Crisis or Opportunity?

What China's 3rd Child Policy Means for Consumer Investors

L **Catterton Consumer Insights**

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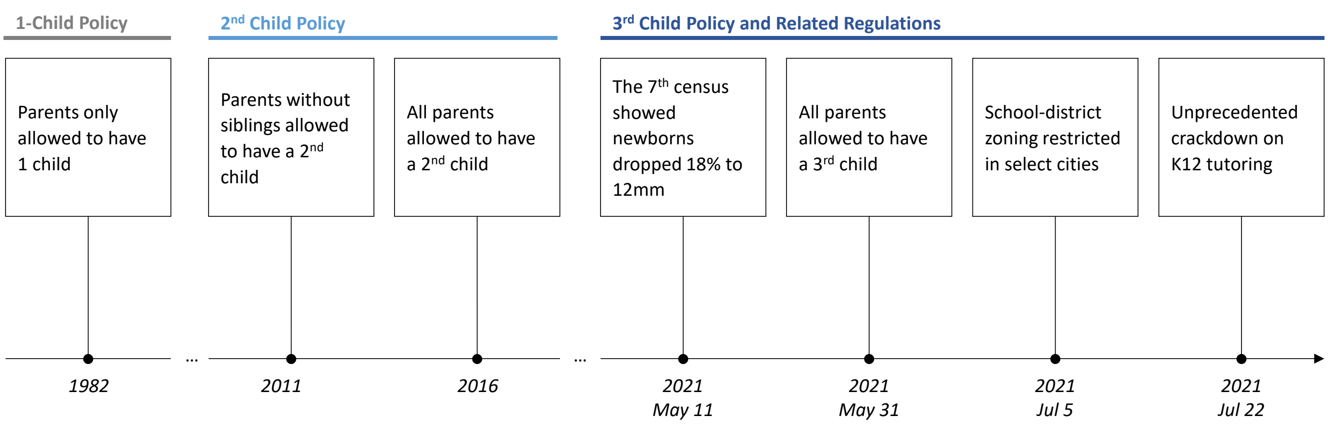
Introduction

On May 31st, 2021, the Chinese government released its latest population policy, lifting the number of children allowed per family from two to three. The explicit gesture towards birth encouragement was unsurprising, considering the staggering 10% annual drop in China's birth rate since 2017[1]. What sent a shock wave across the system, instead, was the sweeping education reform which quickly ensued. In July, the government banned new K12 after-school tutoring businesses from opening, required the existing ones to convert into non-profit organizations, prohibited their public listings and imposed restrictions on foreign capital raising. Combined with the ongoing crackdown on the technology sector, this news triggered a $1.5 trillion sell-off of Chinese stocks on global exchanges[2].

Though seemingly unrelated, the third child policy, the education reform, as well as a string of auxiliary regulatory changes targeted at inflated property prices, white-collar working hours and more stem from the same goal – to alleviate the growing financial burden on Chinese families, so they can supply the population base necessary to drive China's next phase of economic growth. But are these sweeping reforms enough to reverse China's falling birth rate? How will families, consumer businesses and the market react in the medium-to-long term? Ultimately, who will be the winners, and who will be the losers?

