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China Beauty: How Building a China Business Can Sweeten a Private Equity Exit

By Mark Schaub [1]

In 2021, China finally ended mandatory animal testing for most types of cosmetics products.

However, it is not only rabbits that have reason to rejoice.

The beauty industry is BIG. Estimated to be globally $483 billion in 2020 and despite COVID, lockdowns etc. it actually grew to an estimated $511 billion in 2021. China is a big part of this growth story.

The beauty industry has a varied ecosystem – dominated by giants like L'Oreal and Procter & Gamble but also having a vibrant range of medium and small businesses which constantly rise and fall – but also inject innovation and dynamism.

Increasingly, private equity and funds invest in high potential beauty brands with the view of a trade sale to a giant, a listing or a secondary buyout.

These hip and young brands intrinsically capture society's Zeitgeist – as a result they are invariably cruelty free. And this is a problem for their private equity investors – how can an exit be optimized if the largest growth market in the world is off limits?

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[1]. Many thanks to some friends for their input – Mette Knudsen of Knudsen & Co on product registration; Josh Gardener of Kung Fu Data on distribution and ecommerce; and Allie Rooke of Clean Beauty Asia on the market generally

The China Beauty Conundrum – Test or not Test?

Private equity makes its money by improving the performance of a company or by improving the company's growth story before exiting. China ticks both markets.

As outlined above many brands stayed out of China due to the perception that mandatory animal testing on cosmetic products was required. Indeed, for many beauty bloggers selling product in China was shorthand for animal testing. This was not accurate as it was possible to manufacture cosmetics domestically in China with an exemption from animal testing.

However, Hip brands interested in selling to Beijing millennials were petrified that China sales would raise the hackles of their Western consumers in California, Berlin, Sydney etc. Consumers who increasingly buy not just a product but a lifestyle … they do not just have a preference for a certain type of shampoo but increasingly identify with the product. A survey conducted by the UK charity Frame found that 84% of respondents would not buy a cosmetic product that was tested on animals or if the ingredients were tested on animals.

For this reason, although China has been for some time the world's biggest potential market for cosmetics … for most brands the choice was clear: animal testing is just not who we are. But even for the less ethical the economics were clear - you do not give up your existing market for a potential market, no matter how lucrative. A bird in the hand (the Western consumers) is worth two in the bush.

This meant most brands (especially hip brands owned by Private Equity) shied away from the China opportunity or just sold via cross border ecommerce. However, cross-border ecommerce sales are low volume. Generally, selling on China's largest online shopping platform is more than 10 times as successful than selling via cross border ecommerce.

What Changed in 2021?

Since May 2021, a framework exists whereby international beauty companies can sell most of products within China without animal testing.

This has led to the mainstream perception that China now no longer requires animal testing (this is not fully accurate). This means that a new market of 1.4 billion consumers has opened up to ethical beauty companies.

What does this Mean for Private Equity Portfolio Companies?

Western Beauty brands will **NOW** need a China strategy. No more hiding behind cuddly rabbits anymore. Investors will be expecting a growth strategy and if not China then what is the growth plan? US and European brands at a certain stage of development may decide that their internal markets can be sufficient to slake their thirst for growth. But PE owned companies tend to be thirstier.

Accordingly, most of these PE owned companies will decide they need to be in China or will be pushed to building a China business.

For Private Equity the issue will be how can a China market entry strategy be cost effective, carried out within a strict timeline and be value accretive upon the exit.

How to Get to China Fast and Successfully

Western beauty brands looking to enter the China market have a variety of options available:

Model	Comment	Advantages	Drawbacks
Option 1: Distributor	Depends on the Chinese partner. Few partners can do both online and offline. Distributor can act as responsible agent.	Quicker access to market* Experienced* Lower initial costs	Issue of control and disclosure of information. If successful - buying back of distribution network can be expensive. Could be a delay to exit if China business is important.
Option 2: Own Distribution in China plus Imported Cosmetics	The legal steps to establish a wholly foreign owned enterprise are simple but the staffing and implementation can be more challenging. Most international brands can do ecommerce by themselves or with an ecommerce partner.	Full control. No expense or headache of buy back. Imported cosmetics may better reflect heritage of brand.	Do you have the talent to start the Chinese business? Need to solve the domestic responsible person issue.
Option 3: Own Distribution and Manufacture of Cosmetics in China	This is basically option 2 but adding in local production (normally outsourced). Since 2014 it has been possible with an exemption to produce most cosmetics in China without animal testing.	Full control. No expense or headache of buy back. Producing in China likely more cost effective than imported. Easier registration process.	Do you have the talent to start the Chinese business? Need to solve the domestic responsible person issue.

