

ROBUST PERFORMANCE OF JAPANESE COSMETICS INDUSTRY BACKED BY RISING DEMAND IN CHINA - GROWTH POTENTIAL FOR JAPANESE OEM COMPANIES -

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JAPANESE COSMETICS INDUSTRY FARING WELL

In Japan, the value of cosmetics shipments has been around 1.4-1.5 trillion yen since the 1990s. However, it topped 1.6 trillion yen (up 6.6% year on year) and hit a record high in 2017 (Chart 1). Major factors behind this robust performance include rising demand in China for made-in-Japan cosmetics. Looking at statistics for Japan's cosmetics imports/exports, exports started to surge from 2015 and exceeded imports for the first time in 2016. Exports to Asia, such as Hong Kong and China, showed particularly strong growth, and China became the leading export destination in 2017, with the export value of 106.5 billion yen topping that of Hong Kong. In addition to exports, Chinese tourists' spending on cosmetics is also climbing. According to a survey conducted by the Japan Tourism Agency, spending on cosmetics per Chinese visitor eclipsed that for home electronics or apparel. Given the number of Chinese tourists to Japan, the percentage of people who purchase cosmetics, and the average spending per person, it is estimated that the total amount of cosmetics purchases by Chinese tourists reached 300 billion yen in 2017. Note, however, that this figure included purchases of cosmetics made in other countries. In China, skincare products account for about 50% of the cosmetics market. Assuming that Chinese tourists select at least made-in-Japan items for skincare products, the amount of their purchases would be about 150 billion yen. Chinese tourists tend to buy what they bought in Japan via cross-border e-commerce sites upon their return home, and their word-of-mouth recommendations further boost demand for made-in-Japan cosmetics.

(trillion yen)

1.6

1.4

1.2

2003 2005 2007 2009 2011 2013 2015 2017 (Year)

Chart 1: Cosmetics Shipments in Japan

Source: Prepared by MGSSI based on Current Production Statistics Survey

Major cosmetics companies including Shiseido have seen their sales expand 1.4- to 1.8-fold in the past five years, with operating profit margin also widening significantly. Also, the market cap has doubled in the last two years, driven by particularly solid results in FY2017 (Chart 2). Not only large manufacturers but also smaller players in the Japanese cosmetics industry have generally performed well. Nihon Kolmar, the largest OEM (original equipment manufacturer) contract manufacturer in Japan, reported sales of 38.5 billion yen in the fiscal year ended March 2018 (up 1.7-fold in the last five years), and Iwase Cosfa, the leading distributor of cosmetics ingredients, booked sales of 25.4 billion yen (up 1.3-fold in the last four years).

Chart 2: Earnings of Major Cosmetics Manufacturers (2017)

	Market Cap		Sales	Vs. 2012	Operating Profit	Op Profit Margin (%)		Net	Sales by Region	
	As of end- June 2018	As of end- June 2016	(%)			2017	2012	Income		
Shiseido	31,713	10,203	8,964	47.3	717	8.0	5.7	203	Japan 43%, China 14%, Americas 14%, Europe 13%, Others16%	
Kose	10,291	4,749	2,738	82.2	437	16.0	7.0	276	Japan 75%, N. America 12%, Asia 12%	
Pola Orbis	9,733	5,117	2,179	35.1	347	15.9	7.5		Japan 92%, Others 8%	
L'Oréal (France)	138,014	106,494	29,400	1.8	5,420	18.4	17.1	4,046	W. Europe 31%, N. America 28%, Asia 24%, Others17%	
Estée Lauder (US)	52,372	33,474	11,826	21.7	1,883	15.9	14.5		Americas 41%, EMEA 40%, Asia 19%	
Amorepacific (S. Korea)	16,924	21,881	4,534	44.2	528	11.6	12.8	349	S. Korea 62%, Asia 36%, N. America 1%	

Note: Amount in millions of dollars; growth rates on a local currency basis.

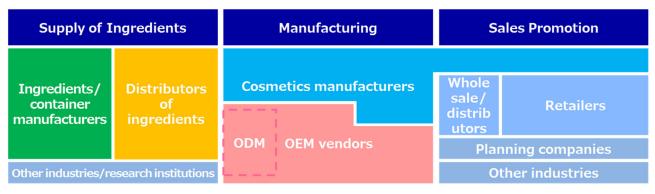
Source: Prepared by MGSSI based on Bloomberg data.

