

MICHEL CHEVALIER & PIERRE LU

FOREWORD BY SIDNEY TOLEDANO, PRESIDENT & CEO, CHRISTIAN DIOR COUTURE.

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LUXURY CHINA

MARKET OPPORTUNITIES AND POTENTIAL

MICHEL CHEVALIER And Pierre Lu

FOREWORD BY SIDNEY TOLEDANO
PRESIDENT & CEO, CHRISTIAN DIOR COUTURE



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This book is dedicated to our wives, Sophie and Qian Qian

FOREWORD

Why a book about luxury in China? Because China will become in a few years the number one market in the world, given its large population and the growing buying power of the Chinese. It will therefore become a very strong market for top European brands.

China will also become for every luxury business the center of their Asian development. In the future, many products will be developed with a specific Asian target or at least, an Asian interest. This approach will integrate as much as possible the desires of clients in Shanghai, Beijing, and Hong Kong.

The Chinese zone will therefore become more than just an important market for French and Italian brands and will become a priority and, in part, a secondary source of inspiration.

Many new ideas and trends will originate from China. It will become more and more difficult in the future to develop products and brands without taking into account what is happening in Beijing and Shanghai, understanding how women in Hong Kong like to dress or how Taiwanese clients or even Chinese people living abroad view sophistication, fashion, and luxury.

As indicated in this book, it is obvious that China is becoming more than just a luxury market. It will develop into a major source of new brands and new products. In the long run, China will probably become a major supplier of new ideas, new talent and new brands in the luxury field.

This is why Christian Dior considers China as a major market and approaches China from a product side as well as from a creative side. A clear indication of our interest in Chinese creativity is the recent exhibition held by Christian Dior at the Ullens center in Beijing. We asked major Chinese artists, painters, sculptors, photographers and plastic specialists to give their interpretation of the Christian Dior brand using its dresses, its aesthetic values, its 'iconic accessories' and the ambiance of its boutiques as sources of inspiration. We asked the artists to share with us and with the general public what makes Dior a synonym for luxury.

What gives Dior this unique aura is a very special combination of passion for elegance and the never ending quest for contemporary beauty. This quest is a major source of creativity for the House of Dior and China is, without doubt, a source of inspiration and challenges.

The merit of this book, *Luxury China*: *Market Opportunities* and *Potential*, is that it is the first one to clearly indicate and to substantiate the fact the China has become a priority for the most dynamic brands and it gives very clear indications about the way in which the market should be developed.

Sidney Toledano

President and CEO Christian Dior Couture

INTRODUCTION

Luxury china? Why do we believe there is a need for such a book? Let us explain what we mean by Luxury China.

A luxury product has to have a strong artistic content. It must be the result of craftsmanship; and it must be international. The *raison d'être* of a luxury brand is to be selective and exclusive. But how exclusive and how selective? For us, Lacoste and Hugo Boss are luxury goods because they provide sophisticated fashion products in an environment which generally remains controlled by the brand owner for sales in self-standing stores, department stores and multi-brand stores.

Is *luxury* very different from top *fashion*? For some analysts, the two terms are quite different: a textile and accessories brand, for example, might start out as a fashion brand and would only be given the status of a "luxury" brand when it has achieved some stability and a quality of "timelessness." According to that view, a new fashion brand has to be creative and come up with new ideas, new concepts and new products for every season, in order to attract the interest of the consumers. However, as it develops "classical" models that sell year in and year out, becoming permanent best-sellers with a signature style, its status will move from fashion to luxury. While this distinction between fashion brand and luxury brand is a valid one, it is misleading and possibly even dangerous. It is misleading because even if it has achieved "luxury" status, a fashion brand such as Chanel or Dior must still come up with new designs each season, and present them in new ways, in order to retain customers' interest. It is also dangerous because it implies that a luxury brand does not have to innovate to the same extent as a fashion brand. which obviously is not the case.

