



FASHION RE-DESIGNED

China Apparel 2020



THE WHIRLWIND IN THE CHINA APPAREL MARKET

In the last decade, expanding in China was an easy ride with high sales growth driven by store expansion and same store sales increase..... but that is about to change. This period was attractive for both local and international apparel retailers in China as Chinese apparel retail enjoyed double digit sales growth. The next decade will bring lower growth, a higher importance of lower tier cities, a significant share for online and nationwide market share gain for the new entrants' generation. This will lead to a market that will be very different from how we know it today, a market that

will require different models to survive and win. How should local and international apparel retailers respond to these changes and win in this market?

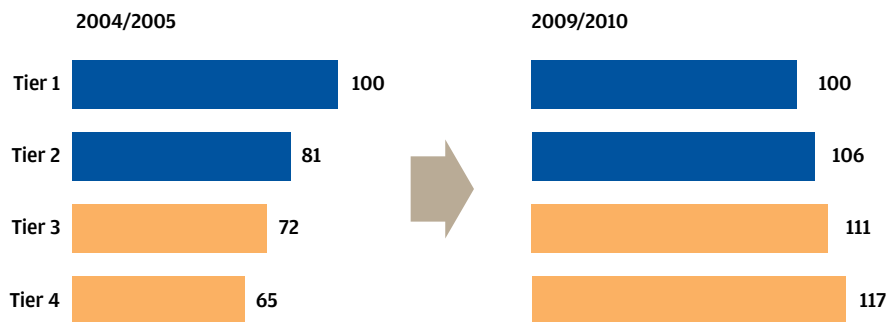
To better understand what the future will bring, we conducted extensive interviews with operators, analysts, mall operators and department stores supplemented by more than 500 in depth street interviews with Chinese apparel shoppers in tier 2, 3 and 4 cities in Central China. Here is what will change.

From double digit to single digit growth

In 2012, apparel sales slowed down in line with the overall economic environment in China. For the coming years, we expect that growth will continue to slow down to single digit growth in tier 1 and 2 cities (from high double digit growth in past years). We expect overall growth to slow down to 9-11%, with this growth mainly driven by the continuing increase of disposable income. Still an attractive number compared to most markets but not the exuberant growth that prevailed for the last decade.

Retail sales development by city tier

YoY change, Index 100 = YoY growth rate in tier 1 cities



Source: City Statistical Yearbooks; OC&C analysis

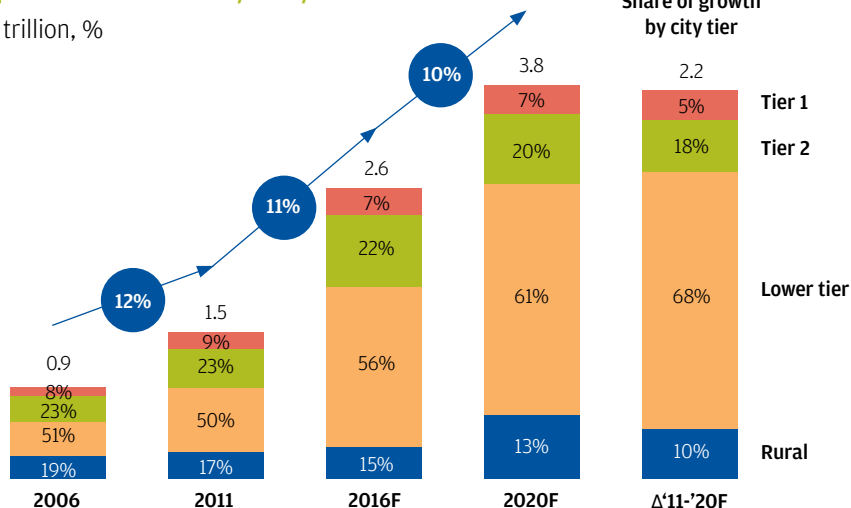
70% of growth from lower tier cities

The growth rate of retail sales in tier 3 and 4 cities will exceed the growth in tier 1 and 2 cities, which have been the most important playing field for new entrants in the market in the last decade. Whereas in 2011 lower tier cities already represented ~50% of the total apparel market, we expect this percentage to increase to over 60% by 2020. The lower tier cities will be contributing over 70% of the total growth in the coming years.

