A Study of the European Cosmetics Industry

Executive Summary

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Prepared by:

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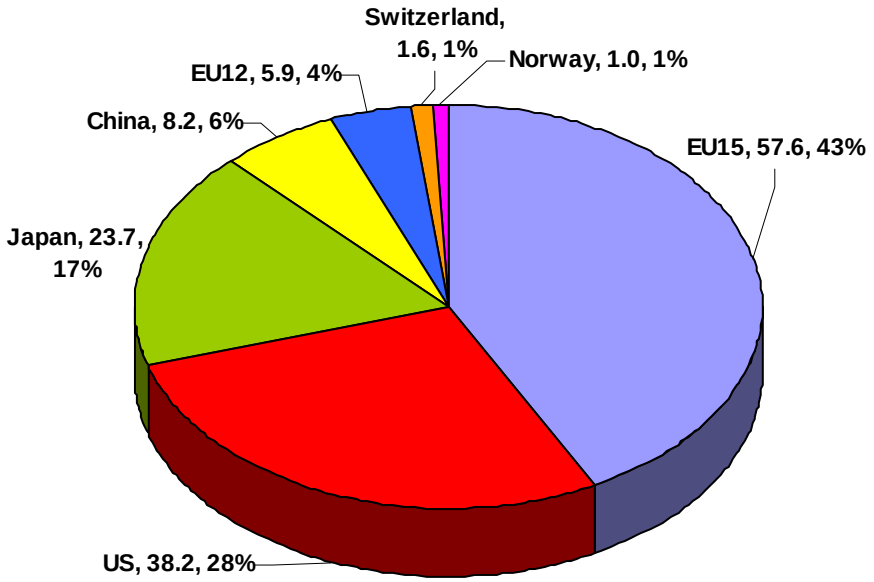
I. Broad Market Study

An overview of the broad cosmetics industry (also referred to as the cosmetics and toiletries (C&T) industry) in the EU, Japan, China, and the U.S. reveals that Europe's market size is almost as large as the U.S. and Japan combined, due to its large population. In 2006, the U.S. cosmetics market was €38.2 billion, while Japan's was €23.7 billion and China's €8.2 billion. The total EU27 cosmetics market was valued at €63.5 billion in 2006. Among the EU countries, Germany has the largest cosmetics market, valued at €11.7 billion, followed by France (€10.4 billion), the U.K. (€10 billion), Italy (€8.8 billion), and Spain (€7.4 billion).

Europe, U.S., China, Japan C&T Market Sizes, Retail Sales Price, 2006, Total market €136.2 billion



Source: Euromonitor, COLIPA Statistics Working Group

Per Capita Spending

The average EU27 per capita cosmetics spending is €128 per year. Denmark and Sweden have the highest consumption of cosmetic products at €171, followed by Spain at €169 and France at €166. Spending per capita is low in Greece and Portugal at just €121 and €104, respectively. Over the period 2000-06, there was sluggish per capita consumption growth in two of the large European markets, France and Germany, and somewhat better performance in Italy and the United Kingdom. In contrast, there was strong growth in the high per capita consumption countries like Denmark, Sweden, Spain, and Norway.

Using a correction for purchasing power parity, per capita cosmetics spending was €174 in Japan, €127 in the U.S. and €24 in China. The table below outlines cosmetics spending

per capita in 2006, the compounded annual growth rate over the 2000 to 2006 period and spending in purchasing power parity terms for China, Japan, U.S. and the EU regions.

Per Capita Consumption by Country and Region

Country	C&T expenditure per capita (€), 2006	CAGR 2000-2006	C&T expenditure per capita (€) at US$ PPP, 2006
EU15	150	1.9%	132
EU12	57	6.8%	98
EU27	128	2.2%	124
US	127	-3.8%	127
Japan	186	-4.5%	174
China	6	4.0%	24

Source: Euromonitor, COLIPA Statistics Working Group

Buying Patterns and Shifting Trends

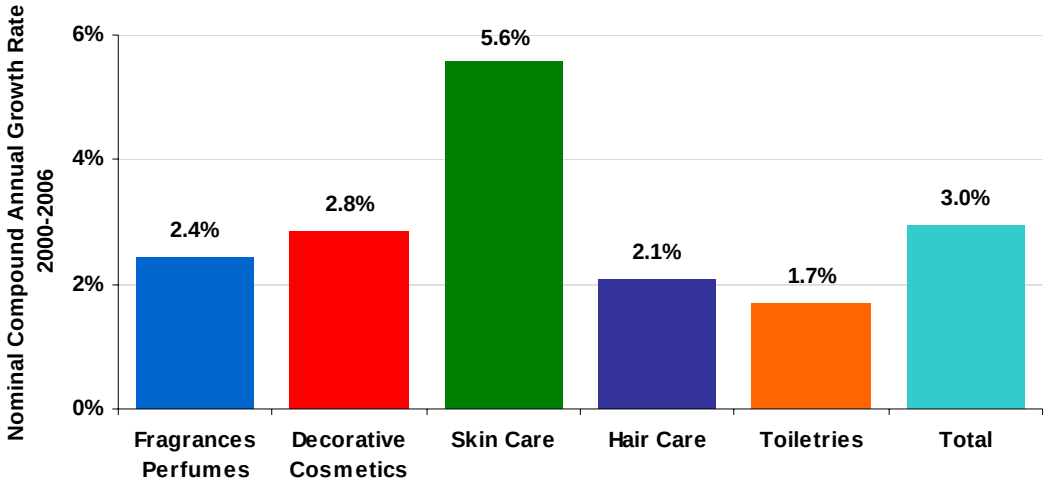
As could be expected in a vast region with different tradition and cultures such as the EU, unique trends in buying patterns may be found in particular countries, as well as some common trends across the board. In most countries, there are growing concerns about skin cancer and exposure to harmful rays that has led to the growing use of sun care products. Anti-aging creams and anti-cellulite skin care products are in high demand among an aging population in the developed countries. There is also a widespread and growing diversity of cosmetics products for men – especially men's fragrances – and a growing demand for natural / organic products in most countries. The declining birth rate in many countries has led to a drop-off in demand for baby care products. It is interesting to note that technologically advanced products, such as self-tanning lotions and creams, are growing in popularity. In the higher-income countries, there is a growing trend towards so-called "masstige", or premium, brands sold at lower prices. This is especially notable in the skin care segment.

