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RETAIL

Luxury brands face a new retail dilemma in China

August 26, 2022

Shanghai's Plaza 66 mall has struggled to retain tenants in 2022. Image credit: Shutterstock

By Avery Booker

With little choice but to increase their focus on brick-and-mortar locations in China over the past two years, luxury brands must now make a difficult decision: pull back from the market or double down.

Facing waning consumer enthusiasm, rising economic uncertainty, high rents and unpredictable and sometimes extended COVID-19 lockdowns, this means we now see signs that luxury brands are re-examining their China market strategies.

This is a significant shift from mid-2020, China was a rare bright spot for luxury even as locations in other major markets remained shuttered.

When China reopened malls in spring 2020, the ensuing revenge spending boom encouraged many brands to open new stores or refurbish others while investing in digitalization efforts. And with affluent Chinese travelers largely unable to head overseas for their once-reliable luxury shopping sprees, luxury boutiques within mainland China saw an extended rise in footfall.

According to Bain & Company, domestic sales of personal luxury goods in China jumped 48 percent in 2020 and 36 percent in 2021, totaling nearly 471 billion yuan ($70.7 billion), a near doubling in just two years.

While demand for luxury goods in mainland China shows no sign of fully drying up, it has been battered.

Over the course of this year, this fact has been reinforced by luxury brands closing stores and taking a wait-and-see approach toward investing more in the market.

Meanwhile, major high-end shopping centers in China have recorded plummeting rental income and rising vacancy rates, exacerbated by the government's strict zero-COVID approach.

According to Chinese-language media, Shanghai's Plaza 66 luxury mall saw rental income drop 17 percent in the first half of 2022 to $105.8 million (724 million yuan) while tenant revenue dropped 38 percent during the same period.

The mall's previous full occupancy has also dropped to 98 percent. This represents a major shift in just one year, with Plaza 66 reporting a 56 percent increase in rental income and a more than doubling of tenant revenue in the first half of 2021.

This problem is by no means limited to Plaza 66 or Shanghai.

In the first half of the year, retail powerhouse Swire Properties reportedly saw a 26 percent drop in revenue at Taikoo Li Sanlitun in Beijing, an 8.2 percent drop at Taikoo Li Chengdu, and a nearly 7 percent decrease in Taikoo Li Guangzhou in the first half of 2022 although Chinese-language media attributes much of this to delays in receiving products from Shanghai warehouses due to the city's extended COVID lockdown.

Even as the market returned to relative normalcy earlier this summer, there are signs that consumer enthusiasm for shopping has dampened.

According to the Shanghai Municipal Bureau of Statistics, total consumption among Shanghai residents from January to May 2022 dropped 18 percent year-on-year, although the department notes that it expects this to show improvement in the third quarter of the year.

The key question is consumer confidence among young and affluent shoppers, which still has a way to go.

According to Chinese-language media, China retail sales in the normally vibrant month of July increased just 3.1 percent this year.

Besides potentially flagging consumer enthusiasm, luxury brands should be concerned about the unpredictability of China's duty-free market.

Earlier this month, more than 80,000 travelers were stranded in duty-free hotspot Sanya were stranded after a COVID outbreak triggered a lockdown that also forced duty-free shops to close during peak tourist season. This, in turn, will impact not only duty-free revenue which averages an estimated 200 million yuan ($29.2 million) per day but also threatens to dent luxury brand confidence in the Hainan market.

In the remainder of 2022 and going into 2023, one of the core questions facing luxury brands is how quickly China's outbound tourism market will recover.

According to current projections, the country may not see outbound travel reach pre-pandemic levels until 2026, at which point China's outbound tourism growth will likely outpace the United States, United Kingdom, Germany and France.

If these figures hold true and China's domestic retail environment remains challenging for the next year or more, brands may need to think about how to rebalance their market efforts investing in mainland China bricks-and-mortar efforts compared to optimizing international boutiques for Chinese travelers sooner than later.

It is highly unlikely that we will see a brand exodus from the market or a precipitous drop-off in brand investment in China in the near to medium-term the market simply remains too large and important for that. But it is also unlikely that we will see brands significantly increase their investment for the foreseeable future, with luxury groups cautious about becoming too reliant on the market and investing only in the highest-performing stores, while closing underperforming locations and reconsidering investment in areas like duty-free.

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