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**Master of Science in
Management, Economics and Industrial Engineering**

Analysis of Business Opportunities for Luxury Brands in Second-tier Cities in China

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Abstract

China now has become the second biggest luxury consumption market and will soon become the number one market in the world. It is not surprising that most lucrative sector of China's luxury market is the 2nd-tier cities, as the purchasing power rising in this area and the market in 1st-tier are reaching a peak. The Chinese 2nd-tier cities have become the main battle field for the expansion of the biggest luxury brands. However, choosing a right place to extend can be difficult for luxury brands. Moreover, applying the same marketing techniques to each area can be a mistake.

This project applies PEST analysis to show how the external environment works for luxury industry, as well as exploring the patterns of luxury consumption in Chinese 2nd-tier cities. The theme of the project is to find out how different luxury brands expand its operation in the chosen 2nd-tier cities, and how do they work out the positioning of products and segmentation of customers. Moreover different communication and distribution channels, and through which how luxury brands manage their customer relationship will be discussed. Finally this project tries to figure out the opportunities and risk of the expansion,

Key words: luxury, marketing, China, 2nd-tier, expansion.

1. Introduction of luxury and overview about China's luxury market

China's role in the global luxury market is becoming more significant year by year. Though the worldwide luxury market is suffering a shrink in the global economic downturn, China's consumption of luxury goods is still on the rise by 25% in 2011. Many international brands are starting to see a recovery in their global sales after 3 very tough years.

It has been over 10 years after the first wave of retailers - with Louis Vuitton, Bally, Gucci and Ferragamo - to open outlets in China. Today, most of the world's leading luxury brands are rapidly developing in China. They are going to or already started the plans to expand with boutiques in 2nd-tier cities. Increase in consumer spending power in these areas is creating a rapid growth in demand for luxury. Nevertheless, the research of TNS shows that brand awareness and willingness to spend in many 2nd-tier cities is already close to the level seen in the 4 1st-tier cities.

However, despite the sheer market size, China is actually a collection of individual sub-markets defined by vastly differing demographic, economic and cultural characteristics. Expanding to 2nd-tier markets can be huge opportunities but hiding risk at the same time. It is the key to success for luxury marketers that understanding where these opportunities lie and how to access them, which can be extremely challenging.

1.1 The definition of "luxury"

What is luxury? As a common cognitive concept, "luxury" refers to products or service of superior quality, whose value is usually beyond its core function, incorporating culture and philosophy, and difficult to obtain. The principal nature of luxury is *"a unique set of characteristics including premium quality, craftsmanship, recognizability, exclusivity and reputation"*¹. Researchers agree that luxury goods are conducive to pleasure and comfort, are difficult to obtain and bring esteem to the owner. Therefore, luxury goods satisfy socio-psychological needs in greater form.

¹ *"The mass marketing of luxury"*, Business Horizons, Vol 41 (6), 1998

Luxury has played a great role in the historical economic, social and political development of humanity. We have observed too much that revealed the fact that, today's luxury is tomorrow's standard. The technologies of luxury, which are firstly introduced at the high end of the market, become more affordable and more widely used over time. Nowadays the quality, taste and style of luxury products are downpouring to common market even faster than ever before. This phenomenon is the so-called **democratization of luxury** brings in the concept of new luxury².

New luxury products are sold at much higher prices than conventional goods and in much higher volume than traditional luxury goods. New shapes of luxury-both products and services show a new trend of spending more on luxury experience and lifestyle rather than goods. There is also a trend in luxury buyer that they are now less interested in purchasing uniform status symbols and try to develop an individual style and expressing themselves in original ways.

The extension of new luxury products includes:

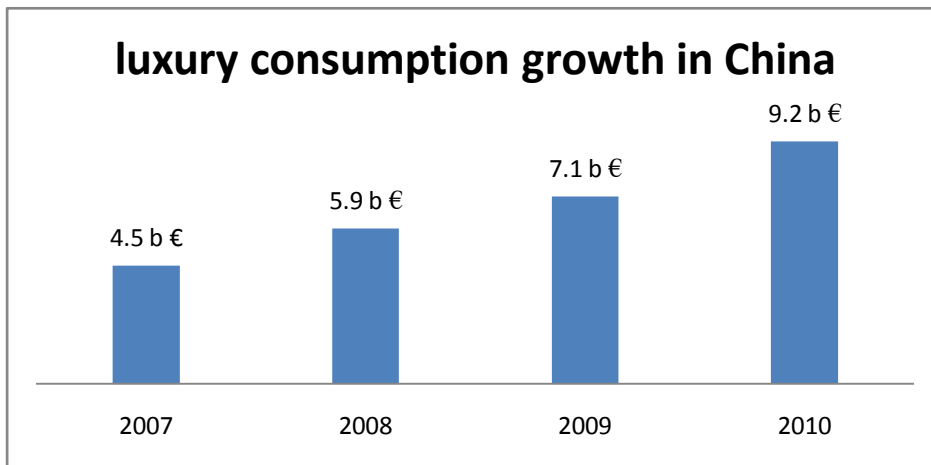
- 1) Accessible superpremium products those are affordable for middle-market consumer, e.g. fragrances or underwear.
- 2) Casual lines or lower-priced versions of old luxury brands created by same companies and designers: Marc by Marc Jacobs, CK Jeans by Calvin Klein, etc.
- 3) Masstige goods, neither at the top of their category in price nor related to other items of the brand. They occupy a position in the market between mass and class, such as iPhone.

1.2 Overview of China's luxury market

While the luxury markets in Europe, North America, and Japan are shrinking in the global economic downturn, China's consumption of luxury goods is on the rise, amounting to \$10.7 billion or 25 percent of the global luxury market. China is now the 2nd largest luxury market in the world, only after Japan. The chart below shows the growth in recent years (in billion €)

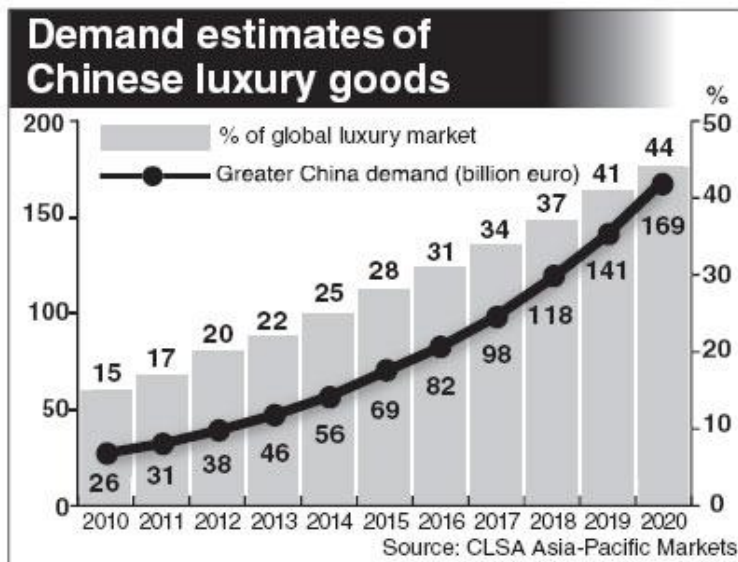
²"The success of luxury brands in Japan and their uncertain future", Ronald Jean Degen, 2009

Figure 1.1: luxury consumption growth in China³



The continuous and rapid growth of luxury consumption of mainland China is due to the rapid rising incomes, the wide availability of luxury products and information, and shifting social attitudes towards the display of wealth. The According to a report released by Hong Kong-based investment bank CLSA Asia-Pacific Markets, Chinese consumers will snap up 44% of luxury goods sold in the world by 2020. As estimated in the report, in 2014 China will take the place of Japan, reaching an amount of 22 billion euros consumption in luxury.

Figure 1.2: demand estimates of Chinese Luxury goods⁴



According to the WLA report the top 10 Chinese cities of largest consumption in China is shown

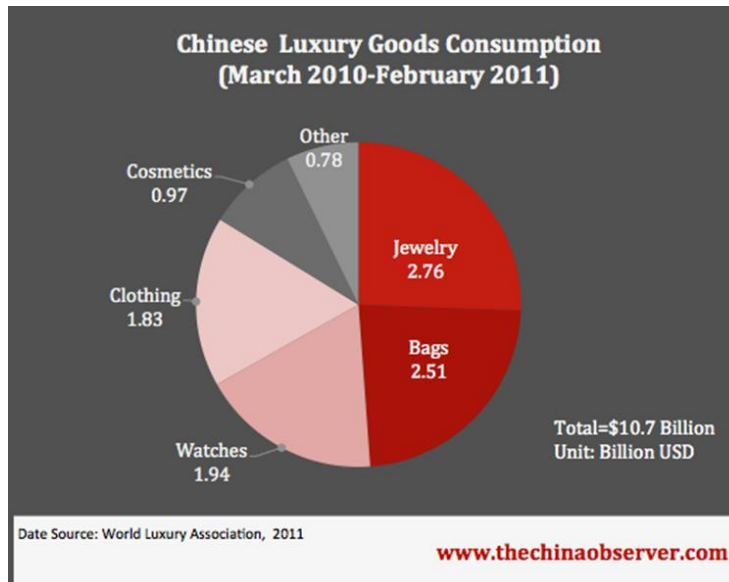
³⁴ Source: WLA (World Luxury Association)

as in figure 1.3. Metropolitans Beijing and Shanghai stand on the top of the list, follow by Chengdu and Hangzhou. Figure 1.4 below shows which luxury goods Chinese consumers prefer to spend their hard-earned money, in period from March 2010 to Feb 2011.

Figure 1.3: Top 10 Chinese cities with the largest consumption of luxury goods



Figure 1.4: Chinese luxury goods consumption by categories



The most well-known and popular brands in China in the 2 categories with largest consumption – Fashion and Jewellery - are shown respectively as follow.

Figure 1.5: brands with top repeat purchase rate in China - Fashion⁵

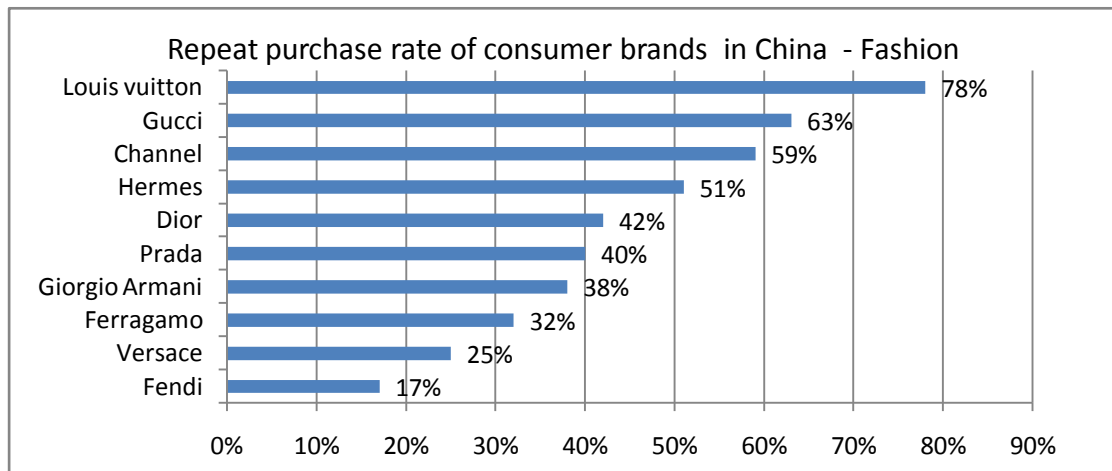
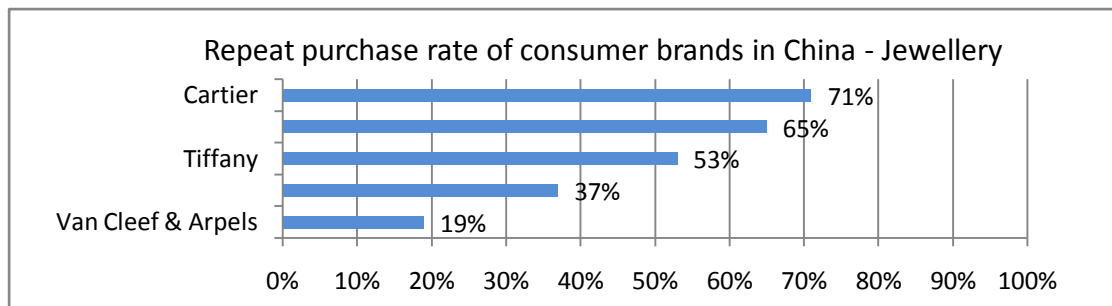


Figure 1.6: brands with top repeat purchase rate in China - Jewellery⁶



According to the WLA report, the McKinsey Insight China Luxury report we can also observed several changing trends in Chinese luxury market:

- a. The second-tier cities will become the major battlefield of luxury brands in the future
 The industry giants have already probed the Chinese market and their next steps are clear: for first-tier brands, such as LV and Gucci, which have a longer history in China and stable foundation in 1st-tier cities, the next step will be expansion into 2nd-tier cities. Luis Vuitton, for instant, by the end of last year had 36 stores in 29 cities, including 2nd-tier cities such as Changsha, Xiamen, Wuxi and Wenzhou.
- b. Decrease in the interest for fake products
 Chinese consumers are increasingly willing and able to afford authentic luxury goods, when the desire to buy fake products dropped from 31% to 12%.

