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Sector focus: Luxury goods firms face up to new Hong Kong reality

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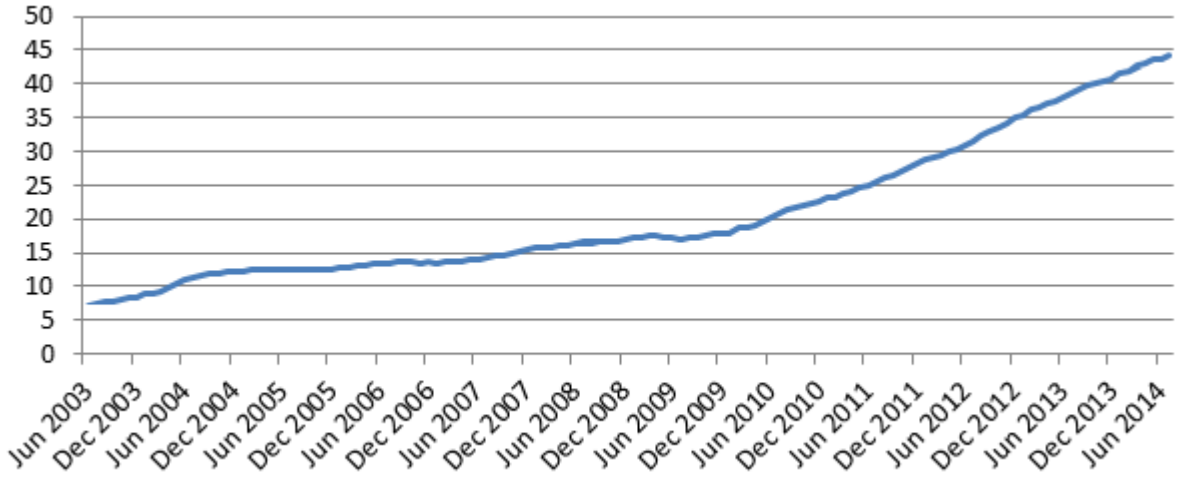
2015 was a terrible year for the luxury goods sector. The MERS outbreak in South Korea, Chinese stockmarket volatility and unusually warm weather all contributed to a poor retail environment. However, the main drag was Hong Kong where sales declined at a double digit rate because Chinese shoppers diverted their holidays and discretionary spend elsewhere. I went to Hong Kong to see whether this deterioration is a temporary problem or indicative of a structural change, and to understand the consequences for the luxury goods sector.

The Golden Decade

Hong Kong used to be the prime shopping destination for Chinese tourists. The introduction of the Individual Visit Scheme in July 2003 marked the beginning of a decade of unprecedented growth in mainland Chinese visits to Hong Kong. Before the introduction of the scheme, a little over 7 million mainland Chinese residents visited Hong Kong on an annual basis[1]. Ten years later that number had grown to 44 million, an astounding increase of over 500%. To put this into perspective, that number of mainland Chinese visitors to Hong Kong exceeded the total number of all inbound tourists to the UK in the same year (34.4 million)[2].

Hong Kong visitor arrivals from China



Source: Hong Kong Tourism Board, 12 month rolling, in millions.

Hong Kong retail sales soared 184% over the same ten year period, reaching over HKD 162 billion (c.£14 billion) by summer 2014. According to the Hong Kong Tourism board, the majority of this increase came from mainland Chinese tourists, as their average spend was almost twice that of non-mainland visitors.

[1] Source: Hong Kong Tourism Board
[2] Source: Visit Britain

During this time, Hong Kong's attraction as a shopping destination for mainland Chinese consumers was clear; it was close and cheap. Firstly, geographic proximity and the introduction of the Individual Visit Scheme meant access was easy. With strict visa requirements and high travel prices, more distant continents were less accessible. Secondly, shopping in Hong Kong was cheaper with no value added or import tax compared to up to 40% tax paid on the mainland, and a favourable currency situation with the Chinese renminbi appreciating over 30% against the Hong Kong dollar from 2003 to 2014. Thirdly, Hong Kong offered a much wider brand selection and product assortment. Ten years ago few Western brands had a meaningful presence on the mainland, and those that did rarely offered their full product range. Finally, the risk of buying counterfeit products was perceived to be lower in Hong Kong. With rising discretionary incomes, the Chinese gravitated towards luxury goods and, as many consumers were first time buyers, status was a big part of the purchase motivation. A Louis Vuitton bag bought in the flagship store in Hong Kong was much more likely to be authentic than one bought from a Chinese retailer on the mainland.

