



# ASIANS DRIVE THE PREMIUM SKIN CARE MARKET

All roads lead to China. What's happening in the new frontier?

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Worldwide cosmetics sales have never declined in the past 18 years, and their annual growth rate was 4.4% between 1993 and 2011. From 2001 to 2011, the Chinese skin/cosmetics market has shown a 17.0% growth rate, and premium skin/cosmetics market has grown by an even faster rate of 22.3%. This is why China is often cited by cosmetics companies as a key market for growth. Estée Lauder, L'Oréal, Shiseido, Proctor & Gamble, etc. have been making substantial investments in the country over the past decade.

Cosmetics market growth rates in China are expected to decelerate compared to the past 10 years, but we believe the industry can



## Cosmetics, Asian Rush

still continue to grow by double digits and even faster for premium cosmetics in the next five years. In addition to nominal GDP growth and population growth, urbanization will be the strong growth driver of cosmetics industry. Urbanization is the top priority of the new government in China. This is important because urbanization will not only stimulate consumer adoption of skin care and color cosmetics but, also, urban households tend to earn higher incomes than rural households which enable consumers to trade up to more discretionary items such as premium cosmetics products.

### China's Attraction

Emerging market consumers need to reach a certain level of income or GDP per capita before adoption of consumer products begin. This adoption wave typically starts with household products like detergents and soaps, extends to packaged foods such as instant noodles and then moves up to relatively discretionary categories, which include most personal care products. Skin care and color cosmetics are one of the later adoption categories, and deceleration occurs here generally more slowly than other consumer products. Thus, cosmetics maintain faster growth rates for a longer period.

China has grown to become the largest Asian market for two gigantic beauty players, namely L'Oréal and Estée Lauder. China accounts for 7% and 5% of L'Oréal's and Estée Lauder's total sales respectively. And this is purely sales from mainland China. We assume Estée Lauder's real sales from Chinese consumers to be around 15% of total company sales, as Chinese consumers will be buying Estée Lauder products in other places

like Hong Kong, New York, and Paris. According to Estée Lauder, every \$1 spent in China implies an extra \$2 in sales from Chinese outside of China.

The Chinese cosmetics industry trend favors foreign luxury cosmetics players not only because of its faster organic growth but also because China (and Asia overall) is a more profitable market. The Asian cosmetics market is over-indexed to premium markets. In China, the premium skin care market has grown to 26% of the total skin-care market from 17% in 2001. Still, the premium market share is under-indexed to other Asian markets, thus we expect China's premium market to continue to outgrow the overall industry. Premium skin care has a 72% market share in Hong Kong, 59% in Taiwan, 57% in

Asian markets including China tend to offer higher returns for many global cosmetics players. This is because Asians spend more on skin care products that tend to have higher price points. Also, it is easier for companies to premiumize skin care products with added functions. There are more opportunities to add values on skin care products with whitening, anti-aging, brightening, etc., compared to color cosmetics or fragrances. Skin care accounts for roughly 70% of the Chinese beauty market whereas it is only 35% in North America, 32% in Brazil, or 37% in Russia. This is again an Asian phenomenon as skin care accounts for 62% of the beauty market in Japan, 64% in South Korea and 62% in India. For Estée Lauder, skin care accounts for 60% in the Asia Pacific market

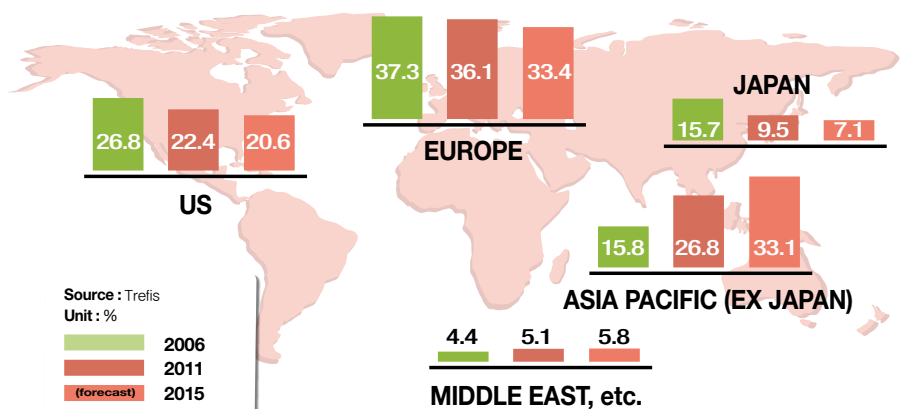
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South Korea, and 55% in Japan, whereas it is only 20% in Germany, 30% in the US, 44% in Canada and 48% in France. We believe China will follow the same path as other Asian countries. This is definitely a tailwind for global cosmetics players who are well-positioned in the prestige and premium market.

