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INDUSTRY PRIMER

Premiumization, Specialization, Consolidation

In our view, the beauty industry remains one of the most attractive CPG industries globally. While average category growth rates have somewhat decelerated (to about 3% currently, slightly more for the prestige segment), most leading marketers of beauty brands continue to generate strong growth rates, very attractive and sustainable gross margins, and high ROIC. This primer provides a high-level overview of current industry trends and should be read in conjunction with our separate initiations of coverage of EL, AVP, and COTY.

- **Prestige Outgrowing Mass by a Factor of 1.5-2.0 Depending on the Country:** Globally, prestige beauty growth continues strongly to outperform total cosmetics. Going forward, we work with the assumption of prestige cosmetics growth of about 4-5% for the next three years versus 3-4% for beauty overall. This favors companies such as L'Oreal and EL, and some of COTY's brands, which are global prestige cosmetics leaders with strong market shares.
- **Channel Dynamics Indicate Trend Toward Specialization:** Specialized beauty retailers such as Ulta and Sephora, travel retail, and online sales are outgrowing traditional channels. Specialized beauty has been boosted by accelerated store growth, introduction of new products, and a focus on digital media. Increased international and domestic passenger flow has benefited travel retail, and cosmetics continue to be the biggest-selling category in this channel. Travel retail growth is key for EL, which is the number one company in skin care and makeup in this channel, and also for COTY.
- **Direct Sales Trends Remain Mixed:** Direct selling is a high-ROIC business model that adapts well to emerging markets, so it tends to benefit from the high growth rates of these markets, particularly with low-income consumers. However, it has some inherent challenges, and its share as a percent of total beauty and personal care sales has been falling since 2009.
- **Premiumization Remains Alive and Well:** Premiumization is a key driver behind positive revenue mix, high margins, and ROIC. It is a positive for the category overall as it grows value sales. L'Oreal capitalizes on its prestige or professional innovation by rolling it down to its mass brands as well. EL has developed transformational products in skin care that retail at a significant price premium to competing products.
- **Consolidation/M&A of Smaller Brands and Companies Will Likely Continue:** M&A makes large companies locally relevant and enables them to capitalize on their global distribution capabilities, while acquired local brands benefit from this incremental distribution potential and bigger R&D and marketing budgets.

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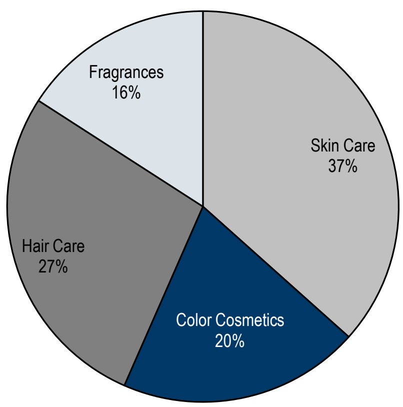
The Global Beauty Industry

Our analysis of the global beauty industry includes the skin care, color cosmetics, hair care, and fragrances categories, essentially the categories to which Estee Lauder, Coty, and Avon Products are exposed. Global beauty is a $270 B industry that is currently growing at low-single-digits and expected to recover and approach 3.5% during the next three years. Skin care, with sales of $100 B, represents 37% of the category, hair care is 27%, color cosmetics 20%, and fragrances 16%.

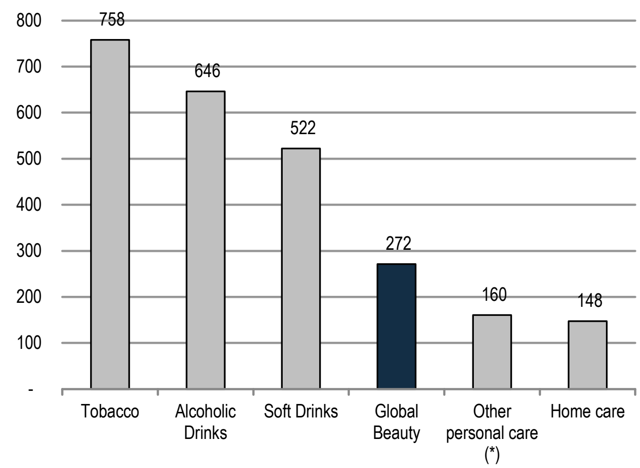
To put the global beauty industry in the context of other CPG industries, it is approximately one-half the size of global soft drinks. For the propose of this analysis, we don't include other personal categories such as oral care, bath and shower, deodorant, and other grooming products, which together account for $160 B of sales.

Exhibit 1: Global Beauty, Composed of Skin Care, Color Cosmetics, Hair Care, and Fragrances, Is a $270B Industry



Source: Euromonitor.

Exhibit 2: Global Beauty Is Approximately One-Half the Size of Global Soft Drinks



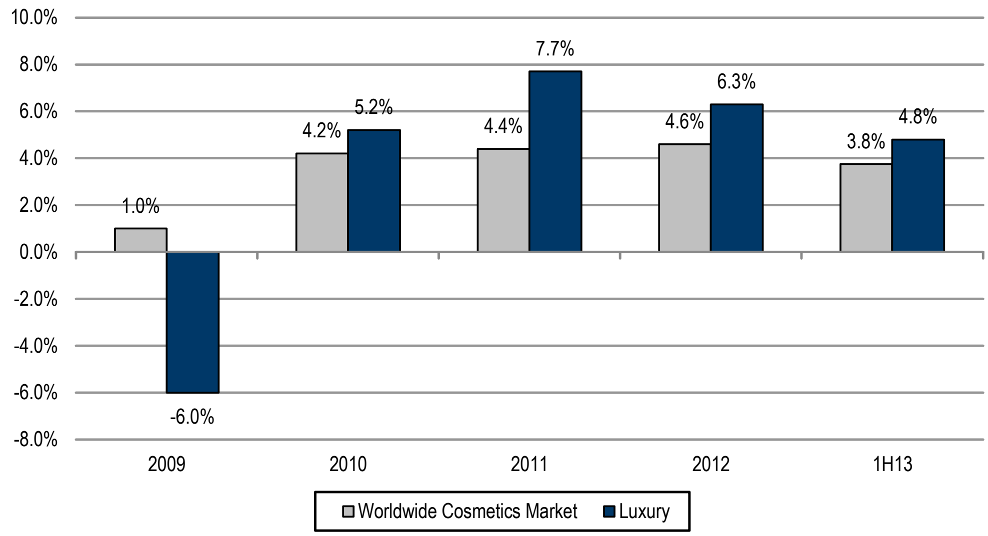
Source: Euromonitor (*) Includes oral care, bath and shower, deodorant and other grooming products.

Industry growth in the mainstream segment is driven mainly by emerging markets, where rising household incomes and the expanding middle class tend to benefit disproportionately the discretionary categories such as beauty, as consumers either start using some of the products for the first time or trade up to so-called masstige or even prestige products as their incomes permit. The prestige segment accounts for 30% of the beauty category overall, and it tends still to rely on developed markets for growth, which tends to be driven by factors such as premiumization and a positive mix.

Third-party data providers and many industry participants generally expect industry growth to accelerate during the next few years and approach 3.5-4.0%, up from about 3% currently. We expect growth in emerging markets to stay at around 6%, driven by increased product penetration and premiumization. Growth in developed markets is expected to recover from about flat to about 1%, driven by the economic recovery in the U.S. and potential stabilization in most of Western Europe.

The premium segment within the overall industry tends to grow faster. According to a L'Oreal analysis, the premium segment has outperformed total cosmetics for the last three and a one-half years, and we see no reason why this wouldn't continue.

Exhibit 3: According to a L'Oreal Analysis, the Premium Segment Has Outperformed Total Cosmetics for the Last Three and a One-Half Years



Source: L'Oreal annual/half year sales presentations.

According to an EL analysis, in most key markets, prestige outperformed mass last year. Prestige growth in the U.S. was more than three times mass growth. For fiscal 2013, EL estimates that the prestige beauty category worldwide grew 4% (down from 5% in FY12). and for fiscal 2014, it foresees global prestige beauty growth of approximately 3-4%.

Exhibit 4: In Most Key Markets Prestige Outperformed Mass Last Year

Year	2012		2011	
Country	Prestige	Mass	Prestige	Mass
USA	6.3%	2.0%	8.5%	1.1%
Brazil	14.6%	13.9%	11.3%	8.9%
China	12.9%	8.7%	20.5%	9.0%
Japan	0.4%	1.7%	-1.2%	0.2%
UK	1.3%	1.9%	5.6%	3.6%
France	0.8%	1.4%	1.3%	0.6%
Germany	2.2%	1.4%	2.6%	2.7%

Source: Estee Lauder.

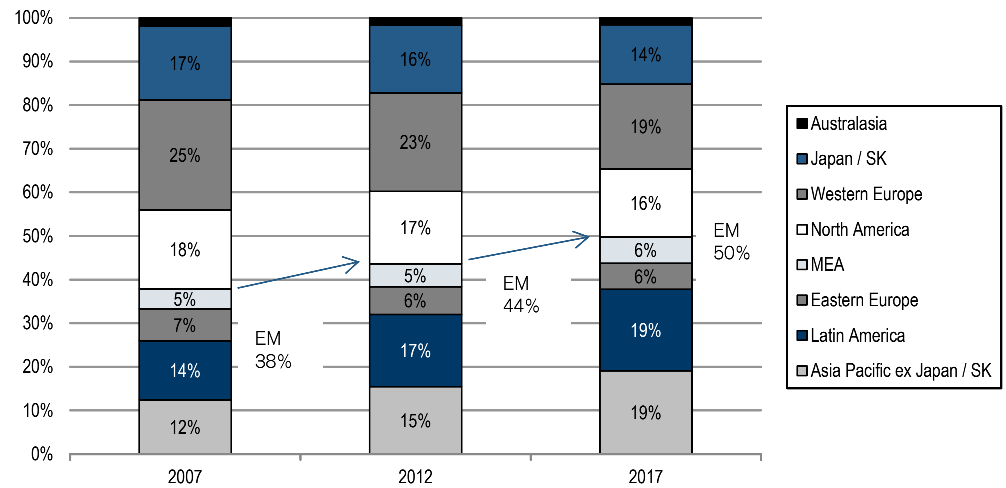
Going forward, we work with the assumption that the prestige industry segment will see a CAGR of about 4-5% for the next three years, versus 3-4% for beauty overall.

Beauty Companies in General Still Find Most Growth Potential in Emerging Markets, Particularly in Latin America and Asia

Over the past five years, emerging markets increased from 38% of global beauty sales to 44% today. By 2017, emerging markets are expected to represent one-half of total beauty sales, with Latin America and Asia-Pacific (ex-Japan/South Korea) being the dominant regions at 19% each. The key market within Latin America is Brazil. The country increased from 7% of total global beauty sales in 2007 to 9% today, and it is expected to reach 11% by 2017. Brazil is unique due to its high urbanization level versus other emerging markets (84%, which is the same as the United States) and high female work force participation (60%, which is higher than the U.S. at 56%). Despite the recent headwinds, general macroeconomic factors continue to be positive in Brazil. The increase in minimum wage, social assistance programs, and a higher employment rate favor disposable incomes among emerging middle-income consumers. Direct selling accounts for roughly one-half of all beauty product sales (and the market is hence key for Avon), while the premium segment is still tiny (low single-digit, on our estimates), providing a long-term opportunity for companies such as EL and COTY.