But at this stage, rather than pursuing this theoretical discussion of the most adequate definition, it may be more productive to describe the different sectors of activity that we will be examining here, as follows:

- The exclusive Ready-to-Wear category, for women and men, which includes, of course, all the selective fashion brands such as Chanel, Valentino, Burberry and Versace; the more traditional brands such as Lacoste and Hugo Boss, as indicated above; and also Ports 1981, which is quite selective in its approach to product and distribution, particularly in China.
- The luxury **jewelry and watches** segment is clearly part of this world and is very important in China.
- **Perfumes and cosmetics**, when sold through selective distribution channels, are clearly luxury products, even if they correspond to low-priced items.
- Fashion accessories brands are run as sister brands of fashion brands. This category includes handbags and leather goods, and also shoes, belts and any other element of a woman's total "look", such as glasses, writing instruments, lighters and so on. For men, it also includes ties and shirts and other elements of their wardrobe.
- Wines and spirits are the only examples of luxury products available in supermarkets and food outlets. But the product concept and positioning of wines and spirits require a level of sophistication that sets these products apart and makes them an important part of the luxury sector.
- While luxury automobiles, luxury tourism and private banking are also clearly part of this luxury category, we will not address them directly in this book because they require very different distribution strategies.

In this book, our definition of "China" is, for the most part, restricted to the mainland, which requires quite different distribution and promotional tools from those used in, say, Hong Kong, Macau or even Taiwan.

But why address the topic of luxury in mainland China at all? The answer is simple enough: in the last decade China has become a very major economic power, with an annual growth rate in the region of 10% and, allowing for differences in Purchasing Price Parity, will soon surpass the United States in the volume of products it manufactures and services it delivers.

For luxury goods, China has certainly become a very important market, as we discuss at length in Chapter 1. As Bernard Arnault said in November 2005: "We knew [China] would someday be the biggest market in the world. Whether it would be in 20, 30, 40 years, it was irreversible."²

So, in what sense is this a challenge? China is a very difficult market. It is the most populous nation in the world, with 57 cities of more than one million inhabitants. Where do you start and how do you deal with such a powerful and diversified country when you want to begin distribution operations here? As we will see in chapters 2 and 3, while Chinese consumers are very interested in luxury products and major luxury brands, it takes time and money to convince them that they should buy a given brand rather than another.

Is it easy to be profitable in China? If large brands have a relatively easy time of it, medium brands undoubtedly find it more difficult to build the necessary volume to offset the minimum costs of operation and of advertising and promotional investments. And smaller brands face the difficult challenge of investing in brand communication and awareness to be able to gain a foothold in this huge market. But profitability is only one part of the issue. Given the very impressive growth of the luxury market in China, a brand

must invest heavily in new stores, new inventories and new accounts receivables to keep pace; and even for profitable brands, major cash injections are often required to increase their local investments.

But the challenge is not merely financial and economic. Developing Chinese activities requires a strong understanding of the way business is conducted and of the basic cultural values and reactions of 1.4 billion inhabitants.

Our regular contact with foreign brands operating in China and with Chinese brands planning to expand their operations worldwide has prompted us to describe in depth this very specific market and to give indications of the best ways to operate. The opportunities on offer in this rapidly expanding market are such that it deserves very special attention and very special investment.

We believe this book will be useful both for executives already operating in China or for those looking at opportunities to start activities here. But it is also addressed to all analysts, journalists and scholars who are interested in luxury brands in general and in the Chinese market in particular.

The objective of this book is to give a better understanding of the Chinese luxury market. We provide a general analysis of the Chinese market and its potential, and describe what we consider the key to successful operations in China. The first chapter deals with the market size. This has not been an easy chapter to write because in this huge country, information is sparse and difficult to obtain. But we wanted to give an idea of the market potential and see if the economists and journalists who are presenting China as the second luxury market in the world, behind Japan, are right.

