



Fads vs. Facts: Hunting for Unicorns in China's Booming Consumer Market

L Catterton Consumer Insights

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Introduction

Despite the enormous disruption and uncertainty brought by the global pandemic in 2020, one finds reasons to be hopeful in watching Chinese entrepreneurs and consumers emerge – with dynamism and gusto – from the crisis over the past few months. Amidst a global contraction, China expanded its economy by 2.3% in 2020¹, becoming the only major economy to achieve growth in a challenging year. In the consumer sector, the energy and accelerating pace of innovation were palpable, especially in the second half of the year. In this article, we discuss key trends that shaped China’s consumer landscape in 2020 as well as expectations for 2021 and beyond. We do so by addressing the following questions in turn: What are the fundamental driving forces behind the rise of Chinese brands in 2020? What unique characteristics set apart Chinese Gen Z from their predecessors and global peers? And, looking forward, which key success factors will define the next generation of winning brands?

“Made in China” is Back...in a Big Way

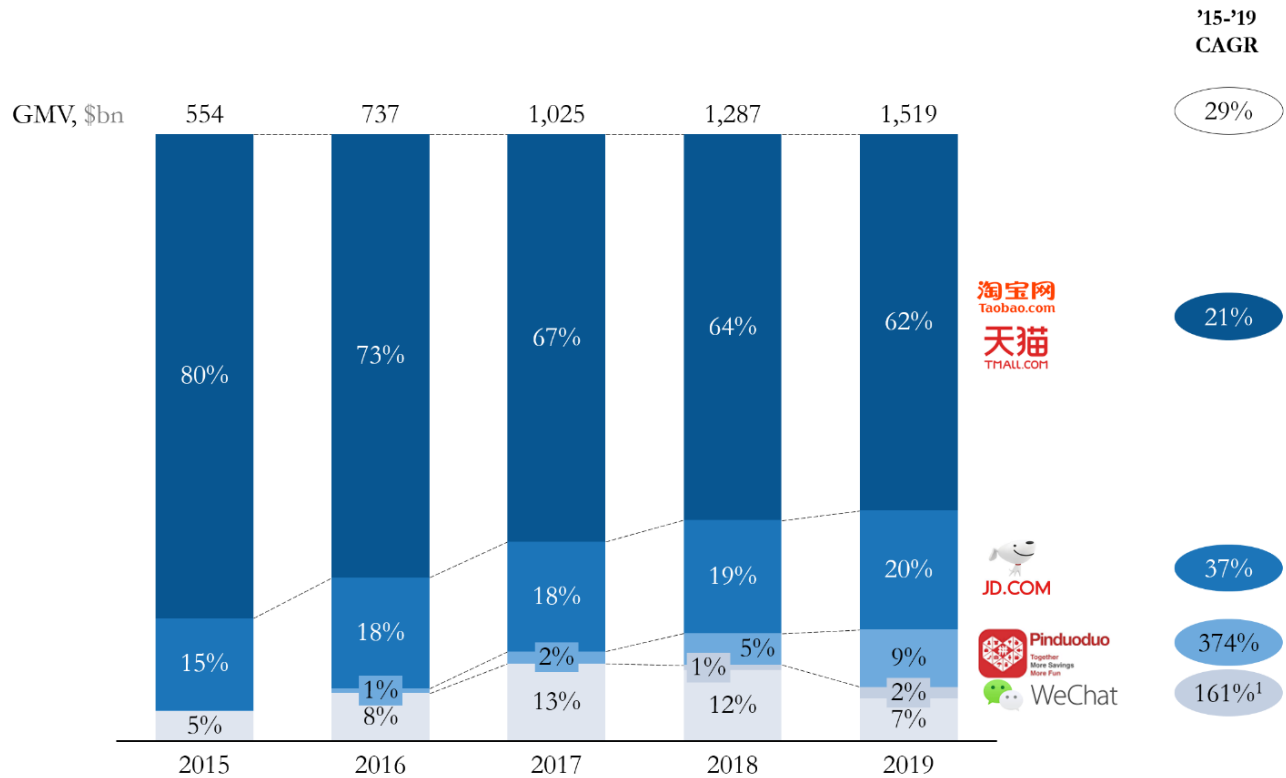
2020 saw the arrival and ascension of a wave of homegrown consumer startups in China. An astounding sum of 357 new brands² topped their respective charts during Alibaba’s Double 11 shopping festival, up from just 11 in 2019. Tmall’s CEO Fan Jiang publicly announced his plans to support 1,000 new Chinese brands to reach \$150mm (~1bn RMB) in annual sales and 100 brands to surpass the \$1.5bn (~10bn RMB) milestone in just 3 years. Amidst rising competition, Alibaba’s strategic interest in incubating new brands to sustain the attention of novelty-seeking Chinese consumers is unsurprising. Since 2017, alternative e-commerce platforms such as Pinduoduo and WeChat have been chipping away at Tmall and Taobao’s market share. Despite the decline, Tmall and Taobao remain China’s most influential online B2B/B2C marketplaces. Given the continued significance of these platforms and their concerted efforts to engineer “newness”, there are bound to be attractive investment opportunities amongst the rising stars and chart-toppers in China’s digital arena in the next 3-5 years.

