against other forms of media.[1] Once again, to mitigate the likely risk of over-response to these attitudinal questions, the responses were measured on a relative basis.

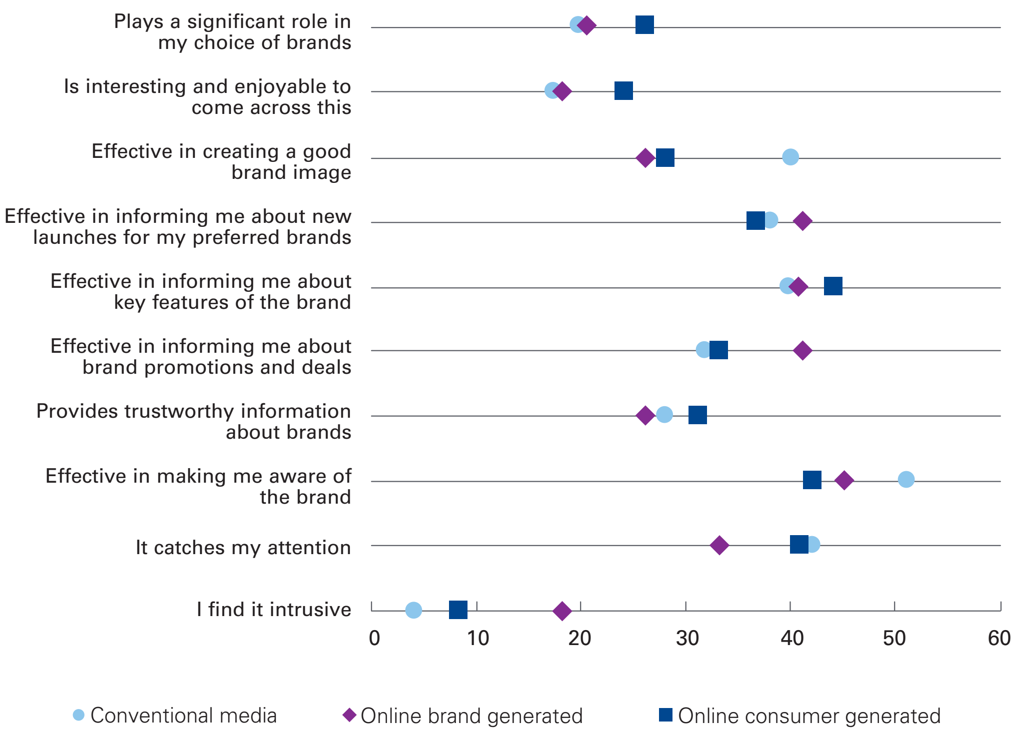
The responses show that above-the-line advertising, event sponsorships and brand events are effective in hitting specific touchpoints. Consumers see sponsorship as most effective in enhancing brand awareness and building good brand image, compared with other offline media channels, while brand events are effective in reaching target consumers.

[1] Conventional media includes TV commercials, print, store display, outdoor, brand sponsorship, and editorials Digital media refers to web/mobile-based media formats, and is further separated into two types: brand generated – powered by brand such as brand official website, pop out ads, TV commercials played on video sharing websites, and brand promotion information sent to cell phones or emails; consumer generated – consumer talking about brands in blogs, microblogs, and social networking sites and ecommerce sites.

By contrast, online brand-generated media scored quite weakly in many areas. Perhaps unsurprisingly respondents were least amenable to online advertising or brand messages sent by email, except when serving quite specific purposes, for example to inform them about specific promotions or new product launches. While the official brand website was viewed as the first point of call for specific product information, celebrity blogs and other micro blogs are stronger in building positive brand image and luxury companies therefore need to think about how their strategies reach key online influencers. Use of such blogs remains in the minority (only 19 percent claimed to visit such blogs, compared to 40 percent of respondents who claimed to visit brand websites), but we believe the usage of such sites may continue to rise sharply.

These trends are summarised in figure 9, which shows areas where consumer-generated content is seen as more effective in engaging consumers and even in persuading them to buy. It also confirms that while brand generated digital media is effective in informing consumers about latest products and promotions, if executed too aggressively it can quickly arouse negative responses from the target audience.

Fig. 9 Effectiveness of different media channels



Time is a luxury

Jiang Qiong Er, Founder and CEO, Shang Xia

For anyone doubting the prospects for a domestic Chinese luxury brand to capture the attention of China's emerging consumers, look no further than Shang Xia.

After three years of preparation, Shang Xia was launched in mid-2010 with the unveiling of a flagship store in Shanghai. Behind the company's range of apparel, ceramics, furniture and other homeware, lies the inspiration of one woman, Jiang Qiong Er.

Qiong Er comes from a renowned artistic family. Her father was famed for designing the Shanghai Museum and her grandfather was one of the first generation of Chinese artists to study overseas. Having studied design at the Tong Ji University and subsequently at the School of Decorative Arts in Paris, she fashioned her own vision for a Chinese luxury brand, one which would provide a link to the past through a combination of simple functional elements and traditional Chinese aesthetics. Hermès bought into her vision. Shang Xia is run as an independent brand but the initial support of Hermès has been welcome.

Qiong Er describes the partnership with Hermès as "a beautiful encounter" between two organisations with a shared passion and commitment to uniqueness and design. She also feels the media reaction has been very positive, if initially sparked by a sense of curiosity. Shang Xia has a mix of foreign and local Chinese customers, with many orders being placed overseas.

While Qiong Er believes that the creation of high-end brands such as Shang Xia could provide an inspiration to other home-grown designers, artists and entrepreneurs, she feels Shang Xia has crafted a unique identity. "A lot of brands are looking to incorporate Chinese influences, but Shang Xia is truly rooted in a Chinese philosophy and aesthetic," she explains. "The words Shang Xia mean 'up' and 'down', reflecting a flow of energy from the past through to the future, and a link between tradition and innovation. We want to create emotion, inspiration and surprise.

This sense of heritage and emotion is also captured in a non-profit exhibition which Shang Xia sponsors, involving the creation of an annual cultural object. This year's campaign was named "Pass It On" and the object at the centre of visitors' attention was a box containing personal artefacts and a book of stories from China's past.

Shang Xia's differentiation is subtle, intended to appeal to the connoisseur of Chinese design. "We have fused certain design elements," Qiong Er continues, pointing to the use of squared and rounded corners on its zitan imperial chair, or the contrasting of delicate ceramics with fine bamboo weaving on its homeware products, as examples. "Although we are a new brand, we are building on centuries of heritage and Chinese craftsmanship. We have set ourselves a mission to resurrect and nurture a sense of craftsmanship which was lost as China became a mass-production economy."