Prestige Beauty Companies Still Rely on Developed Markets for the Bulk of Their Growth, Although the EM Contribution Continues to Increase: For instance, China is the third largest market for EL following the U.S. and U.K. EL has presence with 14 brands in the country (out of a total of 30), with the emphasis being mainly in skin care and less in fragrances. EL has presence in 69 cities, 340 stores, and more than 800 points of sale. As for most luxury companies, China still presents a significant growth opportunity for EL's brands. We estimate that by 2015 China will become EL's second most important market to the U.S., reaching +7% of the company's sales, up from 5% currently. The company's strategy is to expand its presence and capture new consumers by entering new cities (grow strongly also in secondary and tertiary cities), opening more outlets, and bringing more brands online through e- and m-commerce.

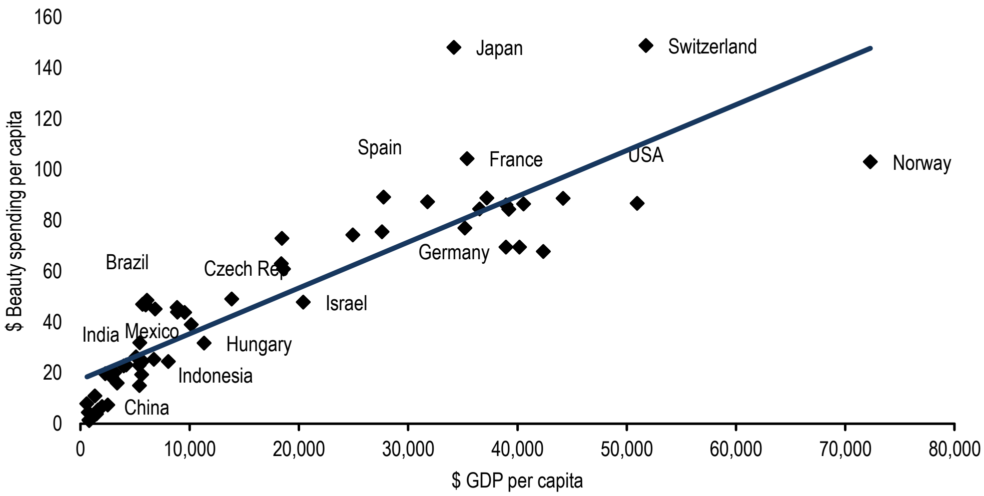
Exhibit 5: **Over the Past Five Years, Emerging Markets Increased from 38% of Global Beauty Sales to 44% Today; By 2017, Emerging Markets Are Expected to Represent One-Half of Total Beauty Sales**



Source: Euromonitor.

Beauty spending per capita shows a clear correlation with GDP per capita and suggests significant potential not only from low-income countries but also from middle-income economies (i.e., Brazil, Czech Republic, Israel), as beauty is more elastic to income than other HPC categories. When it comes to beauty products, as income grows, consumers will generally be willing to spend more and usually find alternatives to trade up.

Exhibit 6: Beauty Spending per Capita Shows a Close Correlation with GDP per Capita

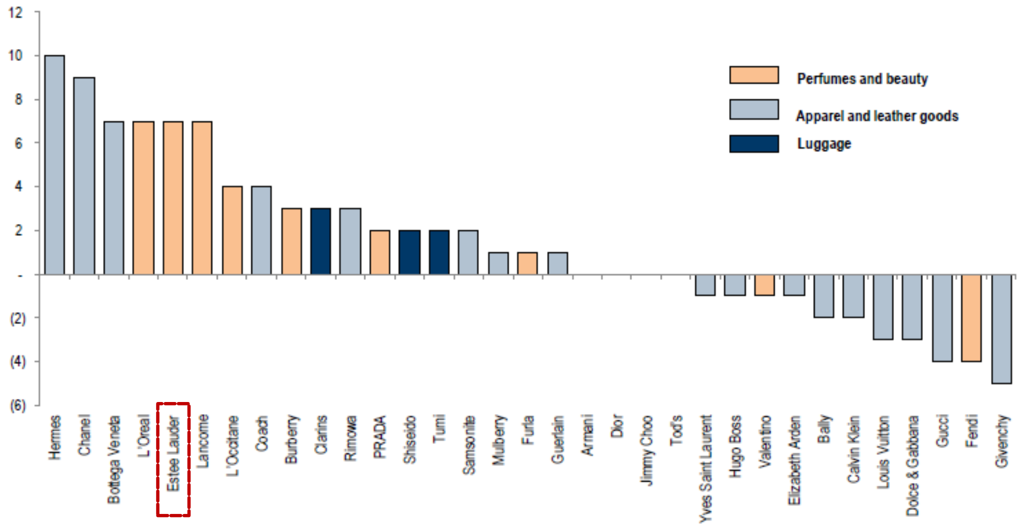


Source: Beauty spending per capita L'Oreal, Credit Suisse estimates.

China: Proprietary Survey Suggests EL's Categories to Be More Resilient than Other Luxury Segments: Credit Suisse's luxury research team interviewed 22 high-end retailers and distributors in Greater China, targeting executives, buyers, or strategic planners with the aim of understanding recent trends and demand prospects for the affluent Chinese consumer. (See the note, titled, *China Luxury Survey*, by the Credit Suisse luxury team, published September 18, 2013.) According to 15 out of 22 respondents, luxury demand in China continues to slow down. Only 5 out of 22 respondents have reported some growth acceleration in recent months. However, lower-ticket items with deeper penetration such as beauty care products have held up better, and the Estee Lauder brand in particular scored very favorably. (See Exhibit 7.)

Exhibit 7: China; Perfumes & Beauty Has Been the Most Resilient Category; Momentum in Other Luxury Categories Is Mixed, with More Diverging Performance Across Brands (Both Extremes)

Our brand sales momentum score (number of "best-selling" answers less number of "selling less well" answers)

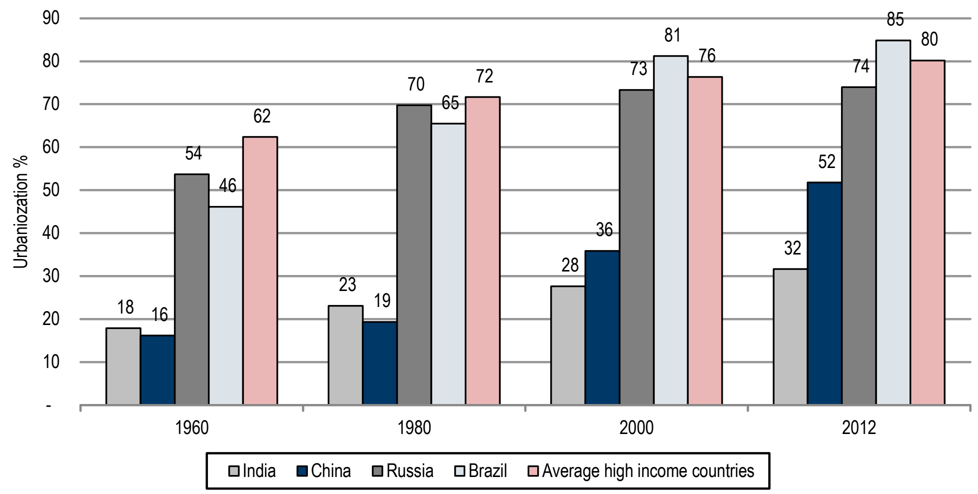


Source: Credit Suisse China Survey, September 2013.

Urbanization Is a Key Driving Force in Emerging Asian Markets

Urbanization is a key driver behind beauty product consumption. The increased population concentration in urban areas facilitates product distribution. It also increases demand for beauty products because (1) it is usually accompanied by an upsurge in disposable income and (2) city life offers a greater frequency of social interaction, hence people grow more concerned about their personal appearance. After some decades of explosive urbanization growth during the twentieth century, Brazil now has a similar (or even higher) urbanization level than the average of high-income countries. The situation in Russia is similar. However, India and China still have significant potential on this front. During the last ten years, China grew its urbanization rate by almost 50%. However, the country is still 35% below the level of developed countries. India is even lower, but growth in urbanization is moving at a slower pace.

Exhibit 8: Urbanization Is a Key Driver Behind Beauty Products Consumption; India and China Still Have Significant Potential to Grow on this Front



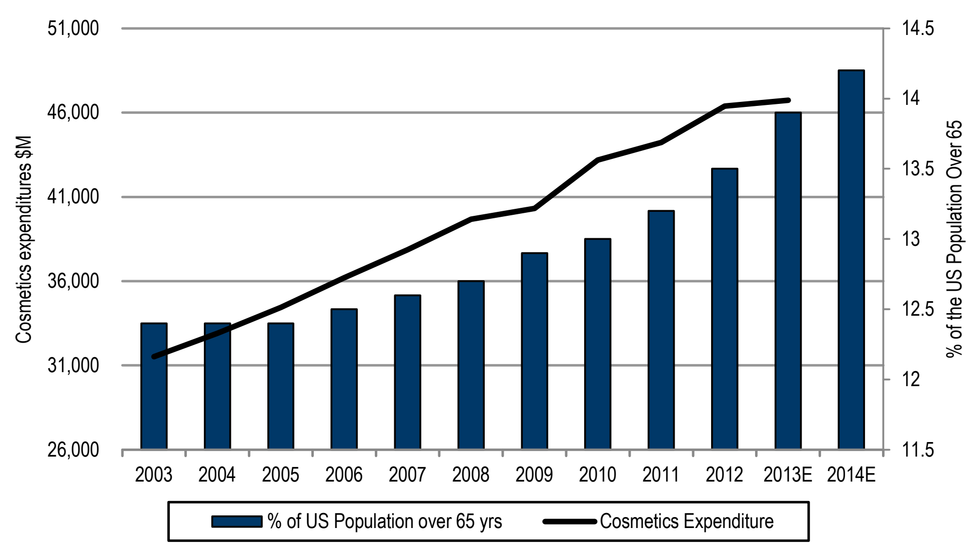
Source: World Bank.

In Developed Markets, Aging Population Is a Driver for Skin Care Products

Demand for beauty and skin care products among the aging U.S. and Western Europe population should support industry sales growth. Seniors, those 65 years and older, are estimated by the U.S. Census Bureau to make up 14.2% of the U.S. population by 2014.

According to Mintel, since 2009, one-half of skin-care launches in the U.S., France, and U.K. were anti-age products.

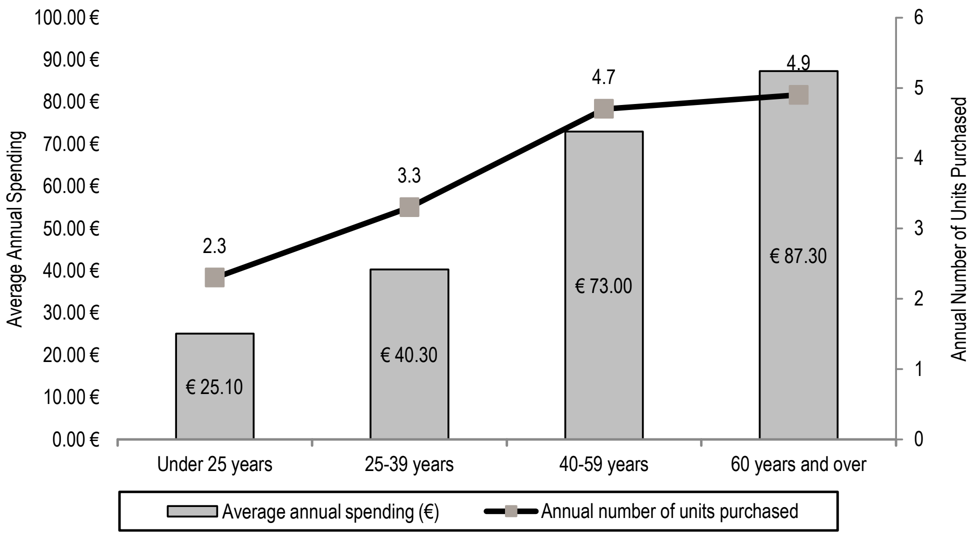
Exhibit 9: Demand For Beauty and Skin Care Products Among the Aging U.S. and Western Europe Population Should Support Industry Sales Growth



Source: US Census Bureau, Credit Suisse estimates.

