TIME TO RE-THINK HONG KONG IN YOUR CHINA STRATEGY?

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Hong Kong has long enjoyed brandowner attention for its unique exposure to Mainland Chinese consumers and its dynamic retail scene. Driven by better prices and quality reassurance, Hong Kong will continue to be a retail destination for years to come.

Many brands have historically leveraged Hong Kong to create a “brand halo” on Chinese consumers. However, as Chinese consumers gain greater access to multiple information sources and the costs of doing business in Hong Kong surge, can brandowners justify reduced profits in Hong Kong with the China halo argument?

Our belief is that it only makes sense for retailers to invest behind a brand in Hong Kong if it is profitable in its own right. For consumer goods companies in certain categories, however, lower profits during the investment stage in Hong Kong may be justified with an upside from potential South China sales. Hong Kong has a significant role to play in consumer goods companies’ multi-regional strategy.

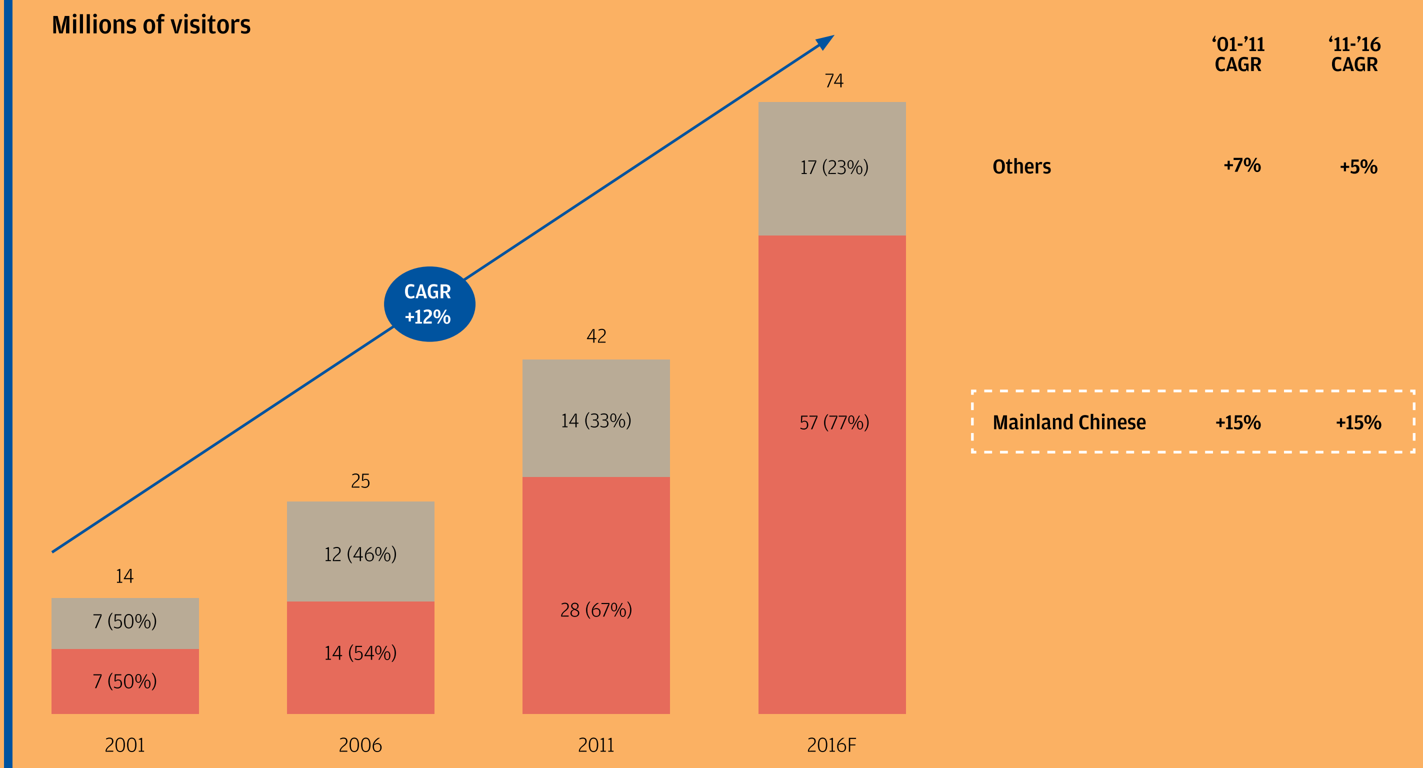
Hong Kong is and will continue to be a retail destination

