

Hainan's \$40 billion prize: The new battleground for global luxury

This popular vacation destination is likely to capture a growing share of Chinese luxury spending.

by Aimee Kim, Alex Sawaya, and Michael Straub



Hainan's luxury market is poised for stellar growth

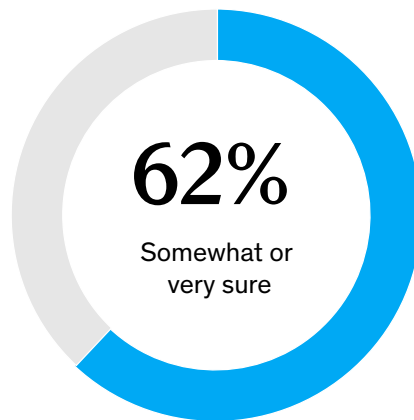
In June 2020, the Chinese government announced a plan to transform the island province of Hainan into the world's largest Free Trade Port. The scheme comprises policies such as reducing corporate and individual tax rates, relaxing visa requirements, drastically expanding the Hainan duty free program to allow visitors to spend up to ~\$15,000, and even allowing consumers to purchase duty free products online for six months after returning home. Starting in 2025, the entire island of Hainan will be designated a duty-free zone, thus eliminating the need for brands to collaborate with duty-free license holders.

Chinese international air travel fell by close to 90 percent in 2020 according to Civil Aviation Administration of China data, and McKinsey analysis suggests it will not recover to pre-COVID levels before 2023/24 at the earliest. As such, Hainan is ideally placed to absorb Chinese luxury duty free demand. Unfazed by the ongoing pandemic, Chinese travelers flocked to the island, doubling overall spend on duty free in 2020 to ~\$4.3 billion, up from ~\$2.1 billion the previous year. Another record-setting year is on the cards in 2021, with spending during the recent Labour Day holidays in May up 248 percent year-on-year, according to official customs statistics from Haikou, the provincial capital. The Hainan government expects spend to surpass \$9 billion for the year as a whole.

Exhibit 1

Hainan travelers are looking to come back

Share of respondents planning to return to Hainan for duty free shopping, even after international travel resumes



Source: McKinsey Hainan duty free shopper survey, N = 552, June 2021

Even after Chinese borders start reopening to leisure travel, Hainan is likely to play an increasingly significant role in capturing Chinese luxury spending.

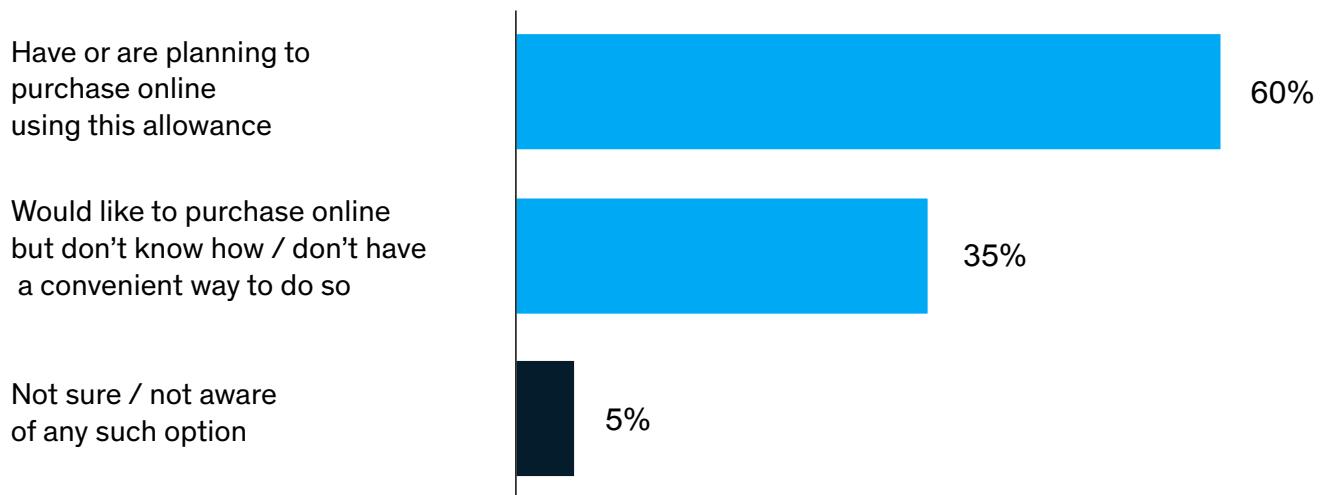
Even after Chinese borders start reopening to leisure travel, Hainan is likely to play an increasingly significant role in capturing Chinese luxury spending. In fact, in a McKinsey survey of 550 Hainan duty free shoppers conducted in June 2021, more than 60 percent of respondents indicated they would return to Hainan for duty free shopping even after international travel resumes. Moreover,

an impressive 95 percent of recent travelers have taken advantage of the new rules allowing for online post-travel duty free purchases or are looking to do so in future. Of those planning to return to Hainan, more than 40 percent seek to increase their spend next time, compared with only 12 percent who are looking to spend less.

