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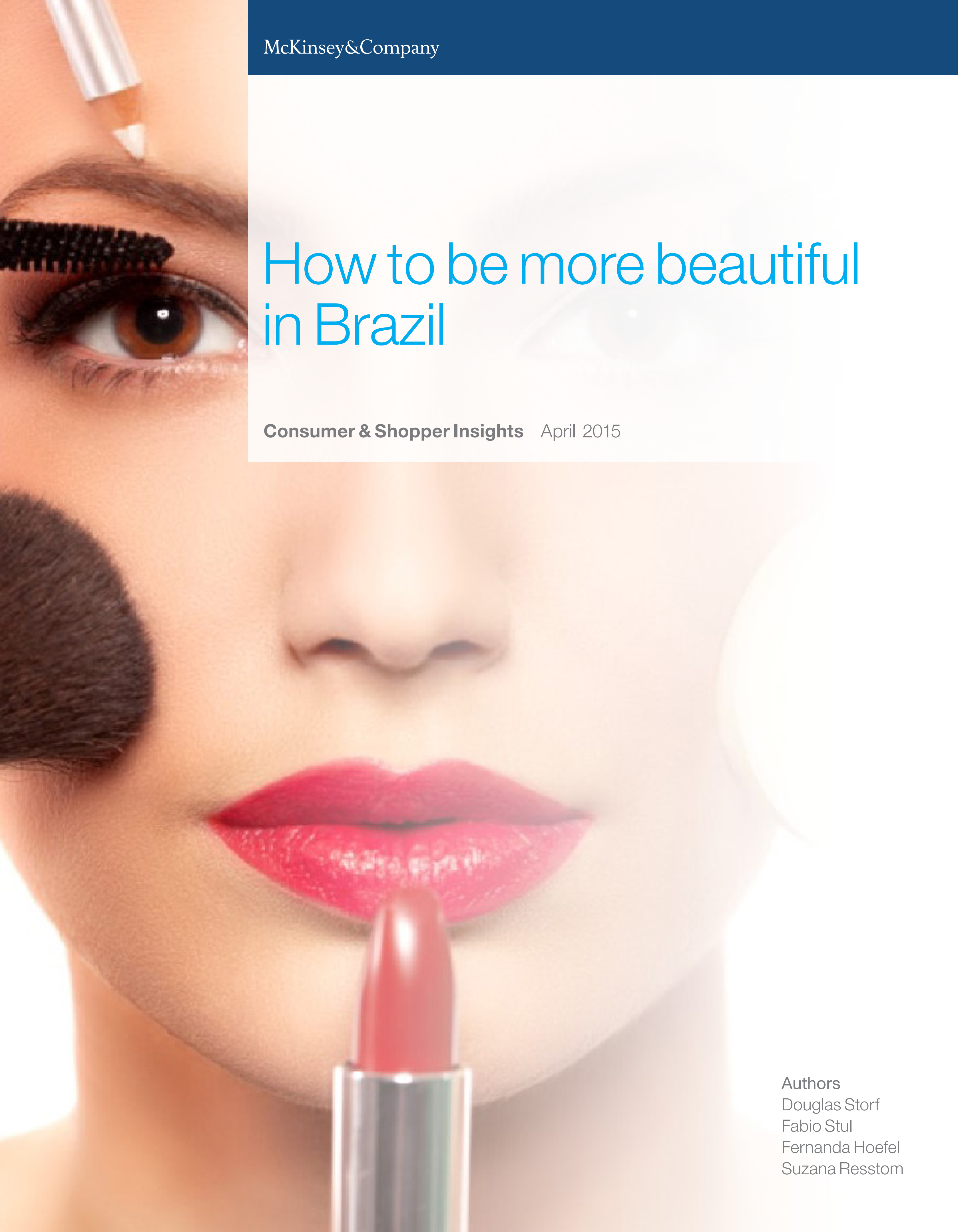