Demographic trends in Western Europe and the US are thus a positive to mix for beauty companies as Exhibit 10 shows.

Exhibit 10: On average European women over 60 buy twice as many skincare products and spend more than three times as women under 25



Source: TNS Worldpanel France. L'Oreal annual report

Technology Is Driving Innovation

Technology-driven benefits (and their convincing communication) is the enabler of premiumization, and premiumization is a key driver behind positive revenue mix, high margins, and ROIC. As companies develop products that offer additional features that are valuable for consumers, they are able to charge higher prices. This is not only accretive to revenue mix but also to margins and returns because companies are able to get more leverage out of their fixed cost structure and asset base when they sell more value-added products.

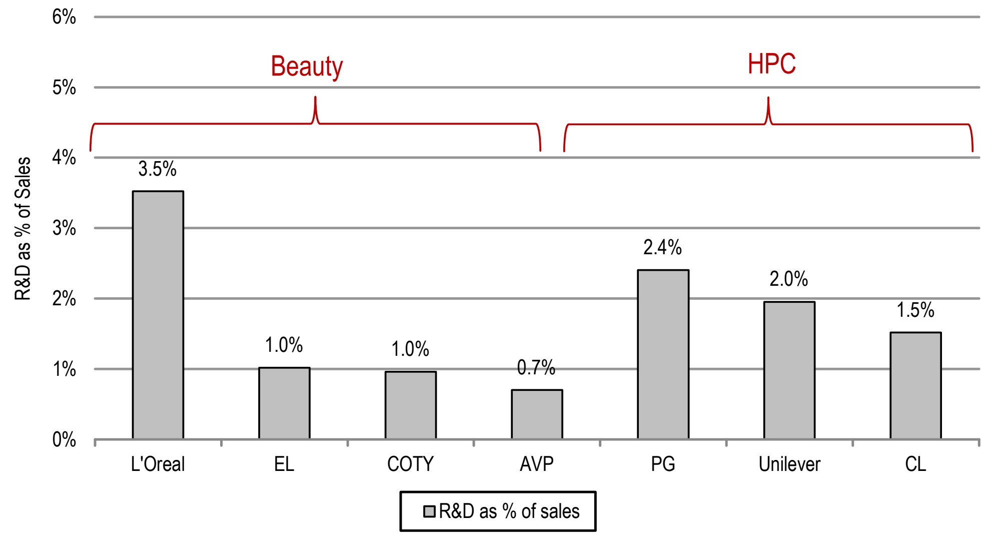
Premiumization is a positive for the category overall as it grows value sales, potentially increases margins for retailers, and expands the consumer base, as consumers are attracted by the additional product benefits.

Innovation is the principal driver of premiumization, and innovation comes from the combination of strong R&D and good marketing capabilities. L'Oreal capitalizes its prestige and professional innovation by rolling it down to its mass brands as well. For instance in hair color, Garnier Olia was the first mass-market hair colorant to incorporate oil delivery system (ODS2) technology developed for the professional segment, enabling Garnier to make substantial market share gains both in Western Europe and North America.

EL has developed transformational products in skin care based on science and R&D. For instance, Clinique Even Better practically created a new category thanks to a proprietary hyperpigmentation technology. The company then followed it with Even Better foundation, which also brings the technology in conjunction with the serum for a better result on foundation. It has now just expanded it to Even Better eyes, which converts the benefit to eyes from dark spots to dark circles.

Technology is also driving COTY's nail polish business in terms of new formulations, formats (Sally Hansen’s nail polish strips, which promote salon results in the home), as well as new application methods, such as fan-shaped brushes or pens.

Exhibit 11: R&D as a % of Sales



Source: Company data, Credit Suisse estimates.

A Trend to More Natural Products

Alongside technological innovation, the natural/organic movement continues to inspire many new cosmetic product launches. A number of new launches points toward a more natural approach in terms of raw material sourcing, ingredient formulations, and packaging disposal. This is driven by consumers' and manufacturers' interest to be more environmentally responsible, as well as the greater scrutiny over the safety of ingredients.

Natural/organic is no longer the domain of niche players, with many high-profile brands like L'Oréal's Garnier Fructis Pure Clean, Beiersdorf's Nivea Pure, and Natural and Unilever's Timotei Organic Delight hitting the shelves in the past couple of years.

Ingredient supply is becoming a lot more diverse, which in turn is opening up opportunities for innovation in formulations and new product applications. Traditional paraben preservatives, silicones, and mineral oil-based emollients are being replaced by naturally sourced and more biodegradable plant alternatives, such as Shea butter, grape seed extract, green tea, and argan oil, for instance.

Packaging goals are about reusing, recycling, and eliminating packaging materials. Size optimization has been used in many new products to reduce the overall packaging, along with more lightweight materials (e.g., the introduction of refill pouches in products like liquid soap), innovation in structural design of products (e.g., upside down bottles).

There is increased development and use of biodegradable and sustainable raw materials. PG's Pantene Pro-V Nature Fusion, for example, now uses a plant-based plastic bottle. The sugar cane-derived packaging reduces the environmental impact through the life cycle by less fossil fuel consumption and less carbon emissions (70% less fossil fuels and releases roughly 170% less greenhouse gases per ton than petroleum-based plastic).

E-Commerce and Digital Advertising Are Growing Rapidly

All major players are stepping up their digital initiatives, with L'Oréal and EL at the forefront. With the proliferation of social media, digital marketers are exploiting these platforms to drive consumer interest in brands by replacing campaign-specific sites with social media communications.

Among the more interesting initiatives, Bobbi Brown and M•A•C launched social media campaigns to revive and relaunch discontinued cosmetics based on votes received by site users. The new M•A•C By Request collection was then to be sold exclusively on the M•A•C Web site. NARS and Covergirl are providing samples on social media to prompt direct purchases there.

In 2011, Shiseido launched a Web-based service, Watashi+, which includes Web counseling, in which customers can get advice regarding the most suitable products from Web-based specialist beauty consultants by using an online virtual make-up simulator.

EL is looking to improve its presence in department stores and enhance the customer experience. Clinique and Bobbi Brown have received an in-store makeover implementing Apple's iPad products.

There are interesting opportunities coming from mobile Internet access in emerging markets. Traditional access to the Internet in EM is less common than in developed markets. However, penetration of mobile phones is higher, with an average gap of 39 percentage points between cell phone and Internet-enabled computer penetration. This trend is even more important for markets with low levels of computer ownership, and the gap increases to 55% for the lowest 40 markets. Of households in Russia, 55% own a mobile phone but not a computer. In China, 64% of households own a mobile telephone, which equates to approximately 250 million households. In Brazil, the gap (12%) may not justify a mobile channel strategy.

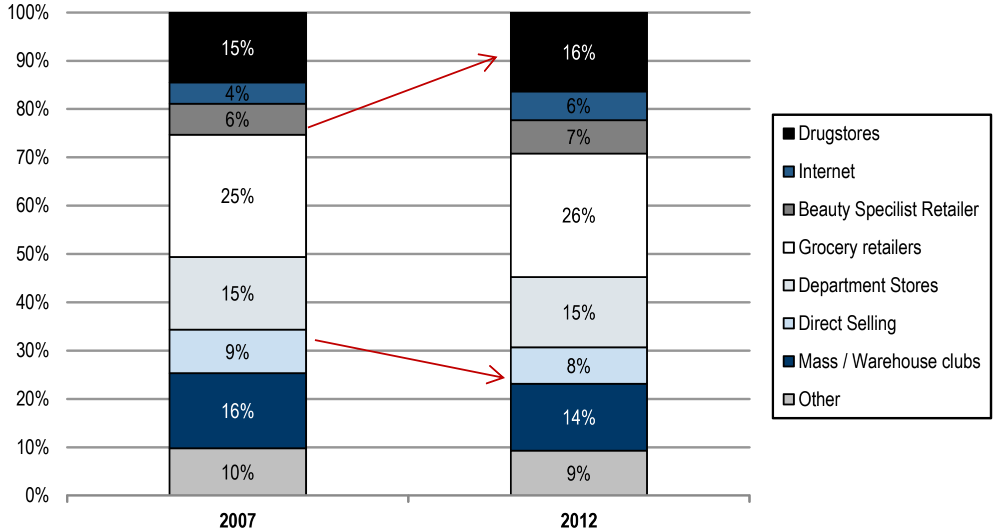
Rapidly Evolving Channel Dynamics

Specialized beauty retailers such as Ulta and Sephora, travel retail, online sales are outgrowing traditional channels. Specialized beauty has been boosted by accelerated store growth, introduction of new products, and increased digital focus. Increased international and domestic passenger flow has benefited travel retail.

Prestige brands are focused on growing in high-touch retail formats like specialty multibrand retail (Ulta, Sephora) and on developing e- and m-commerce capabilities as consumers increasingly shop online and from their mobile phones.

For all beauty and personal care categories in the U.S., channel evolution shows that beauty specialized retailers, Internet, and drugstores have gained share mainly at the expense of direct selling and mass/club during the last five years.

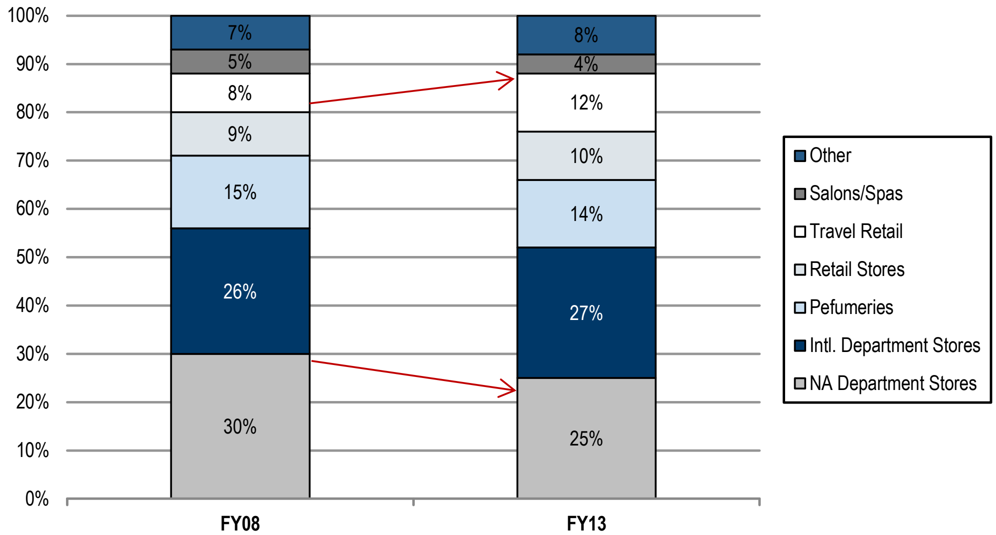
Exhibit 12: For All Beauty and Personal Care Categories in the U.S., Channel Evolution Shows that Beauty Specialized Retailers, Internet, and Drugstores Have Gained Share Mainly at the Expense of Direct Selling and Mass/Club



Source: Euromonitor.

Taking a closer look at prestige beauty, EL's channel evolution for the same period shows that travel retail has been gaining share mainly at the expense of North American department stores.

