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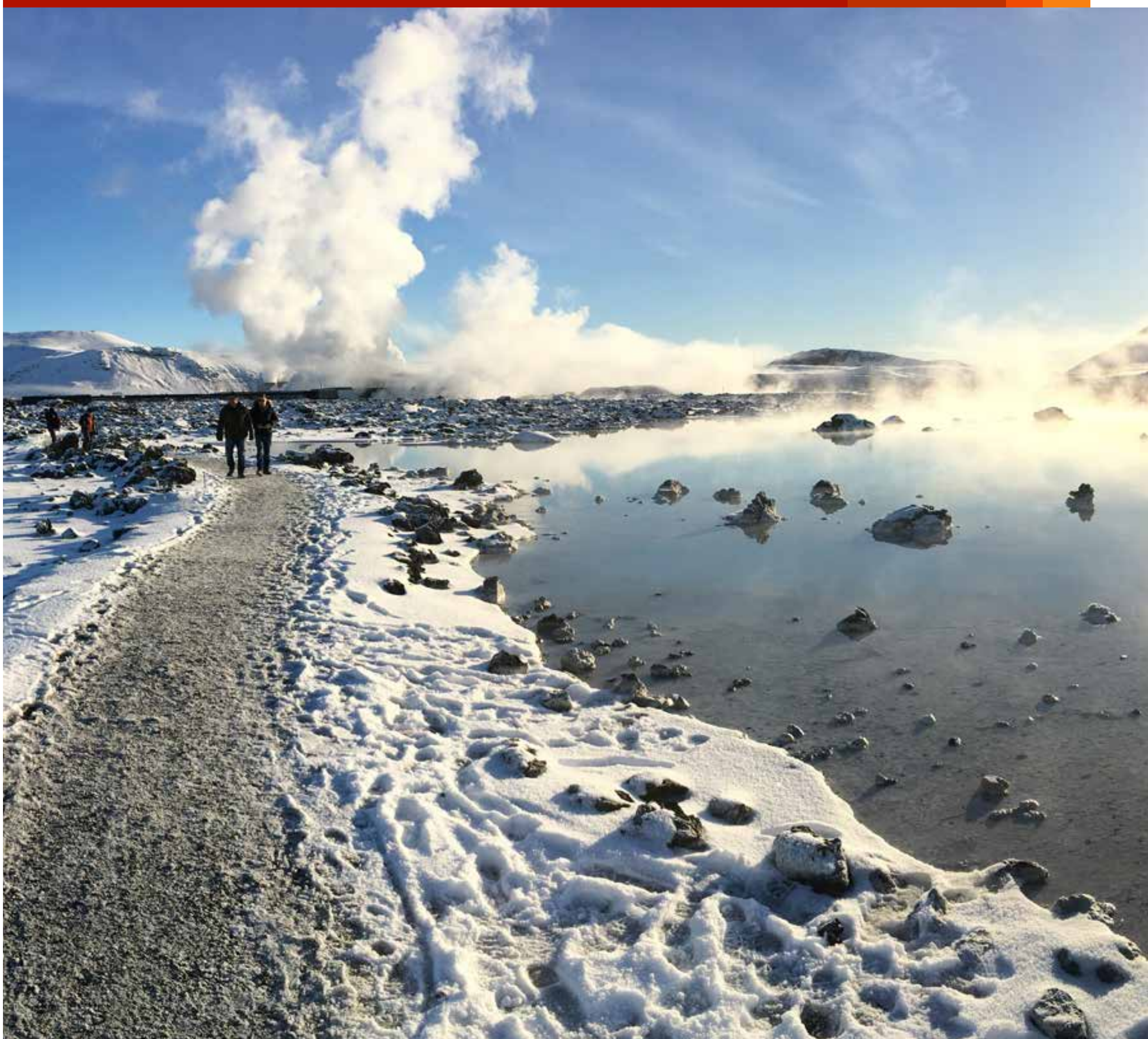
The Disruptive Face of the Retail and Consumer Products Sector in China and Hong Kong

June 2016



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Foreword

The face of the retail and consumer products sector is rapidly changing in China and Hong Kong. This is evident to anyone walking in a crowded shopping district. Whereas previously flagship luxury stores dominated the shopping landscape in Hong Kong, fast fashion and lifestyle stores are increasingly prevalent. The physical face and purchase interface is also changing: younger shoppers can be seen using their smartphones to purchase items online anywhere at any time, or even comparing prices of items while they shop in stores.

This report builds on many of the themes explored in last year's *2015-16 Outlook for the Retail and Consumer Products Sector in Asia*. The focus, however, is exclusively on sector developments in Hong Kong and China. This is for good reason: the pace of change is quickening and businesses are feeling the impact. According to PwC's *19th Annual Global CEO Survey*, 90% of executives in China and Hong Kong are worried about the entrance of new competitors, while 82% of executives view the speed of technological change as disruptive – a testament to the rapidly shifting commercial landscape.

There are numerous sources of this disruptive change. A cyclically-slowing economy in China means that consumers are adjusting their expectations; fewer mainland tourists are coming to Hong Kong for shopping. Structural sources of change, such as demographics and technology, are also rapidly remaking the sector's landscape: the purchasing power of millennial shoppers is increasing, shifting demand to new products that promote life experiences and healthy lifestyles. Technology is permanently changing the way consumers' research and purchase products; businesses are quickly adjusting their marketing, pricing and selling strategies accordingly.

Despite these notable changes, as well as current pessimism, the outlook for the retail and consumer products sector from 2016-2020 is broadly positive. This does not mean that there will not be bumps in the road. But in the midst of disruption, many cyclical and structural factors will promote growth. Industry change will also lead to many openings in the retail and consumer segment as old business models fail and new ones flourish. Disruption can thus be viewed as a key driver of new opportunities, particularly as the economic environment becomes more favourable.

I sincerely invite you to read this report to not only learn more about recent developments in China and Hong Kong's retail and consumer products sector, but also learn how some innovative companies are responding to the challenges.

Michael Cheng
Asia Pacific &
Hong Kong/China
Retail and Consumer Leader

June 2016


JACK JONES
50% OFF SALE
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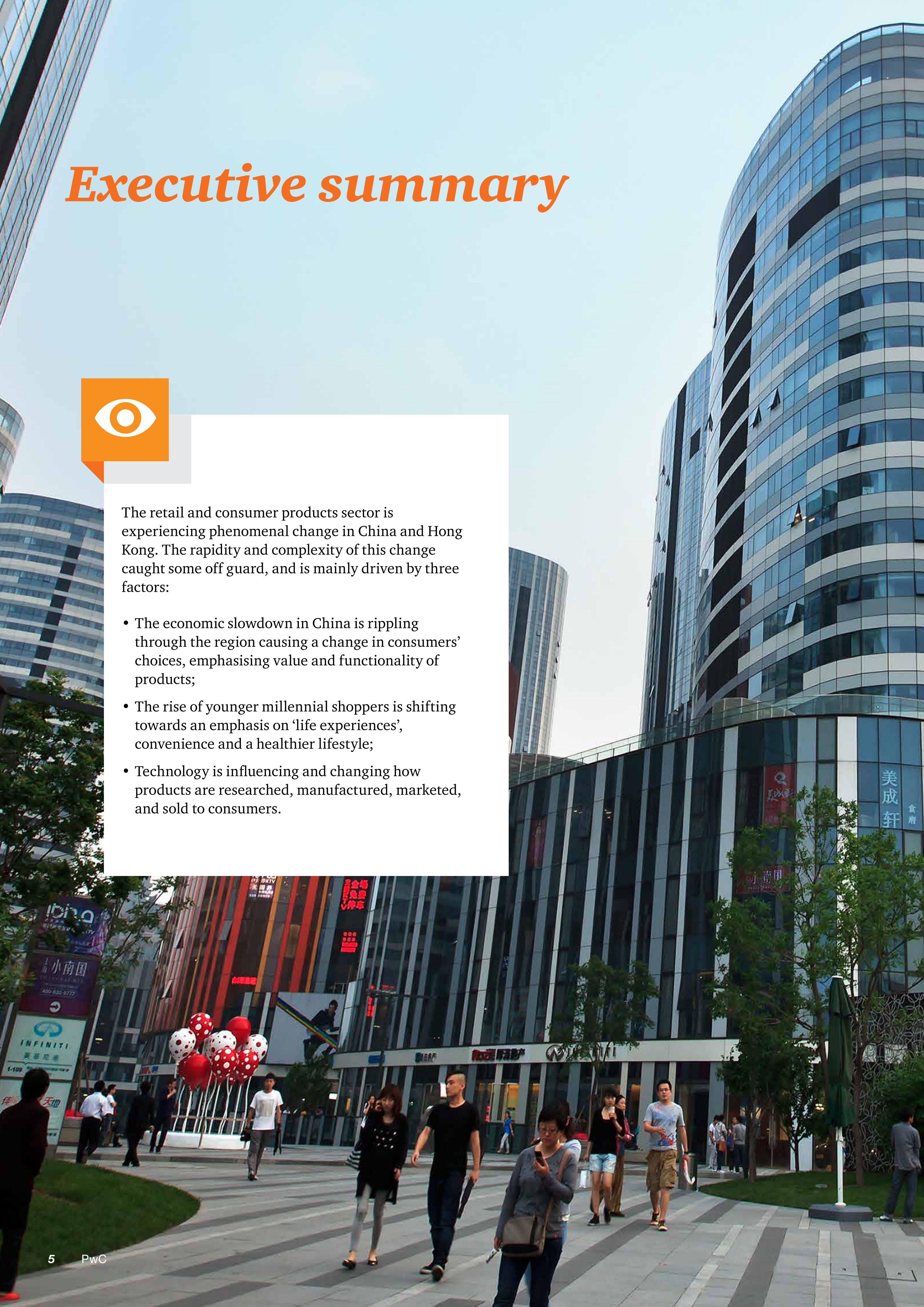


Executive summary

The retail and consumer products sector is experiencing phenomenal change in China and Hong Kong. The rapidity and complexity of this change caught some off guard, and is mainly driven by three factors:

- The economic slowdown in China is rippling through the region causing a change in consumers' choices, emphasising value and functionality of products;
- The rise of younger millennial shoppers is shifting towards an emphasis on 'life experiences', convenience and a healthier lifestyle;
- Technology is influencing and changing how products are researched, manufactured, marketed, and sold to consumers.

