BUILDING A $10 BILLION BEAUTY BRAND THROUGH BOUTIQUES

WHY PHYSICAL RETAIL IS IMPORTANT IN AN ONLINE ERA
The beauty market may appear calm on the surface, but underneath there is plenty of turbulence. With sales growing an average of only 0.2 percent a year between 2011 and 2016, no player can rely on today's apparent state of stability. A deeper look reveals differences in performance across and within different markets.

The variation between regions has been considerable. Asia and North America delivered a growth rate of over 10 percent, while Europe and Latin America struggled. Different categories, too, have varied in their success. Color products have benefited from sustained customer appetite – in particular for BB (blemish base) and CC (color-correcting) creams and lip products – while mass fragrances and body care products are steadily losing revenue.

But the most noteworthy change has been in the retail channels. Traditionally, the prestige segment has been dominated by department stores, but it is now transitioning to a direct-to-consumer (D2C) model, as millennial consumers turn to e-commerce and to brands' flagship stores. New, agile, innovative brands have seen rapid expansion thanks to the D2C model, which gives them a variety of means – ranging from an online presence, to their own stores – to supplement or bypass department stores.

The traditional giants of the beauty industry – such as Estee Lauder, LVMH, and L'Oreal – have acquired some of the new brands. So far, their flagship brands have been left behind, despite some initial efforts to update their traditional distribution model in an attempt to defend

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**Exhibit 1: Channel, regional, and category mix changes in the beauty market**

**GROWTH RATE OVER THE 2011–2016 PERIOD, IN PERCENT**

[Diagram showing growth rates and categories]

*Source: Euromonitor, Oliver Wyman analysis*
market share. If they too adopt the new paradigm of a close, direct relationship with customers, we think they have an exceptional growth opportunity. To do this effectively, they should overhaul their distribution strategies in ways that will make them more relevant to both their traditional customers and the new, more demanding, generation of consumers.

The D2C model can be the trigger for a step change in prestige beauty, and it presents a golden opportunity for global brands to grow into megabrands. Rather than playing it safe, they should fully embrace this transformation.

THE EVOLUTION OF THE EXPERIENCE ECONOMY

The D2C model is evolving as a response to millennial consumers who are increasingly interested in personal experiences. Their expectations go beyond product features and they are looking to buy related services that cannot be delivered solely online. These new demands are giving rise to an experience economy, in which a brand’s value lies in the emotions and sensory experiences it triggers, as well as the interpersonal relationships associated with it. E-commerce will continue to grow steadily, so every beauty player must craft and execute a sound e-commerce business model. But the key to significantly outperforming the market will be to combine an online presence with a well-executed own-brand store strategy.

A D2C model using physical stores enables brands to better communicate with and deliver products to their customers. In addition, it provides unprecedented access to customer data, which are essential for developing a successful customer-centric business. When a customer buys – or almost buys – something online, their journey to that purchase is a powerful source of information on their thought processes, habits, and preferences. By setting up a boutique, a brand gains access to the same kind of information, which it can use to improve its focus on customers’ needs and desires.

This strategy has the potential to revive the cosmetics industry in the regions and categories where it is currently struggling. Today, beauty specialist sales are dominated by large, multi-brand chains such as Sephora and Ulta, and own-brand stores only represent a very small portion of sales. We believe that own-brand stores are an immense, untapped potential source of growth for beauty brands.