Rivalling the United Arab Emirates and Malaysia in population and economic terms respectively, Hong Kong has a sizeable domestic market. Hong Kong consumers are relatively affluent, brand conscious and culturally receptive, cultivating a wide choice of branded flagship stores.

Further, Hong Kong represents a major shopping destination for Mainland Chinese visitors. In 2011, 28 million Mainland Chinese visited Hong Kong. Driven by an increasing number of cities that implement Individual Travel Scheme (ITS), the number is expected to grow at around 15% per annum and will reach 57 million by 2016 (See Exhibit 1).

Ready to untie their purse strings, Mainland Chinese consumers spend heavily. On average, they spend around USD850, 46% more than the next biggest-spending consumers from South-East Asia do (See exhibit 2). Three quarters of Chinese consumers' total expenditure, i.e. USD 640, is attributable to shopping alone.

Exhibit 1: Number of Hong Kong inbound visitors



Source: Hong Kong Tourism Board

Better prices and reassurance on product quality underscore such trends

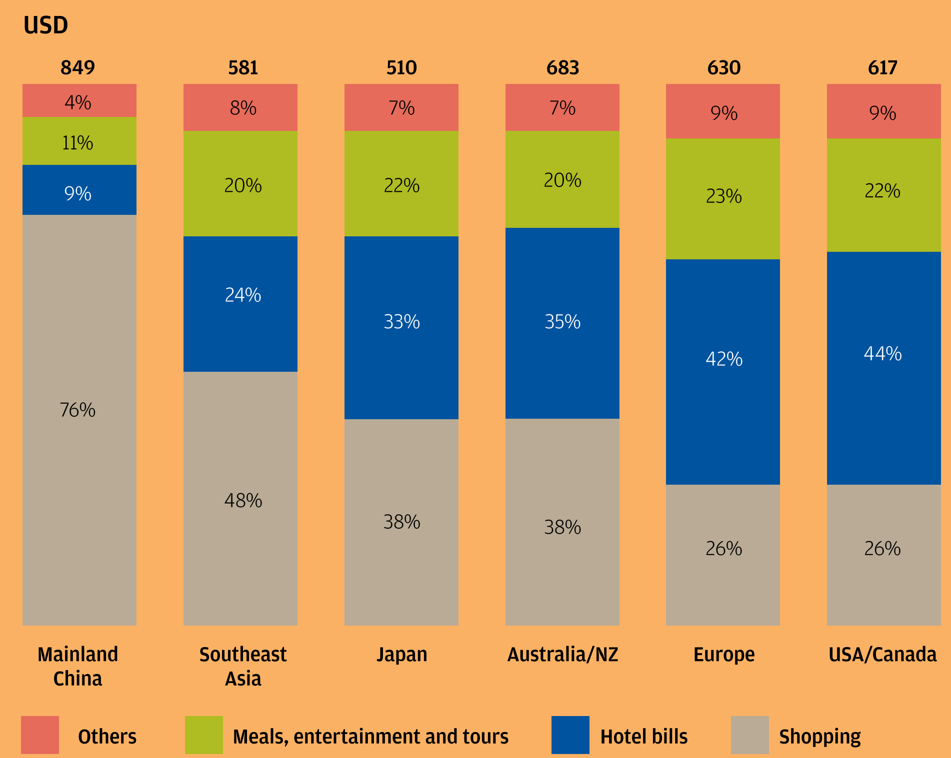
Though price differentials vary by product category, Hong Kong invariably offers better prices. A study in 2011 shows that luxury accessories and cosmetics products sold in Hong Kong are around 20% and 30% cheaper respectively than equivalent SKUs sold in Mainland China.