As a result, the four segments covered in this report are all going through different phases of transition:

Luxury goods: Luxury sales are slumping due to numerous factors: slower economic growth, the anti-corruption campaign in China and changing Chinese consumers' purchasing habits as an increasing number go abroad to consume, with a sharp reduction in the number of mainland tourists going to Hong Kong. This is causing luxury producers to rethink their strategy, including an expanded online presence and creating 'affordable' luxury products. Sales are likely to gradually rebound as cyclical trends turn positive;

Apparel and footwear: Although growth in the segment has slowed, apparel and footwear sales remain resilient among economic head winds. The rise of 'fast fashion' and 'premiumisation' products, as well as the continued popularity of sports and lifestyle brands with consumers, is redefining the segment and opening up new commercial opportunities;

Beauty and personal care: Sales in personal and beauty care products remain buoyant in China. Younger consumers' interest in personal appearance, as well as an expanding line of beauty and environmentally-friendly products, is likely to promote growth in the segment over the short-term;

Consumer appliances: Sales of consumer appliances are decelerating in China and remain sluggish in Hong Kong. The slowdown is due to the economic slowdown, a volatile real estate market, and a reduction of subsidies for appliance purchases in China. The development of new innovative products, particularly 'smart technology' products that integrate new functionality and user control, may help boost the segment's prospects.

How should companies respond to these disruptive industry changes? PwC offers a number of insights for companies in the retail and consumer products sector to turn the challenges of disruption into opportunities:

- ***Deepening 'coopetition'*:*** New market entrants challenge established business models;
- ***Transformative mergers and acquisitions (M&A):*** Moving up the value chain;
- ***Creating trust:*** A retailer's online presence is not exclusively for selling or marketing;
- ***Data is value:*** Leveraging analytics and the proper use of data;
- ***Increasing corporate social responsibility (CSR):*** The challenge of integration.

* Although ideas similar to 'coopetition' have a long history, particularly in game theory, the phrase was popularised in the business literature by academics Adam Brandenburger and Barry Nalebuff. The idea refers to the notion that competitors in an industry can also cooperate in some aspects to achieve a 'win-win' solution.

Drivers of disruption in the retail and consumer products sector

Although numerous drivers are shaping the retail and consumer products sector, three are particularly significant.

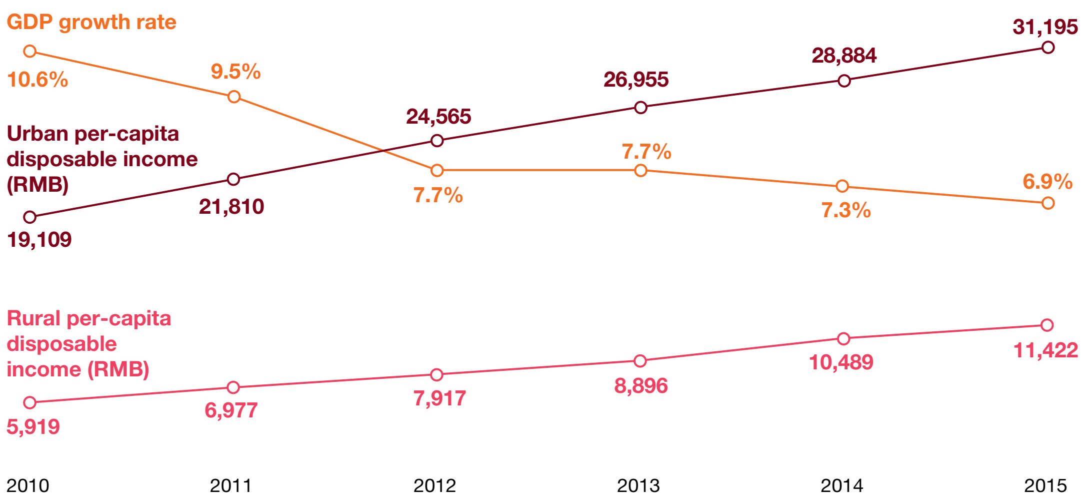
- The cyclical slowdown of the Chinese economy, coupled with a critical structural transition towards greater consumption, is influencing consumers' purchasing choices.
- The changing demographic profile of shoppers is also important: The rise of younger millennial shoppers reflects a shift in personal tastes to emphasise experiences and healthier choices.
- Technology and the shift towards online retailing continues, with more companies in the sector expanding their online presence.

Slumping economic growth

A slowing Chinese and Hong Kong economy is casting clouds over the sector's outlook. While many retailers and consumer-goods companies are adjusting to an environment of reduced structural growth, China's economy registered a 25-year low of 6.9% growth in 2015. The effects of the economic deceleration, coupled with a government crackdown on corruption and a weaker Renminbi (RMB), is broadly affecting industry sentiment from luxury goods producers to big box retailers.

The economic slowdown, however, is arguably positive over the long-term. It represents the economy's necessary rebalancing away from an investment-intensive, export-heavy model to a more sustainable model driven by consumption. Consumption levels are expected to rise: private household consumption as a percentage of GDP has remained roughly stable over the past decade[1]; however, the consumption portion is off a larger economic base, indicating rising personal consumption. At the same time, per-capita disposable income continues to grow both for urban and rural residents (see figure 1). As China already possesses one of the largest middle-class consumer bases in the world, it is likely to increase further even as the rate of growth slows.

Figure 1 **China: Although economic growth is slowing, per-capita disposable income continues to increase, boosting consumption prospects**



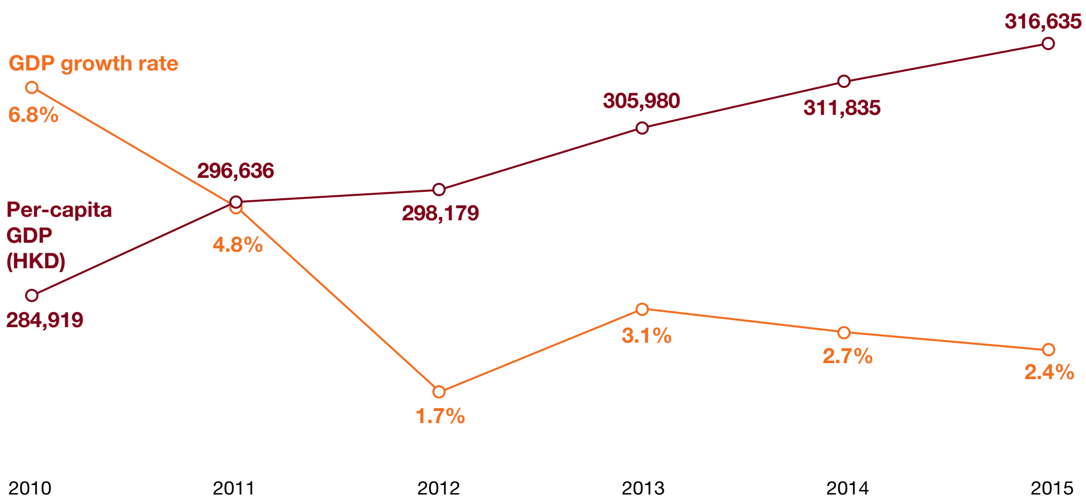
Source: National Bureau of Statistics of the People's Republic of China

1 The World Bank statistics

Hong Kong's economic growth rate is also slowing. Hong Kong's growth rate was 2.4% in 2015, down from 2.7% in 2014. A number of factors are affecting economic sentiment, most notably the slowdown in China, which led a decrease in the number of mainland tourists visiting Hong Kong. The relative strength of the Hong Kong dollar versus regional currencies is also making tourism in Hong Kong, as well as purchasing goods, more expensive. Reduced tourist flows, if maintained, is expected to have a substantial impact on retail sales as tourism accounts for up to 40% of total retail sales in recent years.

Positive structural factors may help mitigate these cyclical headwinds over the short-term. The Hong Kong government's decision to raise the minimum wage in 2015 and initial plans to boost sagging population growth may promote consumption; Hong Kong's per-capita income is rising steadily in an era of stagnant growth. The Hong Kong government's 2016-17 Budget announced matching public funds for technology start-ups, which may boost investment. Regardless of these policies' ultimate success to increase consumption, Hong Kong retailers will be more dependent on the local population to drive retail sales.

