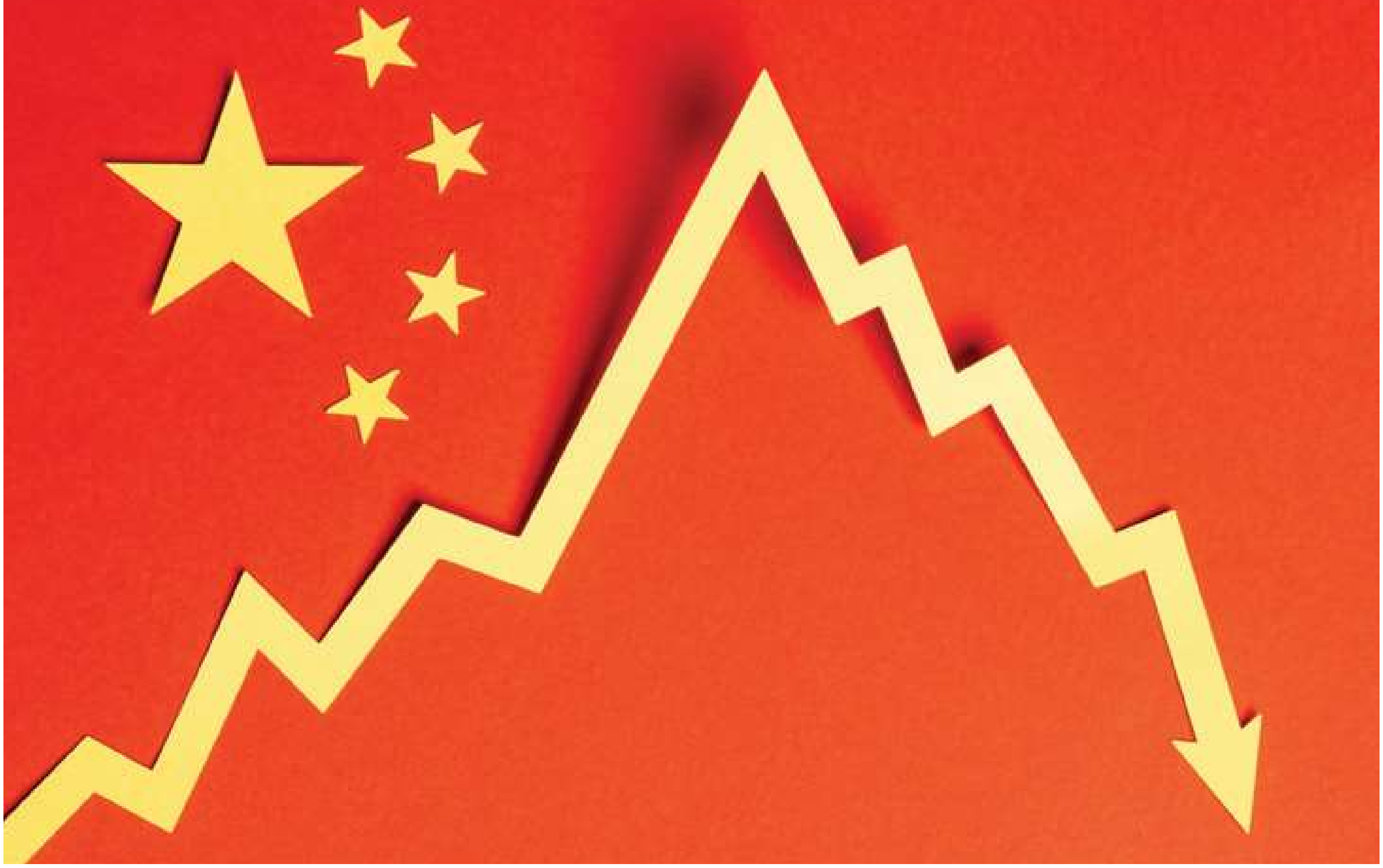

Country overview

The risks and rewards

Slower overall economic growth and harsh Covid lockdowns are set to take their toll on China's beauty market this year

by Sophie Douez

After years of strong growth, momentum in China's beauty market is slowing on the back of economic uncertainty related to the pandemic, a property downturn and a swathe of new government regulations. And this was before the government imposed stringent lockdowns in major cities throughout the country, including in Shanghai, due to a rise in Covid cases. The lockdowns are set to have a major impact on consumer spend (even despite China's sophisticated online environment).