The second and third chapters describe the Chinese consumers. In Chapter 2, we have gathered all existing information about customer spending power and purchasing behavior. We have shown who is buying luxury goods and to

what extent each customer group develops purchase patterns. We have focused particularly on the up-and-coming middle class which, in China like in every country in the world, is the primary source of business potential for the luxury market. In Chapter 3, we have focused on the attitudes of Chinese customers toward luxury and on how the purchase of expensive luxury items fits with traditional Chinese culture and accepted standards of behavior.

In Chapter 4, we explain the different ways to enter the Chinese market, be it through a subsidiary or, at the beginning at least, through a distributor. In a market which is changing very fast and which is very new to the luxury business, we felt it was necessary to explain who the major distributors and professionals of the market are. Chapter 5, outlines the considerations for retailing and licensing in China.

In Chapter 6, we examine what makes China different from other countries and concentrate on the specific communication tools that are the most effective there. In the last chapter, we speak about brand and design registration systems in China, of brand protection and of the best ways to curb counterfeit activities which remain an important area of concern for major brands.

At the end of each chapter, we present a business case of luxury brands operating in China. The aim here is to show different approaches to the Chinese market and to communicate how the diversity of situations and market positions fit into that complex luxury market. The case studies have all been written from outside sources and with no specific arrangements or agreements with the brands concerned. In each case, we describe the brand's major achievements to date and discuss the specific business challenges and opportunities.

One of these case studies deals with Louis Vuitton, which is probably the leading luxury brand in China. We describe

its positioning and its retail strength and the way it has learnt, over time, to deal with the Chinese consumer. But if there is a lot to learn from big success stories, it is also important to describe cases of brands that are not so successful at the worldwide level and this is why the Alfred Dunhill case finds its place here. A masculine brand, which has done well in the United Kingdom and in Japan, it started very early in China, and is moving up rapidly. The issue here is what it should do next and how this may change the company focus at the worldwide level.

We have also decided to present Chinese brand cases, because we believe China will, in the long term, be a major source of luxury brands. The first of these studies concerns Shiatzy Chen, a brand originating from Taiwan, which has worldwide potential, provided it can develop strongly in mainland China and is able to adjust its product offerings to the needs of an international market. Liuli Gongfang, which might be described as the Chinese equivalent of Daum, is another case in the same category. Also originating from Taiwan, it is very strong in mainland China.

Three other cases offer a mix of Chinese and worldwide activities. In "The War of the Spirits," we look at the competition between major foreign alcohol brands and local traditional Chinese products. The Rolex case study examines the brand's position in a market where Omega has established an extremely strong success story. Shanghai brand created by a Hong Kong Chinese Tang is a businessman, with a Shanghai label, belonging to the Richemont group, and managed from Shanghai by a French executive. This brand conveys a strong Chinese image, but one which is somehow internationalized and geared almost exclusively to foreign customers through establishing a very upscale European style, while maintaining a strong Chinese outlook.

In the appendices, we provide details of all the major cities, with special profiles of Beijing and Shanghai. There are details, too, of magazine audiences, of television channel ratings, of city sizes, that are necessary to operate in China and which we hope may become an indispensable handbook for the Chinese luxury executive.

If this book convinces the reader of the real opportunities of the Chinese market for luxury brands and conveys the diversity of winning marketing strategies to establish a brand in China, we would have met our objectives.

What is certain is that a luxury brand which is absent from, or has only a weak presence in, the Chinese market in 2015 or 2020 will simply no longer have claims to being a worldwide brand.

ENDNOTES

- <u>1</u> For this discussion, see Michel Chevalier and Gérald Mazzalovo's *Luxury Brand Management: A World of Privilege*, John Wiley & Sons, 2008.
- 2 Quoted in Thomas (2007): 306.
- 3 Christopher Zanardi Landi, the CEO of Louis Vuitton in China, has been quoted as saying that the company has "never lost any money in any store in China" (see Thomas, op. cit.: 306.)

CHAPTER 1

Challenges and Market Size

To understand the challenges of luxury activities in China, one must look at the total size of the business worldwide and then, for each sector of activity, analyze the size of the Chinese market.