Figure 2 **Hong Kong: Per-capita GDP increases in a sluggish economic environment, maintaining consumption momentum**



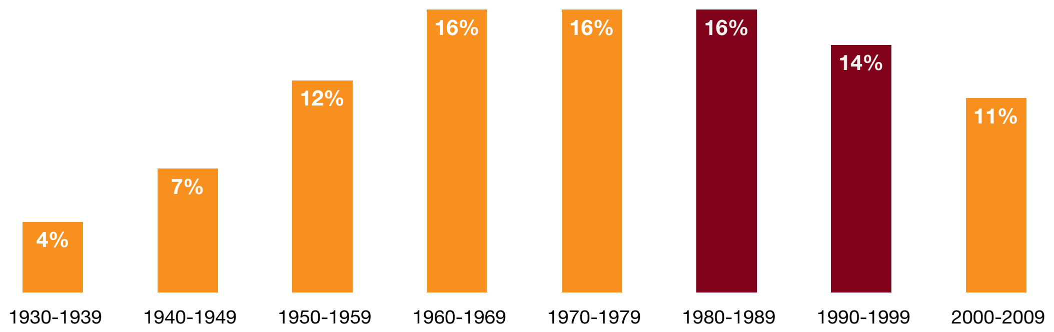
Source: Hong Kong Census and Statistics Department

Shifting demographics and consumer behaviour

The face of retail is also changing due to shifting demographics and consumer behaviour. While an older demographic has traditionally composed the bulk of consumers in China, the shift towards younger, urban, more affluent consumers is leading to changes in consumer behaviour.

According to estimates from Goldman Sachs, 'millennials', defined as those born between the years of 1980-1999 (八零后, 九零后), composed roughly 30% of China's total population in 2014. Although roughly equal in size to other influential demographic groups, the impact of the millennials on the retail and consumer products sector is expected to increase as they move up the professional ladder and boast greater disposable income.

Figure 3 **Millennials compose almost 1/3 of the total population in China (2014)**



Source: Goldman Sachs

The rise of online shopping and payments

The rapid adoption of technology is changing how consumers shop and purchase goods in China and Hong Kong. While media coverage has primarily focused on the migration of retailers online in more developed countries, the online retail ecosystem developing in China is arguably larger, changing faster, with a greater impact on how consumers are purchasing and interacting with brands.

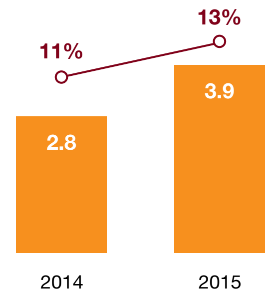
PwC's *Total Retail Survey 2016* data suggests that Chinese consumers are early adopters of technology, particularly mobile technology. In the 2016 survey, 65% of Chinese consumers stated that they shop online via mobile at least once a month; this is a far greater percentage than the 28% of global consumers during the same time period. Indeed, Chinese shoppers, as evidenced by mobile shopping, are a leading indicator for many of the global shopping behaviours that are now taking hold in more developed markets. The reason for Chinese consumers' digital uptake is simple: the high level of mobile penetration is largely due to a lower level of personal computer ownership, as well as the advanced data analytics of e-commerce companies that personalises the mobile shopping experience for consumers.

As a result, online shopping is increasing as a percentage of total retail sales in China.

According to the National Bureau of Statistics (NBS), revenue from online retail sales has grown rapidly from 2014: online retail sales recorded an increase of 49.7% in 2014 and 33.3% in 2015, accounting for roughly 11% and 13% of total retail sales, respectively[2]. The rapid increase in online shopping has not only been facilitated by the widespread success of Alibaba and JD.com in building online platforms, but also through the increased use of electronic payments via Alipay and WeChat. This synergistic development means that China's progress in e-commerce is well ahead of more economically developed countries: the country ranked sixth out of 19 countries assessed in PwC Strategy&'s 2015 Global Omnichannel Retail Index, an Index that assesses countries' e-commerce development in nine different sectors.

While online shopping is popular in China, the overall level of online shopping in Hong Kong remains underdeveloped. Indeed, although Hong Kong arguably boasts an equivalent or higher internet and smart phone penetration rate than China, e-commerce sales value reached only HK$400 billion in 2014 according to the Hong Kong Trade Development Council[3]. Although Hong Kong's current level of e-commerce is less than China, the territory may cash in on the online shopping boom through offering cross-border support: Hong Kong may emerge as a key warehousing, distribution and logistics hub for connecting China and the world through e-commerce.

Figure 4 **Total online retail sales increasing in China as a percentage of total retail sales (2014-2015)**



Online sales (RMB trillion)

Online sales % of total retail sales

Source: National Bureau of Statistics of the People's Republic of China

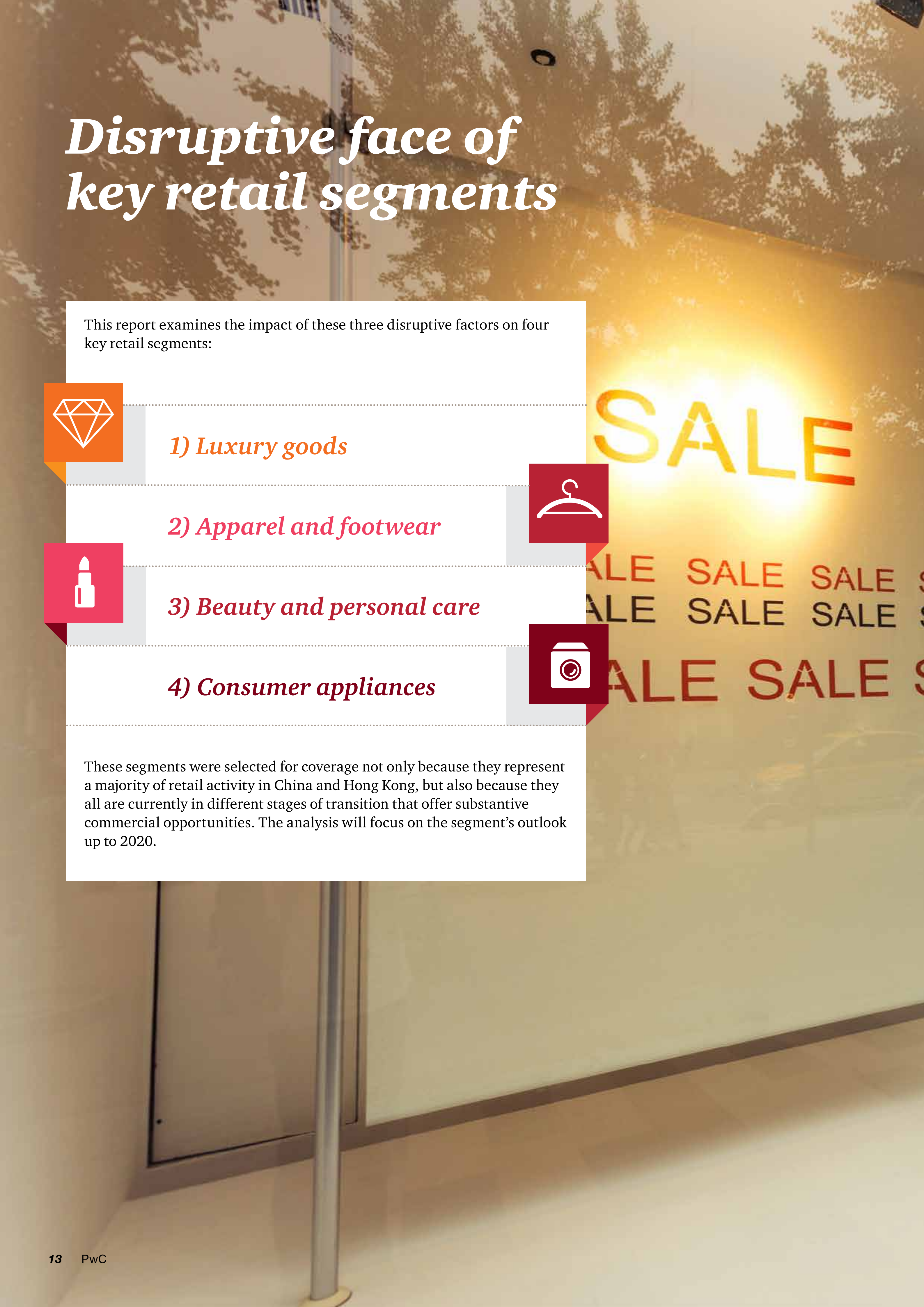
2. National Bureau of Statistics of the People's Republic of China

2014 online retail statistics: http://www.stats.gov.cn/english/PressRelease/201501/t20150120_671534.html

2015 online retail statistics: http://www.stats.gov.cn/english/PressRelease/201601/t20160120_1307123.html

3. Hong Kong Trade Development Council, 15 April 2016. Internet Industry in Hong Kong

http://hong-kong-economy-research.hktdc.com/business-news/article/Hong-Kong-Industry-Profiles/Internet-Industry-in-Hong-Kong/hkip/en/1/1X000000/1X0060U6.htm



Disruptive face of key retail segments

This report examines the impact of these three disruptive factors on four key retail segments:

1) Luxury goods

2) Apparel and footwear

3) Beauty and personal care

4) Consumer appliances

These segments were selected for coverage not only because they represent a majority of retail activity in China and Hong Kong, but also because they all are currently in different stages of transition that offer substantive commercial opportunities. The analysis will focus on the segment's outlook up to 2020.


