ATLANTIS PRESS
Advances in Economics, Business and Management Research, volume 215
Proceedings of the 2022 7th International Conference on Social Sciences and Economic Development (ICSSED 2022)

The High-end Development Process of the Cosmetics Industry in China

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ABSTRACT
Since the beginning of the 21st century, the wave of mergers and acquisitions in China's domestic beauty industry has been surging. M&A is a complex high-risk investment activity, and its core is financial activities. From many successful and failed cases of M&A, it can be found that the failure to implement effective risk management for M&A financial risk is the main reason for the failure of M&A. Fully understanding the financial risk of merger and acquisition and implementing effective risk management is the key to the success of merger and acquisition. Therefore, this paper makes a qualitative analysis of the M&A of cosmetics, the motivation of M&A, and the risks in M&A, and puts forward some methods and measures to deal with these financial risks.

Keywords: *cosmetics industry, mergers and acquisitions, high-end process*

1. INTRODUCTION

1.1. Background

With the continuous development of the cosmetics industry, more and more cosmetics enterprises enter the market, and the cosmetics industry is also rising rapidly. There are thousands of cosmetics companies in China at present, and the competition is fierce. At this stage, China's cosmetic enterprises are still mainly small and medium-sized enterprises, with low scientific research levels and low scientific and technological content of products. The research and development of scientific formulas are is still in the stage of imitation. To enable enterprises to stand out from numerous beauty companies, break through the ceiling of a single brand, achieve sustained growth, cover different categories and positioning, and meet the requirements of various customer groups, more and more enterprises are moving towards the road of M&A.

1.2 Related Research

Previous researches show that national cosmetic brands in China have been experiencing rapid growth. Liu believed that the main reasons for the rapid rise of new brands are the change of human resources, the empowerment of capital, the improvement of logistics speed, and the overall progress of China's cosmetics industry chain. China's cosmetic industry has a promising future with more new brands which are good at seizing opportunities rising in the market [1].

However, under economic globalization and in face of competition from cosmetic companies in foreign countries, many researchers unveil the harsh facts. He et al. pointed out that at present, nearly 80% of the cosmetics market in China has been occupied by the products of imported cosmetics enterprises, and the performance of state-owned brands is worrying [2]. Wang et al. pointed out that at present, the top 10 manufacturers in China's cosmetics market are still big international manufacturers, especially in skincare products. Consumers are willing to pay for brands that are technologically advanced and have a strong grasp of consumer appeal. As a result, global brands are pouring money into building their brands [3]. Both Zhang and LI mentioned that the Chinese cosmetics market is nibbled or swallowed in the competition with international big brands [4]. It's difficult for Chinese cosmetic companies to achieve high-end orientation and realize internationalization [5]. Yang et al. found that Chinese domestic cosmetic firms don’t develop adequate practices for innovation so that they have lost the domain of the domestic marketplace and face competitive pressures of globalization [6].

To deal with the challenges facing Chinese cosmetic companies, many researchers worked out different kinds of solutions including establishing high-quality brand image, city brand image, or even national brand image [4,6], focusing on Research and development with strategic innovation [2,6,7], combining Chinese traditional culture with cosmetic products to add values [7,8], and relying on the emerging digital media to publicize the brand creatively and improve reputation [9,10]. Among them, the integration between companies has been mentioned several times as well.

From the above, it can be noticed that the existing researches mainly emphasizes Chinese cosmetic enterprises' current situation and the general analysis of the solution to tackle their challenges to be high-end oriented and internationalized. While specific empirical analyses of how Chinese cosmetic enterprises can achieve high-end development through mergers and acquisitions are relatively rare. Besides, the precautionary measures to control the risks faced by Chinese cosmetic companies in the process of M&A are still not clear.

1.3 Objective

This paper mainly researched cross-border mergers and acquisitions of China's domestic cosmetics market. Cross-border mergers and acquisitions have become one of the most effective methods to help enterprises to have high-end development rapidly. However, cross-border mergers and acquisitions also face some risks, there is necessary for enterprises to realize, solve or avoid them. We presented the situation of China's domestic cosmetics market, analyzed problems faced by cross-border mergers and acquisitions, some risks which may occur in actual cases. What is more, we presented different solutions according to these risks and problems, helping China's domestic cosmetics market develop.

