
SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 8

THE BEAUTY OF JAPANESE COSMETICS

MB – Malcolm Borthwick

PK – Praveen Kumar

MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

Japanese culture is steeped in concepts of beauty. Over a thousand years ago, during the Heian period, elite women would powder their faces white, repaint their eyebrows, and blacken their teeth. The last bit was seen as beautiful at the time. Today, the Japanese are still obsessed by beauty products and spend more per person on skincare and cosmetics than any country in the world, and Japanese companies are leaders in this field. To discuss this, I'm joined in our Edinburgh studio by Praveen Kumar, manager of the Baillie Gifford Shin Nippon Investment Trust, and deputy manager of the Baillie Gifford Japan Trust.

But before we start, please remember that as with all investments, your capital is at risk and past performance is not a guide to future returns.

Praveen, as an investor, what do you look for in a good skincare company?

PK It's actually no different from what we normally look for in any Japanese company. So, the first basic aspect that we look for is the growth opportunity. What we're looking for are businesses that are exposed to structurally growing markets, markets that can sustain at least five to ten years' worth of really fast growth.

Secondly, we are looking at companies that have a distinct, or differentiated, or indeed a unique business model. Now, that might come about as a result of having unique products, or it might come about as a result of a company trying to solve a problem, of which there are quite a lot in Japan, if you look at the structure of the industry of corporate Japan.

MB Can you give an example of one company?

PK One of our recent purchases is a company called Kitanotatsujin. It's quite a unique business in that it is probably the only company in Japan, and perhaps among the very few globally, that generates almost all of its sales online. So, the products that Kitano sells, you will not find it in any offline store. It's also one of the very few



businesses, that at least I've come across, that has a subscription-based model. The way it operates is you pay a flat fee each month and, in return, you get a box of cosmetics of various types that you can pick and choose. Very cleverly, the quantity in each of those products lasts you just about a month. It's basically quite a nice, clever, way of keeping customers, maintaining customer retention. And at the same time, because it's recurring revenues it tends to be quite high margin as well. The average churn rate for this company – that's the ratio of people who leave every year – is in the low single digits, which is incredibly low.

In terms of the product itself, they actually have quite a different way of approaching it. Rather than developing a product and bombarding customers with a billion dollars of advertising, etc, they've flipped the model on its head. Basically, they've got a very small team who work out, depending on online feedback from customers, reviews, their own research, the most common problems that people are really struggling with. And they identify one of those and then try and work out "is there a way that we can solve this based on the technologies and the products we already have?"

One such product which has become quite a big hit is what they call Hyalo Deep Patch. This is basically hyaluronic acid, which is quite beneficial for the skin. That has become an explosive hit in Japan, not just with women, but interestingly with middle-aged and elderly men as well.

MB The male cosmetics market in Asia is probably bigger than it is – or potentially bigger than it is – In the UK or Europe.

PK That's absolutely right. I think a lot of people forget that, as far as beauty and cosmetics are concerned, there is a massive untapped market in the form of the male market. Traditionally, as you probably know, a lot of the major cosmetics companies globally have focused only on the female market. But I think, especially in Asia where there is a growing recognition of taking pride in one's appearance, and also as a result of the wealth effect as economies grow, as the middle class gets more and more sophisticated and disposable incomes increase, it's a natural progression. Not just for the women but for the men to start taking care of themselves, spending a bit more on cosmetics.

MB Typically what type of product are men buying?

PK At the moment, because the market itself is so underdeveloped, the range of products available are pretty narrow. The most common would be things like styling gel. I think South Korea is probably at the more advanced end in terms of the cosmetics market for men. There you can look at products like skin whitening, for example, and you also have quite a lot of products related to styling gels, which I mentioned with hair care.

MB This is what's really interesting, the difference between Asian and European consumers. Chatting to a Japanese friend, she was saying in terms of what she was looking for with cosmetics is something that's more natural and healthy.



Whereas, in the UK and Europe, we might be looking for something that's more sexy and sophisticated.

PK That's absolutely right. I think the fundamental difference between how, say, the Japanese and the Koreans view cosmetics versus how the Europeans would view cosmetics, is purely down to what they feel the particular cosmetics product is meant to do. Even in the UK, when you think about cosmetics, it's mainly seen as almost like a beauty product. You know, when you go out with your friends, or you're going to a party, obviously everyone wants to look good so that's why you apply cosmetics of various kinds. But in Japan the whole interpretation of cosmetics is slightly different. There, people prefer products that actually have a functional aspect to them. People want healthier skin, people want a solution to some kind of a skin-related problem. For them, when they think about cosmetics, it's less to do with beauty, less to do with appearance, but more to do with "what functionality does this product give me?"

Even the way the cosmetics are sold to customers is completely different. In the UK you would have a handful of beauty consultants or assistants who would offer to apply some makeup, and then look at that and then take a decision. In Japan it's almost as if you're visiting a GP, where there is quite an intense process of trying to understand what it is that you're looking for. The beauty consultant would quite often be a qualified professional with the appropriate degree, and they will try and find out some of the common skin ailments which you may not have realised, or if you do have a specific condition you're looking for. And then once they've done their analysis, they'll start highlighting a few products that they feel might address those concerns. So, the level of engagement as well tends to be quite deeper and quite different.