From country to country, spending on cosmetics varies by product. The French primarily purchase skin care products while Germans and the British spend mostly on toiletries. The Nordic countries – Finland, Norway, and Sweden – spend a much lower share of their consumption basket on fragrances, compared to the EU average, while Spain and Portugal spend lower-than-average shares on decorative cosmetics.

New market trends, specifically toiletry and skin care products targeted towards a burgeoning male consumer marketplace, have provided a major source of new industry growth. Toiletry products grew by 6% in 2004, second only to the skin care segment, which grew 6.7%.

The chart below shows growth in retail sales over the 2000 to 2006 period in the EU15 for the five major products. Clearly skin care has been the most dynamic market with all others below the market total of 3% compounded annually over the period.

Growth of EU15's Cosmetics and Toiletries Product Categories



Source: COLIPA Statistics Working Group

Growth Forecasts

The Global Insight's Global Consumer Markets product[1] was used to forecast the cosmetics market in this study. Income distribution and disposable income per capita are the major forecast drivers. No surprise, China is seen as the fastest-growing market, with significant double-digit growth potential, partly because current per capita spending on cosmetics is starting at a very low base. The EU27 cosmetics market is expected to grow at approximately 4.4% per year over the next decade, the cosmetics market in the new EU members will grow at a faster pace (8.8% compounded annually) than the EU15 countries (3.7%). The Japanese market is expected to grow 3.1% over the next ten years while the U.S. is in the middle of the pack at 5%.

Market Size Forecast – Overview

Country	Market Size, Billions of LC					CAGR	
	2006	2011	2016	2021	2026	2006-2016	2016-2026
EU12	5.2	8.5	12.2	15.9	21.1	8.8%	5.6%
EU15	50.9	61.3	73.4	88.1	111.5	3.7%	4.3%
EU27	65.5	81.8	100.5	122.4	156.2	4.4%	4.5%
U.S.	47.9	62.9	78.4	94.9	114.5	5.0%	3.9%
Japan**	3.5	3.9	4.7	5.7	6.7	3.1%	3.6%
China*	10.3	20.8	38.7	67.0	108.8	14.1%	10.9%

**Chinese market size is given in USD*

***Japanese market size is in trillions of yen*
Source: Global Insight based on Global Consumer Markets

[1] The Global Insight's Global Consumer Markets product is a set of models built to forecast consumer spending activity based on a consistent set of drivers for all countries.

Structure of Industry and Production

In this section the structure of the cosmetics industry in all countries is investigated and compared. The economic concepts analysed include: production value, value added, labour productivity, number of employees, personnel costs and number of enterprises.

Over 142,000 people are employed in the cosmetics industry in Europe. France, Germany, Italy, the U.K., Spain, and Poland together account for more than 127,000 of these jobs. In Japan, there are only about 30,000 employees in the cosmetics industries, in the U.S. about, 54,000 people work in the industry. Employment in the EU and Japan increased by about 7% between 1999 and 2004 while in the U.S., the industry shed more than 15% of its workforce. Employment growth has been remarkably pronounced in the new member states of the EU especially in Poland.

The average unit labour cost in the EU cosmetics industry is at about the same level as in the U.S. and about 25 percent higher than in Japan. Cosmetics industry workers in France, Germany, Belgium and Sweden are the highest paid in Europe, while at the lower end of the spectrum are workers in the new member states.

Industry productivity is vastly different between the EU and the United States. In the U.S. gross value added per person employed is just over €310,000, it is about one-fifth of this level in the EU15. We identify a number of factors that explain such large differences in productivity. Production on the whole in the U.S. (and Japan) is more capital intensive than in the EU where the handcrafted nature of many products is reflected in a high share of micro-businesses. However, this is not the whole story and the productivity gap between the U.S. and the EU is not specific to the cosmetics sector.

The well-known EU KLEMS[2] studies found that since 1996 productivity growth in the U.S has outpaced European productivity growth significantly. These studies reveal a number of important differences between the U.S. and EU economies, including: a greater share of ICT (information and communication technology) in total U.S. manufacturing; a better use of ICT in non-ICT producing industries in the U.S.; significant differences in the productivity growth of market services and finally stronger growth in multi-factor productivity in the United States.

There are a significant number of major international cosmetics firms in Europe - mainly in France and Germany. The market is however best characterized as several hundred small- and medium-sized companies (SMEs) in most countries. In 2004 there were 855 firms with fewer than 10 employees in France while Italy had over 1000 firms with fewer than 10 employees. In the U.S. and Japan firms tend to be more vertically integrated. This is also the case in the United Kingdom.

[2] EU KLEMS is a research project financed by the European Commission with the aim of creating a time series of industry level data on total factor productivity and to carry out comparative analysis of the individual member countries of the EU. The database will consider a large number of factors that impact productivity and will integrate quantity and "price" data from the national accounts with other detailed information on outputs and inputs of capital (K), labour (L), energy (E), intermediate inputs (M), and services (S).

II. Nature of Competition

Currently, large cosmetic corporations combine to control over half of the cosmetics market. The table below lists each of the top 10 companies in 2006 and their respective shares of the global cosmetics market (retail sales value).