¹ Source: China National Bureau of Statistics

² Brands with under 3 years of operations on Tmall

Figure 1: Newer players such as Pinduoduo and WeChat are eating into Alibaba's share

Ecommerce GMV Share by Platform, 2015-2019, %



1. 2019 y-o-y growth rate as earlier data are not available

Source: China National Bureau of Statistics, Growthbox Data, company reports

China's capital market has also doubled down on consumer brands, making it one of the few sectors to see an increase in activity in 2020. The total number of consumer brand-related transactions rose 23%, up from 124 in 2019 to 161 in 2020³. The IPOs of the digitally-native cosmetics brand Perfect Diary and toymaker Pop Mart at jaw-dropping valuations (market cap reached 15.6x and 35.2x P/S, respectively, on their 1st days of trading⁴) spurred as much excitement as they did confusion. Is Perfect Diary's valuation a reflection of fundamental value or mere froth in an overheated market? Why are Chinese Gen Z seemingly addicted to Pop Mart's mystery boxes, a product concept that has existed long before the brand was created? Answering these questions requires a closer examination of the psychology of these young consumers and the playbooks of insurgent Chinese brands.

³ Source: Jingdata

⁴ Price-to-2020 expected sales based on Capital IQ Estimates Consensus

Figure 2: Perfect Diary and Pop Mart are two brands that have reached extreme valuations

