Beauty, Cosmetics & Fragrance Stores in the US
Consumer Discretionary/Consumer Staples

Investment Thesis

We recommend that investors **overweight** the U.S. beauty, cosmetics, and fragrance store industry in 2022. Many beauty retailers are recovering from the pandemic-induced drop in demand but have not returned to pre-pandemic revenue levels. However, we see steady revenue growth and exceeded earnings expectations among the major beauty companies as a positive trend that the recovery will persist. Beauty industry revenue is expected to grow at least 1.5% to 5% annually for the next five years, passing pre-pandemic levels within the next two years.

Drivers of Thesis

- Beauty retailers are investing in their e-commerce experience for customers. The COVID pandemic forced retailers to shift their capital to improving their websites and social media presence. With e-commerce revenue growth reaching 30.8% in 2021, we expect the e-commerce sales to drive revenue growth.
- Anti-aging products and nonprescription treatments represent underserved product segments promising high growth. We expect the anti-aging product revenues to grow at a CAGR of 7% from 2021 to 2026. We expect various nonprescription and skincare products to grow at a CAGR of 6.6% over the next five years.
- Americans are returning to the workforce and public places as the COVID pandemic subsides, driving revenue of beauty products with a CAGR of 5%. Even in the high inflationary environment, cheaper beauty products behave like consumer staples because skincare and overall hygiene awareness has been adopted in more lifestyles since 2020.

Risks to Thesis

- Research surrounding the environmental impact of products and exposing chemical-ridden formulas will pressure beauty retailers to invest capital in ESG. If beauty retailers are unable to comply with ESG concerns, they will lose customers to more socially and environmentally conscious brands.
- Amazon’s transition to brick-and-mortar stores beginning with grocery and clothing stores poses a threat to beauty retailers. The main competitive advantage retailers have over Amazon is their in-person store experience for customers. Retailers must continue to invest capital toward diversifying their customer experience to prevent customer churn.

### Key Industry Statistics

<table>
<thead>
<tr>
<th>Description</th>
<th>Source: FactSet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$26.8B</td>
</tr>
<tr>
<td>Annual Growth 2016-21</td>
<td>1.5%</td>
</tr>
<tr>
<td>Annual Growth 2021-26</td>
<td>0.8%</td>
</tr>
<tr>
<td>Profit</td>
<td>$2.9B</td>
</tr>
<tr>
<td># of Businesses</td>
<td>104K</td>
</tr>
<tr>
<td>Annual Growth 2016-21</td>
<td>1.2%</td>
</tr>
<tr>
<td>Annual Growth 2021-26</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

### Key Company Statistics

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Cap ($B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ULTA</td>
<td>21.7</td>
</tr>
<tr>
<td>BBWI</td>
<td>12.4</td>
</tr>
<tr>
<td>COTY</td>
<td>7.2</td>
</tr>
<tr>
<td>SBH</td>
<td>1.8</td>
</tr>
<tr>
<td>ELF</td>
<td>1.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EPS (NTM)</th>
<th>($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ULTA</td>
<td>18.5</td>
</tr>
<tr>
<td>BBWI</td>
<td>4.7</td>
</tr>
<tr>
<td>COTY</td>
<td>0.3</td>
</tr>
<tr>
<td>SBH</td>
<td>2.6</td>
</tr>
<tr>
<td>ELF</td>
<td>0.8</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>EBITDA 5Yr CAGR (%)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ULTA</td>
<td>11.4</td>
</tr>
<tr>
<td>BBWI</td>
<td>-1.5</td>
</tr>
<tr>
<td>COTY</td>
<td>2.0</td>
</tr>
<tr>
<td>SBH</td>
<td>-3.1</td>
</tr>
</tbody>
</table>

### 12 Month Performance

![Graph showing 12 Month Performance](Source: Yahoo Finance)

### Industry Description

The beauty industry in the U.S. encompasses retailers of cosmetics, fragrances, and miscellaneous personal care products sold through company-owned, franchised, e-commerce, and partnerships (department stores). Beauty retailers offer a variety of brands at various price-points, making the industry accessible to anyone with a desire for appearance-enhancing products. Because of these price distinctions, beauty products can be classified as both consumer staples and discretionary goods.

Important disclosures appear on the last page of this report.
EXECUTIVE SUMMARY

We recommend that investors take an OVERWEIGHT position in the beauty, cosmetics, and fragrance industry of the U.S. for 2022. In the final quarter of 2021, we saw reported revenues above expectations for most of the industry leaders. Although revenues are not at pre-pandemic levels, the steady growth of recovery exemplifies a sustainable upward trend within the industry that we expect to continue for five years.

We recognize that not all beauty retailers in the industry will be a positive investment. Luxury beauty retailers will not capture the positive trends and are the main suppressor of our overall estimates. We see evidence in their price to earnings multiples that suggests they cannot sustain their earnings and will not see future growth to justify investors' overpayment for their stock. We propose that the beauty retailers with products at various price-points and enough market influence to afford to acquire new beauty brands will be the most successful investments.

INDUSTRY DESCRIPTION

The beauty, cosmetics, and fragrance industry in the U.S. contains stores that retail cosmetics, perfumes, and personal care products, such as body creams and appearance-enhancing products. The target market of the industry is men and women aged 20-64. The male consumer segment is relatively new for the beauty industry and their products continue to be developed and adapted as more market research is conducted. Because male consumers within the cosmetics market represent a recently added consumer demographic, this report will not discuss expectations for that unknown segment. However, men have been consumers in the personal care segment for items such as face wash and shaving cream for much longer. Many of the beauty retailers operate on a global level, but we are focused on their U.S. operations. It is important to distinguish between their global operations because beauty standards and practices vary by culture. The U.S. is the world’s leading beauty market, capturing 20% of the industry’s total market share.

