

2017 China Luxury Report

Chinese luxury consumers: The 1 trillion renminbi opportunity

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Foreword

With luxury consumption dropping in 2016 to its lowest level since 2009, much attention has been focused on one of the biggest forces in global luxury spending: Chinese consumers. As the Chinese economy slows, and growth in luxury consumption cools in China and abroad, there's a growing concern among industry observers that Chinese consumers are losing their passion for luxury goods.

Is luxury losing its appeal for Chinese consumers? And, how will this weigh on the outlook of the global luxury market? These are some of the questions we address in our latest analysis of Chinese demand for luxury goods. For more than eight years, McKinsey has been monitoring the evolution of Chinese luxury consumers and their increasing influence on the global luxury goods market. Our latest research focused on understanding the fundamental attitudes and behaviors of Chinese luxury consumers. Through our research, we have discovered a more sophisticated and discerning set of luxury shoppers in China. And while warning signals about the slowing growth of the market should not go unheeded, we believe Chinese consumers will remain one of the biggest drivers of growth in the global luxury market for the foreseeable future. Much of this growth, moreover, will be driven by the wealthiest Chinese, which we define as those with annual household income of more than 300,000 RMB.

To capture this growth, however, luxury goods players will need to rethink their approach to winning the hearts of China's luxury spenders. And since two-thirds of Chinese luxury spending happens overseas, luxury brands will need to identify ways to become an integral part of the Chinese traveler's itinerary.

The central role of wealthy Chinese in the global luxury market

Massive role in luxury spending

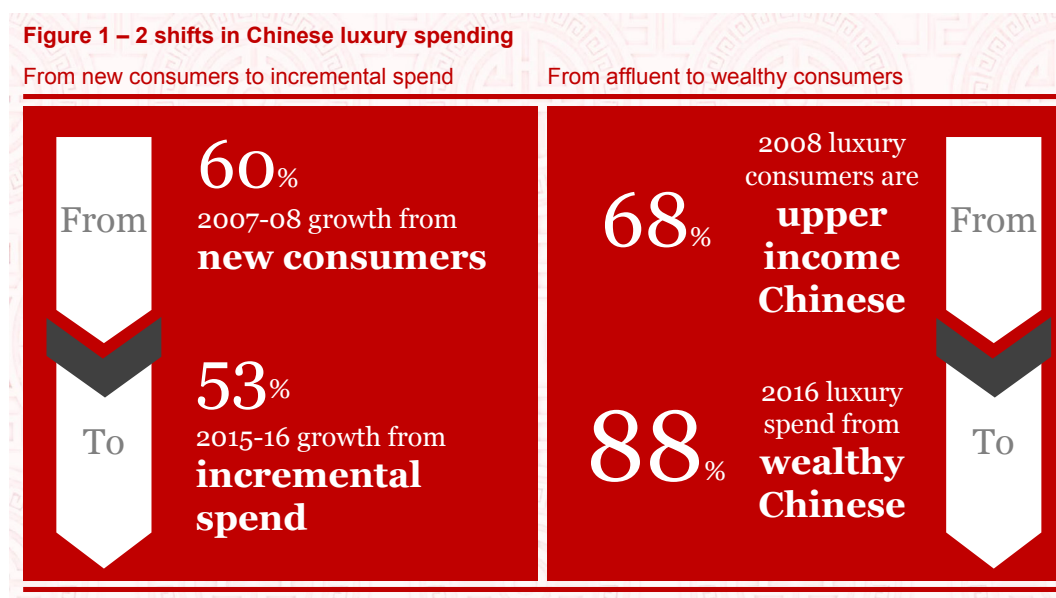
The importance of China for the luxury goods market is best shown through some statistics. The number of Chinese millionaires is expected to surpass that of any other nation by 2018, and by 2021 China is expected to have the most affluent households in the world. In 2016, we estimate that 7.6 million Chinese households purchased luxury goods—a number larger than the total number of households in Malaysia or in the Netherlands. Each of these 7.6 million households spends on average 71,000 RMB in luxury goods per year—which is twice what French or Italian households are spending. Chinese luxury consumers thus account for over 500 billion RMB in annual spending, representing almost a third of the global luxury market.