This is a growth opportunity that can't be missed by any player who wants to be a winner in the apparel market. When expanding into lower tier cities, companies should be aware that consumer characteristics and needs are different. Brands are less important with consumers mostly buying local brands today; though this could be driven by less choice. But international brands are quickly catching up and brand will matter more. Sportswear remains a bigger component, having a share of ~20% in the wardrobe of consumers in tier 3-4 cities compared to 5-10% in tier 1 and 2 cities; however this share has decreased in recent years and consumers expect it to decrease further.

Apparel market by city tier

RMB trillion, %



Source: China Statistical Yearbook; City Statistical Yearbook; Euromonitor; OC&C analysis

Brands bought most often by city tier



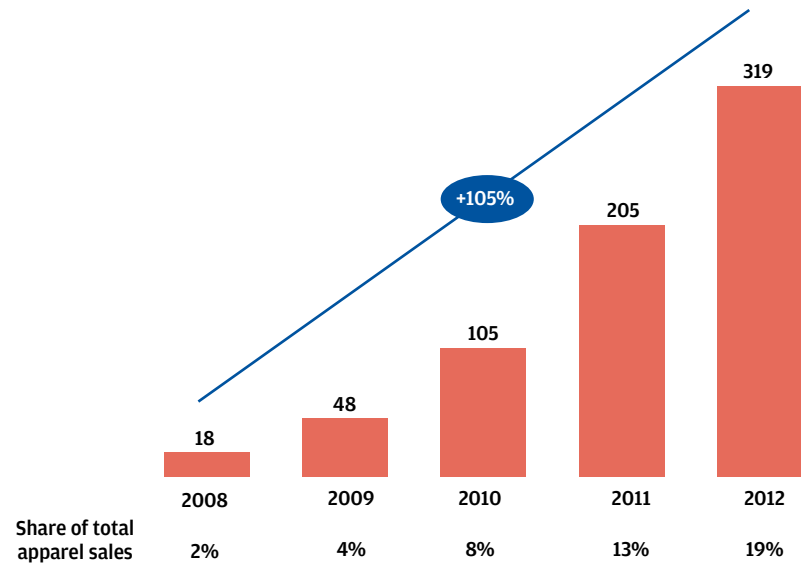
Source: OC&C street Intercept survey (Nov 2012); OC&C analysis

One out of four pieces will be sold on line

The online channel has already become a major sales channel, representing 9% of total apparel sales in 2012, up from only 2% in 2008. China's online apparel share is already above the level of the UK and South Korea and our analysis suggests that the online channel will reach 25% in the next 5 to 10 years. Online apparel shopping is especially popular among women, with an online share of 14% for women's clothing compared to 7% for men's clothing in 2011.

Share of online apparel sales

China's Online Apparel Sales and Market Share¹, 2008-12
RMD bn, %



Source: iResearch; Euromonitor; OC&C analysis

With one piece out of four bought online it does not mean other channels will disappear. Malls and departments stores

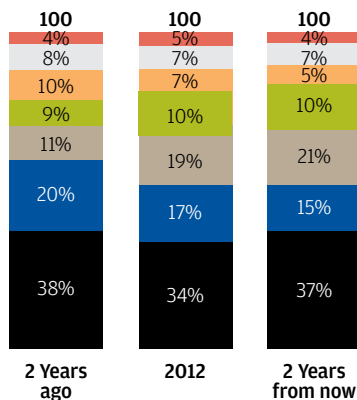
will survive; but store economics will be more demanding and under pressure from lower productivity. High streets will

suffer more unless it transforms into large destination flagships for the brands.

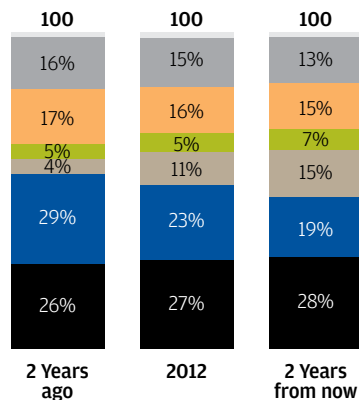
Change in channel mix of apparel spending by city tier