Exhibit 2

Almost all travelers have or are looking to take advantage of online replenishment

Willingness to try online replenishment ordering after leaving Hainan, %



Source: McKinsey Hainan duty free shopper survey, N = 552, June 2021

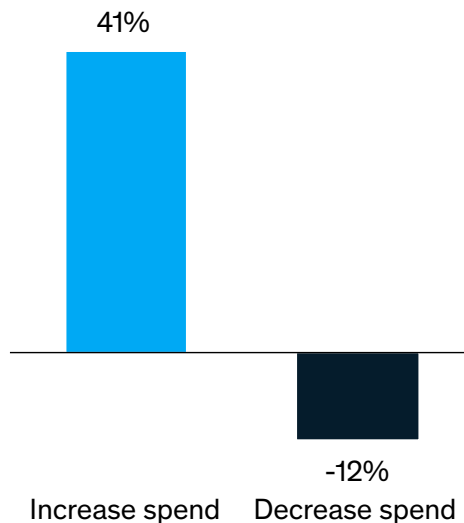
The Hainan Provincial Government's 14th Five-Year Plan estimates Hainan's duty free market will grow tenfold between 2020 and 2025 to reach \$46.5 billion and become one of the world's largest travel retail locations. This astonishing growth will be supported by:

- **Favourable regulations:** Local and central government will continue promoting Hainan's evolution into a globally competitive duty free and luxury hotspot through measures such as granting more duty free licenses, increasing the duty free allowance to a world-leading ~\$15,000 per person, and introducing further online post-travel replenishment options.
- **Significant investment from major stakeholders:** New duty free operators and ecosystem players (such as Alibaba and JD) are entering the market, developers are planning to double duty free mall capacity over the next four years, and brands are investing heavily in marketing duty free business through social media and omnichannel events to drive market growth.
- **Price competitiveness:** A narrowing price gap with comparable overseas duty free shopping destinations, and significant price advantages compared with the domestic market of as much as 20-30 percent before additional discounts, will further stoke demand and syphon off demand from domestic and overseas travel retail markets.

Exhibit 3

Hainan shoppers are looking to increase spend in future visits

Share of respondents planning to increase and decrease spend in their next trip to Hainan



Source: McKinsey Hainan duty free shopper survey, N = 552, June 2021

While beauty has been leading the development of the market and accounted for roughly half of all Hainan duty free sales in 2020, there is a growing opportunity for other luxury categories as consumers look to diversify spend. For example, while only ~15 percent of beauty shoppers surveyed indicated they had purchased fashion during their most recent visit, almost one in three said they would like to do so on their next trip.

Long term risks to luxury brands

The majority of brands in Hainan duty free currently operate under a wholesale-like model, where the duty-free operator (DFO) runs the multi-brand and single-brand stores and commands strong control over inventory, pricing, and staff. This model has been successful at driving immense volumes through ultra-efficient sales aimed at price-sensitive, high-volume buyers. However, it also entails significant risks for luxury brands in the long term, including:

- **Damage to brand equity:** The DFO-led model optimizes for volume at a significant discount, ensuring that pricing and discounts are the top reason for buying. This disregards brand-building, or providing a differentiated, luxury shopping experience.
- **Margin erosion:** Without control over pricing and little incentive for the DFO to maintain pricing consistency with domestic markets, luxury brands risk cannibalizing their China domestic business, and eroding their total China brand margin in the long run.
- **Lack of customer relationships:** With DFO staff operating stores and promoting the DFO's own membership program, brands are severely limited in their ability to build new customer relationships, generate insights on consumer behaviour in Hainan, and retarget consumers after they have returned home.

The response of some luxury brands has been to actively limit their presence on the island or to refrain from opening a presence entirely. However, with Hainan growing fast to take an increasingly significant share of the Chinese luxury market, and

slated to become a fully duty-free island province by 2025, it is imperative that luxury brands formulate a strategy to enter, operate, and scale in the market.

Setting up a winning play

A clear winning model for luxury brands has yet to emerge. For luxury brands to build long-term sustainable growth on the island, the following actions are critical:

1. Define a differentiated retail operating

model: Depending on the negotiating power of the brand and the DFO:

- Vis-a-vis strong incumbent DFOs, tactically seek win-win opportunities to increase brand control, such as installing brand-managed store managers that both drive productivity and strengthen staff brand training.
- Vis-a-vis newly entering DFOs lacking scale and prime locations, define a radically different, brand-led model with strong control over pricing, merchandising, staff, a shared supply chain, as well as demand planning, and data operation.

2. Create a unified view of the Chinese

customer: Across both Hainan and domestic businesses, shared loyalty programs, customer data platforms (CDP), and a shared data analytics team enable retargeting of Hainan travelers after returning to their hometowns, and vice versa. Making this happen will require brands to fundamentally rethink their domestic & travel retail organizations and collaboration model.

3. Establish a set of strategic partnerships:

Aim to gain critical access and capabilities in the market, in particular:

- Explore online collaborations with ecosystem players, for example home delivery and online replenishment offerings for unused duty-free allowances. Only 5 percent of shoppers surveyed took advantage of home delivery due to the hassle and long delivery times involved, and 30 percent indicated they would like to replenish online but are unaware of a convenient way to do so.

- Manage relations with all key policymakers at the central, Hainan provincial, and municipal levels, accounting for different policy considerations and mandates.

4. Lay the groundwork for directly operated stores: Starting in 2025 brands will be able to operate duty free stores in Hainan without needing to collaborate with a DFO. To prepare for such directly operated stores, brands need to gradually develop teams and capabilities, such as brand-owned supply chain strategy & oversight, real estate development, government relations, local merchandising & pricing, as well as a dedicated Hainan talent development unit.

5. Maintain agile Hainan brand-building operations: Adopt a stage-gated investment model, in which new investments are unlocked once the prior stage has shown to produce results. This should give brands necessary flexibility in Hainan's rapidly evolving market.

Hainan's authorities have made the most of limitations on international travel and inculcated a desire among Chinese luxury shoppers to support the island province's development into a global duty-free shopping hub. The opportunity for luxury is evident, but in the current model trade-offs between driving volumes and protecting brand equity remain. The winners will be the brands that succeed in creating a new model that defines a luxury experience to attract customer interest in Hainan for years to come.

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