In 2008, when China hosted the Olympics in Beijing, Chinese consumers accounted for only 12% of global luxury spending. In the eight years that followed, we estimate that over 75% of the total growth in global luxury spending, over \$65 billion, could be attributed to purchases made by Chinese consumers, either at home or abroad.

Two recent shifts in Chinese luxury

From 2008-2014, the number of Chinese households purchasing luxury products doubled, fueled by growing incomes and greater access to luxury goods. Since 2015, the primary driver of increases in luxury spending has shifted from consumers making their first purchases of luxury goods, to the incremental spending from existing luxury consumers. This transition means that luxury goods players need to invest more in building loyalty among existing customers than recruiting new ones.

Along with the shift from customer recruitment to customer retention, the profile of Chinese luxury consumers has also been evolving. In the past, luxury consumers in China were mainly comprised of those belonging to upper income households, which we define as households earning 100,000-300,000 RMB. Through our research, we've observed the increased importance of wealthy Chinese, or those with household income in excess of 300,000 RMB. In 2008, wealthy Chinese represented only a third of Chinese luxury consumers; today they represent half of the shoppers in this category and account for 88% of Chinese luxury spend. [Figure 1]

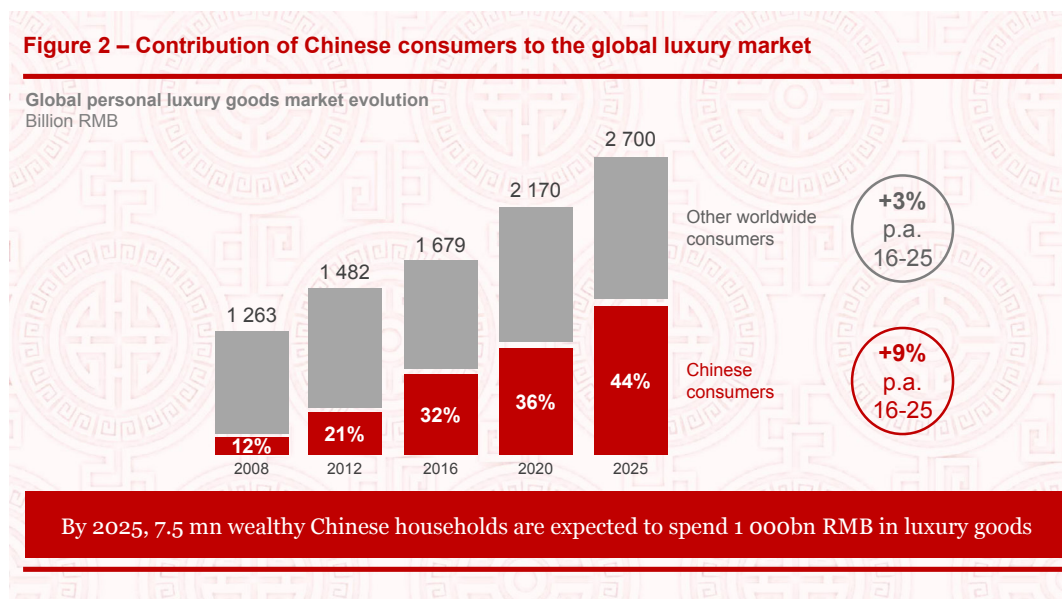


Looking forward: the trillion-RMB opportunity

Compared to average Chinese consumers, wealthy consumers report a much more positive outlook about their future spending: one out of two wealthy consumers expects to spend more in 2017, while only one in four average Chinese consumers plan to spend more. Bolstered by their confident outlook, we expect wealthy consumers will be looking to trade up, either to more expensive brands, or to more expensive products from their current brand. We expect incremental spending from existing wealthy consumers to account for over half of the anticipated growth in Chinese luxury spending from 2016 to 2025.

By 2025, we forecast the value of the global luxury goods market to climb to 2.7 trillion RMB, with 1 trillion RMB being added over the next nine years. As they have in the past, Chinese consumers will account for a majority of this growth, and by 2025 will account for 44% of the total global market.