% of total apparel spending

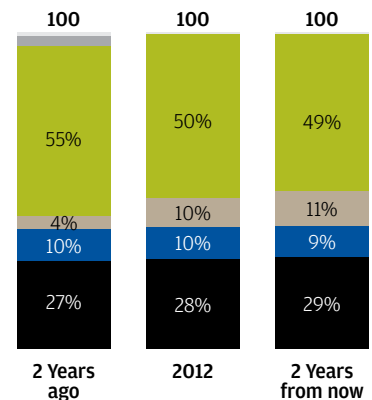
Tier 2 (Changsha)
N = 124



Tier 3 (Zhuzhou and Xiangtan)
N = 191



Tier 4 (Yiyang and Loudi)
N = 203



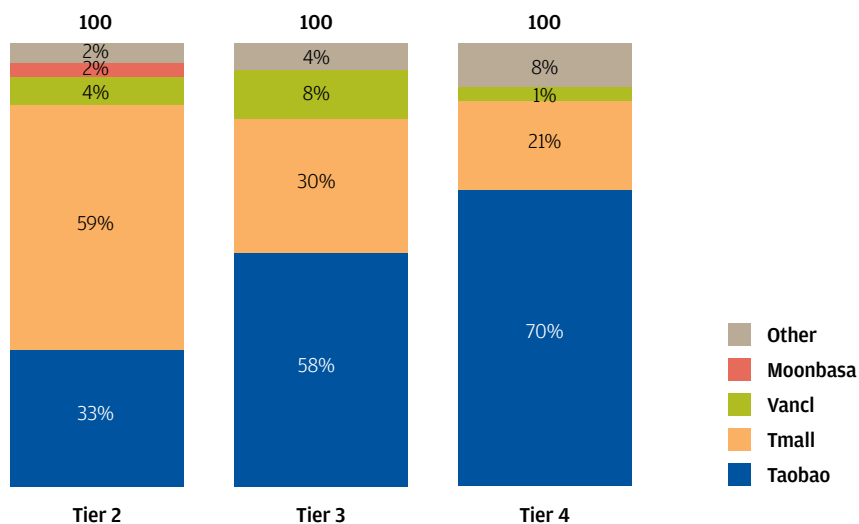
Source: OC&C street Intercept survey (Nov 2012)

Tmall (~85% of online B2C), although less developed in lower tiers, is making impressive inroads there and more brands will be offered to consumers who currently are geared towards C2C platforms which mostly offer low priced, non-branded products .

In lower tier cities, low prices are still the main reason for consumers to shop online. But in higher tier cities consumers also start to value the online channel for convenience and range. Ten years from now, the increased wealth in lower tiers will also change consumer behavior in the same direction while price will remain an important factor.

Online apparel purchase share by online retailer by city tier

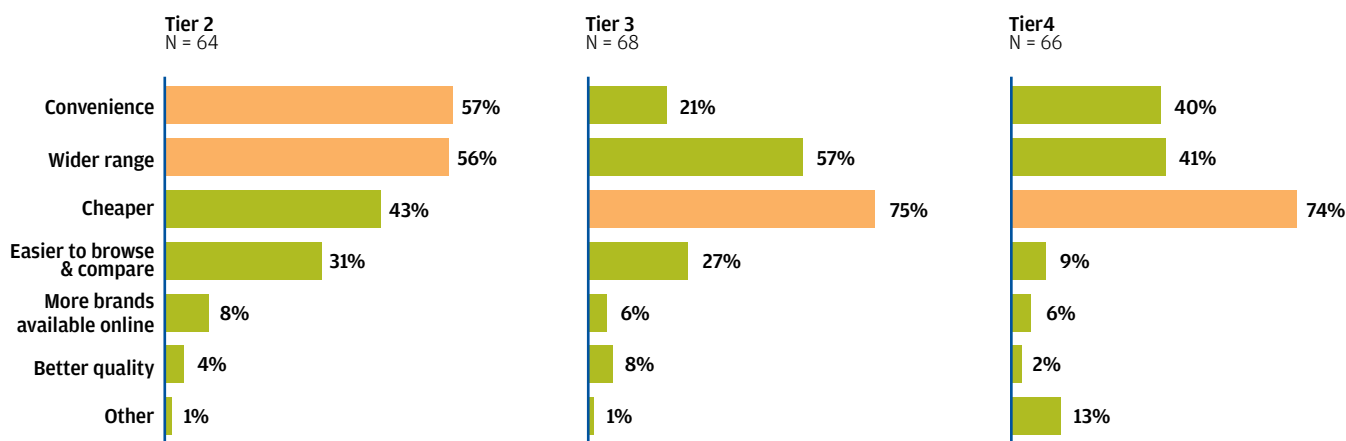
% of total online apparel spending



Source: OC&C street Intercept survey (Nov 2012); OC&C analysis

Reasons for shopping apparel online by city tier

Importance of reasons for shopping apparel online by city tier
% of maximum score