Market Share for Top 10 Global Cosmetics Companies 2006

Company	2006 C&T Sales (€ millions)	Share
Procter & Gamble Co*	18,360	12.7%
L'Oréal Group	15,011	10.1%
Unilever Group*	10,264	7.1%
Colgate-Palmolive Co*	5,783	4.0%
Estée Lauder Cos Inc	5,313	3.9%
Avon Products Inc	4,801	3.3%
Beiersdorf AG	4,327	3.1%
Johnson & Johnson Inc*	4,048	2.8%
Shiseido Co Ltd	4,314	2.6%
Kao Corp	3,235	2.5%

Source: Global Insight estimates based on Company Reports and Euromonitor data

Holding a position as one of the top 10 manufacturers is enviable, however, these companies understand that they must constantly reconsider and re-evaluate their market positions by listening to the demands of their customers, gaining footholds in new markets, and evaluating their organizational structures. These large multinational firms are finding themselves facing stiff competition from other popular brands. Other cosmetics companies are pushing ahead, trying to gain their own place in the market, and have largely been successful in developing their own name. In the last fiscal year, several of these companies saw similar or greater rates of growth in their product lines compared to those in the top 10.

The industry's key players pursued a strong acquisition strategy in recent years. The purpose of this strategy was to introduce new business lines, streamline production, and expand the types of products under company control. Over the next few years, the success of these acquisitions will have to be evaluated as the relentless demand for the consumer's loyalty will surely continue.

Barriers to Entry

The cosmetics industry exists in a market structure called monopolistic competition. The industry is characterized by a large number of firms that attempt to differentiate their products and maintain a certain degree of control over their pricing. In general monopolistic competition is characterized by relatively low barriers to entry and exit. Government regulation (mostly related to differences in the approach to safety issues) and distribution channels appear to be the most significant barriers to entry in the cosmetics industry.

EU cosmetics companies have had little success in penetrating the market in Japan and China. Regulatory barriers may have been an issue for EU firms in the past however the accessibility of the Japanese cosmetics market has greatly improved since it was

deregulated. Deregulation included the abolition of pre-market approval, the establishment of a prohibited ingredient list similar to the EU and the abolition of the designated ingredient list. Despite the 2001 simplification of the regulatory framework, cosmetics can potentially be classified as quasi-drugs (e.g. deodorants, mouth wash) or drugs, making it more difficult for companies to export to Japan. This category generally requires pre-market approval and is subject to limitations on composition and manufacturing processes. In China the regulation of cosmetics is complex, involving two separate government bodies. There are differences in requirements between imported and domestically-produced cosmetics. Furthermore, the overall approach is not aligned with that of the EU or any other main regulatory model. Burdensome regulations increase the cost of business and take time. Cosmetics legislation in China is currently under review, and may be subject to considerable change in the near future.

Distribution channels play a very important role in the cosmetic market. Consumers pay great attention when choosing the channels according to the type of product that they are seeking. In the EU they fall under four main categories: mass distribution, specialized distribution, pharmacy sales and direct sales. Channels are very similar across EU countries and somewhat similar in the United States. They operated quite differently in Japan and this difference forms the most significant trade barrier. The retail sector in Japan underwent considerable changes during the 1990s eliminating some of the inefficient practices that previously made it difficult for foreign retailers to sell to Japanese consumers. More recently, imports share of the market has been trending steadily higher. Barriers to trade from the market's structure appear to be more limited in China as cosmetics imports (especially from France) have been expanding rapidly.

While R&D does not appear to be a significant factor in limiting companies' entry to the cosmetics market, it is to be noted that the cosmetics industry is very dynamic and is characterized by innovation and a high rate of product development. Innovation is essential to maintain global competitiveness, improve performance, safety and the environmental impact of products, and to keep up with constantly evolving consumer preferences.

Some current market trends that drive R&D are:

- Anti-aging skin care is a growing market segment with the aging of the baby-boomer generation. Consumers want to see immediate results and are not brand loyal.
- Men's growing acceptance of the importance of being well groomed led to very strong performance in this segment, which is expected to continue going forward.
- Natural cosmetics are another fast growing category. This reflects the increased preference of consumers for less synthetic and more "natural" or "botanical" products.
- Customers are becoming increasingly aware of the risks posed by different ingredients used in cosmetic products. This is particularly the case in the U.S. where the cosmetic industry operates with little oversight by the Food and Drug Administration. In China there have been a number of product

withdrawals due to safety concerns in spite of the country's stringent regulations.

- Technological advances have allowed for the creation of multi-functional products. They have become popular because they place strong emphasis on value for money.

III. Sources of Competition

In the last few years, new forms of treatments brought alternatives to traditional cosmetics products. Skin care and sun care have clearly been the most dynamic product segments in the cosmetics industry and are being targeted by both the medical devices and pharmaceuticals industries.

Medical Devices and Pharmaceuticals Industries

Invasive cosmetic surgery has been around for some time, however long recovery times and scarring restricted its use. More recently minimally invasive methods including: laser and light treatment, chemical peels and microdermabrasions have been introduced as well as more drastic procedures such facelifts and laser resurfacing. In general the medical devices industry has been more successful recently in this segment with the introduction of more cost-effective and less disruptive procedures. These non-invasive cosmetic treatments have been experiencing very strong growth.

The pharmaceuticals industry introduced Botox (a purified form of botulinum toxin A) as an alternative to anti-aging creams. It is used to eliminate facial fine lines and wrinkles. Botox's effects usually last for as long as a year, resulting in the need for repeated procedures. In Europe, botulinum toxin Type A is marketed under the brand name Dysport and has been approved for use there since 1990. The U.S. FDA is in the final stages of approval for Dysport. Botox will likely face stiff competition from Dysport as it seems to have a better safety profile and a completely different mechanism of action.