For the time being, Shang Xia has just one boutique and Qiong Er does not believe in building a brand empire. "If we develop the right concept and way of thinking then profitability will follow," Qiong Er says. "Our priority now is to develop this business in a stable way, not grow so fast that we risk compromising on quality. Our products are hand-crafted and time intensive so our output is very limited. We are working with traditional craftsmen who have refined their skills over a lifetime. This does not allow us to scale up our production very easily."

Qiong Er admits to having a "lot of dreams" about the future. "One of my dreams is to prepare the younger generation for the future, maybe even develop a new 'School of Craftsmanship'. We have time; this is already a luxury for us. And we are only taking a first step because we want to create something to pass on to our next generation."

When the shoe fits

Paul Cadman, Asia Pacific CEO and Christian Foddis, Regional General Manager, Salvatore Ferragamo

Ferragamo has been expanding its retail footprint in China for more than two decades and the market is now a key one for the whole group. "Ferragamo's heritage is Italian, an Italian Family business with all of our products 'Made in Italy'," explains Asia Pacific CEO Paul Cadman. "In the early years there was a strong association with Hollywood and we supplied footwear to many iconic movie stars, a tradition which continues today. Ferragamo built a very strong position in the US market on those foundations, so it is only more recently that we have really considered Asia Pacific surpassing the US as our largest market. Things have really changed in the past few years and our fastest growing market is now clearly China. When you include Chinese people travelling we believe close to half of all our consumers worldwide are from Greater China and other parts of Asia."

Today, the shoe is indeed very much on the other foot. With 51 stores across China, including domestic and airport locations, Ferragamo has a significant presence which few other top-tier brands can rival. "Looking back, we probably could have been more aggressive in our expansion over the last year or two," he explains. "We took a relatively cautious approach and our sales far exceeded our expectations. In fact, 2010 may prove to be one of the best years in our brand's history, (with all regions performing well) and with Asia leading the growth trend."

With a good presence already, shop-count is not something that preoccupies Mr. Cadman; he is keen to emphasise that the company will not set targets to open a certain number of new stores in the coming years. Instead, the focus is increasingly on store image, location, floor size, store positioning and consistency. "If a new mall comes onstream in a second- or third-tier city in China, we need to consider taking a large space because we might not see another property of that quality coming onstream for some time," he says. "Where in the past Ferragamo may have opted for a 150- or 200-square-metre store in lesser known cities, now we will look at spaces of up to 300 square metres. As these locations become more significant to our business, relative to the larger cities, it is critical that we continue to upgrade our stores, commit to these locations and continually revitalise the retail experience."

Christian Foddis, Regional General Manager, has the task of travelling to many dozens of locations across China and working with the China management team, managing the company's growth. He sees very clearly how the opportunities exist in second- and third-tier cities. "The hardware and the infrastructure are developing so fast," he remarks. "The dramatic improvement in many cities and development of travel links such as airports have provided new retail opportunities, while malls are opening that give brands the opportunity to implement the best and freshest retail concepts. There are probably more malls opening in China than in the rest of the world put together, so that means there are really exciting opportunities for innovation and growth."

Mr. Foddis believes mall operators in China have a good perception of Ferragamo. "We are one of the names that our competitors, and the landlords, will look for in a property. They know we can deliver results in our space."

Ferragamo is committing resources to digital marketing and building online sales formats. The first Asian market to launch will be Korea and Mr. Cadman expects China will follow quickly after. While this could be a particularly critical success factor in China, he does not believe digital marketing will be effective if approached in isolation. "In the last [couple of] years we have adjusted our mix of above-the-line and below-the-line marketing activity with more focus on events, personal interaction and experience," Mr. Cadman explains. "The perception of our brand in China is shaped by the quality and comfort of our products, the perception of our stores and the adjacencies to our brand within the mall locations. The use of digital media such as SMS and iPhone apps has huge potential, but these technologies will be far more powerful once a customer has had the personal experience of using our products and visiting our stores."

Succeeding in a crowded market

Brand recognition among Chinese consumers continues to rise as companies build up their retail presence and deploy more resources to marketing. On average, our middle income respondents now recognise 57 luxury brands, a figure that has risen steadily over successive surveys. Respondents in tier-one cities recognised 61 brands, compared with an average of 53 in tier-two cities.

The highest levels of recognition were in the luxury car category (77 percent), followed by the jewellery category (43 percent). The pattern was similar across tier-one and tier-two cities.

Fig. 10 Brand recognition (Total)

		Clothes	Bags and shoes	Watches	Jewellery	Import cars	Total
2011 survey	Average number of brands recognized	13.5	15.9	8.8	5.6	13.1	56.9
	As a percentage of brands listed	35%	40%	34%	43%	77%	
2010 survey	Average number of brands recognized	9.8	11.9	7.5	4.9	11.3	45.4
	As a percentage of brands listed	27%	35%	31%	38%	66%	
2006 survey	Average number of brands recognised	9.3	4.7	7.6	2.5	10.1	34.2
	As a percentage of brands listed	28%	31%	30%	28%	60%	

Fig. 11 Brand recognition (tier-one cities vs tier-two cities)

		Clothes	Bags and shoes	Watches	Jewellery	Import cars	Total
Tier-1	Average number of brands recognized	14.7	17.3	9.9	6.0	13.2	61.1
	As a percentage of brands listed	38%	43%	38%	46%	78%	
Tier-2	Average number of brands recognised	12.6	14.7	8.0	5.2	12.9	53.4
	As a percentage of brands listed	32%	37%	31%	40%	76%	

The marketing mix

Advertising and marketing channels in China are not only fragmented in terms of location and ownership of media. With the advent of digital media, they increasingly vary. Brands face a range of choices as they develop their marketing mix, each with the potential to impact upon consumer sentiment in different ways. Holding lavish events has been a popular approach for building prestige around a brand in major cities such as Shanghai and leading brands compete fiercely for prime magazine and outdoor advertising space, but as brands seek to extend their reach to more cities and provinces, many companies may need to consider a more multi-pronged approach.