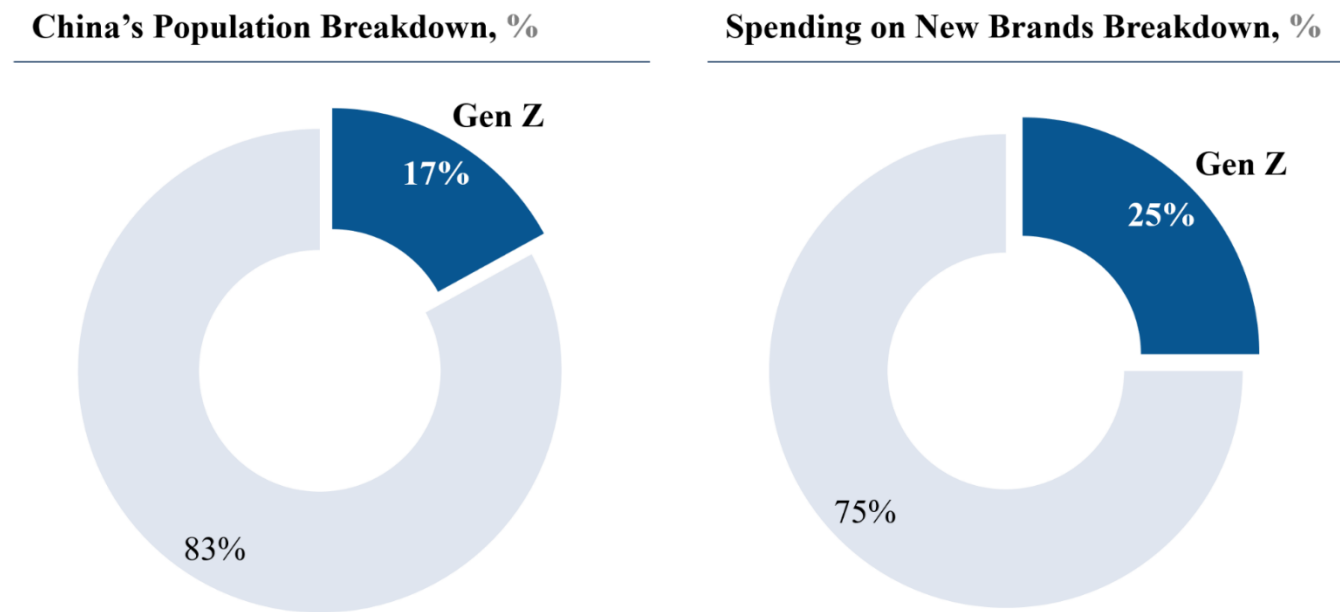


Chinese Gen Z – Everything is Different

An undeniable force underpinning the rise of Chinese brands is the growing purchasing power of Chinese Gen Z. This group of young consumers, born between 1996 and 2010, accounts for 17% of China's population but 25%⁵ of total expenditure on new brands, even though half of the cohort is still in school, with limited income. Relative to the generations that came before, this cohort is notably more global-minded, more digitally-savvy and more accepting of "Made in China" products. Rather than fixating on product origin as the singular purchase criteria, young Chinese shoppers are drawn to products that can serve as a medium for their self-expression and personal values. Given China's growing prominence and assertiveness on the global stage, the rising sense of national pride amongst youngsters has translated into a fondness for homegrown brands that set out to highlight Chinese cultural symbols in products as varied as tea (e.g., HeyTea), color cosmetics (e.g., Florasis) and sportswear (e.g., Li Ning, Feiyue).

⁵ Source: CBNDData

Figure 3: Gen Z account for 17% of the population but 25% of spending on new brands



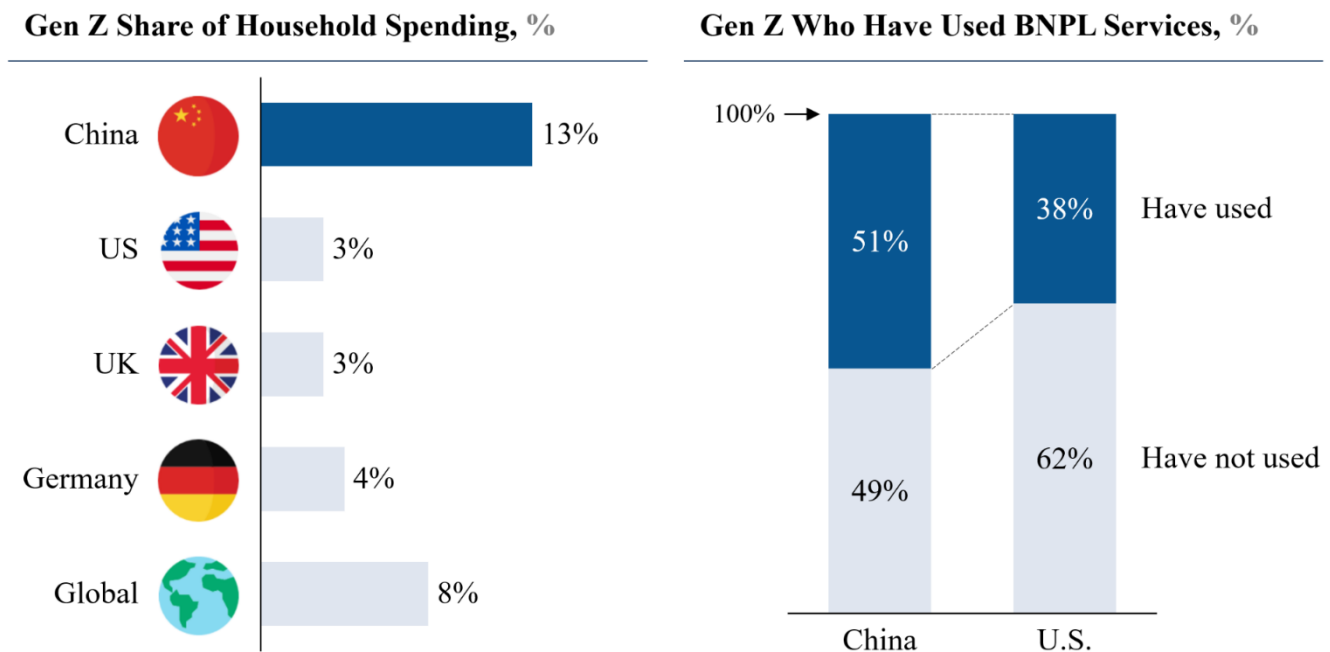
Source: China National Bureau of Statistics, CBN Data

Another feature that separates Chinese Gen Z from their global peers is their high spending power. These young consumers accounted for ~13% of Chinese household spending in 2018, relative to 3% in the U.S. and 8% globally⁶. In addition to generally improved economic well-being, their outsized influence on family expenditure can be attributed to the typical “4-2-1” family structure, which places the only children’s well-being at the center of a household supported by 2 parents and 4 grandparents. This generational economic liberalism is also manifest in their openness to consumer credit products – over 50% of China’s Gen Z have used buy-now-pay-later (BNPL) services at least once, relative to 38% in the U.S.⁷.