**assumes an experienced and reputable partner – this is not always a reasonable assumption*

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics?

➢ Challenge 1: Realistic Planning

Launching a brand in China can be an expensive exercise. China in 2021 is not the China of 1991 – employees, real estate, lawyers, advisors are all expensive. As PE is generally under time pressure to show results it is important to put together a realistic and cost-effective plan.

Interestingly, China is a market where over planning can be as dangerous as not planning. One US accessories company painstakingly conducted a feasibility study (6 months)… hired a strategy consultant to prepare a report to the board (4 months) … established a PRC company (6 months) … planned an opening party with the US Embassy (2 months) and then… left China after 6 months.

It is important to cost and have timelines on the critical path items and hold the advisors to these forecasts. Also check that the advisors have experience in relation to launching brands in China and also stress test their promises. Some TP partners we know often lose out on tenders because they provide reasonable (i.e. realistic and attainable) sales forecasts. Spend a little time to find the right support that also understands the requirements of PE.

➢ Challenge 2: Implementation

If the plan is to build a reasonable China story within 5 years then it is unlikely that the right team for implementation will be a joint venture partner. The most likely path to success is close involvement by **HQ** (ideally seconding someone for an initial phase) with a locally hired team.

One Swedish brand decided on a partner approach. They looked for the right partner (9 months) … found a Hong Kong partner with no experience in beauty or China … argued with me whether the partner was the right partner (1 month) … negotiated joint venture (7 months) … invested in the PRC company (2 months)… sent over management to support PRC entity (1 month) … realized that I was right about the Hong Kong partner being useless (3 months) … trying to dissolve joint venture relationship with Hong Kong partner (6 months) … trying to just close down and retreat back to Sweden (8 months). A partnership can work very successfully but not with parties you do not know well or if you are in a hurry.

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics? (Cont.)

➢ Challenge 3: Setting up an Entity

Many still believe, even today, 40 years after China opened up to foreign investment, that international companies wishing to do business in China need to enter into a joint venture. This is not true. Most types of business can be established by foreign investors as a **wholly foreign-owned enterprise (“WFOE”)**.

Most cosmetics companies would establish an entity to import product, distribute product on and off-line, marketing, customer service etc.

Early on (i.e. in the 1980s and 1990s) most foreign invested companies in China took the form of a **joint venture (“JV”)**. Initially, China was seen as too complicated and too difficult for a foreign investor to navigate alone. However, as many foreign investors noted to their chagrin, much of the difficulty and complexity originated from having the wrong partner. Accordingly, they turned to establishing their own WFOEs.

The vast majority of private equity owned or backed beauty companies entering the China market will decide to establish a WFOE. A JV will be time consuming to negotiate the establishment and difficult and expensive to negotiate the buy out. PE investors will be unlikely to have the requisite patience.

A WFOE can generally be established within 6 weeks. There is no minimum investment but typically the international investor will invest enough to meet the operational costs (i.e. employees, office space etc.) to run the business until it achieves break even. Most clients will start with an initial investment of between USD 75,000 and 150,000. The other main issue is to consider where to locate the company and negotiate with the local government for the best subsidies.

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics? (Cont.)

➢ Challenge 4: Protecting your Brand in China

If you wish to have the rights to a trademark in the PRC then you will need to **register it as a trademark in the PRC**.

If you fail to register your brand then there is a high risk that someone, somewhere will register it instead or already have.

The main things an international brand owner needs to know in respect of trademarks in China are as follows:

First to File Jurisdiction - China has a first to file system for trademarks. This basically means all things being equal the first party to file for a trademark will wind up owning the mark. Most Western jurisdictions have a first to use system for trademarks (i.e. the party to show first use will prevail). Accordingly, this may be part of the reason to explain why some Western companies have failed to register trademarks … but not really. Another part of the reason may be that many Western companies have decided that as they have heard it can be difficult to enforce IP rights in China that it is best to do nothing … except complain… they often like to do this. The problem with this strategy of "doing nothing" is that it removes with one stroke any possibility of the international company being able to take any action in China.

Therefore, it is crucial for beauty companies to secure their trademarks or logos in China as soon as possible. It is true that the PRC as a member of the Paris Convention does grant trademark protection to "well-known" trademarks even if these trademarks are not registered. However, it would be extremely unwise for a company to rely upon such protection as it is difficult to bring an action. It should be noted that even if you

1. have a famous brand (which you do not), and
2. negligently failed to register such famous brand in China

then you will still have some difficulties in that it is unlikely that the Chinese version will be accorded the "well-known trademark" status.

In short, no matter what your situation is, the best advice is to register early and often. Even if you have a famous trademark, it is clear that the costs of convincing Chinese authorities that it is well known will be far greater than the costs of registration.