While many economists believe that China is the third-largest luxury market in the world, after the United States and Japan, the situation for individual brands is quite different. For example, for Italian fashion brands, Italy remains the primary market, with Japan in second place and the United States in third. When China develops, it will become fourth or fifth. For French fashion brands (with a few exceptions such as Louis Vuitton) the French market remains number one, with China often in fourth or fifth place—which is already quite a performance. For the industry as a whole, Korea is also very strong and profitable, as soon as a critical mass is reached, constituting the fourth-largest market for many brands.

A 2006 study by IPSOS, Paris found that the Chinese market is the fourth-largest in the world behind Japan (40%), the United States (20%) and Europe (17%). Of course, the figures need to be treated with some caution because they appear to be related to the ready-to-wear area rather than considering the luxury market as a whole. Nevertheless, they do give an indication of China's importance in the field.

In global terms, Chinese economists used to include the figures for Hong Kong, Macau and Taiwan in their analyses. These three markets have been developing now for almost

30 years and have reached very high volumes and a high degree of sophistication. Hong Kong's duty-free status enables it to benefit from a large number of tourist purchases, particularly from Japanese and American nationals. Taiwan, while not a duty-free territory, has limited duties and also constitutes another large market of luxury products sold to domestic customers and tourists.

So, when these three territories are included, China is the third- or fourth-largest luxury market in the world. However, it is also important to note the incredible growth that luxury products are experiencing in mainland China.

Also, one should add to such figures the market potential presented by Chinese tourists purchasing luxury products abroad. In 2006, some 35 million mainland Chinese traveled abroad and it is estimated that this figure will reach 100 million by 2015.

To understand the situation one has to start with an evolution of the general worldwide market before studying the specific market situation in China.

The size of the global market

A recent study places the value of the worldwide luxury market at close to US\$265 billion at wholesale or corporate value. A breakdown by category is shown in Table 1.1.

TABLE 1.1: Value of worldwide luxury market by category, 2008 (US\$)

Ready-to-wear	30 billion
Leather goods and accessories	24 billion
Fragrances and cosmetics	41 billion
Spirits, champagnes and still wines	107 billion
Watches	16 billion
Jewelry	40 billion
Others (including Tableware)	7 billion
Total	265 billion

The size of the Chinese mainland market

A breakdown of our estimates of the figures for the Chinese mainland market is given in <u>Table 1.2</u>. The estimated amount of US\$15 billion, representing 5.5% of the worldwide market, is very much in line with the figure of US\$6 billion produced by the investment bank Goldman Sachs for 2004, taking into account the present growth rate of luxury goods in China, which, for all luxury categories, can reach 25% a year.

TABLE 1.2: Value of luxury market in mainland China by category, 2008 (US\$)

Ready-to-wear	1.5	billion
Leather goods and accessories	1.6	billion
Fragrances and cosmetics	4 bi	llion
Spirits, champagnes and still wines	4 bi	llion
Watches	1.3	billion
Jewelry	1.3	billion
Others (including Tableware)	1.3	billion
Total	15 k	illion

If the figures for Hong Kong, Macau and Taiwan were included, the total for 2008 would probably amount to US\$27 billion, or 10% of the worldwide market, but this figure would be skewed by double counting (many products sold in mainland China are imported through Hong Kong and may have been registered at export prices in Hong Kong and then at wholesale or retail prices on the mainland).

While we have mentioned an estimated average yearly growth rate of 25%, the actual figure is very difficult to come by because it depends very much on the subcategories of luxury products that we may consider.

What is known for sure, however, is that many "iconic" brands were growing at around 30% in their existing stores and were expanding the number of stores by about 20% each year between 2001 and 2007. Together, they provided

an additional annual sales growth of 50%. If they wanted to maintain their market position, and if they compare themselves to Prada, Louis Vuitton, or Gucci, they had to invest and keep growing at this rate.