SALE
-70%

Luxury goods

China

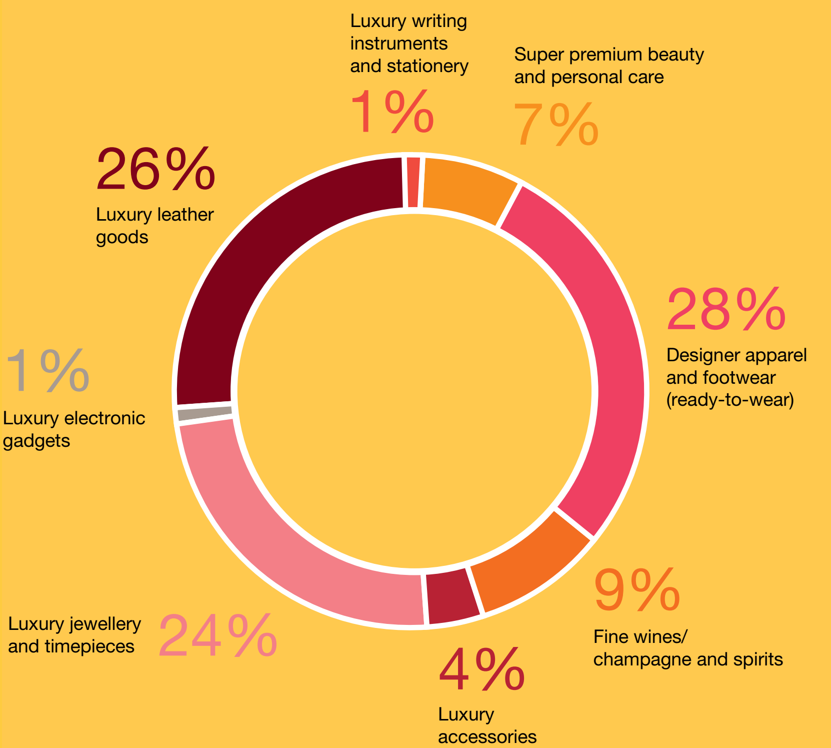
The luxury goods segment is arguably undergoing the most significant transformation. On the one hand, economic changes and regulatory policies are adversely impacting consumer sentiment; on the other hand, the rise of a younger, urban demographic means that consumer preferences and the traditional definition of ‘luxury’ is changing.

Sales of luxury goods in China has notably slowed over the past three years, with some estimates of negative year-on-year growth from 2013-2015. To some extent, the slowdown is cyclical: slower economic growth, as well as temporary differential price strategies among luxury retailers, meant that some luxury products were up to 50% more expensive in China.

Luxury consumers also increasingly go abroad to purchase. Regional currencies, such as the Japanese yen and Korean won, noticeably weakened against the RMB from 2013-2015, making luxury goods less expensive in Tokyo and Seoul. Although organised shopping tours, known as ‘dai gou’, (代购) used to be a key source of this overseas demand, its influence is expected to decrease. Consumer concerns over counterfeit goods are increasing and government regulations to prevent the parallel import of goods are strengthening, challenging dai gou’s business model over the long-term.

The cyclical headlines of pessimism, however, have clouded broader changes in consumer purchasing habits. Chinese consumers still prefer to buy quality at a discount. Luxury purchases in the traditionally strong segments of accessories, men’s wear, and watches, which still compose majority share by value, have noticeably declined. One reason for this decline may be the impact of the government’s crackdown on corruption: the focus has changed from men luxury shoppers, which favour alcohol, clothing and fine watches, to women who have different luxury preferences. At the same time, the concept of luxury is also evolving: new products and experiences not previously classified under the ‘luxury’ umbrella, such as fine dining experiences, cultural outings and traveling, are becoming more popular.

Figure 5 Designer apparel and footwear, luxury leather goods and luxury jewellery and timepieces drive China’s luxury purchases (2015)



Source: Euromonitor

How consumers research and purchase luxury goods is also evolving. While Chinese consumers still purchase higher priced luxury goods in flagship stores and malls, a diversity of selling points, both online and offline, is developing. The emergence of outlet stores selling luxury goods at lower price points have expanded the category's reach to middle-income shoppers. Online shopping and e-commerce has also contributed to a change in consumer motivation and purchasing behaviour. Indeed, different online models have emerged based on diverse strategic goals among luxury brands in China. Some of the main elements of luxury providers' online strategies are outlined further below:

- **Digital marketing and content:**
  Roughly all luxury brands are engaged in digital marketing online, including written and video content for consumer engagement. The strong emphasis on marketing content reflects consumers' increased reliance on it to influence purchase decisions, especially through platforms such as Weibo and WeChat:
  - Chanel, the French luxury company, in addition to having a brand website, also engages consumers through releasing exclusive videos on a variety of platforms in China, including celebrity blogs.
  - Others, such as LVMH, have established an online presence on Youku, one of China's main video platforms, for videos of how their products are made, 'how-to' videos, and other ways for consumers to engage with the product.

Innovative online engagement models emerge as consumer preferences shift.

- **Online sales:**
  Only a number of luxury brands have established an online sales presence due to concerns over loss of the brand's 'exclusivity' to some brand-conscious shoppers. Online sales occur through two channels: 1) B-to-C (Business-to-Consumer); 2) C-to-C (Consumer-to-Consumer).

  B-to-C plays an increasingly important role in the luxury market, particularly as some brands sell directly to consumers and the rise of e-commerce (e.g Tmall) as a platform for brand promotion and sales. The rise of online luxury 'flash sale' platforms, such as Mei.com (formerly Glamour Sales) backed by internet giant Alibaba, have also emerged as a key player in this space, allowing luxury providers to sell slow-moving lines and older stock to value-conscious consumers, while also alleviating concerns over potential counterfeits.
- **Omni-channel:**
  No luxury brand in China has developed a fully integrated 'omni-channel' model that engages the consumer both online and offline. However, some brands have established elements of a strategic platform that will allow them to build one in the future.
  - Burberry, the English luxury provider, has experimented by offering options for consumers to collect their purchases in store, or opt to have their online purchases delivered. This type of optionality is key not only in building an interactive platform, but also to understanding consumer preferences.

As the market in China matures, however, tastes are diverging. Chinese consumers are looking for more premium, less accessible items, straying from the easily available and often showy designs that once held the market in rapture. While brand reputations and heritage have solidified the positions of some of the more well-known brands in the industry, mainland shoppers are opting for decidedly more sophisticated, low-key luxury or more premium designs. Less familiar luxury names and affordable luxury are also becoming fashionable among China's wealthy set looking to differentiate themselves from the masses. This will likely contribute to further fragmentation in the market.

Overall, the long-term outlook for luxury goods in China appears brighter over the outlook period: a stabilising Chinese economy, increased emphasis on 'experiential' luxury (including spas, travel, and health), and new sales outlets appealing to new shoppers will help boost the segment. In addition, an increasing proportion of luxury sales is also likely to be booked domestically. The standardising of luxury goods' pricing, including their sale in duty-free zones in Hainan and Shanghai, and more competitive domestic pricing, will likely mean an increasing number of purchases that would have been made abroad will stay at home.

Luxury goods
Hong Kong

An evolving luxury market in China means that Hong Kong's luxury market is also going through a transition. Indeed, one prevalent luxury goods sales model in Hong Kong is clearly changing: the building of flagship stores in high-traffic, expensive districts to attract mainland tourists. An economic slowdown, coupled with a reduced number of mainland tourists, total arrivals from mainland China recorded the first year-on-year drop in over a decade in 2015, and means luxury producers are rethinking their strategy.

Many luxury companies are seeking to reduce the cost of sales. In 2015, luxury brand Coach left its flagship store location on Queen's Road (Central), others are closing stores or moving locations. There is increasing downward pressure on rents: Adidas is now tenanted in Coach's place, and will pay 23% less for the space. Similarly, Colourmix Cosmetics is now a tenant in the space formerly occupied by luxury timepiece brand Jaeger-LeCoultre in Causeway Bay, paying 60% less than the HK$1.75 million monthly lease for the latter. The appearance of mid-tier and mass-market tenants on Hong Kong's high streets paves the way for a more interesting and diverse local retail mix. Some luxury providers are looking to reduce cost of sales through utilising multi-brand retail outlets and sharing retail space in malls. They are also looking outside of the traditional selling perimeter, opening up outlets in outlying areas and other emerging districts to expand brand recognition among consumers.

Hong Kong ranked as second most appealing luxury retail market in 2016.