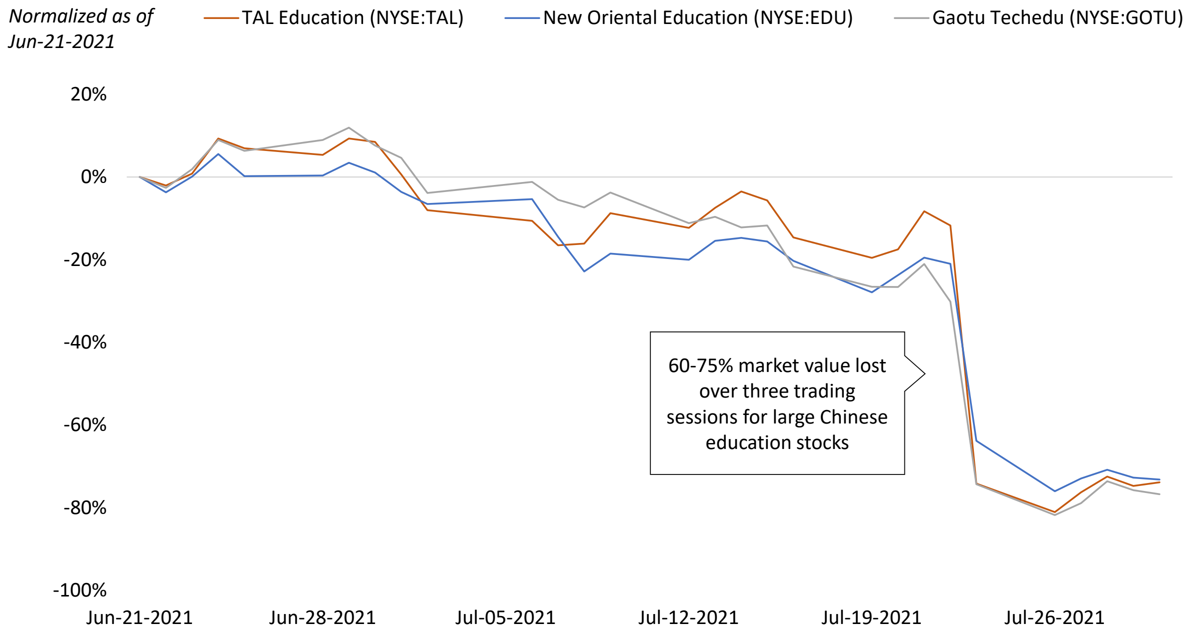
In this piece, we take a deep dive into China's demographic challenge by analyzing its root causes, the potential impact of remedial policies, and the implications for investors in the consumer market.

Figure 1: Timeline of birth-related policies in China



1 National Bureau of Statistics
2 https://www.bloomberg.com/news/videos/2021-07-28/why-china-s-stock-market-is-selling-off-video

Figure 2: Stock performances of China's leading tutoring companies



Where did the babies go?

A quick glance at the numbers and one understands why the Chinese government has been alarmed into action. The number of new births has plunged from 18 million in 2016 to 12 million in 2020. The current fertility rate[3] of 1.6 children per woman falls far short of the replacement rate of 2.1, spelling a future with a shrinking population, and more problematically, a downsized workforce for the world's most populous nation.

The culprits for the contraction in China are many. The rising cost of urban family life, the infamous "996" work schedule (whereby employees work from 9 AM to 9 PM, six days a week) normalized by startups and tech giants, as well as the proclivity for extended singlehood and courtship amongst the country's millennials and Gen Z have all conspired to delay, if not discourage, procreation. Adults in China today seem simply too financially strained, too busy and too self-focused to have babies.

The intense level of competition in China's education system has only exacerbated the situation. For decades, after-school tutoring has exerted financial and mental stress on academically-motivated parents and students. Worried about being out-competed, driven families cram their children's already-full schedules with supplementary classes, spending up to $43,500 per year on after-school tutoring for a better chance of being accepted by a top academic institution[4].

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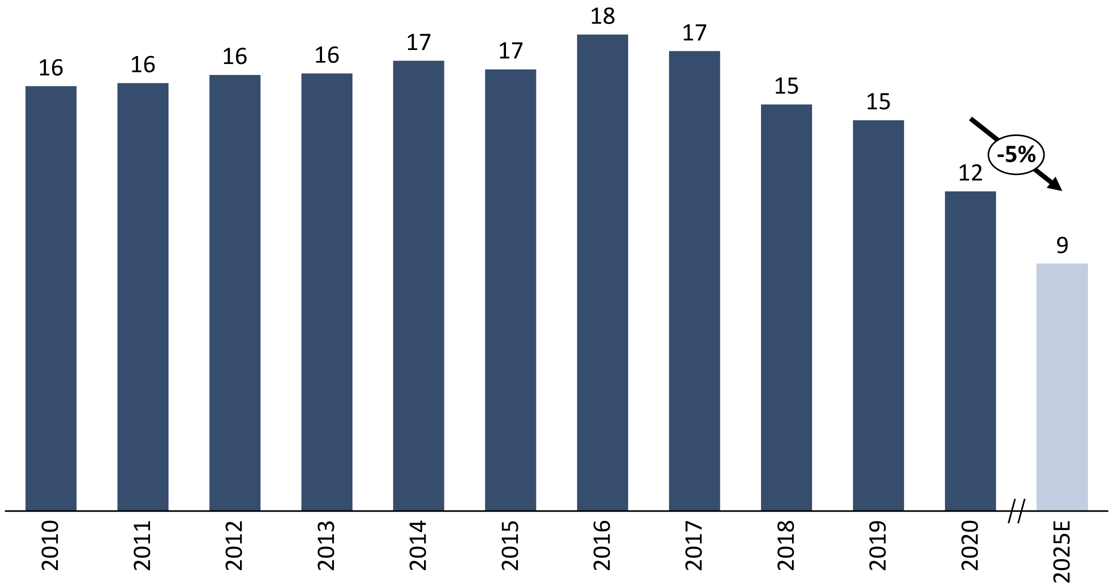
3 An estimate of the number of babies a woman would have over her lifetime; https://www.nytimes.com/2020/01/16/business/china-birth-rate-2019.html