Beauty retailers operate through both company-owned stores and franchises. We will focus on the development of “mini stores” rather than franchises because we see the industry moving toward these retail spaces instead giving the shift in consumer shopping habits. We also discuss the e-commerce sales and overall internet presence of beauty companies, which is becoming the new standard to keep up with Amazon’s growing share of the market. Beauty retailers carry a wide variety of brands, some of which include their own brands, like ULTA Beauty Collection or Sephora Collection.

We identify product adaptability, consumer’s access to educational information, retail partnerships, and technological investment to be the main indicators of a company’s continued success in the beauty industry. We advise investors to move away from global companies that have spread their portfolio too thin and are unable to adapt to new trends quickly. Coty Beauty represents a portfolio of over 40 brands, primarily luxury beauty brands. We believe their portfolio is spread too thin, leaving them unable to recognize and implement new trends before its competitors. Instead, investing in beauty companies with a strong U.S. presence and ability to acquire smaller brands fulfilling a niche consumer need to be the better investment.

Major Players

<table>
<thead>
<tr>
<th>TCKR</th>
<th>2022 Revenue ($M)</th>
<th>Market Capitalization ($M)</th>
<th># of Stores 2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>ULTA</td>
<td>8630.89</td>
<td>21749.83</td>
<td>1308</td>
</tr>
<tr>
<td>BBWI</td>
<td>7882.00</td>
<td>12446.79</td>
<td>1755</td>
</tr>
<tr>
<td>SBH</td>
<td>3952.60</td>
<td>1753.50</td>
<td>4893</td>
</tr>
<tr>
<td>COTY</td>
<td>5284.20</td>
<td>7179.94</td>
<td>-</td>
</tr>
<tr>
<td>ELF</td>
<td>378.20</td>
<td>1334.29</td>
<td>-</td>
</tr>
<tr>
<td>EL</td>
<td>16215.00</td>
<td>94641.33</td>
<td>1600</td>
</tr>
</tbody>
</table>

Source: FactSet

The table above shows the fiscal year 2022 revenues, market capitalizations, and number of stores of the top six beauty companies in the U.S.: ULTA Beauty (ULTA), Bath and Body Works Inc. (BBWI), Sally Beauty Holdings (SBH), Coty (COTY), e.l.f. Cosmetics (ELF), and Estee Lauder (EL). This report focuses on publicly traded beauty companies based in the U.S., which is why large companies like Sephora and L’Oreal are not included.

The table reveals that EL achieved the highest revenues for 2022, with nearly double the sales of the next highest company, ULTA. EL also has the largest market capitalization but does not operate the most stores. EL products are sold through many different channels other than their 1,600 stand-alone stores. Department stores and beauty stores such as ULTA and Sephora distribute EL products, which gives EL more market presence than most of the other brands.
Neither ELF nor COTY sell their products through brick-and-mortar storefronts. ELF closed its 22 stand-alone stores in 2018 and has not released plans to reopen. ELF distributes its products through beauty stores like ULTA and convenience stores like Target and Walgreens. COTY manages a portfolio of cosmetic and luxury brands. CoverGirl, Rimmel, and Sally Hansen represent a few of COTY’s mass beauty brands. COTY primarily operates the fragrance and cosmetics segments of prestige or luxury brands such as Burberry, Gucci, Kylie Jenner, Marc Jacobs, and Tiffany & Co. Because of their wide market reach, their brands’ store counts would not be comparable to the other beauty companies analyzed. A few of these companies will be further discussed in the “Peer Comparisons” section of this report.

Product Segmentation

All companies within the beauty industry provide a wide variety of products with slight variations to meet the different skin, hair, body, and nail types of their customers. The chart below shows the average product segment weights across beauty stores based on the total sales in each product segment. The pie chart shows that cosmetics currently account for over half of the stores’ revenues. Cosmetics’ share of the market shrunk during the pandemic lockdown, but we saw strong recovery in the cosmetics revenues of 2021 as Americans returned to their offices and public spaces.

While the other three product categories have grown in share in the past several years, hair products have remained stagnant in their position. We see an opportunity for growth in textured hair products to grow the haircare segment’s share in 2022. Approximately 65% of the world’s population has textured hair and the number of products for that category has not taken advantage of that consumer need. Textured hair products represent 80% of the sales growth in the haircare segment as of 2020. As companies recognize the underserved textured hair segment, the haircare category could be driven to over 16% of the product share distribution in 2022. We recognize SBH to be best positioned to capture the growth in the textured hair care. SBH earned over 55% of its revenue from their hair care and color product lines in 2021. SBH also launched several DIY training seminars specifically for textured hair in 2022. Given their overweight haircare segment and employees’ expertise, SBH is the best positioned among its competitors to recognize growth in the haircare sector.

Anti-aging products are a type of skincare that requires extensive research and development, but the release of new products drives growth in the skincare segment. By providing anti-aging options, beauty companies can sell to consumers on the top end of their 20–64-year-old target range. The foundation of the anti-aging segment has been around since the 1990s, but millennial women are aging and will continue to create growth in the segment. From 2013 through 2019, the anti-aging market grew at a CAGR of 7.8%. The graph below shows the expected anti-aging sales using a CAGR of 7% between 2021 and 2026, which will push the percentage of skincare segment share without becoming oversaturated in the short-term.

Source: IBIS World

Source: Statista
Industry Revenue Growth

A wider customer base has driven revenue growth from 2017-2021 for the beauty industry. Specifically, aging millennials and male-specific beauty and skincare products have increased overall revenue. The growth rate of beauty industry revenue in the past five years has increased 1.5% annually, totaling $26.8 billion by 2021. The graph below shows the constant increase in revenue year-over-year (ignoring the COVID-19 dip). We expect the recovery in 2021 to be followed by at least 1.5% growth annually in the following five years. These growth expectations are conservative compared to the revenue growth from 2013 through 2019, which was averaging 5% annually1.