Source: OC&C street Intercept survey (Nov 2012); OC&C analysis

For these online apparel shoppers outerwear is the main category bought online, a high proportion of them also buys their footwear, accessories, hosiery and underwear online. Most consumers (~95%)

do their online apparel shopping on their computers at home, but the penetration of consumers shopping at their computer at work or on their mobile is also significant. Alipay and online banking are most often

used as payment method, but consumers also frequently use cash on delivery or their credit card especially in higher tier cities.

Continuous roll out for big chains

The China apparel market is still very fragmented with the top 10 only representing 3-5% market share overall (compared to 26% in the US and 11% in the UK). In tier 1 cities like Shanghai however the top 10 players already account for around 10%-15% where successful entrants like Zara, H&M and Uniqlo have been enjoying good growth; the single

store sales of their most successful stores exceed US\$ 20 million. As these players are now expanding into lower tier cities we expect that the overall China market will become more consolidated and be more comparable to tier 1 cities in the coming years. In addition, new powerful entrants are likely to come attracted by the competitors' fast growth.

Timeline of international brand entry



Source: Company websites; Desktop research; OC&C analysis

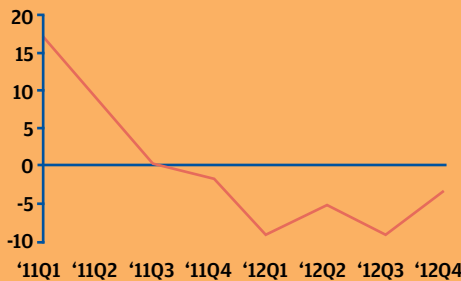
WHAT DOES THIS ALL MEAN?

Decrease of same store sales

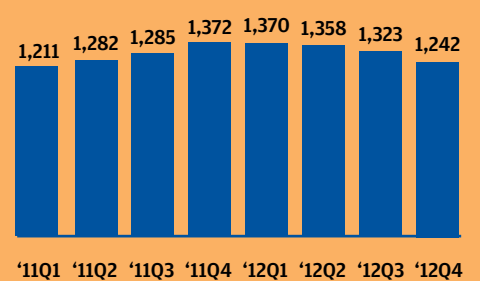
Some local nationwide players are already experiencing negative like-for-like sales growth. We expect a further decline of store productivity driven by the move to online and more intense competition. As labour and rental costs will continue to rise, offline retailers will face more and more pressure on their store margins.

Same store growth and store portfolio Giordano

Same store growth
YoY % change



Store portfolio
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Source: Corporate Annual Reports; Analyst Reports; OC&C analysis

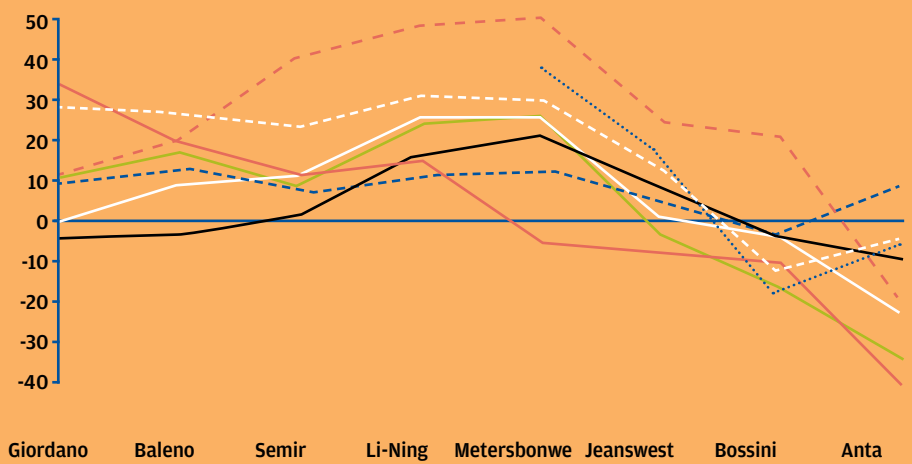
Store portfolio adjustments

Early entrants used a franchise model to open a significant number of stores and get across the country quickly. But the leading local players with a high number of stores are now suffering from a sales decline driven by negative like-for-like sales growth and store closures. Geo-marketing and clearer positioning of store formats will become essential.