⁶ Here Gen Z is defined by OC&C as those born 1998-2016, which is different from the previous definition but does not impact the conclusion here. Source: OC&C 2018 Gen Z survey (N=15,500)

⁷ Source: iResearch survey (N=10,244), Ascent survey (N=~1,800)

Figure 4: Chinese Gen Z have high spending power



Source: OC&C 2018 Gen Z survey, iResearch survey, Ascent survey

In addition to their openness towards Chinese brands and high willingness to spend, young Chinese consumers have also cultivated unique consumption habits, which create opportunities for new startups. In beauty, given the popularity of livestreaming amongst Chinese youths, Perfect Dairy partnered with one of the hottest livestream celebrities, Austin Li (44mm followers on Tiktok, 40%+ of whom are Gen Z⁸), who sold 100K+ eyeshadow palettes to his fans in one minute⁹. In F&B, as more urbanites live alone and favor convenience over complexity with at-home dining, brands such as Zi Hai Guo, a producer of single-serving hotpots that self-cook in 15 minutes, generated over \$140mm USD¹⁰ in revenues in 2020, 2 years after its initial launch. In apparel, Shi San Yu sold ~\$40mm USD¹¹ of traditional style Chinese garments (汉服) in 2019, as the leader in a niche apparel category that is zealously pursued by a subset of Gen Z fans.

⁸ Follower profile as of 25th June 2020. Source: LCA research

⁹ Source: <https://ishare.ifeng.com/c/s/7ucGxXb6ALF>

¹⁰ Source: <https://www.ebrun.com/20201111/410083.shtml>

¹¹ Source: <https://www.36kr.com/p/920791114057608>

Figure 5: Traditional garment brand Shi San Yu features its KOL founder Dou Kou to appeal to Gen Z customers



Who Will be the Next Unicorn?

With strategic backing from tech behemoths, abundant liquidity in the capital market, and consumers' evolving spending habits, the ground is fertile for new startups to emerge in China. However, competition is also intensifying, raising the bar for entrepreneurs and investors alike. To distinguish between consumer brands with long term potential and those without, investment targets ought to be measured against several key criteria, including product innovation agility, consumer engagement quality and strength of brand equity.

1. Is the Brand Innovating Fast Enough?

Many consumer startups manage to strike gold with one or two hero SKUs, but most find it difficult to scale their initial success. The ability to consistently and rapidly launch new SKUs that are embraced by the market is therefore critical to ensuring longevity, especially for companies in categories most susceptible to trends and fads. Perfect Dairy is one such example in the color cosmetics space. The 4-

year-old company launches 5-6 new SKUs every month on average¹², and its data-driven approach de-risks market rejection for new SKUs. As an example, one of its top-selling lipsticks, Black Diamond, is designed by analyzing the colors of thousands of trending lipsticks on social media and e-commerce sites. Compared to international incumbents whose product development processes tend to be less agile, decision-making cycles longer and attitudes towards localized marketing more conservative, homegrown brands like Perfect Diary enjoy a clear edge in satisfying the increasingly insatiable consumer appetite.