4 https://www.scmp.com/news/china/society/article/2176377/chinese-parents-spend-us43500-year-after-school-classes-their

Unsurprisingly, the government has unleashed a bout of regulatory changes aimed at addressing each of these pressure points, with education being the first and main target. The recent reform effectively put an end to after-school academic tutoring programs, but it remains to be seen what activities will fill the gap. Meanwhile, a host of supplementary policies, such as the removal of select urban school zones that previously drove real estate price inflation[5], a new law that deems it illegal to require employees to work 72 hours a week (as was the case with "996" schedules)[6], and the tax deductions afforded to parents with three children[7] have collectively signaled the government's resolve to make raising children less daunting and more appealing to its citizens.

However, these multi-pronged, strictly-enforced policies may not be enough to reverse the trend of declining births. According to a forecast by the Boston Consulting Group, while there will be a slowdown in the pace of decline following the new policies, the number of newborns will still drop by 3-5% year-on-year from 2021 to 2025. Experts concur on this range, suggesting that the new measures will at best mitigate the drop by 0.5-0.6 million babies per annum[8], and impact mainly lower-tier cities. Similar to tackling climate change and income inequality, resolving a demographic crisis will take a long-term, consistent, and comprehensive set of political and social changes. One would be naïve to expect the issue to disappear overnight.

Figure 3: Number of newborns in China, 2010-2025 (million babies)



Source: National Bureau of Statistics, expert interview, LCA analysis

5 https://www.scmp.com/business/china-business/article/3141444/houses-beijings-top-school-district-lose-allure-young
6 https://www.protocol.com/china/china-996-overtime-era-ended
7 https://www.china-briefing.com/news/china-releases-supporting-measures-for-three-child-policy/
8 https://mp.weixin.qq.com/s/r6KEnbGqiw1L5e5jEJ17YQ

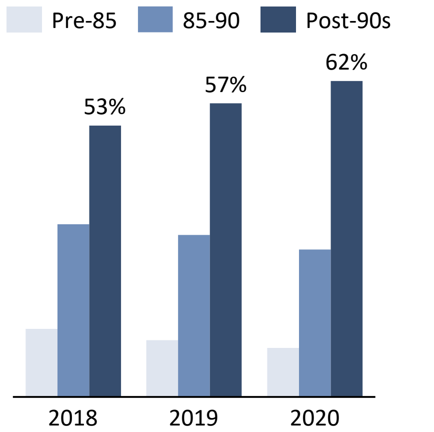
Given this outlook, how should investors view deal opportunities in the Chinese market, especially in the maternity and children (M&C) space? Where might investible opportunities lie, underneath the shrinking headline numbers? As consumer-focused, insights-driven investors, we have backed numerous distinctive M&C businesses in our 32-year history, including the Honest Company, Zarbee's and Plum Organics. Informed by our experience investing across economic cycles and demographic shifts, we believe that challenges also breed opportunities. In the next section, we review key consumer segments and business models that could serve as growth engines in the space, particularly in relation to post-90s moms, parents in third- to fifth-tier cities, and outbound opportunities.

Opportunity #1: Post-90s (九零后) moms

Post-90s moms represent around 60% of China's new mom population today. Compared to their predecessors, they are more sophisticated in evaluating product formulations, efficacies and designs, and are more focused on their own wellbeing when pregnant and when raising children. As such, premiumization tendencies among such consumers and the penetration headroom of new product categories in this group represent pockets of growth even amid declining birth rates.