2. CHINA'S DOMESTIC COSMETIC MARKET ANALYSIS

Benefiting from the rapid growth of China's economy, China's cosmetics market has realized the expansion of consumer groups and the upgrading of consumption levels. China has gradually become a major country for the consumption of cosmetics. China's cosmetics market continues to grow. According to Forst & Sullivan, the market scale of the Chinese cosmetics industry keeps expanding. Besides, based on statistics from Euromonito, the retail scale of cosmetics in the domestic market expanded from 205.187 billion yuan in 2010 to 318.03 billion yuan in 2014.

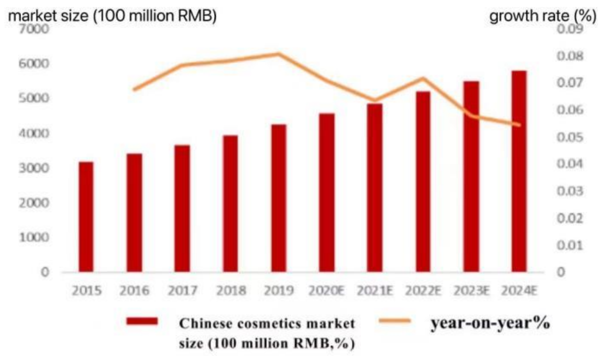

Figure 1 Market size and Growth rate of Cosmetics in China (100 million RMB, %)

The rapid growth of the cosmetics industry is not only shown in the sales scale increasing year by year but also in the evolution of sales channels. Cosmetics retail channels mainly include supermarkets, professional chain stores, department stores, e-commerce, and so on. In recent years, China's cosmetics channel structure has gone through a rapid adjustment. From 2010 to 2014, the market share of the two traditional sales channels, supermarket, and department store, declined rapidly, replaced by the development of new channels such as e-commerce.

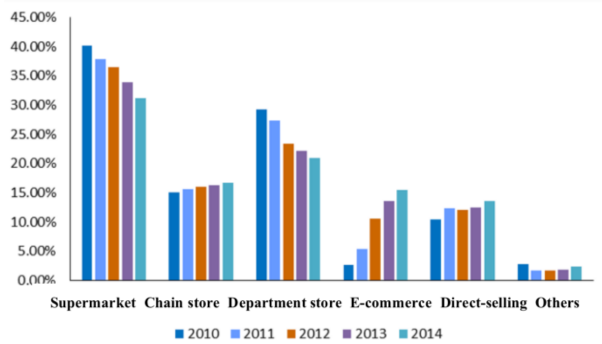

Figure 2 China cosmetics industry channel structure change statistics 2012-2014

Meanwhile, the competition is becoming more and more fierce. There is not only homogenization and competition at the same level among local brands but also the pressure brought by foreign mature brands to local enterprises. The main brands of Chinese cosmetics are mostly concentrated in the middle and low-end market, and the high-end market is largely monopolized by foreign brands. At present, the top 10 manufacturers in China's cosmetics market are still big international manufacturers, especially in skin-care products [3].

Although foreign brands occupy the Chinese cosmetic market on a large scale, they have brought scientific management systems and rich marketing methods. Young local Chinese brands have gradually grown up in the fierce market competition and began to work together through integration to optimize resource allocation, expand enterprise-scale and strengthen brand strategy. Strong and excellent local enterprises have gradually emerged, starting to acquire overseas cosmetics brands and expand actively. Among them, typical cases include Horizontal M&A: Shanghai Jahwa Corporation's acquisition of Kecai on March 20, 2008, which acquired 51% of the equity of Sichuan Kecai, with a price of 65.2162 million yuan. This is the first time that two domestic enterprises have begun to cooperate after several brands have been acquired by foreign-funded enterprises; Vertical M&A: in 2015, Qingdao Jinwang acquired Shanghai Yuefeng to build a complete cosmetics industry chain; Conglomerate M&A: in December 2015, Lang Zi acquired 10% equity of South Korea brand L&P for about RMB 330 million to enter the cosmetics industry.

Chinese cosmetics industry has entered the era of merger and integration. Through M&A, enterprises will reintegrate capital, brand, sales channel, and process technology. The integration can reverse the situation of low development level, unreasonable product structure, and homogeneous competition of domestic cosmetics industry, improving the market structure and promoting the new upgrading of the whole cosmetic industry.