Exhibit 13: EL's Channel Evolution for the Same Period Shows that Travel Retail Has Been Gaining Share Mainly at the Expense of North American Department Stores



Source: EL annual reports.

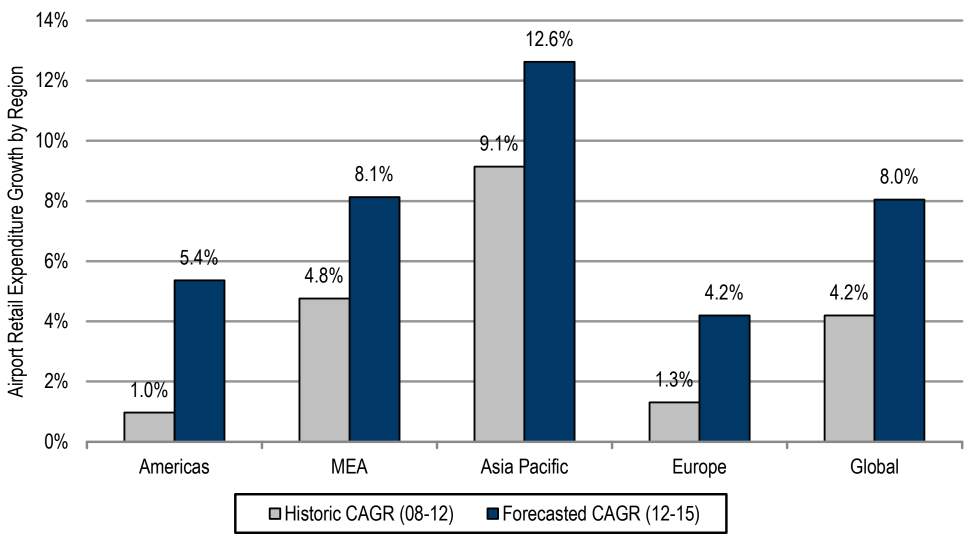
Travel Retail—Strong Growth

In 2012, travel retail was a $33 billion global industry with a three-year CAGR of 7.5% (or a four-year CAGR of 4% including a 5% decline in 2009). Within airport retail, perfumes and cosmetics are the largest category, representing 40% of sales. It is also the second fastest growing category, with a CAGR of 5.5% during the last four years.

There are several favorable trends that should continue to benefit travel retail. Airport retail expenditures are expected to grow at 8% during the next three years (see Exhibit 14). This is driven by (1) international patterns of traffic, which are growing rapidly in emerging markets and are forecast to grow 5.5% annually over the next three years; and (2) increasing average spend per passenger, which is expected to grow 3% globally during the same period. (See Exhibit 15). China is a key catalyst for this, with its continued major expansion in air travel infrastructure and the desire of its growing middle class to travel abroad.

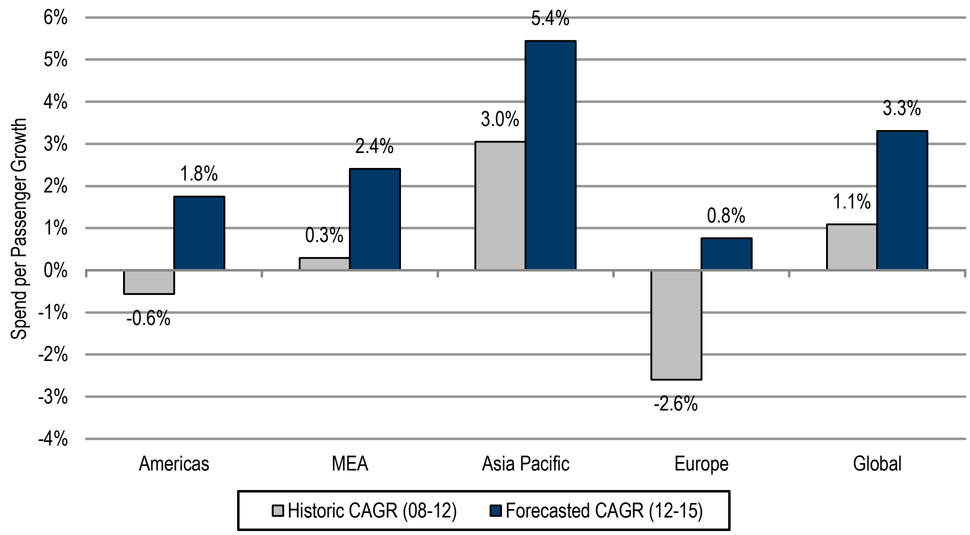
The underlying consumer base growth, in addition to distribution gains as airports are built, expanded, and remodeled often with increased retail presence, has led to double-digit gains in the travel retail portion of beauty companies like EL and COTY. Travel retail makes up 11% and 6% of EL and COTY's businesses, respectively.

Exhibit 14: Airport Retail Expenditures Are Expected to Grow at 8% During the Next Three Years, up from 4.2% During the Last Four Years (or 7.5% Excluding the Decline in 2009)



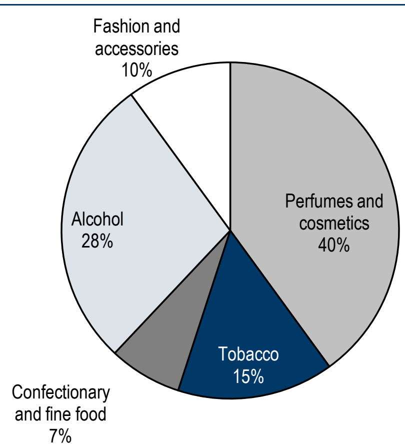
Source: Veredict Research, Credit Suisse estimates.

Exhibit 15: Average Retail Spend per Passenger Is Expected to Grow 3% Globally During the Next Three Years, up from 1% During the Last Four Years



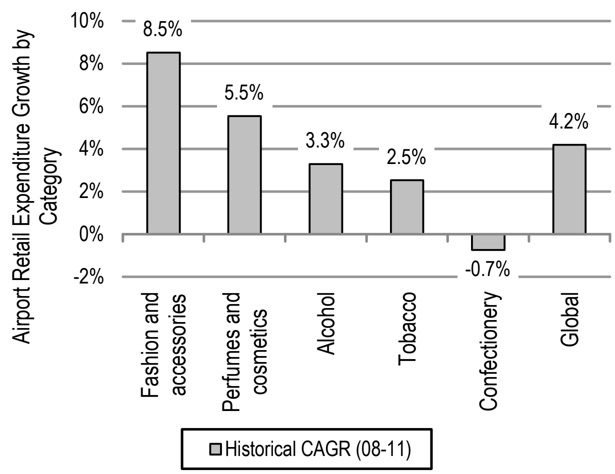
Source: Veredict Research, Credit Suisse estimates.

Exhibit 16: Perfumes and Cosmetics Are the Largest Category in Travel Retail, Representing 40% of Sales.



Source: Generation Research. IATA industry forecasts.

Exhibit 17: It Is Also the Second Fastest Growing Category, with a CAGR of 5.5% During the Last Four Years



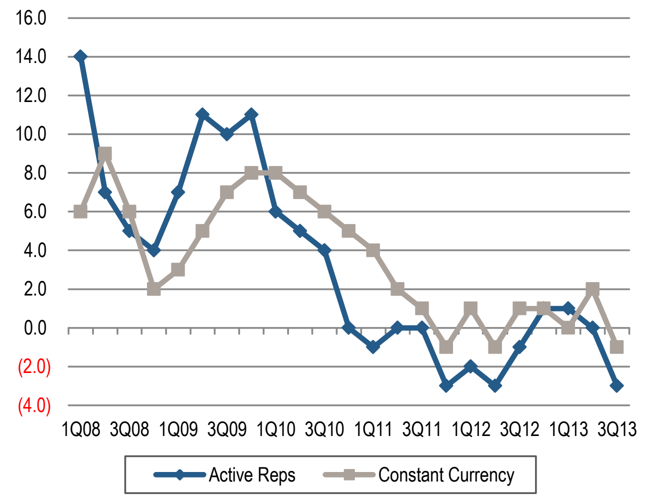
Source: Generation Research. IATA industry forecasts.

According to the Global Business Travel Association, China is likely to add 100 new airports in the next decade, including emerging cities like Chongqing and Wuhan. Domestic growth passenger growth in China and Brazil is expected to grow at 10% and 8%, respectively, during the next four years, compared with just 3% in the U.S.

Direct Selling—Mixed Landscape

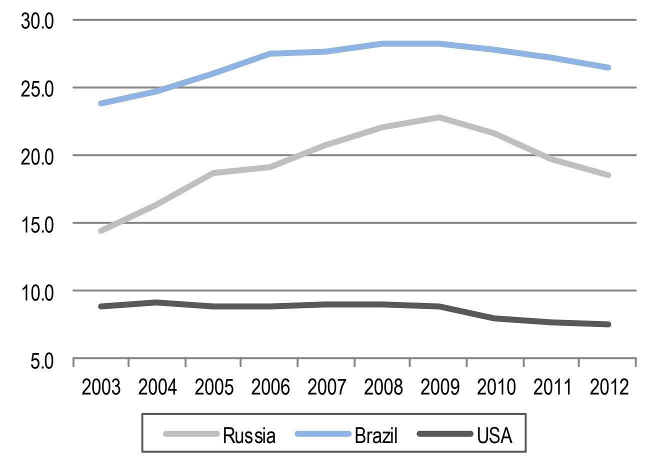
Direct selling is a high-ROIC model that adapts well to emerging markets, so it tends to be benefited by the high growth rates of these markets. However, it has some inherent challenges, and its share as a percent of total beauty and personal care sales has been falling since 2009

Exhibit 18: AVP Global Growth in Active Reps Is in Decline



Source: Company data.

Exhibit 19: Direct Selling as a % of Total Beauty and Personal Care Sales Has Been Falling Since 2009



Source: Euromonitor.

Positives

- Geographic mix is heavily skewed to emerging markets. In many of these markets (Brazil is a good example), direct selling of mass-market cosmetics products is a key distribution channel, and we think that the less developed a market is, the more attractive it is for direct sellers.
- Recruiting reps should be made easier by macroeconomic uncertainties. Improving the growth of active sales reps is a key revenue driver and should be made easier in times of economic difficulties.
- Finally, it is a high-ROIC model. Given the low capital-intensive nature of direct selling, the financial model remains one that enjoys a high ROIC

Some Significant Challenges

The direct selling business model has some inherent challenges, as it: (1) lends itself to stranded customers, as rep turnover is high; (2) has a lack of customer data, as sales reps, which are not employees, effectively own the customer list; and (3) relies on push sales tactics, which may not work if sales reps are not properly incentivized. It is the reps that drive growth first, followed by the brands.

- **Part-Time Sellers Are Self-Users:** The sales force is made up of career representatives, who attempt to earn income selling the products, and customer representatives, who primarily buy for self-consumption. These part-time sellers usually make up the bulk of the sales force and have a high turnover, perhaps up to 100% per year.
- **Relies on Push by Reps Versus Impulse Buys or Brand Pull:** Reps need effective and clear goals, innovative products, and a strong support network to drive sales. If a rep does not get the service they need, this can result in an immediate drop in sales growth.

- **Sales reps impact brand image:** In many cases, there is no financial barrier to becoming a sales rep, and in many ways, the rep becomes the brand, or at least part of the brand.
- **Confined to the Mass Market:** This challenge can create barriers to increasing prices or changing stigmas.
- **Lack of Customer Data:** The vast majority of sales representatives are independent contractors and not employees. They technically own the customer list and are the primary source of customer feedback.

