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THE WALL STREET JOURNAL.
WSJ.com

OPINION ASIA | March 8, 2012

A New Outlet for China's Consumerism

Foreign retail innovation brings affordable luxury to the middle class.

By CHRISTOPHER CAROTHERS

Beijing policy makers say they're eager to encourage greater domestic consumption. Chinese shoppers are famously luxury-happy, flying to Hong Kong and further afield in droves to stock up on Louis Vuitton, Gucci, Chanel and more. All of which means the stage is set for the next great innovation to hit China: outlet malls.

Outlets have long been a staple of the American and European retail landscapes. The concept is simple: High-end retailers operate shops in outlet malls to sell out-of-season merchandise at a steep discount. The companies earn some return on items they would otherwise destroy. Shoppers gain more affordable access to luxury goods, although at a distance—outlet malls tend to pop up in out-of-the-way spots, so that the hassle of traveling there creates a "cost" for consumers that makes the outlet less likely to cannibalize sales of the more convenient, more expensive and more "on-trend" high street shop.

As the outlet-mall concept comes to China, it's shaking up the retail environment. Consider Florentia Village, a 60,000 square-meter re-creation of a 16th century Italian village that opened last year about 50 miles outside of Beijing. One of the first such complexes in China, the joint venture between Italian retail giant RDM and the American Waitex Group is betting on reeling in first-time luxury consumers from the middle class with discounts of 30% to 70% on European brands like Prada and Bulgari.

RDM sees big untapped potential among brand-conscious middle-class shoppers, and aims to "open the market to many," chairman and chief executive Jacopo Mazzei says. He's not alone. "In the last year or so, [outlet retail has] suddenly a lot of investment," consultant Paul French says. Florentia Village is among the only foreign, large-scale outlet malls so far, but many more are in the works. RDM is planning to open two new outlets next year, and Value Retail, a British outlet company, will open its first outlet complex near Shanghai in 2013.

Such malls promise to fill an important niche. China's brand-conscious middle class still lacks for ways to spend its spare cash. These consumers might not fly to Hong Kong for shopping trips, but also tire of limited choices at home.

Which makes outlet malls a useful case study in how foreign investment will be crucial to China's transition to a domestic-consumption-led growth model. Chinese-owned outlet malls have been around for at least a decade, but so far they lag behind foreign outfits like RDM in size and quality. Foreigners turn out to have critical soft skills in the outlet business.

One sign of this is that Chinese-owned outlet malls "fail to attract top brands" because those brands "don't want to hurt their business" by cooperating with Chinese companies, analyst Qiu Yujun of Planet Retail says.

Outlet malls involve a certain reputational risk for high-end companies. Selling even out-of-date merchandise at cut-rate prices can undermine the pricy perceptions these brands carefully cultivate.

So the quality of the outlet mall is important—it has to look like a place where luxury is sold. "It's not like a big box store," Mr. French says. "Your maintenance costs are high to make the [outlet mall] look good. But what will a Chinese one look like in six months?" Luxury brands, it seems, have nightmares in which Western newspapers run full-page photos of their logo decorating a rundown strip mall in Lanzhou. Mr. French notes that these brands look warily at poorly maintained regular malls across China and wonder how well they can trust local managers.

An International Council of Shopping Centers report on Chinese outlet development published in 2010 shed some light on the mistakes the Chinese are making. Some developers built malls with multiple stories only to discover that "neither tenants nor customers were willing to go upstairs." Many developers significantly underestimated the demand for parking spaces, while others built "village-style" malls—buildings connected by outdoor sidewalks instead of fully enclosed spaces—in areas prone to extreme weather.

Foreign outlet-mall operators have a much easier time recruiting top brands to their China ventures because they already have established trust from their European and American malls. It's all about the relationship brands have with certain operators, Mr. Qiu says.

This fits in with a broader pattern. Boosting domestic consumption is not simply a matter of diverting goods produced in exporting factories into the home market instead. A successful consumption economy requires special skills all its own—the skills to brand and market products, in addition to the ability to physically distribute them.

One of China's challenges in rebalancing is building up these skills. Foreign companies, with the quality management and marketing know-how China needs, will be key to this transition. While domestic outlet-mall operators struggle, foreign ones have started pulling new middle-class consumers into the luxury market and convincing people to shop at home instead of flying abroad. Given the country's economic goals, this trend should be food for thought for the National People's Congress.

Mr. Carothers is a Princeton-in-Asia fellow at the editorial page of The Wall Street Journal Asia in Hong Kong.

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