Small and Medium-Sized Enterprises

Large international firms and their subsidiaries dominate the cosmetics market, receiving over half of the entire industry's sales. Nevertheless successful small businesses are making their presence felt. Some of these firms have been able to change the core values of the cosmetics industry by offering consumers the opportunity to make purchase decisions based on their enthusiasm for these innovative ways of doing business. The evolution of The Body Shop from a small store to a huge multinational with a leading global cosmetics brand is just but an example. The company's marketing strategy focuses on the use of natural ingredients in personal care products while its core business model promotes various social causes. In March 2006, the company was purchased by L'Oréal.

Growth in the natural cosmetics industry has been driven by a growing awareness of human environmental impact along with a desire to eliminate the use of products with potentially harsh chemicals. This new market segment is growing in Europe at a clip of roughly 20 percent per year. Natural cosmetic sales are booming in the United States as well, achieving a 10 percent share of the market. In Europe, over 400 SMEs supply organic cosmetics while in the U.S. companies have significantly consolidated operations in recent years in the hopes of gaining more exposure for their products by taking advantage of larger marketing potential.

Direct Selling Approach

Direct selling offers consumers a unique opportunity to purchase products outside of the traditional retail environment. Because this method has been so integral in the development of consumer relationships, it continues to be a popular method of sales in many countries. The direct selling approach enables the company to offer low-priced products to its customers because of reduced expenditure on advertising and promotion, the elimination of middlemen, and limited reliance on brick and mortar stores. Moreover, under this approach, consumers can ask questions, seek advice and get their product questions clarified directly from the sales consultants in a free and relaxed environment. Direct selling also ensures reliability and convenience to the consumers.

IV. Key Policy Issues – Research & Development

Today's cosmetic market is driven by innovation including new colour pallets, treatments targeted to specific skin types and unique formulas concentrating on different needs. R&D in this industry is constantly ongoing and conducted to facilitate new product development in response to changing consumer demands. In order to stay competitive, companies must successfully anticipate the coming consumer trends. Many companies have increased their R&D spending over the last few years due in part to improved profit levels and a realization that consumers may not always stay brand loyal. Many of the latest advancements include cosmetics that are designed to treat multiple problems with faster acting formulations. The growing men's cosmetic market has also led to a new direction in innovation for many companies.

Cosmetics companies need to be careful when introducing products that claim to have a medicinal or drug-like benefit. Drugs, defined as products which cure, treat, mitigate or prevent disease or that affect the structure or function of the human body, undergo highly regulated testing before they can be sold to consumers. Cosmetics however remain outside the scrutiny of these governmental bodies. This constraint may cause companies to understate the effectiveness of their products. New cosmetic products with these characteristics have taken on the name cosmeceuticals. Claims stated on labels, in advertisements, on the Internet, or in other promotional materials which could result in a product being classified as a drug could launch the regulatory scrutiny that so many companies are trying to avoid.

The following table provides a sample of the amount of R&D spent in the most recently available fiscal year by several major companies. This amount is also expressed as a portion of their total net sales.

R&D Spending

Total Cosmetic Related R & D Spending		
	Value (€ Millions)*	Share of Total Sales
L'Oreal Group	533	3.4%
Shiseido Co Ltd	119	2.5%
Beiersdorf AG	95	1.9%
Estée Lauder Cos Inc	59	1.1%
Avon Products Inc	52	0.8%
Henkel	51	0.4%
Dior	43	0.3%
Kose	30	2.3%
Revlon	19	1.8%
Alberto Culver**	11	0.4%

**For companies who report their financial statements in currencies other than Euros, a conversion was made using an average exchange rate for the 12 months prior to the end of the fiscal year.*
***From 2005 Annual Report which was latest available.*
Source: Company 2006 Annual Report unless noted.

Total R&D spending within an individual country also illustrates the importance of the cosmetic market and the impact that it can have on the economy. Given that France has

the largest domestic cosmetic market it's not surprising that industry R&D allocations are large. The cosmetics industry in Germany allocates €108.9 million to R&D activity. Combined these countries account for nearly the entire EU total. R&D activity is surprisingly low in Italy given the relatively large size of its domestic cosmetic market. R&D activity is minimal in some countries and zero in a large number of others.

R&D Expenditures by Country

	R & D Expenditure		
	Last Available Data Point	Total Intra-Mural Expenditure (€m)	Share of R&D Expenditure in Value Added
France	2001	262.4	8.4
Germany	2004	108.9	6.7
United Kingdom	2001	16.8	0.9
Spain	2000	14.6	3.1
Italy	1999	2.9	0.3
Belgium	2001	0.6	0.3
Austria	2004	0.2	0.8
Hungary	2001	0.2	1.6
Portugal	2001	0.1	0.3
Cyprus	2001	0.0	0.0
Finland	2002	0.0	0.0
Latvia	2004	0.0	0.0
Lithuania	2001	0.0	0.0
Malta	2002	0.0	0.0
Romania	2004	0.0	0.0
Slovakia	2001	0.0	0.0
Slovenia	2004	0.0	0.0

Source: Eurostat
Note: Intramural R&D expenditures are all expenditures for R&D performed within a statistical unit or sector of the economy.*

*Note**: No data was found for the U.S., Japan and China from Eurostat or other sources.*

Intellectual Property / Patents

The following table displays the number of patents published within a given year in the EU countries, the U.S., China and Japan.

Over the past 25 years, the number of cosmetics patents filed has increased tremendously. The United States, Japan, Germany, and France have received the majority of patents published; not surprising given their large domestic markets. According to the European Patent Office (EPO) cosmetics patents published by the U.S., China, Germany, Japan, Austria, and France combined for nearly 55 percent of the total patents published in 2005. Over the last 25 years, China, Japan, and Germany have had the most growth in the number of patents published. Meanwhile, the U.K. and Italy have experienced relatively large declines over the same period. Poland accounted for over three-quarters of all the patents published within the EU12.