compared to that of 43% for the group. In China, specifically, 82% of sales were incurred from premium facial care and the rest from premium color cosmetics. Asian consumers tend to spend or invest more on skin care because of the increased cultural importance of having well-maintained skin. A significant

### GLOBAL SALES OF PRESTIGE COSMETICS PRODUCTS





**MNCs have stronger moats in the household beauty and personal care (HPC) business.**

number of women are buying LV bags in China, and we assume that these same women would be more than happy to pay a premium for their beauty.

**The Men's Market**

Another emerging trend in cosmetics is the fast-growing men's grooming segment. In the past, it was almost taboo for European men to use skin care products, but this now is changing. In fact, the popularity of the men's segment actually started in China. According to the president of L'Oréal Asia, the company saw a boom in men's skin care in China and realized the potential for the segment globally. It has become a larger market earlier in Asia because there is no such taboo for Asian men and partly due to Asian climates, as skin care products are more of a necessity in some regions. Still, cosmetics is largely women's category globally, but if it can be extended to men, there will be another strong demand pull for the whole industry.

Local players in Asia are generally very strong compared to those in other emerging markets. This is because many Asian countries have solid competitiveness in manufacturing, and local companies usually have better distribution networks. This is especially true for food companies. Food is an indigenous product and locals better understand

their region's tastes. We believe, however, that multinational corporations (MNCs) have stronger moats in the household beauty and personal care (HPC) business especially when it comes to luxury or high-end consumer goods because then it becomes more of a brand game. Global cosmetics players well understand such phenomena and thus invest significantly in emerging markets.

HPC is a purely brand business as a product itself is homogeneous and does not require much localization unlike food. This provides a

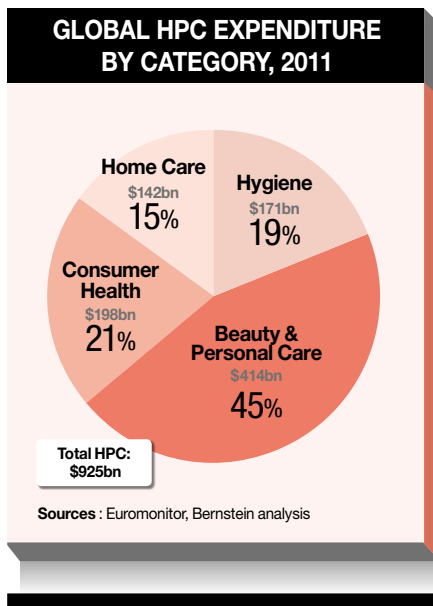
**Cosmetics, Asian Rush**

massive advantage to MNCs as they can easily leverage their global heritage brands into emerging markets. Local companies in emerging markets may somehow—albeit this is also a challenge—make a breakthrough to manufacture a good quality product, but even if they do so, they cannot build a brand story in one day. Also, MNCs tend to have stronger muscles for heavy advertisement and R&D. Particularly for cosmetics, since brand is so important, it can also be seen as an advertisement and marketing battle. L'Oréal and Estée Lauder spend around 30% of their sales on advertising and promotions.

**The "Lipstick Effect"**

The cosmetics market is about aspirational brands which provide natural moats to MNCs with many global brands. As emerging market consumers acquire higher pricing power with double-digit wage growth in China, consumption trade-up will increasingly benefit global cosmetics companies. Such characteristics are evidenced by the top 12 Beauty and Personal Care (B&PC) companies having a more-than 50% global market share compared to that of only a 17% share for the top 15 global food and beverage (F&B) companies. The prestige and premium cosmetics market will continue to be a game between only a handful of global companies, just like other luxury goods.

Cosmetics is a unique category, having both staples and discretionary characteristics, and even luxury characteristics for prestige/premium cosmetics. It is a consumer staple because women (soon perhaps men as well) have to use cosmetics every day once they start using them. At the same time, consumers trade up to premium brands along with an increase in discretionary income. In a recession, women tend to satisfy their luxury demand with lower-ticket-price items and typically they buy prestige cosmetics. This is the so-called "lipstick effect." Thus, cosmetics category growth is usually faster than other consumer staples goods in a good economy and it also tends to be more defensive than luxury goods growth in slow economy.