⁵ Source: World Luxury Association

⁶ Source: World Luxury Association

c. Potential buyers from the emerging upper-middle class

For China's 13 million upper-middle class households, though they can only afford occasional luxury purchase, the willing of saving their budget to buy luxury watches, jewelry, bags and clothes are growing rapidly. A number of 76 million households in this class can be expected by 2015.

1.3 How do Chinese people perceive luxury

In Mainland China, luxury goods are consumed on a mass level, and are not constricted to a certain group of classes. Higher classes purchase luxury goods for better quality or investment, while the lower –income classes, even if they cannot afford a luxury brand item today, they will save up several months of savings to eventually have it. Moreover, gift-giving is also a conventional and sanctifier behavior among Chinese society. During the festivals, celebrating events or even social interactions, luxury goods are often chosen to show the veneration and respect, or to demonstrate the social status.

Generally speaking, financial and career success and achievements naturally became a way for people to distinguish themselves from others. People openly display a person's individual success, and luxury goods and designer brands effectively communicated status and wealth. Thus The Chinese relationship with luxury, at the moment, is basically functional other than emotional. In this case we can conclude that luxury goods are playing the role of a "signifier", as a tool to stand out and obtaining admiration in a deeply structured and rigidly hierarchical society. For example, a diamond ring on a woman's finger may signify that 'my husband is very rich', while wearing a exquisite mechanical watch could mean "I am an elite and I am sophisticated."

However, at the core of this newfound wealth and status was the honest pursuit of better living condition, which meant for higher quality products and upscale brands. Therefore, international luxury brands perfectly fulfilled the needs of Mainland Chinese consumers from all angles – cultural, social, and economic – attributing for a more modern, powerful, and self-confident

approach to life.

We can find that status and self-reward are two particularly strong motivations in China. Among the people who took the survey, they found that:

- 1) More than 70% saw luxury brands as a way to demonstrate their status and success.
- 2) Less than 30% objected to paying a higher price for a luxury brand.
- 3) Over 60% of respondents brought luxury goods as a way to reward themselves for their hard work and success.⁷

In a survey in 2011 by the same institute based on 1200 middle class consumers based in 24 1st and 2nd-tier cities we observe that, compare with the result in 2008, self-reward and connoisseurship are becoming stronger motivations of luxury consumption while the importance of status declining. As the market grows in sophistication Chinese consumers are moving from satisfaction of owning a product to being able to appreciate the meanings and history of a luxury brand⁸.

Figure 1.7: comparison between motivations of buying luxury goods (2008vs2011)⁹

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



⁷ "Luxury brands in China", KPMG, 2007

⁸⁹ "Luxury experience in China", KPMG, 2011

2. The macro and micro analysis of 2nd-tier cities luxury market

Many companies trying to enter China for the first time see the country as a whole - as one distinct market. However, China is a patchwork of regional markets at various stages of economic development. These markets are bound together as one nation and yet separated by differences in government, communication challenges, regional rivalries and poor infrastructure. The same situation also occurs in the Chinese luxury market.

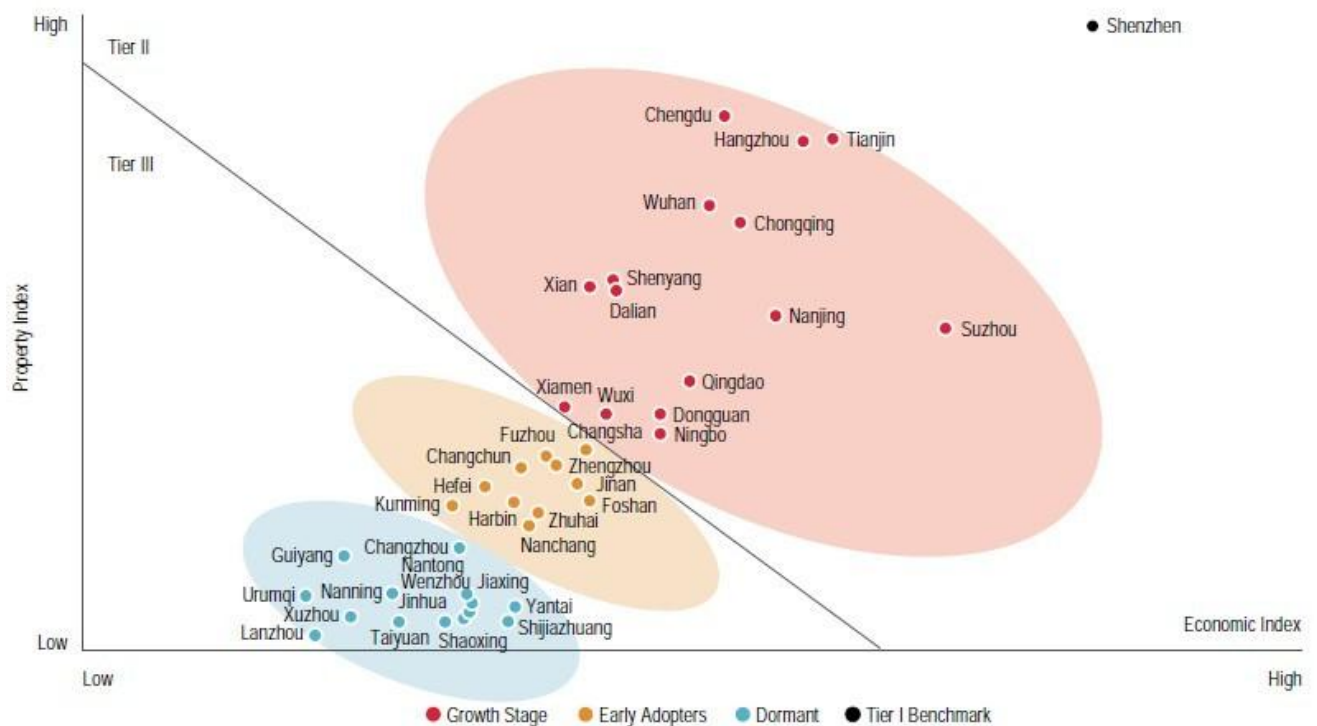
China's "1st-tier" cities, such as Beijing, Shanghai, Shenzhen and Guangzhou were historically the destination for a large portion of those relocating to China. However, along with the industrial development and civilization, the 2nd-tier cities, as reported by Chinese government, are quickly becoming the growth engines of the Chinese economy, boosted by huge amounts of investment, new infrastructure and an influx of new talent. The new emerging wealthy and upper-middle class have captivated the sights of top luxury brands, who seek the new opportunities of business expansion in mainland China as the 1st-tier market has been saturated. That is the reason why we focus on the luxury market in Chinese 2nd-tier cities. The so-called "second-tier" cities should actually be called "first-class opportunities."

2.1 The definition of 2nd-tier cities of China

Analysts often categorize China's Tier 2 cities in different ways, since the Chinese government does not officially define tiers. "Second tier" cities are usually a bit less developed in this support network, less cosmopolitan and have a smaller Western community. However, many of these cities have developed quite rapidly over the past several years in the area of these support services, in many cases reaching similar levels to "first tier" cities. In one report by Jones Lang LaSalle in 2009, which relies on the based on a range of economic and real estate indicators, and also considering office, logistics and retail investment. Considering the overlaps between consumers of luxury brands and estates, we can similarly define 15 Chinese 2nd-tier cities represented by the red spot:

Figure 2.1: definition and display of Chinese 2nd-tier cities

Fig 2: City Evolution Curve



The 15 2nd-tier cities plotted above are: Tianjin, Chengdu, Hangzhou, Wuhan, Chongqing, Xi'an, Shenyang, Dalian, Nanjing, Suzhou, Xiamen, Wuxi, Qingdao, Dongguan and Ningbo¹⁰.

2.2 PEST analysis of 2nd-tier cities

PEST analysis stands for "Political, Economic, Social, and Technological analysis" and describes a framework of macro-environmental factors used in the environmental scanning component of strategic management. Through PEST analysis we can find hints on what opportunities and where they lie in the 2nd-tier cities' luxury market.

Politics

When it goes to the luxury market related policies and regulations, such as customs duty, import VAT and consumption tax, there are rarely different between the cities in mainland China, except some regional policies which provide benefits to attract the investors.

¹⁰ Source: Jones Lang LaSalle

1) Custom

Despite falling international tariff rates, luxury goods remain subjected to high customs duties within mainland China. Here is a table showing the custom taxes rates depending on product categories:

Figure 2.2: Custom takes rates by categories¹¹

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%

The non-dutiable costs such as royalties, the Free Trade Agreements and tariff classifications and other custom issues should be carefully evaluated.

2) Special trade zones

Free trade zones and Bonded Logistics Parks are located in major coastal cities such as Dalian, Shanghai, Shenzhen and Guangzhou. These special tariff areas are regarded as outside of China for customs purposes. Goods can be stored here and not subject to import taxes until shipped into China's domestic market.

3) Transfer pricing policies

Transfer pricing focuses on making sure that tax deductions are not claimed for over valued goods purchases, thus reducing taxes payable.

Economics

Urbanization is perhaps the single most inescapable reality of China's current economic development. McKinsey speaks of "China's urban billion" by 2030, predicting nearly 400 million

¹¹Source: www.customs.gov.cn/

new urban residents (an increase from 47% of the total population to more than 64%)¹², exceeding the population of the United States. It is the rapid rise of 'second-tier' cities that changing the urban landscape", expressed by Euromonitor International. Indeed, the current four Tier 1 cities are likely to experience a decline in relative demographic and economic importance as future development and investment spread to a broader group of cities –the Chinese 2nd-tier cities are the main beneficiaries. Broadly speaking, many Tier 2 and Tier 3 cities have been growing substantially more rapidly than Tier 1 cities (up to 5% faster, according to Jones Lang LaSalle).

According to figures from the US Commercial Service, 15 of China's second-tier cities account for 8 percent of the population but 54 percent of the total imports from the US. McKinsey estimates that 25 of the 100 top Chinese cities will see consumption double between 2008 and 2015. Economic growth and rising incomes in China's Tier 2 cities have made entering these markets much more attractive than it was in the past. Nowadays the increase in consumer spending power in these cities is creating a rapid growth in demand for higher quality products. In particular, cities such as Tianjin, Nanjing, Suzhou and Hangzhou all offer strong commercial opportunities.

Here we can see a list of the top 10 cities in China, ranked in terms of highest amount of disposable income

Figure 2.3: disposable income ranking in Chinese cities¹³

City	GDP per capita (RMB)	Per capita disposable income (RMB)
Shenzhen	92,771	28,838
Shanghai	77,556	28,837
Guangzhou	88,834	28,266
Wenzhou	32,595	28,021
Hangzhou	70,832	26,864
Beijing	68,788	26,738
Suzhou	117,200	26,320
Dongguan	56,591	25,320
Tianjin	55,473	21,402
Wuxi	73,053	17,175

¹² "Multinational Retailers' Quest for Gold in China's Tier 2 and Tier 3 Cities", 2011

¹³ Multinational Retailers' Quest for Gold in China's Tier 2 and Tier 3 Cities

As we can see, not surprisingly, that the GDP per capita of Suzhou have already caught up with all the 1st-tier cities and disposable income per capita of Hangzhou, Suzhou, Dongguan, even Wenzhou, a 3rd-tier city are now at the same level with those 1st-tier, even higher than Beijing. We can conclude that there is much potential growth of luxury market in these affluent 2nd-tier ones.