Total Cosmetics Patents - European Patent Office

	Total Patents Published						Patents Filed Per Million People - 2005
	1980	1985	1990	1995	2000	2005	
EU27	783	880	719	1,993	1,945	2,599	5.30
EU15	770	852	697	1,777	1,614	2,429	6.28
EU12	13	28	22	216	331	170	1.64
U.S.	170	214	401	498	871	685	2.31
Japan	469	790	1,111	1,961	2,524	2,976	23.28
China	0	0	25	68	482	683	0.52
Austria	56	18	29	256	131	496	61.17
Germany	109	170	193	727	741	1,317	15.97
France	98	83	111	263	402	470	7.73
Denmark	28	50	46	98	57	37	6.82
Portugal	15	32	53	0	27	67	6.36
Poland	6	0	1	85	120	131	3.43
Slovenia	0	0	0	0	0	6	2.99
Cyprus	1	0	1	0	0	2	2.39
Hungary	3	10	20	60	114	16	1.59
Lithuania	0	0	0	2	0	2	0.58
Czech Republic	0	0	0	27	26	5	0.49
United Kingdom	185	73	42	40	17	26	0.43
Bulgaria	1	0	0	8	14	3	0.39
Finland	12	32	12	48	2	2	0.38
Belgium	39	40	16	4	2	3	0.29
Romania	2	18	0	5	4	5	0.23
Sweden	46	36	20	15	7	2	0.22
Spain	25	45	13	255	158	9	0.20
Netherlands	42	24	13	3	2	0	0
Greece	3	31	13	37	47	0	0
Italy	97	182	71	30	19	0	0
Ireland	11	13	32	1	2	0	0
Luxembourg	4	23	33	0	0	0	0
Estonia	0	0	0	0	2	0	0
Latvia	0	0	0	2	1	0	0
Malta	0	0	0	0	0	0	0
Slovakia	0	0	0	27	50	0	0

Source: European Patent Office.

Counterfeit Goods

Research performed for an organization called the Global Anti-Counterfeiting Group estimated that counterfeit perfumes and cosmetics cost the EU cosmetics industry €3.0 billion annually in lost revenue and a €555 million in lost profit. Counterfeiting reduces company revenues, stifles investment and innovation, and retards economic growth along with adversely affecting jobs and tax revenues. Of the 100 million counterfeit goods seized in 2003, 1.1 million of them were cosmetics and fragrances.

A recent study by Technopolis[3] commissioned by the European Commission on the effects of counterfeiting on EU SMEs found that these problems are particularly acute for smaller firms since they lack the resources to secure effective protection and enforcement of their intellectual property rights. The study makes the important point that judicial and administrative actions are available however proper registration of intellectual property is necessary to institute an action and 80% of SMEs in the EU fail to register their patentable rights.

[3] Technopolis – "Effects of counterfeiting on EU SMEs and a review of various public and private IPR enforcement initiatives and resources", available at http://ec.europa.eu/enterprise/enterprise_policy/industry/doc/Counterfeiting_Main%20Report_Final.pdf.

V. External Trade

The table below illustrates the size (in Euros) and compound annual growth rate from 1999 to 2005 of cosmetics exports. France has, and continues to be, the world's dominant cosmetics exporter. In 2005 France exported more than € 8 billion worth of cosmetics. This is more than twice the amount exported by Germany, Europe's second largest exporter, and 35% of total European exports. The United Kingdom, Italy, and Spain round out the top five European exporters, which collectively account for nearly 80% of Europe's total cosmetics exports.

The U.S. is the largest cosmetics exporter of the non-EU countries at € 3.8 billion of cosmetics products per year. China exports € 825 million of cosmetics products per year.

C&T Industry Exports

Product	2005		1999		CAGR%
	Value (€ 1,000)	EU Share	Value (€ 1,000)	EU Share	(6-year)
France	8,081,539	35.0%	5,531,614	38.6%	6.5%
Germany	3,967,456	17.2%	2,132,888	14.9%	10.9%
United Kingdom	2,910,471	12.6%	2,291,672	16.0%	4.1%
Italy	2,089,161	9.0%	1,116,698	7.8%	11.0%
Spain	1,378,227	6.0%	688,100	4.8%	12.3%
Netherlands	992,424	4.3%	381,298	2.7%	17.3%
Belgium	969,403	4.2%	698,335	4.9%	5.6%
Poland	750,066	3.2%	172,055	1.2%	27.8%
Ireland	483,107	2.1%	571,062	4.0%	-2.7%
Sweden	245,213	1.1%	151,707	1.1%	8.3%
Denmark	222,073	1.0%	111,683	0.8%	12.1%
Hungary	209,107	0.9%	38,332	0.3%	32.7%
Austria	172,356	0.7%	121,082	0.8%	6.1%
Greece	167,278	0.7%	78,079	0.5%	13.5%
Czech Rep.	139,393	0.6%	59,526	0.4%	15.2%
Luxembourg	81,795	0.4%	47,504	0.3%	9.5%
Portugal	81,779	0.4%	33,635	0.2%	16.0%
Finland	60,728	0.3%	49,774	0.3%	3.4%
Latvia	27,410	0.1%	4,677	0.0%	34.3%
Lithuania	23,683	0.1%	7,841	0.1%	20.2%
Slovakia	14,995	0.1%	7,347	0.1%	12.6%
Malta	12,103	0.1%	9,759	0.1%	3.7%
Estonia	5,744	0.0%	4,209	0.0%	5.3%
Cyprus	4,279	0.0%	5,578	0.0%	-4.3%
Total EU	23,089,792		14,314,457		8.3%
USA	3,815,577		2,549,353		7.0%
China	835,692		183,520		28.7%
Japan	633,578		443,146		6.1%
Grand Total	28,374,639		17,490,476		8.4%