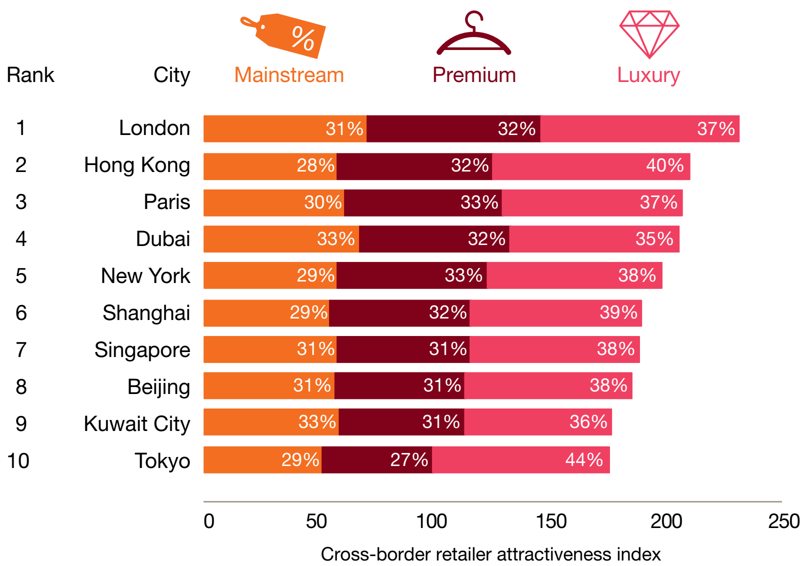
The luxury brand landscape and product offerings are also changing. Although perennial 'high' luxury brands, such as Prada and LV, still lead the market in overall purchases, they face greater competition from upstart mid-tier Western and Chinese brands. The emergence of middle-tier luxury brands, such as Michael Kors and Givency, have risen in popularity along with the expansion of luxury to a younger and middle class group of shoppers. As a result, luxury providers, such as Chanel and Prada, have developed more affordable bags, with different price points, to compete with the new segment upstarts. New Chinese luxury brands, such as Lao Feng Xiang, are also using Hong Kong as a platform to expand luxury sales and brand recognition to reach Asia and the world, sometimes entering rental spaces previously occupied by Western competitors.

As online retailing in luxury remains slow in Hong Kong, online marketing should be focused on providing access to information that can be helpful for the consumer decision-making process. The use of social media and the internet is high among Hong Kong shoppers, who use these tools to gather information on promotions and marketing events. Content can include access to customer reviews, curated content, additional information on products, as well as fit visualisers.

E-commerce is likely to pick up over the forecast period, while brands tailor their O2O (online-to-offline) strategies to suit the current preferences of the local Hong Kong customer. The infrastructure for e-commerce is in place, and will help drive future sales, particularly in apparel and footwear, as Hong Kongers begin to trade the convenience of nearby shopping malls for the sheer variety and value available online. Despite decreasing tourist flow, an effective e-commerce strategy can also serve to reach the tech-savvy Chinese tourists before they even step into Hong Kong.

Overall, all news is not pessimistic concerning the luxury market in Hong Kong. Despite notable challenges, Jones Lang LaSalle ranks Hong Kong the second most attractive global destination for luxury retailer in 2016. The study confirms that the fundamentals underpinning Hong Kong's position, such as serving as a springboard for luxury companies both into mainland China and the global market, are still intact. Although the market will continue to endure tough times during this transition, these fundamentals should allow it to rebound.

Figure 6 **Top ten most attractive markets 2016**



Note: The coloured bars and percentage values illustrate the share of international retailers by category present in each market.

Source: Jones Lang LaSalle, Destination Retail 2016

Apparel and footwear
China

Although the apparel and footwear segment faces similar economic headwinds, the wider consumer base has resulted in more resilient growth. Indeed, while the segment posted double-digit growth up to 2014, it only decelerated to higher single-digit growth starting in 2015.

Growth in this retail segment is increasingly at the edges: 'fast fashion' and 'premiumisation'. While slower economic growth has driven consumers to seek value offerings, the demographic change has also shifted emphasis to a more rapid fashion cycle: from a lifestyle perspective, the younger demographic focuses on design and utility, which evolves from season to season, rather than necessarily having loyalty to just one brand or look. This loss in brand loyalty has bred a highly fragmented marketplace, with the top ten industry players only accounting for around 12% of overall value in 2014. Fast fashion brands, such as H&M and Uniqlo, have gained market share through competitive pricing and attractive designs.

Shifting consumer tastes has also bred unique brand collaborations, or diffusion lines, between fast fashion and premium providers. Collaborations between high-street labels and

Millennials' preference for sporty lifestyles and fashion functionality driving growth.

premium brands such as Balmain, Jil Sander, and Versace make this value-for-money proposition an alluring one to the Chinese consumer. Such diffusion lines also afford higher-end brands the opportunity to experiment with reimagining existing lines for a new, wider market, as well as expanding the brand's mind share among the larger market. The recent Balmain and H&M release in China was marked by a launch party attended by celebrities, strengthening the value of these capsule lines in the eyes of shoppers.

Apparel and footwear brands have adopted a 'bifurcated' strategy to online retailing. Apparel retailers, especially 'fast fashion' brands, have continued to open brick-and-mortar stores in second- and third-tier cities to help build brand recognition among new groups of middle-class consumers.

Due to higher costs in opening stores and maintaining logistical networks, apparel and footwear retailers are utilising e-commerce platforms. Indeed, partnerships with online marketplaces allow retailers to access customers in China with an 'asset-lite' approach. In August 2015, Macy's, an American retailer, along with Fung Retailing Limited announced the establishment of a flagship store on Tmall Global – a cross-border, online platform that gives global brands access to Chinese consumers.

Other apparel retailers are using online platforms to help streamline their supply chain. Korean retailer Lotte.com partnered with JD.com to create 'Lotte Hall', retailing products from Lotte Group subsidiaries online. The partnership not only provides economies of scale for Lotte, but also reduces the cost of customer acquisition and payment costs through using established payment networks. While consumers are increasingly shopping online, China's delivery infrastructure remains an area for improvement. Delivery systems are plagued by teething issues such as missing parcels and delays in delivery, incidences which often detract from the online shopping experience.

The segment's growth rate is expected to moderate over the short-term. Concerns over economic stagnancy will likely be overcome as younger consumers, who value fashion and new designs, continue to purchase offline and online. In addition, one significant factor will likely be supportive of future growth in the segment: The Chinese government's decision in January 2016 to allow married couples to have a second child should provide opportunities in baby, children's and maternity wear in upcoming years.

Apparel and footwear

Hong Kong

Hong Kong's apparel and footwear market has steadily declined. Consumers' preference for apparel has meant a larger market share by total sales volume of the segment, but growth in footwear is expected to outstrip that in the much larger apparel category. Changing consumer preferences are driven by a younger demographic that puts greater emphasis on a healthy lifestyle and more utility-based footwear. Hong Kong's apparel manufacturers have also integrated their product lines to cater to a greater consumer emphasis on fitness. Indeed, the blending of lifestyle apparel and fitness has become more pronounced, with new fashion elements encouraging inspired, functional elements.

Hong Kong consumers' purchases in the segment, although currently in a time period of decelerated

Value for money still remains primary consumer consideration.

growth, it is expected to increase over the time period. Increasingly prominent in driving this growth is the adoption of sportswear among Hong Kong consumers, as well as marked shifts in attitudes towards footwear. Today, footwear is increasingly seen as an extension of individual expression: shoes are no longer just functional, but also offer variety, comfort and style. The increasing importance of footwear means that a growing number of Hong Kong's consumers are now more willing to pay a premium for comfortable, well-designed, and often branded footwear.

The landscape in Hong Kong is dominated by international brands, and their rise to prominence in the consciousness of the Hong Kong shopper is often at the cost of domestic labels. Leveraging the advantage of reasonable prices and on-trend, innovative designs are slated to take prime street locations in Hong Kong, including those of fast fashion retailers.

Fast fashion brands have increased their presence in Hong Kong as a means to greater regional expansion, often times at the cost of domestic labels. Uniqlo opened up an estimated total of ten stores in Hong Kong over 2014-2015 (through August 2015), while H&M expanded into shopping malls in the New Territories: both brands targeting growing consumer purchasing power. Online shopping, as in other retail categories, is only starting to increase for the segment. The economic shakeout in Hong Kong's more exclusive retail spaces may drive retailers' move to scale down and increasingly adopt a more robust omni-channel model.

Beauty and personal care

China

Beauty and personal care, of all the examined segments, will continue to remain a bright spot in China's retail scene. The segment posted double-digit growth from 2010-2014, largely on the back of growth in personal income and increased consumer importance on health and personal grooming.

The emphasis on improved personal appearance, particularly among millennial consumers, is driving increased sales in skincare. Indeed, while middle-aged women previously were considered the main consumer sub-group for this segment, the emergence of younger women (and men) concerned with health and personal appearance adds another important source of demand. As a result, skincare and beauty products that offer convenience and multifunctionality are rapidly expanding along with an increase in consumer demand. This is particularly the case for creams and foundations that can be applied easily and quickly, which are increasingly popular among time pressed white-collar consumers.

Well-established multinational brands still possess a strong market position; however, they are being challenged by domestic and regional

Trust has emerged as a key factor affecting consumer purchases.

competitors. Well-known brands such as L'Oréal, Mary Kay, and Olay composed only roughly 10%[4] of the total market by value. However, their position is being challenged by upstart domestic brands: Jahwa and Jala Group are in the top ten, primarily going after consumers in the lower-to-middle price points, while rising brands such as Chando and Proya have aimed their products at the premium-priced market. Korean brands, such as Laneige and Sulwhasoo, have penetrated higher price points on the back of Chinese consumer interest in the 'Korean wave' and celebrity endorsements. The market is likely to grow more fragmented as consumers value both functionality and quality, and brands look to gain share in the pivotal Chinese market through introducing new product lines and packaging innovation.