Social

Along with the growth of the middle class in demographic terms, the emerging shift toward consumerism as a way of life, offers a potential windfall to retailers able to tap into new consumer trends. In a 2007 ACNielsen study, 1/3 of mainland respondents said clothes shopping was their favorite thing to do, which is 20% higher than the world average. In the same study, 34 % of respondents said they would go shopping just for entertainment once a week.

Chinese consumers are extremely brand conscious, with some 45% believing that higher pricing corresponds directly to better quality, compared to just 16% in the US and 8% in Japan¹⁴. In the same way, far more Chinese consumers are willing to buy more expensive branded products than their counterparts in the rest of the world. While this impression is gradually becoming less pervasive, it remains a core belief and explains why less known brands continue to be less successful in China.

Guanxi, the most inevitable and meaningful topic in Chinese society, even means more in the 2nd and 3rd-tier cities. Guanxi refers to traditional Chinese social networking practices and exchanges of favors for business and personal gain. Therefore the business gifting becomes one of the biggest factors for spurring the growth of the luxury market in China. Those giftable luxury items are always salable. In the Hurun Best of Best awards they even list out the *Top 10 Gifts for the Chinese Luxury Consumer*.

The figure of graphic below points out that business gifting is a rational motivation of luxury consumption in mainland China, which is most likely to happen in 2nd-tier cities.

¹⁴ "Luxury China: market opportunities and potential", Michel Chevalier & Pierre Lu, 2010

Figure 2.4: buying luxury as a gift for business partner¹⁵



We should also take conformity into account. In lower-cities most people are more apt to be the follower within the social group. They would buy what most of their fellows buy. Thus the brands become one of the emblems of certain groups, differed by consumption levels.

Technology

Online luxury sales continue to rise globally, but with the modern technology and internet luxury brands can do much more than that.

The day-by-day improvement of technology renews advertising channels. Consumers now obtain more information about luxury goods through internet ads than through TV and print ads. Some new and innovative online advertising technologies (e.g. banner ads, online classified advertising, e-mail marketing, rich media ads and even social networking advertising) enable brands to deliver messages without geographical or time boundary, to present brands under a more entertaining light and engage a wider audience in a more interactive and fun way.

Social networking can be an important tool for luxury retailers in guiding and managing consumer

¹⁵ Source: Albatross Global solutions and Ruder Finn Asia

sentiment about their brands, when 1/5 Chinese consumer will not purchase a product without first researching it online. Mainland China's unique internet situation, where the Facebook, Youtube and Twitter were blocked, and the most widely used tools are QQ, Renren, SinaWeibo and other local offerings, requires luxury brands to develop a new vision, to educate the new customers about the value of brand and experience.

The impact of mobile devices also offers great potential for fast, interactive communications with customers. The new APPs appear and mostly focused on practical aspects. An IBM's research shows that 65% of respondents are positive about using SMS to make reservations and book tickets. 57% of them would be interested in receiving updates on new arrivals or limited editions by SMS, while 64 would be interested in validating the genuineness of their purchases using their mobile phones or other digital devices¹⁶.

2.3 Comparison between luxury market in Chinese 1st and 2nd-tier cities

The luxury market in China's Tier 1 cities, with highly populated areas with a large, middle-class representation and income levels well above the national average, are the most mature markets in terms of consumer behavior, and are typically the most suitable testing ground for foreign brands with limited experience in China. Although being based in a Tier 1 city may offer the lowest market risk, it will also mean that the company faces higher operational costs, signs of market saturation, and high costs of retail space. That is why luxury brands are turning their eye sights to those lower-tier markets.

Knight Frank, a famous global property consultancy, takes Chengdu, Dalian, Tianjin, Harbin, Chongqing and Wuhan as the representatives of 2nd-tier cities, makes a research about retail between the 1st-tier cities and them. The graphic below shows the typical monthly rent of prime shopping centers for Level One (ground floor) assuming a unit between 100-250 sq m. On this comparison, the average rent for the Tier 1 cities is RMB 1,367 per sq m, whilst average Tier 2

¹⁶*"Luxury extents its reach across China", KPMG & TNS*

rents are 46% lower at RMB 765 per sq m.

Figure 2.5: comparison of rents for retail use between 1st and 2nd-tier cities



Some brands estimate that their level of sales per sq m is 3 times lower in mainland China than it is in Japan. Though the cost of sales staff is much lower, but it all boils down to the rental cost of a store in a top location in Shanghai, Beijing or Guangzhou. Nevertheless Shenzhen is getting more expensive today.

In addition, the pull effect from rising consumption across China's dispersed urban centers has been a key driver for the extension of luxury brands in 2nd-tier cities. These retailers have been attracted by the combination of strong economic growth, an increasingly wealthy middle class, and the one child policy which has produced an army of young, aspiring spenders keen to show off their new wealth and status. Luxury retailers are tracking the spread of China's growing affluent and middle classes into increasingly unexpected geographies.

By calculating the quantities of stores of the 5 chosen brands, which are widespread and popular in China, we can compare the difference in luxury stores penetration in 1st and 2nd-tier market.

Considering the geographical position of Guangzhou and Shenzhen and people's preference to purchase in Hongkong and Macau or even abroad, because of price and tax issues, we can neglect the low dispersion of luxury stores in this two Cantonese cities. From the figure we can see the penetration of luxury in the 15 2nd-tier cities is much lower than in Beijing and Shanghai. Based on such big amount of affluent and middle class consumers, there is still much market space for luxury brands to invade.

Figure 2.6: Penetration of 5 chosen brands in Hongkong and Macau, 1st-tier and 2nd-tier cities¹⁷

	LV	Gucci	Chanel	Ferragamo	Prada
Beijing	3	4	2	7	3
Shanghai	3	4	5	6	3
Guangzhou	1	0	1	3	1
Shenzhen	2	1	0	1	1
Tier-2 cities	14	11	1	20	8
Hongkong& Macau	11	11	12	18	10

Moreover, we can figure out that watch and menswear have penetrated most deeply into Chinese 2nd and lower-tier cities, as what historically concentrated in Chinese luxury market, while we are starting to see jewellery and women's apparel and accessories are most widely spread in the 1st-tiers¹⁸.

¹⁷ Source: official websites of the 5 brands

www.louisvuitton.com

www.gucci.com

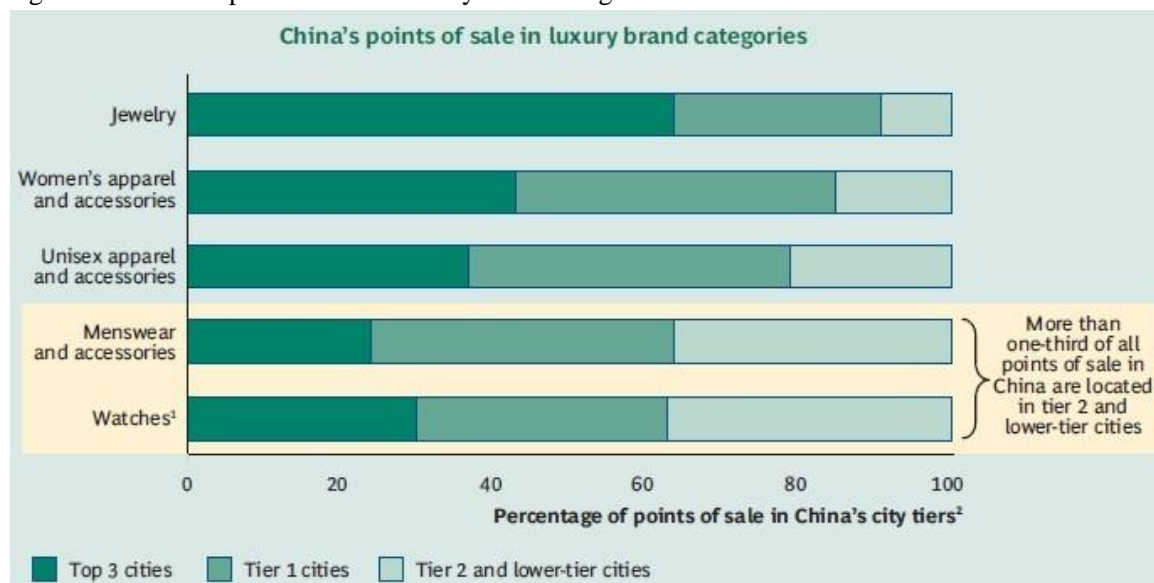
www.ferragamo.com

www.chanel.com

www.prada.com

¹⁸ "China's Luxury Market in Post-Land-Rush Era", Boston Consulting group, 2009,

Figure 2.7: China's point of sale in luxury brand categories



2.4 Consumers in 2nd-tier cities

As the consumers in tier-2 cities are becoming more mature in areas such as consumer perceptions and purchasing power, the gap between the tier-1 and tier-2 luxury markets is narrowing. A research by Ruder Finn Asia and Albatross Global Solutions has clearly revealed this recent trend.

Despite the current economic situation, consumers in tier-2 cities show their strong capacity of luxury consumption, with 54.6% saying that prices have little impact on their purchasing decision, only 4.3% lower than the proportion in tier-1 cities. When asked about the purchasing plan over the next year, 36.6% respondents expressed optimistic views that their purchasing power will increase, which is slightly lower than 38.9% in tier-1 cities.

Among all the measured factors, “Brand Reputation” was named as the most important factor by 75.3% of respondents in tier 2 cities, followed by “Brand Heritage”. In addition, some 46.6% of respondents in tier 2 cities said that they are loyal to certain brands, which is close to the percentage in tier 1 cities (47.2%), while Eastern tier 2 cities top the national list with 51.7%. As there are fewer luxury brands in tier 2 cities than in tier 1 cities and Hong Kong, the faster brands tap into the tier 2 markets, the easier it will be for them to build brand loyalty.

When asked about their most favorable destination for their luxury purchase, 39.8% tier-2 city respondents voted Hong Kong as their first choice, and 33.3% respondents from eastern tier-2 cities voted Shanghai. The report also reveals the considerable amount of people who would like to purchase locally. Less than twenty-five percent declared that it wasn't necessary to travel to tier-1 cities or Hong Kong in order to purchase luxury goods, whereas respectively 28.8% and 27.3% respondents from western and northern cities feel it they must travel. The result shows strong evidence that luxury products are becoming more commonly accepted in daily lives among tier-2 city lovers of luxury goods.

With the increasing popularity of luxury goods in tier-2 cities, brands are applying marketing strategies which are used in tier-1 cities, to tier-2 cities, where comprehensive information can reach the consumers through newspapers, magazines, TV, internet and various marketing campaigns. The figures told us that no matter in tier-1 or tier-2 cities, print media still rated as the most effective way to communicate the brand information with consumers. Nearly 82% of tier-2 city respondents prefer learning the new trends of the brands through reading enrich articles or stories, while around 20% comment that TV report enhanced their knowledge of the luxury brands. Figures are similar with the percentages of tier-1 city respondents.

When asked about the awareness and recognition we can see a similar pattern between 1st and 2nd-tier ones¹⁹.

Figure 2.8: brand recognition (1st-tier vs 2nd-tier cities)

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 recognized	12.6	14.7	8.0	5.2	12.9	53.4
	As a percentage of brands listed	32%	37%	31%	40%	76%	

¹⁹“Luxury experiences in China”, KMPG & TNS, 2011

Moreover, consumers of 2nd-tier are now more willing to pay for experiential and connoisseur-based luxury. Lifestyle expense and beauty treatment is rising. However the penetration of these categories is generally higher in 1st-tier cities, only the passion for fine art is slightly higher in 2nd-tier.