Disposable Income Trends

Beauty products represent both a consumer staple and consumer discretionary product, depending on the product type, price point, and customer’s purpose for purchasing the good. Cosmetics, fragrances, and other personal care products that consumers use daily are classified as consumer staples. The luxury product lines such as Gucci, Marc Jacobs, and Burberry fragrances and cosmetics operate in the consumer discretionary sector. Given these distinctions, in times of economic hardship, consumers will substitute their luxury personal care items for cheaper alternatives. For example, a consumer might switch from their $70 Gucci foundation to a $36 Mac or $10 Covergirl foundation when they have less disposable income available.

U.S. per capita disposable income is a measure of the amount of money earned per person in the U.S. It is often used as a proxy for the standard of living in a region. Per capita disposable income is a major driver behind consumers’ ability to purchase beauty products. Within the past several years, wages have increased through a shift in power from employers to workers. However, the wage gains are not equal across all careers in the U.S. Per capita disposable income grew 1.8% in 2019 but declined in 2020 with the economic downturn of the COVID pandemic. The stimulus payments of 2021 resulted in a 5.7% increase in the disposable income of Americans. We recognize that was not an increase that will be sustained in 2022.

The upward inflationary pressures and immanent tightening of the Fed’s monetary policy are indicators of a reversal of disposable income in 2022. In the following five years, economic recovery will drive annualized disposable income growth upwards of 3%. These expectations support the thesis involving lower revenues in the beauty industry in 2022 followed by growth in the subsequent five years. The graph below shows predictions for the disposable income growth in the U.S., including the 2022 dip and subsequent recovery1.

Higher per capita disposable income growth in the U.S. will allow consumers to splurge on luxury personal care items. Therefore, in periods of high disposable income growth, we expect luxury or high-end beauty companies to realize higher sales volumes than the companies with lower
priced products. Given our disposable income growth assumptions, we expect companies with low- to mid-priced goods to perform the best through 2028. However, the expected 3% disposable income growth rate is not negligible. Because of this positive growth, luxury goods could perform well individually, but will not realize the strong growth rates experienced by the beauty companies operating in the consumer staples sector.

ESG Analysis

The environmental, social, and governance (ESG) movement has become an important factor for both investors and consumers to consider when choosing companies. Eco-friendly beauty products provide opportunities for sales growth as consumers grow more aware of their environmental impact. Waste-free packaging and cruelty-free products are seeing increased demand from consumers. Changes in suppliers and supply costs will eat into profits, but we expect the growth in the new segment category to outweigh the higher costs.

The chart below shows the growth of the market value of natural beauty products from 2018 to 2021. The expected market values from 2022 to 2027 are calculated using a CAGR of approximately 5.2%, which was the average annually from 2018 through 2021².

![Market Value for Natural Beauty Worldwide](image)

New research has brought attention to the harmful effects of chemical-laden makeup. A 2016 study from UC Berkeley found a drop in a person’s hormone-disrupting chemicals when certain makeup products’ usage was stopped. As more conclusions are made public, consumers will gain incentive to pay more for natural products. The U.S. FDA does not currently control the label “organic” on products. If regulations change, makeup suppliers will face higher costs to maintain their natural status. The growth of the market value of this natural segment will draw attention to this lack of regulation, posing a risk for beauty producers within the next ten years¹.

Eye-opening statistics surrounding the environmental impact of beauty products have been released and changed consumers’ priorities. Zero Waste Europe estimated 120 billion units of beauty product packaging are created annually, and merely 9% of the waste is recycled. L’Oreal, Henkel, LVMH, Unilever, and Natura & Co began working together in September of 2021 to develop a standardized environmental impact scoring system for beauty products. This system is still in the development stages, so it will not be accepted within the beauty industry quickly. Over 50% of beauty consumers consider sustainability a key factor when shopping, but the unregulated and confusing company jargon makes the industry difficult to navigate¹⁵.

These industry-leading companies are creating a pact to mimic the sustainability scoring present in the fashion and jewelry industry. If scores are given to beauty brands, they will feel pressure to improve their score and keep a competitive advantage. We expect the companies to work to improve their environmental impact if they are given a score purely to keep consumers by avoiding negative publicity. Many brands have committed to planet-friendly packaging by 2025 and are working toward sustainability long-term. We do not expect this to be a short-term change in the industry, but we expect the conversation to continue in company reports and small shifts in packaging and ingredients to aggregate overtime.

Competitors’ ESG Scores

Comparing ESG scores of the industry’s top competitors provides an overview of which companies are best positioned in the industry and which companies are exposed to significant risk. Sustainalytics, a Morningstar Company, is an ESG rating company that provides data on the ESG-driven risks and opportunities. We will use the data from Sustainalytics to compare the main companies and establish a lower and upper bound for the beauty industry’s ESG scores.
The table above displays the ESG risk scores for the top six competitors discussed previously. The companies are scored from 0 to 100 based on their risk, with a lower score being desired because it means the company has lower risk. The score ranges are categorized as negligible (0-10), low (10-20), medium (20-30), high (30-40), and severe (40+). Using these metrics, ULTA, BBWI, and SBH all have low risks and COTY has high risk. We hypothesize that COTY’s high score is caused by the wide range of brands COTY operates, each with their own specific risks. ULTA, BBWI, and SBH have low risk profiles because they operate on smaller scales than the other companies that tend to do more global business. These smaller beauty companies have greater control over their environmental impact and can operate with higher transparency without hassle.

### RECENT DEVELOPMENTS

#### COVID-19 Impact

The reopening and expansion of many in-person beauty stores will continue to persist throughout 2022 as pandemic mandates ease. Many retailers have chosen to permanently close unprofitable stores and allocate their capital to their online presence. We expect the demand for beauty products to continue to increase as people return to the office and their normal cosmetic and hairstyling practices resume. The chart below shows the change in various cosmetic product users caused by the pandemic. Because cosmetics account for over 50% of beauty retailer products, we thought it was beneficial to quantify their usage change. The beauty industry was significantly affected by the lifestyle changes brought during COVID, and the beauty industry will have to work to recapture its previous percentage of total consumers again.

