Julius Bär

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Made by China – the rise of Chinese brands

TRANSCRIPT

Nisha Pillai [NP]: Welcome to the Julius Baer Think Tank Podcast. In this series we'll be walking you through the mega trends of the future and bringing you closer to our network of thought experts who are capturing the world's major changes and putting them into context for us.

I am Nisha Pillai, former BBC World News presenter and your moderator today.

"Made in China" has evolved into "Made by China", driven by the country's shift towards a consumption-driven economy, policy support for home-grown champions, changing inter-generational preferences, and the one-off boost to domestic consumption from the Covid-19 pandemic. Chinese companies are also giving foreign brands a run for their money with insightful marketing, clever use of digital tools, superior supply chain management and quality product offerings.

Today, we'll be talking to Jen-Ai Chua, Singapore-based Investment Analyst at Julius Baer, and Esteban Polidura, Head of Advisory and Products for the Americas at Julius Baer, about the boom of new brands from China over the last years and the rise of a new generation of consumers who have re-shaped the consumption landscape and fuelled the ascent of the Chinese brands.

[NP]: Jen-Ai, welcome. Good to have you with us on Think Tank.

Jen-Ai Chua [JA]: Thank you very much Nisha for having me.

[NP]: We have seen a boom of new Chinese brands over the last years. Can you tell us more about that?

[JA]: Chinese brands have traditionally been well known in hardware-related sectors like computers and mobile phones – think Lenovo and Huawei, for instance. But in recent years, we have seen the emergence of exciting new brands in a diverse range of sectors previously dominated by foreign brands. For example, Heytea and Nayuki are giving Starbucks a run for their money in the beverages segment in China. Li Ning and Anta are catching up on Nike and Adidas in sportswear. And Perfect Diary,

Herborist and Proya are making big market share gains in the domestic cosmetics and skincare segments.

Then there is another category of Chinese brands that would be totally unrecognisable within China, but which are making waves internationally. There is Shein, an ultra-fast fashion retailer, whose app is one of the most popular among teenage girls in the US. And also, Anker, a company that produces computer and mobile peripherals like chargers. It is one of the top sellers on Amazon.

[NP]: That is indeed interesting. And why have the Chinese brands been rising so quickly recently?

[JA]: At the macroeconomic level, China is undergoing a tectonic shift from an export-oriented growth model to one that is consumption driven. Separately, a long period of economic growth has created a sizeable middle class with deep pockets for discretionary spending. We are seeing fastest growth in rural spending due to the sheer size of the rural population, strong growth in lower tier cities and upgrades in consumption.

[NP]: I see. How about individual consumer preferences?

[JA]: In terms of demography, the profile of the consumer is changing. Millennials and Gen Z are taking over as mainstream consumers. They tend to be spenders rather than savers, and are more open to exploring young upstart Chinese brands with a strong Chinese identity.

They are also digital natives. To this end, technology has been a great enabler of the rise in Chinese brands. China is the global leader in online shopping, with the highest penetration rate of 79%. And Chinese brands have harnessed the power of the internet to great effect – first, through social media platforms like Douyin and XiaoHongShu; second, through aggressive e-commerce live-streaming strategies, complemented by the use of influencers or key opinion leaders (KOLs); and third, through WeChat member groups.

[NP]: Live streaming certainly reminds me of the teleshopping programs on TV that used to be all the rage a few decades ago. Has the Covid-19 pandemic somehow boosted the popularity of live streaming and the rise of the Chinese brands as well?

[JA]: Yes, definitely. During the pandemic lockdowns, when mobility was limited, live streaming was a way for brands to gain awareness and move excess inventory. The Chinese brands were quick to

capitalize on this trend compared to foreign brands. Overall, Covid-19 has benefitted Chinese brands. Domestic goods tend to be more affordably priced vs foreign goods, and this was a plus point when household budgets are constrained. There is also a hygiene concern over whether parcels may be tainted with Covid-19 during the international delivery process, which worked in local brands' favour. Finally, travel restrictions have spurred domestic tourism. The emotional connection from re-discovering one's own country and returning to old customs has increased willingness to explore new Chinese brands.

[NP]: It sounds like so many factors are now working in favour of Chinese brands. What about the products themselves?

