

## Rosefinch Research | Danger and Opportunity in Duty-Free Arena

How much do the Chinese consumers love shopping? According to UN World Tourism Organization, in 2018, Chinese citizens spent \$277.3 billion abroad, which is higher than the entire GDP of Greece. Since 2012, China has been the biggest country in offshore tourist spending every year. According to the 2020 report on Global Luxury Market by Bain and Altagamma, in 2019, Chinese mainland consumers purchased over 64 billion EUR of luxury goods while traveling abroad, which is more than twice of what they spent domestically. The pandemic had an impact on this spending pattern: in 2020, Chinese consumers bought 47 billion EUR of luxury goods domestically, which is 3 times what they spent abroad that year. The pandemic kept the Chinese consumers at home, and their luxury consumption wallet as well. Another change is quietly taking place as well. Sunrise Duty Free, which is the largest duty-free operator in China, launched a WeChat app that opened window of direct delivery. Instead of visiting the Sunrise Duty-Free shop in Hainan province, you can order from the WeChat app and get your favorite cosmetics delivered at home with a 40% discount, how sweet is that! The pandemic brought changes in the consumer distribution channels, which may very well be permanent. We will dig into how these changes are taking place through four perspectives:

1. Birth: The Irish Business Model
2. Opportunity: Squeezing Out the Victory
3. Focus: From License to Supply Chain
4. Brawl: New Opponents for Duty-Free Shops

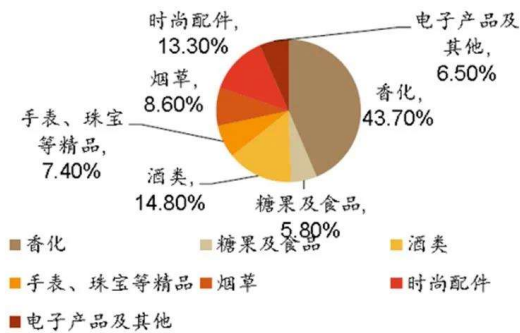
### Part 1 – Birth: The Irish Business Model

In 1947, Brendan O'Regan invented the concept of Duty-Free shop. With a counter that's barely two meters across, he started the first Duty-Free counter for cigarette and liquor at the Shannon Airport, which attracted many trans-Atlantic passengers. In China, the Duty-Free shops started in the 1980s to promote more incoming tourist industry. And after 2000, the Duty-Free shops in China took on another mission: to capture locally China's luxury goods consumption.

China has become the biggest luxury goods consumer nation in the world. From 2012 to 2018, China contributed over half of global luxury goods' increase. In 2018 alone, Chinese citizens spent 770 billion RMB on luxury goods, though with 70% or 500 billion RMB spent overseas. This consumption pattern is linked to China's tax code. The consumption tax for luxury goods in China is between 10 to 30%, which means for the high-end products there is a 20-30% gap between prices in China and in Europe or US. Considering these are big-ticket luxury items, the gap can be rather large in absolute terms. If the government wants to increase local consumption, it may be easier to retain the existing luxury goods consumption via tax-free policy than create hundreds of billions RMB of new consumptions. But not all luxury goods currently consumed abroad can be brought back to China – it depends on the luxury goods' brand strategy and consumer psychology.

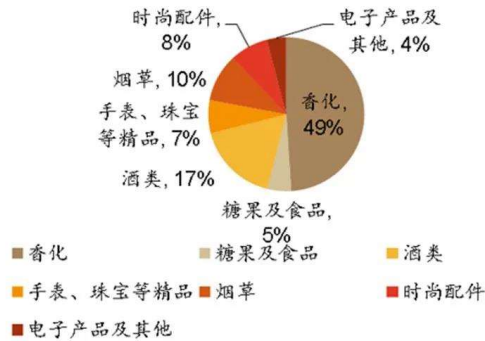
There are two main types of luxury consumption: first is the high-end luxury goods represented by bags or luggage; second is the medium luxury goods like perfume, cosmetics, cigarette, or alcohol. Even though it may be more profitable to distribute through Duty-Free shop, some luxury brands would rather keep their bags out of Duty-Free shops and distribute in their flagship stores instead. Chinese tourists can still buy them at the brand stores and receive tax rebates upon departure. Therefore, it's rather difficult to capture these high-end luxury consumptions via Chinese Duty-Free Shop. Instead, the focus will be on medium luxury goods like perfume, cosmetics, etc.

