GIANNI, ORIGONI, GRIPPO & PARTNERS

China's Luxury Sector: is the open door about to get wider?

Contenuts

Chinese authorities may soon make another significant step in China's shift from being the global manufacturing hub to becoming the world's biggest consumers market. During a press conference held in Beijing last 15 June, Yao Jian, the spokesperson of China's Ministry of Commerce (MOFCOM) announced the upcoming reduction of import duties on luxury goods. If implemented, this reduction is likely to further boost sales of luxury goods in China and accelerate the achievement by the Middle Kingdom of the title of biggest luxury market in the world.

1. China's luxury market

The potential for further growth in China's luxury sector is immense: the combination of China's 1.3 billion population (of which more than 250 million can be qualified as middle class) with rapidly rising income and disparity in wealth distribution make China the *El Dorado* of luxury brands. A report released by consulting firm *McKinsey & Company*[1] last May contained stunning figures on the current status of China's luxury market and showed a bright future becoming reality at an increasing speed. The main points of such report can be summarised as follows:

- China luxury market is expected to reach an annual turnover of more than Euro 20 billion by 2015, accounting for over 20% of the global market, overtaking Japan as the world's largest luxury market;
- The three categories of products representing the biggest share of China's luxury sector and its future growth are watches, jewels and leather products;
- Western luxury brands are expanding their presence, both in number of retail points and cities/provinces covered, at an increasing speed;
- Luxury consumers in China are significantly younger that their Western peers, with 45% of them having an age comprised between 18 and 34 years.

[1] McKinsey & Company, *"Understanding China's Growing Love for Luxury"*, 17 May 2011.

2. The regulatory and tax framework of China's luxury sector

The retail sector has been subject to a rapid and substantial liberalization, with foreign investors currently enjoying an almost boundless freedom to structure their China operations, in terms of geographical locations, number of retail points and legal structures of the operations.

We provide a summary of the three most common legal structures used by foreign investors in their retail operations in China, with the relevant pros and cons:

STRUCTURE	+	-
Wholly foreign owned enterprise	Rapid set up procedure (in most cases local authorities are in charge of the approval, which approval can be obtained in less than 8 weeks) Wider freedom in managing the Chinese operations	Necessity to build a retail/sale network and client base from scratch
Franchise	Lower costs and business risk	Material risks of IP infringements or frauds by the franchisee
Joint Venture	Possibility to leverage the experience and connections of the local partners (*e.g.*, lower rent costs, smoother relationships with local authorities)	Higher risks of IP infringements Lower degree of freedom in managing the Chinese operations

The second biggest obstacle, after IP infringements, encountered by Western luxury brands operating or interested in operating on the Chinese market is represented by the heavy taxation of luxury products.

In line with the socialist spirit maintained throughout the thirty years of Chinese reforms, the ban on the import of luxury products has been replaced over the time by high tariffs on the imports of such goods, with rates adjusted (increased or decreased), depending on the attitude of the rulemakers in Beijing. Products such as French cosmetics, Italian leather handbags or Swiss watches are subject not only to VAT and consumption tax (similarly to the same products manufactured in China) but also import duties with rates ranging between 5% and 50%.

In order to provide a rough idea of the taxation imported luxury goods are subject to under Chinese tax regulations, we provided in the chart below some examples summary of the three most common[2]:

PRODUCT	Vat[3]	Consumption tax	Import duty	Total[4]
Luxury cars (cylinder capacity ≥4L)	17%	40%	25%	82%
Cosmetics	17%	30%	25 ~ 50%	72% ~ 97%
Yachts	17%	10%	10%	37%
Golf equipment	17%	10%	10% ~ 14%	37% ~ 41%
Leather bag	17%	0%	17%	34%
Jewellery and precious stones (other than gold, silver, platinum and diamond)	17%	10%	8% ~ 24%	25% ~ 41%
Gold, silver, platinum and diamond jewellery	17%	5%	10% ~ 35%	31% ~ 56%

3. MOFCOM's announced measures

During a press conference held in Beijing last 15 June, MOFCOM announced some significant changes, in the direction of a general reduction of import duties on luxury goods. In the same conference, MOFCOM released the results of a survey on 20 luxury brands of different products (*e.g.*, watches, suitcases, clothes, wine and electronics) showing that prices of such products in China are 45% higher than in Hong Kong, 51% higher than in the United States, and 72% higher than in France. These figures have attracted the attention of

[2] The complete list of goods subject to consumption tax is significant longer and the rates vary on the basis of certain factors (*e.g.*, percentage of alcohol in the case of spirits, cylinder capacity in the case of vehicles).

[3] Businesses other than manufacturing activities are subject to business tax instead of VAT. Business tax is a non-recoverable turnover tax imposed in China at a rate ranging between 3% and 5%, or 20% in the case of entertainment activities.

[4] For reference only. With regards to a given product, the calculation of VAT, consumption tax and Import duties varies significantly.

For any further clarifications or research please contact:

Milan

Stefano Beghi
Tel. +39 02 763741
sbeghi@gop.it

Shanghai

Edoardo Agamennone
Tel. +86 18 6216 50157
eagamennone@gop.it

Chinese officials as an increasing number of Chinese travels to Hong Kong or Europe solely or mainly in order to buy luxury goods such as jewels cosmetics or high-end fashion brands. The overall amount of *renminbi* leaving the country each year to be spent in upscale shops and *boutiques* Hong Kong, Paris, Milan or New York is reaching astonishing figures: in Europe alone, Chinese tourist are reported to have spent more than Euro 150 million shopping in 2010. Also in order to drain such outflow of money and boost internal consumption, Chinese authorities now decided to lower the consumption tax rates.

Based on the information released by MOFCOM, in the coming months import duties will be lowered so as to have all rates comprised between a minimum of 2% and a maximum of 15%.

4. Conclusions

Few doubts seem to exist on the fact that China will soon become the most important market in the world for luxury goods. This should occur in 2015, a few years before overtaking the United States as biggest economy in the world by GDP. However, the combination of economic (increasing number of Chinese able to afford luxury goods) and regulatory factors (such as higher compliance and enforcement in the field of IP rights and a reduction of taxes and duties targeting luxury goods) may further accelerate this trend and making inevitable for luxury brands to put China at the centre of their business strategies.