![Market Share of Users Chart](image)

**Source: Sustainalytics**

#### Russia-Ukraine Conflict

Given the uncertainties that have arisen in Russia and Ukraine after Russia’s invasion on February 24, 2022, it is important to recognize the exposure companies have in both markets. Companies that continue selling to Russian consumers or keep their Russian storefronts open will be chastised by investors, which will be reflected negatively in their stock price. On the contrary, stopping sales in Russia will potentially eliminate a geographic revenue stream, harming the company’s total revenue. Companies that rely on suppliers in either of the countries will experience supply chain disruptions that will persist for an unknown length of time.

SBH, ULTA, and ELF do not operate stores in or ship to Russia or Ukraine. Therefore, these three companies will not be harmed financially by the effects of the invasion.

EL, BBWI, and COTY have stores in or sell to Russia and Ukraine. Since the invasion, EL announced their cease of operations of their companies in Russia. EL earned $5,486
million in sales in their Asia/Pacific region in 2021. This region’s revenue made up 33.8% of EL’s total revenue. We recognize that China is driving most of these sales, but there is still significant exposure to the Russian market. Given COTY’s large portfolio of brands, they have many companies operating in Russia and are exposed to the next highest amount of risk. In 2021, COTY’s total Asia Pacific region had revenue of $579.3, accounting for 12.5% of their total $4,629.9 million of revenue. Much of this revenue comes from China, but we still recognize COTY as being heavily exposed in the Russian market. However, COTY does not have any corporate facilities for manufacturing and research and development in Russia or Ukraine. BBWI has 80 locations across the Middle East, North Africa, Turkey, Russia, and Poland. BBWI’s total international revenues were $283 million in 2021, which only account for 3.6% of BBWI’s $7,882 million of total revenue. This means BBWI’s revenue exposure to Russia is less than 3.6% of their total net sales\(^\text{20,22,24}\).

Tracing each of these companies’ suppliers is an arduous task, so we are focusing on generally where most makeup and personal care products are produced. Four of the ten largest cosmetic manufacturers operate in the U.S. Johnson & Johnson, Procter & Gamble, Estee Lauder, and COTY all operate in the U.S. The other six companies operate in Japan, South Korea, and Europe, with no operations in Russia or Ukraine. Because most beauty manufacturing companies are not in Russia, we do not consider risk for the beauty industry on the supply side regarding this conflict\(^\text{25}\).

**Same-Day Delivery**

By the Fall of 2020, Sephora, ULTA, and SBH all offered same-day delivery in select U.S. cities through partnerships with DoorDash and InstaCart. The pandemic increased consumers’ desire for on-demand products, including their beauty needs. Amazon leads the way with their established, reliable delivery service, while beauty retailers sought partnerships to achieve these new delivery speeds. The retailers released the delivery partnerships in time for the holiday season and highest revenue quarters. Because the deliveries were completed by the established delivery services, the beauty companies did not see an increase in their cost of goods sold. The delivery companies also benefited from increased business through fees of approximately $7 a month per customer. When the beauty retailers split from the partnerships and develop their own same-day delivery systems, they will experience higher cost of goods sold and growing pains from the expansion. We do not expect the beauty retailers to adopt this practice until they have earned enough revenue from their e-commerce business and have expanded to enough cities to justify the demand for two day shipping\(^\text{18}\).

**INDUSTRY TRENDS**

The beauty industry is very responsive to current trends because consumers’ demand closely tracks the current fads. Wage pressure in the U.S. economy, changing retail real estate, increased e-commerce sales, and nonmedical/nonprescription beauty enhancers are the largest changes we expect to alter the beauty industry.

**Educated Employees**

Beauty stores with a consumer-oriented experience retain consumers better than those with a more casual shopping experience. These educated employees require higher wages as the power has been shifted to them in the labor market. The overall employment of barbers, hairdressers, cosmetologists is expected to grow 19% from 2020 to 2030, which is much higher than the average growth for other occupations\(^\text{26}\). While demand is high and beauty stores reopen, wages as a portion of revenue will remain high compared to other industries\(^\text{8}\).

The total number of general cosmetology degrees awarded in 2019 was just over 52,000 in the U.S. The number of degrees declined 7.17% from 2017, while the average wage grew 10.7%. There will be plenty of positions open for cosmetology graduates, but not enough experts to fill the roles. Therefore, the beauty stores need strong benefits to attract and retain educated and licensed workers in the short-term\(^\text{8}\).

**Opening New Stores**

The top competitors in the beauty industry, ULTA and Sephora, are expected to open new establishments in 2022. New store openings are expected to increase 1% per year over the next five years\(^\text{1}\). During the COVID pandemic, stores were closed and smaller competitors, like SBH, permanently closed some locations. On the contrary, ULTA and Sephora opened new smaller stores within Target and Kohl’s. New competitors in the industry must rely on superior product range and quality rather than business relationships that the large companies are utilizing.
Beauty stores are moving away from dying malls and focusing on stand-alone and “mini shops”. “Mini shops” are beauty counters or kiosks that operate within a separate store or business. The leaders are focused on growing their presence in suburban locations to increase accessibility and follow their moving consumers. The partnerships with department and larger retailers are also to increase product placement. The companies can operate at a much lower overhead cost with these new partnerships\textsuperscript{18}.