Being a well-known brand is still a very important factor for luxury brands to succeed in China. Only 21 percent agreed that a luxury brand should be "a niche brand known only to a few". Forty percent agreed that a luxury brand should first be well-known before it can be considered successful and 64 percent said they would be more willing to pay a premium if a brand is popular and well-known. Even if status-seeking is a less dominant motivating factor for consumers, it seems the brand name nonetheless helps to validate their decision to pay a premium.

Consumers in China also distinguish very clearly among countries of origin, and associate certain countries particularly strongly with certain products. Switzerland is overwhelmingly associated with luxury watches, while Italy scores highest for footwear and France for clothes, accessories and cosmetics. There continues to be an extremely strong association towards European brands at the expense of brands from other parts of the world. Brands intending to launch a product in a category where there has not traditionally been a strong association with that country of origin need to think carefully about how they position and differentiate themselves.

Fig. 12 Country association for different luxury product categories (%)

	France	Italy	Hong Kong	Mainland China	UK	US	Japan	Switzerland
Clothes	37	30	10	7	6	6	3	1
Bag	33	31	8	7	9	6	1	5
Shoes	19	43	7	9	8	10	2	2
Watch	2	2	3	2	2	1	1	87
Jewellery	26	16	25	9	10	4	1	9
Cosmetic/perfume	76	3	5	2	3	5	4	1
Alcohol	35	7	2	37	13	4	0	2

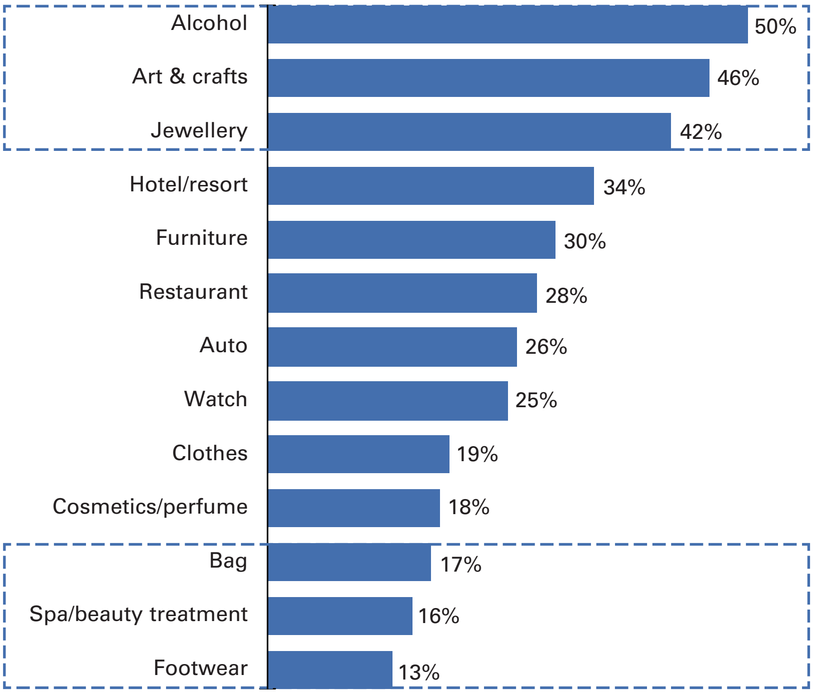
Prospects for domestic luxury brands

One question which can polarise opinion among luxury executives is whether domestic Chinese brands have the potential to become more established in the luxury sector. Many executives feel that Western brands have a heritage and track record which serves as a barrier to entry and which Chinese brands cannot match. However, others argue that China simply needs to rediscover its own history of craftsmanship and aesthetic and that the rapid growth of Chinese-born artists and designers bodes well for Chinese originated brands in the future.

The country association question presented in figure 12 suggests Chinese brands are only weakly associated with luxury in most product categories (less than 10 percent in all categories except alcohol) at present.

However, when asked about future potential of domestic brands, respondents saw alcohol, arts and crafts, and jewellery products having the strongest prospects for success. Certainly this appears to be good news for companies such as Shang Xia and Hiersun, two domestic brands which are featured as case studies in this report. Conversely, product categories where European brands dominate such as watches, clothes and accessories are seen as having the lowest potential for penetration by domestic brands. When asked specifically about watches, only 5 percent believed Chinese luxury brands had strong potential to rival international brands.

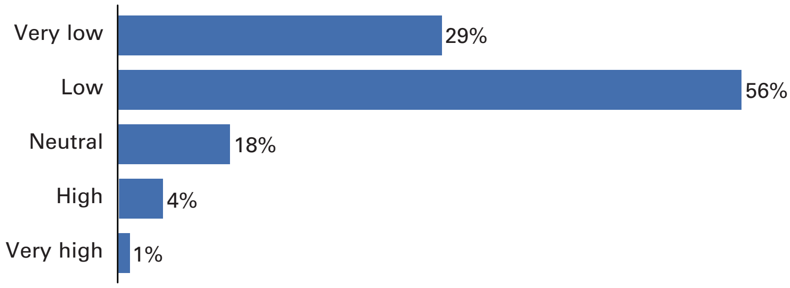
Fig. 13 Categories where consumers believe local luxury brands will take off



"Brands rooted in Chinese elements are gaining international recognition but are also sought after by Chinese customers," says Sandy Chen, research director with TNS. "There is a rising sense of national pride and cultural renaissance. In a consumer trends poll conducted in 2009, 75 percent responded 'I love my own country' compared to 25 percent who responded 'I love the whole world'. Eighty-three percent said they were proud of the Chinese cultural heritage and felt guided by it."

Ms. Chen believes that categories that require strong technological capabilities (such as automobiles or watches) are less likely territories for Chinese luxury brands to excel. However, in these cases Chinese consumers's tastes are having an increased influence on new design.[2] When it comes to products based on traditional fine craftsmanship or a secret recipe, she believes home-grown brands could do well. "Chinese luxury companies do possess a great opportunity to win the heart and mind of the Chinese consumers, especially when traditional Chinese elements are smartly blended with modern technology and marketing," she adds.

Fig. 14 Prospects for development of Chinese luxury watch brands to rival international brands



2 "China influence on design growing fast," *Financial Times*, 19 April 2011

Recognising a market, seizing the opportunity

William Li, Chairman, Hiersun Diamond Group

William Li, the chairman of Hiersun Diamond Group, believes China's luxury market is in its infancy. "You must stay calm and be objective when looking at China's luxury market," he says. "It is developing very rapidly but for products such as diamonds it has not yet matured. When a fashionable woman has satisfied her basic needs, the next things she wants might be a bag or a pair of shoes, then it might be a valuable wrist watch. Only after that may she start to consider diamond accessories."