Source: United Nations, Comtrade Database

Revealed Comparative Advantage

Traditional economics states that a country will export goods where it has a comparative advantage and import goods where it does not - comparative advantage helps to explain the direction of trade in goods between countries. Revealed comparative advantage (RCA) is used to quantify and test this well-known theory. The simple formula is as follows:

$$RCA = \frac{(\text{Country A's Exports of Product i} / \text{World Exports of Product i})}{(\text{Country Total Exports} / \text{World Total Exports})}$$

The figure below presents the revealed comparative advantage analysis for the 27 countries. The bubbles in the figure fall into one of four categories. The upper left quadrant countries with threatened cosmetics industries. Lower left quadrant contains countries with weakly positioned cosmetics industries. The upper right quadrant contains countries with strongly positioned cosmetics industries. Finally, the bottom right quadrant contains countries that have improving cosmetics industries. The size of the bubble is proportional to its 2005 export value in Euros.

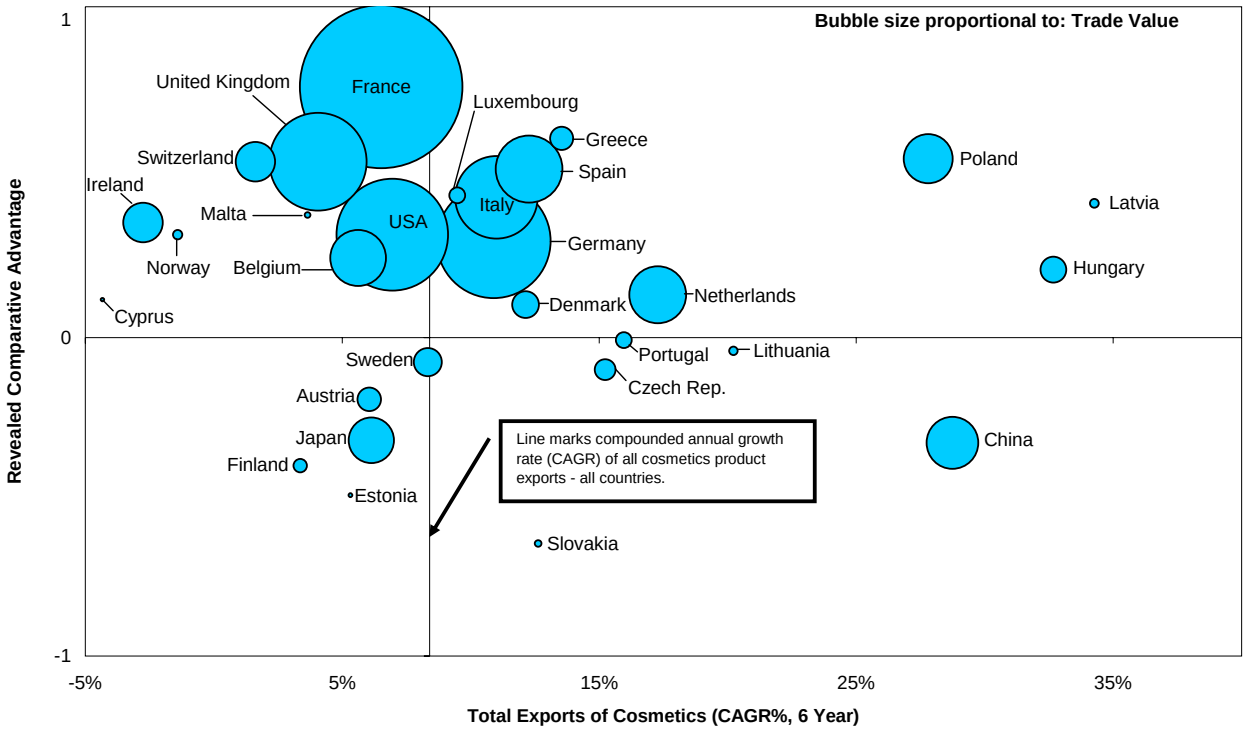
All of the largest cosmetics exporters have RCAs above zero – they have a comparative advantage in cosmetics products. Despite a clear competitive advantage, three of the top four cosmetics exporters by value, France, U.K., and the U.S. are threatened - each has grown more slowly than the industry.

Poland, Latvia, and Hungary form a clear cluster of very well positioned cosmetics industries. Each has grown at more than three times the cosmetics industry average, while maintaining a clear comparative advantage in the industry. This group is well positioned and their cosmetics industries can be expected to continue to flourish.

China is the only other country analyzed with a similarly high compound annual growth rate, at 28.7%. Despite having an RCA below zero, the extremely rapid export growth over the last 6 years makes it clear that China's cosmetics industry is poised to improve rapidly and gain market share.