To remain profitable they will need to further adjust their store portfolio to adapt to the change in the market structure.

Sales development local players

YoY half-year sales growth, 2009H1 - 2012H2



Source: Annual Reports; Analyst Reports; OC&C analysis

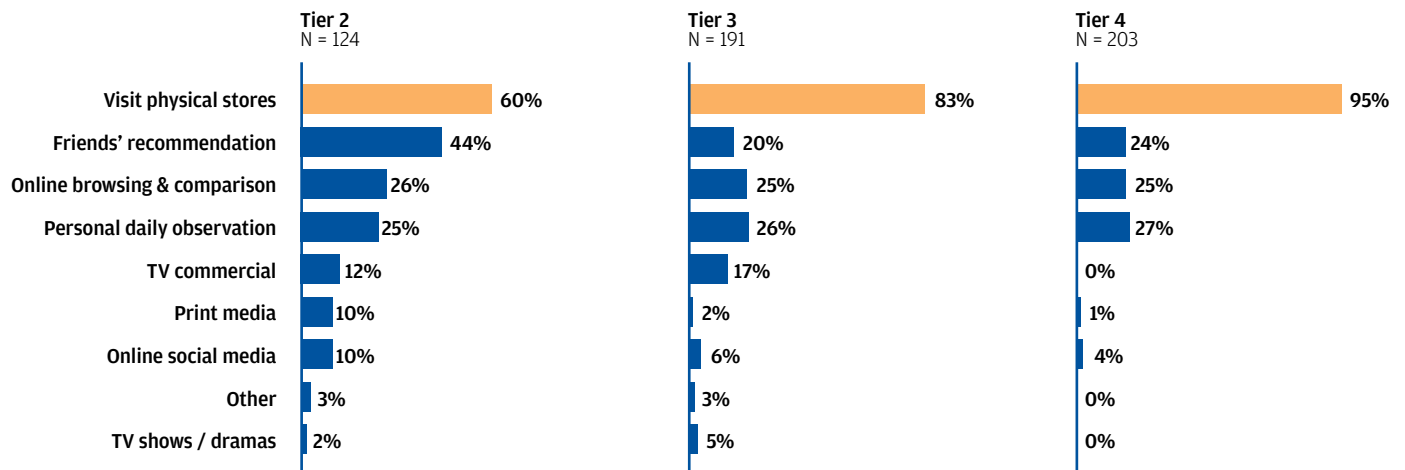
Although online will capture a significant part of the market, physical stores will remain important for brand building. Our research shows that physical apparel store visits are still a main source of inspiration across city tiers and many consumers still

prefer to shop in the physical store when they can choose between buying online or offline from a new international apparel retailer. So, when retailers are expanding their reach to lower tier cities, online only will not be sufficient and physical stores for

brand building in the new cities will still be required. They may however need fewer stores than they might have a few years ago.

Inspiration sources for apparel shopping by city tier

% of maximum score²



Source: China Shopping Center Development Association of Mall China, OC&C analysis

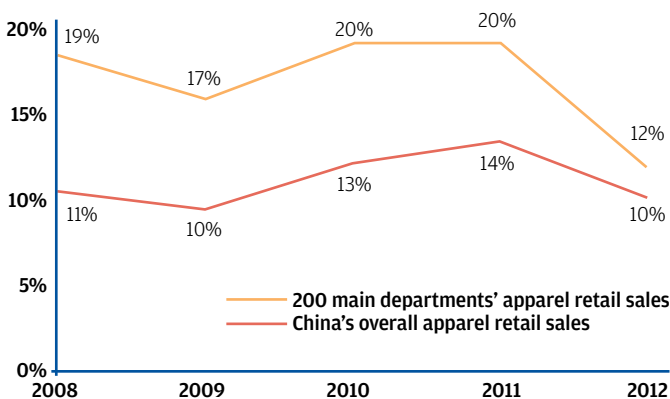
Another adjustment will be on store format; high street stores are the store format that will suffer most from the increasing share of online. Department stores seem resilient as they have consistently been outperforming the market in recent years.

Shopping malls will continue to open at a hefty pace, especially in lower tier cities. Our research shows that consumers expect to shop more in shopping malls in the future. This will put even more pressure on high street stores (especially in the north and south where shopping malls

and department stores allow for much more convenient and enjoyable shopping experience given the climate). Do not expect super prime location prices to go down though! Yes, rents may go down in non performing malls and street but who cares?