Better prices, combined with perceived reassurance on quality, better shopping experience, better choice and authenticity, help position Hong Kong as the pre-eminent shopping destination for Mainland Chinese tourists.

Given the relatively small geographical span and numbered shopping clusters, Hong Kong should be a very attractive platform that offers exposure to 57 million relatively affluent Mainland tourists in the near future, who are willing to spend USD 640 each time they visit Hong Kong.

Tickets aside, though, how can brandowners benefit from Chinese consumers by having a physical presence in Hong Kong?

Exhibit 2: Per visitor, per visit spend in Hong Kong



Source: Hong Kong Tourism Board

"Brand halo" comes in two forms. Over the years, we have observed that retail and FMCG brands can benefit from a strong equity in Hong Kong in subtly different ways.

The first form of "brand halo" refers to the perceived quality reassurance derived from having a tested consumer brand in Hong Kong. It is especially relevant for segments in which consumer trust and product safety are key purchase criteria.

One such segment is food product. Names such as Aji Ichiban (优之良品), Honeymoon Dessert (满记甜品) and Hui Lau Shan Dessert (许留山) are brands that began in Hong Kong years before making inroads into China. As of today, these brands have built a notable presence in China's tier 1 cities. Chinese consumers we speak to unanimously say that they place more trust with these brands since they are tested in Hong Kong. Brand companies have to be aware that, however, strict sourcing practices are necessary to maintain such halo.

The second form of "brand halo" points to the taste leadership effect - "since Hong Kong people are fashionable, successful brands there must be good for me". It is more relevant for consumer segments in which judgment on taste dominates the buying agenda.

A group of fashion and apparel chains leads in creating this form of halo. Examples include i.t., izzue, b+ab, and Staccato. These fashion brands have benefited from a strong base in Hong Kong, historically. Recently, however, we have found that a growing number of Chinese consumers, while recognising that these brands are "from Hong Kong", consider the Hong Kong element irrelevant.

Chinese consumers are changing. They have greater access to overseas travel, information and alternative purchasing channels. They simply have greater confidence in the choices they make.

Chinese consumers are gaining sophistication. They now have a wide range of options when it comes to travel. Rising wealth levels and easing travel requirements have made travels to Europe, the US and Japan within reach. Hong Kong is no longer the only accessible aspirational destination for Mainland Chinese visitors.

Mainland Chinese have also moved away from looking up to Hong Kong consumers for taste reference. The younger generation has come to view social media such as weibo as the primary information source and e-commerce platforms such as Taobao and 360buy as the preferred purchase channels, at least for some fashion categories.

Chinese consumers are empowered. They are leveraging their new power to research and make informed decisions. They simply have greater confidence in the choices they make.

Due to attractive prices, better quality reassurance and geographic proximity, Hong Kong will continue to be a purchase market for Chinese consumers. However, the taste leadership "halo" created by having a physical store in Hong Kong will diminish as alternative reference sources become readily available to Chinese consumers.