Although China's economy grew at a faster-than-expected rate of 8.1% in 2021, growth slowed significantly in the second half of the year. The World Bank forecasts Chinese economic growth will slow to 5.1% this year, as the downside risks to its economic outlook increase.

In beauty, online sales, which represent more than half of total sales for many major prestige beauty groups operating in China, continued to see good growth year-on-year. But, in line with the overall economy, the category showed a slowdown, from 47% growth in the first half of 2021, to 15% in the second half, according to The NPD Group, due in part to sporadic lockdowns.

Despite slower growth at the end of last year, the harsh lockdowns and an overall less rosy economic picture, beauty executives continue to stress that the fundamentals of the Chinese market remain intact, citing a growing middle class and increasing per capita spend.

Consumer fatigue?

But despite this optimism, the distribution environment and consumer habits in China have changed dramatically, as has the business climate. Many observers point to consumer fatigue with online festivals and the relentless push-to-buy that categorizes the Chinese market, as a key factor in the downturn.

"Overheated consumption particularly in e-commerce was prevalent in the Chinese mainland until the first half of 2021, but lately we have seen a shift to a more sober and steady consumer behavior," comments Kanebo Cosmetics China Senior Director of masstige cosmetics business Asei Shioji. "When selecting cosmetics, cost performance remains a strong criterion for Chinese consumers. What has also changed is that consumers nowadays are less influenced by emotional factors, such as brand image, but place more importance on transparency and scientific evidence, such as ingredients, production processes, formulation, and efficiency."

Skincare continues to dominate the prestige beauty category, with the past year marked by increased emphasis on functionality and a rising tide of Chinese derma brands like QuadHA, Winona, or Dr Alva. Skincare contributed 76% of gains in 2021 prestige e-commerce beauty, compared to make-up, which contributed 12%, according to NPD.

"Riding on the momentum of function driven skincare, a bunch of local functional derma brands have been witnessing unprecedented success in terms of sales performance thanks to their unique positioning, problem-solving formulas, ingredients and KOL and celebrity marketing," comments Ifop Asia Head of Qualitative Amy Tan.

Another category that is seeing strong growth is fragrance. Indeed, the explosion of fragrance sales in China has been put forward as one of the key reasons for the category's growth globally. L'Oréal Luxe President Cyril Chapuy recently commented that fragrance, which has traditionally accounted for less than 5% of the luxury beauty market in China, reached close to a 10% share in the last months of 2021.

> "The beauty market in China is expected to grow, albeit at a slower pace in the coming year, as it is expected to face supply-side pressures and potential lockdowns and border closures. Constantly changing regulations, both Covid-related and beauty industry ones, exacerbate operational complexities"
>
> Luxasia Group CEO Wolfgang Baier

Fine fragrance sales in China reached $1.4bn in 2020, a 15% increase over 2020, and rose 30% in 2021, according to Euromonitor International. Still, only 5% of the population in China use fragrance. Fragrance house Takasago estimates that that China, which is currently the sixth-largest fine fragrance market globally, will reach the number-two rank by 2025, just behind the US. Niche fragrances have been performing particularly well in the market.

International mainstream niche fragrance brands such as Jo Malone, by Kilian or Penhaligon's have been busy ramping up marketing efforts and opening stores in tier-one cities. However, Gen Z's thirst for newness and culture resonance is also seeing Chinese fragrance brands like Documents, a high-end offer built on a rebellious, mysterious and solemn image, make a splash in the market, says Tan. "Thanks to its original and strong concept and its high concentration EDP fragrance, Documents is recognized as a special, singular and high-end niche fragrance brand competing with the international ones," comments Tan.

Meanwhile a focus on self-care is fueling sales of bodycare and haircare products. Men's beauty is also seeing strong growth ,as men gravitate to a more refined grooming routine, comments Tan. "Key products like foundation and eyeliners are becoming popular [among men] and the growth rate of boys (born after the 2000s) buying liquid foundation is twice that of girls and four times that for eyeliners," she says.