Apparel sales of 200 main department stores vs. overall market

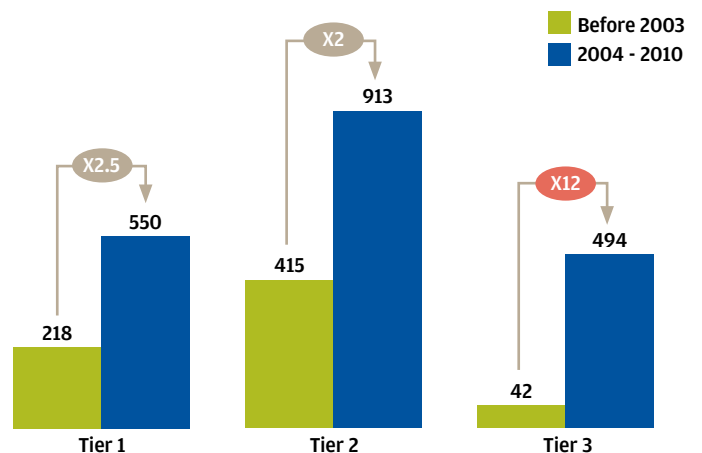
YoY change, %



Source: First Capital Securities Research Institute; Euromonitor; CCGM; OC&C analysis

Shopping mall openings by city tier

Cumulative number of openings



Source: China Shopping Center Development Association of Mall China, OC&C analysis

More intense competition in lower tier cities

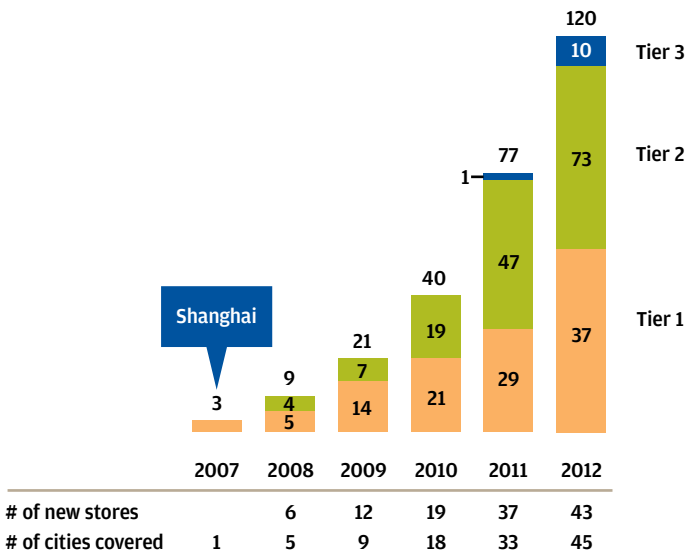
Currently, the lower tier cities are dominated by local and international brands who entered the market years back. But as the international new entrants are expanding into tier 3 cities, the local

brands should expect fiercer competition like in tier 1 and 2 cities. International players like Zara and H&M are accelerating their number of new store openings, now opening around 30 new stores per year.

Store rollout of H&M and Zara by city tier

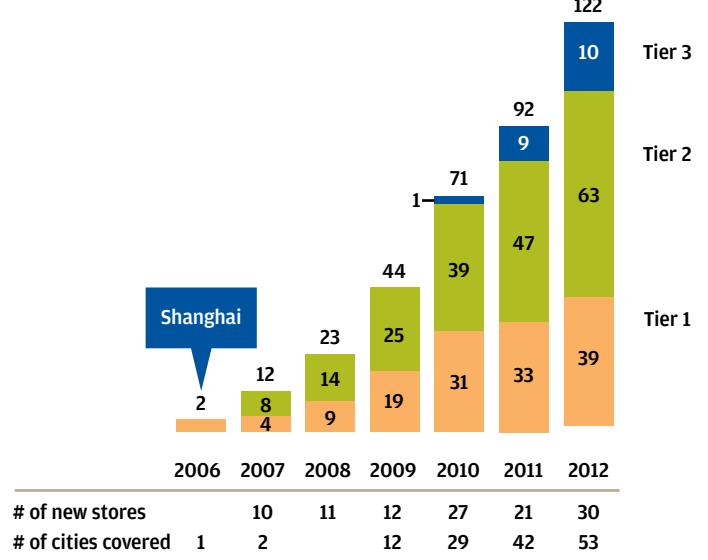
H&M rollout roadmap by tier

of stores



Zara rollout roadmap by tier

of stores



Source: Annual Reports; Desktop research; OC&C analysis

Consolidation of brands

Not all brands will be able to survive in this re-designed marketplace. Consolidation in

the market, especially for the sportswear and local value players is expected.