**Increased E-Commerce Sales**

During the peak of the COVID pandemic, there was a significant decrease in physical store foot traffic. Most stores were required by law to close for a period of time. Many consumers used company websites to purchase their beauty products. Beauty stores are a particularly vulnerable shopping experience because of the intimacy of the products and inevitable spread of germs. The chart below shows the annual growth percentage in e-commerce sales of personal care products. The peak of 30.8% in 2021 does not represent a sustainable growth rate. We expect beauty e-commerce growth to persist, but at a rate of 10% annually\textsuperscript{2}.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{Health_and_Personal_Care_Retail_E-Commerce_Sales_Growth_in_the_US.png}
\caption{Health and Personal Care Retail E-Commerce Sales Growth in the US}
\end{figure}

Although we expect high e-commerce growth rates, the overall beauty industry revenue growth is only 1.5% to 5% annually. We believe that consumers are shifting from in-person to online shopping, rather than the online consumers being totally new customers in the beauty industry. We believe only a small portion of the e-commerce revenue is coming from a new consumer base. Therefore, our overall revenue growth looks conservative given the high e-commerce sales, but it is caused by a shift in shopping trends rather than an expanding consumer base.

Because consumers demand extensive information on beauty products before purchasing, it is critical for the company websites to continue to provide an effective shopping experience. For example, color-matching quizzes to correctly match foundation shades are a useful tool for new shoppers. Beauty stores were forced to expand their e-commerce platforms out of necessity during the pandemic. Smaller companies with better customer service and a more tailored experience will have a competitive advantage over the larger companies as they take longer to fully transition.

**Nonmedical/Nonprescription Enhancers**

The social acceptance and availability of beauty-enhancing procedures in the U.S. has increased significantly in the past decade. Therefore, the beauty retailers are seeking a way to bridge the gap between medical procedures and products that mimic the effects of those procedures to enter this growing market. Millennials unwilling or unable to get medical enhancements or prescriptions are seeking a way to participate in the beauty trend through a different channel.

The first nonprescription products adopted by beauty retailers were acne treatment products. The demand first arose from consumers’ desire to save money on doctors’ visits and treatments for common skincare problems. Through 2015, the over the counter (OTC) acne products were a profitable segment of the beauty industry’s revenue. From 2015 to 2020, the OTC acne products experienced a -7.5% CAGR, and we expect the negative growth to continue. The decline was driven by an oversaturated market, import regulations, and improved economic conditions that allowed consumers to allocate more to their skincare expenses. We expect skincare issues to persist as air quality declines and mask-wearing persists, so the beauty industry needs to invest in organic, natural skincare products to meet consumer demand\textsuperscript{1}.

The newest trend we see is the adoption of nonprescription eyelash growth serums. Previously, these products required a prescription and removing this barrier
made these products accessible to all consumers. The eyelash serum market was valued at $746.7 million in 2020 and we expect a CAGR of 6.6% through 2028. We are confident in this aggressive estimate because of the growing demand and increasing number of new companies entering the market. The market is young, meaning there is not a dominating company so many new brands are emerging with varying price points. We divide the market into three price points: under $50, $51-$100, and over $100. Each of these segments serves a different target demographic and together they capture the whole customer-base. Recognizing new beauty trends by following modeling and celebrity looks is crucial for predicting new product development in the beauty industry.

MARKETS AND COMPETITION

Threat of New Entrants

Young, independent beauty companies have operational advantages that the larger companies with retailers do not capture. These companies do not have to share profits with distributors for placing their products on shelves and save on advertising costs. Today, companies can create very targeted ads that are cost-effective and achieve higher interaction. The message they create is focused based on information they can access from platforms like Facebook and TikTok. Direct communication with the customer shows transparency on behalf of the brand. Customer communication with other users of the products helps build a strong community of loyal consumers.

In the social media world of influencers and product reviews, smaller companies are in a favorable position to gain brand awareness quickly and cheaply. We expect the beauty industry to attract venture capital investment in 2022 as the growth potential of many companies is recognized. In January of 2021, Paper Cosmetics, a natural and sustainable personal care company, closed their funding round. New companies that can capture a niche group that is under-severed by the large companies will gain a meaningful share of the market. The large companies have spread themselves too thin are recognizing their inability to specialize in every product category.

The top four beauty companies accounted for 59.7% of the total industry revenue in 2021. Because of their large market share, we believe that it is unlikely that the smaller companies will pose a material threat in the short-term. We expect industry concentration to remain stable over the next five years because stores will reopen, and consumers will return to their trusted beauty and personal care suppliers to which they are loyal.

Mergers and acquisitions executed by the larger players will accelerate growth in the industry through synergies. For example, Estee Lauder bought make-up brand Too Faced in 2016 for $1.45 billion. This acquisition allowed Lauder to connect with the younger beauty generation through Too Faced’s large social media presence. In December of 2021, Procter & Gamble entered the hair care segment through the purchase of Atkin’s Ouai. We expect the other large companies in beauty to continue the trend of acquiring smaller, growing companies with a niche purpose.

Amazon’s Presence

Amazon’s beauty product segment achieved 7% growth between February and March of 2020, at the beginning of the pandemic. Consumer’s familiarity with the Amazon.com site combined with the temporary closure of beauty stores created an opportunity for Amazon to capture many new beauty customers. The chart below shows the market share growth in the U.S. of the top online beauty retailers. The market share is based on each of the retailers’ total revenue compared to the beauty industry’s revenue as a whole. The growth in the market share is based on the retailer’s market share in 2019 versus their market share in 2020.

![Market share growth in the U.S. in 2020](chart.png)

Source: Statista
ULTA’s website achieved the highest market share growth with a rate of 67%, but Amazon direct trailed closely with over 53% growth. Amazon market allows for third-party sellers, while Amazon direct is products owned solely by Amazon. Consumers are more wary of purchasing beauty products from Amazon’s market because there has been a high volume of counterfeit products sold. These scandals have deterred some consumers from choosing Amazon for their beauty needs².