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# ESTÉE LAUDER ON TOP IN PRESTIGE BEAUTY MARKET

Its sales are expected to grow twice as fast as the rest of the beauty industry.  
By Mirae Asset US research team, Photos by SHUTTERSTOCK

Estée Lauder is the second-largest cosmetics company in the world, but the only multinational corporation offering pure-play exposure to the prestige beauty market. This \$160 billion industry is projected to grow at an annual rate of 4-5% through 2015, while Estée projects its sales will grow twice as fast over the same period. The company stands to benefit from long-term

structural trends in the global marketplace, such as emerging market consumption growth and the expansion and premiumization of the personal care industry.

Wide exposure to a fast-growing and highly profitable segment of the global personal care market differentiates Estée from its peers. Whereas the company's main competitor, L'Oréal, receives 60% of its sales

from the mass beauty market, Estée operates solely in the premium prestige beauty realm. As prestige beauty sales continue to outpace mass beauty spending on a global basis, the company is benefiting from the secular growth of the industry.

### Competitive Strategy

One of the company's long-term strategic priorities is to focus its resources on markets with the greatest growth potential and most attractive consumer demographics. China has been one of the world's fastest-growing

2013 Estée Lauder  
Global Sales Forecast

**US 43%**

**Asia Pacific 21%**

China	Japan	Korea	Hong Kong	Taiwan	Others
5.3%	5.2%	3%	2%	2%	4%

**Europe, Etc. 37%**

Source: Estée Lauder, Bernstein estimates



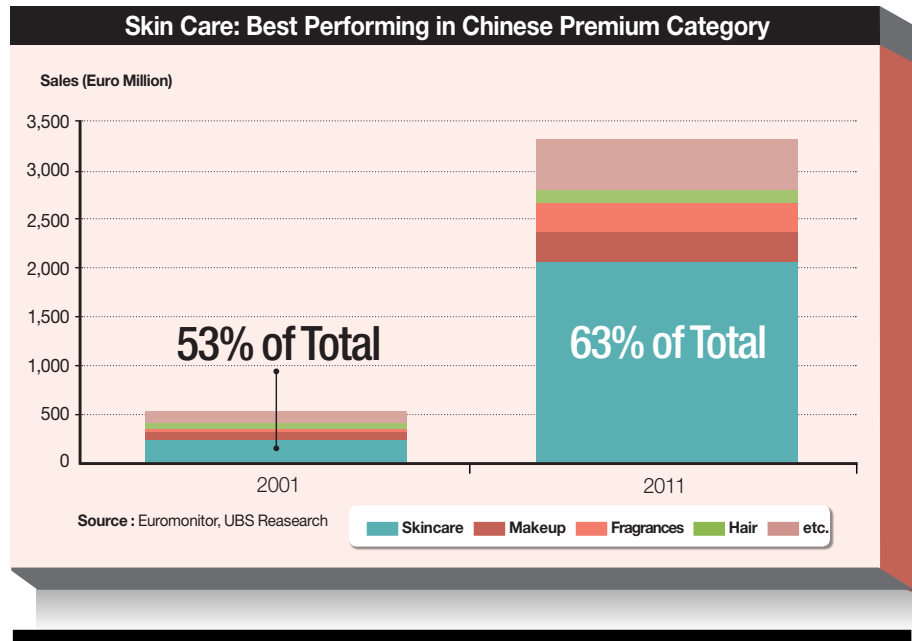
personal-care markets over the past decade, and Estée Lauder CEO Fabrizio Freda has declared his intent to make it the company's "second home market ." While the global beauty market has grown by 5% annually over the past 10 years, the Chinese beauty market has expanded by 12% per annum over the same period. Prestige beauty has proven to be a particularly dynamic segment of the industry in China, growing in excess of 20% each year.

Skincare has been a key catalyst for prestige beauty growth in China. Asian consumers tend to have more sophisticated skincare regimes compared to their global counterparts. An Asian woman, on average, will use eight different skincare products each day, including special products like whitening creams . A recent survey by China Reality Research found that middle-class Chinese women are much more likely to trade up in their beauty regimen, rather than trade down in order to save money. The Chinese consumer is most aspirational in terms of skincare, as an overwhelming 68% surveyed said they would trade up compared to only 2% planning to trade down.

### Fast-Growing Skincare Market

Skincare is a major strength for Estée Lauder, as it is the company's most profitable and fastest-growing product segment. As such, the company has largely focused its innovation and advertising efforts in this area. In the fall of 2012, Estée launched a luxury skincare line specifically targeting the local preferences of Chinese consumers, in hopes to further penetrate the most important market for the category globally. Osiao, as the brand is known, was developed over a five-year period with dedicated R&D specialists in Shanghai who extensively studied different types of Asian skin and tested the product on several thousand women across the region. The company has ambitions for Osiao to become one of the major brands of its Asian portfolio.