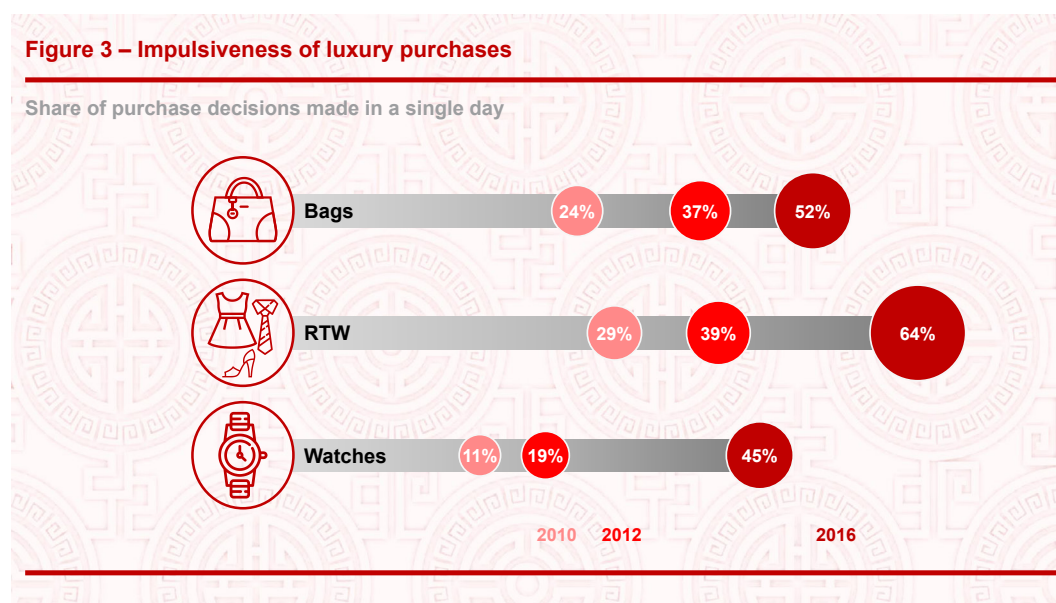
Wealthy Chinese will represent a major force behind this increase in luxury spending. By 2025, 7.6 million Chinese households will represent 1 trillion RMB in global luxury sales, an amount that is double that of 2016, and equivalent to the size in 2016 of the US, UK, French, Italian and Japanese markets combined. [Figure 2]



Increased sophistication of wealthy Chinese consumers

More impulsive consumers, relying on word of mouth

Wealthy Chinese consumers are heavy spenders, spending on average 71,000 RMB annually on luxury goods; 38% of them spend more than 100,000 RMB annually. This number has been increasing by more than 5% per annum since 2010. In addition to increasing their spending, they have become much more impulsive in the way they shop for luxury goods: one in two of their purchases are decided within a single day. This represents a major shift in behavior: back in 2010, only one luxury bag in four was purchased with only a day's deliberation. This trend is consistent across categories of luxury goods we studied. [Figure 3]