This is borne out by the fact that 70 percent of diamond purchases in China are for weddings. "For this purpose, the diamond has almost become a necessity," Mr. Li remarks.

Mr. Li's knowledge of the diamond market has been critical to the development of Hiersun. He launched the Hiersun Diamond Palace in 1999 in a 1,500-square metre space in Oriental Plaza in Beijing. With this step he established Hiersun as the first high-end diamond brand in China. It had relatively little competition and sales were strong but Mr. Li expanded cautiously, opening another Diamond Palace in Beijing, and two more in Shanghai and Harbin. "These stores focus on high-end diamonds which weigh more than one carat," Mr. Li explains. "To the customers of Hiersun, the buying process is part of the luxury experience."

Recognising that diamond rings are a must-have for weddings, in 2006 Hiersun launched a dedicated wedding ring brand called I DO. It has become the top brand in the industry with more than 200 stores across China. Thirty percent of these are in the tier-one cities of Beijing, Shanghai, Guangzhou and Shenzhen, with the remainder spread across numerous tier-two and three cities. "We will slow our pace when we have opened over 300 I DO shops," says Mr. Li. "After such strong expansion, we are starting to review our management and internal controls. We realise that expansion brings risk as well. Some of the brands just focus on expansion and ignore management issues, and gradually turn into second-class brands or even disappear."

While I DO maintains its high-end positioning, Mr. Li is developing another brand to target tier-four cities. "We could open up to 2,000 shops across China if it launches successfully. This could become the greatest growth driver for Hiersun over the next 10 years," Mr. Li explains.

When asked whether Hiersun will make use of online retail channels to promote the brand and sales, Mr. Li replies calmly: "Diamonds are uniquely luxurious items which are not really suited to being traded on the internet. I cannot see online shopping significantly having an impact on traditional sales methods. People will be more inclined to come to our shops for a diamond as the price of that purchase goes up."

Mr. Li believes Chinese companies can learn much from international peers. He also believes the reason why Hiersun quickly established a leading position in the diamond market is because it understands the unique nature of diamonds. "Everyone knows the quality of diamonds is measured under the 4C standard (Carat, Clarity, Colour and Cutting)," he explains. "By ensuring we had imported high-quality diamonds and cutting them to the best of our skills, we quickly established a high-end brand."

With many foreign luxury brands entering the China market, Mr. Li appears unfazed. "We have our own market positioning which is distinct from foreign brands," he says. "The market is big enough to accommodate us all. I was born and live in China, if I need to choose a location for a new outlet, I can go there and make my assessment quickly, I will know where the best location is; but foreign brands may have to go through more lengthy procedures and assess different options. It is not a bad thing, but it may slow their response time."

Mr. Li attributes three essential elements to the success of any luxury brand, namely, cultural heritage, the spirit of craftsmanship and talent. "China's richness in cultural heritage is unrivalled, but we have to devote ourselves to produce the best product. That is what we call the spirit of craftsmanship. The development of luxury brands in China has just begun — we need talented people to work in this sector."

The glamourous network

Thibault Villet, CEO China, Glamour Sales

Thibault Villet has spent much of his career in Asia, working in senior roles for L'Oréal and Coach. As Vice President for L'Oréal in China in charge of the Luxury Products Division, he drove the launch of many of its leading brands, including Shu Uemara, and established Lancôme as a market leader in China. After a brief posting to Japan, he returned to China with Coach, where he negotiated the buy-back of their distribution from a local partner, launched a new flagship store in Hong Kong and helped reposition the brand with a renewed focus on retail and service culture.

Having achieved so much, Mr. Villet had no interest in resting on his laurels. His latest venture is bringing the concept of private sales to China. Glamour Sales initially launched in Japan where it built up 500,000 loyal members. It then launched in China in April 2010. This online platform provides a unique way for brands to clear their end of season stock, while maintaining a sense of prestige and exclusivity among members.

With financial backing from a local partner and a private equity fund, Glamour Sales is ramping up its scale and building first-mover advantage. It already has more than 350,000 members in 500 cities across China, so it could prove to be many of these peoples' first encounter with prestigious brands. "This is a new distribution format, a private community," Mr. Villet explains. "It is not just about sales, it is also about promoting brands in a really positive way. We have a community of bloggers and trend advisors with strong links to the media who are helping us highlight these different brands. We also have our own creative team producing video content and high-quality photography to help us promote our new lines."

Mr. Villet's experience and connections in the industry have proved invaluable in this start-up process. "Since we launched last year we have worked directly with 350 brands, ranging from upscale fashion to high-end luxury," he explains. "We act as the authorised distributor for each product for a very short and defined period. A lot of the sales are apparel, accessories and cosmetics, but we have also sold watches, jewellery and shoes. Through our networks we are able to secure deep inventories, but it is also important to have exactly the right concept, positioning and delivery. To succeed it is important that luxury is in our DNA. Our art director joined us from *Marie Claire* magazine and all our merchandisers have backgrounds in the luxury business. This understanding of the products, their differentiators and the need for utmost quality of service is absolutely critical."

Mr. Villet believes consumers are showing a growing propensity to buy online and with luxury products in particular, consumers are using the internet to make their decisions. At the same time, China is quickly becoming accustomed to making orders or payments online, to an extent that was unthinkable just a few years ago. "We receive 55 percent of our revenues as online payment through the website, with the remaining 45 percent based on cash on delivery," he explains. "We are still at the early stage of eCommerce in China but things are changing fast. Our average transaction size is RMB 700, which is probably higher than any other online retailer you could find in China."

While attitudes to technology and payments are changing, Mr. Villet believes Glamour Sales only got to its current position through word-of-mouth and he therefore returns to the importance of the positive customer experience. "Building loyalty is still the big challenge," he says. "I am focusing on building our customer service skills on a daily basis."

In KPMG's previous luxury report, we explored the potential for outlet malls to take off in China in the same way as they had done in the West. One year on, Mr. Villet sees a few outlets doing well, however he sees online private sales providing a strong differentiator. "Our model has greater reach and offers a very different kind of service and personal experience," he says. "In some ways what we do will be complementary to outlet malls, but we can do so much more because we can capture information and harness the technology of our platforms. Having great locations is not enough anymore."