Figure 2.9: penetration of different forms of experiential and connoisseurship-based luxury²⁰

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

²⁰“Luxury experiences in China”, KMPG & TNS, 2011

3. Analysis of marketing strategies

3.1 Positioning

There is a statement goes that positioning does not exist in luxury. To a certain extent this may be correct. Luxury is 'superlative' and not 'comparable'. It is a creative expression of a passionate artist, to be enjoyed by oneself or for others to enjoy. A positioned product says 'I have this feature or that feature, and for the price I represent the best value' whereas a luxury item tells the world 'this is who I am'. The value perception of luxury is so subjective that positioning in luxury is difficult and confusing.

However, the key success factor for luxury is still quality, and positioning is necessary for marketing management in any product or service industry, in order to shape new products, take actions against competitors and to look after "gaps" in the market for business potential. As we mentioned in section 2.3, in the China, especially in the 2nd-tier cities, marketers need to consider the implications of the needs of national identity and how they construct and maintain social status among the emerging upper-middle class. Thus luxury goods must attempt to satisfy a social need to project success.

For the products supplied to Chinese market are even with larger range and more variety in 1st-tier cities, we can consume no difference between positioning policies in 1st and 2nd-tier cities in luxury brands. Luxury consumption always involves with aspiration and imagination, but it can have real effects in facilitating the construction of self-identity. It is vital to tap into deep consumers' desires for social status and indulgence. Different luxury brand obtains different position in this interaction and trade-off between the 2 factors. Thus we can place the brand judging from 2 axes: classic/eccentric and exclusive/democratized.

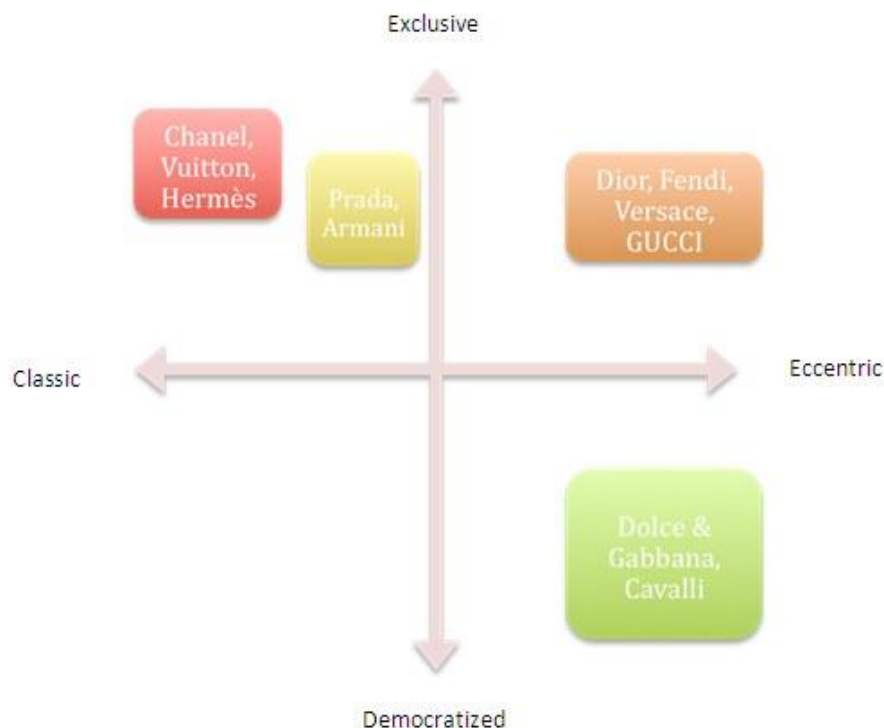
The former dimension refers to the style and concept of the brand, Classic implicates mainstream value about beauty, exquisite, traditional craftsmanship, sophisticated tastes and iconic design.

Eccentric implicates more trendy and changing styles, individualized products, technical innovations in manufacturing or material, new and niche market. It is the criteria about the brand nature and how they satisfy the consumers' tastes.

The latter dimension refers to the difficulty to own the products, in another word, to what extent the brand is "luxury" (for Chinese consumers exclusivity and expensiveness can be a signal of prestige). Exclusive implicates premium, more expensive, more difficult to obtain, fewer quantities or limited purchases, which means higher degree of luxury. Meanwhile democratized means wider spread, easy acquisition, lower prices and more popularity, which refers to a lower degree of luxury. It is a criteria about how the brands keep their image by controlling the quantities and quality of the consumer groups.

Thus the most recognizable luxury brands in Chinese market can be generally positioned as the graph below:

Figure 3.1: positioning examples for most recognizable luxury brands in China



Of course, the strategies of luxury brands are not simply just positioning. Luxury brand leaders are trying to find ways to distinguish themselves from other premium brands and some are now pushing prices up to an unprecedented level to maintain their luxury positioning, but being expensive can not maintain the positioning. Louis Vuitton is maintaining prestige while selling to the masses without ever having an end of season sale. Burberry is doing a phenomenal job transforming itself into a luxury brand. Chanel is making sure style never goes out of fashion and is never affordable. Tiffany & Co. is still making sure everyone understands what the little blue box means.

Hermès is the most extreme example. It offers a true luxury experience with only a limited number of bags to sell each season. Only a few distinguished customers can purchase a bag in-store, but generally, customers must order before buying a Hermès bag. Most bags in the store are just for display. Customers choose the material, and the color of the hardware, then they have to wait 6-8 months for their bag. That is how Hermès make their products desirable.

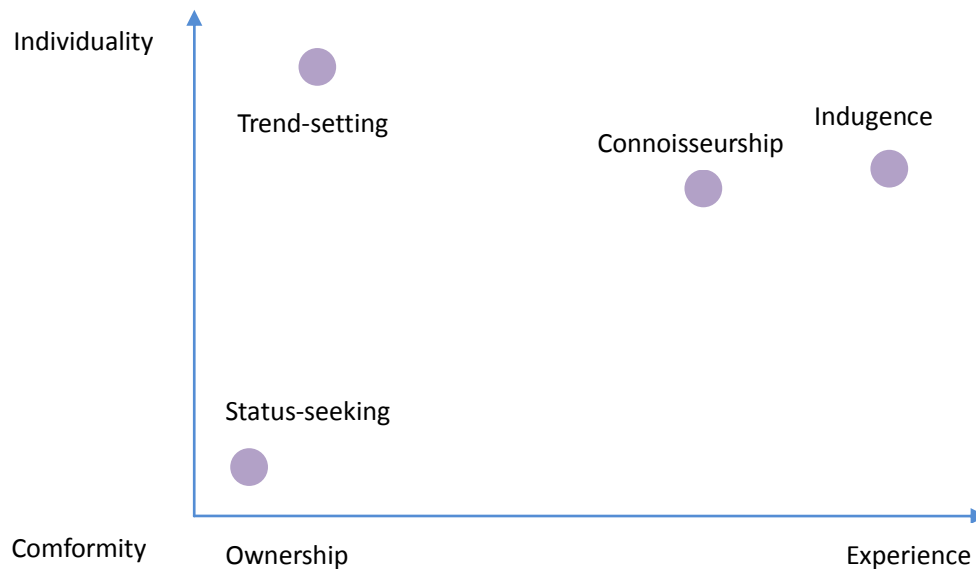
3.2 Segmentation

China used to be the only market where men consume more luxury, especially in ready-to-wear sector. This is of course due to the men's interests on revealing status men's control to the family's budgets, which was more likely to happen in 2nd and lower-tier cities of China, while only women with and active business life had clear financial autonomy. The market was traditionally divided into 4 segments: the traditional business elite, new luxury shopper, independent women and youth.

However the situation is changing. Currently, it is reported that spending on women's apparel constitutes 54 percent of the total spending on fashion among adult urban consumers. As women's incomes rise and becoming economically independent, it is expected that their apparel spending will pick up significantly. As a result the segmentation should not always feature the gender and ages any more.

Two important needs that are guiding the evolution of luxury are need for individuality and the need for a rich and indulgent experience. The other two factors are the traditional one: conformity and ownership. Based on these dimensions we might identify 4 broad segments: status-seeking, connoisseurship, indulgence and trend-setting.

Figure 3.2: Segmentation of Chinese 2nd-tier cities' consumers



Status-seeking

Conformity and status seeking are widely agreed to be key motivations for luxury consumption among China's emerging rich. For example, in one TNS report in 2008 66% of the 2nd-tier cities respondents stated they were willing to pay a premium for products that were popular and famous. The fame and status of a brand are particular strong factors among the youngest (20-24 years old) and oldest (over 35 years)²¹.

Exclusivity is an important factor for Chinese consumers, but they also seek status and recognition among their wider peer group. A relatively low figure (23%) believed that goods could only be considered luxury if they were known and appreciated by the minority.

²¹²² "China's luxury consumers: moving up the curve", KPMG & TNS, 2007

Connoisseurship

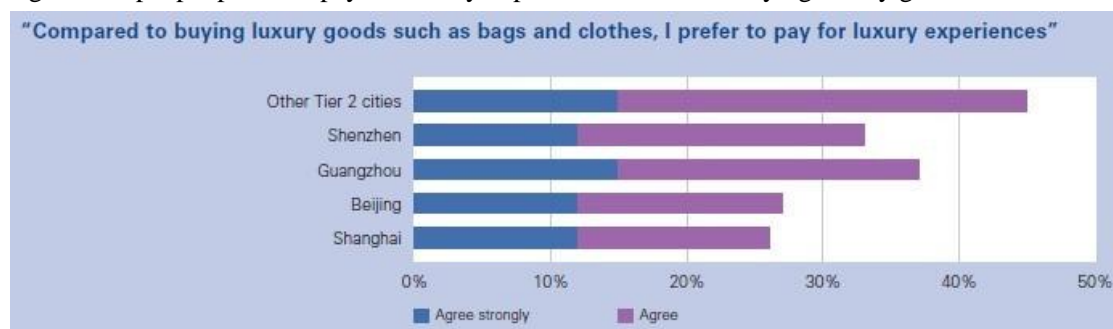
Connoisseurship and collectors are still a rare group in China, especially in 2nd-tier cities, only approximately 15% chosen connoisseurship as the motivation for buying luxury goods, according to the TNS report. Watches and expensive furniture are the favorite collectible items, while female connoisseurs also collect bags and jewelleryes²².

Connoisseurs appreciate uniqueness and heritage, and also treasure a high level of craftsmanship. Compare to the status seeking purpose they consider deriving internal satisfaction from their luxury collection is more enjoyable.

Indulgence

As I mentioned in the 2nd chapter, over 70% consumers bought luxury products as a form of self-reward. This suggests that the spending money for indulgence relaxation and experience is an even higher factor over time. In 2nd-tier cities, over 40% respondents in the survey showed a stronger preference for luxury experience over purchase of luxury items such as bags and clothes, which are a little bit surprising because this figure is even higher in the 4 1st-tier ones.

Figure 3.3: people prefer to pay for luxury experience other than buying luxury goods²³.



The wealthiest consumers are becoming increasingly familiar with the luxury of 5 star hotels, spas and high-end restaurants and other new luxury relaxing forms. Many join luxury brand club not for exclusivity but because they are regular consumers of luxury experience and privileges and

²³ "China's luxury consumers: moving up the curve", KPMG & TNS, 2008

expect a consistent level of service or some extra benefits.

Trend-setting

A small but growing segment of Chinese consumers no longer wishes to use luxury brands as a tag. They enjoy adopting new or niche brands much earlier than the masses, and mixing these purchases with more well-known brands', thus to express their own taste and individuality.

These consumers exist in every city not just the 1st-tier. Over 40% of 2nd-tier cities consumers willing to pay a premium for fashionable goods and brands, almost catch up with Beijing and Shanghai. TNS believe this segment is typically younger than average, working in white collar roles and well-educated. Moreover, fashion was also seen as relatively more important among the over-35 age group nowadays.