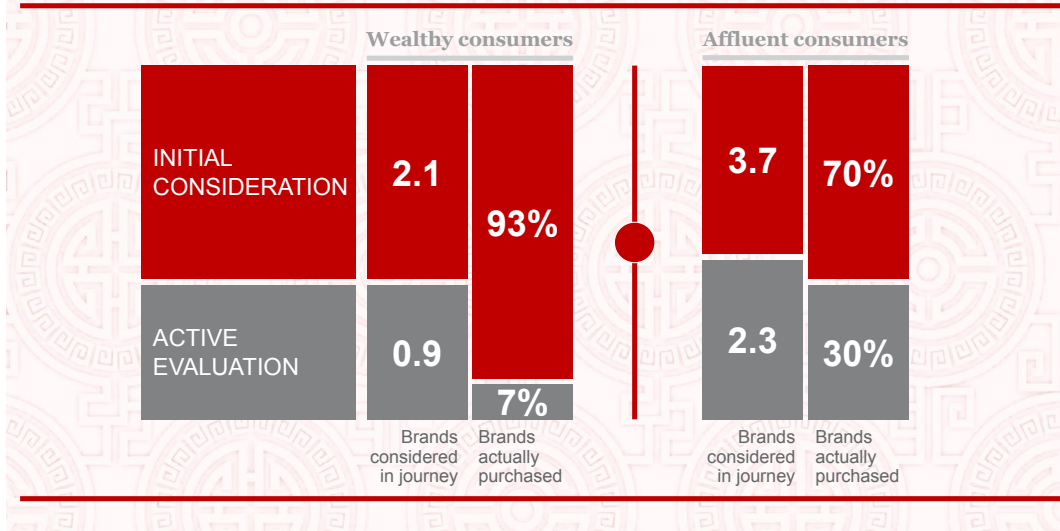


As wealthy Chinese luxury consumers have become more impulsive, the role of word of mouth has gained in importance. We found that 30% of luxury purchases are directly influenced by word of mouth, up from only 14% in 2010. Word of mouth from friends and family is now the number-one factor influencing purchase decisions, ranking above the in-store experience.

Initial consideration is becoming critical—as is the role of brands

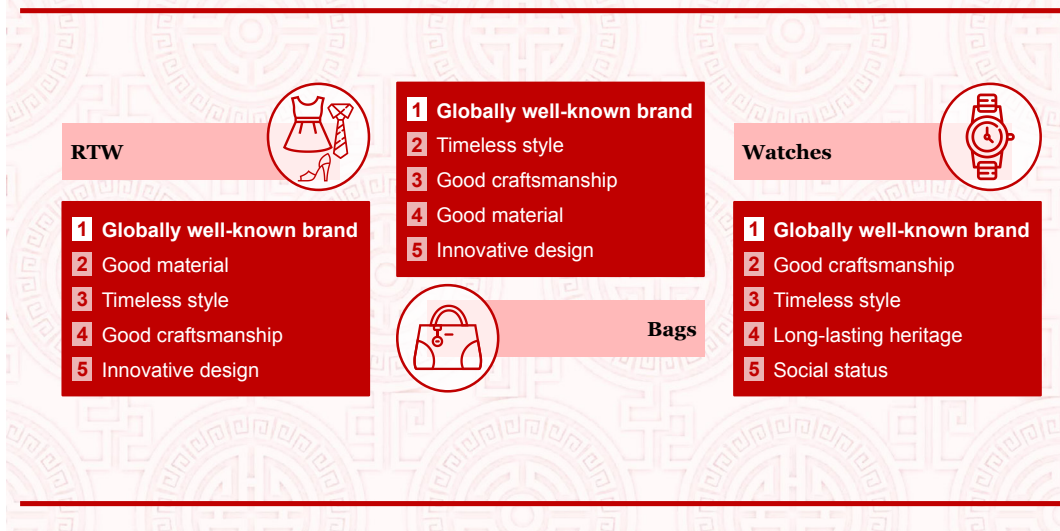
Related to growing impulsiveness is the importance of the initial consideration phase in consumers' decision journeys, specifically the brands that consumers consider top-of-mind before they actively gather information. Of the three brands considered for luxury purchase, 2 are considered top-of-mind, and are the ones that consumers actually buy on 93% of their purchasing occasions. While affluent Chinese consumers might purchase a brand they did not initially consider, wealthy Chinese are unlikely to purchase luxury goods that don't fall within the two brands they consider top of mind. [Figure 4]

Figure 4 – Role of initial consideration in the decision journey



Given the critical role of initial consideration, brand preeminence—that is, being a globally well-known brand—is now the top buying factor across all categories. This was not the case six or eight years ago, when wealthy Chinese luxury consumers were more concerned with quality of materials or craftsmanship than with brand recognition. “Timeless styles” has also emerged as a key driver of luxury purchase decisions, surpassing “innovative designs” in relative importance. [Figure 5]

Figure 5 – Top 5 buying factors



Online purchases of luxury have yet to take-off

China is home to some of the most innovative digital services and platforms like WeChat or TMall. Chinese consumers are avid users of social media, and 35% of them generate online content on a daily basis. Yet this has yet to translate into online purchases of luxury: only 7% of Chinese luxury sales occur in official online channels. We don't expect this situation to change much in the near future, as only 16% of wealthy Chinese luxury consumers expect to increase their online luxury spending in 2017. Nevertheless, as luxury brands further develop "O2O" initiatives that bridge the online and offline worlds into a seamless experience, it is likely that more luxury sales will be conducted online.