Sportswear makers have employed this strategy over the past two decades and benefited from the accompanying insights and lessons. Players such as Nike, Adidas, Lululemon, and Under Armour are all in the experience business: They have developed their own retail networks and learned how to leverage them to deliver high impact.
EVOLUTION OF THE BEAUTY DISTRIBUTION MODELS

<table>
<thead>
<tr>
<th>1980s DEPARTMENT STORES</th>
<th>1990s SPECIALTY STORES</th>
<th>2000s E-COMMERCE</th>
<th>2010s DIRECT-TO-CONSUMER</th>
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<tbody>
<tr>
<td>Players</td>
<td>Macy’s, Harrods, Galeries Lafayette</td>
<td>Sephora, Ulta</td>
<td>Amazon, MAC, NYX, La Clé de Peau</td>
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<td>Economy</td>
<td>Product</td>
<td>Services</td>
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<td>Personal</td>
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NIKE IN NUMBERS

1990
NIKE OPENS FIRST NIKE TOWN IN PORTLAND
Initially conceived as a showroom to avoid cannibalizing sales through wholesalers – A brand promotion tool to stimulate buying at other retail outlets

NOW
1,045 NIKE STORES ACROSS THE GLOBE
Stores used to promote the brand and deliver a unique product/service experience – Products can be tested or even created by the customer

NIKE CAGR* 2009-2016:

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<th>Wholesale Channel</th>
<th>Direct-to-Consumer</th>
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<td>6%</td>
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NIKE REVENUES EVOLUTION BETWEEN 2009 AND 2016

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<th>2009</th>
<th>2016</th>
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<td>Wholesale Channel</td>
<td>$16.8 BN</td>
<td>$30.5 BN</td>
</tr>
<tr>
<td>Direct-to-Consumer</td>
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</tbody>
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* CAGR: annual compound growth rate
Source: Oliver Wyman analysis
Nike opened its first Niketown in Portland in 1990, initially seeing it as a showroom to increase product exposure. Since then, Nike has opened more than 1,000 stores worldwide, using them not just for institutional communication but, more importantly, to sell directly to its customers. Through these stores, Nike learned that products would sell better if they could be tested or even created by the customers themselves. The company’s revenues grew from $16.8 billion in 2009 to $30.5 billion in 2016, mainly driven by D2C sales, which increased 20 percent a year over that period.

Nespresso and Apple have also grown by using own-brand stores to better understand client needs so they can fine-tune their products and services. Perhaps more importantly, these stores have also been valuable laboratories for enhancing customer experience and driving growth in non-direct distribution.

This kind of transformation requires agility. Sports goods have usually been sold through small, independent stores, which do not have the power to prevent the likes of Nike from setting up its own stores. But big cosmetics firms have traditionally had deals with powerful retailers such as department stores and hypermarkets, which they were reluctant to upset by creating independent boutiques. So newer, smaller beauty brands have a structural advantage, as they do not need to struggle with the tectonics of these distribution channels or the big expenses associated with traditional media and marketing. Because of their inertia, the giants of the sector have only reluctantly begun to develop new distribution channels.

DOUBLE-DIGIT GROWTH IS POSSIBLE

Indie cosmetics brands have excelled through their expertise in experiential multichannel retailing. They combine boutiques and an online presence in an experience-based sales model that gives them an edge over rivals.

NYX, for example, deploys specialist make-up artists in many of its stores, all of which are equipped with beauty bars, tutorial centers, and “looks books,” so that every shopper can become their own make-up artist. Online sales are rising, but NYX has kept the in-store experience at the heart of the brand. The strategy delivered 55-percent annual growth between 2011 and 2016. “Cosmetics are a very tactile product, which people want to feel and see before they purchase,” says Tonie Shin, Vice President of Marketing at NYX. The company was bought by L’Oréal in 2014 but has so far retained its indie DNA and business model.

Another new way to connect with customers was pioneered by Rodan + Fields, a US luxury skincare brand. The company’s “community commerce” model, as it is now called, uses social media to deliver word-of-mouth marketing, and sales commission is offered to people who
recommend the brand’s products. This communication is supplemented by department store booths, where clients can have one-on-one consultations. Revenues, which come from beauty kits costing between $400 and $1,000, shot up from $50 million in 2011 to $1 billion in 2016.