Lower-tier potential

With tier-one and tier-two cities saturated when it comes to beauty, many companies—including Chinese brands and retailers—are focused on building the business in lower-tier cities, where rising purchasing power is seeing consumers trade up in their beauty purchases.

"Lower-tier cities are seeing an increase in spending potential for prestige beauty," comments Daxue Consulting Project Leader Steffi Noel. "Prestige beauty brands in those lower-tier cities are also showing growth in offline retail stores."

While the upper-tier cities remain the go-to destination for quality retail, the increased competition there is having an impact on overall profitability. Lower-tier cities present good opportunities for high-end brands to enter, but the motivations of consumers here are different to those in upper tiers, comments Luxasia Group CEO Wolfgang Baier.

"They are highly brand-conscious and are more price sensitive," he says. "It's important to think of China not as a single country, but an amalgamation of many regions and provinces, with different operating contexts, cultural nuances, maturity of logistics structure, accessibility, and therefore different strategies for brand-building execution."

With the Chinese restricted to domestic travel, prestige beauty brands have increasingly focused on Hainan to compensate for lost travel-retail sales, and not without reason. Total sales at Hainan's duty-free stores increased 85% year-on-year in 2021, and the most purchased duty-free products are beauty products. Noel says the duty-free policy on the island has become a key factor driving fast-growing beauty brands in China. And as non-duty-free retailers continue to enter the island, Hainan is now being seen as an opportunity to offer prestige beauty shoppers elevated retail experiences without the accompanying duty-free discount. "China duty-free groups as well as many others significantly increased store numbers in Hainan and have launched duty-free apps enabling consumers to purchase duty free beauty products in just a few clicks," comments The NPD Group E-commerce Commercial Lead Samuel Yan. ■■■

Top-five prestige brands in e-commerce in China 2021

Lancôme (L'Oréal)
Estée Lauder (Estée Lauder Companies)
SK-II (P&G)
The History of Whoo (Amorepacific)
Shiseido (Shiseido)

Source: The NPD Group

China's prestige beauty e-commerce sales 2021

Category	Sales value Rmb (US$)	% change 2021/2020
Skincare	Rmb58.23bn (US$9.15bn)	+30.1
Make-up	Rmb16.89bn (US$2.65bn)	+14.1
Fragrance	Rmb531bn (US$834m)	+27.5
Haircare	Rmb2.41bn (US$378m)	+68.3
Total sales	**Rmb82.83bn (US$13.02bn)**	**+27.1**

Source: The NPD Group

▲ A.S. Watson created 'WatsNew' a brand incubator platform that enables new brands to leverage its O+O platforms to form a community to trial and review new products

■■■ However, given the lockdowns due to Covid, domestic travel in China has been impeded, which is set to hit Hainan hard.

A tougher market

Although China's prestige beauty market continues to grow, analysts across the board say the operating environment has become much tougher. Prestige brands like SK-II (P&G) have seen sales in the country flatten due to department store closures or the impact of lockdowns, while many brands are pulling out due to the increasing costs and complexity. Maybelline (L'Oréal) has pulled out of department stores in favor of adjusting its offline experience, while expanding online says Tan. Notably, it has launched on group-buying platform Pinduoduo.

Meanwhile, new cosmetics regulations introduced this year has forced many brands to be removed from shelves as they contain newly banned ingredients. "In the future, the SPDA (State Food and Drug administration) will further regulate the beauty market," comments Tan. "As cosmetics enter the era of efficacy evaluation, the future product record is the absolute truth."

"Brands that are pre-acquisition are being much more hesitant about going in," comments Clean Beauty Asia Founder Allie Rooke. "Before they would want to go in to prove they could do China, but now I think enough of them have had their fingers burnt that they probably don't go in because then at least you haven't proved that you can't do it."

Watsons China says the appetite for new beauty brands in China is huge and will continue to drive growth. The company has created 'WatsNew' a brand incubator platform that enables new brands to leverage its O+O platforms to form a community to trial and review new products.

> "Key products like foundation and eyeliners are becoming popular [among men] and the growth rate of boys (born after the 2000s) buying liquid foundation is twice that of girls and four times that for eyeliners"
>
> Ifop Asia Head of Qualitative Amy Tan

However, last year's changes to animal testing regulations have yet to deliver on the promise of enabling many new brands to enter China, given the difficulty that continues to exist around registration and regulations required for the domestic market.