Managing a robust tax environment

Luxury goods companies are showing an increasing interest in tapping into the China market, a fact which has not escaped the attention of China's tax authorities. The authorities are increasingly focused on ensuring that China secures its share of the global value chain, most notably by scrutinising transfer pricing practices. As such, effectively managing cross-border, related-party prices to mitigate any potential transfer pricing risks is key for luxury goods companies looking to unlock the revenue potential of the China market.

Given the importance of brands in commanding a premium price, extensive advertising, marketing and promotional activities are common. These promotional expenses are often associated with the creation of marketing intangibles. The definition of marketing intangibles is not always clear; however the term can include

brands, trademarks, local market position of a company or its products, distribution channels and customer relationships. Since many luxury brands operating in China are on the cusp of generating profits, the value attributed to these intangibles is also cloudy.

The China market is characterised by another unique factor, namely that identical goods may attract a higher price in China than in the global market. This 'local market premium' can be a something that local tax authorities will raise, commonly contending that this premium should be allocated to the China entities within the group's value chain. Developing supporting counter-arguments requires an upfront assessment of the drivers of this premium, as well as recognition that the lifespan of the premium is often limited.

To deal with these strengthening challenges in transfer pricing, luxury brands need to establish a clear and proactive strategy which preempts and addresses the most commonly-encountered transfer pricing issues in China.

Royalty payments in China's luxury sector

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

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

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

The development of local marketing intangibles is also shaped by brand recognition. Many brands have high potential, but initially a low level of recognition in China. The China distribution entity may invest significantly in developing the profile of the brand in the China market. The most obvious example of this is the substantial resources committed by many luxury brands to establish flagship stores as a visible marketing channel.

Tax authorities are beginning to claim that if the contributions of the China entity go beyond those a more routine distributor would make, the China entity has at least partial economic ownership of the brand name in China. Accordingly, the tax authorities assert that the China entity is therefore entitled to retain a share of the residual profits generated by the brand name in China, and that these profits should not be directed, in full, offshore via a royalty payment. This again places the focus on royalties and raises the potential argument that Chinese affiliates may be overpaying for brand licensing.

As a result, in recent years, China's tax authorities have intensified transfer pricing audits for these types of transactions.

Management or service charges

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

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

Transfer pricing documentation

Chinese transfer pricing requirements, applicable from 1 January 2009, mandate that short-term analyses be updated contemporaneously. Chinese taxpayers who fall within the documentation requirements often respond by putting in place transfer pricing documentation reports for the applicable years.

This documentation is now beginning to come under scrutiny from Chinese tax officials. A circular released in July 2010 sets out the procedures for local tax authorities to request and examine 2008 and 2009 transfer pricing documentation reports and provide feedback to the SAT on the completeness and quality of the documentation.

As luxury goods companies plan, they should ensure that their transfer pricing documentation justifies their transfer pricing method, particularly if the taxpayer applies the Transactional Net Margin Method, which tax authorities have indicated is over-applied in their opinion. Companies may also want to provide some opinion as to why other transfer pricing methods would be less reliable.

Mitigating luxury sector taxpayers' risk

Due to the complexity of transactions in the luxury goods industry, luxury companies may also consider two long-term alternatives offered by the Chinese tax authorities: Cost Sharing Agreements (CSAs), and Advance Pricing Arrangements (APAs).

Article 41 of the new Corporate Income Tax (CIT) law introduces CSAs as an option for Chinese taxpayers. Under Article 112 of the CIT Implementation Rules, an enterprise may share common costs if the costs and expected benefits match. As Chinese tax authorities become increasingly insistent that local marketing activities create value for brands, companies with local marketing expenditures which create value for a brand may benefit from sharing these costs with overseas related parties. A company is more likely to benefit from a CSA because the royalty payment for using luxury brands or allocated service costs is deductible, and theoretically no additional business tax and withholding tax should be levied. However, companies need to balance the risk that a portion of commercial ownership of valuable marketing intangibles would reside in China.

Another long-term planning option companies in the consumer market arena may benefit from is an APA. China has concluded several APAs within the past five years, and with more underway, the SAT is becoming increasing sophisticated in proactively resolving transfer pricing issues. APAs provide luxury companies with a practical approach to reducing uncertainty about their related-party transactions.

Another benefit of APAs, especially for luxury goods companies in turbulent economic conditions, is that they encourage stability by agreeing on the structure for calculating revenues in advance.

Conclusion

The key transfer pricing risk management strategy for luxury goods companies operating in China is determining which approach to use and how to successfully justify this to the Chinese tax authorities. Furthermore, although luxury goods companies in China may encounter challenges from tax officials in relation to royalties, local marketing intangibles and local market premiums, there are both short- and long-term planning tools at their disposal to help them mitigate any transfer pricing risks.

Stepping ahead in China

Dinesh Tandon, CEO, Asia Pacific North, Bally

Bally is a Swiss luxury leather goods and clothing label, also credited for its involvement in the production of shoes worn on the first trip to the moon. Founded as a family business in Switzerland in 1851 and now part of the Labelux luxury group, the 160-year old brand established a presence in China in 1986. Bally now directly operates a network of more than 55 boutiques in China.

The company now plans to take its footprint in China a step further. It has just teamed up with Yoox, an Italian internet mail order retailer, to launch an e-commerce platform in China. The newly launched Chinese language website showcases some of the brand's most popular collections.

Dinesh Tandon, who heads up Bally's North Asia operations, explains: "Despite not having a dedicated Chinese language website, we are already getting many hits from China on the Bally worldwide site. Furthermore, at least 20 percent of our customers in China come from third- and fourth-tier cities and beyond, so this gives us an indication of future untapped potential. This was our motivation to launch a Chinese language e-commerce site."

The Greater China region currently contributes around 35 percent of Bally's worldwide sales, with two-thirds of these coming from China and the remainder mostly from Hong Kong. This is in terms of direct sales from retail outlets. The brand has 55 outlets scattered across 40 Chinese cities and Mr. Tandon expects at least six more to be added by the end of 2011.

He notes that luxury brands scaled up their operations in China in the build-up to the Olympics. Brands that historically would have established a 4,000-5,000 square foot boutique in a top-tier Chinese city were instead opening stores on a far larger scale, based on rising turnovers in the smaller stores. This has helped, he says, to change the consumer perception that Hong Kong has a larger collection of brand items than mainland China.

"The China market has significantly expanded for us since we launched direct retail outlets in 2008. The turnover levels are rising, and with WTO rules coming into effect, duties are declining. Differences in prices between Hong Kong and mainland China are also narrowing," he adds.