FOR RETAILERS

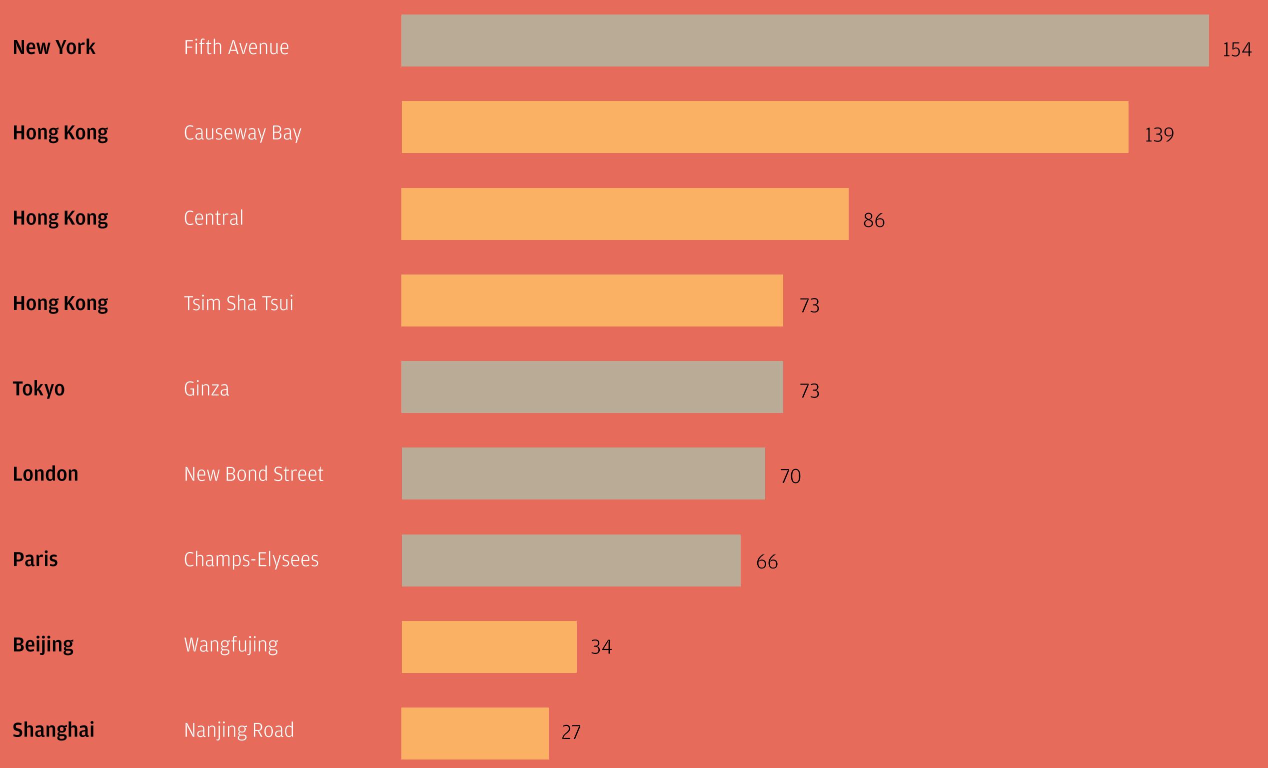
Surging costs of doing business further weaken the case for retail brand-building in Hong Kong.

Hong Kong is notorious for high rental costs. As of 2011, Causeway, a major shopping and tourist destination in Hong Kong, ranks among the world's most expensive prime retail locations.

Retail spaces in Hong Kong are 3-4 folds as expensive as comparable locations in Mainland China, namely Wangfujing in Beijing or Nanjing Road in Shanghai. (See exhibit 3)