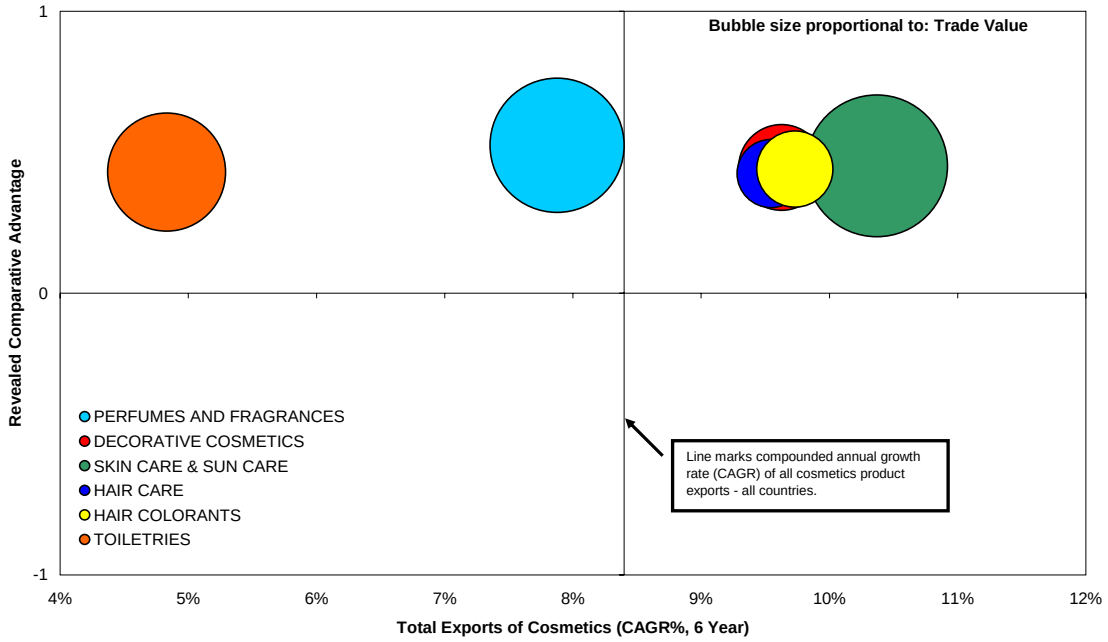
Japan is the largest weakly positioned cosmetics industry. Japan's RCA is well below zero, while cosmetics exports have grown at only 6.1% annually. Austria, Finland, and Estonia are the only European countries with a weak cosmetics industry.

Cosmetics Industry RCA Analysis



Source: UN, Comtrade Database & Global Insight, World Economic Service

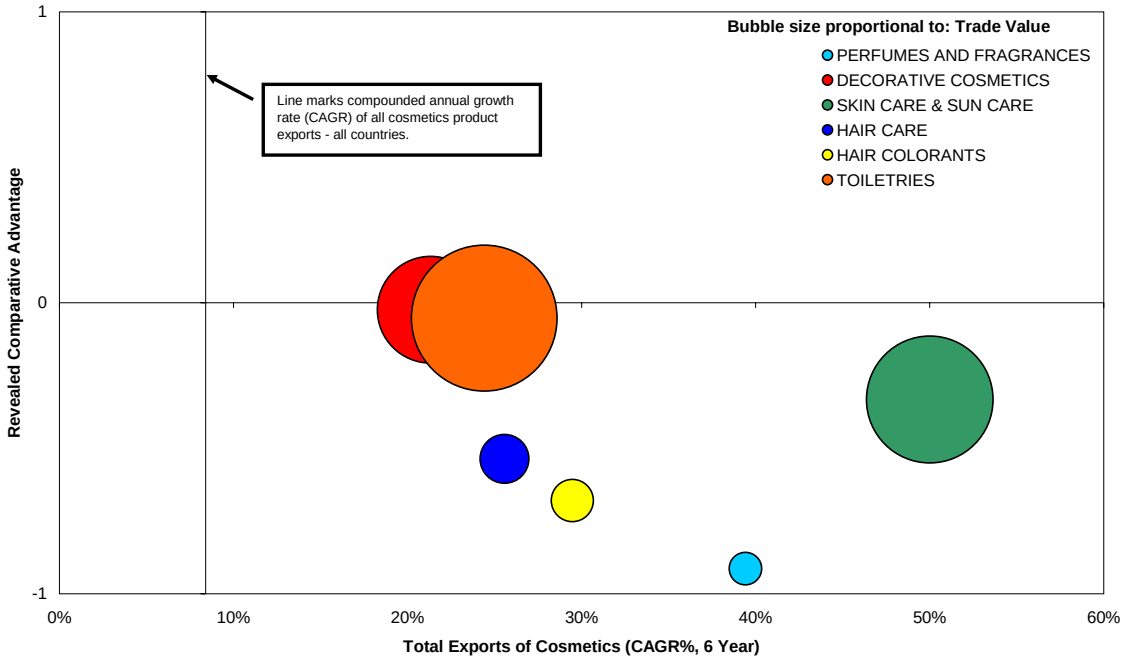
EU Cosmetics Industry RCA Analysis



Source: UN, Comtrade Database & Global Insight, World Economic Service

The figure above illustrates the relative strength of the overall cosmetics industry in the EU. The EU region in fact has a comparative advantage in every cosmetics product group. Only the toiletries and perfumes and fragrances product groups are threatened despite being quite large and having an RCA value well above zero. Skin care and sun care are the EU's best positioned product group while decorative cosmetics, hair care and hair colorants are also strongly positioned as their rate of export growth is faster than the industry average.