The company has developed a number of limited edition items for the Chinese market, however the aim is try to keep the collection 'global'.

"Mainland Chinese consumers are maturing at a much quicker pace than markets like Japan in the past. Japan experienced roughly a 20-year cycle for luxury brands whereas China will probably achieve this level of growth much faster, say in eight or nine years. Therefore, it makes sense to stay with designs that form an essential component of the brand DNA," Mr. Tandon adds.

Some of their shoe designs can be customised to local needs. Their made to measure programme allows customers to choose different materials and colours for selected styles of shoes.

It remains important to stay ahead of the curve as competition amongst luxury brands in China is on the rise, Mr. Tandon explains. "Many brands are competing for the same space in all shopping malls across China. The bigger brands are expanding and newer brands are coming in, so relationships play a very important role. You cannot take existing space for granted and one needs to be thinking ahead for business development opportunities, to open in new cities where the market has not been tested but the potential exists."

Supply chain issues also need to be considered across such a vast space as retailers need to balance stock levels; e-commerce is set to play an important role in this respect.

Mr. Tandon concludes: "Our Swiss heritage plays an important role from a branding perspective, as it creates a unique space for us in China. We are constantly on the lookout for new expansion opportunities to maximise the potential of the brand."

Understated prestige

Dirk Paulsen, Board Member, Patek Philippe

Patek Philippe's relatively conservative and traditional approach to the China market mirrors the traditional values embodied in its hand-finished products. The 172-year-old watch company may have moved slowly into China but it has built a loyal following of connoisseurs. Dirk Paulsen, a board member who heads up operations in Asia, believes China now constitutes the company's most important market.

This conservatism should not be confused with inflexibility. As a family-owned company, Patek Philippe has an unusual degree of freedom in the way it pursues its strategy, plans its investments and resists pressure for sudden growth. The company has only had a retail presence in China for the past six years and continues to set carefully controlled growth targets.

"Until six years ago, we didn't believe we had enough watches to satisfy this enormous market," Mr. Paulsen explains. "Now we have two boutiques in China, one on the Bund in Shanghai and another in the former US Embassy in Beijing. These are unique, historic locations, which are perfect for our brand positioning, and considering these factors, we have little need to open in malls elsewhere. We produce 40,000 timepieces a year so it is very important for us to manage our supply and be fair to all our customers."

Mr. Paulsen has been working for Patek Philippe since the 1970s and feels a great affection for a business in which he feels like a family member himself. "We have grown up together, and our success rests on close relationships: amongst the management, with distributors and with our customers," he explains.

In Europe, he explains that the company has worked with many of the same retailers for over a century while in Asia, Melchers has carried the brand throughout its history. Melchers is headquartered in Singapore but operates the two stores in Beijing and Shanghai. It has deep experience managing the logistics and the sales and service aspects of the Patek Philippe customer experience.

The latest step in this process is expanding the after-sales support, and the company is currently considering relocating to another boutique location on the Bund where it can build a larger after-sales facility on-site. "We are planning to employ and train more watch makers to support our after-sales here in China. This training process can take many years," Mr. Paulsen emphasises.

Mr. Paulsen feels Patek Philippe's customers in China are no different to those in other countries. "Our customers are typically business people. They are very knowledgeable; they appreciate the technical and mechanical detail of our timepieces," he explains. "Even where people are buying our watches as gifts, we learn that the recipients are themselves usually very knowledgeable."

The personal connection to customers is also important given the demand that exists for Patek Philippe watches. The company produces some limited edition models which it sells exclusively to its most loyal customers. Given the potential for these sought-after models, it continues to track the secondary market closely.

Patek Philippe has built brand awareness in China through selective events, traditional advertising and photography in high-quality magazines. "Advertising and education go hand in hand. Once we are engaged with the customer, we seek to build loyalty and respect through personal channels," Mr. Paulsen adds. "Our customers don't really buy a Patek Philippe watch to show off. Our timepieces are understated, but our customers are loyal and passionate collectors. Our customers are true connoisseurs amongst luxury consumers in China today."

Customs approaches for luxury companies

Although tariffs and duties are falling in many parts of the world, most luxury goods remain subject to customs duty within China, in addition to consumption taxes which generally range from of 5 percent to as much as 40 percent. The potential scale of these costs illustrate why it is so important for luxury companies to effectively and efficiently managing customs risks and opportunities.

"Customs expenses are often mistakenly treated as unavoidable costs of doing business, when in fact customs offers many avenues for direct cost savings," explains Alex Capri, KPMG's Asia Pacific leader for Trade & Customs. "A better understanding of the key customs issues can help companies in the luxury sector identify customs risks and opportunities."

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

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

Identifying non-dutiable costs

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

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

Royalties

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

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

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

Free Trade Agreements

There are more than 100 regional and bilateral FTAs offering preferential duty rates for trade between Asian states as well as global trade. The question is whether the benefits of these preferential duty rates outweigh the internal administrative costs of complying with the country-of-origin and documentation requirements.

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

Tariff classification

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

Transfer pricing interplay

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

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

Foreign exchange controls

China's foreign exchange controls have been progressively relaxed to accommodate the rapid expansion of its trade with the rest of the world and the rising economic significance of the renminbi (RMB). Gradually, more transactions are being allowed to be settled in RMB. An RMB Trade Settlement simplifies tax and customs documentation in that (i) foreign exchange verification documents can be waived for customs declaration and export VAT refund (exemption) purposes, and (ii) the export tax refund (exemption) policy shall apply to export trades settled in RMB. Companies are encouraged to review their current documentation with a view to strengthening their compliance from a customs and tax viewpoint to ensure that these aspects are considered as part of the project implementation.

Logistics providers

Many companies rely heavily upon third parties such as customs brokers and freight forwarders, particularly in the early stages of their market entry. As such, much has been entrusted to these third parties, particularly involving functions that could have administrative, risk management or strategic ramifications. It may be more cost effective to turn these responsibilities over to in-house resources, or at the very least, to assess the cost-benefit ratio of paying a third party to perform all these services.