A number of other indie brands achieved double-digit annual growth between 2011 and 2016 by combining e-commerce and brick-and-mortar stores in a genuinely direct-to-consumer approach. In contrast, established global brands had flat sales over this period and struggled to maintain market share. (See Exhibit 2.) To boost their brands and growth, they should rapidly invest in experiential marketing and craft more-integrated multichannel strategies.

One reason cosmetics brands have been slow to set up their own stores is the high cost. However, if the stores are rolled out with the right customer relationship management capabilities and salesforce, they are the best way to maintain control over customers as well as an opportunity to boost foot traffic and sales. Nike doubled its revenues – so there is no reason a beauty brand should not do the same, going beyond the generally accepted maximum scale of around $5 billion and expand to $10 billion.
A direct-to-consumer strategy can be a powerful growth driver for beauty brands. While online channels make a substantial contribution, they must be supplemented by own-brand stores because of the growing importance of the experiential economy. These stores should leverage direct marketing capabilities to increase the average basket, as well as operations that optimize execution, limit operating costs, and get the best return on investment.

Exhibit 3: There are six golden principles for beauty brands to develop their own retail networks

- **CUSTOMER VALUE PROPOSITION**
  - **Memorable experience**
    - Experience at the heart of the customer journey; sales almost as a collateral impact
  - **Unrivalled value**
    - An offer that is differentiated between channels and that brings best value for money

- **STORE OPERATIONS**
  - **Bricks and clicks**
    - Seamless integration with online business to mutually reinforce D2C model
  - **Effectiveness and efficiency**
    - Impact via strong visual identity and profitability thanks to lean management of investment and operating costs

- **DIRECT MARKETING CAPABILITIES**
  - **Innovation lab**
    - Easy testing of new products in real-life conditions with fewer financial risks
  - **Customer relationship management (CRM) expertise**
    - In-store associates as pivot in customer relationship based on intimate knowledge of client data

Source: Oliver Wyman analysis
PROVIDE A MEMORABLE EXPERIENCE

Personalized services help to give customers an emotional experience, increase brand awareness – and, ultimately, drive sales. Sales points are being turned into showrooms, where customers experience different products in stages. First they have a skin diagnosis, then go to the beauty studio. After that they visit the nail bar, followed by flash skin care. Personalized experiences raise customer satisfaction and increase traffic. For example, when Dior opened its first make-up boutique in New York in November 2016, there were six make-up counters and a skin diagnosis counter. There was also a mix-and-match video table, where customers could experiment with different colors of lipstick and nail polish on a virtual model.

DELIVER UNRIVALLED VALUE

Own-brand stores will coexist with department stores, online channels, and specialist retailers, so customers will need a compelling reason to choose any one of these. This could be a product assortment broad enough to make them the go-to place to access an entire range or to find limited editions and avant-première products. The make-up boutique opened by L'Oréal Paris in 2016, for example, showcases more than 600 products, of which 150 are exclusive, and displays one limited collection per month. Customers can also preview new products and attend events.

However, the integrity and coherence of pricing need to be carefully managed: If boutique prices are too low, they might undermine other channels; if they are too high, the brand might lose customers’ trust. In an age of digital transparency, customers must be confident that a brand’s own boutique will have the best prices for all available products. One way to control prices is through a coherent, cross-channel strategy. Product assortment also needs careful management in order to maintain a smooth relationship with wholesalers and avoid cannibalization. This can be done by carefully tailoring each channel’s product assortment according to criteria such as size and color. Then, unique products and pricing can be sold through different channels without cannibalization.

KNOW YOUR CUSTOMERS

Maximizing revenues requires better engagement with customers, so that they will make purchases more frequently and increase the average size of their baskets. To build an intimate knowledge of customers, brands will have to invest in customer relationship management, by developing tools, recruiting talent, and making use of external resources. This will help them to better personalize their direct marketing and build stores that respond more to customers.
Brands will have to build the right data management systems and transform their workforces so that staff can work with the new systems. Traditionally, information about consumers was collected through external studies carried out by a specialized market research department. Now, big-data and analytics skills will leverage new data on customer purchases and from research. These are valuable resources, which are now directly accessible through the new channels.