3.3 Marketing mix

Product

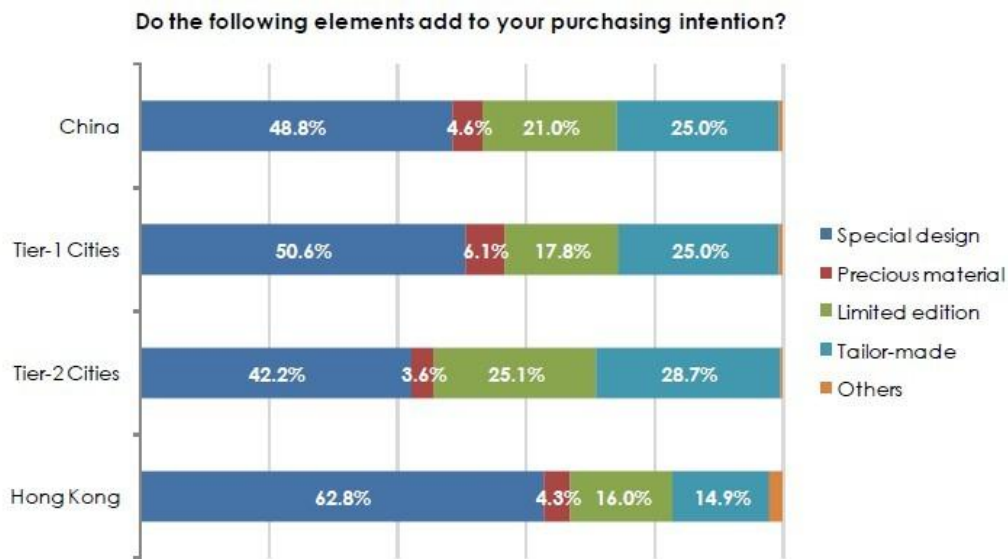
Personal accessories such as cosmetics, perfumes and watches, which are smaller items that affordable and considered as rewards and business gifts, are the most sellable in 2nd-tier market. On the other hand, men are buying clothes in premium level more often than women. The fact that men are important customers for luxury ready-to-wear sector to an extent that is rare in other countries, makes some brands paying special attention in China market in this sector. Ermenegildo Zegna, whose stores cover most of the network of 2nd-tier cities, is the best example.

However, the products timeliness in 2nd-tier cities are comparatively falling behind. Most of new products are firstly shown on the shelves in boutiques in Paris and Milan. A few weeks later they would arrive at Asia, appears in the windows of stores in 1st-tier cities in China. Finally they arrive at the 2nd-tier cities. During these timeline the freshness and the abundance of products are diminishing day by day. Moreover, the 2nd-tier cities in China usually will not be chosen to push the limited and special edition to the market. The choices for consumers in these cities are

obviously limited compare with the boutique abroad.

At the product level, consumers in tier-2 cities considered special design to be the top priority in the decision making process when compared with precious material, limited edition and tailor-made. They place more importance on being unique than their counterparts in other regions: 25.1% prefer limited editions while 28.7% choose customization and tailor-made products

Figure 3.4: the elements increase purchasing intention for luxury products²⁴



Among young and upper middle-class consumers, in particular, the desire for luxury products that draw on China’s rich culture and historical heritage is evident. Some companies are responding, such as Hermes, which recently launched a Chinese brand, Shang Xia, with a store in Shanghai and other planned for Beijing and possibly Paris. The products are based on Chinese designs and craftsmanship, and the prices are two or three times lower than hermes.

There is a trend that more products tailored to China’s need will hit the market. The list of “Made for China” products goes on: dENiZEN by Levi’s was designed to fit the slim Chinese bodytype, and the new long-wheelbase BMW 5 Series Sedan was designed to cater to the Chinese preference for big sedans. These products will play a major role in the companies’ entry into regions outside of

²⁴“China luxury forecast”, Albatross global solutions, 2009

China as well.

Price

On one hand, consumers are willing to pay more for publicly displayed possessions to signify wealth, meaning price will be an indicator of exclusivity. On the other hand, it does not mean they do not care about the pricing. With around 2/3 of luxury consumers having made at least one overseas trip, consumers have access to external benchmarks for comparing prices back home, for instance, only 2/5 of people knew that the price of luxury products in China was at least 20% higher than overseas markets. By 2010 66% of consumers were well aware of this difference.

We can choose 3 hand bags that are classic, most representative in with each own brands and whose sales amount are stable, compare their prices in Europe, in Hongkong and in China market respectively.

Figure 3.5: prices comparison between Europe, Hongkong and Mainland China

	Chanel Classic Flap Bag (Medium)	Dior Lady Bag (Medium)	Louis Vuitton Neverful MM
Europe	3100€	2400€	525€
Hongkong	35900(~3482€)	26850(~2604€)	6600 HKD(~640.2 €)
Mainland China	34500(~4109€)	25000(~2977€)	6100 RMB(~726.5€)

As we can calculate that the price in mainland China is averagely 31.6% higher than in Europe Market and 15.2% higher than in Hongkong.

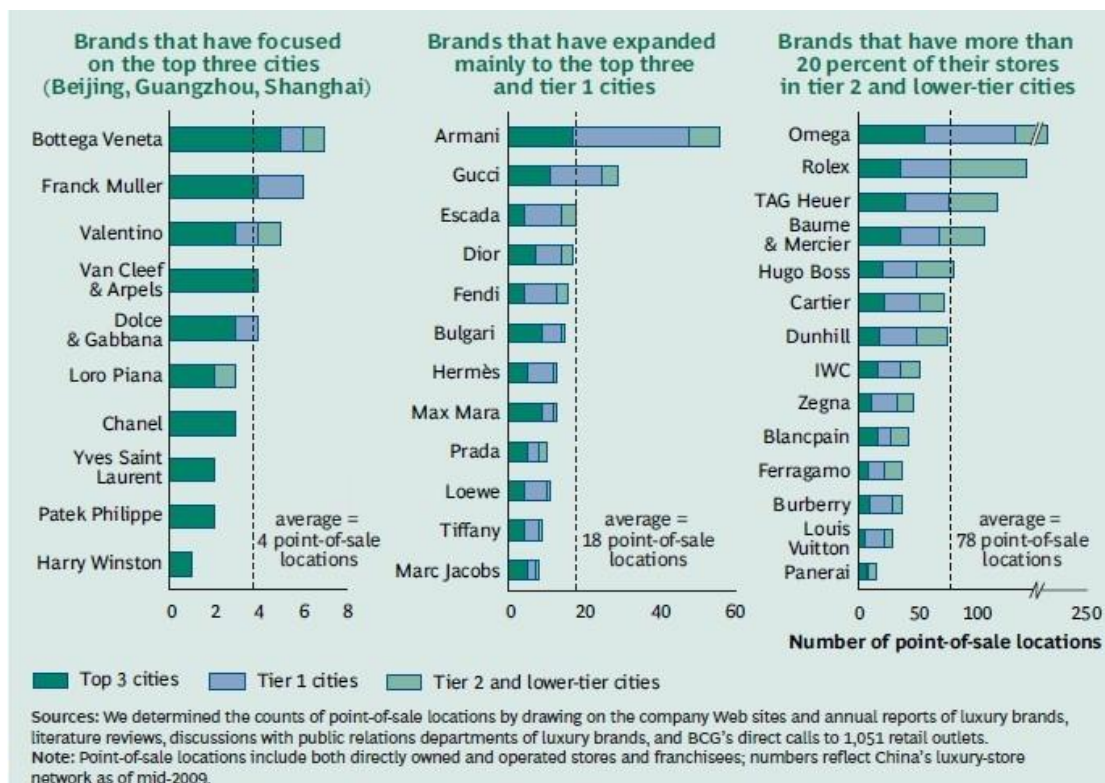
Place

In many countries, the question of where to go would not make much sense, but China does. The Chinese market is huge, and can be approached from different angles and different perspectives.

Luxury companies are pursuing very different strategies according to the scale of their operations,

and scale of their ambitions: some brands have grown rapidly, others more slowly. There are a few patterns: many super-premium brands have focused mainly on the top 3 cities of Beijing, Guangzhou and Shanghai, whereas premium-priced brands, such as Dunhill and Burberry, have established a considerable percentage of their point-of sale locations in 2nd-tier and lower tier cities, as shown in the graph below:

Figure 3.6: penetration of different brands with different expansion plan and direction²⁵

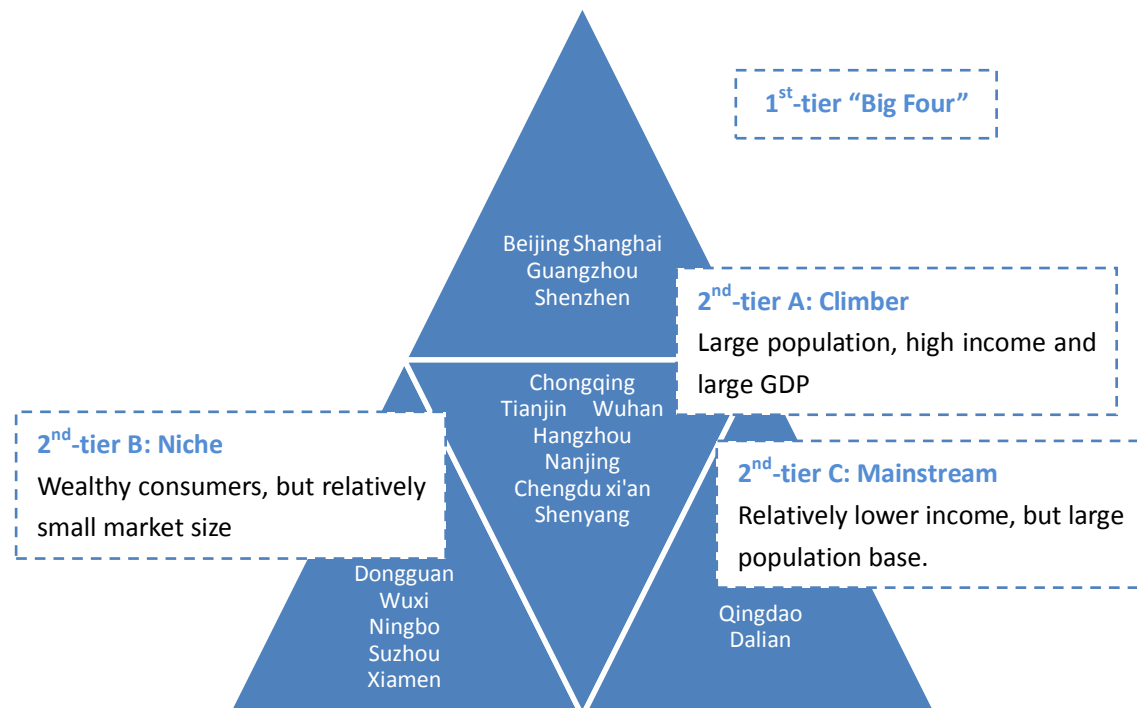


By collecting the allocation of the major luxury brands that are already in China, we can see that only Louis Vuitton, Armani and Ermenegildo Zegna have a relatively strong coverage of the countr, which are not only present in stores in most of the cities in 2nd-tier list, but also appear in 3rd-tier cities such as Changchun and Kunming. Among the top brands, Chanel is quite late in its development and only 9 stores present in mainland China, among which the only one in 2nd-tier cities is located in Hangzhou.

²⁵ "China's Luxury Marker in Post-Land-Rush Era", Boston Consulting group, 2009,

The 15 chosen cities can be divided into 3 categories as below (the study specifically focuses on the households with an income above USD 6500 per year, as above this level people can start to be in the market)²⁶:

Figure 3.7: division of 2nd-tier cities in luxury market



The cities belong to 2nd-tier A category, which most important cities covering a vast range of north, west, centre and east of China, is the markets where luxury brands should pay special attention. Among these cities, Hangzhou, famous for its sites of traditional garden arts, is a strange case because it is definitely a 2nd-tier a city, but some brands give it a special status. Hangzhou's luxury segment is one of the most advanced among 1st-tier cities with retailers including Giorgio Armani, Burberry, Chloe, Celine, Dior, Ferragamo, Gucci, Louis Vuitton and Versace. Some observe even rank it as a 1st-tier city. The key attraction to Hangzhou is that it is among the first places in China to allow direct foreign ownership of businesses. But legal progressiveness is only a small part of the region's appeal. International luxury brands that have chosen to open stores in Hangzhou are enjoying a steady stream of shoppers. Hangzhou is known to be very

²⁶"China's luxury consumers: moving up the curve", KPMG & TNS, 2007

fashion-conscious, but also fairly conservative, and thus easily lured by international labels. People in Hangzhou are exceptional because they are among the few Chinese who spend more on fashion than on food.