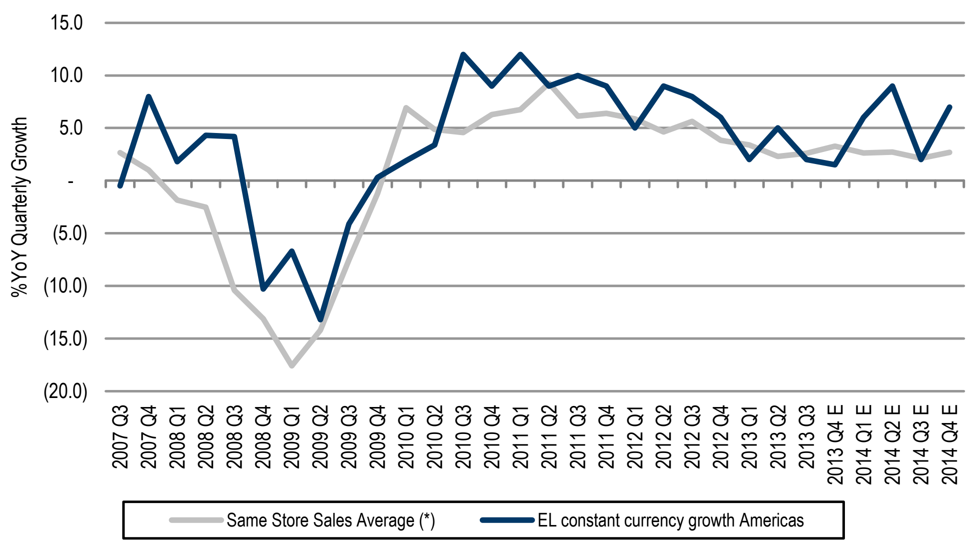
U.S. Department Stores—Still a Bastion of Exclusivity for Prestige Brands

Traditional department stores still have a lock on much of the beauty business, and beauty is the single most important profit category and traffic driver for many of them. For beauty companies, the relationship with department stores is a way to maintain the exclusivity and protect the equity of their brands. This year, Estee Lauder is making a significant investment with blockbuster launches such as Clinique's DDM+, Estée Lauder Advanced Night Repair serum, and Modern Muse fragrance, with special emphasis on the department store channel.

U.S. Department stores are emphasizing prestige beauty within their growth plans. Kohl's is adding 20 new beauty and fragrance brands to its Web site and select stores nationwide as it experiments with expanding its cosmetics offerings. The Bon-Ton Stores has also made cosmetics a key part of its growth plans, while J.C. Penney is opening Sephora inside its stores.

Prestige beauty sales in the U.S. show a close directional correlation with department stores SSS. Credit Suisse broadline retail analyst Michael Exstein expects U.S. average department store SSS growth to be 2.5% for 2014.

Exhibit 20: EL Americas Sales Have a Strong Directional Correlation with Same-Store Sales of Department Stores, but Overall Growth Tends to Be Higher



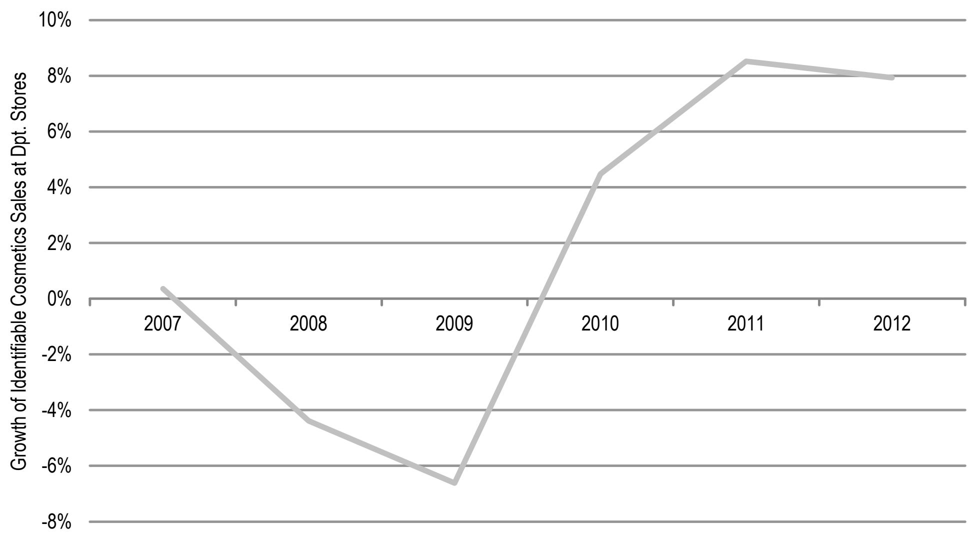
Source: Company data, Credit Suisse estimates (*) Simple average of SSS growth of Nordstrom, Neiman Marcus, Saks, Dillard's and Macy's.

Exhibit 21: Department Store Premier Cosmetics Sales (Identifiable)

	2007	2008	2009	2010	2011	2012
Nordstrom	0.8%	1.4%	-7.1%	8.6%	13.8%	13.5%
Saks	4.8%	-4.1%	-25.7%	-0.3%	3.3%	9.4%
Macy's	0.4%	-5.4%	-4.4%	5.0%	8.5%	7.7%
Dillard's	-5.7%	-5.2%	-10.8%	0.4%	2.3%	5.3%
Bon-Ton	1.7%	-3.3%	-4.7%	-0.1%	4.2%	2.6%
Neiman Marcus	8.9%	4.8%	-20.8%	1.4%	18.2%	8.6%
Total (ex. Macy's)	**0.4%**	**-1.6%**	**-12.6%**	**2.9%**	**8.5%**	**8.6%**
Total	**0.4%**	**-4.4%**	**-6.6%**	**4.5%**	**8.5%**	**7.9%**

Source: Company data, Credit Suisse research.

Exhibit 22: Cosmetics Trends At Department Stores Indicate a Strong Recovery Since the Recession



Source: Company data, Credit Suisse research. Nordstrom Cosmetics, Saks: Cosmetics & Fragrance, incl. Off Fifth (after 2009); Cosmetics only, Saks and Direct only (pre-2009), Macy's: Feminine Accessories, Intimate Apparel, Shoes, Cosmetics, Dillard's: Cosmetics, Bon-Ton: Cosmetics.

Qualitative comments for the most recent quarters indicate that trends for the cosmetics industry are improving. Some of the 3Q commentary from department stores has been quite supportive:

Macy's: *"Sales in the center core categories continued their **very strong performance** driven by handbags, **cosmetics**, fine jewelry, intimate apparel and boots (..) the **Traditional Gift categories are trending very well. This would include** businesses such as fine jewelry, **cosmetics**, cashmere, handbags and housewares"*

Kohl's: *"**Strong results in our Beauty categories** reflect positive impacts of our beauty remodel program and the new brand launches (…)Our new brands in Beauty are performing very well and are exceeding our expectations. And although it's very early, we have seen significant Beauty sales increases in the renovated stores"*

Nordstrom: *"**Top-performing categories included Cosmetics**, Women's Apparel, and Women's Shoes"*

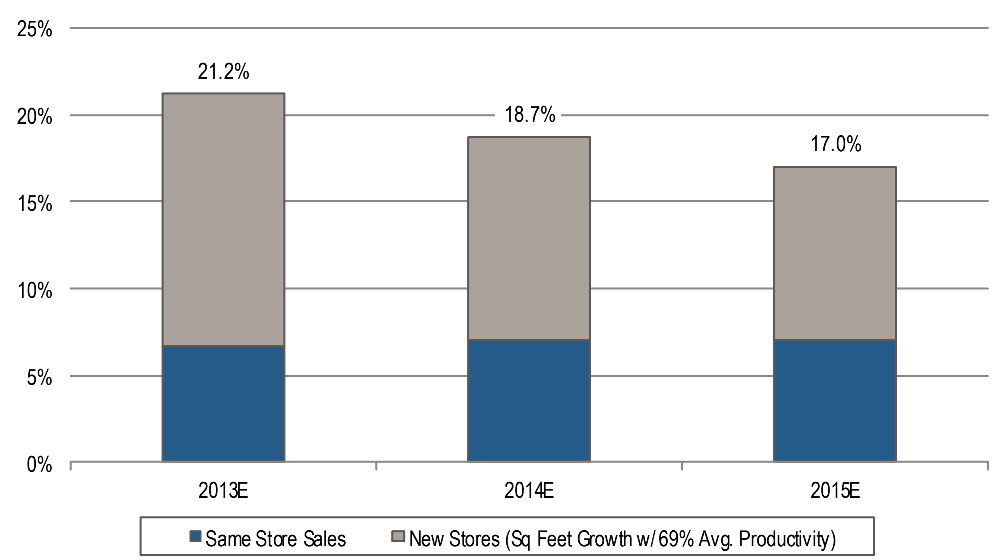
Drugstores—An Evolving Channel

In the beauty and personal care segment, many masstige brands are upward extensions of existing mass brands (e.g., Olay into Olay Regenerist), so it makes sense that many of them have been distributed in the same channels as mass brands. A more surprising trend has been the increasing presence of prestige brands in the drug channel as companies seek to reach new customers and boost growth with increased distribution. It is also a reflection of the evolving drug channel. Some stores, notably Duane Reade (WAG), have remodeled some of their urban locations to include Look Boutiques. These boutiques have upgraded displays, dedicated beauty advisors, and a few even offer beauty services such as brow shaping or manicures to encourage more frequent visits. These more premium spaces have been able to attract some brands that we would classify as prestige such as La Roche Posay, for example. While this may be a good strategy to grow distribution for more value-priced prestige products, especially in urban areas, we think the overall impact is limited. The overall number of these remodeled drug stores is small, and the more premium-priced prestige products are unlikely to dilute their hard won prestige positioning by distributing in less premium channels. We also think it is more likely for companies with a larger proportion of mass and masstige brands to distribute their prestige brands in drug stores, as it leverages their existing distribution network. With that in mind, we expect PG and COTY to benefit relatively more from this distribution growth than EL.

Specialized Retailers—Gaining Share

ULTA is growing rapidly, with Credit Suisse estimating an average of 19% sales growth from FY13 to FY15 and fast growth in square footage in addition to approximately 7% same-store sales growth. While some of this growth is coming from a premiumization in ULTA's product mix, the majority is from share gains. ULTA is taking share from department stores in prestige and from the drug and discount channels in mass.

Exhibit 23: ULTA's Sales Growth from Same-Store Sales and Additional Square Feet



Source: Company data, Credit Suisse estimates – Gary Balter's hardlines team.

ULTA's top-line strength has lately been driven by prestige cosmetics and skin care. According to the company, customers are choosing higher-price-point products and offsetting that with not buying in other categories. Its e-commerce business is growing strongly, driven by prestige cosmetics and skin care categories.