STRENGTHS OF MADE-IN-JAPAN COSMETICS AND STRUCTURE OF INDUSTRY

Made-in-Japan cosmetics are popular for their good image and stable quality. Unlike home electronics, etc., as cosmetics are directly applied to skin, safety is especially important. In addition, consumers decide which cosmetics to buy based on the image of a product and their feeling about it, as it is difficult to quantify effectiveness. Generally speaking, Chinese consumers are suspicious of cosmetics made in their country. As such, Japanese products, which are believed to be safe and reliable, are attractive to them. The good image of Japanese products is underpinned by their stable, high quality, which is supported by individual players in each layer of the Japanese cosmetics industry. The process of manufacturing cosmetics requires meticulous management and control at each step, from the manufacturing/procurement of raw ingredients and containers to the manufacturing of final products. The good image and high quality of the Japanese cosmetics industry is achieved by the concentration of efforts made by providers of raw ingredients, of which stable quality is highly valued worldwide, distributors of raw ingredients, which procure a wide variety of materials in small quantities, as well as cosmetics companies and OEM vendors, which have established production management systems and quality management/assurance systems that help secure a high degree of safety.

Of note, OEM contract manufacturers have made significant contributions to securing the quality and responding to surging demand in recent years. The enforcement of the Revised Pharmaceutical Affairs Law in 2005 added momentum to the growth of OEM companies in Japan. After the revision, companies which outsource manufacturing can sell cosmetics without obtaining marketing approval, as long as contract manufacturers have such approval. This made it easier for players in other industries to enter the market. It can be also noted that small- and medium-sized brands can develop sales channels with less effort, as the mail-order market (including online shopping) continues to grow. Against this background, OEM companies that can respond to small lots and a wide variety of products have enjoyed robust growth. In addition to manufacturing products with stable quality, they are also expanding their ODM (original design and manufacturing) function by developing formulations and proposing product concepts/designs to small- and medium-sized brands. In the past, companies which outsourced such function were mainly planning companies and new entrants from other industries. In recent years, however, major cosmetics companies also outsource part of the development process, in addition to production, to OEM/ODM vendors, due to surging overseas demand and shorter product life cycles caused by an increasing number of new entrants (Chart 3).

Chart 3: Structure of Cosmetics Industry (Concept)



Source: Prepared by MGSSI

Another strength of Japanese products is the similarity of the Japanese and Chinese markets. Looking at a breakdown of major categories in cosmetics, percentages of sales by category differ from region to region. In Western Europe and Latin America, perfume accounts for a significant portion, while in Asia, skin care products account for a large portion (Chart 4). As such, Japanese products have potential to be widely accepted in China, as Asian people tend to have similar hair and skin types. Japanese manufacturers have developed products catering to Japanese users' needs and skin types. For example, almost all active ingredients for whitening in the world have been developed in Japan, which have helped Japanese skincare products differentiate themselves in functional ingredients.

Chart 4: Major Categories in Cosmetics, Breakdwon of Sales (%) by Region (2017)

	Skincare	Makeup	Perfume	Hair care	Men's	Others
N. America	21	19	10	15	10	25
W. Europe	22	14	14	15	13	22
Latin America	14	10	20	20	17	19
Asia Pacific	42	13	3	16	6	20
Japan	45	18	2	16	5	14
S. Korea	49	17	4	10	8	12
China	52	10	2	14	4	18

Note: Others include oral care and bath & shower products.

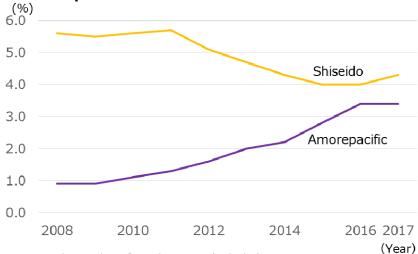
Source: Prepared by MGSSI based on Euromonitor data.

COMPETITORS IN CHINESE MARKET

As the domestic cosmetics market is expected to shrink going forward, the growth of the Japanese cosmetics industry should hinge on how to expand sales in China, where Japanese players can capitalize on their strengths. Major competitors in the Chinese market are South Korean companies, whose domestic market has similar characteristics. According to the Korea Customs Service, the export value of cosmetics has exceeded the import value since 2012, and the former reached 3.3 times the latter in 2017. Looking at China's cosmetics imports by trading partner, South Korea overtook France and ranked top in 2017. In the skincare products market in China, Shiseido has lost share while South Korean rival Amorepacific has gained share (Chart 5).

South Korean cosmetics companies have several strengths. First, they have excellent marketing capabilities. They have successfully created the image that their products offer good cost-benefit performance, and have introduced new categories by focusing on existing but little explored concepts, such as BB (blemish balm) cream,

Chart 5: Shares of Leading Japanese and S. Korean
Companies in Chinese Skincare Products Market



Note: Sales at duty-free shops not included.

Source: Prepared by MGSSI based on Euromonitor data.

which was developed by a German dermatologist in the 1960s, and cushion foundation. European/American majors and Japanese companies have added such new categories created by South Korean companies to their product portfolios.