The 2nd-tier B category covers the east and south coast of China. What we shall pay attention to is that, Suzhou, another wealthy and popular tourist destination near to Shanghai as well as Hangzhou, has long been of interest to various retailers. Wuxi's retail market is currently one of the least significant among the 2nd-tier cities, but has significant potential for growth. The city is attracting increasing interest due to strong retail sales growth and a large market of wealthy residents. Gucci and Emporio Armani have recently opened stores in the city and more luxury retailers are set to follow. Dongguan, to the contrast, though is one of the cities with highest disposable income in China, is a special case that shows no current necessity for luxury brands to set new stores. The geographical position may be the main reason why none of the luxury stores is located in this rich city: standing in the heart of the Pearl River Delta, no more than 60 KM from either of the 1st-tier Guangzhou and Shenzhen, and with the duty-free city of Hongkong is just near by.

The 2nd-tier C covers the coast of Bohai Bay, the area of northeast of China. The two beautiful beachside cities with the income not on the top but large market size based on the population and large quantity of tourists, have the affection to the top luxury brands such as Hermes, Louis Vuitton, Gucci and Cartier.

While 1st-tier cities will continue to remain centers of gravity, those smaller cities will become large enough to justify a luxury footprint. It is expected that luxury consumption in cities such as Qingdao and Wuxi to triple over the next 5 years, and by 2015 consumption in such cities will approach the level of Hangzhou and Nanjing today, which are among China's most developed luxury goods markets. By 2015 luxury consumption could pass RMB 500 million (Euro 62.5 million) in more than 60 cities, compared to just 30 today.

Pomotion

Though brand awareness is gradually catch up with the 1st-tier cities, promotional events are not so likely to held in the 2nd-tier. However luxury brands are investing large sums of money in heavy marketing to not just promote their brand and products but also to inform Chinese consumers about “luxury” and why they should pay a premium for products offered by luxury brands.

Word-of-mouth luxury promotion and advertising through low circulation print media has not proved effective in Chinese 2nd-tier markets, as many people attend those luxury events are just onlookers. However, promotional events featuring celebrities have been proved effective in reaching both aspirational and dedicated luxury purchases. It is a chance to experience a so-called “luxury life-style” and to see products that are not available in the stores yet. Organizers would not feel unhappy about windows shoppers as they expect that in the near future these middle-class shoppers will be able to afford the products.

Companies should be more creative in building their brands, traditional avenues for strengthening a luxury brand, such as glossy ads in fashion magazines, are often less useful in inland China lower-tier cities, where circulation is low and consumers are less sophisticated about luxury products. That is why many companies use a network of point of sale boutiques to strengthen brand identification.

4 Communication

Communication and advertising are always the key issues for branding in any market all over the world. Although China is such a huge market with great complexity and diversity, the communication models in 2nd-tier cities are similar to those used in 1st-tier cities. The challenge is how to apply these affectively in these areas where localization is the key.

Choosing the most relevant information channels to communicate with consumers in these cities is crucial for luxury brands looking to strengthen their position in these markets. Differences are narrowing between tier-1 and tier-2 cities in the way consumers use information channels: print media articles, advertorials and department stores are the three top channels to obtain luxury information and tier-2 cities respondents are as likely as their tier-1 cities counterparts to check information online²⁷.

What values should be passed from luxury brand to consumers through communication? Apart from brand reputation, brand heritage is the second most important factor to be transmitted. It is an important tool to persuade a potential customer, especially in 2nd-tier cities. Brand heritage is more important for consumers who have little understanding of a brand. In other words, when a consumer is not sure yet about the quality of a brand and the value it brings, he/she relies on what is being communicated about the history and tradition of this brand. This highlights the necessity to focus on brand reputation and awareness as a core objective of a communication strategy, especially for luxury brands entering into tier-2 cities markets.

4.1 Formal communication

The traditional communication tools for luxury brands in Chinese 2nd-tier cities are megazines, newspapers, TV and outdoor media, which are normally published or designed nationwide, thus

²⁷ *"Luxury China: market opportunities and potential"*, Michel Chevalier & Pierre Lu, 2010

there are not much difference from 1st-tier cities. What shouldn't be forgotten is that China is still exercising strict control over media content and images. However despite the restrictions, it is not impossible for a luxury brand to communicate its message effectively and successfully.

Press

Through establishing partnership with local businesses, today many famous international fashion magazines already have Chinese version published in mainland market. The most influential of these include *Vogue China*, *Elle China*, *Cosmopolitan China*, *Bazaar China* and *Marie Claire China*. Major local fashion Magazines include *Ruili* and *Xinwei*. Other influential lifestyle publications available include *Tatler*, *Noblesse*, *Vision* and so on. For men there are *FHM*, *Bazaar Men*, *Trends Esquire*, *L'officiel Hommes* and *Men's Uno China*.

Since entering China in 1987 *Elle China* has become widely recognized as the most authoritative magazine featuring fashion, beauty and lifestyle. It is also the best media partner for premium brands to reach young, well-educated and affluent female consumers. Of local fashion magazines *Ray Li* has the strongest marketing system, with showcase terminals nationwide, giving it the most effective regional coverage over markets in region-level cities and above.

Television

Many of the leading international luxury brands – Cartier, Hennessy, Remy Martin, Chivas, Rolex, Chanel perfumes and Dior J'adore – used TV to advertise themselves when they entered the Chinese market. It is noticeable that these are mainly cosmetics or spirits brands, rather than fashion. In fact very few fashion brands have chosen TV as a communication form. The problem is that the huge expense involved makes it uneconomic for fashion brands which, in any event, can benefit from the free TV news coverage of fashion shows and other promotional events.

Outdoor media

1) JCDecaux

The company's Chinese business begins at 2005 and now spans 22 cities, including Hongkong and

Macau, creating the largest and most diversified outdoor-media network in Greater China, covering metro, bus street furniture and campus advertising.

2) Floating advertisement

The Vega company offers a new advertising form – boats carrying a huge double-side LCD screen which runs advertising day and night on the rivers. An established image of luxury, romance and enjoyment and floating advertising has the potential to work well for luxury brands looking to enter the market.

3) Focus Media Group

Founded in 2003, the Focus Media Group provides a special advertising platform based mainly on LED in public places, such as shopping districts, entertainment and social venues and mobile phones. It has some 112,000 flat-panel displays reaching middle-class and affluent individuals in over 90 cities in China²⁸,

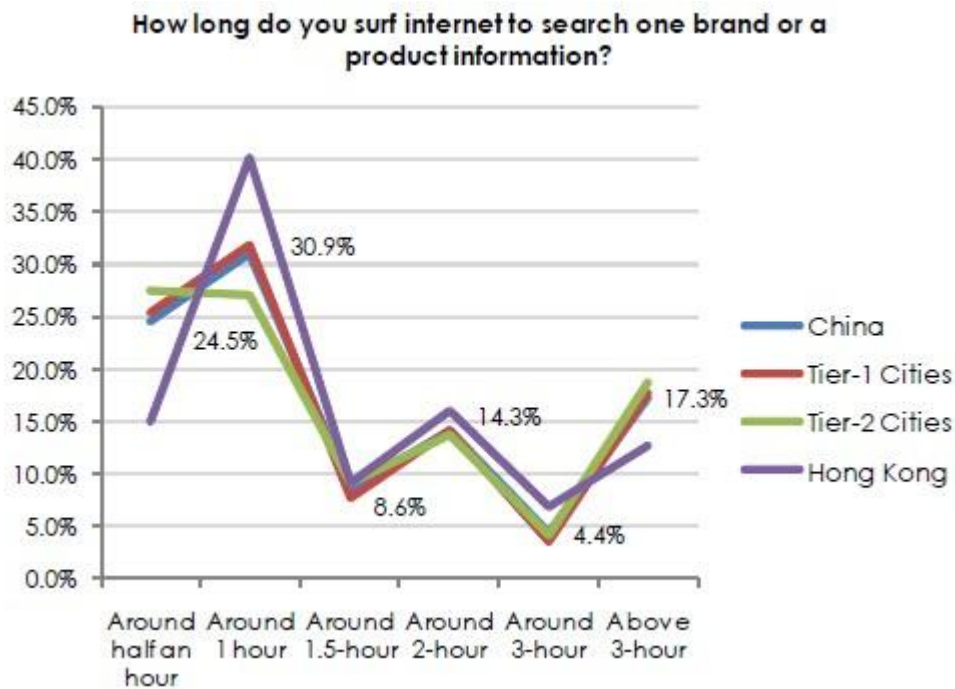
In both tier-1 and tier-2 cities, most consumers are more likely to receive information about luxury brands and products through articles in print publications. This emphasizes the importance of print media and makes a contribution to PR as compared to advertising. Advertising, which faces more mass online users, cannot guarantee strong return in the luxury field, which is targeting a niche market, while public relations can be used to engage consumers through traditional and new media, and also to increase luxury brands and products visibility.

4.2 Internet

More than a third of Chinese consumers use a substantial amount of time looking for information online. In 2nd-tier cities the figure is over 25% of consumers spend half to 1 hour and near 20% spend 3 hours or more, which means that consumers are becoming more rational in choosing luxury goods and more willing to carefully browse through various resources. The implication is that there is room for more in-depth information about brands and products to be placed online.

²⁸ *“Luxury China: market opportunities and potential”*, Michel Chevalier & Pierre Lu, 2010

Figure 4.1: how long it takes consumers to search one brand or product information on internet²⁹



As a matter of fact, not a single global Internet commerce or media leader (e.g., Ebay, Yahoo!, Amazon, etc.) has a leadership position in China, calling attention to the need for local digital marketing strategies. International social media platforms Facebook, Twitter and YouTube remain blocked in China for political reasons. Thus it is dominated by instant messaging platform, QQ and associated site Qzone, Facebook equivalents, RenRen and Kaixin001, and video sites: YouKu and Tudou. Homegrown giant Baidu rules search, occupying 62% market share.

A research by Doug Guthrie, Dean of the School of Business at George Washington University, indicates that while luxury brands are eliciting thousands of user-generated comments, video uploads, blog posts, and photos on popular Chinese SNS sites, very few brands are interacting directly with consumers on the sites. Even user-generated uploads suggest a dearth of localized Chinese digital assets as more than 50% of the estimated 125,000 videos uploaded on YouKu associated with brands studied are in English.

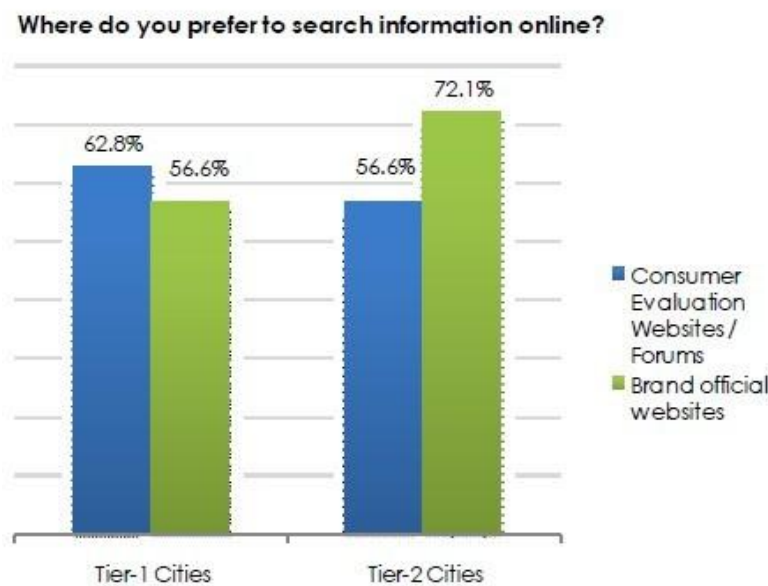
Some digitally savvy brands are beginning to engage directly with users on SNS platforms.

²⁹ "China luxury forecast", Albatross global solutions, 2009

Mercedes-Benz, Audi, and BMW host contests on RenRen, while Dior has a page on Qzone. Lancôme boasts an official group on Kaixin with more than 250,000 members. Brands like Hugo Boss, Ferragamo, and Ermenegildo Zegna have pursued aggressive retail expansion strategies, including building stores outside of 1st-tier cities, but generate limited buzz online. Meanwhile brands including Chanel, Givenchy, and Yves Saint Laurent have a limited retail presence on the Chinese mainland but generate substantial fan discussion on popular social networking sites.