Need for reassurance and competitive prices

Although wealthy Chinese consumers have become more sophisticated, they remain cautious, needing reassurance about the quality and authenticity of their purchases. We found that these are the top two factors for selecting where they choose to make their purchase. The other value that has not changed over the years for wealthy Chinese luxury consumers is price sensitivity. This concern is best illustrated by their awareness of price gaps between Mainland China and overseas markets. This need for reassurance and competitive pricing means that wealthy Chinese luxury consumers tend to shop either at official channels, such as department stores or brand stores, or at duty free shops. *[Figure 6]*

Figure 6 – Where wealthy Chinese luxury consumers shop



Global and always on the move

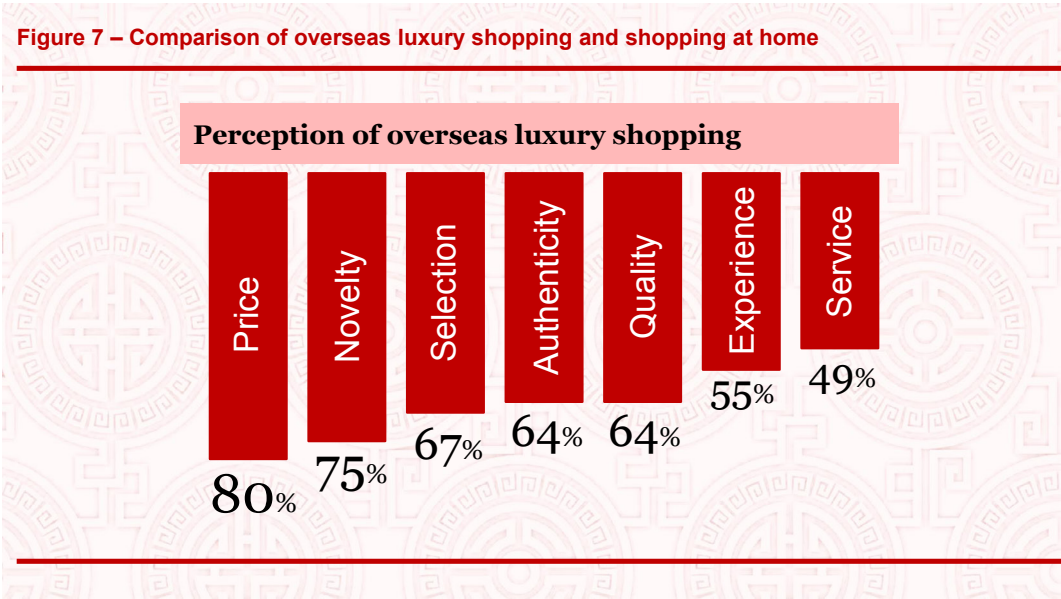
Global shopping behavior

With 5.9 international trips on average per year, wealthy Chinese accounted for a major share of China's outbound travel. Shopping is cited as the primary reason for these consumers' choice of travel destination, and when they shop overseas, Hong Kong remains their top destination, followed by South Korea and Japan.

Dissatisfaction at home

Price remains a key factor determining whether a wealthy consumer makes a luxury purchase at home or overseas, and they are becoming less tolerant of disparities in prices. In 2012, 60% of consumers were willing to accept a 20% price markup on luxury products sold in China. Today, only 20% of consumers tolerate such markups.

Surprisingly, only 70% of them would choose to purchase luxury goods in China if offered similar prices to overseas outlets. This phenomenon is a reflection of how dissatisfied wealthy Chinese consumers are when it comes to purchasing luxury goods at home. Compared with their luxury buying experiences overseas, wealthy consumers are less satisfied with product assortment, the in-store experience, and the quality of customer service they receive when purchasing luxury goods at home. [Figure 7]



The Mainland mismatch

Given how unsatisfied wealthy consumers are with their luxury experience at home, it's not surprising to see them shift their purchases overseas. Between 2008 and 2016, overseas luxury purchases increased from two-thirds to three-quarters in terms of spending value. Yet, over the same period, we've observed a growing mismatch between demand and supply of luxury in China. Despite the boom in overseas luxury spending and flagging demand at home, the number of luxury stores in Mainland China increased by 3.3 times from 2008-2016 while domestic sales increased by only 2.3 times.