3. RISKS FACED BY CROSS-BORDER MERGER AND ACQUISITION IN THE HIGH-END DEVELOPMENT PROCESS OF CHINESE COSMETICS BRANDS

3.1 Valuation Risk

The inaccurate value of risk assessment by the acquired enterprise due to asymmetric information makes it difficult for the acquired enterprises to determine the correct value and profitability, which may make the income generated by the merger and synergy effect of enterprises whose price is higher than the purchase price unable to be measured in monetary terms, thus leading to financial risks for enterprises. Among them, because of the geographical environment, the market environment, and cultural environment where different parties are located, the acquirer cannot accurately and thoroughly investigate the acquired enterprises. At the same time, shareholders or executives of the acquired company may conceal the financial losses in financial statements or exaggerate brand awareness to a certain extent, to obtain a higher purchase price.

In June 2018, Yunifang announced that it would purchase 60% of Afu Essential Oil for 1.02 billion. According to public information, the consolidated statement of Afu Essential Oil parent company on the benchmark date of June 30 shows that the net assets were RMB194 million, while the value of 100% equity interest of the target company increased to RMB1,641 million after the appraisal, and the appraisal value increased by RMB1,447 million, with the appreciation (premium) rate reaching 744.51%. To this end, the Shenzhen Stock Exchange has issued two letters of inquiry, requesting Yujiahui to disclose more detailed asset descriptions to explain the high appreciation rate of the appraised price of this transaction. However, Yujiahui only said on November 14 that it planned to modify the trading scheme and has not replied to this inquiry letter since. On December 25, Yujiahui announced the termination of the acquisition.

3.2 Payment Risk

Payment risk refers to the unreasonable payment method adopted by the acquirer during the acquisition process, which may lead to the loss of funds. In the process of merger and acquisition, the acquirer may choose to pay the fixed purchase price to the target company in the form of cash, stock, or a combination of cash and stock. Although cash payment is simple and easy, it can make the acquisition complete quickly, but it will also make the company face liquidity problems and increase operational risks. The stock payment will dilute the equity, reduce the earnings per share and harm the interests of existing shareholders. For example, Wanda Group acquired Legendary Pictures in 2016. Wanda Group paid about $3.5 billion in cash(23 billion yuan). However, Wanda Group's main business is real estate, and its asset-liability ratio is very high, so Wanda Group needs to have a smooth cash flow. After this overseas acquisition, it requires capital expenditure, which is bound to increase the capital chain tension of Wanda Group. Cash payment of enterprise mergers and acquisitions, the funds of mergers and acquisitions generally come from enterprises' funds and bank loans. Because of the payment methods of this acquisition, Wanda Group relies on bank loans to support overseas mergers and acquisitions. This payment method enables its capital chain can remain relatively stable in the short term, while once the financial policy changes, the tight capital chain will bring fatal risks. When the actual results of mergers and acquisitions fail to reach expectations, interest payment risks and repayment risks may emerge. That is one of the reasons why Wanda Group sold its cultural tourism project in June 2017.

3.3 Financing Risk

In the process of acquisition, enterprises need to raise a lot of funds to ensure the smooth progress of acquisition activities. Generally, there are three ways of financing, debt financing, internal financing, and equity financing. Too much bias of any one of the three will not be a good financing decision, causing financing risks. First, if the acquirer primarily issues share to raise capital, it faces the risk of stock dilution, which might result in shareholder losses. Financing with equity entails higher costs. It may not only raise M&A expenses but also raises the acquiring firm's average borrowing costs. Internal funding, on the other hand, mainly depend on the company's profitability. Internal funding can be used if the firm has a solid base for generating adequate income. However, if the acquirer places too much emphasis on internal funding, it may be unable to respond quickly enough and adapt to changes in the external market. For example, in the share purchase agreement signed by Midea and KUKA in 2017, Midea Group paid KUKA 4 billion euros (29.2 billion yuan), most of which was paid with its funds. This was mainly due to Midea's good operating performance in 2015, in which the annual floating monetary fund reached 12.9 billion yuan, net profit reached 13.6 billion yuan, and operating cash flow reached 26.7 billion yuan. The amount of self-owned funds accounted for 91% of the purchase price, which showed that it could fully meet the payment of most of the acquisition amount. Although the internal financing was simple and convenient, it weakened the liquidity of Midea Group's funds. As a traditional manufacturing industry, Midea Group had a large demand for working capital, so the outflow of large acquisition funds lower the liquidity, causing financing risk of mergers and acquisitions [14]. Finally, debt financing differs from internal financing in that it entails not just the duty to repay the principal (debt) and interest at regular periods. Furthermore, the buyer is responsible for repaying the target firm's debts. The purchaser may fall into the debt trap if the capital structure has a high debt burden. Thus, acquisitions can increase the debt burden of enterprises.