While user-generated contents and social media play an ever increasing role online to influence consumers' purchase decision process, the brands' official websites can't be ignored. Especially in 2nd-tier cities, 72.1% of respondents consider them as their preferred information channel for luxury brands³⁰. Consumers could enhance their tastes and get satisfaction through the navigation of the brand website, which can't be replaced by other websites such as consumer evaluation websites or forums. Unlike more mature markets, where luxury brands are clustered together in a digital arms race, some digital advanced brands in China are developing what looks to be a nearly insurmountable lead, building large online communities, transacting with customers, and building brand awareness online.

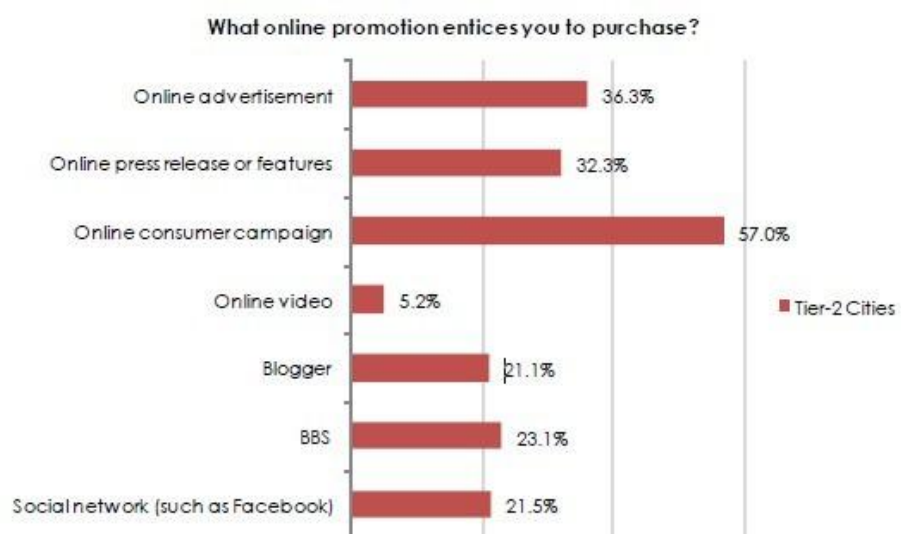
Figure 4.2: where do consumers prefer to search information about luxury³¹



^{30,31} "China luxury forecast", Albatross global solutions, 2009

Online advertising and press release or features are 2 of those effective ways in motivating internet users. But of all the online channels, consumer campaigns proved to be the most attractive one to tier-2 cities' consumers (57.0%), giving hints that they are even more efficient in tier-2 cities than in tier-1 cities. Online advertisement and press release

Figure 4.3: what online promotion entices consumers to purchase³²



4.3 In-store experience

Delivering exceptional in the store is critical. Indeed, among all of the possible consumertouch points, 44% of the luxury fashion buyers' decision is influenced by what they experience inside the store; trying the product on, talking to a salesperson, and how products are displayed.

The in-store experience shows even more importance in the 2nd-tier cities than in the 1st-tier ones for luxury brands. According to the report mentioned in 3.4, this shows more importance in 2nd-tier cities than in 1st-tier ones. 64.5% of respondents in tier 2 cities said they sourced their information on luxury goods from leading department stores, 15% more than in tier 1 cities. In addition, 61% of the respondents said that a salesperson's attitude would influence their

³² "China luxury forecast", Albatross global solutions, 2009

purchasing decision while 54.6% said they would make a decision after carefully listening to the advice of sales staff.

Figure 4.4: where do consumers get info about luxury goods³³

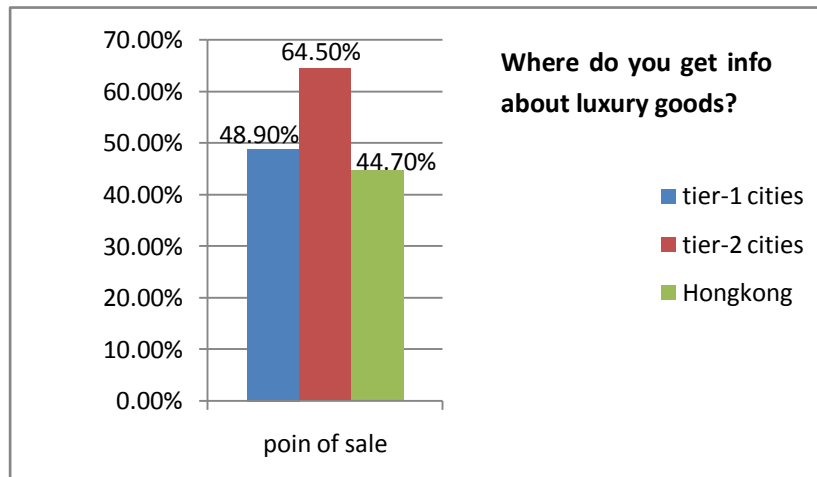
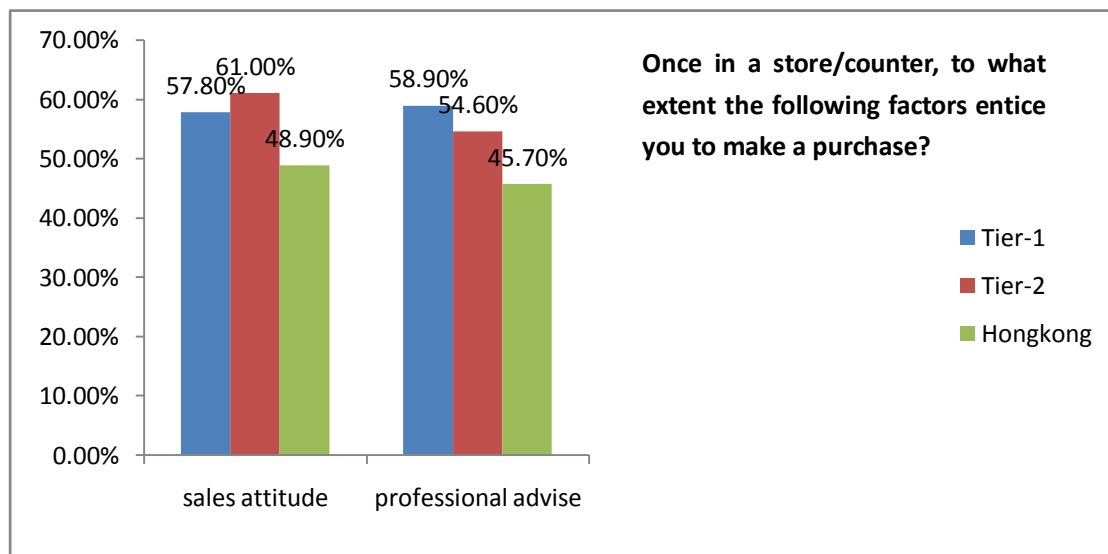


Figure 4.5: what factors entice consumers to make a purchase in a store³⁴



Sales staff can be an extremely powerful tool – with the ability to not only inform consumers of the benefits of their brand, but sway them towards making a purchase. Sales staff should be familiar with the latest fashion trends, exhibit exceptional levels of patience with Chinese shoppers who prefer to linger in the store, and are helpful without rushing customers or applying

³³³⁴ "China luxury forecast", Albatross global solutions, 2009

sales pressure. Louis Vuitton is one brand that has figured this out. They assign a specialist to spend time educating luxury shoppers about such things as the story of LV's founding, the company's deep European roots, and the way they handcraft leather goods. To ensure that specialist focus on their task of impairing the brand's heritage, their compensation is not tied to store sales.

Impulse purchase accounts for a substantial percentage of sales for brands such as Louis Vuitton and Gucci. Attracting impulse purchasers requires tactical decisions about location, design of window displays and product availability. Sales staff should be able to guide the customers to the most appropriate products within his or her price range. They should also be able to help customers select gifts for business associates and friends. Most consumers rely on sales associates to explain a brand's value proposition. The staff should be trained to compare their brand's features favorably with those of competing brands.

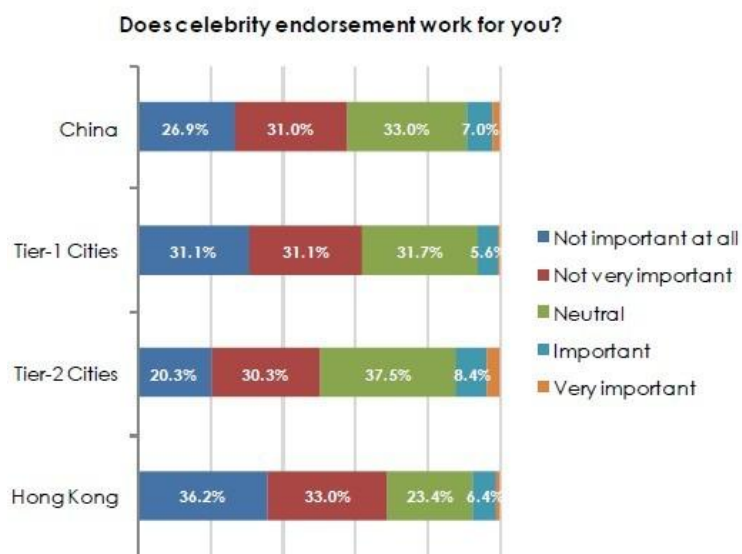
Many luxury brands are building up their CRM system. Tools include systems to maintain relationship with the travelling consumers, whether they are shopping in Wuhan, Hongkong, or Paris. Top brands are already using their loyalty databases to encourage Chinese customers to invite friends to events and engage more frequently with the brands. Even if the events held in 2nd or lower tier cities where the brands do not have a point of sale (an event is less expensive than opening a new point of sale, after all) it is worth inviting valued consumers to events in nearby cities where they travel. They can also create brand affiliation by placing points of sale in Hongkong, Macau, airports and top mainland cities to attract frequent travelers.

4.4 Celebrities and events

Celebrity endorsement can be a good way to strengthen brand publicity in the short term. But as the survey result shown below, it is not likely to be a direct initial trigger leading to a purchase. It is mainly used to attract media attention while launching a product and to generate media buzz so as to raise awareness, and have impress effect on the way the brand is perceived at beginning.

Survey shows that celebrity affect works better in the 2nd-tier cities.

Figure 4.6: celebrity endorsement's effect on consumers³⁵



Celebrities from show business, sports, or the business world are good presentations for companies in the fashion and luxury industry to promote their brands. Their value comes from creating a positive association between the celebrity and the brand. Compare with Shanghai's overwhelming preference of international celebrities (96.3%) over local ones (82.1%), 2nd-tier cities consumers prefer Chinese faces, including fashion bloggers. This can be used to great effect in China as long as the image of the chosen celebrity is appropriate for the brand. However, the two do not always sit well together.

It does not mean simply putting a famous Chinese face on a luxury brand is going to work. One of the important issues is the consistency of the brand's positioning matches the celebrity values. For example, when a movie star have several advertising contracts in different types and levels at the same time, the value of the star would be confused by its association with other mass-market products.

In addition to general market communications, indoor and outdoor events are extremely effective in helping to retain established customers and VIP clients. Brands such as Zegna, Louis Vuitton,

³⁵ "China luxury forecast", Albatross global solutions, 2009

Cartier, Omega and many others have adopted this method, inviting local or international celebrities, organizing exhibitions and PR activities for clients to maintain and stimulate their interests.

5 Distribution

The traditional entry route for international companies has been through partnerships with local franchises and distributors. Since 2004, China has removed restrictions on the foreign ownership of retail and distribution businesses, so foreign companies no longer have to establish a joint venture to enter the luxury market. There is a growing willingness to invest directly in China's luxury and retail sectors, but distributors and joint venture partner can still play a valuable role in helping develop a brand's presence, especially in Chinese 2nd-tier cities that the market conditions are less familiar.