In addition to the rise in the number of Mainland retail stores, we found that 80% of luxury stores are located in the top 15 Chinese cities as measured by GDP. Yet these cities are home to only 25% of wealthy Chinese consumers of luxury, revealing a clear mismatch between the presence of luxury brands and the demand for their products. *[Figure 8]*



Implications for luxury players

Becoming a part of the travel itinerary

Wealthy Chinese luxury consumers are constantly on the move, and shopping plays an important role in their global travel plans. And they expect a globally consistent brand experience. This means:

- Having access to the brand's core products across all geographies.
- Purchasing any product within a globally consistent price range.
- Being individually recognized by the store staff in every store of their favorite brands they walk in.
- Experiencing a similar level of familiarity with sales staff as if they were in their preferred stores, like color preferences, or fitting rooms.

But consistency is only one part of the equation. To become an integral part of the travel plans of wealthy Chinese, luxury brands will need to craft a much more appealing experience for these highly demanding consumers.

- One of the most powerful ways to achieve this is through store design. Luxury brands should invest in unique store designs, adapt store design guidelines to the designs taught in local architecture schools, and create distinctive store atmospheres.
- Another way to appeal to global customers might be to offer a handful of products that are only available at certain stores. They could also offer locally-tailored products that serve as luxury “souvenirs.” For example, a Shanghai store might offer a city edition t-shirt with the word “Shanghai” printed on it.
- Local events could be another way to attract travelling consumers. Inviting a local sports team into the store, or holding an event at an iconic venue in the city, are just a couple examples of such events.

Rethinking the Mainland model

Given the mismatch between luxury brands' store footprint and actual demand in Mainland China, these brands need to rethink their mainland business model. Their focus should be on fostering the loyalty of wealthy Chinese consumers and capturing their increasing spend. Here are a few initial ideas for changing luxury brands' Mainland models, starting with addressing the key reasons behind the current dissatisfaction of wealthy Chinese consumers:

Tailoring the assortment: As offering more perceived novelty is critical, brands could contemplate increasing seasonal SKU rotation or accelerating visual merchandising cycles. Providing a wider product selection even if the store's format does not allow it is also key. (This might require the adoption of digitally enabled product displays.)

Redesigning the stores' footprint and segmentation: Given current Mainland market dynamics, luxury brands should assume that not all their Chinese stores should focus on selling. They could think about assigning clear roles to the different stores—from image-building flagship stores to stores focused on generating sales, or stores that serve primarily as relationship touchpoints. Such a revised segmentation might require revisiting—and redesigning—the formats of existing stores.

Connecting with customers outside the stores: With 75% of potential consumers living outside of the top 15 cities in China, it seems difficult to conceive of a world where luxury brands could establish stores to reach them all. As a result, connecting beyond the store, like organizing brand events in cities without any store presence, matters. Another idea would be to establish new brand touchpoints in Tier 2 and 3 cities that have little potential for new store openings. For example, they might open “brand apartments” that combine the elements of a luxury showroom with the experience of a café or bar. Another idea that might resonate with core customers might be developing a VIP social network to stay in touch with these customers virtually.



Chinese consumers are not losing their passion for luxury goods. They will continue to expand their spending in luxury goods and maintain their leading role in the growth of the global luxury goods market. And the most wealthy of them will play a central role in this.

Yet, with the rising sophistication and growing complexity in the shopping behavior of wealthy Chinese consumers, luxury brands won't capture these highly valuable and discerning customers by doing more of the same. They'll need to undertake a complete rethink of how they address Chinese luxury consumers at home. This will require moving from a “sales push” model to building long-lasting relationships at home, while crafting strategies that will make them an integrated part of wealthy travelers' itineraries abroad.

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