Sales associates will play a major role in embedding customer knowledge, so their responsibilities will go beyond merely selling products. They must represent the history and values of the brand, be true experts in their product category, and engage with customers. The era of the generalist beauty advisor seems to be over. They will be replaced by specialists, such as perfumers for fragrances and make-up artists for cosmetics. Building the right capabilities is the trickiest and most important challenge for beauty retailers, and it raises a number of questions: How do we increase the skillset of existing beauty advisors? What should be the mix between internal and external specialists? How do we turn experts – make-up artists and therapists, for example – into effective sales associates? The answers to these questions will vary between brands, and they will depend on current capabilities and the degree to which existing sales associates’ skills can be improved.

SET UP AN INNOVATION LAB

Dedicated boutiques can also act as labs to help rapidly create, test, and launch new products, by reducing the friction that occurs between development and launch. The tests can be carried out in real-life conditions with little risk or volume, saving time and energy that would otherwise be needed to coordinate with third-party retailers. Test results can be used to persuade third-party retailers to distribute new products in the second phase of a launch. They can also contribute to demand forecasts.

These innovations will increase traffic to boutiques and better satisfy loyal customers. Indeed, presenting innovations to customers before wholesalers is a very effective way to trigger repeat visits and purchases.

BE EFFECTIVE, BE EFFICIENT

In much of Asia, beauty brands have acted as their own retailers for 30 years or more, helped by the relatively low price of real estate in prime locations. In the United States and Europe, good locations are rare and expensive, making it hard to set up a profitable boutique. It is therefore important to choose locations carefully and optimize the use of space. Financial considerations aside, smaller boutiques can provide a more intimate experience than department stores, which are often impersonal and disorienting. For example, Rituals owns 520 stores of between 60 m² and 100 m² in size that emulate aspects of a luxury spa to provide a soothing, relaxing shopping experience.
The décor and visual atmosphere of the point of sale also contribute to a memorable experience for customers. With just one glance, customers should be able to perceive and understand the brand’s values. Most of the outperforming challenger brands focus on one product category at each point of sale – make-up, skincare, or fragrance, for instance. This helps them present a clear picture of what they represent. Multicategory brands face the challenge of balancing the store’s design and total area for different product types, keeping features such as fragrance testing and make-up trials separate in a small space.

When investing in new boutiques, brands should aim for high quality at the best possible price, for example by anticipating areas about to become trendy and signing leases before prices rise. In established retail areas where brands have to be located, brands can seek to optimize construction costs – though this is often difficult, given the requirements for prestige brands, such as upmarket, expensive materials. We have seen some brands innovate in their interior decoration by using local materials. Doing this can strengthen a brand’s image, while also helping the brand adapt to regional specificities and deliver value for money.

USE BOTH BRICKS AND CLICKS

Own-brand networks need to be completely integrated with online retail operations. While the physical network is the best way to deliver a differentiated experience and increase a brand’s share of customers’ spending, online features have a key role to play in triggering repurchases. However, many beauty players separate their online and brick-and-mortar customer relationship management (CRM), preventing both from fully leveraging all the available information on customers. At some point, boutiques will evolve to become more like showrooms than points of sale. Customers should then have a seamless experience with the brand across every channel.

ACT – BECAUSE OTHERS WILL

Own-brand retail networks have the potential to turn the beauty industry upside down. If global beauty brands do not act swiftly, they might find themselves overtaken by the trend, which will be more than a passing fad.

However, if they seize the direct-to-consumer model as an opportunity, it could help them to form relationships with customers, regain double-digit growth, and turn into megabrands. To do this, they must invest in CRM capabilities, increase their direct marketing skills, and train their boutique staff. They will then be able to open inspiring own-brand sales points and craft unforgettable customer experiences, while still controlling their costs.