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Cosmetics: Inside the Beauty of the Brazilian Market

Strong historical growth and high market concentration in few companies proportionate to the middle and small competitors opportunities in differentiation and niche strategies, as well contribute to the consolidation of the sector by Merges and Acquisition activities (M&A).

By

Vinicius Biagi Basílio

The Cosmetics, Fragrances & Toiletries Sector is increasingly consolidating itself as one of the Brazilian economy's most important sectors. Its role is essential not only from an economic and financial perspective, but also from a social and sustainability viewpoint, due to the number of workers that compose the upstream, middle stream and downstream markets, as well as due to the strong contribution toward

investment in sustainable initiatives.

Driven by rising per capita income, economically active population growth, increase of women joining the labor force and the evolution of the C consumer class, the sector had net sales of R\$ 34 billion in 2012, and has maintained double-digit growth for a decade, highlighted by a very high performance vis-à-vis Brazilian GDP growth.

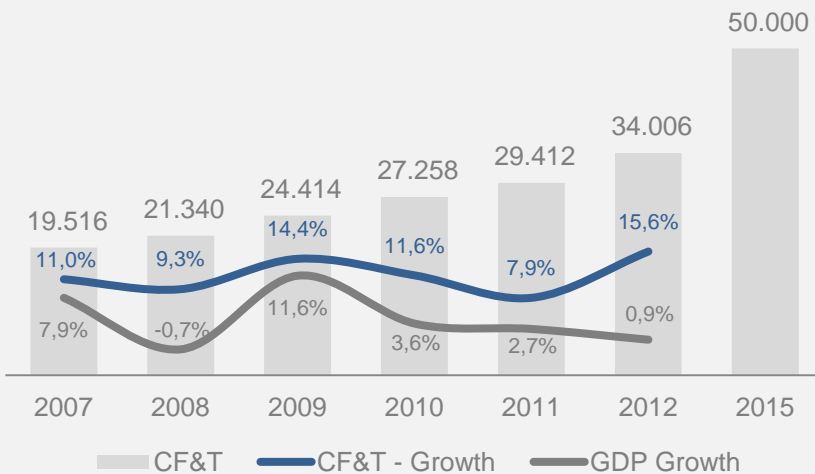
The use of cutting edge technology helps to increase productivity and changes in prices in the industry (which grew less than inflation in recent years), as well as the volume of new product launches, adapting to market needs and the life expectancy of the population. These characteristics insert Brazil in the global context as the 3rd largest CF&T market,

benefiting major companies in the international context.

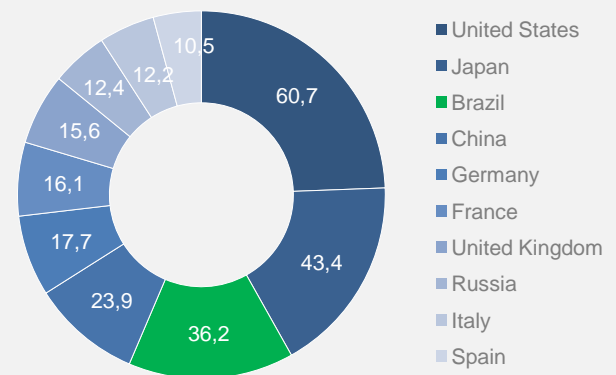
Optimistic expectations about the future of the sector and active history of mergers and acquisitions reveal a panorama of transactions involving consolidation of the sector in the short and medium term.

Overview of the CF&T Sector

Net Revenue Evolution



World Overview



General Overview

In 2012, the CF&T sector achieved sales of R\$ 34 billion Reais, 15.6% growth compared to 2011, exceeding the historical average of 13% over the last 15 years. In volume, the sector reached 1776 tons in 2011, an increase of 4.3% over 2010.

Brazil ranks third in the world, according to 2012 data, with sales of USD 42 billion

(consumer prices), behind only of U.S. and Japan, with lower growth in the CF&T sector.

Regarding jobs generation, the sector has significant contribution. In 2012, 4.94 million jobs were created.



Price fluctuations below inflation registered in the country, pursuant to the Amplified Consumer Price Index (IPCA), reflects strong growth in terms of volume and value-added products. From 2007 to 2011, the Brazilian general price index accrued a 35.6% increase, while in the same period, the price index for CF&T products determined by Fipe (Fundação Instituto de Pesquisa Econômica da Universidade de São Paulo) was 17.5%;14.3% for beauty products versus 29.4% in the General Consumer Price Index.