MB And the packaging is important as well. It's maybe a bit more of a challenge with a podcast. You've brought some examples here, talk me through them.

PK Yes. This first one is called Kaiteki Oligo. It's basically a fructo-oligosaccharide from Kitanotatsujin which, as I mentioned earlier, is a company we've recently taken a holding in. This is basically a popular way of improving your intestines. You can take a spoonful of this mixed in water, and it's basically an oligosaccharide that's derived from sugar beet, so it's quite a naturally occurring product. That's another quite fundamental character that Japanese consumers in general look for in products. Everything has to be natural as far as possible.

MB And the companies invest a lot more in R&D [research and development] don't they, as well?

PK Exactly. A lot of these companies tend to be quite backward integrated. By that what I mean is, in terms of sourcing the raw material, in terms of the production, everything tends to be quite a seamless supply chain, quite often linking back to some of the traditional rural prefectures where a lot of the raw materials are grown. It's very much in-house manufactured. There's very little outsourcing to some other part of the world. Everything is done within Japan. What that means is they're able to closely control the quality as well. That's one thing the Japanese loathe - to



compromise on quality, just because they're able to sell a few more packets of a product. They usually don't do that.

And as you can see from this packaging, it's quite comprehensive, it has a lot of information on it. And to a western consumer looking at it, it would be very easy to get a bit overwhelmed. Part of the reason is that it goes back to Japanese culture and Japanese tradition, where they tend to have a lot of information, not just on products but even on their websites, for example. The level of package tends to be quite sophisticated, with very nice little touches. A big reason for that is Japanese cosmetics companies in general believe that the packaging is, in a way, the face of the product.

MB And you've got something a little bit more unusual, which is a product that's made from placenta.

PK Exactly. So again, the Japanese aren't afraid of experimenting. The really interesting thing is, because they have this intense focus on all things natural, they have the ability to extend that to some really unusual ingredients, and actually do the relevant tests, etc, and come up with really interesting products that actually seem to work - if you believe consumer feedback.

So, I've got this product here, which is called Herbal Extracts. It's made in Japan by a company called FFID, and it's basically a facemask that's made out of placenta.

MB So do they use human placenta for that or is it animal placenta?

PK It's human placenta, and it's all placenta that's voluntarily donated. It's been a fairly long-standing process of sourcing placenta.

MB Have you tried any of these, for research purposes, any of these products?

PK Well, if you look at the glow on my skin you would probably get an idea that I have tried some. No, I haven't but my wife has. I have a willing guinea pig at home, and obviously she speaks quite highly of these. So yes, this facemask derived from placenta, that's again, another very unusual product and one that's actually very popular and commonplace in Japan.

MB The other interesting thing is it's not just the Japanese consumer in Japan. I remember I used to live in Singapore, and we'd go to Japan. I went with a cameraman and he'd have specific orders from his wife to go to Takashimaya in Tokyo because they couldn't get the blue packaging for something that they bought in Singapore. So, there's a lot of demand, isn't there, from Asian tourists outside Japan?

PK That's absolutely right, and if you see, in recent years, the vast proportion of the inbound tourists coming to Japan are from China. And in general, tourism to Japan has actually been growing year-on-year for a number of years now, and the numbers have reached well over 20-odd million people every year. One of the items where most of the money is spent when tourists come to Japan is cosmetics because there's a growing recognition - and a lot of these brands are also well



established. But there is an acceptance that Japanese cosmetics usually mean really high quality, functional products, and products that, in some ways, aren't that expensive as well. You're not paying a massive premium for these kinds of products, and also, they are natural so you can rest assured that it does what it says on the tin.

So, if you put all of this together it's not too difficult to see why demand for cosmetics should remain in a structural uptrend over the next 10, 15 years.

MB Praveen, thanks a lot for joining us. I hope you'll join us again soon on the podcast.

PK Thank you, Malcolm.

MB You can find the podcast on our website at bailliegifford.com/podcast and subscribe on Apple Podcasts, Spotify, and TuneIn. We hope you enjoyed it, and please spread the word. To read more about Praveen's thoughts, check out the Autumn edition of *Trust* magazine. 40 years on from the launch of the iconic Sony Walkman, Praveen looks at Japan's fast-growing and disruptive companies of today. You can find his article and more at bailliegifford.com/trust.

Praveen, do you remember the Walkman? Was that something that was as important to your life as mine?

PK I actually have a couple at home. Yes.

MB So those orange, foamy headphones and...?

PK No. The Walkman that I have - they're pretty ancient. One of them is a Sony Walkman, interestingly, and yes, I've lost the headset, but it was one of the earliest gifts that I got on my birthday from my parents.

The way I think about how Japan has evolved is, post the second world war, you had the first wave of entrepreneurialism, where you had companies like Sony, Hitachi, Toshiba, etc, come to the fore. And I think what we're seeing now is probably akin to a second wave of entrepreneurial burst in Japan. Being an eternal optimist in Japan, I consider this almost the second coming of Japan, in a way.

MB So, there you go, you've got a taste of Praveen's article in *Trust* that's to come.

Many thanks to Lord of the Isles for the music. The track we've used is called *Horizon Effect*, which was released on Permanent Vacation. Until next time.

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