Another strength is their development speed. South Korean companies take less time to develop an idea and launch new products than companies based in other nations. Some people call them "fast beauty", like "fast fashion" brands in the apparel industry such as ZARA and H&M.

The third strength is support from the government. The government of South Korea has helped the cosmetics industry to grow. For example, when the EU-Korea FTA came into force in 2011, the South Korean government decided to enhance its support in areas where imports from the EU were expected to increase. Cosmetics was one of such areas, and the government stepped up its support in R&D and exports. The government also spearheaded the initiative to export Korean music, TV dramas, and other contents. These contents have become popular in Asia, providing a boost to exports of cosmetics.

In South Korea, the development and manufacturing of emerging cosmetics brands are supported by OEM contract manufacturers. While leading cosmetics company Amorepacific saw its sales temporarily decline in 2017 due to lower sales of high-end products at duty-free shops, two leading OEM companies in South Korea, namely Cosmax and Korea Kolmar, enjoyed robust growth of 17% and 23%, respectively. The total sales of the two companies came to 1.7 trillion won, which was more than 30% of Amorepacific's sales. As the sales price of an OEM product is only one fourth of that of a final product (retail price), it is estimated that production at the two major OEM contract manufacturers has already outperformed that at the largest cosmetics company in South Korea. The growth of OEM contract manufacturers has accelerated as they tap into demand not only from South Korean brands but also from Chinese brands.

Major cosmetics companies based in the US and Europe also have a significant presence in the Chinese market, with L'Oréal and P&G achieving significant market share. Some of their brands, especially in low- and middle-range price points, saw their market share drop due to the emergence of local companies in the last several years. However, they have stepped up measures to capture demand in growth markets and expanded their R&D facilities in China in order to develop products catering to local consumers' needs. There are also some moves to tap into the Chinese market by taking over South Korean brands which are becoming popular in China. For example, Unilever bought Carver Korea, which owns a number of brands, including anti-aging skincare brand A.H.C (Aesthetic Hydration Cosmetics), for about 300 billion yen in September 2017, and L'Oréal

purchased NANDA, an emerging company which has a reputation for its makeup brand 3CE targeting the young, for about 40.0 billion yen, in May 2018.

FUTURE OUTLOOK

The skincare products market in China came to 27.6 billion dollars in 2017, which was 1.5 times that of the US market and accounted for roughly 30% of the global market. Consumers' needs have been shifting to more high-value-added items, including those with anti-aging benefit. China's overall cosmetics market was 53.5 billion dollars and accounted for just more than 10% of the global market. This suggests that there is meaningful growth potential for makeup products. Against this background, Chinese companies, which used to focus on low- and middle-priced cosmetics, are entering the market for high-end products.

It is said that many Chinese consumers who are interested in buying made-in-Japan products are concerned about the safety of Chinese products. However, if Chinese brands establish sufficient quality management and quality assurance systems in each process from development of formulation to manufacturing of final products in their country so that they can earn consumers' trust in terms of safety and security, the attractiveness of the made-in-Japan products may not be as overwhelming as they are now. This is a shared view in the industry, although there are different opinions on when. To remain competitive against rivals in South Korea and China, Japanese cosmetics industry needs to strengthen its ingredient procurement process, formulation development process, and production system so that it can maintain/enhance the added value of made-in-Japan products, including quality and safety, while such advantages remain intact. It is also important for brand owners to step up marketing in China. Major cosmetics companies in Japan have already taken some measures to improve their brand power and enhance product development capability. Ingredient manufacturers/suppliers and OEM contract manufacturers, which support cosmetics companies to secure the quality and safety of final products, are also strengthening their core competence.

Meanwhile, Japanese OEM contract manufacturers can take a new approach -- dealing directly with Chinese brands, which are entering the high-end market and seeking higher quality. OEM cosmetic companies have grown by expanding their customer base from cosmetics companies to emerging brands. Recently, there are cases in which overseas companies entrust production to Japanese OEM vendors, to provide "made-in-Japan" products. In Japan, various players in the cosmetics industry, from ingredient manufacturers to cosmetics companies, have worked together and experienced solid growth. As such, OEM companies often expanded overseas as subcontractors of Japanese cosmetics companies. Going forward, however, there will be more opportunities for them to manufacture products for local cosmetics companies and emerging brands in China, with Japanese quality. In such cases, it is important to engage not only in production but also in development of formulation and design of concepts (i.e., ODM function), which are not covered by Chinese OEM vendors. Although the competition with Korean OEM/ODM companies will likely be fierce in terms of price and development speed, we see meaningful growth potential for Japanese OEM/ODM companies, given emerging/diversifying local brands and the sophistication of consumer needs in the growing cosmetics market in China.