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics? (Cont.)

➢ Challenge 5: Creating a Chinese Brand

You really need a Chinese trademark. Many companies believe that they do not need a Chinese name. “We do not have a Chinese name”. “The Chinese market only knows us by our English name”. “Our name cannot be translated.” This is a serious mistake. Every product sold in China will have a Chinese name. Most Chinese consumers do not easily read English and therefore they will tend to develop a phonetic Chinese name based on the sound of the international name. Accordingly, it is important to avoid ‘doppelgängers’ (Chinese versions that exist but you do not own) from building market awareness.

➢ Challenge 6: Registering your Products

To sell directly within the Chinese market, cosmetics brands will need to register/file their products with the **PRC’s NMPA**. While product registration/filing is relatively straight forward in Europe (and non-existent in the US), China has the strictest cosmetics law in the world.

The product quality and safety must be documented in detail. *The information required includes details on the raw materials used (and their suppliers), the manufacturer, packaging material, and many more.* All efficacy claims must be supported by actual evidence – even for ordinary claims such as “moisturizing”. As “time to market” often makes the difference between a profitable or loss making product, it is vital that brands relatively quickly overcome regulatory hurdles and bring new products to the market as swiftly as possible.

In China it should take between 4-6 months to register a regular cosmetics product. Most new entrants will not have their own local regulatory team to handle registrations in house so it is sensible to find well-known agents to work closely with you. The right advisor can reduce risk, ensure compliance and actually get the products registered.

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics? (Cont.)

➢ Challenge 7: Finding a Responsible Agent

One challenge specific to beauty brands is the appointment of the **Domestic Responsible Agent**. The concept of Domestic Responsible Agent is that for imported cosmetics there must be a party situated in China that can be held accountable in the event of a safety issue arising in respect of such product. The Domestic Responsible Agent is a pre-requisite to apply for a NMPA Product Registration – and therefore in order to have a product registration in China means you will need to have a Domestic Responsible Agent. For this reason, international brands that have limited themselves to cross border ecommerce did not need NMPA product registrations and therefore did not require a Domestic Responsible Agent.

Legally, the main requirement is that the Domestic Responsible Agent must be established in China, must meet a variety of requirements and are subject to on-site inspections. *In most cases the Domestic Responsible Agent for international brands in China are likely to be either the Chinese Distributor, a consultant or the WFOE.*

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics? (Cont.)

➢ Challenge 8: Building a Distribution Network

Most beauty companies will embrace **ecommerce** as a mode to enter the China market. Many cruelty free brands have been using cross border ecommerce as a means to generate sales and market awareness in China as cross-border ecommerce bypassed animal testing requirements. Also going forward special use cosmetics will still need to be imported via cross border ecommerce to avoid animal testing.

For beauty brands in a hurry the most likely means by which to build a business will be to entrust an online authorised services provider. Such firms will manage the brand's online commercial ecosystem both online and offline and are now commonly referred to as "trade partners" as their scope of work often includes anywhere the brand sells direct to consumers in China. For larger brands, a flagship presence in the main online shopping platforms, live video broadcasting platforms and other specialty channels is standard issue.

China's online shopping platforms are competitive across the world with thousands of different vendors in each product category. As such, being able to obtain Key Account status with those platforms is critically important. In addition, it is important to team up with a partner that knows how to work within their systems.

Marketing spend on those shopping platforms is primarily on keyword purchase. However, these will need to be adjusted nearly every other week depending on the current keyword search trends of consumers. An experienced partner in a product category will be much more successful in identifying and purchasing the right keywords. Other less experienced partners will lag behind, making the spend ineffective.

It should be noted that China's online shopping platforms have recently become much more selective in accepting vendors on their Global platform, and it has become increasingly difficult for companies to be accepted to open a Global store. Again, this is where a good partner can assist. They will generally have strong relationships with the country manager where your company is based and can also use their existing data to demonstrate market demand for your products.

What are the Challenges to Setting up a Chinese Market Entry for Cosmetics? (Cont.)

Furthermore, if your partner has strong connections and you have desirable products, those large platforms may be willing to provide concessions to your store, including free ad space and preferential treatment for your sales, which is similar to Key Accounts.

Those services partners also provide similar operational services for other cross-border and domestic ecommerce channels as the ecosystem has expanded far beyond the platform itself. Social and community networks are now fully integrated and online shopping platforms are pioneering tech and shopping experiences with Livestream and New Retail. The functionality is either “embedded” into product listings, set up as a channel within a store or platform or native to the APP itself.