"It wasn't the flood gates opening; it's like they opened a little crack and then there's a huge amount of obstacles behind that crack," comments Rooke. She says many newer, natural ingredients used by indie brands are not yet on China's safe list, meaning brands would have to either reformulate or submit to animal testing to enter the domestic market. "Most of the brands I talk to are still very much focused on cross-border first and investigating their registration in parallel, but it's definitely a secondary step. Cross border has longevity there, and it's going to be there for a little while."

Outlook 2022

Looking ahead, prestige beauty sales are forecast to continue to grow, even as the market's complexity intensifies. Baier forecasts 7% to 9% growth in 2022, rising to 10% to 12% in 2023 and beyond. He says competition in the market can be expected to heat up, and key challenges will come from the abundance of choice across all price points and increasing brand disloyalty.

"The beauty market in China is expected to grow albeit at a slower pace in the coming year as it is expected to face supply-side pressures and potential lockdowns and border closures," comments Baier. "Constantly changing regulations, both Covid-19 related and beauty industry ones, exacerbate operational complexities. [They] also make it very difficult for smaller international brands to keep up and survive."

Analysts say demand for functional products can be expected to continue as consumers become increasingly focused on self-care, and more aware of ingredients and product efficacy. However, NPD's Yan predicts beauty brands will have trouble matching the very high growth rates they have garnered in the past.

"Major prestige brands need to carefully consider their strategy to appeal to consumers, especially when sales are mainly contributed by pillar products," says Yan. "How to maintain the fast growth of pillar products when the sales base is already very large will be a challenge." ■

Shop shifts

An analysis of the changing distribution landscape in China, both online and offline

by Sophie Douez

As China's e-commerce environment continues to fragment, beauty brands are faced with a seismic shift in the distribution landscape, with emerging players JD.com, Douyin (TikTok) and branded livestreaming continuing to eat into Tmall's market share.

Brick and mortar retailing—arguably more important than ever for prestige brands looking to provide elevated experiences—is also experiencing churn as brands pull out of poorly performing department stores, and cashed-up local multi-brand beauty retailers rapidly open new doors across the country.

> "Alibaba's market share is going down, and it is not insignificant. They used to have 70% of the market and in the first year of livestreaming they had an almost 80% market share. This year it's going to be in the 40s. Their overall sales are up, but their share is going down and that's because the experience they have is not proprietary to them anymore"
>
> Kung Fu Data CEO Josh Gardner

Tmall's declining share

"We are still going big on Tmall, but there's a gigantic shift. Tmall is facing a lot more competition from other players," comments Benefit Cosmetics Director Global Marketing and communications Lisa Li. "JD is on the rise, Douyin is being established, and they are all becoming major challengers, and it has happened really fast too."

Growth on Tmall, still China's dominant e-commerce channel, is slowing significantly: According to WalkTheChat, the platform accounted for 64.2% of China's e-commerce market in the third quarter of 2021, compared to 28.5% for JD.com, but turnover grew faster on JD, which booked a 24.7% rise, compared to Tmall's 12.9%.

GMV growth on Tmall during the 11.11 shopping festival declined from 86% in 2020 to 8% in 2021, and is expected to stay in the single digits for the foreseeable future. While there are arguments to be made about unfair comparisons with 2020, which was boosted by the extension of the festival to a four-day sale, analysts say customer fatigue and increased competition, especially from livestream, are key contributors to the slowdown.

"Alibaba's market share is going down, and it is not insignificant," comments Kung Fu Data CEO Josh Gardner. "They used to have 70% of the market and in the first year of livestreaming they had an almost 80% market share. This year it's going to be in the 40s. Their overall sales are up, but their share is going down and that's because the experience they have is not proprietary to them anymore."

Livestream, once the calling card of the Alibaba platforms Taobao and Tmall, has propagated across China's entire digital ecosystem to become the must-do channel for brands. Li says that for prestige beauty overall, brands' own livestreams contributed to 70% of total livestream sales in the third quarter of 2021. At Benefit, the brand's flagship store own livestream sales grew 102% year on year during the same quarter.