A booming travel trend among emerging



***Estée Lauder is well-positioned to benefit from the secular tailwinds of the rising emerging market consumer.***

market consumers is yet another growth driver for the prestige cosmetics industry. Estée Lauder has been able to capitalize on the trend by shifting some of the focus away from its traditional department store business model toward faster-growing, more profitable channels, like travel retail.

The company's travel retail business has become an especially important driver of earnings growth in recent years, as it has emerged as a key beneficiary of increased travel rates in Asia. Over the past decade, Chinese outbound travel activity has grown by more than 20% each year and is anticipated to rise by 15% annually over the next decade to more than 100 million people . While traveling, consumers have an increased proclivity to shop, whether in airport retail or downtown stores. And brands

with strong recognition in their home market are more likely to be purchased by consumers when traveling abroad. Because of this, increased travel trends largely benefit multinational cosmetics companies with strong brand equity, like Estée Lauder. The company recently cited that for every \$1 worth of cosmetics sold in China, it is able to generate \$2 abroad from Chinese consumers . As travel retail trends continue to grow, Estée Lauder's sales figures should follow closely in line.

Estée Lauder offers a sustainable competitive advantage over its peers operating in the personal care industry due to its pure-play exposure to the prestige beauty market, strong geographic footprint in emerging economies, and increased focus on high-growth, high-margin product categories and retail channels. The company is well-positioned to benefit from the secular tailwinds of the rising emerging market consumer, and it continues to invest more heavily in the business to gain market share globally.

We believe this is one of the strongest global growth stories taking place in the market today and will be following the company closely in years to come.



# L'ORÉAL DREAMS OF ONE BILLION NEW CONSUMERS

As L'Oréal operates in categories across the beauty spectrum, the company is able to reach more consumers relative to its competitors and retain dominant market-share positioning.

By Mirae Asset US research team



L'Oréal is a global beauty powerhouse. With \$26 billion in annual sales last year, the company enjoys a commanding market share advantage over its competitors in the home and personal care industry, such as Procter & Gamble, Unilever, and Estée Lauder. The company boasts a broad presence globally, with operations in 130 countries across 27 international brands.

Over the next decade, the company is targeting one billion new customers. Secular growth trends in the global personal care industry, increased investments in innovation and marketing efforts and a focus on growth markets and categories should

enable L'Oréal to reach this goal. Home and personal care is an \$820 billion global industry with a projected annual growth rate of 6.4% through 2020, up from 5.1% from 2001-2011. Emerging economies of Asia and the Middle East/Africa are expected to drive 60% and 27% of this growth, respectively. As these countries develop and their consumption levels converge with those of more mature markets, it is estimated the industry could be six times as large—nearly \$5 trillion globally. Personal care currently accounts for nearly half of the industry's sales and has the highest expected growth rate among all sub-segments, with beauty products emerging

as a clear winner .

L'Oréal is expected to benefit from the global growth of the home and personal care industry. Revenue growth of personal care companies correlates highly to increasing income and consumption levels in emerging markets.

### Global Reach

Therefore, exposure to growth is largely determined by a company's geographic footprint. In 2012, emerging markets accounted for almost 40% of L'Oréal's total sales, with a growth rate of nearly 10% on a year-over-year basis. Asia Pacific and Middle East/



Africa regions made up more than 60% of total emerging-market revenue. And the company anticipates 75% of its future growth to come from the developing world. As a result, locally relevant innovation, increased manufacturing capacity, and a broad retail presence in these regions have become strategic pillars for L'Oréal.