If a company uses multiple customs brok
wise to reduce these ser
number and leverage bet
administrative charges. It is also benefi
to manage customs, as the
of the company's business processes.
strategic planning and proactiv

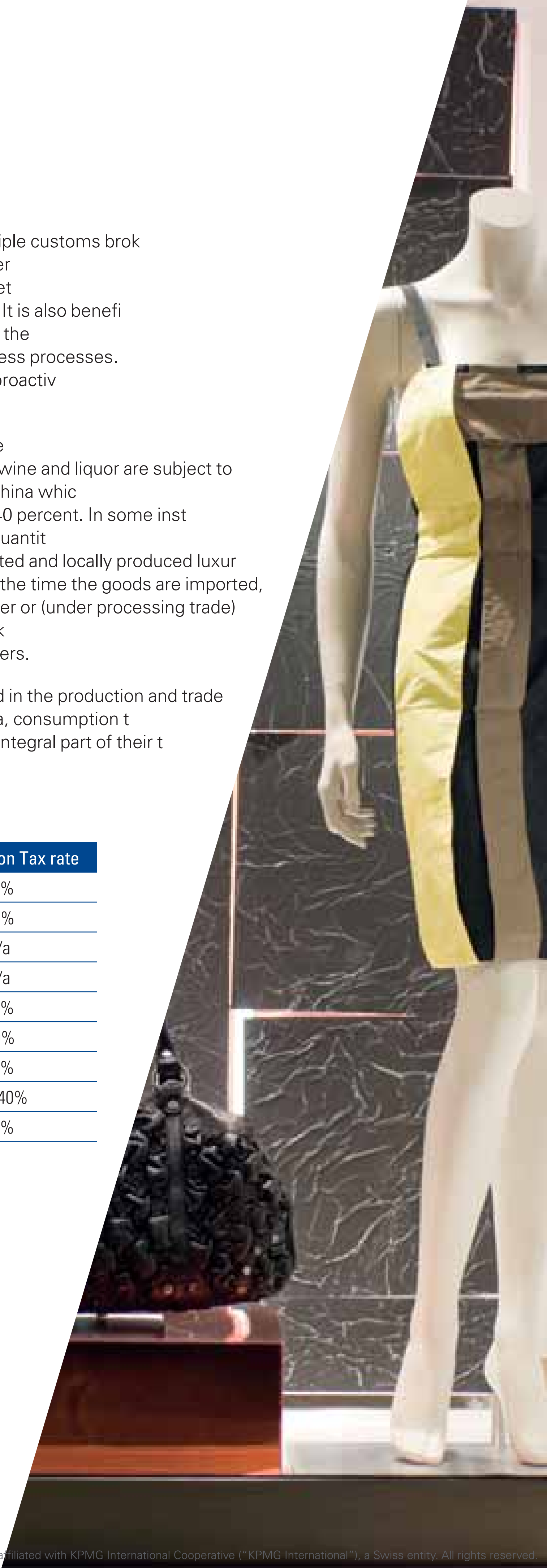
Consumption Taxes

Luxury goods such as je
equipment, cigarettes, wine and liquor are subject to
consumption taxes in China whic
percent to as much as 40 percent. In some inst
are assessed on a per quantit
imposed on both imported and locally produced luxur
goods and are levied at the time the goods are imported,
sold by the local producer or (under processing trade)
when the principal retak
outsourced manufacturers.

For companies engaged in the production and trade
of luxury goods in China, consumption t
to be considered as an integral part of their t
customs planning.

Fig. 15 Customs and tax rates on luxury goods

Product	Customs duty rate	Consumption Tax rate
Jewellery	3%-35%	10%
Watches	11%-23%	20%
Clothing	14%-25%	n/a
Bags	10%-20%	n/a
Wine	14%-20%	10%
Cosmetics	6.5%-15%	30%
Golf equipment	12%-14%	10%
Automobiles	25%	1%-40%
Yachts	10%	10%



Under the hammer: Wines and watches in China

Vanessa Herrera, Head of Watches, Sotheby's China and Southeast Asia, and Jamie Ritchie, CEO and President, Americas & Asia, Sotheby's Wine

China's insatiable demand for all things bespoke and luxurious extends to timepieces and fine wine, two areas where auction sales to Chinese consumers have risen strongly in recent years. Chinese buyers accounted for 40 percent of Sotheby's Hong Kong watch sales in 2010, up from 8 percent in 2008, while more than 60 percent of Sotheby's entire wine sales in 2010 were notched up in Hong Kong, much of that going to buyers on the mainland.

Vanessa Herrera, Head of Watches, Sotheby's China and Southeast Asia, believes Chinese buyers have well-defined preferences but are also starting to diversify into categories such as pocket watches. "Chinese buyers tend to prefer modern pieces, mainly those made after 1970, and complicated limited-edition watches by brands such as Patek Philippe, Cartier and Richard Mille," she says. "But some are now looking for decorative enamelled pieces that were initially made in the 1850s and sold to Chinese dignitaries. These have become highly collectible and tend to fly at auction."

She notes this market is also ripe for independent luxury watchmakers that can provide bespoke services for clients, including opportunities to meet the maker of their watch.

Geneva-based Patek Philippe continues to notch the highest sales at the Sotheby's auctions in Hong Kong. "A lot of it comes down to brand presence, but also their marketing efforts in China," she says. "They also have a holistic view of their brand, in terms of linking the modern collection with the vintage watches which they sell in Geneva, even back to their pocket watches. Patek Philippe presents a complete brand image to a new collector."

Ms Herrera points out Chinese buyers appreciate a comprehensive archive system. A museum presence is also important to collectors. "The educational value that brands can give to our new collectors will play a major role," she explains. "A watch brand relies on a sense of archived history and craftsmanship, but some more avant-garde brands such as Richard Mille are focusing on adding technological innovations to their timepieces, something that older brands don't always prioritise."

The rising sense of connoisseurship has also been a boon for the wine trade, at a time when Hong Kong's zero tax rates for imported wines and good storage facilities has made it an important hub for wine collectors in Asia. The auction house sold USD 14 million worth of high-end wines in the territory in 2009; that number rose to USD 53 million in 2010.

Jamie Ritchie, CEO and President, Americas & Asia, Sotheby's Wine, says: "We see that 99 percent of what we sell in Hong Kong is purchased by Asian buyers, again led by the mainland Chinese. In the next three to five years, we expect the US and UK to be net exporters of wine to Hong Kong."

Mr. Ritchie notes that Chinese buyers prefer to buy from the large auction houses, as a safeguard to ensure the wines are genuine and in good condition. If they are looking to build up a collection, the auction house model makes sense, as they can buy large scale from a trusted source. The most iconic wine brand in China is Bordeaux's Château Lafite-Rothschild, which has benefitted from being an early mover into this market. At a Sotheby's wine sale in October 2010, mainland Chinese buyers bought three bottles of the 1869 vintage for HKD 1.8 million (USD 0.2 million) each, a new world record for wine sold at auction.