Abundant demand and a low cost environment made Hong Kong an ideal location for international retailers. This was especially true for luxury goods retailers, as these highly priced items meant that the tax and currency differentials resulted in greater absolute savings for the consumer. Although not explicitly disclosed, most luxury goods companies admit that Hong Kong was comfortably their most profitable market.

The new reality

Today the situation in Hong Kong is very different. After a decade of 11% compound annual growth, 2014 marked the first year of a decline in Hong Kong retail sales. So far there are no signs that growth is picking up again, with 2015 Hong Kong retail sales plummeting to an extent last seen during the SARS crisis in 2002.

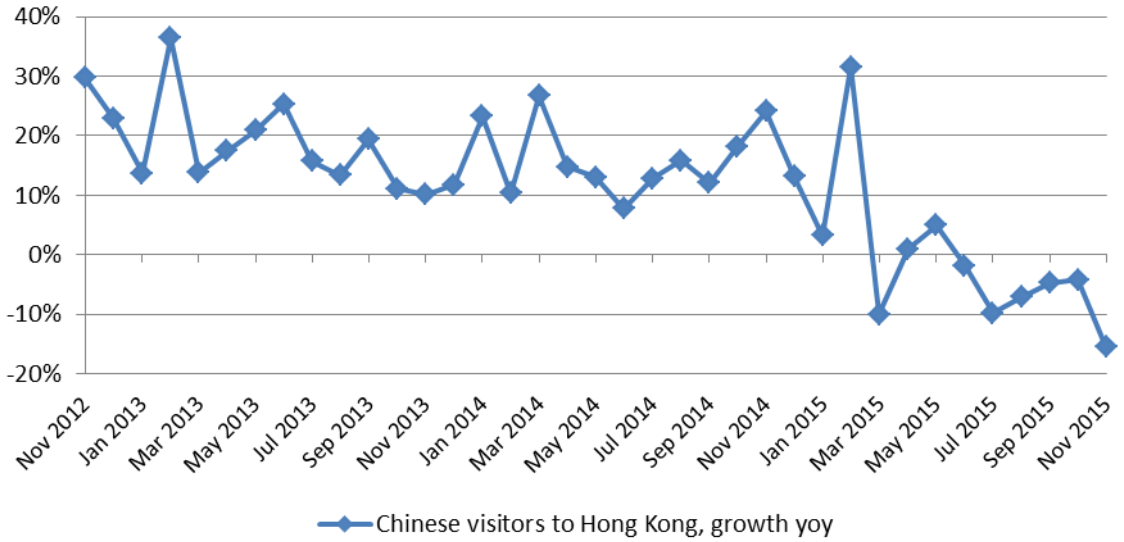
Hong Kong retail sales growth

Source: Census and Statistics Department Hong Kong, December 2015

This is due to the decline in Chinese visitors, which was down 15% year-on-year in November 2015. This marked the sixth month of consecutive declines after a decade of 20% compound annual growth. Bain and Altagamma[3] estimate that the Chinese represent over a third of global luxury sales. In Hong Kong this number is likely to be higher; Hong Kong mall sales to tourists range from 30% to 70% and the Chinese represent close to 80% of total Hong Kong tourists. This implies that the Chinese can represent up to 56% of Hong Kong mall sales.

[3] Source: Altagamma 2015 Worldwide Markets Monitor, October 2015.

Chinese visitors to Hong Kong



Source: Hong Kong Tourism Board, December 2015.

What happened?

The decline in Chinese visits and retail sales is a consequence of a variety of factors, including the Chinese government's anti-corruption campaign, Hong Kong residents' perceived hostility towards mainland visitors, currency fluctuations, changes in travel patterns and consumer sophistication.

The Occupy Central protests from September to November likely contributed to lower retail sales and inbound tourism in 2014. During this time, most industry players and commentators thought that the slump in visits by Chinese tourists was transitory. However, the declines have only accelerated since and the current consensus view is that this decline is structural.