### 全球免税销售品类分布



数据来源: Generation Research, 德邦研究所, 朱雀基金

### 中国免税销售品类分布



数据来源: Generation Research, 德邦研究所, 朱雀基金

*Global vs China Duty-Free Shop product mix. Source: Generation Research, Topsperity Securities, Rosefinch*

The Chinese overseas consumption of perfume, cosmetic, cigarette, alcohol, watch, and jewelry is about 30% of total, or 170 billion RMB. Remember the entire market for Chinese high-end white liquor is only about 200 billion RMB, so these consumptions are sizeable. If these luxury spending can be brought back to local consumption, it's equivalent to creating another white liquor market. The experiment to attract overseas luxury consumption started in 2011 with Hainan province starting "tax-free" shopping for domestic consumers. There's noticeable increase in capture consumption with Chinese duty-free industry increasing from 12 billion RMB to 54.5 billion RMB, or average annual growth rate of 47% in the 9 years since 2011.

### 中国免税行业销售规模及增速



数据来源: 商务部, 前瞻产业研究院, 德邦研究所

*Source: Ministry of Commerce, Qianzhan Industry Research Institute, Topsperity Securities*

## Part 2 – Opportunity: Squeezing Out the Victory

During the pandemic, when travel stopped and most commercial activities slowed, the luxury market had its boom. LV rose prices four times within one year, and Chanel Classic Purse #2.55 went from 38,100 RMB to 51,500 RMB. Along with the prices came the sales numbers for the Duty-Free shops. In 2020, Hainan province's Duty-Free revenue was 27.5 billion RMB, up 103.7% YoY vs previous +50% growth rate. The pace is still picking up, with the July to Oct 2020 average per visitor purchase of 6,553 RMB, or +28% vs 1H20. This sudden growth burst is mainly due to evolution of distribution channel and return of foreign consumption flows. The government policy also helped, with a timely increase of Duty-Free cap raised from 30,000 to 100,000 RMB. Meanwhile, with number of travelers down dramatically due to various pandemic restrictions, Duty-Free shop is moving online.

There are two main ways to do online Duty-Free shopping: follow-up purchase or direct mailing. Follow-up purchases refers to using online channel to purchase Duty-Free goods within 180 days of visiting Hainan province. The direct mailing refers to Sunrise Duty-Free that mail goods directly to the consumers after purchases via online app. The online distribution brought tens of billions of revenues for the Duty-Free shops, but it also impacted the current main channel of airport Duty-Free shops. With the quick increase of online distribution, the bargaining power of Duty-Free shops are increasing. During the pandemic, Duty-Free shops signed new updates on airport agreements, where guaranteed rental payments are replaced by percentage of revenues. Airports are becoming risk partners rather than landlords, which brings more risk. While the online consumption will reduce value of airport distribution, it won't completely replace it. Airports see a lot of traffic amongst the middle-class to wealthy consumers, which still has a lot of value.

With Duty-Free shops now deploying online direct distribution like a cross-border e-commerce merchant, there's a new problem of how to balance the interests of branded goods. When Duty-Free shops take the branded goods, the prices via duty-free or online distribution will all be lower than the prices at the brand flagship stores. The main reason for the Duty-Free shop's pricing advantage is government's effectively subsidizing via lower tax. The purpose for this policy was to increase domestic tourism spending and capture oversea luxury consumption. From brand perspective, Duty-Free is a consignment channel. While consignment is easier and without fixed costs like shop space or logistic costs, it is harder for the brand to control distribution and maintain its prestige. Therefore, brand products usually go with the direct-sales channel rather than consignment channel. On the other hand, the traditional target group of consumers for Duty-Free shops have high purchasing power, which makes them a natural target group for luxury brands as well. At the same time, sales via Duty-Free shops generate higher profits thanks to less overheads. Therefore, some luxury brands are willing to distribute via the Duty-Free shops. If the same prices are made available to all consumers, it may generate higher profits overall, but may damage the pricing system or brand's luxury image. In Asia, luxury goods carry a certain status symbol, which is why it must avoid being seen as a general consumer item. The eco-system of consumer goods is like a pyramid: luxury goods are at the top. All the brands are battling each other

furiously, with any slip in its brand value means a drop in its pyramid layer where it's even more competitive. Maintain the brand's compatibility with its target clients' status is the red line that must never be crossed. From this perspective, Duty-Free shop doing online distribution may look like a simple distribution channel switch, but it's actually a battle between Duty-Free shops with the brand for its exclusivity status. With more licenses for Duty-Free shops, the game is getting more complex. Duty-free industry is moving from the wild west towards the competition for the brick-and-mortar supply chain capabilities.

### Part 3 – Focus: From License to Supply Chain

From 1979 to 2011, the Duty-Free policy went through a period from opening to tightening, and then gradually loosening.



Source: government website, Topsperity Securities, Rosefinch

In the last 20 years, Duty-Free licenses are very hard to get. There's very little competition in the industry, with easy profits for those that have the licenses. Largest Duty-Free shops have over 90% of the market share. Even if they split 40% of revenue with airports, there'll still be over 10% margin. As more licenses are released, more players are getting into the field, and licenses' values are decreasing while competition is increasing. Duty-Free shops must now balance the upstream and downstream needs, expand its eco-system, and excel in its supply-chain management. The competition of the industry will shift from licensed access to stable supply-chain.