Due to issues of trust with beauty and personal care products, online content plays an increasingly important role in consumer decision making. Similar to luxury goods where online content helps to build recognition and consumer understanding, the rise of e-commerce platforms such as Jumei helps to build consumer trust in providing information on the web site and through disseminating content via Weibo and WeChat. Other forums, such as Kimiss.com, help consumers to make decisions via going through reviews posted by over 3 million registered users.

However, those same consumer concerns over trust have limited the growth of online shopping in the segment. Roughly 40%[5] of goods sold online in China were reported to be counterfeit or of sub-standard quality. This has led to extreme caution among Chinese shoppers to purchase online products in China. Brands have tried to expand their brand presence in order to fill this gap as a trusted provider of goods. For example, some brands such as Elizabeth Arden have developed a presence on Lefeng.com and Tmall.com to help consumers who might not be able to physically purchase their products. Chinese consumers in PwC's *Total Retail Survey 2016* conveyed a similar message: Chinese consumers were more likely than global peers to purchase luxury and cosmetic goods on overseas web sites, possibly as a means to guarantee authenticity.

The outlook for the beauty and personal care segment is optimistic. In addition to continued growth in the traditional strength of skincare, new innovative products such as anti-smog skincare, as well as those boasting protection from UV damage, appeal to a group of increasingly affluent and concerned urban women consumers.

4. Euromonitor
5. Euromonitor

Beauty and personal care

Hong Kong

Image consciousness among Hong Kong shoppers and new retail products will continue to support the retail segment. Indeed, of all the retail categories examined in Hong Kong, the most support exists for continued growth of beauty and personal care products, although the growth rate will definitely slow and uncertainty increase in the near-term, primarily due to the decline in tourism from China. The main growth will come from the premium products market.

Despite an increasingly competitive environment marked by the entry of Korean brands, established foreign multinationals continued to dominate the market: Estée Lauder, Procter & Gamble, L'Oréal, and Shiseido were the key companies in the segment, capturing more than 40% market share in 2014 between them.

Tough economic conditions have led to the rise of 'masstige' product lines, which promise premium performance at lower price points. French brands like Avène and Melvita, while positioned as

6. Euromonitor

Economic uncertainty shifting sales focus to department stores and specialty stores.

brands accessible to the masses, are also perceived as high-quality, high-performing products by the local population, driving their popularity amongst Hong Kongers. The emphasis on 'masstige' products is slated to continue as Hong Kongers shop more selectively and seek out products with differentiating characteristics, including improved and natural formulations. Retailers will meet this growing demand via accessible, mass-market retailing channels, which will lower costs and raise margins on a unit per sold basis.

Due to the segment's uncertain future trajectory, producer preference for less risky sales models are consolidating. Establishing standalone branded shops, due to the high level of financial risk in a sluggish market, is decreasing, while expansion through department store beauty counters is more popular. Department store beauty counters play a particularly important role in servicing Chinese tourists who have patent concerns over fake products; department stores also provide friendly payment systems for China-based credit and payment cards. Beauty specialist stores are expected to drive beauty and personal care distribution due to their multi-brand offerings and better price points for the imported products. Finally, foreign brands entering the Hong Kong market should exercise attention regarding their sales model and how it is supported: Korean cosmetics retailer Missha prematurely withdrew from the market after its initial partner failed to support the venture.

Overall, growth is expected to continue in this segment, although at a level marginally lower than previous years. Retailers are introducing new lines of products, such as anti-aging creams, that should boost growth in an increasingly older population. Retailers are also rethinking their sales and distribution models to lower operational costs, which includes moving stores to new areas in Hong Kong, and even opening retail shops on the Hong Kong and Shenzhen border to cater to short-term visitors.

Consumer appliances

China

Consumer appliances has structural support for continuous growth over the short-term. Indeed, China has emerged as one of the most important markets for consumer appliance goods globally, representing 24% of the world's total consumer appliance sales (by volume) in the most recently available statistics[7]. Double-digit growth in the segment over the past five years is slowing as a result of a weaker real estate market and reduced subsidies for appliances.

While first-time purchases played an important role growing volume over the past five years, replacement purchases will become a more significant driver as technology drives a shorter product replacement cycle. Appliance demand among young, urban consumers is likely to remain strong, particularly as consumers seek upgrades from basic appliances. These upgrades include washing machines (from semi-automatic to automatic) and appliances (from low capacity to high capacity).

Unlike other retail categories, domestic producers have established a sizable position in the

7. Euromonitor

Unique online/offline partnerships rapidly changing segment landscape.

appliance market, particularly at the mid-and lower-price points. Well-known producers such as Haier, Midea and Hisense still are the main players in the market, where competitive pricing and basic functionality have driven purchases. Chinese companies have increasingly tapped M&A as a strategic tool: Haier and Midea recently made acquisitions in the space to upgrade their product offerings and access to key markets.

Product differentiation will also help to appeal to emerging classes of consumers. Greater convenience and control over appliances allows customers greater flexibility: Mobile access to and remote control over appliances introduces flexibility and increased control over product use. Gree Electric, a Chinese manufacturer, has led development of smartphone control over appliances, while Haier has invested to develop appliances that can be manipulated over the web, as well as allowing customers to 'customise' appliance purchases directly on their web site. Appliance makers are already planning how to integrate current product offerings with the 'Internet of Things', essentially putting all appliances online to monitor their performance and adjust use.

Online purchases are becoming more prevalent with the rise of multi-brand retailer and online e-commerce platforms. Many larger appliance markers currently have their own branded web sites, with national retailers such as Suning and GOME Electrical attempting to expand their reach to new consumers, particularly in second and third-tier cities. They have also sought beneficial partnerships with e-commerce platforms: Alibaba signed a deal with Suning in August 2015 to invest US$4.6 billion in the appliance maker. The deal symbolised the growing synergies between online and offline retailers, as Suning aligned with Alibaba's expanding e-commerce platform, and Alibaba gained access to Suning's extensive logistical network to compete with other e-commerce rivals.

Overall, the outlook for the consumer appliance segment in China is marginally more optimistic than others. While consumers are demanding more functionality and interaction with technology, the product replacement cycle is shorter, raising the prospect of increased sales. This is particularly true for niche categories such as senior appliances, green appliances, and 'smart appliances' utilising the 'Internet of Things' and other emerging technologies.

Consumer appliances

Hong Kong

Growth in Hong Kong's appliance market has and will continue to be slow over the near-term. Several structural factors underpin this trend. First, population growth and household formation has remained low. This is particularly true as Hong Kong is a more mature market with a low replacement rate that has kept sales lower. Second, although product innovation is gradually increasing, it has remained stagnant in the past, limiting new options for consumers.

Multinational companies still hold primary market share in the Hong Kong appliance market, with Philips, Panasonic, and De'Longhi SpA compose roughly 40% of the market. The rest of the market is divided between upstart Chinese brands, such as Haier, as well as carefully segmented players such as LG and Samsung, which have grown their brand recognition in niche product areas with consumers.

Hong Kong's move to become 'smart city' will increase product selection.

Online shopping for appliances in Hong Kong has lagged. Similar to other retail segments, Hong Kong consumers still prefer an in-store experience where they can see and interact with products before making a final purchase. The low prevalence of online shopping despite high penetration of internet and smartphones may be developing along with the online plans of key retailers in the segment. Fortress, one of the main appliance retail outlets in Hong Kong, is building its online presence to support an online/offline presence to boost consumer convenience.

Over the long-term, the outlook for consumer appliances will somewhat be driven by government regulations and technological development of new products. Energy efficient products, due to costs associated with electricity and limited space, will continue to rise in importance, with manufacturers (both local and global) aware that government regulations mandate labelling of the product's energy use.

The emergence of 'smart devices' and the 'Internet of Things' will also help stimulate new product demand. Hong Kong currently aims to establish itself as a 'smart city', building substantive internet connectivity to enable smart product use. Hong Kong consumers already seek premium appliance offerings under the 'smart' products umbrella, including greater control over devices in their home. LG's Twin Wash washing machine is not only energy efficient, but also can be controlled via smartphone application, offering lower energy bills and convenience in a time-starved city. With the passage of time, smart appliances are likely to grow in number and in popularity among Hong Kong consumers.

China and Hong Kong retail and consumer products sector forecast (2016-2020)

In order to better understand the future trajectory of the retail and consumer products sector, PwC forecast growth prospects in the China and Hong Kong markets from 2016-2020. The forecasts are based on historical performance, as well as current industry trends and policy support.