Figure 4: The post-90s generation has become the major mom cohort

Age composition of moms



Source: Babytree (N=3,564)

Characteristics of post-90s moms

Ingredient & function savvy	**90%** of post-90s moms want "more specific functionalities that suit my baby"
Design & IP savvy	**72%** of post-90s moms "prefer unique designs in baby products to make my baby stand out and shine"
Care for their own wellbeing	**>80%** of post-90s moms "care more about their own physical health and appearance" in 2021 than in previous years

Source: iResearch (N=2,500)

Indeed, brands catering to these self-caring, high-spending moms have emerged. For example, premium maternity personal care brand Evereden promotes a five-step baby skincare ritual – including body and hair wash, massage oil, body lotion, face lotion, and bottom balm products – all made with 100% organic ingredients. Another of the brand's top-sellers is its Golden Belly Serum, which uses the same botanical active ingredients that can be found in luxury facial serums to prevent stretch marks.

With premium product quality at price points 2-5 times higher than peers’, Evereden has created and occupied a white space in the market, which did not have a sizable audience until this generation of new moms showed up.

Figure 5: Evereden caters to new moms looking for premium products

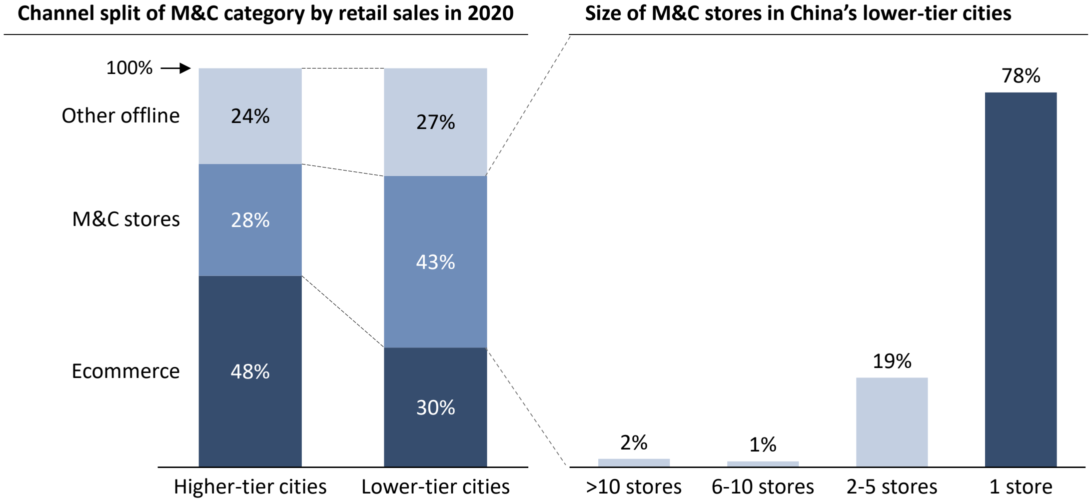
It is worth noting that a key caveat in pursuing this premiumization thesis is the size of the total addressable market, which may be limited by the relatively high price point and the niche nature of the relevant product categories. Therefore, to win with this strategy, premium brands must be equipped with superior capabilities in brand-building and storytelling, in addition to product development. For those in search of a more sizable slice of the pie, the mass market presents an alternative opportunity, which we turn to next.

Opportunity #2: Parents in third- to fifth-tier cities

As stressful lifestyles pervade the metropolises, tier 3-5 cities are expected to contribute over 80% of China’s newborns in the foreseeable future[9]. Consumers in this market exhibit drastically different shopping preferences than their peers in tier 1-2 cities. They tend to be more price-sensitive, less focused on technical functionalities, and most importantly, they purchase from much more fragmented and localized channels. In these lower-tier cities, M&C stores represent the largest sales channel (43% market share vs. 28% in higher-tier cities). Within this channel, 78% are single-store businesses and only 2% belong to chains with over 10 stores.

9 https://mp.weixin.qq.com/s/GPeC9wg3YwcS07DecEpzmg

Figure 6: Channel structure in higher- vs. lower-tier cities



Source: Kantar Worldpanel

Source: Hipac 2020 survey

Given the channel fragmentation, brands looking for success in lower-tier cities need to be able to penetrate a vast network of dispersed points of sale. Besides building this capability in-house, brands can also rely on ecosystem enablers to break into hyperlocal neighborhoods. Hipac is one such an enabler, helping over 8,000 brands get on the shelves of more than 220,000 M&C stores[10] across the nation. Leveraging local market insights, the company also helps brands incubate customized SKUs to appeal to customers. For example, in 2019, Hipac collaborated with Pampers to launch a "Gold Pampers" product, which offers enhanced absorption features to address parents' habit of changing diapers only once every night in lower-tier cities[11].