[JA]: When it comes to product quality and image, Chinese brands have greatly increased the ante in terms of investments in advertising and promotion as well as R&D. They have also developed strong digital engagement strategies and have enjoyed superior access to supply chains due to proximity to manufacturing hubs in China. The speed at which they can produce items is amazing. For instance, Shanghai Chicmax, a cosmetics brand, can go from designing to selling a facemask in three days, a process that could take a foreign shampoo brand three years. Variety and speed are critical to a brand's success as young Chinese consumers like chasing trends. GlaxoSmithKline had 400 products for European customers in one oral care category, whereas there were 12,000 for China.

[NP]: If Chinese buyers are embracing home-grown brands, what about the rest of the world? Is there a similar revolution going on?

[JA]: The Chinese brands have yet to make a splash on the global stage. World Brand Lab's list of top ten most influential brands in 2020 did not include any Chinese names. A separate survey, the Kantar Brandz 2021 - Most Valuable Global Brands, did have a number of Chinese brands on its ten most valuable global brands list. But this was a relatively modest showing, just 2 names.

A revolution is nevertheless ongoing, and the clearest indicator of this is their astounding rate of growth. In Kantar's 2021 survey, China outpaced Europe, with 18 brands on the Top 100 list vs 17 from Europe. Of the five brands singled out in the report as having more than doubled their brand values in the past year, four were Chinese - namely Pinduoduo, Meituan, Moutai and TikTok.

[NP]: I can certainly recognise some of those names. Would you agree, then, that China has shaken its image of "cheap" brands off and the whole idea of "Made in China" has changed?

[JA]: Well, one of the undeniable selling points of Chinese brands is that they are affordably priced, and this has remained a key advantage. But the reason they are doing well is because they have been able to marry affordability with quality. For example, one Perfect Diary lipstick is said to cost a quarter the price of an Estee Lauder lipstick, but quality is in no way lacking, as they partner with Milan-based OEM Intercos and Seoul-based Comax. Chinese buyers also believe that they are better attuned with what is good for domestic consumers as they are a local brand. Similarly, Transsion, a China-based smartphone manufacturer, has captured a 44.3% share of the African smartphone market thanks to its feature-rich, ultra-low-end price bands of about USD 100.

Therefore, to go back to the question, yes, I would agree that the label "Made in China" has definitely changed. It has now evolved into "Made by China" and "Made for China".

[NP]: Can you tell us a bit more about Chinese brands in the beauty and fashion sectors? Can you share some insights about them?

[JA]: I'm glad you asked, because Chinese brands in both of these sectors are at the cutting edge of some of the biggest trends in the market.

Let's look at the fashion sector because there is a really interesting but mysterious company that is upending established incumbents in the sector. Back in 2020, Reuters published an interesting article about the emergence of fast fashion 2.0 and the risk that giants like Zara could be crushed. Fast fashion 2.0, or ultra-fast fashion, is powered by companies that can reach millions of shoppers through social media without the use of physical retail space. Shein, for instance, is a Chinese company that is at the forefront of this. Earlier this year, it toppled Amazon as the most downloaded shopping app in the US – quite a feat for a seven-year-old clothing brand.

[NP]: And how did it do it?

[JA]: Through ingenious supply-chain savvy and data-driven clothing design. Prices average USD 15 per piece, and the company can launch as many as 6,000 pieces of clothing a day through small batch manufacturing. Google trends and rival websites are studied. Once new items are launched, user behaviour, such as clicks and additions to shopping carts, are monitored to forecast demand and inventory. A week of its new releases can match Zara's rollouts for a whole year. Customers are encouraged to share their buys on social media, with endorsements from social media KOLs, who

receive free clothes and commissions of 10%-20% on sales. Additionally, Shein benefited from US-China trade tensions after China waived export taxes for D2C companies in 2018.

Very little is known of Shein. It shares almost nothing with customers about its origins or how it sources materials. Some customers are surprised to learn that it is Chinese. Observers have noted that this likely reflects the reality that the competitiveness of a Chinese brand image is still not quite there. Nevertheless, the company has made the most of its proximity to the world's largest supply chain to create a fashion empire. Shein bid for Top Shop this year but was outbid by ASOS. It is reportedly mulling an IPO. Shein generated close to USD 10bn in revenue in 2020, reportedly its eighth consecutive year of >100% revenue growth. I am sure there would be no lack of interest if a listing materialises.

[NP]: What an interesting conversation, Jen-Ai. Thank you for joining us on Think Tank.