5.1 Counter in department store

The first thought about entering a country for many brands is to let major department stores acquire and distribute the brand. The brand will solicit leased counters located in department stores and will share the profits with the department store. The company is responsible for deciding the retail price and providing the goods. The department store is responsible for selling goods, issuing invoices and resolving customer complaints regarding defective goods.

This system has the advantage of being cheap, secure and easy. As a first step, it is possible to see if the brand finds its own consumers base, and to wait for a few years to see how things develop. The problem is that only a few department store companies are strong enough to cover and provide this service in most 2nd-tier and lower-tier cities. Normally it is quite important way for perfumes, cosmetics, jewelleries and watches, while most department stores' positioning does not necessarily suggest it as the ideal entry for very upscale brands.

The Japanese department store Isetan can perhaps bring this top image, but it has only 5 stores – 2 in Shanghai and 1 in each Tianjin, Shenyang and Chengdu. MaisonMode, created in Shanghai in 1994, deals in upscale men's and women's fashion, carrying strong brands such as Gucci and Ferragamo, having 5 stores in Shanghai, Beijing, Chengdu, Chongqing and Xi'an. Other operators

like Guangzhou Friendship Stores, Wangfujing Department Store and Beijing INTIME group all have locations in main 2nd-tier cities.

Although the large luxury shopping centers that have been developed in various cities, they only act as property providers and leasers: they never purchase merchandise. Overall then, the department stores cannot really provide a strong nationwide distribution network in Chinese 2nd-tier market.

5.2 WFOE

In recent years, as the business landscape in China has become more open and transparent, many companies have fully acquired their retail operations in China. For luxury brands that want to retain strict control over management and intellectual property, and whose expansion plans might be less dramatic (in terms of actual numbers of outlets), operating directly through a wholly foreign-owned enterprise (WFOE) is an increasingly and feasible option. This approach has been pursued by many of the largest and most high-profile retail brands and groups.

A number of brands have switched to this approach over the past several years, but doing so requires a greater commitment of financial resources and local knowledge of the market. The WFOE also needs to understand how customs declarations were handled under previous distributor arrangement, to ensure consistency

Most western luxury brands have made the choice to not alter their formats when operating in China as they believed that even minor adaptations could seriously damage the parent company's brand and global positioning. Thus Luxury brands are operating mega-store formats (often large stores for the brand) to educate consumers about a brand and aspire a desire for spending in a controlled environment.

Yet, making money in the most developed cities can be challenging, given astronomical rents,

intense competition, and consumers spoiled by the redundancy of competing alternatives. Running retail in 2nd-tier cities, on the other hand, presents huge opportunities – the spending power of consumers in these markets is often on par with those in first-tier cities, but rents are lower, there is less competition, and consumers are more open to new brands.

On the downside, while operating retail is challenging enough in the chaotic landscape of China's 1st-tier markets, the prospect of running retail by “remote control” in 2nd-tier cities is even more demanding and daunting.

5.3 Work with local partners

The opportunity offered by fast growth in 2nd and lower tier cities often leads brands to pursue a franchise/retail operator model in these areas. This decision is also influenced by the challenges of regional variations and the need for strong local relationships to overcome the inevitable operational barriers while jumping headlong into hinterland markets.

Joint venture model allows companies to benefit from the knowledge and resources of their local partners. It continues to be used by large international retail seeking rapid expansion. In many cases several joint venture partners are needed to succeed in different markets. An alternative approach, favored by many brands seeking even stronger penetration in the complex market, has been to work with a distributor and establish local franchises.

The challenge with these approaches, especially in the luxury market, is to find a partner that shares the company's own high standards and values and can execute the branding effectively. Franchising or joint venture arrangements also need a clearly established timeframe and criteria that provide an adequate incentive to the licensee to develop the brand and clear terms for how the two parties might agree to end the arrangement in the future.

Operating as a WFOE is easier in larger cities where third party service providers are available to

provide support, but can prove more challenging as companies expand more widely. As a result, some brands may set up a WFOE model, but still opt for joint venture or franchising arrangements in certain cities.

Dunhill is a good example. It officially entered China in 1993, with stores in Shanghai, Shenzhen and Guangzhou operating through franchise arrangement. The company realized that it needed to take a share of the market with greater control over its products. Today Dunhill directly owned 42 stores across 14 cities while 48 stores in 30 cities continue to operate through franchises.

In China, it's either about retail or franchise retail, which means heavy investment on distribution. The balance between wholly-owned and franchise arrangement requires additional investment to ensure consistency in the retail experience. The franchises are very receptive and they share valuable feedback on the trends in their local market. Developing a good system to reward franchise partners that maintain and exceed high standards helps the brand ensure that product mix and retail experience is consistent across all stores in China. In past 2 years Dunhill has taken over ownership of the franchise outlets in certain cities including Tianjin, Chengdu, Hangzhou, Kunming and Chongqing.

5.4 Outlets

Outlets are comparatively new to Chinese market. Some luxury retailers indicated that outlets did not at present form a significant part of their plans for China. However others saw them as a cost-effective means of disposing of over-stocked merchandise and generating cash.

This new retailing practice grew rapidly after that, bringing together hundreds of shops under one roof, usually outside a main city and near large expressway interchanges in China, rather than in expensive city center locations. According to CITIC Securities, China now has more than 200 outlet malls across the country. However, there are only 10 that meet international standards. Lack of ability in attracting top brands is the biggest challenge facing those mall operators.

Outlet operators are also stepping up plans to enter China's 2nd and 3rd-tier cities. Last year, several outlet malls were opened in Hangzhou, Changsha, Zhengzhou and Ningbo. European retailer Retail Detail Merchandising (RDM) announced in January the company will invest 6 billion RMB to establish five outlet malls in China over the next five years. The company's first mall was open in Tianjin in May 2011.

5.5 E-commerce

The passion of buying luxury products online in 2nd-tier cities has caught up the average level. Though 2nd-tier cities consumers prefer the in-store experience, the absence of luxury stores in their cities is why they choose to buy online. The average willingness of 40% means great amount of potential sales for those luxury goods e-commercial sites, regarding the huge population base in 2nd-tier cities.

Figure 5.1: willingness of consumers to purchase luxury goods online³⁶



³⁶ "China luxury forecast", Albatross global solutions, 2009

Traditionally luxury brands do not like to offer their products directly online for fear of diluting their brand. While the size of the total e-commerce market in China quadrupled from 2006 to 2009, only ten of the luxury brands boast sites that are e-commerce enabled. The beauty and skincare category has been among the first to entertain e-commerce. Fashion brand and China first-mover Ports 1961 is one of the few foreign brands outside of the beauty industry that maintains an e-commerce site in China.

Many luxury brands today are finding great opportunities in establishing an official presence even on consumer e-commerce sites such as Taobao, which handled online transactions worth around RMB 400 billion in 2010. Luxury marketers are finding that their goods are being sold there anyway, and are establishing official Taobao sites that enable them to exert greater control over how their brand is presented online, even if they aren't likely to generate substantial sales. A few brands are making bold moves, such as Armani, which in Nov 2010 launched a site that allows customers to place orders online.

Several local brands are also early movers: Chinese liquor brand Moutai and Hong Kong jeweler LukFook are the only sites in their categories to transact online. Chinese Beauty and Skincare upstart, Herborist, and Hong Kong fashion house Shanghai Tang also boast e-commerce capability. Shanghai Tang is also the only brand that features a Chinese language version of its iPhone application. In general, local brands struggle to match the buzz of foreign competitors in Social Media and are not as visible to search engines. However, local brands achieve site scores 50 percent higher, than foreign peers, with content that appeals to locals.

Milan based luxury e-commercial website Yoox.com, which sells discount designer fashion online, has selected China as a test market for its standby service, a system Yoox has arranged with FedEx where the deliverer waits at the door in case the customer is dissatisfied with the delivered product and decides to return the item to Yoox. If this service is successful in China, Yoox's largest market, the company will expand the service to other countries.

6 Challenge & Risks of expansion towards the 2nd-tier market

The expansion towards the 2nd-tier cities and inland China has brought tremendous opportunities to the luxury retail industry. Because of the high running expense in the big stores in 1st-tier cities, 2nd-tier ones are becoming the source of profit for these luxury brands. But expansion also brings increase in cost and approach transformation. The challenge and risks cannot be ignored

1) Working capital

Many brands looking to expand in 2nd-tier and 3rd-tier cities are facing a challenge of managing working capital. Luxury companies can tend to have weaker cash management systems than companies in other industries. Regarding the global economic uncertainty, there is a risk of product over-supply either draining cash resources or impacting brand value. The challenge for luxury retailers in China is how to continue to expand their product range and maintain strategic investment growth whilst efficiently managing their cash and working capital.

2) Managing risks

In order to get better distribution channels and the market knowledge of local dealers, as well as to lower operating costs, many luxury brands choose to license to Chinese retailers. This always lead to failure if they could not adequately control their distribution channels so that many brands choose to build dedicated retail outlets of their own and focus on the main stores. However for smaller luxury brands this may not be feasible and using an intermediary may be essential. If this is the case, then it is important to monitor the franchisee close so that the bran is protected and uncompromised at all times.

3) Staff shortage

Some luxury retailers, initially attractive by the low cost of labor in 2nd-tier cities, have struggled because of a lack of local management talent, as the educated and intellectual resources are more concentrated in big 1st-tier cities. There is also a clear shortage of trained staff in sales and service positions related to luxury goods. Luxury brands need to empower their employees to become

brand ambassadors.

4) Ineffective advertising and media

Chinese newsstands are overflowing with advertisements to the extent that most readers barely notice a luxury newcomer. The size of the country is also a barrier of setting a advertising message. Many cities outside of the main commercial centers may have potential customers, but reaching them means you must do something that can be seen directly, for example, Cartier has not only gone to print but also to television as the best choice for developing the Chinese market³⁷. Media costs can be very expensive in China. However it is cheaper in 2nd-tier cities. Complemented by heavy clutter and difficulty in reaching targeted audiences, building brand equity is a costly exercise.

5) Loss of exclusivity

As the income raising and market becoming matured, an increasing number of Chinese people, including white-collar workers and other middle-class groups, are buying luxury goods to reward themselves. As a result, many traditional luxury brands are changing their business strategies to lure them, eschewing exclusivity and welcoming the new source of income. However the positioning should be very carefully livered. Expanding quickly within a vast range like Chinese 2nd-tier cities can bring in the danger of losing prestige and high-end position.

³⁷ "Luxury labels test marketing mix for virgin territory", Media Asia, 2004

7 Conclusion

The so-called “2nd-tier” cities should actually be called “1st-class opportunities,” not just saying the Chinese economy, but also can be used to describe the Chinese luxury market, given the unprecedented urbanization, rapidly increasing incomes of middle class and dramatically transforming of society in these cities. China now has become the second biggest luxury consumption market all over the world. Luxury brands wrest back China market. To keep their China expansion alive, many of the global players are expected to move into China's 2nd-tier cities in the coming years to tap demand there. Rapid development of high-end shopping malls and retail spaces are offering attractive terms to land big-name brands.

Great opportunity comes along with concerns and challenges. On one hand, China is in no way a uniform and homogenous market. Even just within the 2nd-tier domain, the economic and cultural views differ from East to West, from coastal to inland areas. On the other hand, the luxury consumption is experiencing a transformation from just showing-off to revealing identity and personal taste, from impulsiveness to savvy. It is crucial for luxury brands to carefully position and segment their brand and products, and to develop an effective operating strategies to tailor these 2nd-tier cities in rapid expansion.

Considering the social issues and consumer reaction towards different promoting forms, the communication method should be different from Western and Chinese 1st-tier market. The current application of Web-based marketing is the most effective channel to reach Chinese consumers.

When it goes to the distribution, the recent trend is the wholly foreign-owned enterprise (WFOE) model, which enables direct control of their operations, as most brands don't want to share their high profit with others since the luxury market in China. However in Chinese 2nd-tier market luxury brands rely much more on the knowledge and resources from local partners, which as mentioned, due to the social and economic complexity. Meanwhile, the outlets and e-commerce

business are up-coming to take their places in the market. Some brand has chosen 2 or more channels during expansion. Anyway, brands examine the challenge from all angles, create the model that best fits its brand identity, opportunity, and risk profile. It is also necessary to iterate and adjust their strategy to suit the changeable landscape of this fastest-growing market.

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