"To be honest, I think it's not even incremental growth, what we are ■■■

▲ JD has added a string of beauty brands over the past year and is seeing growing share and sales in the category

▲ A.S. Watson brought its European prestige retail brand Marionnaud to China last year. Bonnie & Clyde, which sells luxury niche brands, plans to double its store count in China to 12 this year

■■■ really seeing is traffic overall has dropped so significantly because it's all eaten up by livestream traffic," comments Li.

Douyin and JD on the up

JD.com and Douyin are pushing hard for a greater share of China's e-commerce market. To date, Douyin has garnered a lukewarm reception to its efforts to transform its short-video platform into a strong e-commerce business. Owned by private company ByteDance, Douyin's target was to double its GMV to Rmb1trillion for 2021, but reports suggest they managed just half the figure amid overall slower growth. Like Tmall, it is also struggling under the weight of new regulations that enable consumers to move freely between the platforms, allowing them to easily search for the best price and bounce to their preferred platform when purchasing.

"We've got clients who have launched on Douyin and it's a slow crawl so far," comments Gardner. "Douyin is changing the game of commerce; their software is very smart and is able to entice you to go from short video experience to purchase, instantly. It's called interest commerce, and everyone is trying to copy it, but Douyin owns it. They've got an asset in the tech and a form of an experience that is interesting; their risk is that it's leaky. They can't force people to transact inside the platform and they don't have the commercial-grade infrastructure built in."

Enthusiasm is much higher around the potential of JD.com, which Gardner says delivers higher margins than Tmall because it covers marketing. Benefit, together with its LVMH stablemate Make Up For Ever, launched on JD last September, with the result that, six months in, both brands are doing around 15% of the Tmall business comparatively on the platform, says Li.

> "The selection of retail chain partners is crucial for brand positioning and target audience reach. Some of these [new] chains focus on architectural aesthetics, while others focus on indie brands and/or brands with Gen Z appeal"
>
> Luxasia Group CEO Wolfgang Baier

"Both brands have smaller assortments on JD, and the model we go in with is more of a sell-in, simplify the operation side of it," comments Li. "JD provides such a significant experience in customer service and that's what wins the consumer. It has such a big presence in the north because it's headquartered in Beijing, and Tmall is in Hangzhou and Shanghai. If you look at the penetration, the customer base is definitely northwest so there is good potential to provide incremental coverage."

Back to stores

In physical distribution, which still accounts for some 40% of luxury brands' sales, the headline news has largely focused on international beauty brands like Etude House, Innisfree, Maybelline, and Benefit Cosmetics pulling out of department stores or closing own-brand stores in favor of e-commerce. Such moves buck the trend of local retailers and brands like The Colorist and Wow Color, which are rapidly expanding their multi-brand store networks in the fast-growing lower-tier cities.

"Customers in lower-tier cities have more leisure time and pay more attention to instant gratification and in-store experience," comments Watsons China. "They rely more heavily on beauty advisors in physical stores to provide them with professional advice and services. Therefore, physical stores need to be more experience driven and we have extended our in-store service to offer make-up looks, skin testing [and] facial SPA."

Luxasia Group CEO Wolfgang Baier says that although stringent restrictions on movement due to the pandemic have seen brands move quickly to a digital-first strategy, physical retail should not be neglected or undermined in China. He says local flagship stores can also double up as fulfillment centers for online orders in lower-tier cities.

"The selection of retail chain partners is crucial for brand positioning and target audience reach. Some of these [new] chains focus on architectural aesthetics, while others focus on indie brands and/or brands with Gen Z appeal," he comments.

With more than 70 stores in China, Sephora has long been the go-to specialty-multi physical retailer for international brands, especially those lacking the means to open branded stores. Baier says it continues to be trusted by Chinese beauty consumers and extends a halo effect to the brands it carries. However, others say Sephora's struggles with lack of differentiation—international brands found in Sephora are generally easily found everywhere—have been accentuated by the rapidly shifting market dynamics of the past two years.

"Sephora has always been one that's been a little bit tricky in the market, they haven't really landed on their feet in terms of desirability," comments Clean Beauty Asia founder Allie Rooke. "But they are really pushing now to get international brands into their stores, beefing up their cross-border offer, not on Tmall, but on their dot.cn site and in their own stores. It's a clever move because not all brands want to go through registration."