Even if the current growth rate decreases, mainland China's share of the luxury market will reach 15% in 2015. Add in Hong Kong, Macau and Taiwan and it will account for between 20% and 25% of worldwide sales. In categories like fashion and accessories, China and Japan (with approximately 20% of the world's population) between them will represent 50% of the worldwide volume—a clear indication that what happens in these two countries is essential in this business field.

For the past five years, China has, along with Russia, been the fastest-growing market in the world. But whether it is profitable is another issue, and one we will discuss later in this chapter.

The outlook for different market segments

The analysis must now go one step further and look at each product category.

Fashion and accessories

Our estimates for fashion and accessories are still limited, as we are talking of a total of only US\$2.6 billion. This market has probably been growing from anywhere between 20% and 30% a year and is very much an "El Dorado" for the very top brands.

This is also the only market in the world where ready-towear products for men sell more than ladies' wear. This is of course due to the very keen interest in luxury products among men, and the fact that men control their own budgets, while only women with an active business life have clear financial autonomy.

Brands such as Louis Vuitton, Chanel, Gucci and Salvatore Ferragamo have different profiles. Louis Vuitton has 21 stores, Chanel three stores, Gucci 17 stores, and Salvatore Ferragamo 23 stores. Other brands which are perhaps not very well-known in Europe (the Canadian brand Ports 1961, for example) are developing very rapidly.

In fashion, the merchandise sold in the various stores is very dependent on the profiles of their clientele. In China, men are buying more often than women. This is why in the merchandise mix, accessories form the majority of sales, and in ladies' fashion, simple tops are purchased more often than sophisticated dresses. However, as men may buy fashion goods from the same brand from the same store at the same time for their *tai tais* (wives) and for their *er tais* ("second wives"/girlfriends)—a traditional style for one and a flashier look for the other—there is a need for very diversified merchandise.

The fact that men are important customers for luxury products to an extent that is rare in other countries provides an additional opportunity for men's lines. The clearest case of this is Ermenegildo Zegna, whose 52 Chinese stores (including franchises) make China one of its most important markets.

Another problem for luxury fashion products in China is that the large price difference between, for example, a branded luxury jacket and a jacket purchased for a few dollars in an open-air market is huge. There is a need for basic training so that the consumer can understand the difference and feel confident about such products. In some cases, for example, the consumers don't want to buy a dress simply because they are afraid of giving it to their local dry-cleaner with a pile of standard dresses.

In the ready-to-wear category, Chinese men (like their Japanese counterparts) like basic colors for their suits, and have a strong preference for white or light-blue shirts. Women are slightly more modern in their taste. They like to use strong colors and have a very strong taste for pant suits over skirt suits.

In the fashion sector, the major brands have no difficulty finding an acceptable balance between growth and cash. Smaller brands, on the other hand, don't find it very easy to develop. If they want to operate their own stores, they must have a presence in Shanghai, Beijing and Guangzhou at least. If they want to be known by Chinese customers, they have to advertise and organize public relations activities and, perhaps, special fashion shows without any guarantee that this will produce an immediate increase in sales.

Fendi's solution to this problem was to organize an event that would both raise its profile in China and be large enough to be seen and mentioned around the world. The fashion show it organized on the Great Wall in December 2007 certainly had a great impact in Europe, the United States, and Asia.

Department stores provide another avenue of operation, although the set-up is perhaps not ideal for top-range luxury brands. So many brands have flagship stores in Hong Kong or multi-brand store activities and are still considering whether it is worthwhile setting up on the mainland. Distributors such as Bluebell, which had developed activities for fashion brands in China, pulled out once they realized that it would take them a very long time to make any money. Uncertainty continues over whether their "principals" would be willing to sign distribution agreements that could start with a prolonged period of losses and without any guarantee of long-term profitability.

What is striking in China is that many medium-size international fashion brands have a very limited visibility or

are absent altogether. Rather than finding diversity, one is confronted with a few very large brands, trying to be as powerful as possible. In the long run, this may be a problem because it is its diversity, its difference and its creativity that makes fashion interesting.