How to be more beautiful in Brazil

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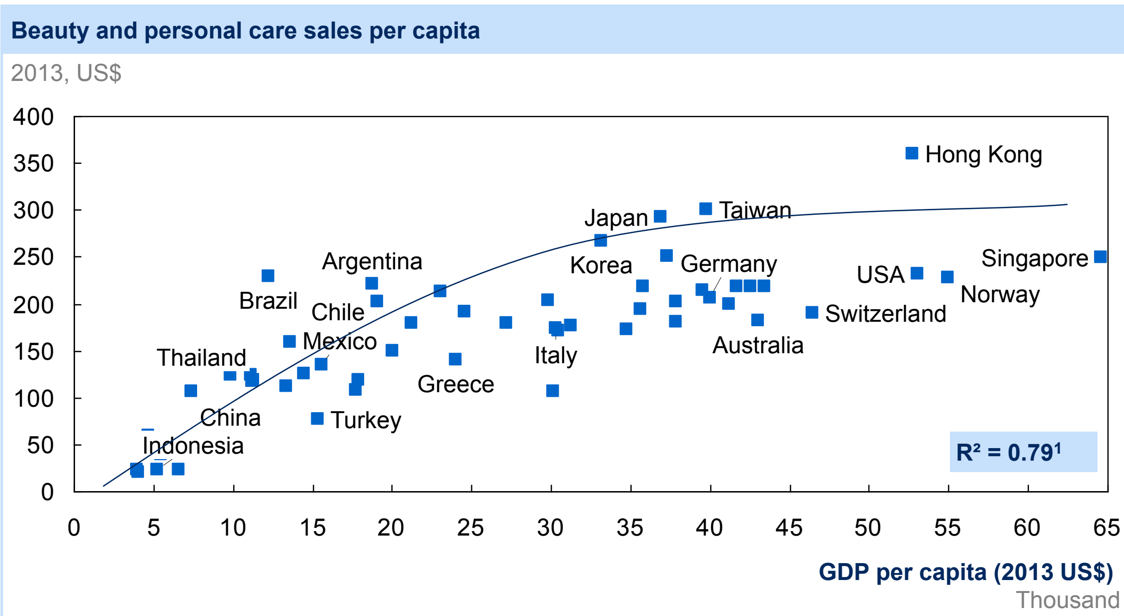
Brazil's beauty and personal care products market remains vibrant, but competition is getting more intense and the channel landscape is evolving rapidly.

Brazilians understand the power of beauty. Their focus on physical self-betterment is not taken lightly. Brazil, after all, has given the world its own unique brand of butt exercises, hair treatments and waxing procedures. The country ranks number two in the world for both number of plastic surgeries and liposuctions performed.

It's no surprise then that Brazil's beauty and personal care (BPC) products market is among the largest in the world. In recent years, it has also been the planet's fastest growing by far, accelerating at an annual rate of 14 percent over the last five years, according to Euromonitor. The two markets larger than Brazil – the U.S. and China – grew at 2 percent and 10 percent, respectively. Brazilians' devotion to beauty is perhaps most evident in its per capita spending on beauty and personal care goods, which ranks as the world's highest relative to GDP. Brazilians spend more on beauty and personal care products than Americans do – \$230 per person per year for a total market value of \$43 billion, with a majority of these sales coming from Brazil's large and emerging middle class, which is composed of people earning the equivalent of \$10,000 to \$24,000 annually. (See Exhibit 1)

Exhibit 1

Per capita BPC consumption in Brazil is high even when compared to developed countries such as USA and Germany



Note: All dollar figures are adjusted for PPP

[1] Trend line is based on a logarithmic relationship between BPC spend and GDP per capita, which implies diminishing growth to BPC as income increases

SOURCE: Euromonitor; IMF

Although this robust market has a track record of growth above inflation, the pace of growth is slowing down as Brazil's economy faces a period of hardship and uncertainty, with steep devaluation of the Brazilian real relative to the American dollar. In addition, competition in Brazil's BPC market has recently grown more intense, as the market concentrates and new entrants battle for space. Consider, for instance, that in 2002 the top five players owned 37 percent of the market; today it's 49 percent. New players from all over the world have entered the space and are strengthening their position. The Body Shop, for instance, opened its first store in Brazil in 2014 and Sephora arrived in Brazil, at the JK Iguatemi mall, in 2012, generating unprecedented lines of customers outside the store that lasted for days. To address this new competition, existing players invested heavily in product development and marketing, and have stepped up their media investments considerably, even as media space has gotten more expensive over time.