New entrants

For prestige beauty, physical retailing remains important, and brands emphasize strong store or pop-up experiences still form a key part of building premium brand equity. This is evidenced by the success of specialty retailer Harmay in the upper tier cities, and moves by other prestige retailers to expand in the country. French prestige department store operator Galeries Lafayette is set to open its third Chinese store in Shenzen next year, a fourth in Macau, and plans to bring its total store network in China to 10 by 2025.

Meanwhile, A.S. Watson has brought its European prestige retail brand Marionnaud to China. In 2021, A.S. Watson opened three Marionnaud x Watsons stores in China, in the cities of Shanghai, Wuhan and Xian. Since then, the retailer has opened two new stores, bringing the total number of Marionnaud x Watsons stores in China to five, in the cities of Shanghai, Wuhan, Xian and Chongqing. Marionnaud says the shops respond to the growing demand for luxury beauty in China, and bring international high-end beauty to more consumers. Marionnaud says it will look to open new stores in other cities across the country.

Chinese multi-brand beauty retailer Bonnie&Clyde, which is owned by brand accelerator platform Ushopal and focuses on niche luxury brands, also plans to open six new stores in China in 2022. The retailer currently has six stores in the country. In 2021, Bonnie&Clyde opened new stores in top-tier malls in the country and also introduced new brands to China, including Suqqu, Natura Bissé, and Zaha Hadid Design. Bonnie&Clyde's average ticket value for the year came in at Rmb8,000 ($1,258). Based on the growth, the retailer will open six new stores in luxury malls including Chengdu IFS, Changsha IFS, and Nanjing Deji across east, central, west and south China. Bonnie&Clyde CEO William Lau said the retailer expects 70% year-over-year growth in 2022. It will also introduce new services, including an enhanced loyalty program and improved last-mile delivery, to respond to its Gen Z and millennial customers' demands and shopping habits.

"I still think experience-first marketing will work in China—pop-up stores, or places to hang out, playground type concepts. It will be a lasting trend. Younger consumers are very hungry for this, and I see a lot of brands doing it," comments Li. "[We'll] continue to maintain Sephora but also find new ways to really drive services with them."

According to Rooke, Australian multi-brand retailer Mecca, having launched on Tmall Global two years ago, is also preparing to enter China with physical stores.

"There's a gap there," she says. "If Mecca can get it right in terms of desirability versus destination versus what Sephora got wrong, then there's a lot of money to be made. It's just a big bet." ■

Expert view: Navigating change

Two experts on how they see the evolution of distribution for prestige beauty in China and what brands should watch out for

Digital Luxury Group Partner, Head of International Client Development Iris Chan

"What we are seeing is social platforms offering more robust e-commerce options; there is more competition and Tmall is not the one and only. The overall pie of what's happening online is fragmenting, so you now have to focus across more than Tmall, and be on Douyin, WeChat, Red and JD.com.

Also, although the offline component hasn't been as much of a focus over the past couple of years, it's coming back for sure. There are small, more targeted, private sales events happening that are more omnichannel driven. Whatever channels you are in, it's a question of how you start to split your time and effort across the different ones. That's one of the big challenges. Brands have to be smarter in thinking about which events make sense for them in which channels. There's a lot more thought that needs to be put into it."

Kanebo Cosmetics China, Senior Director of Masstige, Cosmetics Business, Asei Shioji

"Brick-and-mortar retail is becoming more specialized in first-tier cities, where there is a stronger market saturation. In other cities, physical shops are still in a growth phase. In recent years, brick-and-mortar retailers set out to differentiate themselves from major e-commerce platforms by effectively using their sales networks to offer immediate delivery services. In addition, they have been expanding their services to maximize the value of experience, while proactively attracting customers to their shops through O2O business models. Brick-and-mortar retail is ideal for providing shopping experiences and expanding brand awareness. We are striving to balance the role of offline and online retail in view of the characteristics and market penetration stage of each brand. We have improved our market coverage by developing new e-commerce platforms, as well as brick-and-mortar retail locations outside the first-tier cities."