Figure 6: Perfect Diary's Black Diamond lipstick adopts a data-driven approach

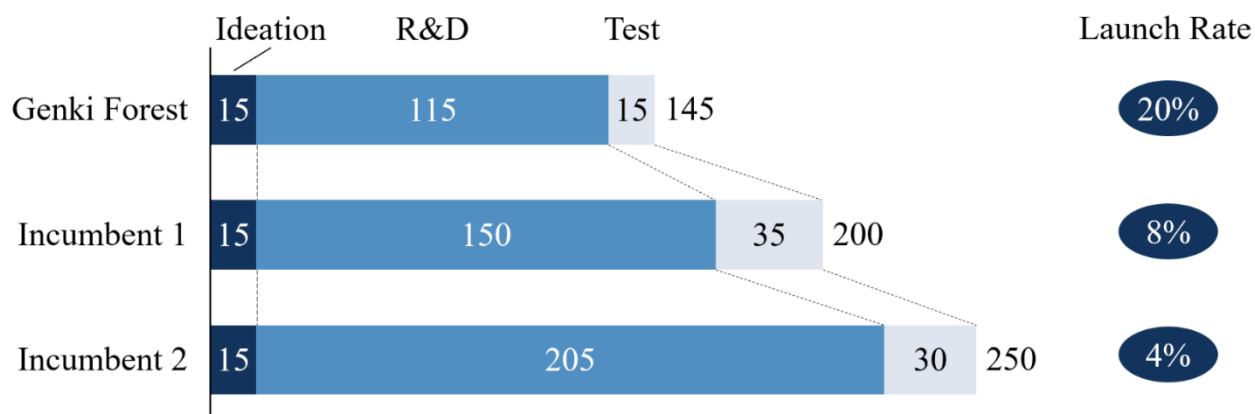


In categories with longer product development cycles such as soft drinks, challengers are also pushing the boundaries on the speed of innovation and iteration.

¹² Source: Growthbox Data

Figure 7: Genki Forest has a shorter product development cycle and higher launch rate than incumbents

New Product Development Speed Comparison, # of days



Source: LCA research

2. Is it Engaging Consumers in Direct and Creative Ways?

Going direct-to-consumer (DTC) is a more challenging task in China than in the U.S., since the vast majority of online GMV is intermediated by giants like Alibaba and JD, leaving only ~5% for proprietary channels like dot-com sites¹³. By contrast, the dot-com channel accounts for >20%¹⁴ of the U.S. market. This picture is likely to change, however. Brands in China have historically had limited direct touchpoints with their consumers, until WeChat, China's largest "Super App" with 1bn+ MAU, began building commercial functionalities that enable brands to reach customers directly. Tools such as official accounts and mini programs grant brands access to consumers' in-app engagement data at a minimal cost. Seizing this opportunity, Perfect Diary launched Abby, a WeChat avatar managed by a team of 350 FTEs, to interact with 2mm fans in 10K+ WeChat groups¹⁵. From Abby, a Perfect Dairy fan receives automated product promotions that nevertheless feel personalized and intimate, as if from a friend. The fan can also interact with other brand followers in one of the WeChat groups, where the discussions may induce herd purchase. While the ROI of this intensive digital engagement model remains to be tested, high-quality DTC communications are likely to be essential for the success of future consumers brands.

¹³ Source: LCA research

¹⁴ Source: LCA research

¹⁵ Source: McKinsey research

3. Is it Focused on Building a Brand?

While up-and-coming Chinese consumer brands enjoy natural advantages due to their proximity to well-established supply chains and domestic consumers, a common area of weakness lies in brand-building. Given the sheer size of the Chinese market and its speed of growth, it is relatively easy for new concepts to gain initial traction. However, as the companies scale, customer loyalty becomes indispensable. Building brand loyalty requires not only high-quality products, but also emotional connectivity and value-based resonance between the brand and its consumers. The importance of cultivating distinctive brand values as a competitive barrier is beginning to take root in the minds of Chinese entrepreneurs. Indeed, many have begun to realize that competition will wash away the pure momentum players, leaving those with true staying power to shine. An example of a young Chinese brand that has been deliberately investing in brand-building is Florasis. A color cosmetic brand founded in 2017, Florasis has created a brand image based on the notion of Eastern aesthetics, which permeate the brand's visual identity, product design and messaging. This distinct brand image has stood out in a category that is 75% dominated by international brands today¹⁶. For instance, the body of its top-selling lipstick features an intricately carved impression of an ancient Chinese love story. In Jan 2021, Florasis also released a complete upgrade of its visual identity, launching a proprietary Florasis font inspired by traditional Chinese gems glaze (琉璃) and white jade (白玉), as well as a new campaign based on the *yin* and the *yang* of traditional and modern Chinese aesthetics.

¹⁶ Source: Euromonitor

Figure 8: Florasis has focused its brand image on Eastern aesthetics to differentiate itself from international competitors



2021 and Beyond

In 2020, a host of Chinese consumer brands rose to remarkable heights. 2021 and beyond will likely bring on more intense competition, as new players enter the stage – at China speed, no less - and MNCs recover from COVID disruptions. In China's ceaselessly self-disrupting consumer landscape, more sophisticated and nuanced consumer behaviors are bound to emerge, more innovative business models will evolve to address those needs, and more robust, world-class brands will be forged in that process.



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