[JA]: Thank you, Nisha, it was a pleasure.

[NP]: Let's now bring in Esteban Polidura for his investment views. Esteban, we just heard from Jen-Ai how the rise of Chinese consumer brands might offer opportunities for investors. For which other sectors in China does the Julius Baer team have a positive outlook?

Esteban Polidura [EP]: Indeed consumption is becoming a dominant driver of China's economic growth as we are heading towards a bi-polar world. This is why it is one of the three key thematic ideas in our Research Asia team's "Wealthy China, Healthy China, Pretty China" in-depth report. Let me then speak about the other two.

Healthcare demand is naturally increasing given demographics first of all. The elderly population will reach 300m for the first time. On the other hand, new-born registrations were 10m in 2020, which is 15% lower than 2019. Second, health awareness is also increasing. Consumers are more willing to purchase commercial health insurance and perform independent diagnostics and health checks. And third, more Chinese are suffering from chronic diseases, unfortunately. Policies have arguably impacted the sector economics, but they should accelerate consolidation and benefit national champions. We should keep track especially of digital healthcare, which includes online diagnosis, health and wellness management, as well as sales and marketing services. It is estimated that the total addressable internet healthcare market may reach RMB 2trn in 2025.

And as far as "pretty China" goes, environmental protection has moved up the policy agenda after President Xi pledged the country to carbon neutrality by 2060. Renewables will gradually replace coal as the dominant energy source in China. Our team thus expects a sustainable increase in penetration of electric vehicles. Moreover, to achieve the net zero target, upstream commodities will likely be reshaped with persistent supply control, which will in turn support prices.

While all three themes are sound investment ideas over the long term, the attractiveness of their entry levels varies. Our team sees value re-emerging in Wealthy China stocks after a sharp decline in most consumption names. Within Healthy China, pharmaceuticals may consolidate for a couple months but should then catch up, and investors should start to re-engage digital healthcare where earnings expectations and valuations are now reasonable. Within Pretty China, momentum is currently the strongest in electric vehicles, but our analysts think new energy also has room to extend the recovery rally.

[NP]: So, how does Julius Baer suggest investors to approach China's equities after the recent corrections?

[EP]: Investors are increasingly taking a thematic approach in equity allocation, as stock returns have been driven more by themes and less by country and sector-specific factors. So, consumption, healthcare and environment are three long-term investment themes that are worth looking into regardless of price corrections.

Now, for those that have a broad approach to Chinese equities, our team has suggested not to buy this dip. This means that our investment managers will refrain from rebalancing their Chinese equity position as they believe this asset class should remain pressured tactically and strategically for the foreseeable future. In the former case, there are no signs that government scrutiny is anywhere close to subsiding, market valuations are still above historical averages and there is little relief from the monetary policy front to be seen. And in the latter, China's latest actions to control its capital market are pushing investors' priorities to the side-lines for the foreseeable future. The earliest our analysts expect to see a sustained recovery in the market will likely be late this year.

[NP]: What other sectors may face regulations next?

[EP]: Our research team in Asia has pointed out that when China's edicts first started, the regulations that came along with them were clearly detailed and defined, so the internet platforms knew what to

amend in order to satisfy the requirements. Our analysts felt that while they did impact growth and margins, they were not enough to change their optimistic view, nor would they hurt demand meaningfully. But the edicts announced in July were more worrying, as they dealt not just with unfair or unregulated practices, but also with data security. This falls under the national security framework, so the focus is not simply an economic one, and therefore regulatory scrutiny could be more intense.

It appears that the state would like to see capital and human resources allocated away from sectors it sees as either non-vital or detrimental, to those that it believes deserve greater support, and where competitiveness needs to be on par with global peers. Government regulations seem to be focused on antitrust and social equality, data security, and undesirable social trends.

[NP]: Thank you, Esteban, for putting it into context for us.

[EP]: Thank you, Nisha, for having me today.

[NP]: Power is being handed back to the Chinese consumer. The most direct way investors can benefit from this structural shift would be through participating in the rise of the Chinese brands.

If you have any more questions on a rising China or the rise of the Chinese brands, please don’t hesitate to talk to your representative at Julius Baer.

Thank you for listening to this episode of Think Tank. Do subscribe to our podcast series on Spotify and Apple Podcasts.

From me, Nisha Pillai, goodbye for now.