Exhibit 3: Prime retail rental

USD / month / sqft



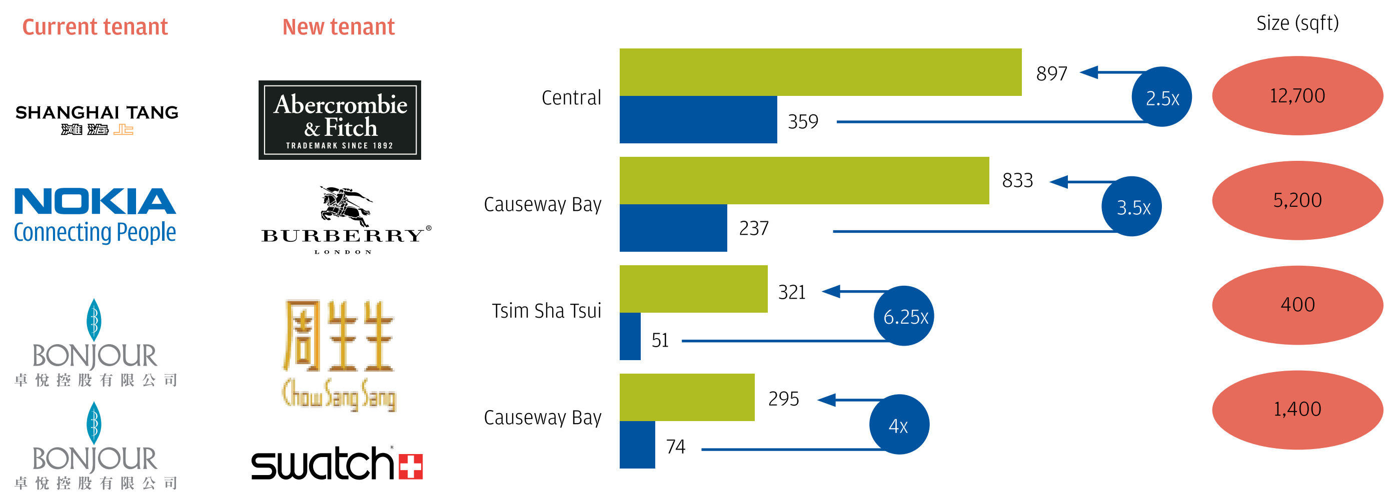
Source: Bloomberg; CBRE

Although this can partially be justified on the grounds that sales productivity is around 150% to 200% higher in Hong Kong than in equivalent locations in China's tier-1 cities, sales growth is not catching up with rental expense growth.

On average, new lease rental costs have at least doubled for new prime location leases in Hong Kong since 2008 (See exhibit 4). For a location in Tsim Sha Tsui, another popular shopping destination, the new rents are even five times higher than the previous cost for the same location three years ago. Costs for a prime retail location are expected to grow at an average rate of 30-35% per year over the next 3-5 years.

Exhibit 4: Retail rental comparison

USD thousand



Source: Company data

Putting these figures in context, Hong Kong recorded only a year-on-year increase of retail sales growth of 11% CAGR between 2006 and 2011. Even with an optimistic estimate of retail sales growth of about 15-20%, buoyed by still growing numbers of Mainland Chinese consumers, many retailers in Hong Kong will experience reduced margins going forward.

As the costs of doing business in Hong Kong will likely continue to surge for retailers, Hong Kong will increasingly look less attractive than other options such as Macau, Shanghai or Beijing. Take Macau for example, the number of Mainland Chinese visitors reached 16 million in 2011, representing a 22% increase.

For retailers of luxury and masstige branded goods, the implications are clear. As brand halo diminishes and the costs of doing business surge, Hong Kong should be viewed only as one of the many alternatives to building a strong brand in China and it will make sense to do so if it is sustainable in its own right.

FOR FMCG COMPANIES

Consumer goods companies can leverage Hong Kong to build a superior South China consumer brand

The local Hong Kong market alone represents a substantial opportunity for consumer goods companies. Although Hong Kong will likely require dedicated resources in the broader China organisation, Hong Kong offers a great marketing platform with its accessible channels and media.

There are added benefits for consumer goods players competing in categories where product safety is a key buying criterion. Chinese consumers attach great importance to product safety. We believe they place a "quality premium" for certain product categories that are selling well in Hong Kong.

Observing what consumers purchase at various districts bordering Mainland China, we find that the top three product categories purchased by Chinese visitors are, unsurprisingly, infant milk formula, beautycare items and packaged food products. Primarily from Southern China, these Chinese consumers are ready to pay a slight price premium for quality reassurance. Thanks to a better healthcare and monitoring system, products sold in Hong Kong still project an image of superior quality and product safety.

For companies competing in these "safety first" categories, brand-building in Hong Kong still makes sense. Hong Kong still creates a reassurance halo on Southern Chinese consumers.

Beyond a sizeable cross-border business / commuting community, language and cultural similarities help bond Hong Kong and the Pearl River delta region. These elements will allow brand companies to develop brand equity in Hong Kong and then convey similar brand message to vast Southern Chinese populations through intense cross-border interactions.

Much like Shanghai in the Yangtze delta area and Beijing in the Bohai area, Hong Kong is crucial in South China for ambitious brandowners. For consumer goods, success in Hong Kong likely indicates strong Chinese consumer acceptance in South China. As such, Hong Kong has a significant role to play in consumer goods companies' multi-regional strategy in China.

On this basis alone, consumer goods companies may justify lower early profits in Hong Kong with an upside from potential future sales in South China.

Management, however, needs to be aware that prolonged financial under-performance can never be justified with this potential upside. Savvy business leaders in China should not forget that distribution control and pricing competitiveness are also crucial winning factors in China.

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