4. SOLUTION

4.1 Paying Attention to Valuation Risks and Solve Valuation Problems from Multiple Perspectives

4.1.1. Having a Comprehensive Understanding of the Present Situation of the Cosmetics Industry

At the present, the number of cosmetics manufacturing enterprises in China has reached thousands, but the comprehensive economic strength of the enterprises is generally weak, and the funds available for research and development of cosmetics products are limited. To maintain the livelihood of the enterprise, some brands often save budgets on raw materials of products, which leads to frequent quality incidents of cosmetics products, allergic reactions among consumers after use, and hindering the healthy development of the cosmetics industry. Therefore, it is of great significance for cosmetic companies to purchase raw materials, which can not only supplement the shortage of advanced raw materials but also supplement their R&D team.

Ashland Global Holdings Limited (hereinafter referred to as "Ashland") announced that it had signed a final agreement on January 19th, 2021 to acquire the personal care business of Sch ü lke & Mayr GmbH (hereinafter referred to as "Shu Mei"), a global investment company EQT. Ashland officials said that Ashland spent a total of 263 million euros in cash to acquire personal care business in Shu Mei. The main purpose is to strengthen the raw material end and at the same time help to expand Ashland's rich special additive solutions, enhance the strength of biotechnology and microbial technology, and make up for the defects of the raw material end.

4.1.2. Reasonably Judging the Size of the Synergy

The synergy effect of enterprise merger and acquisition refers to the effect that the efficiency can be improved through the merger and acquisition so that the overall benefit of the new company after the merger and acquisition is greater than the sum of the independent operations of all parties involved in the merger and acquisition, I.E. The economies of scale and economies of scope can be realized through the association and sharing of various resources after the merger and acquisition. Reasonably judge the degree of coordination to prevent the financial burden caused by over-anticipation.

After successfully creating the perfect diary of the new brand of national makeup, Yatsen e-commerce announced the acquisition of international high-end skin-care brand Eve Lom, and the seller of the transaction was Manzanita Capital. In this M&A activity, the two sides made full use of the synergy effect. Through this merger and acquisition, Yatsen e-commerce can explore foreign markets and increase its popularity in the international market; Make up for the lack of skincare line of Yatsen e-commerce group and enhance its competitiveness. For Eve lom, the acquisition helped to open up the Chinese market. Eve lom can make better use of various marketing models of Yatsen e-commerce, such as KOLs and DTC model, to increase sales volume and revenue, and eventually achieve one plus one greater than two.

4.1.3. Selecting an Appropriate Value Assessment Method

Firstly, different pricing methods may produce different results for the same target enterprise. Pre-acquisition motivation, whether the target enterprise can survive after the acquisition, and whether the available information is sufficient. The valuation method should be gradually extended from the equity-based asset method to the cash flow method and the market method. Secondly, when engaging professional institutions to conduct a corporate valuation, targeted mergers and acquisitions should be conducted in light of the rapid development and changes in the beauty industry. The valuation methods of the US cosmetics industry include the P/E valuation method, PEG valuation method, book-to-book value valuation method, market rate, P/S marketing rate valuation method, EV/Sales marketing rate valuation method, RNAV revalued net assets valuation method, EV/EBITDA valuation method, DDM valuation method, DCF discounted cash flow valuation method, NAV net assets value valuation method, etc.

4.2 Choosing Proper Payment Methods

First of all, acquiring enterprise should have a reasonable evaluation of borrowing capacity, capital structure, and costs of cross-border M&A, combine with the enterprise's situation such as borrowing capacity, equity, capital structure, and future cash flow of the target enterprise, etc. and then plan cross-border M&A payment method. The acquiring enterprise can buy a target company with cash, stock, or a combination of the two. This choice needs to meet the requirements of both acquiring company and acquired company and help to reduce the pressure about acquiring enterprises to repay loans after M&A, ensuring financial security. If the acquiring company has abundant cash flows, it can choose to pay in cash. If the acquiring company has a poor financial position and poor cash liquidity, it can buy the target company with stock. In a nutshell, the stability of production and operation is closely related to the payment methods. Enterprises can also innovate the combination of payment methods according to situations, to make them more balanced and reasonable, relieve the pressure of cash flow and reduce the financial risks brought by payment. In the beauty industry, choose the reasonable and proper payment method to enable enterprises to input more capital in research and development about cosmetics.