Mr. Ritchie also sees Chinese investors looking to acquire chateaux in France. "They are travelling more regularly to meet the winemakers and to see how their favourite wines are grown and produced. Chinese buyers are also now shifting their interest from top-end Bordeaux to Burgundy wines. These wineries tend to produce smaller quantities and are seen to be more exclusive and niche. This reflects the growing wine sophistication of the mainland Chinese buyers. They are buying to collect, invest, drink and enjoy."

Wines also go well with Chinese cuisine. "There are good pairings, although you need to be aware of spices and strong flavours. A thousand-year-old egg with Krug Vintage 1990 was a pretty good combination," Mr. Ritchie concludes.

B&W fine-tunes its China strategy

Lars Hundborg, CEO, Bowers & Wilkins (B&W) Asia

"One needs to have a long-term strategy in China and stick to it, because its economy is rapidly changing. If you don't focus on your strategy and your heritage, you risk losing your identity and your unique DNA" – that's the mantra adopted by Lars Hundborg, who runs the Asia business for Bowers & Wilkins (B&W), a British manufacturer of high-end audio equipment.

B&W Asia established a foothold in China in 1993 to sell its entry and mid-level products to Chinese consumers. From 2006 onwards, they started to market their high-end audio products, including speakers that retail from RMB 50,000 (USD 7,600) to RMB 120,000 (USD 18,250) a pair. B&W's iconic Nautilus loudspeakers retail at RMB 600,000 (USD 90,000) a pair.

China is a fast growing market for the company, currently its fourth-largest in absolute terms, after the US, UK and Germany. Mr. Hundborg anticipates it will climb to the number three spot in 2011. B&W expects to sell more than 30,000 high-end speakers this year, compared to less than 20,000 in 2007.

With Hong Kong as its Asia Pacific headquarters, the company recently established a Wholly Foreign Owned Enterprise (WFOE) in Shenzhen, in southern China.

Mr. Hundborg, the CEO for B&W Asia explains: "We initially used dealers across China which were engaged through a single importer, but a WFOE is a better option if you want to have control over your brand, overheads and overall strategy. We can get products into China at the speed we want or that the market requires. We don't need to rely on a dealer to make or implement these decisions for us. It means we can take a more strategic approach to the China market."

The company has since divided its business into various segments, including B2B and new media, allocating resources to each category on a need-to basis.

Mr. Hundborg outlines ambitious expansion plans in China, targeting tier-two cities and exploring possibilities of real estate acquisitions. This would enable them to establish their own showrooms across China. "We currently use a special form of franchise whereby the dealers own the real estate and establish the retail outlets with our input and guidance," he explains.

Mr. Hundborg also notes they currently don't face competition from foreign or domestic audio brands. "It's not the usual suspects. Our competitors could be a Rolex watch, Italian designer furniture, a luxury holiday, a down payment on an apartment or a car, in other words anything that is expensive."

While entry and mid-range products are manufactured in China, high-end versions are assembled in the UK. Mr. Hundborg does not foresee this changing anytime soon: "Chinese consumers place a lot of importance on the heritage aspect of a luxury brand. We are perceived to be a UK company with a long history. Chinese factories also cannot make the curved cabinets which we specialise in to the quality we are looking for."

Meanwhile new media opportunities are on the rise in China, as their global partnership with Apple demonstrates. The success of Apple's iPhone 4 in China has also driven simultaneous sales of B&W's audio range. "Headphones and anything you can plug into an Apple device are also doing well. In fact, we are expanding our entire headphone category," he adds.

It's an exciting time for the brand. B&W is now creating designs for a more discerning Chinese consumer, with plans to launch a dedicated product range for China in 2012. "When consumers pay large amounts of money for a pair of loudspeakers, it shows they are identifying with the company philosophy and history. They also prize the complexity and craftsmanship of our audio cabinets. It would have to be an iconic product, not a square box, that won't work," Mr. Hundborg concludes.

Working with partners and vendors to protect brand value

The growth in sales of luxury products in China has led to an associated increase in luxury brands' engagement with local vendors as well as subsidiary offices of global vendors, such as media agencies and logistics providers. Ensuring appropriate contracts are in place with these vendors, and that they are complying with the contract terms, has both cost and reputation impacts for luxury brands.

Trust and relationship-building with partners is extremely important for anyone doing business in China. For luxury brands, the need for robust controls and monitoring to protect brand value is critical. "Whilst contracts may be in place with media agencies, there is not always effective monitoring by luxury brands to ensure the agency is complying with all contract terms," explains Patty Wu, KPMG China's Head of Contract Compliance Services. "In media reviews performed in China we have found instances of media agencies inadvertently overbilling clients, or billing for advertisements that either were not placed, or did not air. While our findings are not isolated, these agencies may not be doing it intentionally. In some cases their focus is more on delivering an effective media campaign than billing and back-end processes. Nevertheless, the financial impacts can be substantial given luxury brands' significant spend on advertising and events in China."

A number of brands are developing their business away from reliance on local distributors and franchises to wholly owned operations. However, in a country with such diverse and dispersed markets, many are still reliant on local partners, or a combination of approaches to accommodate different local conditions.

Luxury brands may need to periodically revisit their franchised contract terms and franchise partner performance as part of their China development strategy. A number of our case studies highlight the importance of working with partners to uphold brand value, including through contractual arrangements which need ongoing monitoring.

These quite wide-ranging issues highlight a common message - that succeeding in China often rests on successful partnerships and that contractual arrangements with partners deserve ongoing scrutiny. Many companies in Asia are tolerant of certain risks and accept that there may be a certain trade-off between maintaining relationships and maintaining the brand. Yet for luxury brands, such trade-offs are rarely acceptable.

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In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China, and its Hong Kong operations have been established for over 60 years. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the firm's appointment by some of China's most prestigious companies. Today, KPMG China has more than 9,000 professionals working in 13 offices.

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Our Consumer Industry sectors — Retail, Food and Drink, and Consumer Goods — have a global network comprising the major practices around the world, with particular strength across the Asia-Pacific region. Our network gives us the ability to provide consistent services and thought leadership to our clients, while always maintaining a strong knowledge of local issues and markets.

Our Global Luxury team has centres of knowledge based across key markets and capabilities extending across audit, tax, transactions and performance issues.

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