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FINANCIAL SERVICES

What's holding luxury back from investing in China?

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Cathay Capital announced the launch of a fund in partnership with Kering, L'Oral and Pernod Ricard. Will luxury be taking the Chinese investment market seriously in 2022? Image credit: Chen Peng

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Just as 2021 is drawing to a close, Cathay Capital announced the launch of the Cathay Consumer Co-Creation Fund.

The joint fund established in partnership with industry leaders Kering, L'Oral, and Pernod Ricard will invest and incubate early-stage Chinese companies with high-growth potential in the consumer goods and retail sectors: proof of a trend that has been on the verge of tipping for a decade.

However, back when Herms opted to create a Chinese luxury brand in 2010, many scoffed. How could China produce a contemporary luxury brand? Fast forward to today and that possibility is now a reality.

So, as COVID-19 continues to keep borders shut, why are more Western companies not eyeing local Chinese market leaders for a strategic route in, and where are the big success stories?

Aside from the notoriously slow burn of luxury investments requiring especially long pockets, past examples have often not been sufficiently localized.

Qeelin, Shang Xia or even Shanghai Tang are brands that could have done quite well, according to Shanghai-based Ben Cavender, managing director of China Market Research Group, but were not positioned and supported in a way that truly allowed them to be successful.

"The challenge with these examples is you have a domestic brand that's taken foreign investment but has then been given a foreign lens to look at the market," Mr. Cavender said. "So the products appeal to a luxury consumer sitting in the West."

Naturally, if you are a Chinese brand selling to Chinese consumers, there needs to be a reorientation on what your story and products should be. Mr. Cavender thinks this is often mismatched.

Over the last number of years, this "misfit" has been better served through partnerships with young Chinese designer brands as a way to test the water: Chenpeng, 8on8 and Feng Chen Wang have all collaborated with Western names.

"China is not just a consumer market, it's a hotbed of creative talent too," said Swetha Ramachandran, fund manager at GAM Investments. "For brands to remain relevant in China, they need to be able to tap into that."

Canali, Moncler and Canada Goose have all tapped into local creative talent to their advantage.

Still, companies need to wade in further.

Flaio Cereda-Parini, managing director at equities firm Jefferies Group believes that every luxury brand of size that is significantly involved in the country would do well to know that "they need to engage beyond the commercial aspect there's more to it than that."

For Mr. Cereda-Parini, that more could be acquiring and nurturing local talent which shows a level of commitment to the country, a fact that now plays especially well with the younger generation of consumers. In his words, it also shows that "you aren't just flogging as many shoes and brands as you can. While it may not change much in the short-term, ultimately, it shows goodwill."

Of course, investments are naturally more than goodwill: Spanish company Puig saw the potential when it shelled out for China's favored Gen Z fragrance label, Scent Library, or , its brand valuations rose from 300 million RMB in 2018 to 1.6 billion RMB in 2021.

Similarly so for Procter & Gamble's procurement of cult brand Farmacy Beauty, founded in 2015 by entrepreneur David Chung. The label's flagship store on Tmall Global so far has attracted 375,000 followers.

Given this rosy outlook, what is causing concern?

Likely, headwinds concerning Evergrande's increasing financial difficulties, as well as a spate of crackdowns from Beijing on various sectors such as fin-tech, gaming, and overseas public listings. These may well be scaring backers off.

Yet, in October, a 2035 long-term objective from Beijing stated that the country will push for opening up businesses in fields such as finance, Internet and culture, and relax conditions for investment by high-quality foreign investors.

The Ministry of Commerce also predicted that total foreign investment in 2021 will exceed $160 billion as 36,000 foreign enterprises established in the first three quarters.

CNBC noted that, this year, venture capital investment in China rose in the third quarter, bringing year-to-date totals to more than all of 2020.

Mr. Cavender thinks that companies are misinterpreting Chinese President Xi's "Common Prosperity" to mean anti-business, which is not the case.

"It's about the government shifting its growth initiatives to support development in underdeveloped areas here, so it's not an anti-business environment at all even though it seems to be presented that way sometimes in a lot of the media," Mr. Cavender said.

Given this, a lot of domestic brands have taken the opportunity of locked borders and rising patriotism to strengthen their position in the market. Now is clearly a very good time to be looking at Chinese businesses.

"This will carry them forward and put them in a strong position over the next 5 to 10 years," Mr. Cavender said.

Currently, it has also been more difficult for companies without local teams on the ground to keep a sense-check on what is happening and to carry out the necessary due diligence required: looking at store traffic, what is being written online by consumers, comparing how a product portfolio matches up, tracking pricing strategy and discounting in real time.

If the company is publicly traded or about to file for an IPO, the proposition is different but no more certain.

Ms. Ramachandran pointed out the delicate balance between growth and exclusivity, which is why local brands need to be careful regardless of the source of money. She advised "restraining growth in the short-term to build a much better foundation in the long-term" as a solution.

Entering the market slowly, even if Chinese, is another.

"The current accepted underpinning of brands that succeed in mainland China are domestic authenticity or international credibility if both, that's better," said Michael J. Oliver, cofounder of Global Partnership Family Offices.

Mr. Oliver recommended watching off-the-beaten-track brands such as Baudoin & Lange, an artisanal shoe brand founded by a Chinese national.

"It's building international credibility before entering the China market very soon," Mr. Oliver said. "For a value play, Baudoin & Lange is well-priced and positioned for the tailwinds mentioned above."

Sportswear design house Feng Chen Wang was highlighted by luxury industry expert Catalin Dascalu, who feels these brands are the ones that will bring "the balance" in the luxury industry on the Chinese market and beyond, too.

"In my opinion, even if it is a long way to become a really high-level, top brand, Chinese designers are the ones who should be put on the short list from the investment perspective in the coming years," Mr. Dascalu said.

Frankly, this needs to happen before the opportunity to invest may organically be closed off to luxury as domestic sources continue to do the heavy lifting.

For example, homegrown direct-to-consumer sportswear brand MAIA ACTIVE have just announced an investment by Chinese shoe retailer, Belle International. Prior to this, the label filed three rounds of funding, led by high-profile investors including Chinese Culture and Huachuang Capital.

All the while, domestic names continue to flex their muscles beyond the mainland.

Most recently, local beauty outlays have been especially aggressive: USHOPAL, China's leading beauty brand group, nabbed Argentum Apothecary, Yatsen Global acquired British high-end skin care brand Eve Lom and makeup brand Kevyn Aucoin was bought by beauty store HARMAY, which already owns French skincare name Graine de Pastel.

It is all happening. Really, investing in China should be a given for Western brands active in the market. Will this decade be the time for backers to pile in?

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