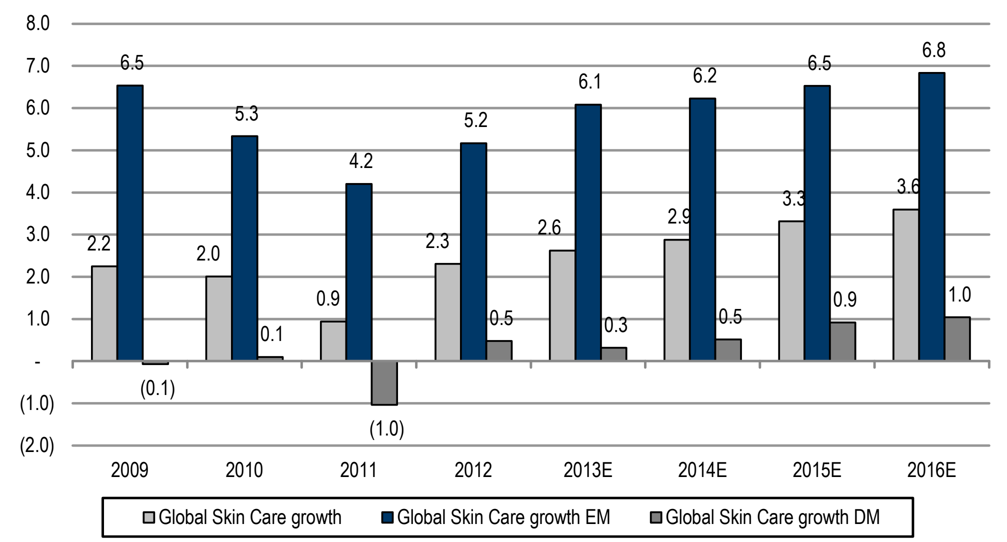
Similarly, Sephora is growing market share in all key regions, driven by positive momentum in existing stores, particularly in North America, Asia, and the Middle East. LVMH said there was strong progress of its online sales and the successful introduction of new products. For the nine months ended on September 2013 like-for-like growth for Sephora was about 10%.

Category Overview

Skin Care

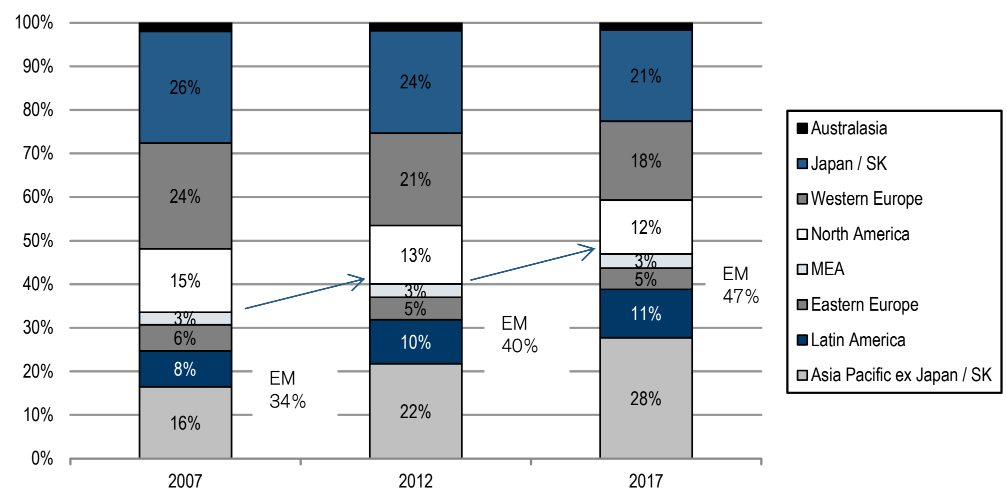
Skin care is a $100 B global category that is currently growing at midsingle digits. Most of the growth is coming from emerging markets, which currently represent 40% of the category (up from 34% five years ago). They are expected to become 47% of the category in 2017, with China being a significant driver. Asia ex-Japan and South Korea is expected to be the dominant region by 2017, representing 28%, and China alone will be 17%.

Exhibit 24: Skin Care Is a $100 B Global Category that Is Currently Growing at About 2%



Source: Euromonitor.

Exhibit 25: Emerging Markets Currently Represent 40% of the Category (up from 34% Five Years Ago); They Are Expected to Become 47% of the Category in 2017



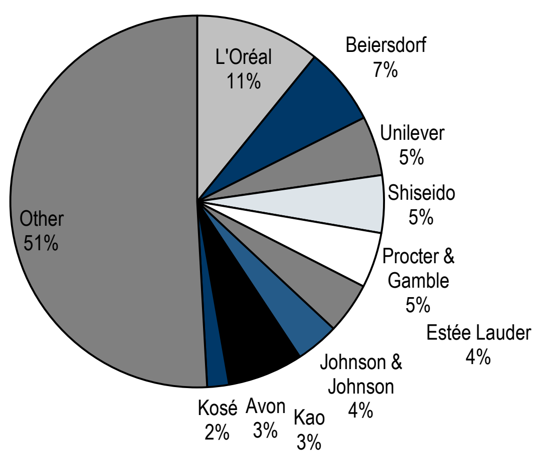
Source: Euromonitor.

L'Oréal and Beiersdorf are dominant players in the category, with 11% and 7% global shares, respectively.

EL commands a 4% share, given the company is solely in premium skin care. Its success has been driven by its well established brand portfolio, notably Clinique and Estée Lauder. The 2010 launch of Clinique Even Better Clinical Dark Spot Corrector continued to perform well into 2012. The company is promoting the great value offered by Clinique through signage at department store counters with pricing information. Clinique is priced at the low end of premium skin care, with its Dramatically Different Moisturizing Lotion priced at only US$26.00 for a 4.2 fl oz bottle.

AVP has a 3% market share. The company's masstige brand Avon Anew is positioned as offering demonstrable results, often featuring claims of reducing the signs of ageing within a few weeks. Its mass brand Mass brands Avon Solutions focuses more on basic claims of cleansing and hydration, and it competes on price.

Exhibit 26: L'Oréal and Beiersdorf Are Dominant Players in the Skin Care Category with 11% and 7% Global Shares, Respectively



Source: Euromonitor.

The divide between certain categories is becoming ever more blurred. There is a clear trend toward products with multitasking features. This is evident in the wider availability of BB creams across Europe and North America. BB creams are taking a new dimension from their traditional values from Asia. LabSeries has extended the concept into the men's category

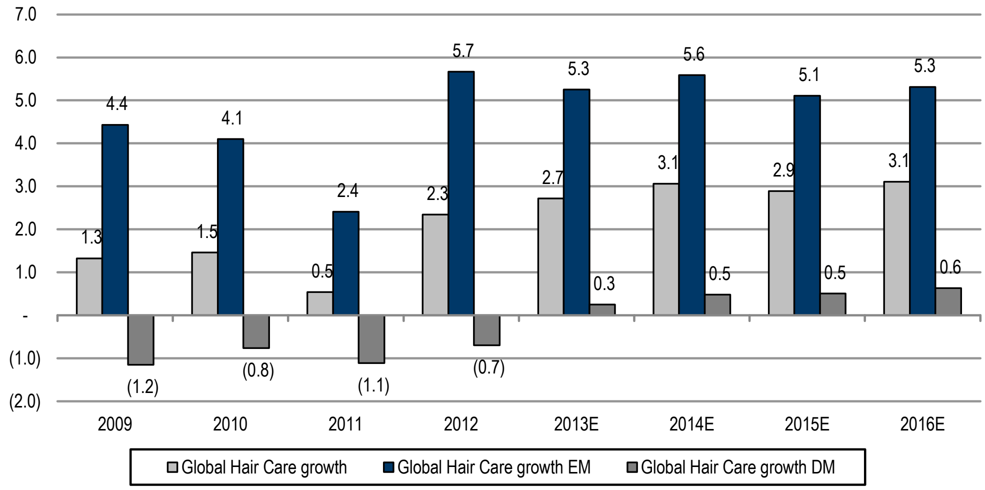
Multifunctionality is creating opportunities in many product areas, from hand care (hand sanitizers and moisturizers in one) to make-up (foundation and anti-ageing serum in one), all promoting the convenience of a single-step process.

Brightening features are becoming a more important trend in anti-ageing products across Europe and North America, indicating a slight shift in how products are being positioned. There is a more holistic approach to anti-ageing. Radiance, even skin tone, and luminosity are gaining prevalence over wrinkle control.

Hair Care

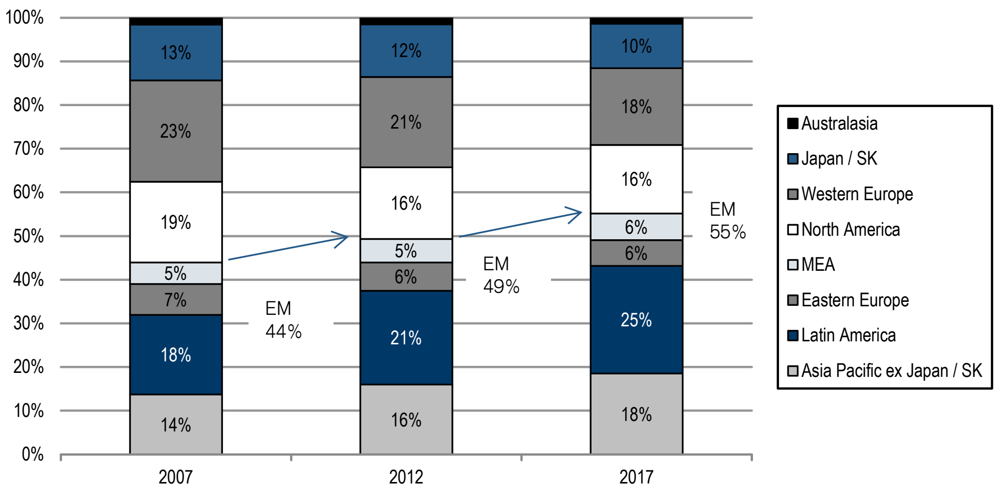
Hair care is a $75 B global category that is currently growing at 2%. The category is expected to accelerate during the next five years, driven by a recovery in developed markets, while emerging markets are expected to continue growing at around 5.0-5.6%. Emerging markets currently represent 49% of the category (up from 44% five years ago). They are expected to become 55% of the category in 2017, with Latin America being a significant driver

Exhibit 27: Hair Care Is a $75 B Global Category that Is Currently Growing at 2%



Source: Euromonitor.

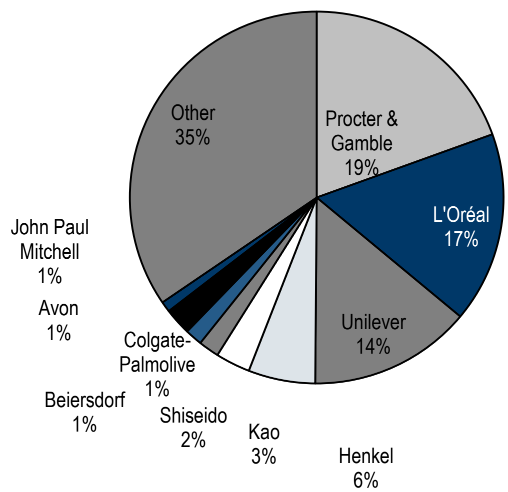
Exhibit 28: Emerging Markets Currently Represent 49% of the Category (up from 44% Five Years Ago); They Are Expected to Become 55% of the Category in 2017



Source: Euromonitor.

PG and L'Oréal are dominant players in the hair care category, with 19% and 17% global shares, respectively. AVP has a 1% global market share.

Exhibit 29: PG and L'Oréal Are Dominant Players in the Hair Care Category, with 19% and 17% Global Shares, Respectively



Source: Euromonitor.

In developed markets, an increasingly ageing population benefits the hair care category. Anti-ageing formulations are already popular in both the premium and mass markets, with even more products likely to hit the market in the coming years.

The introduction of hair powder styling agents appeals to a more mature audience. This products' ability to volumize hair is an attractive prospect to those with thinning hair. In addition, the focus on the roots and the ability to add color is attractive to both men and women that would like to hide greying roots for longer spells between salon colorings. These effects and the cross-gender appeal make hair powders an interest innovation to watch in the coming years.