The relevant performance is a result of large investments in innovation and products technology, along with the modernization of production processes as reflected in increased productivity. In 2012, CF&T invested R\$ 13.6 billion in Brand, R&D and Assets, equal to 40% of industry revenue. R&D alone accounted for 1.8%, while Brand obtained the largest investment.

Regarding sustainable development, there are various investments in environmental policies. Millions of Reais are invested in natural resource management, nature conservation and in research and development of environmentally friendly products and processes, such as the use of "green plastic" in the packaging or development of supplier partner communities of natural ingredients and assets.

Competitiveness

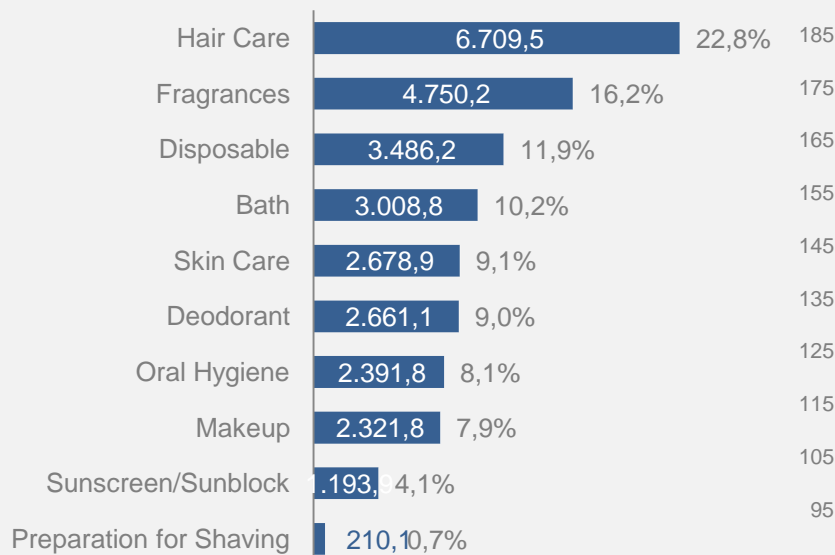
Currently, the industry is composed of approximately 2,423 companies, an increase of 70% over 2004, with particular note to the concentration in the Southeast region, with approximately 1,492 companies. Among them, only 20 companies dominate 73% of the market, with revenues over R\$ 100 million.

An important characteristic of the industry is the intensive capital necessity, with high investments in brand, R&D and fixed assets. Maintaining competitiveness depends on massive cash flow, access to capital and distribution capabilities and sale points, so that competitiveness in small industries is restricted to niche performances.

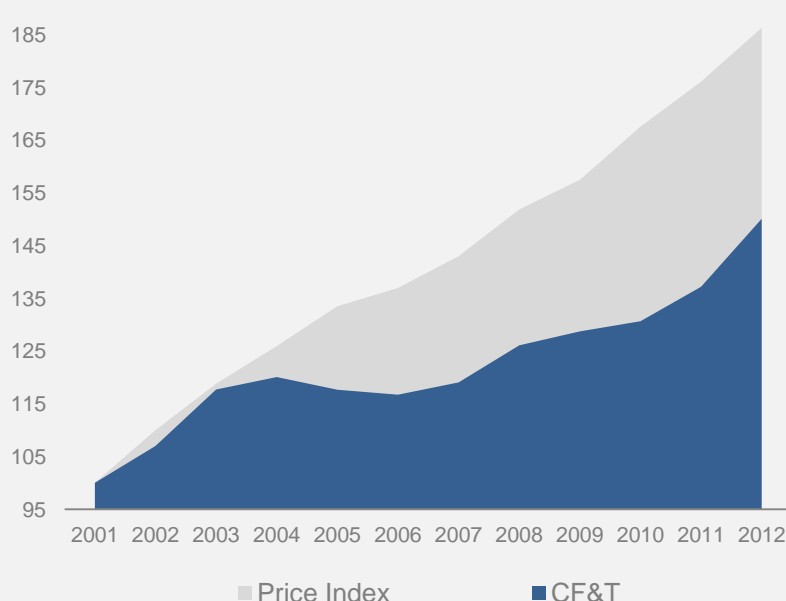
In this environment, growth alternatives for small and medium companies are restricted to product innovation and brand differentiation or development of partnerships, joint ventures and mergers and/or acquisitions of smaller competitors.