A changing channel landscape

Perhaps the biggest changes, and thus the greatest opportunities, in the beauty and personal care market revolve around how and where products are sold. The channel landscape in Brazil has evolved considerably in recent years, as consumers have moved away from the traditionally strong channels such as direct sales and hypermarkets, and migrated toward specialty retail (both mono-brand and multi-brand stores), drugstores and the internet, which is the fastest growing channel. Players are investing in order to develop their channel architecture, which increasingly needs to be a multi-channel one. Compounding the challenges are the facts that department stores do not play a big role in Brazilian retail and that there are no entrenched multi brand chains yet. Here is what companies need to know about the evolution of each channel and how to adapt to the changes. (See Exhibit 2)

Exhibit 2

A closer look at the channel landscape of BPC reveals a greater diversity of formats

Channels		Value proposition	Category focus	Example of players
Direct Sales		▪ Focus on convenience and service ▪ Mass and masstige products	▪ Color cosmetics ▪ Fragrance ▪ Skin care	natura, AVON
Super/hyper-markets		▪ Planned purchases ▪ Hyper struggling as a format ▪ Supers investing in convenience for urban population	▪ Hair care ▪ Bath & shower ▪ Deodorant	Carrefour, Grupo Pão de Açucar
Small box specialty	High end perfumarias	▪ Focused on fragrances and color cosmetics of high-end brands ▪ Dedicated individual service	▪ Fragrances ▪ Make-up	Calèche
Small box specialty	Low end perfumarias	▪ Pricing and assortment	▪ Hair ▪ Color cosmetics ▪ Body	IKESAKI COSMÉTICOS
Small box specialty	BPC category killers	▪ Assortment and experience	▪ All	SEPHORA, beauty
Small box specialty	Monobrands	▪ Good quality at an affordable price (upper mass & masstige) ▪ Strong presence in shopping malls ▪ Strong brands	▪ Mono or multi category	O Boticário, contém 1g, Kiehl's, L'OCCITANE EN PROVENCE
Pharmacies		▪ Convenience and education in the store through beauty consultants	▪ Hair care ▪ Deodorants ▪ Skin care	Onofre, RaiaDrogasil
Internet		▪ Multi-brand with broadest price range and SKUs at reasonable prices ▪ Fastest growing channel, although profitability challenge	▪ Fragrance ▪ Skin care	SEPHORA, ÉPOCA COSMÉTICOS

SOURCE: Euromonitor; McKinsey analysis

Drugstores: More love for beauty

Beauty and personal care products are an increasingly important category for drugstores, as they are often the fastest growing product sector in the store and can account for as much as 30 percent of store sales. BPC also offers drugstores considerably better margins than prescription or OTC drugs do.

As drugstores have expanded in BPC they have successfully differentiated their image as a place for both convenience and health and beauty expertise and are now recognized as a key channel for dermo-cosmetics. One of the strengths of the drugstore channel is its level of service and information. Many stores have beauty consultants to educate consumers and help them choose products. Some also offer home delivery, stores that are open 24 hours a day, and a more premium portfolio of products. According to consumers, drugstores are also attractive because they offer similar prices to other channels, such as supermarkets and specialty stores. (See Exhibit 3)

Exhibit 3

The pharma channel successfully differentiated its image positioning from other personal care channels.