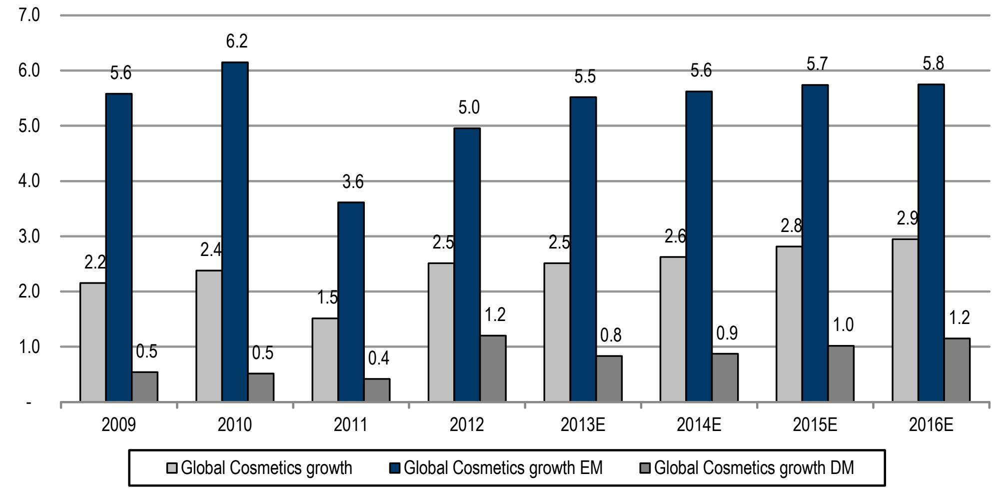
EL launched a line of new colored hair powders in 2012 under the Bumble & Bumble brand. As consumers (both female and male) become more familiar with these sorts of styling products, they should begin to adopt them in greater numbers.

In Brazil, the recent entrance of professional brands such as TRESemmé by Unilever and Wella Series by PG are pushing the focus on image and quality with massive ad campaigns. Conditioners, treatment creams, and post-shampoo products still offer good opportunities to expand in the short term due to current low per capita consumption.

Color Cosmetics

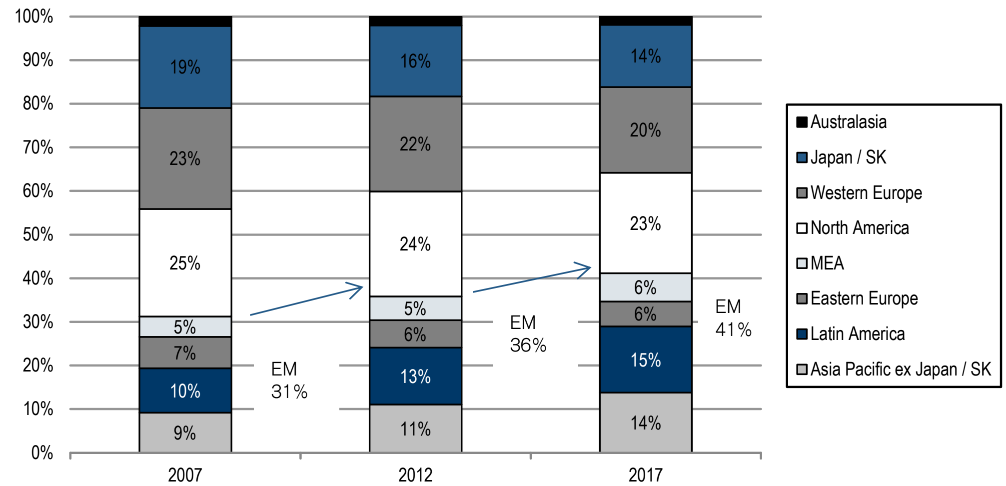
Color cosmetics is a $55 B global category that is currently growing at about 2.5%. Most of the growth is coming from emerging markets, which currently represent 36% of the category (up from 31% five years ago). They are expected to become 41% of the category in 2017. North America, although expected to lose relative importance during the next five years, should remain as the dominant region, representing 23% by 2017.

Exhibit 30: Color Cosmetics Is a $55 B Global Category that Is Currently Growing at about 2.5%



Source: Euromonitor.

Exhibit 31: Emerging Markets Currently Represent 36% of the Category (up from 31% Five Years Ago); They Are Expected to Become 41% in 2017



Source: Euromonitor.

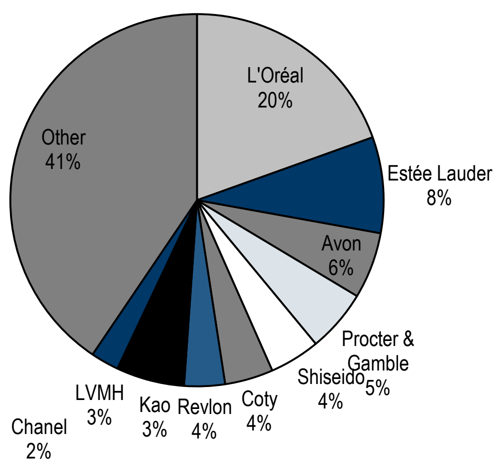
L'Oréal, EL and AVP are dominant players in the color cosmetics category, with 20%, 8% and 6% global shares, respectively.

EL's Clinique brand's relatively low prices for a premium brand and scientific foundations are the base of its success. M•A•C is marketed as a fashion-forward make-up artist brand and has found considerable success with its edgy, alternative positioning, while Bobbi Brown aims for a more sophisticated consumer who prefers a natural, classic look.

COTY's nail brands OPI and Sally Hansen have thrived during the last couple of years. Nail polish has become the new index for the beauty industry in volatile economic times over lipstick, as it offers the feel-good factor at relatively affordable prices. It has also grown on the back of bold innovative nail designs in fashion advertisements, celebrity-focused media channels and fashion shows. This has boosted sales not only in salons but in retail outlets too. Much of North America's color cosmetics growth was owing to nail polish, which grew by a staggering 31% in the U.S. and led to the country overtaking Brazil to become the biggest nail polish market globally. The U.K., Germany, and France were also key engines of growth.

The nail business, which had experienced strong growth rates since 2008, has hit a snag lately. Category growth rates decelerated to flat or slightly down in late 2Q13 and early 3Q14, amplified by retailer destocking. However, it continues to be a very much in-trend category. Fashion bloggers and magazines have been promoting nail art. Nail art offers self-expression and a feel-good factor to those looking to revamp their look at fairly low cost. Advances in nail polish technology played a major part in boosting sales of nail polish. COTY's Sally Hansen nail polish strips, which are nail polish applied to a flexible polymer, continued to do well. Despite its price tag of up to US$9.99 for one package, Sally Hansen nail polish strips found popularity among women who desired the look of striking nail art for up to ten days of wear.

Exhibit 32: **L'Oréal, EL and AVP Are Dominant Players in the Color Cosmetics Category, with 20%, 8% and 6% Global Shares, Respectively**



Source: Euromonitor.

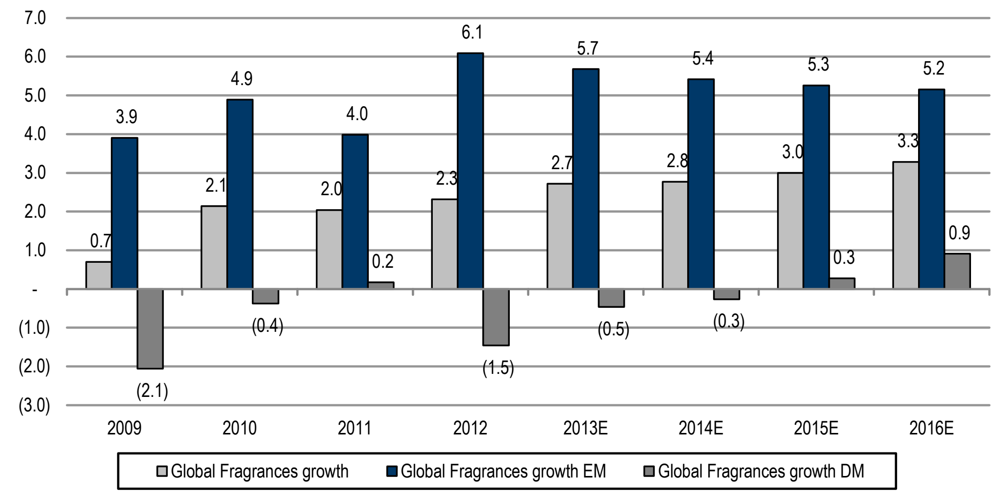
BB creams, also known as beauty balms and blemish balms, have been popular in Japan and South Korea for a number of years. Practically unknown to other markets before 2011, BB creams and the most recent CC creams have become favorite of beauty editors and women, as they claim to offer multifunctional benefits. Although similar to tinted moisturizers, BB cream is promoted as an all-in-one product to replace serum, moisturizer, sun protection, primer, and foundation. Many BB creams also tout skin care properties such as antioxidant protection, brightening, and soothing through ingredients such as vitamins C and E, aloe, chamomile, and soy. BB and CC creams are expected to do well in the short to medium term as consumers are looking for multiple benefits, including coverage and sun protection without a heavy feeling on the face.

Fragrance

Fragrance is a $43 B global category that is currently growing at about 2%. The category is expected to accelerate during the next five years, driven by a recovery in developed markets (expected to recover to about 1% in 2017 up from a 1.5% decline currently), while emerging markets are expected to decelerate slightly to 5%.

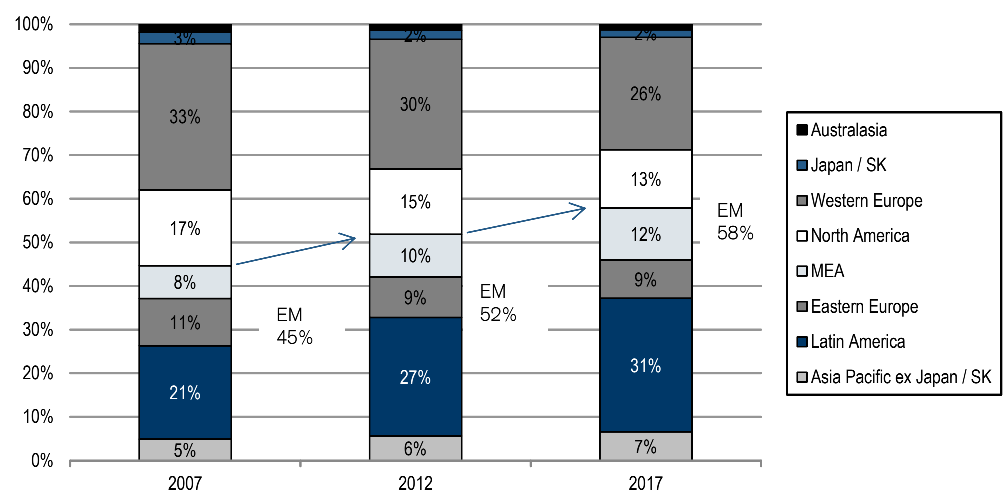
Emerging markets are already dominant in fragrances, representing 52% of the category (up from 45% five years ago). They are expected to become 58% of the category in 2017. Latin America is expected to displace Western Europe as the dominant region, and it is expected to grow from 27% to 31% during the next five years. Brazil alone, which currently represents 15% of the industry, is expected to grow to 18% by 2017.

Exhibit 33: Fragrance Is a $43 B Global Category that Is Currently Growing at About 2%



Source: Euromonitor.