When it comes to supply chain, there are three key factors: product sourcing, negotiation prowess, and supply chain stability. Product sourcing is a core ingredient for the supply chain. The buyer must have strong insights on the consumption trends, confirm specific product types and volumes, and manage the inventory efficiently throughout the process. Because there are only a handful of Duty-Free shops, those buyers who are familiar with the industry are in short supply. The next factor is the negotiation prowess, which is required both for purchasing and brand distribution. The Duty-Free shop must build good communication channel and trust with the global brand headquarters. And the stability of supply chain must come from detailed operational capabilities and effective logistical controls. Since

most of these factors take a long time to achieve, many new Duty-Free shops are choosing cooperative model with major global Duty-Free players.

As online and offline shopping merge, the competition of Duty-Free shopping is no longer only about the Duty-Free status. Much of the popular products for Duty-Free shops overlap with typical e-commerce platforms. From retail sales perspective, both channels are competing for the same client base. And this business area has another major competitor: the internet giants.

#### Part 4 – Brawl: New Opponents for Duty-Free Shops

In the past few decades, the Duty-Free market is small and driven by policy support. When the license values erode, the advantages of Duty-Free shops are disappearing. From retail sales perspective, the Duty-Free shops are servicing the mid- to high-luxury retail market. Even though e-commerce merchants are subject to taxes, because they have better control of supply chains, they can deliver competitive prices even below Duty-Free prices for selected products. As these e-commerce merchants' supply chain management improves, they will become even more competitive with more products.

#### 官网&电商&免税&跨境电商价格对比

单位: 元	品牌官网	天猫旗舰店	CDF 海南免税 官方商城	天猫国际	考拉海购(自 营)	京东国际
雅诗兰黛第七代小棕瓶修复 精华	9.47/ml	9.47/ml	6.97/ml	无单品	7.25/ml	8.99/ml
海蓝之谜 浓缩修护精华露 50ml	4250	4250	2973 (暂缺货)	--	2649	2750
兰蔻 玫瑰露清滢柔肤粉水 400ml	435	435	263 (三件 85 折)	249	225	自营无单品
SK-II 肌因光蕴环钻白精华 露 50ml	1540	1540	948 (三件 85 折)	1299	1109	1389
资生堂 红妍肌活精华露 100ml	9.83/ml	9.83/ml	6.43/ml	13/ml	11/ml	自营无单品
乔治·阿玛尼 权利权力粉底 液红标 30ml	600	600	323	自营无单品	418	408
SAINT LAURENT PARIS 圣 罗兰 黑管唇釉 #416	335	335	187 (三件 85 折)	自营无单品	279	235
CPB 肌肤之钥 黑长管隔离 乳打底霜 37ml	540	540	395	485	349	319
Amani 阿玛尼女士手表 AR1909	3790	3200	3040	3072	2999 (暂缺货)	3070

数据来源: 品牌官网, 天猫旗舰店, CDF海南免税商城, 天猫国际, 考拉海购, 京东国际, 德邦研究所  
注: 数据截止到2021年6月10日

As the Duty-Free shops move online and the internet giants globalize, they're butting heads in the mid- to high-luxury retail market. They are both looking for a sharp growth curve, with the Duty-Free shops facing the steeper climb. In e-commerce, other than supply chain management, IT development, volume management, and synergy between online and offline businesses are all important factors. These are often challenging for Duty-Free shops, so they often choose cooperation with e-commerce companies. For internet giants, they lack the global supply chain capabilities. Rather than building their own supply chains, the internet giants found a shortcut via cooperation with global Duty-Free players like Dufry and Lagadere. The global Duty-Free shops can't access China market directly, so cooperating with Chinese internet giants or Chinese Duty-Free shops is a good way to monetize their supply chain.



Hainan Development Company cooperates with Dufry, while Hainan Tourism Investment Company cooperates with Lagadere, and both partner with an internet giant to create two major leagues. These leagues and new Duty-Free entrants are increasing competitiveness in the market and taking market share away from leading Duty-Free shops.

From Rosefinch Consumer team's perspective, even though some market shares will be taken away from leading Duty-Free shops, the whole industry is benefiting from returned oversea luxury goods consumption and online distribution. When we look at the historical developments of South Korea's Duty-Free industry, those shops with excellent supply chain and familiarity with consumer preferences will have clear advantages in the Duty-Free brawl.

The pandemic has changed the consumer sector via different distribution channels. It also changed the consumption behaviors where certain previous offline purchases are moving completely online. With any destruction will come creation. Any disaster will also have opportunities. When you go with the trend, you will find your 2<sup>nd</sup> growth curve and achieve superior returns for the investors.

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