Figure 7: Hipac's tailor-made product for Pampers featuring enhanced absorption features

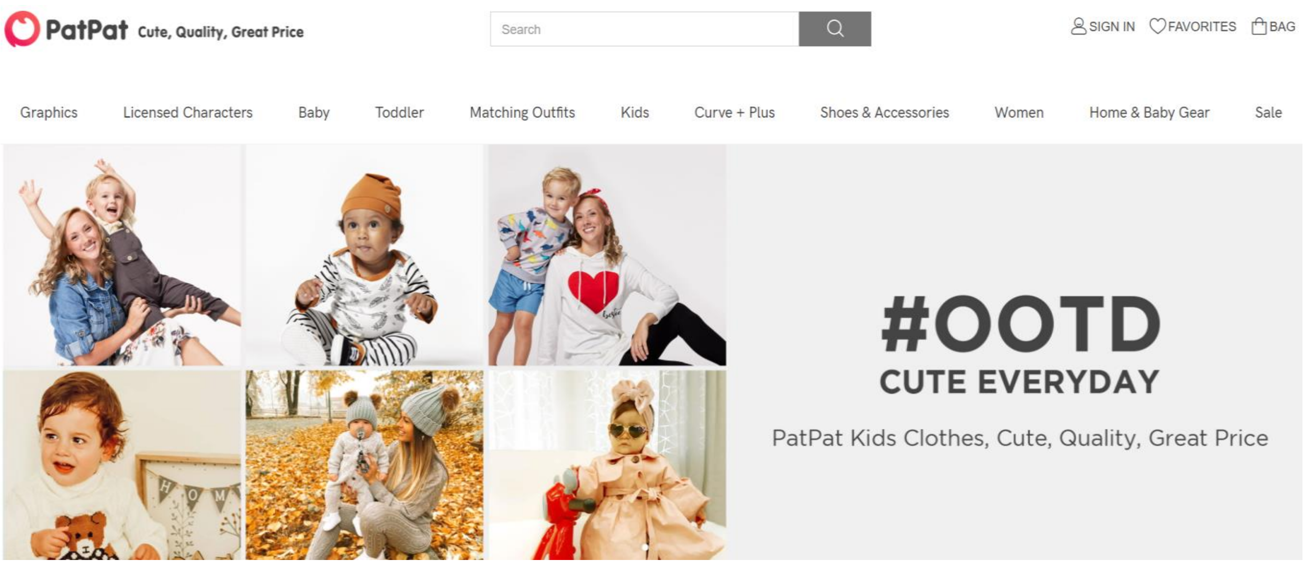
[10] From company website
[11] https://mp.weixin.qq.com/s/t11kteuEvebu3U7RY-jmag