Moreover, the presence of a few large companies becomes conducive to industry consolidation. In an environment where few Brazilian companies occupy a prominent position, like Natura and Boticário, there are numerous opportunities for mergers and acquisitions, aimed at expanding the musculature of some medium sized Brazilian players for increase of competitiveness, or the search for access to niche markets.

Revenue Breakdown - 2011



Sector Inflation Evolution



Trends

Despite the uncertainties in the international market, Brazil has favorable macroeconomic fundamentals for growth and the outlook for the retail sector is positive and will continue on an upward trend, fueled by the increase in the minimum wage and low unemployment.

It is worth remembering that Brazil is undergoing a change in its social structure. The rise of classes C and D expands the consumer market and, coupled with the desire from repressed consumption and the willingness of the new middle class to use their funds for different and more diversified goods, this is an important pillar for the advancement of aggregate demand.

Thus, the socio-demographic structure, combined with the increase in per capita income and the growing public interest in the health and beauty habits, in addition

to a climate that favors hygiene and good looks and a rich source of active ingredients and natural resources, have directed investments of cosmetics companies.

Changes in the pattern of consumption of the general public as well as the products that companies offer to their consumers and their marketing strategies converge toward different trends, which themselves are important, and, together, are characterized as essential changes in the sector.

More recently, companies in the CF&T sector have to deal with audiences of different ages, different preferences and interests in products that perform specific functions - due to increased life expectancy and differentiated physical characteristics - offering them specific products, such as shampoos that cater to different types of hair through unique formulations and packaging,



creams for dry or too oily skin, and many other products. An example is the stores that are intended for different audiences such as those from Grupo Boticário, "Quem disse Berenice" and "The Beauty Box".

In terms of business strategies, there is a growing trend toward the incorporation of new active ingredients, for example, anti-aging, and moisturizing active ingredients aimed at increasing elasticity and firmness of the skin. In addition to the development of new proteins, amino acids and amino acid chains with more specific functions, the form of application has received increased investments. More recently, the development of the applications of nanotechnology to cosmetics is gaining momentum as one of the priority areas in R&D labs of large companies in the sector and its contracts with universities and research institutions. In addition to the dermocosmetics, nanotechnology is also being used in hair preparations.

Another important trend, already quite consolidated, is the growing concern of companies developing products that use natural and organic ingredients, stimulated by environmental and ecological concerns of consumers, resulting in increased use of raw materials with ingredients that give increased functionality to products such as natural fragrances.

In general, companies seeking to differentiate themselves through the appeal of organic products highlight the

increased use of natural extracts from flowers, seeds and fruits and less use of synthetic ingredients that can harm the skin, such as dyes and preservatives. Furthermore, there is concern about environmental responsibility, which implies the use of recyclable or biodegradable packaging, the commitment not to test on animals or use fruit species or endangered flowers, and also the environmental sustainability of production of natural inputs.

However, the growth of plant extracts experience a slower pace of growth in the face of competition offered by synthetic materials - petroleum products - that have lower prices and greater availability.

It is also possible to highlight the rise both of many small companies operating in niche market as well as more prominent companies that have managed to link their image to natural products and celebrities, such as Weleda, L'Occitane, Jequití and the Natura market.

Among large companies, we can point the strategy of M&A, for example, the Sannoflora, specializing in organic cosmetics, by L'Oreal, as well as other several transactions involving strategic investors and private equity funds. GP Investments acquired a stake in the company Beleza Natural in July 2013, Hypermarcas acquired Bitufo in November 2010 and more recently, the Australian company Emeis was purchased by Natura seeking international expansion in the premium market.



Another recent example was the sale of 51% of the shares of Empório Body Store from the Brazilian state of Rio Grande do Sul, to the French company L'Oréal, a case where the first sought the capital necessary to compete and sustain its growth and the second sought a distribution network for its products.

Also noteworthy is the launch of "nutricosmetics", as are known oral ingestion products (food, beverages or tablets) with ingredients that promise to promote the health and beauty of the body, skin and hair. Many companies in the food industry, such as Danone, have been seeking to develop functional foods, recently beginning to highlight the effects of their products on beauty. In the Asian market, Nissin Foods recently launched enriched noodles with collagen. However, perhaps the most important initiative is the positioning of L'Oreal, which has developed a line of nutricosmetics in partnership with Nestle. The products developed have active ingredients that are absorbed by the body and promote antioxidant action.