With the anti-monopoly laws now disrupting platform exclusivity, mature brands have their partners run 3-4 commercial channels. This usually depends on resources, scale and the success of current activations. With this in mind, the workstreams of their partners have radically expanded. They handle every aspect of operations, from merchandising, inventory management, ERP integration, logistics and customer service to business planning, media buying, studio creative, event management, performance marketing, social seeding, influencer marketing, livestream, short video, content production and – of course – relationships with category managers.

In addition to online sales most beauty brands also find benefit in having **offline** channels (i.e. department stores). The problem is that most online platform trading partners have no offline experience and offline distributors do not generally understand the fast paced world of ecommerce. Beauty brands will often use innovative offline activities such as pop-up shops, promotions, small consignment sections etc.

What is the Cost to Launch a Beauty Brand in China in Time and Money?

This is naturally for guidance only but a possible budget may be in the range of:

Action Item	Approx. Cost USD	Timing
Create Chinese brand*	USD 5,000	2 weeks
Register trademarks in China	USD 700 per mark for 10 years protection	Gain priority from application – registration will take approx. 12 months
Create online presence	Depends on ambition and existing infrastructure	Most would register accounts with China's online shopping platforms and live video broadcasting platforms
Trading Partner	Typically, a retainer and then a commission based on sales revenue	A partner can normally be signed up and up and running within 2 months. Some partners are willing to finance inventory.
Product registrations – most beauty companies would start with a selection of 10 - 15 SKUs	USD 30,000	5 - 6 Months
Marketing Budget	Depends on ambition.	Depending on the model the distributor may share the marketing budget.
Find a Chinese distributor	N/A	Normally, a quality distributor can be identified and contracted with within 6 -12 months
Establish a Chinese WFOE	USD 15,000	100% Chinese subsidiary can be established within 6 weeks and set up costs will be in the region of USD 15,000.
Investment to operate a China establishment (i.e. staff and lease) for first 6 months.	USD 50,000	This naturally is difficult to estimate but this is a typical starting point for many brands.

**this is at the lower end as top end can be USD 100,000*

Summary

In 2021 any semi-mature private equity funded beauty company needs a strong argument as to why it is not in China.

The dismantling (for the most part) of animal testing has removed the greatest ethical and regulatory hurdle to entering the China market.

And the China market has never been more alluring. Although beauty has been a largely COVID proof business globally, it has boosted the China market even higher as consumers eschew trips to Paris or New York. These same consumers are buying these same products at home.

However, China is dynamic. What works a year ago, may not now. Some brands burn brightly and then slowly turn dull. In respect of cosmetics China has turned from a largely unregulated sector to now being world standard in respect of regulation.

The question for PE is what return on investment can it make on its exit if its portfolio brand successfully launches a China business.

Learn more

We frequently publish thought pieces on China's business and legal sectors and trends. A selection of recent publications are below:

Videos

Animal testing changes discussion

The Red Tree Webinar - China: How to Access a Beauty Market Showing 30% Growth

Publication

Cosmetics China New Ingredients – how to protect the innovator

China: Beauty Revolution New Regulations Announced for Cosmetics

China's Move to Cruelty Free: New Draft Regulation Changes Requirements for Cosmetics Filing

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MIKIMOTO COSMETICS

Advised Mikimoto on sales of cosmetics in China

MARY KAY

Perennial counsel for Mary Kay

Christian Louboutin

Represented Christian Louboutin on patent infringement litigation

L'ORÉAL

Advised L'Oréal on product related legal matters

Johnson & Johnson

Advised Johnson & Johnson on its 100% acquisition of Beijing Dabao Cosmetics Co., Ltd.

L'OCCITANE EN PROVENCE

Advised L'Occitane on opening its flagship T-Mall store, contract review, and other legal issues

PERCY & REED LONDON

Advised Percy & Reed on distribution contracts

NU SKIN

Advised Nu Skin on sales contracts and foreign direct investment and real estate issues

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  Chambers Asia-Pacific Award Asia, 2020
- Regional Law Firm of the Year, Most Innovative China Law Firm of the Year
  IFLR Asia Awards, 2021
- China Law Firm of the Year
  ALB China Law Awards, 2021
- Innovation in Strategy and Changing Behaviours
  Financial Times 2019
- Law Firm of the Year and Best Overall Law Firms
  China Business Law Journal, 2018
- Asia-Pacific Innovative Lawyers Awards 2017: 'Innovation in Legal Expertise' and 'Innovation in the Business of Law'
  Financial Times, 2017
- Most Innovative Law Firm in the Asia-Pacific
  Financial Times, 2014-2015
- North Asia Firm of the Year
  asialaw Profiles, 2017
- Firm of the Year-China
  Who's Who Legal, 2016

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