Regardless, Amazon poses a threat for all beauty retailers. As Amazon pushes toward opening brick-and-mortar clothing and fashion stores, we expect miscellaneous products to be on their horizon soon. If Amazon opens these stores, the beauty retailers will lose their main competitive advantage of providing an in-store shopping experience. Therefore, beauty companies focused on allocating capital toward technological advancements, skilled employees, and strong customer loyalty programs will be best equipped to compete with the retail giant⁶.

Power of Suppliers

The power of suppliers in the beauty industry is of little concern to the beauty retailers. There are ten large manufacturers for the industry that all use similar inputs. Therefore, beauty retailers could switch suppliers with little disruption in operations and overall product outcome. For example, a beauty brand could switch from Johnson & Johnson to Procter & Gamble without consumers noticing a difference in the beauty product’s ingredients or quality because nearly identical inputs are used¹⁶.

EL, ELF, BBWI, and COTY manufacture all their own products because they are both manufacturers and retailers. SBH, ULTA, and Sephora act primarily as retailers, with small lines of their own products. Most of SBH, ULTA, and Sephora’s products come from thousands of other brands such as Too Faced, Mac, and Olaplex. These retailers now make their own lines of products and have purchased smaller brands to have exclusive selling rights. Therefore, the retailers are less exposed to manufacturing risks because the processes occur before their involvement.

Power of Buyers

Consumers of beauty products have relatively high power compared to other industries. The increased competition in the industry and higher availability of products (online, in-person, etc.) has given consumers more power in the beauty industry recently. Because there are many retailers with near perfect substitutes, retailers are not in a position to raise prices without losing customers as a result. Long term, the high power of buyers will diminish retailers’ profitability, making this a threat that needs to continue to be tracked¹.

The beauty industry in the U.S. is primarily controlled by four companies ULTA, Sephora (LVMH), SBH, and BBWI. The graph above shows the percentage of the market (based on their individual sales as a portion of the industry’s total sales) that these four companies capture, which is over 60% of the industry’s total. ULTA and Sephora have gone back and forth for the first position, but ULTA has grown their market share over the past five years while Sephora has been shrinking. We believe ULTA’s exclusive focus on the U.S. is the reason for their market share growth, while Sephora is trying to gain a share in the European and Asian markets¹.

The companies in this industry are focused on providing a large selection of beauty and personal care products at a variety of price points. Companies shift their product segmentation based on changing consumer trends. We compared ULTA, COTY, BBWI, and SBH. Sephora (LVMH),
not COTY, is the fourth largest player in the industry, but the LVMH portfolio has too many other business segments that make its market cap much larger and multiples difficult to compare. The chart below compares the 2022 sales and current stock price of the four companies evaluated.

<table>
<thead>
<tr>
<th>TCKR</th>
<th>FY 2022 Sales ($M)</th>
<th>Share Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBWI</td>
<td>7,882.00</td>
<td>$55.93</td>
</tr>
<tr>
<td>ULTA</td>
<td>8,630.89</td>
<td>$364.26</td>
</tr>
<tr>
<td>COTY</td>
<td>5,284.20</td>
<td>$8.58</td>
</tr>
<tr>
<td>SBH</td>
<td>3,992.60</td>
<td>$16.95</td>
</tr>
</tbody>
</table>

Source: FactSet

**BBWI**

BBWI is the industry leader in the fragrant body care products. Fragrance mists, body lotions, candles, soaps, and hand sanitizers make up the majority of BBWI’s portfolio. Unlike its competitors, BBWI does not produce or sell cosmetics and has not released plans to enter this product segment. Hand sanitizers accounted for 5% of total revenue in March of 2020, so we are confident that the revenues will not be significantly hurt once the pandemic subsides.\(^{12}\)

BBWI was the leader in sales for 2021, which we attribute to their domination in number of brick-and-mortar stores globally of over 2,000. However, ULTA overtook their position in fiscal 2022. BBWI became independent of Victoria’s Secret (VSCO) in August of 2021 and has surpassed earnings growth expectations since the divestiture. BBWI sales are up 53% on a 2-year basis when compared to the third quarter in pre-pandemic 2019. The holiday season in Q4 drove a large portion of BBWI’s total sales, so we expected a slow start in 2022 but believe BBWI is still in a strong position in the industry to continue to dominate.\(^{11}\)

Now that they are a separate entity from VSCO, BBWI plans to expand their operations beyond dying malls. Off-mall store locations had a higher percentage of purchases made by shoppers than mall browsers. Because of their strong brand, BBWI negotiates new leases with landlords for more favorable overhead costs. At these new locations, BBWI can compete more closely with Target and ULTA.

**ULTA**

ULTA is a beauty product retailer that operates over 1,200 stores in America. ULTA provides a variety of low to high end makeup, skin care, tools, fragrances, and bath and body products. ULTA offers over 25,000 products from over 600 established and young brands, including their own ULTA Beauty Collection. Each ULTA store also operates a salon with employees to offer a range of beauty services.

Throughout 2021, ULTA closed over 50 stores, but they plan to open over 60 stores during 2022. Their partnership with Target is a large driver of their ability to open “mini shops” with significantly low overhead. ULTA planned their first global expansion to Canada in 2019. Once the pandemic hit, ULTA decided to prioritize their growth in the U.S. and cancel the Canadian expansion. Because of this decision, ULTA lost over $55 million in lease obligations. We still believe ULTA will expand globally in the long-term, but their Target partnership will be the most cost-effective way to test the market before entering using stand-alone stores.\(^{18}\)

Sales revenue for ULTA in Q1 of 2021 recovered from the pandemic dip and exceeded the previous high set in Q1 of 2019. The stimulus payments and easing store restrictions both drove the increase in ULTA’s sales. ULTA’s need for stronger online sales led to a partnership with Google for their virtual try-on tool and a partnership with Adeptmind, an AI retail technology company, to personalize their website search engine. We expect these investments in digital innovation to pay off in the long run for ULTA. Without store locations globally, it is important that ULTA has a cutting-edge digital presence to attract international consumers.\(^{3}\)