Another example is L'Oreal's partnership with Coca-Cola for the development of tea-based beverages with skin beauty promotion properties.

In this sense, though positioned as product of high value added, is the Beauty'In brand created by entrepreneur Cristiana Arcangeli, designated "aliméticos", consisting of foods with cosmetic properties.

Additionally, studies conducted by ABIHPEC estimate some macro trends that will guide the sector in coming years, the main ones being:

(a) Digital relationship: the use of social networks and viral marketing will become increasingly relevant to the purchase decision, as well as advertising strategies;

(b) Personalized customer loyalty: access to information and database with consumer behavior information allows companies to direct their marketing strategies to specific niches;

(c) Smartphone: the use of mobile phones in the purchase decision upon comparing prices and to receive advertising and as a tool for purchasing goods is a very strong tool in countries like the United States and Japan. As mobile phone usage spreads in Brazil, this trend can also take on great strength in the country;

(d) Sensory Experiences: access to information and rapid communication becomes much more demanding. It not only seeks the acquisition of goods, but also distinctive experiences at the time of purchase. The creation of concept stores reflects this trend;

(e) The consumer market for cosmetics by the male audience is quite important in other countries. In Brazil, as the prejudice decreases, more men are becoming concerned with their appearance.

In numerical terms, studies by ABIHPEC together with the consulting firm Booz&Co estimate that the sector should reach R\$ 50 billion in net sales by 2015, an increase of 47% compared to 2012 and US\$ 50 billion in consumption (consumer prices). Also according to the study, business investment shall reach R\$ 20 billion in the same period.

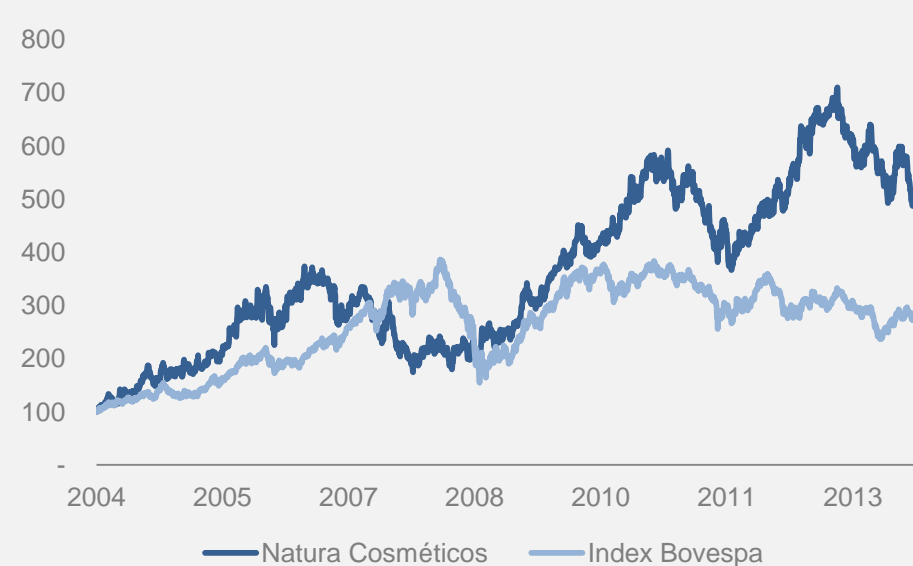
In the stock market, the company Natura Cosméticos S.A. is an example of optimistic expectations of investors in the sector.

International companies also see high value in the Brazilian market. One of the largest retailers in the world of cosmetics, Sephora, of the LVMH group, estimated that it would open 40 stores by 2018.

These trends and the expectations of investors point to an environment for investments in several fields, not only in traditional chemistry, but also in the field of pharmaceuticals, biotechnology and nanotechnology.

Small and medium enterprises that can scope a position within these market changes will find an opportunity for development in niche markets, and with a solid strategic direction, will be able to assume a prominent position in the industry and participate in consolidation processes, while those who are already consolidated in the market will be able to further develop their competencies, and accelerate their growth through mergers and acquisitions to obtain innovative technologies and access to market niches, especially in Brazil, a country that still has many opportunities available in the sector.

Natura's Shares Evolution Since IPO



Since the company went public in 2004, with shares listed at R\$ 8.00, the company appreciated 423%, reaching R\$ 41.80 on February 12, 2013, with a peak in January 04, 2013, when the shares reached R\$ 59.89.

Source: ABIHPEC, Sebrae, Booz&Co., BMF&Bovespa, ABDI.