Exhibit 34: Emerging Markets Are Already Dominant in Fragrances, Representing 52% of the Category (up from 45% Five Years Ago); They Are Expected to Become 58% of the Category in 2017

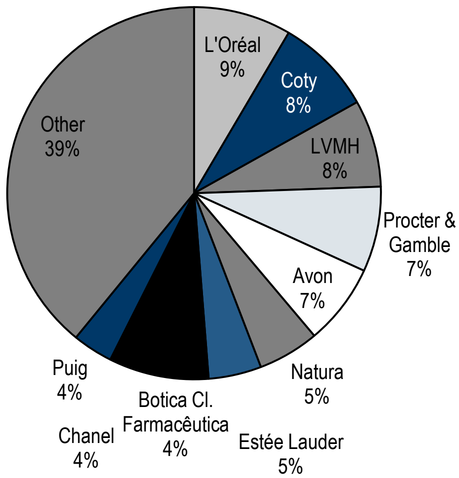


Source: Euromonitor.

L'Oréal and COTY are dominant players in the category, with 9% and 8% global shares, respectively.

COTY is strong in both mass and premium fragrances. In the mass segment, COTY markets a wide range of established strong brands, such as Adidas, Jovan, and Stetson. It also has a significant presence in the premium segment with its Calvin Klein fragrances. The company has been successful with its Marc Jacobs, Vera Wang, and Kenneth Cole fragrances, which are licensed from successful fashion designers. Celebrity fragrances have been a key focus of the company, as it launched fragrances from Jennifer Lopez, Celine Dion, Sarah Jessica Parker, and Tim McGraw. Despite introducing new fragrances such as Beyoncé Midnight Heat and Marc Jacobs Dot, COTY lost share in 2012 due to its underperformance in its mass fragrances division.

Exhibit 35: L'Oréal and COTY Are Dominant Players in the Fragrances Category, with 9% and 8% Global Shares, Respectively



Source: Euromonitor.

Most mass-market fragrances tend to be short lived (one or two seasons before being pulled from the market), as there are too many fragrances competing for too few consumers, in particular many of the new teen-targeted, celebrity-based products, such as Nicki Minaj, Pink Friday, etc. Fragrances aimed at a more sophisticated audience (such as high-end fashion designer fragrances) have a longer shelf life because the designers' couture collections give the fragrance glamour. Overall, however, we think one of the key issues in the fragrance category is a relatively low level of brand loyalty with consumers as a result of too many launches. Very few brands have generated true longer-term brand loyalty, and those that did tend to be the more upscale brands such as Lancôme, Chanel, or some of Estee Lauder's brands.

Potential company activity is likely to involve fewer launches, smaller formats, and the use of eco-friendly ingredients. In response to retailers keeping a tight hold on inventory and the difficulty in creating a successful new product, companies are likely to promote their existing fragrances and launch brand extensions instead of launching new products that may only last a season or two.

Companies are expected to introduce smaller sizes, such as 30 ml (1 fl oz) bottles, to appeal to value-conscious consumers who want to have a wardrobe of fragrances while still being on a budget. Small formats, such as roller balls and solid rings, are also a better match with today's on-the-go lifestyles, so women can refresh their fragrance throughout the day. Frequent travelers also appreciate smaller sizes so they do not have to fill up a portable atomizer.

Greater demand for exclusivity and unconventional fragrances as well as a return to an appreciation of high quality and craftsmanship have driven growth. Alongside this, a number of brands have been exploiting packaging and limited editions as ways to enhance their luxury credentials and exclusivity. Going forward, industry experts expect greater emphasis on the personalization of premium beauty, particularly in the higher-value developed markets of Western Europe, as well as a strategic focus on artisanal and natural products.

Eco-friendly fragrances are likely to remain a niche over the next few years. EL launched its PureDKNY fragrance in July 2010, which was marketed as using vanilla bean sourced from Uganda through a partnership with CARE, an organization devoted to fighting global poverty, especially among women. The company added a Verbena variety in 2011.

Companies Mentioned *(Price as of 15-Nov-2013)*

Avon Products Inc (AVP.N, $17.32, NEUTRAL, TP $19.0)
Beiersdorf (BEIG.DE, €73.93)
Coty Inc (COTY.N, $15.73, NEUTRAL[V], TP $17.0)
Dillard's Inc. (DDS.N, $89.84)
Estee Lauder Companies Inc (EL.N, $73.67, OUTPERFORM, TP $82.0)
JC Penney (JCP.N, $9.03)
Johnson & Johnson (JNJ.N, $94.39)
Kohl's Corporation (KSS.N, $53.95)
L'Occitane International S.A. (0973.HK, HK$17.1)
L'Oreal (OREP.PA, €125.35)
LVMH (LVMH.PA, €140.35)
Macy's Inc. (M.N, $51.09)
Natura Cosméticos S.A. (NATU3.SA, R$42.5)
Nordstrom (JWN.N, $62.8)
Procter & Gamble Co. (PG.N, $84.84)
Revlon (REV.N, $24.56)
Saks Incorporated (SKS.N, $15.99)
Shiseido (4911.T, ¥1,767)
The Bon-Ton Stores, Inc. (BONT.OQ, $13.29)
Ulta Salon, Cosmetics & Fragrance, Inc. (ULTA.OQ, $131.46)
Unilever PLC (UL.N, $39.98)

Disclosure Appendix

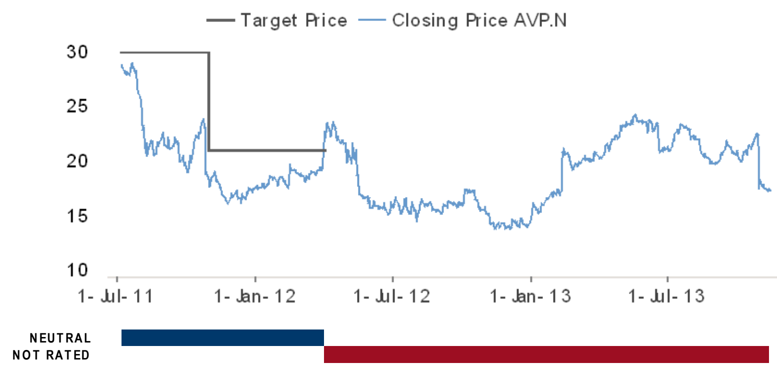
Important Global Disclosures

I, Michael Steib, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

3-Year Price and Rating History for Avon Products Inc (AVP.N)

AVP.N Date	Closing Price (US$)	Target Price (US$)	Rating
07-Jul-11	28.74	30.00	N
31-Oct-11	18.28	21.00	
02-Apr-12	22.70		NR

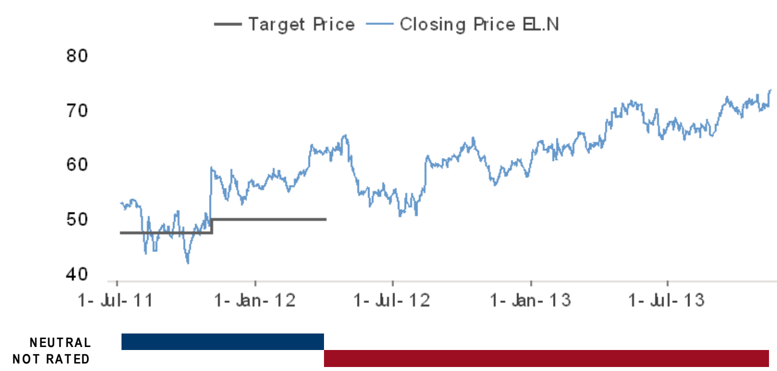
** Asterisk signifies initiation or assumption of coverage.*



3-Year Price and Rating History for Estee Lauder Companies Inc (EL.N)

EL.N Date	Closing Price (US$)	Target Price (US$)	Rating
07-Jul-11	52.90	47.50	N
04-Nov-11	58.97	50.00	
02-Apr-12	62.39		NR

** Asterisk signifies initiation or assumption of coverage.*



The analyst(s) responsible for preparing this research report received Compensation that is based upon various factors including Credit Suisse's total revenues, a portion of which are generated by Credit Suisse's investment banking activities

As of December 10, 2012 Analysts' stock rating are defined as follows:

Outperform (O) : The stock's total return is expected to outperform the relevant benchmark*over the next 12 months.

Neutral (N) : The stock's total return is expected to be in line with the relevant benchmark* over the next 12 months.

Underperform (U) : The stock's total return is expected to underperform the relevant benchmark* over the next 12 months.

**Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; Australia, New Zealand are, and prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, 12-month rolling yield is incorporated in the absolute total return calculation and a 15% and a 7.5% threshold replace the 10-15% level in the Outperform and Underperform stock rating definitions, respectively. The 15% and 7.5% thresholds replace the +10-15% and -10-15% levels in the Neutral stock rating definition, respectively. Prior to 10th December 2012, Japanese ratings were based on a stock's total return relative to the average total return of the relevant country or regional benchmark.*

Restricted (R) : In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.

Volatility Indicator [V] : A stock is defined as volatile if the stock price has moved up or down by 20% or more in a month in at least 8 of the past 24 months or the analyst expects significant volatility going forward.

Analysts' sector weightings are distinct from analysts' stock ratings and are based on the analyst's expectations for the fundamentals and/or valuation of the sector* relative to the group's historic fundamentals and/or valuation:

Overweight : The analyst's expectation for the sector's fundamentals and/or valuation is favorable over the next 12 months.

Market Weight : The analyst's expectation for the sector's fundamentals and/or valuation is neutral over the next 12 months.

Underweight : The analyst's expectation for the sector's fundamentals and/or valuation is cautious over the next 12 months.

**An analyst's coverage sector consists of all companies covered by the analyst within the relevant sector. An analyst may cover multiple sectors.*

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Global Ratings Distribution

Rating	Versus universe (%)	Of which banking clients (%)
Outperform/Buy*	42%	(55% banking clients)
Neutral/Hold*	41%	(49% banking clients)
Underperform/Sell*	15%	(41% banking clients)
Restricted	3%	

**For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.*

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Price Target: (12 months) for Avon Products Inc (AVP.N)

Method: Our $19 target price is based on a DCF model which assumes an average three year EBIT growth rate of 14%, mid-term FCF growth of 8%, a perpetual growth rate of 2% and WACC of 9% with an impact to valuation from the ongoing FCPA investigations. This methodology is consistent with a forward PE multiple one year from now of 16.0X, essentially in line with AVP's current FY14 multiple.

Risk: Risks to our $19 target price include a settlement of ongoing FCPA investigations that materially impacts the business, failure to improve field health in North America, the unproven China retail business model and currency risk from AVP's large international exposure.

Price Target: (12 months) for Coty Inc (COTY.N)

Method: Our $17 COTY target pice is based on a DCF model which assumes a three year EBIT growth of 3%, mid-term FCF growth of 4%, a perpetual growth rate of 2% and WACC of 8%. This methodology is consistent with a forward PE multiple one year from now of 18.5X our estimates, in line with diversified CPG and smaller beauty companies.

Risk: Risks to our $17 COTY target price include significant margin expansion of the Skin & Body Care segment which could increase group gross margins by 1ppt or attractively valued acquistions that significantly change the make-up of COTY's portfolio or geographic exposure.

Price Target: (12 months) for Estee Lauder Companies Inc (EL.N)

Method: Our $82 target price is based on a DCF model which assumes a three year EBIT growth rate of 9.5%, mid-term FCF growth of 7.5%, a perpetual growht rate of 3% and a WACC of 7.8%. This methodology is consistent with a forward PE multiple one year from now of 25X, in line with prestige beauty peers.

Risk: Risks to our $82 target price are failure to achieve organic sales growth target, further deceleration in growht of U.S. department stores, travel retail vulnerability to global and regional economic swings and terrorism, failure to achieve expected margin expansion and currency exposure.

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See the Companies Mentioned section for full company names

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