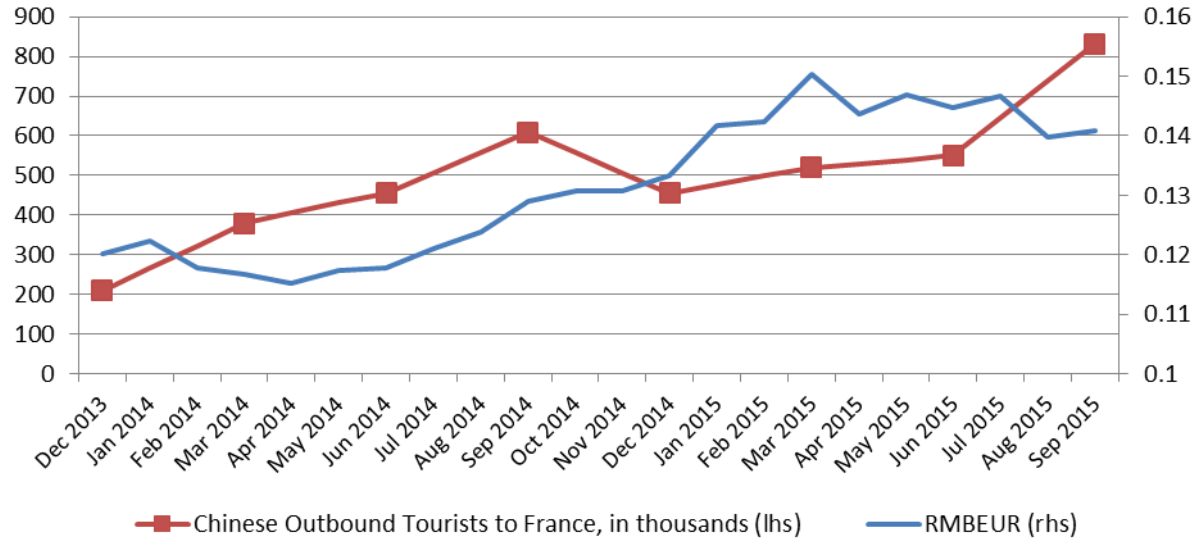
While the crackdown on corruption has put a dent in overall conspicuous consumption amongst Chinese consumers, the decline in retail sales and visitors to Hong Kong has been far more pronounced than the slowdown in overall Chinese luxury consumption and outbound tourism. For example, in a recent quarterly earnings call LVMH noted that Louis Vuitton sales to Chinese consumers worldwide grew at low double digits in the first half of last year, while total retail sales in Hong Kong declined 2% over the same period. Similarly, total Chinese outbound tourism increased 15% during the first nine months of last year, whereas the number of mainland visitors to Hong Kong did not grow at all. Clearly, the Chinese are still travelling and shopping, just not in Hong Kong. Therefore there must be other, Hong Kong specific factors at play.

Firstly, mounting cultural tension has likely had an impact. While the influx of mainland Chinese tourists benefited the Hong Kong economy, concerns have been building over the impact on the local community. The explosive growth in retail sales meant commercial real estate was in high demand. Naturally, retail rental prices increased substantially. As a consequence, the smaller shops serving local people's needs were forced to move outside central areas where rents were more affordable. Hence, the supply of daily necessities became more restricted for Hong Kong residents. Another concern related to over-crowding on public transport. As many mainland tourists would only visit Hong Kong for a day, they fill up both buses and the Mass Transit Railway on their way back. This is not very different to other big cities with significant tourism, but in the case of Hong Kong a handful of violent incidents have received a lot of press coverage. Consequently a perception of hostility has emerged amongst the Chinese and many no longer feel welcome in Hong Kong.

Secondly, shopping in Hong Kong is no longer cheap for mainland Chinese tourists. As the Hong Kong dollar became slightly stronger while the euro became significantly weaker, price differentials between Hong Kong and Europe increased substantially. A purchase made with Chinese renminbi in Hong Kong was now much more expensive than buying the same goods in Europe. As many luxury goods companies were reluctant to lower prices for fear of jeopardising brand equity, price differentials between continental Europe and Hong Kong went as high as 200% in certain instances. Additionally, as more and more people went online these pricing differentials became highly visible to consumers. Not only were price differences across regions higher than ever before, any brand's global pricing structure was now completely transparent. It didn't take long before the Chinese discovered a loophole in the Chinese tax system, whereby online international purchases are exempt from paying import tax. The amount varies across product categories, but for luxury goods it can be as much as 20%.

The shift in exchange rates also contributed to a change in travel patterns. The relaxation of visa requirements coupled with higher discretionary income and a favourable exchange rate spurred exceptional growth in Chinese tourism to continental Europe, Japan and South Korea.