SIPG

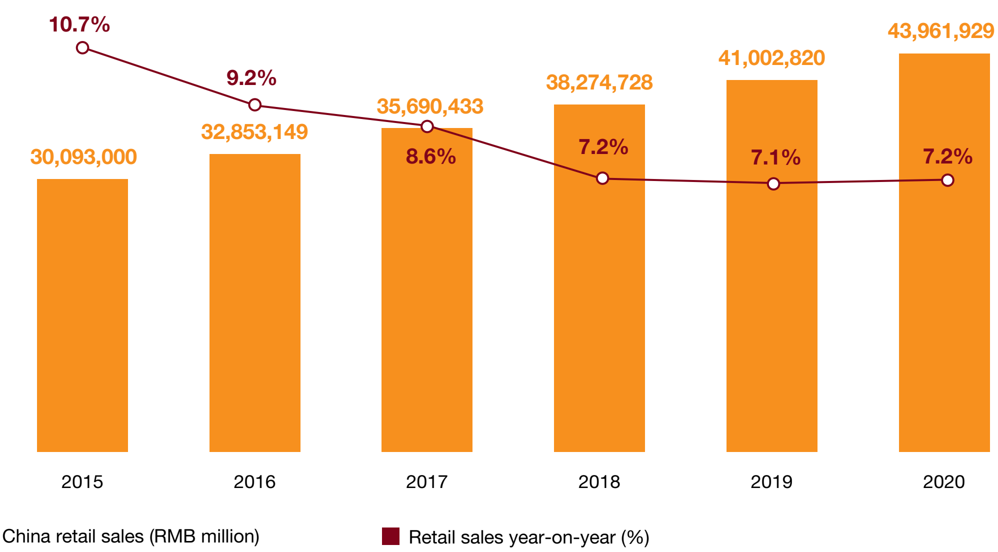
China

China's retail and consumer products sector, along with the economy, is in a state of transition. A turning of current negative cyclical trends, coupled with supportive structural industry and policy trends, will drive the sector's growth prospects from 2016-2020.

The Chinese economy is expected to stabilise over the forecast time period. With the Chinese economy registering 6.7% growth in the first quarter of 2016, and financial markets showing less volatility, the level of economic uncertainty is slowly decreasing. The Chinese government also recently released economic growth targets for the 13th Five-Year Plan (2016-2020) of at least 6.5% average annual growth. The government's plan to shift the focus of economic growth from exports to personal consumption will support sector growth; a potential lessening impact of the anti-corruption campaign may also help the return of traditional gifting behaviour which may lead the growth in the luxury segment. Over the long term, several structural trends may also help boost growth in the sector, including the Chinese government's decision to allow couples to have two children in January 2016 and the strengthening of pension and health care coverage that may lead to lower levels of discretionary saving.

Based on these factors, PwC forecasts a compounded annual growth rate (CAGR) of 7.5% in China's retail and consumer products sector by value from 2016-2020. The retail sector is expected to continue its momentum in 2016, posting roughly 9% growth, gradually decelerating to roughly 7% growth over the rest of the forecast period. The gradually slowing forecast growth rate is due to a maturing domestic economy and larger retail sector.

Figure 7 **China's retail and consumer products sector may continue to grow as cyclical factors turn positive and structural factors support**



Source: PwC

Hong Kong

Hong Kong's retail and consumer products sector is also forecast to slowly recover, albeit at a lower growth rate than China's. Hong Kong's cyclical sectoral slowdown is undoubtedly deeper and more pronounced than China's; however, there are signs that with a potential uptick in overall economic sentiment, coupled with more supportive long-term government policies, the sector may rebound from 2016-2020.

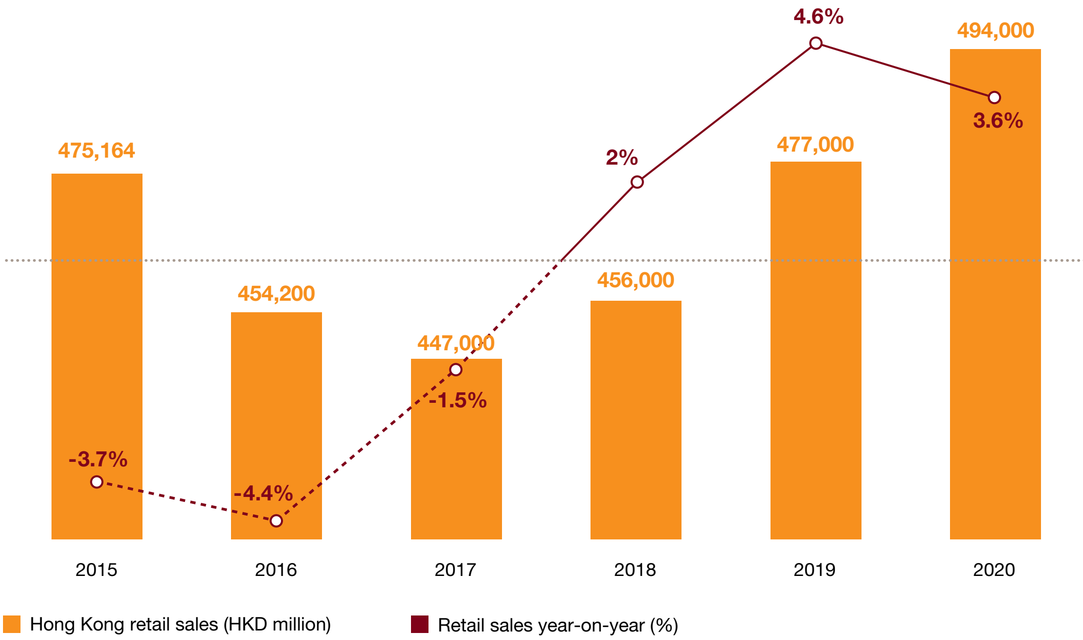
A cyclical upturn in China's economy will play a key role in supporting growth in the sector. Stable economic growth will help boost consumer sentiment, primarily through the stabilisation and gradual rebound of the real estate and equity markets in Hong Kong. An improved economic outlook will also help to recover some of the lost mainland Chinese tourist flow to Hong Kong. In addition, the Hong Kong dollar will likely face a more volatile currency market over the short-term due to uncertainty over the trajectory of the US dollar and regional currencies such as the Japanese yen and Korean won. This will mean a more fluid environment of changing price competitiveness between regional destinations.

Beyond these cyclical factors, more structural policies to diversify the sector's demand base and increase its attractiveness would also help recovery. Policies aimed to increase tourism should not only focus on mainland China, but also include other geographies to ensure that the sector is not too dependent on just one market for growth. Hong Kong may also economically benefit from the ongoing e-commerce boom in China: the territory is in a prime position to attract investment as the warehousing, distribution and logistics hub between mainland China and the rest of the world.

Infrastructure projects to further develop the airport's capacity and other nearby developments will also help make Hong Kong more attractive to tourists.

Based on these factors, PwC forecasts a CAGR of 2.1% in Hong Kong's retail and consumer products sector from 2016-2020. The expected growth, however, is forecast to be uneven and volatile. Total retail sales are forecast to contract a further 4.4% in 2016 after a decrease of 3.7% in 2015[8]. Sales are forecast to rebound starting in 2017, reaching year-on-year growth of 4.6% in 2019.

Figure 8 Hong Kong's retail and consumer products sector is forecast to rebound



Source: PwC

8. Hong Kong Census and Statistics Department

http://www.censtatd.gov.hk/hkstat/sub/sp320.jsp?tableID=089&ID=0&productType=8

Insights on turning disruption into opportunities

Although retailers and consumer goods companies of all stripes face increasing challenges to remain profitable, global trends and best practice, taken from PwC's *19th Annual Global CEO Survey* (and related interviews) and PwC's *Total Retail Survey 2016*, offer potential insights on how companies should deal with this disruption and turn it into opportunities.

1

Deepening 'coopetition': New market entrants challenge established business models

The rapidly shifting sectoral landscape has resulted in a changing relationship between traditional competitors. For example, luxury goods providers typically could identify which brands or products were its main competitors. Beauty goods and footwear/apparel producers had a significant but limited choice of outlets (e.g. branded and outlet) where to ultimately sell their goods. With changing consumer preferences and the rise in e-commerce, these traditional assumptions no longer necessarily hold.

According to PwC's *19th Annual Global CEO Survey*, 90% of CEOs in China are worried about new market entrants, particularly non-traditional ones. The retail and consumer goods sector in China provides evidence for why this is the case. Consumers' classification of luxury goods is no longer limited to bags and watches. The rise of 'experiential' luxury means that traditional industry heavyweights such as Prada and Chanel are increasingly competing with travel agencies, spas and restaurants for affluent consumers' disposable income. Today's competitors are not yesterday's competitors.

At the same time, competition between brands and retailers, both foreign and domestic, is evolving. Foreign brands and retailers continue to invest in the Chinese market; however, they are doing so in more innovative ways. Following the decisions of retailers such as Home Depot and Best Buy to eliminate their brick-and-mortar presence in China, foreign retailers are increasingly choosing to open stores on e-commerce platforms to access Chinese consumers. Macy's reached an agreement with Fung Retailing Limited to jointly open an e-commerce store on Alibaba's Tmall Global platform in August 2015. Costco made a similar decision to open a store on Tmall in 2014 rather than enter with a bricks-and-mortar presence. Foreign brands are also getting into the act: fashion brands Asos, Topshop and Miss Selfridge have directly entered the market with online shops in China.

Investments by overseas brands and retailers in China are putting pressure on domestic retailers and brand owners. They will need to respond accordingly, including expanding their product portfolio to compete with an increasing array of industry players. As part of a larger strategy, the rise of 'coopetition' (a hybrid of the word 'competitor' and 'cooperation') in China and Hong Kong retail will likely be a key trend over the forecast time period. Examples of this concept are already emerging. In 2015, Alibaba and Unilever struck a unique strategic partnership: Under the terms, Unilever will be able to access rural customers in China through Alibaba's distribution channels, use proprietary data from its online marketing unit and cloud to digitally target consumers and deepen innovations in supply chain management[9].