Second, the company can use a deferred payment agreement. If the company uses cash payment, the corporate assets as a bank loan mortgage are not suitable and it is hard to meet the seller's requirement one-off payment, then the company can ask the merger of the enterprise to delay part or all of the payment or use payment by installment. The buyer can invest elsewhere, generating additional income by using outstanding funds. The acquisition agreements can be flexible. If the target company is acquired, the business is in good shape and the profit growth rate is very fast. The acquiring company pays a higher price to the acquired company. Instead, it will be lower.

4.3. Using Reasonable Financing Methods and Constructing an Appropriate Capital Structure

To cope with financing risk in the process of acquisition, acquiring company should use reasonable financing methods, and construct an appropriate capital structure.

First, the company should scientifically analyse its financial capabilities, identify multiple funding methods, so that it can use reasonable financing methods. Acquiring 122company should not solely focus on one way of financing. Instead, they should use different combinations of the three financing methods mentioned above. A reasonable combination of financing will reduce the financing cost and solvency of enterprises. For example, Bohai Leasing has used a reasonable capital structure of the sources of funding which provides powerful support. They use proactive debt instruments to raise funds from the internal and external capital markets, bond market, and interbank market, by combining direct and indirect financing methods, gradually establishing a long-term stable market, thus securing financing mechanisms [11]. However, in the process of Midea Group's acquisition of KUKA, the German KUKA company only accepted cash payment, so to complete the acquisition, Midea had to use its funds and syndicated loans, which inevitably increased the external debt of Midea Group. Therefore, it is more suitable for Midea to choose diversified leverage financing under the premise of considering its financial condition when choosing financing methods for M&A [12]. Besides, as for those enterprises with good financial status, cash and equity financing can be adopted moderately, which not only avoids the lack of liquidity funds but also effectively reduces the financing risk of enterprises. On the other hand, enterprises with low liquidity, can prevent and control financing risks by issuing bonds and issuing additional stocks. All in all, too much bias of any one of the three methods will not be a good financing decision. The company should understand its financial capabilities to apply different combinations of financing methods.

Second, Mergers and acquisitions should change the capital structure of enterprises to some extent. A reasonable capital structure will optimize the ratio of assets and liabilities, which is conducive to business development after mergers and acquisitions. Midea group's acquisition of KUKA caused a huge amount of cash to pay so that its long-term short-term borrowing amount rose significantly. Therefore, for short-term debt, Midea Group and the bank syndicate agreed to deduct it from the net profit regularly, to reduce short-term debt repayment risk. Meanwhile, for long-term debt, they chose the way of refinancing to ease debt repayment risk, temporarily reduce their asset-liability ratio, and reduce their debt repayment pressure [12]. Therefore, enterprises can rationally reduce the debt ratio, reduce the interest expense, reduce the asset-liability ratio and optimize the capital structure in M&A.

5. CONCLUSION

This paper has presented the cross-border merger and acquisition in the road of the high-end development process of the cosmetics industry in China. In conclusion, we analyzed the situation of China's domestic cosmetics market, China's cosmetics industry has entered an era of integration. We researched risks faced by cross-border mergers and acquisitions, including valuation risks, financial risks, and payment risks. Enterprises need to have a comprehensive understanding of the present situation of the cosmetics industry, judge the size of the synergy reasonably and select an appropriate value assessment method then focus on valuation risks from multiple perspectives. In addition, companies should choose proper payment methods, they can also use reasonable financing methods, and construct an appropriate capital structure. Chinese cosmetics companies want to be high-end, there is a need for Chinese enterprises to move towards cross-border mergers and acquisitions. We firmly believe that China's cosmetics industry has a promising future and increasing enterprises will grow rapidly. More and more companies will have cross-border mergers and acquisitions. Cross-border Mergers and acquisitions will benefit both acquiring companies and target companies. Merger and acquisition help to improve reputation and increase global market shares, fill the gap of high-end cosmetics products and low-end products, increase the net revenue and expand consumer groups from the mass market to the high-end markets.

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