Consumer perception of drugstores

- ✓ A large number of consumers (mainly women from C class) believe that the **drugstore channel has changed**
- ✓ According to consumers, this channel offers **similar prices to other POS**, like supermarkets and specialized stores
- ✓ Drugstores are starting to be seen as **a place for health and comfort**
- ✓ Strengths in the drugstore channel are services. **Information, product references and sales support** are highly valued in this type of retailer
- ✓ The channel is ideal for people who look for **solutions in a short time** (consumers spend an average of 5 minutes inside the stores)

SOURCE: "O Comportamento do Consumidor em Farmácias e Drogarias" (POPAI)

However, the drugstore channel remains fragmented, with only 10 percent of stores belonging to the large chains, which account for some 30 percent of total category sales. These top chains are investing to further prioritize the BPC category. Several years ago, Drogaria São Paulo, for instance, invested R$11 million (USD $5 million at the time) to refurbish 112 stores, giving makeup, hair care products and dermo-cosmetics increased and more premium shelf space. The chain also employed in-store “beauty assistants” to help customers choose products and launched a free beauty guide that offers recommendations for new products. The further consolidation that’s expected among drugstores will tend to squeeze margins from BPC manufacturers and create an even fiercer battle for shelf space. A typical store already stocks 21 brands of facial skincare, 27 hair care brands and 15 different kinds of deodorant.

The remaining 90 percent of drugstores in Brazil are independently owned and vary considerably in their approach to BPC. Engaging with these stores may require indirect distribution and a tailored trade marketing strategy in order to overcome the low level of professionalization in stores.

Whether dealing with the top chains or a patchwork of independent ones, CPG companies can play an important role in shaping the pharma channel. This requires advanced capabilities for managing and collaborating with retailers, as well as advanced insight into POS planning and execution.

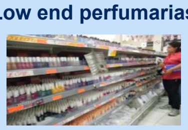
Beauty specialists: The power of the mall

Over the last five years, this channel – which includes high and low end toiletry stores, category killers like Sephora, and mono-brand stores – has experienced above market growth, with sales more than doubling. Much of this growth has been propelled by mono-brand stores, which offer valuable brands and high quality products (both upper mass and masstige) at an affordable price as compared to the traditional offerings in this channel. Mono-brand stores also have a strong presence in shopping malls, which remain the primary beauty and makeup shopping location for consumers since department stores have never succeeded in Brazil. For this reason, mono-brand stores are the preferred channel for international brands entering the country and it is expected that these stores will continue to flourish as these players expand and as more and more consumer spending is concentrated in shopping malls. However, a mono-brand strategy may not be viable for all players since developing a proprietary channel is expensive.

Multi-brand specialists have an incipient presence in Brazil today. Yet as they grow, considerable potential exists for them to shape the BPC channel landscape, thus offering brands an additional distribution channel not currently available in the country. (See Exhibit 4)

Exhibit 4

Beauty specialist channel should continue flourishing as more consumption concentrates in shopping malls and players expand

	Description	Examples
Monobrands 	▪ Sells own products/brands usually located in shopping malls ▪ Good store experience (product trial, salesperson assistance etc.) ▪ Focus on value-added products such as gift sets	oBoticário, L'Occitane en Provence, mahogany, contém 1g, Kiehl's, Granado, Empório Body Store
BPC category killers 	▪ Usually located in shopping malls and high end locations ▪ Sells multi-brands, mostly international ▪ Focus on fragrances, make-up and skin treatment ▪ Sephora brought 11 brands to Brazil	Sephora, The Beauty Box
High end perfumarias 	▪ Usually located in shopping malls and high end locations ▪ Sells mostly international brands ▪ Focus mostly on fragrances and color cosmetics	Calèche, Opaque parfums & cosmétiques
Low end perfumarias 	▪ Fragmented market, with local and independent stores in streets ▪ Sells several brands, both local (Niely, Hypermarcas etc.) and international ▪ Have a wide assortment and competitive pricing	Ikesaki Cosméticos, Perfumaria Sumirê, Abaeté Sua Loja de Beleza

SOURCE: McKinsey analysis

Direct sales: On the decline?