**COTY**

COTY is an international beauty company involved in the manufacturing, marketing, sales, and distribution of 77 branded beauty products. The company provides the products through high-end retailers such as perfumeries, department stores, e-retailers, direct-to-consumer websites, and duty-free shops. Fragrances make up over 57% of the company’s total revenue.\(^{3}\)

COTY’s brands rely on celebrity endorsements more than any of the other companies in the industry. A large portion of both Kim Kardashian’s and Kylie Jenner’s beauty brands
are owned by COTY. COTY also owns brands that frequently advertise celebrity endorsements. Celebrity brands or product lines with a relatable purpose tend to have higher sales. For example, Selena Gomez frequently works with Rare Beauty, and a portion of the sales are donated to mental health organization funds. Gomez has been transparent with fans about her struggles, and her involvement with the brand has had a positive impact on sales and Gomez’s reputation. On the flip side, celebrity brands struggle when their celebrity’s reputation does. Kylie Cosmetics has multiple accusations of product plagiarism. Once the speculation arises, consumers turn to the original, smaller brand to support their product over the billionaire’s stolen “copy” of the product.

COTY’s revenue peaked in 2018 with a value of $9.4 billion, which was over 50% lower in 2021 at just $4.6 billion. Revenues fell 31% over 2018 to 2020, which the company claims to be caused by lower unit volumes and negative foreign currency exchange translation. COTY completes a large portion of their business in the Eastern Asian market, so it is critical that they are using derivatives to effectively hedge their currency exchange risks, especially in the current uncertain global economies.

We believe COTY took too aggressive of an M&A strategy before the pandemic occurred and spread their portfolio too thin. COTY overpaid for stake in brands such as Kylie Cosmetics. Their financial troubles were worsened by the pandemic and abrupt management changes. We expect COTY’s sales to continue to recover and hold a strong share of the market globally. However, we believe COTY will continue to struggle in the U.S. because of increased competition and their inability to justify the high price tag on their products compared to other companies’ brands.

SBH

SBH is an international retailer and distributor of professional beauty supplies including hair color, hair care, nails, and salon products. SBH carries over 10,500 professional brands in their 3,500 stores globally. Hair color and care products represent the largest percentage of total revenue for SBH.

Revenue for SBH has nearly returned to its pre-pandemic levels. SBH revenue peaked in 2016 at $3.95 billion and hit $3.88 billion in 2021, a percentage decrease of only 1.96%. Strong demand for hair care products from DIY and professional consumers drove the company’s recovery.

SBH is leading the industry by investing in textured hair products and knowledgeable stylists to provide educational tools. The textured hair market is severely underserved, so we expect SBH to see strong revenue growth in their hair care product segment.

Compared to their competitors, SBH is recovering well, especially considering their agenda to permanently close over 136 stores that were no longer profitable for the company. SBH gauged their customers’ reaction to the store closures by tracking their e-commerce sales, which totaled 8.3% of their total sales for 2021. SBH plans to invest more capital in the development of their online presence.

Same-Store Sales Growth

Same-store sales (SSS) growth is a metric commonly used in the retail industry to determine what portion of a company's current sales is attributable to sales growth in existing stores versus growth attributed to the opening of new stores. The table below displays the percentages that indicate the relative amount of increase or decrease in revenue from 2019 to 2022 for the four top competitors.

<table>
<thead>
<tr>
<th>TCKR</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022E</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBWI</td>
<td>3.00%</td>
<td>-1.00%</td>
<td>21.00%</td>
<td>10.60%</td>
</tr>
<tr>
<td>ULTA</td>
<td>8.10%</td>
<td>5.00%</td>
<td>-17.90%</td>
<td>37.30%</td>
</tr>
<tr>
<td>COTY</td>
<td>-20.00%</td>
<td>-4.00%</td>
<td>13.50%</td>
<td></td>
</tr>
<tr>
<td>SBH</td>
<td>-8.10%</td>
<td>10.20%</td>
<td>3.80%</td>
<td></td>
</tr>
</tbody>
</table>

Source: FactSet

SSS represent a measure of the company’s ability to generate revenue from their existing assets. If a company’s growth is negative or only caused by inorganic growth, such as opening new stores, it may be a sign that the demand for a company’s product is diminishing. Positive SSS growth means that the company generated more sales per store than the prior year and demand continues to grow.

Positive SSS growth is not always a sign of good performance, it is relative to certain benchmarks and expectations. Using competitors to gauge a company’s SSS performance provides a framework for context. We expect to see the strongest performance from BBWI and ULTA in 2022. ULTA’s plans for expansion will inevitably increase their SSS, which is why their estimate is much higher than their peers’ estimates. BBWI has a high estimate because we have seen the highest growth in demand for their
products amongst the other companies in the industry. COTY’s large negative number in 2020 further supports the fact that poor management of existing resources leads to negative SSS growth.

**Store Closures & Openings**

Gathering information about store closures and openings that a company has executed over the past few years is an indicator of their financial health and strategic position. The table below shows the number of stores in operation by BBWI, ULTA, SBH, and Sephora. We do not have complete data for Sephora because LVMH reports according to European standards and operates many brands. However, Sephora has been expanding and will continue to expand through the Kohl’s partnership. ULTA and BBWI have also been consistently expanding. SBH is the only company shrinking their overall position in this group.