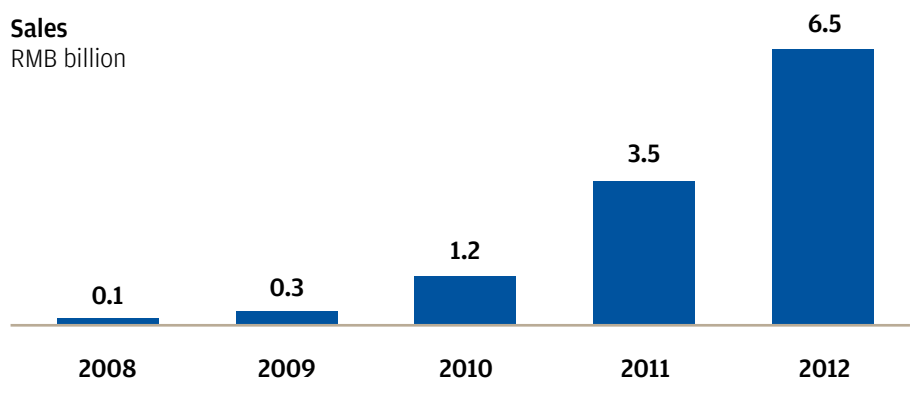


A new platform to win

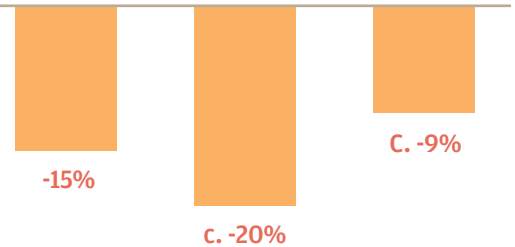
Despite the high growth of online, the economic model of pure play online players is yet to be proven. Although revenue of Vancl, the leading pure play online apparel player is increasing fast, it is still years away from making money. The results of our Proposition Index showed that Vancl significantly dropped in consumer ranking after not being able to deliver its promise. It tried to increase prices to improve profitability which damaged its customer perception. The race for size cannot last too long as apparel shopping is by definition a short life cycle!

Vancl financials

Sales
RMB billion



Profit margin
%



Source: Company website; Desktop research, OC&C analysis

HOW TO SUCCESSFULLY SURVIVE THE NEXT DECADE?

- **Invest in your brand with better control over execution**

As the market gets more competitive, not all brands will be able to survive. Winners will be the ones with strong brands that resonate with consumers. Better control in store execution will be key to deliver strong, consistent brand messages, especially for operators with franchisees. This means strict management of store operations, integrated IT systems, and potentially buying back franchisees

- **Continuously restructure your store portfolio**

The future channel structure will be different from today's with a significantly higher share of online, fewer high street stores and with department stores and shopping malls the winning offline formats. To fully capture the potential, adjustments in store portfolio will be needed, including choosing the right mix of property types. These different property types will require other adjustments including store format, layout, merchandising, and collections

- **Be more responsive to the market**

As the apparel market will become more volatile, winners will need a model that enables quick responses to market volatility. Integrated supply chain from design to store and better management of factory outlets (online and offline) for inventory clearance without harming the brand will be essential

- **Define a winning online proposition**

Pure online players have not found the right economic model yet; maybe a combination of different online platforms will be needed. In any case, a clear definition on the roles of each off- or online channel and fine-tuning of assortment and prices will be drivers of success. Going straight for online could be a good strategic option for entrants for testing and brand building; Forever21 and Topshop are examples of recent new entrants into the market who first opened an online store to test the market before opening physical flagship stores

- **Develop an integrated multichannel model**

The future will increasingly require an integrated multichannel model where the internet should be leveraged both as a selling platform and as a marketing tool. An integrated model that allows consumers to switch between channels smoothly at will (check the latest designs in the flagship store, check prices and buy online and maybe return products to the physical store) will be more complex to operate but success will only be at that price

If you want to know more about our research, please do not hesitate to contact us. We will be more than happy to share our detailed insights.

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