Chinese visitors to France / renminbi-euro exchange rate



Source: China Outbound Tourism Research Institute, Bloomberg, December 2015

Finally, the Chinese consumer has evolved. As with most emerging market consumers, their initial priority for discretionary spending was physical goods. Now that they are becoming more sophisticated their priority is shifting towards experiences and services. This becomes problematic as Hong Kong has not evolved much as a tourist destination over the past decade. Whereas cities like Paris, Rome and Tokyo are rife with cultural experiences and ancient history, Hong Kong is still primarily seen as a shopping destination. With prices up to 200% higher than in continental Europe and other parts of Asia, shopping in Hong Kong is no longer a draw.

All in all, with easy access to other destinations where prices are lower, the range of experiences is greater and there is no perceived cultural tension, the Chinese are not left with many reasons to visit Hong Kong. After all, why would you go to Hong Kong to buy a handbag when you can go to Paris and get the same bag for half the price, and visit the Louvre, see Notre Dame and take a selfie in front of the Eiffel tower at the same time? The luxury goods companies are left in a difficult situation as they have invested heavily in sizeable and expensive retail networks in Hong Kong. Most companies have seen their profit margins weaken significantly as footfall in their Hong Kong stores is down by double digits.

As European investors, do we care that Chinese shoppers have abandoned Hong Kong?

All is not lost. The majority of the listed European luxury goods companies have explicitly communicated that their store networks in Hong Kong remain highly profitable. Although they have historically benefitted from abundant Chinese tourist demand, there is a place for them to serve domestic demand as well. And there is still hope for a pick-up in tourism. The Hong Kong tourist association has announced plans to launch a campaign to promote Hong Kong as a travel destination to tourists outside China and is looking to diversify its offer away from shopping. Nevertheless, even if the Chinese eventually return to Hong Kong or tourism from other nationalities starts to pick up, it has become widely accepted that the golden decade in Hong Kong is over. This begs the question, how will the luxury goods companies respond?

Some store network rationalisation seems highly likely and we are seeing signs of this already. For example, Burberry announced earlier this year that it will reduce the size of its store in the Pacific Place mall. Many companies are also trying to mitigate profit margin pressure by negotiating lower rents with their landlords. Some have already been successful in negotiations for their street level locations, but the negotiations are proving tougher in malls. Firstly, mall operators still have a waiting list of brands ready to take up any available space. This implies that there is still underlying demand in the market, and many brands do not want to lose their space as there is no new mall capacity coming on in Hong Kong. Secondly, mall operators believe that the luxury brands partly have themselves to blame for the sluggish sales, as the substantial price differentials deter customers from making purchases in their Hong Kong stores. Many mall operators see this is as a key source of their frustration with weak footfall and some are trying to incentivise the brands by offering lower rents in return for price cuts.

Many luxury brands have already started to adjust their global pricing structure, but this is a gradual process; it

would not be wise for any brand to halve their prices in a day. The luxury goods brands are in a particularly delicate position, as price cuts can be harmful to brand equity and is seen to violate the intrinsic value proposition of a luxury product. Some brands have implemented double digit price cuts in Hong Kong while raising prices in Europe and Japan. The danger here is twofold. Firstly, excessive price increases in any country puts domestic demand at risk. Secondly, exchange rates fluctuate every day and even if you align your prices today the situation can be completely reversed in a couple of months. Others are choosing to make adjustments through introducing new products at aligned prices. The difficulty here is that the longevity of the luxury goods product cycle makes this a very lengthy process.

What are the investment opportunities?

Luxury goods companies are facing up to the new reality in Hong Kong and the risk of earnings disappointments continues. But for the time being, it seems that the Chinese are likely to continue to travel and spend their money elsewhere, so all is not lost. This will inevitably require some re-jigging in terms of company structure and strategy. Management execution will be crucial in tackling the imbalances in global pricing structures and downsizing store networks might be necessary in adjusting to a structural decline in the Hong Kong consumer base. It is becoming increasingly apparent that the sector will have to be more agile in the future, in responding to fluctuating currencies, subsequent changes in travel patterns and rising online penetration.

The relative winners during this transition will be those companies that can be flexible in their inventory management and have the ability to predict the location of consumer demand and shift their products accordingly. A digital offer and omni-channel strategy will also become even more important in order to capture the growing online demand from ever more sophisticated consumers. When facing an uncertain future, investment opportunities will arise. We believe that identifying those companies that are prepared to tackle pricing imbalances, have the flexibility to respond to changes in the location of end demand and have a superior digital offering to capture online demand will deliver the greatest investment returns.