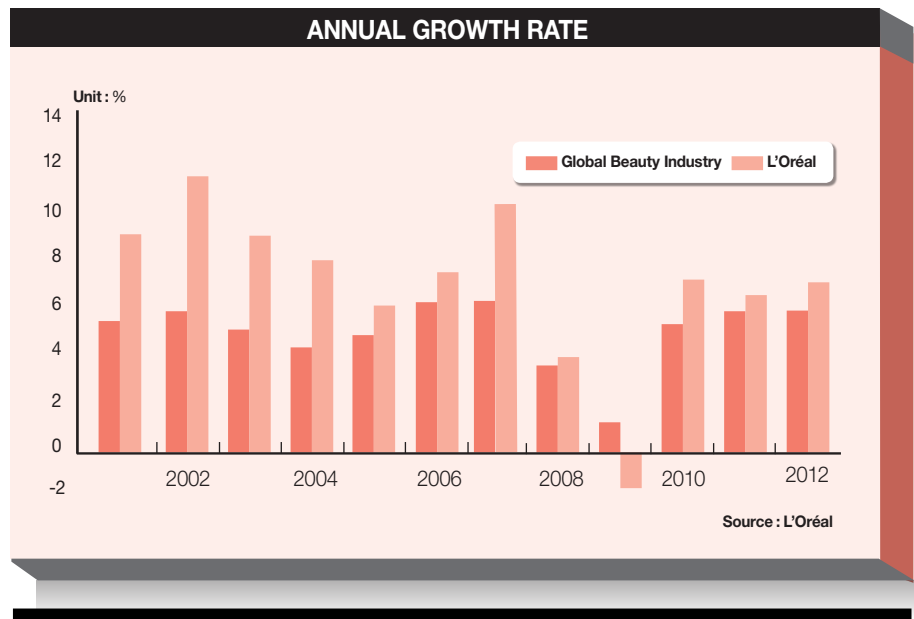
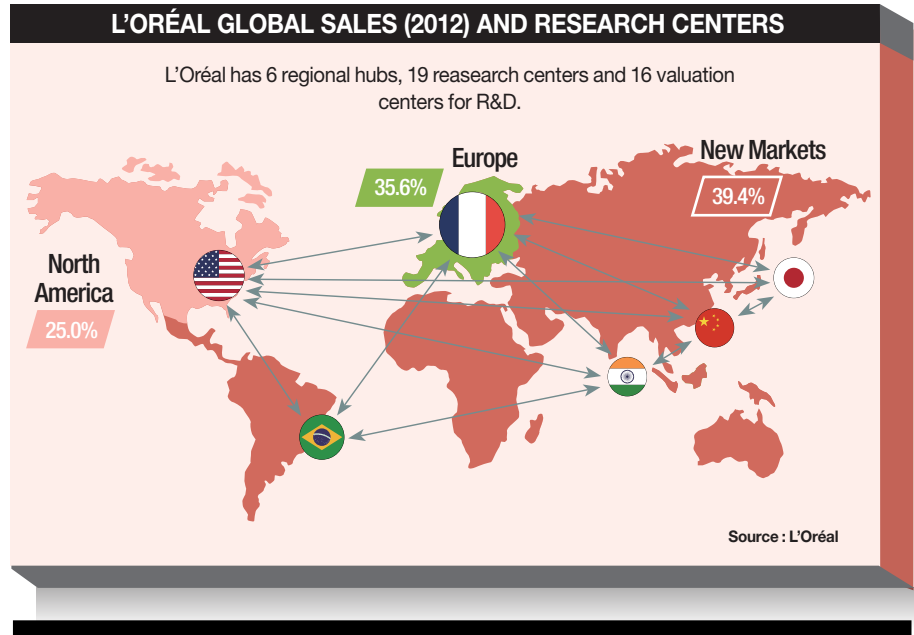
One of the company's core beliefs is that beauty is founded in technology. As such, L'Oréal invests heavily in R&D initiatives to bolster its innovation pipeline. Research hubs have been established in all major geographies in order to study local markets and develop formulas that meet the preferences

***By offering products at varied price points, L'Oréal appeals to a broader consumer base than its competitors.***

of the specific consumer base. L'Oréal has also been at the forefront of developing and patenting molecules used in their anti-aging products. The United Nations has cited unprecedented and pervasive aging trends across the global population in the 21st century, with no parallel in human history. Aging demographics, coupled with booming consumption trends in the personal care industry, should lead to a sustained increase in demand for anti-aging beauty products, both in developed and developing markets. While Estée Lauder competes strongly in the prestige segment of this category, L'Oréal's robust innovation platform should help the company to gain further share in the prestige and mass markets globally.

### Everything and Everywhere

The depth and breadth of L'Oréal's product portfolio offers yet another competitive advantage over its industry peers. The company operates in mass, luxury, salon, cosmeceutical, and natural beauty categories.



By offering products at varied price points across a wide range of distribution channels, L'Oréal appeals to a broader consumer base than its competitors. Employing a differentiated product strategy, in conjunction with high levels of marketing and R&D spend, has enabled L'Oréal to consistently outpace the growth of the global beauty industry.

L'Oréal has emerged as the leader in global beauty. A continued focus on the world's

fastest-growing markets and categories will drive L'Oréal's success in years to come. The company will be a major beneficiary of secular tailwinds from rising emerging market consumption trends, particularly in the personal care industry, and will retain dominant market share positioning through a robust innovation pipeline and strong marketing platform. One billion consumers agree: the future looks bright for L'Oréal.