Opportunity #3: Outbound brands

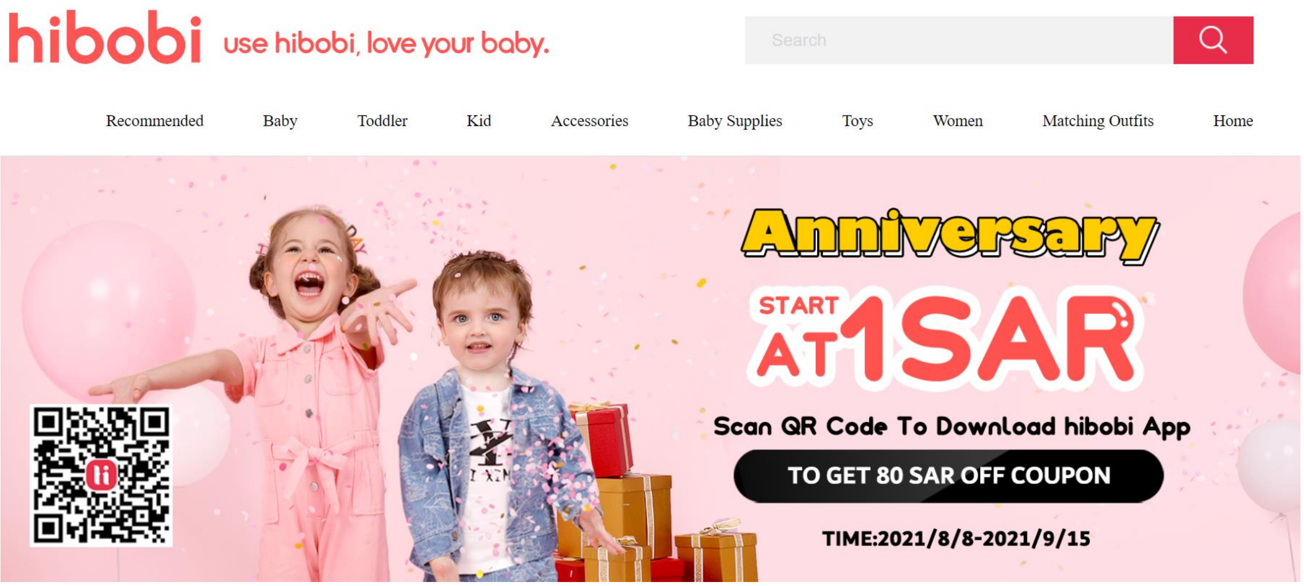
Yet another emerging strategy is to go overseas. The so-called “outbound brands” leverage China’s hyper-efficient supply chain networks to ship direct-to-consumer (DTC) products at a fraction of the costs of international competitors and delivery at a much faster speed. Leading players in this space include Shein, Patpat, and Hibobi, all of which have developed childrenswear lines. Shein, already a formidable global fast fashion player on track to reach $15 billion in annual sales, focuses its kids’ line, which is simply a downsized version of its women’s products. Patpat has become the largest pure-play childrenswear outbound brand, reaching $200 million in global sales in 2020 and raising more than $660 million from Softbank Vision Fund, General Atlantic, and Sequoia China in previous rounds. Hibobi is a relatively new entrant that differentiates itself by focusing on the Middle East, but it also aspires to expand into more emerging markets and product categories in the future. Even though Patpat and Hibobi are each less than 1/20 of Shein’s size today, given the immensity of the $150 billion global childrenswear market[12] and rising ecommerce penetration across the board, we believe a winner-takes-all scenario is unlikely and that more insurgents can reach scale.

An increasingly salient challenge to this strategy, however, is the heightened ESG risks associated with the fast fashion business model. Some businesses are already facing consumer backlashes and regulatory scrutiny related to labor practices and supply chain opacity, so brands will have to balance productivity with social responsibility more thoughtfully going forward to sustain their growth and consumer appeal.

Figure 8: Patpat and Hibobi websites



[12] Euromonitor



Looking beyond the maternity and children market ...

While the M&C market is the most directly impacted by China's demographic shift and regulatory changes, these developments hold broad implications for the entire consumer market. Secondary effects spill into sectors including education, pet, and consumer health, just to name a few. As after-school academic tutoring becomes restricted, lessons in non-academic disciplines such as the arts and sports are likely to gain traction. As urban adults stay single for longer, they increasingly turn to pets for emotional companionship. One can therefore expect an acceleration in the humanization of pets and the premiumization of pet products. Finally, as China's population distribution tilts towards seniors, chronic disease management and elderly care will likely see an increase in demand, and so will the broader "silver hair economy".

Amidst structural shifts in the economy and the accompanying regulatory changes, players in China's consumer market continue to adapt, evolve, and self-disrupt. As insights-driven, consumer-first investors, we at *L* Catterton remain laser-focused on how the market behaves alongside the changing landscape. As always, we look forward to being the partner of choice to distinctive entrepreneurs as they navigate the changing waters to build world-class brands.

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About *L* Catterton

With $30 billion of equity capital across its fund strategies and 17 offices around the world, *L* Catterton is the largest global consumer-focused private equity firm. *L* Catterton's team of nearly 200 investment and operating professionals partners with management teams around the world to implement strategic plans to foster growth, leveraging deep category insight, operational excellence, and a broad partnership network. Since 1989, the firm has made over 250 investments in leading consumer brands. For more information about *L* Catterton, please visit www.lcatterton.com.

Important Information