Selling directly through beauty consultants, long the primary sales channel for key players in the market, represents some 25 percent of total BPC sales. Yet, while some players are still experiencing direct sales growth, the overall channel has been losing strength in recent years. This is due to several factors, including the acceleration of other channels like pharma and specialty stores, the internet's replication of some of the convenience direct sales once represented, and the country's favorable macroeconomic situation. Direct sales thrive when a large number of sales reps, mostly women, use it as a means of complementing their monthly income. As Brazil's GDP per capita has risen, unemployment has hit an all-time low, and more women have joined the formal workforce, direct sales have become less attractive for sales reps. At the same time, consumers now have a wider range of channel options to choose from.

Although it is possible that direct sales, which remain a sizeable share of the market, could regain strength during periods of economic slowdown, the channel's long term viability as a propeller of the BPC market is questionable.

Internet: Must-have channel for the future

Although growing fast, online sales of BPC products are still very small, accounting for only 1.5 percent of category sales. In part, this is due to a timid overall market for ecommerce in Brazil relative to other countries. Despite this, an online store is a critical piece of a multichannel offering and is essential for creating a relationship with consumers.

The number of new ecommerce consumers is growing rapidly, at 35 percent a year between 2004 and 2013. In 2013, these consumers placed 88 million orders, representing a 32 percent increase over 2012. It's important to note that these are not only upper class consumers. Although internet penetration is highest among the upper class (92 percent have access), more than half of lower middle class consumers go online.

Players will ultimately need to build muscle in the internet channel in a way that goes beyond sales. There is still a profitability challenge when selling online and the actual value that companies have captured thus far remains small. Beyond sales, online and mobile stores need to serve a variety of other functions – as a window shop for the brand, a convenient provider of product and category information, a means for gaining valuable customer data, and a strategic tool for targeted promotions about new and existing products.

Becoming multi-channel

First, the opportunity: Having a presence in multiple channels at once allows companies to engage new shoppers and capture a greater share of consumer spending. It also enables brand building and allows companies to keep up with, or even move ahead of, competitors who are already multi-channel.

On the other hand, reaching increasingly multi-channel consumers means meeting the challenge of being everywhere at the same time. In this context, channel conflict becomes an unavoidable reality. Managing each channel effectively is an ongoing exercise that should originate with a clear view of the strategic role of each channel within the broader architecture. This way, the choices made about channel conflict will stem from a more holistic view of the company's aspirations. It is also critical for channel-specific capabilities to be leveraged by all brands and businesses within the portfolio, so that healthy internal competition is balanced with a process of "learning from the inside." Additionally, due to the price transparency available on the internet, SKU differentiation across channels becomes more important in order to minimize conflict.

Leading BPC players in Brazil are present in at least three channels, ranging from specialized stores, pharmacies, internet, direct selling and multi-brand stores. Many are experimenting with channels that depart considerably from their usual channel architecture. L'Occitane, for instance, which has physical stores in all regions of Brazil, began selling online and in drugstores in 2010. Several years later, the company added another channel, partnering with a supermarket chain to sell a secondary, lower-priced brand. It also created mall kiosks that look like mini-markets for this brand.

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Even though Brazilians are beauty obsessed and their consumption of beauty products is high, the country is facing a period of slow economic growth and low consumer confidence. If the local currency continues to slide and the macro economic situation remains unstable, we expect demand to suffer and imported products to become more expensive, thus challenging the profitability of many players who import goods into Brazil.

In this environment, capturing growth will mean being surgical about where to invest and how to optimize your resource allocation. This includes being strategic about pricing, thinking about returns on marketing investments robustly and in a fact-based fashion, and understanding granular regional and category-specific opportunities for expansion. Additionally, we believe the channel landscape in Brazil will continue to evolve and move away from traditional channels. As it does, there will be wide open opportunities for brands to explore new means for distributing and marketing their products. The key will be to architect a channel strategy that takes advantage of short term opportunities while also preparing for the future.

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