Wines and spirits

The wines and spirits market in China is not easy to assess as it includes three different product categories. The first of these comprises imported spirits and includes, for example, Hennessy Cognac and Johnnie Walker whisky which are sold though the Diageo-LVMH joint venture and have a strong presence in the clubs and bars. It also includes Pernod Ricard's Chivas and Royal Salute whiskies and Martell cognac. Rémy Cointreau also has a strong presence with Rémy Martin, which for a long time was the number-one cognac in China, but has had to give way to Hennessy, which has invested heavily to promote its product in conjunction with bars and nightclubs.

In this category, too, we must include other foreign companies such as Bacardi or Brown Forman and all their brands, which are also sold in restaurants and nightclubs as well as supermarkets or expensive food-and-liquor stores.

The second category includes wines that have been developed locally in the territory. In 2006, China consumed 495 million liters of wine or around 650 million bottles. This represented sales of approximately US\$1.7 billion. This was predicted to increase to the point where, by 2012, China will be the eighth-biggest wine consumer in the world.

According to Channel Consulting Ltd in Beijing, dry red wines represent 68% of the consumption, sweet red wines 23%, and dry white wine 8%. It is estimated that 65% of wine is purchased in supermarkets, 25% in hotels, restaurants and clubs, 9% in bars and 1% in specialist stores.²

Most of the consumption is of domestic wines. In this very large market, three brands represent half of the total: Changyu (a local brand created in 1914), Dynasty (created by Rémy Cointreau in 1980) and Great Wall (a local initiative started in 1985). Imports represent only 15%, with more than 10% of this coming from bulk wines, mainly from France (40%) and branded in China, often with Chinese names and a Chinese presentation, as is the case for Imperial Court.

A third category comprises domestic spirits, including white liquor (generally made of grains or potatoes and containing over 40% alcohol). The leader in this market is Maotai from the Maotai group.

It also includes "yellow liquor," which is generally brewed from sticky rice and contains between 15% and 18% alcohol.

The final category of Chinese "spirits" is beer, but this product certainly does not belong to the luxury market.

Overall, the market has traditionally been growing at approximately 30% a year.

Watches

Watches are very important in China as they are a product selected by men. It is estimated that 75% of watches purchased are bought as gifts, and generally business gifts. A common arrangement is for men to select the watch they want and for it to be paid for by a business associate. This market, which represents 10% of worldwide sales, is worth about US\$1.3 billion, with an annual growth rate of 20%. This includes products entering from Hong Kong, and licensed watches from the likes of Charles Jourdan, Sonia Rykiel and Bertolucci which are made in China, as well as combination watches that are manufactured and sold locally.

The Chinese luxury-watch market seems to be concentrated in middle-range luxury products. Omega alone commands approximately 30% of the market and is followed by Rolex, Longines, Rado and Tissot.

Perfumes and cosmetics

Unlike their Japanese counterparts, Chinese consumers are interested in fragrances, skin care and make-up. Import statistics for 2006 give a figure of US\$300 million; again, though, a lot of products are manufactured locally under the Dior or Estée Lauder brands, for example.

Before a product can be sold in China, it should be officially registered with the Chinese authorities. This is of course a long process, and it is also quite expensive; which means that before the importer can recoup the registration costs, it must sell a large number of products and be able to sell to many individual stores.

But statistics for Chinese products tell a different story. For 2006 the cosmetics industry reported national sales of US\$14 billion, as follows:

Skin care	40%	US\$5.6 billion
Beauty care (including make-up)	15%	US\$2.1 billion
Hairdressing care and perfumery	40%	US\$5.6 billion
Others	5%	US\$0.7 billion

The difficulty here, of course, is to distinguish between mass-market and selective products. A large part of the hairdressing care and perfumery category, for example, comes from shampoos, which are very far from being luxury items.

There are some 300 cosmetics brands found in China, 80% of which are foreign brands. The market is expected to grow between 10% and 20% per year for the next five years.

Customs statistics show an export value for 2006 of US\$812 million, much of which relates to international