Not only are traditional barriers to entry between different product segment eroding, but the additional channel options added by online shopping mean that retailers face both new threats and opportunities in cooperating with different stakeholders. This augurs that traditional business models, and strategic relationships will need to change in order to keep up with shifting consumer preferences and purchasing behaviour.

9. Reuters. 7 July, 2015. Alibaba, Unilever announce partnership to reach Chinese consumers

2 *Transformative M&A:* Moving up the value chain

With rapidly changing consumer preferences and monetisation of lower-value products, manufacturers want to move up the value chain to remain competitive. Indeed, a recent wave of proposed M&A illustrates the desire of companies, both incumbent and upstart, to enter the premium product space and access new customers.

Haier's US$5.4 billion purchase of GE's appliance unit in January 2016 illustrates the ambition of the Chinese company to enter the homes of consumers around the world with a well-known brand. Although Haier is one of the dominant appliance makers in China, the company has faced difficulty entering more developed markets, particularly in the US and Europe. The deal will elevate Haier's position in the US appliance market, with a well-recognised appliance line that manufactures refrigerators, freezers, washing machines and dryers. The acquisition will also provide more expansion opportunities for its 'value segment' offerings.

Midea, another fledging Chinese appliance producer, announced the acquisition of a portion of Toshiba's home appliance unit in March 2016. Midea reached a memorandum of understanding with Toshiba to purchase 80% of the company's assets in the appliance division. Midea will leverage Toshiba's brand name and distribution channels abroad, as the home appliance business will continue to produce white goods such as washing machines, vacuum cleaners, and other smaller appliances.

Although in a different retail segment, Samsonite's acquisition of Tumi in March 2016 is also considered a transformative transaction for the world's largest manufacturer of luggage products. Samsonite's US$1.8 billion acquisition of Tumi will allow the company to immediately move into the travel premium bag segment, where Tumi is considered to have a strong market presence among both affluent male and female consumers. The deal will also allow Tumi to expand its offerings into new markets through Samsonite's distribution channels, while Samsonite, well known for lower-to-mid priced offerings in the market, essentially enters a key value premium segment and attains larger scale for existing products.

This wave of recent transactions speak to a larger point: in an increasingly competitive marketplace and compressing margins on lower-value products, M&A is one strategic tool increasingly being utilised to move up the value chain and reach new consumers. Although there are inevitably challenges to fully integrate purchased units into the existing business, the ability to move quickly and decisively outweighs those potential risks for many companies.

3 *Creating trust:* A retailer's online presence is not exclusively for selling or marketing

With the rising number of shoppers online, many retailers and consumer goods companies have established an online platform to interact with consumers. While some retailers have utilised that platform exclusively to sell goods to customers, many others, particularly in China and Hong Kong, use it as part of a broader channel for marketing and consumer engagement. Results from the PwC's *Total Retail Survey 2016* indicate why this may be a good idea: a growing number of Chinese consumers are not only buying things online, but also researching purchases and brands online, via online discussion forums and social media, which plays an important role in influencing final purchases.

On a global level, Gucci has adopted a comprehensive online strategy that has boosted the brand's visibility. Indeed, the company launched its e-commerce site back in 2002, which allows consumers not only to purchase products online, but to learn more about the brand and how its products are made. The site is a hit: In 2015 alone, the site received 100 million visitors. Kering, Gucci's holding company, prioritises e-commerce as a means to increase brand recognition, trust, and sales across different channels. The company continues to invest in the company's online presence, with social media also playing a key role in supporting the brand's message through strategic posts[10].

Online interaction with consumers will also be particularly important for two of the retail segments covered in China and Hong Kong. Due to enhanced issues of trust in the purchase of luxury and personal care products, survey data suggests that consumers are getting more likely to research potential purchases first online and ultimately purchase online, with a high proportion purchasing on overseas online sites to ensure product authenticity. Although still in its infancy, many retail and consumer products companies are developing building blocks for the 'omni-channel' model that allows for interaction with consumers from the research to the purchase and delivery stage. PwC survey research suggests that understanding how different consumers interact (online/offline specialisation) and customisation of experience helps to optimise the decision regarding what services to offer and by what medium.

10. Digiday, 2 May, 2016. The digital strategy driving Gucci's growth

4

Data is value: Leveraging analytics and the proper use of data

With an increased online presence, retailers and consumer products companies will find themselves with greater access to valuable consumer data on consumer preferences and purchases. The value proposition of this data is well known: According to results from the retail and consumer industry findings of PwC's *19th Annual Global CEO Survey*, 64% of consumer goods CEOs rated data and analytics as likely to generate strong returns for engaging with stakeholders.

How to extract value, however, is a more difficult question. One interviewed CEO clearly saw the value, although admitted 'it's that they struggle with putting it into practice. The path to getting return-on-investments is not as clear as it is in other industries.' While other CEOs offered a potential road forward for value realisation: 'We are delivering that customisation and personalisation that millennials are demanding for our services. Data analysis tells you so much about customer behaviour.'

Data is arguably even more plentiful for retailers in China as not only do a higher proportion of consumers' research and shop online, but the rich payment ecosystem may allow retailers to actually track purchases. Thus, data and analytics has risen in importance among CEOs: 83% of CEOs in China from the PwC's *19th Annual Global CEO Survey* are using technology to deliver on wider stakeholder expectations, including data and analytics for customers (and customer relationship managment), but identified challenges in its use and communication of results to stakeholders.

Thus, the challenge is not only to identify what data is important to a company, but also identifying how it can potentially change how retailers and consumer products companies target and retain customers over the long-term.

5

Increasing corporate social responsibility (CSR): The challenge of greater integration

Due to increased consumer attention regarding how products are sourced and company behaviour, retailers and consumer products companies must prioritise CSR. According to results from the retail and consumer industry findings of PwC's *19th Annual Global CEO Survey*, 58% of global retail CEOs agree that corporate social responsibility will be core to everything they do in five years' time. At the same time, a gap exists at the global level between the importance assigned to CSR initiatives and integration initiatives: Only 40% of global retail CEOs stated that they have a standalone programme (compared to being integrated across operations) to address those concerns.

The issue of CSR will likely play a greater role in China and Hong Kong's retail and consumer products sector. Consumer interest in CSR in China in increasing as a result of numerous product quality incidents, particularly in food safety, which has led to questions about companies' broader CSR commitments. Indeed, according to PwC's *Total Retail Survey 2016*, 28% of Chinese consumers responded that knowledge of where products are sourced would be a factor in deciding whether to increase shopping at a local retailer.

The rise of Chinese millennials' purchasing power may deepen this trend. Global survey results suggest that Chinese millennials not only demand business involvement in addressing important social issues, but also expect that companies are actively engaging in these issues and measuring results. The challenges for retailers are even greater as many deal with complex supply chain issues, including sourcing that is both respectful of the environment, as well as paying a living wage to workers. This type of operational integration goes well above and beyond many CSR initiatives implemented by luxury companies and retailers, which are typically piecemeal in nature focusing on a single cause or issue. While these efforts are certainly well received, they will likely need to be integrated across a retailer's operations to illustrate that such concerns have become core to the company's brand and decision making processes.

Conclusion

The winds of disruption blowing through China and Hong Kong's retail and consumer products sector will permanently alter its face. Adjustments being made by retailers and consumer companies already attest to this fact: a proliferation of different O2O models, a raft of price and product portfolio changes and a different high street shop mix.

As this report suggests, the opportunities available during this forecast period (2016-2020) are tremendous. Companies can reach consumers across an expanding array of channels to deliver value. Consumers have more product choices and interaction with companies to shape the goods and services that they want. Technology serves as the connecting thread: digital technology allows consumers to research, receive information, and make purchasing decisions anywhere, anytime with the touch of a few buttons.

In the case of China and Hong Kong, these sectoral developments will play out against the larger backdrop of China's economic transition. The Chinese economy is growing at a slower pace than its historical average; however, plans by the government to promote domestic consumption and the services sector augurs greater potential opportunity for companies in the sector. The ability of Hong Kong's retail and consumer products sector to rebound back to previous highs will be dependent on the stability of the Chinese economy and resumption of tourist flows.

Ultimately, these changes will not benefit all companies equally. Those companies with robust operational fundamentals, including sound management of inventory and supply chain, will be in a better position to capitalise. But the industry landscape is shifting quickly. Companies must react to a raft of emerging challenges, including the development of unique industry partnerships, transformative M&A transactions, increased focus on CSR initiatives and the promises (and perils) of big data for their business. Those companies that do so will put themselves in a better position to survive and thrive during this age of change.

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Further reading on retail and consumer topics, such as reports below, can be accessed at www.pwc.com

Total Retail 2016

19th Annual Global CEO Survey: Retail and consumer industry key findings

What is next for cross-border e-commerce (B2C) business in China?

19th Annual Global CEO Survey: China's new economic course: Navigating turbulence

Retail sector: Tax rate benchmarking

Latest developments and trends of tax policies for cross-border trade and e-commerce in China

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