<table>
<thead>
<tr>
<th>TCKR</th>
<th>2019 Stores</th>
<th>2020 Stores</th>
<th>2021 Stores</th>
<th>2022 Stores</th>
</tr>
</thead>
<tbody>
<tr>
<td>ULTA</td>
<td>1174</td>
<td>1254</td>
<td>1264</td>
<td>1308</td>
</tr>
<tr>
<td>BBWI</td>
<td>1721</td>
<td>1739</td>
<td>1736</td>
<td>1755</td>
</tr>
<tr>
<td>SBH</td>
<td>5061</td>
<td>5038</td>
<td>4911</td>
<td>4936</td>
</tr>
<tr>
<td>Sephora</td>
<td>2300</td>
<td>2037</td>
<td>1990</td>
<td>2700</td>
</tr>
</tbody>
</table>

Source: FactSet

We still expect strong performance from SBH regardless of their shrinking presence. SBH is closing their least profitable stores. SBH has far more locations than its competitors and is growing their online platforms, so we do not expect their revenues to be significantly impacted by the store closures. SBH operates much smaller stores than its competitors in terms of square footage, which is the direction larger retailers are switching too as well given the “mini shop” developments. We expect BBWI to open stores at a much slower rate than its competitors because they operate through malls, which are dying out in the U.S. Therefore, BBWI will have to shift their focus to off-mall locations and potentially close their mall locations in regions with falling performance. We expect the expansions of ULTA and Sephora and closures of SBH stores to all be successful for each of the companies’ different goals. We believe BBWI is the worst positioned company in the industry regarding their store locations and possibility for expansion.

**Price Multiples**

We used the price to sales (P/S) and price to earnings (P/E) multiples of the 2021 fiscal year to understand some of the retailers’ valuations. The table below shows the multiples for our four industry leaders.

<table>
<thead>
<tr>
<th>TCKR</th>
<th>P/S FY2021</th>
<th>P/E FY2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBWI</td>
<td>1.20</td>
<td>11.80</td>
</tr>
<tr>
<td>ULTA</td>
<td>2.50</td>
<td>60.00</td>
</tr>
<tr>
<td>COTY</td>
<td>1.50</td>
<td>934.00</td>
</tr>
<tr>
<td>SBH</td>
<td>0.50</td>
<td>7.00</td>
</tr>
</tbody>
</table>

Source: FactSet

The P/E ratio for COTY stands out, having a value of 934. A value this large means that investors are willing to pay significantly more today for the stock with the expectation of high growth in future earnings. As we discussed in the COTY section above, we recognize that COTY is coming out of a couple years of very poor performance. However, we do not see any indicators that the company will be able to achieve significant growth in the future based on their current business plan. We do not think the current EPS of COTY are sustainable long-term, which is why we do not think there is justification for the high P/E ratio.

The P/S ratios of the four companies are on a much tighter range. SBH’s P/S ratio of 0.5 signals that investors may be overlooking this undervalued stock. We believe that investors should feel comfortable paying more per dollar of SBH’s sales because the company is still in pandemic recovery but continues to steadily grow and beat revenue expectations. We see strong growth potential for SBH because their e-commerce sales continue to compensate for the closure of 136 physical stores\(^9\).

**Real Gross Domestic Product**

Real gross domestic product (real GDP) is an inflation-adjusted measure of all goods and services produced in an economy. Real GDP is a relevant metric for evaluating the growth of an economy and their population’s purchasing power. Purchasing power and economic growth are strong indicators of the future direction of the movement of industries within consumer discretionary.

Real GDP increased 5.7% in 2021, which corrected the 3.4% decrease in 2020. The increase was driven largely by...
personal consumption expenditures (PCEs). PCEs are used as measures of household expenditures and include how much consumers spend on durable and non-durable goods. Therefore, it is a positive indicator for growth in the consumer discretionary industries as consumers continue to increase their spending.

Future Wages

We expect labor shortages and elevated inflation to continue throughout 2022. In November of 2021, The Conference Board conducted a survey involving 240 U.S. employers to gauge expectations of wages in 2022. Projections for salary growth as compared to the April 2021 survey were almost 1% higher, increasing from 3.0% to 3.9%. Because of the labor shortages, we expect wages for blue collar workers to grow faster than average driven by the need to fill essential positions. The elevated inflation is forcing the need for cost-of-living adjustments.

Our wage predictions mean two important changes for the beauty industry:

1. Beauty retailers will face pressure to increase wages to retain and attract employees, increasing the retailers’ overhead expenses.
2. Consumers will have more income freed up for discretionary spending, which will drive demand for products.

KEYS TO MONITOR

The beauty industry continues to see increasing demand as pandemic mandates are lifted and lifestyles return to normal activities in public but maintaining revenue growth requires strategic investments moving forward. We recognize that the beauty industry is in a mature lifecycle and becoming oversaturated. It is important to monitor the industry’s anticipated growth rate compared to GDP growth. Industry growth is closely tracking GDP growth at a rate of approximately 2%, which is indicative of a mature industry.

As new companies enter the market to capture specialized product segments, it is important to track the leading retailers’ response. We expect the retailers who continue to invest in their customers through loyalty programs, knowledgeable staff, and superior in-person and online shopping experiences to achieve the best resilience in keeping their market share. Because the beauty industry targets a wide demographic, it is critical that retailers continue to cater their products with all consumers in mind.

We expect the leaders in the industry to be the retailers that have invested capital in their online presence. Aside from looking at the companies’ financial statements to see how much was allocated for the company’s website, we can visit the websites and social media pages of each of the companies to see which have the most user-friendly layout and largest social media following. Sephora and ULTA have 20.9 million and 6.8 million Instagram followers, respectively. Instagram is an interactive platform where the company can share informational content from makeup professionals and announce new products and brands. ULTA and Sephora also have the most developed websites. On the SBH website, the company provides many free informational DIY videos. SBH has the most interactive website, which we expect to help them attract both professional and retail consumers. Given the aforementioned advantages, we expect ULTA and SBH to have the best performance in 2022 based on their strong user interface and range of reasonably priced, rather than luxury, personal care goods. Overall, investors should be overweight in their positions in beauty retailers that operate in the consumer staples segment, rather than the luxury brands in the consumer discretionary segment.

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