China Cosmetics Industry RCA Analysis



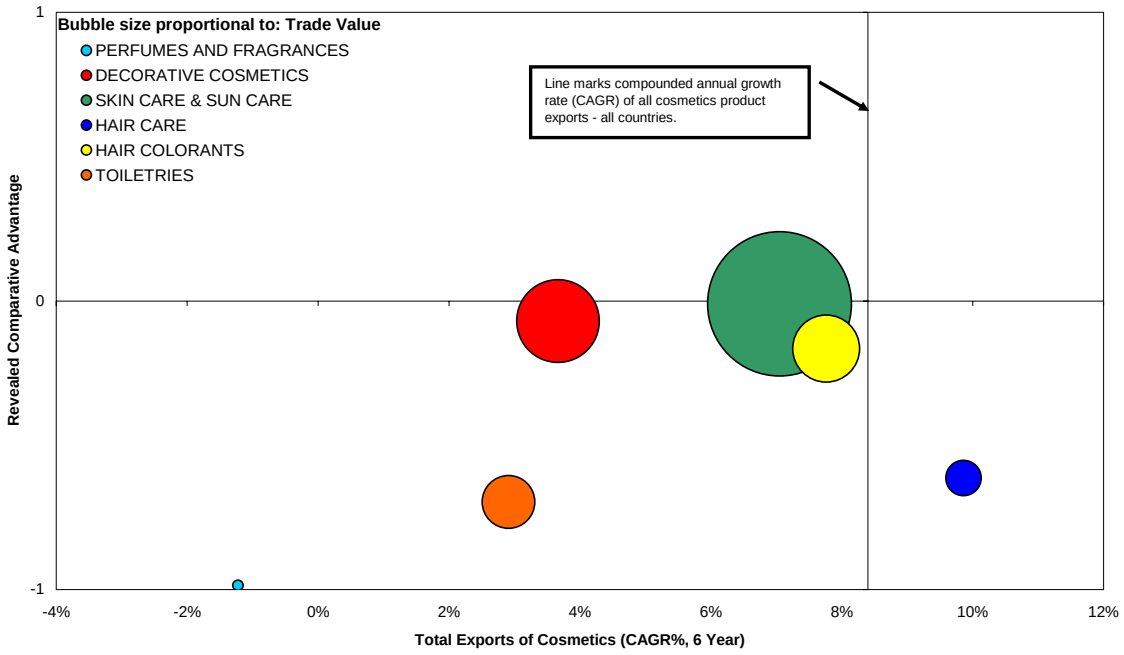
Source: UN, Comtrade Database & Global Insight, World Economic Service

The figure above illustrates the relative strength of the overall cosmetics industry in China. China does not have a comparative advantage in any cosmetics product group.

The apparent weakness belies the potential of the Chinese cosmetics industry. The compound annual growth rates of each of these product groups are phenomenally high. From 1999 to 2005 skin and sun care products increased more than 11 fold, growing at a compound annual rate of 50.0%. The compound annual growth rate of all Chinese cosmetic product groups combined was more than 25% annually, three times greater than the industry average.

Even perfumes and fragrances, the smallest and least comparatively advantaged cosmetics group in China has grown at nearly 40% annually. The speed of growth in the Chinese cosmetics industry is so fast that each product group is improving and has tremendous opportunity to gain market share.

Japan Cosmetics Industry RCA Analysis



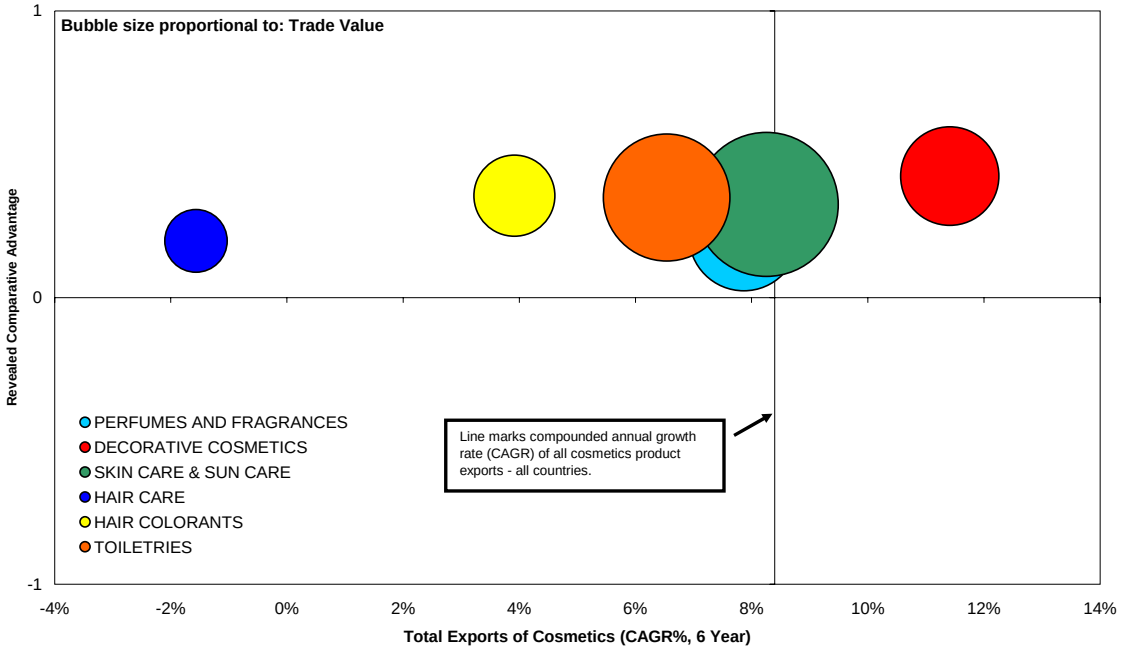
Source: UN, Comtrade Database & Global Insight, World Economic Service

The figure above illustrates the relative strength of the overall cosmetics industry in Japan. Japan does not have a comparative advantage in any cosmetics product group.

Hair care is the lone bright spot in the outlook for the Japanese cosmetics industry. Despite the RCA below zero, exports are growing faster than the cosmetics industry average. Even this somewhat positive news is mitigated by the fact that hair care is a particularly fast growing product segment world wide. Although the industry export as a whole are growing at 8.4% annually, exports of hair care products have grown 10.4% per year. When measured against this product specific growth rate, Japan's hair care exports appear weakly positioned.

The balance of Japan's cosmetics product groups are more clearly threatened. Each has a weak or declining comparative advantage. A major shift in the industry would be necessary for these products to regain their competitiveness.

United States Cosmetics Industry RCA Analysis



Source: UN, Comtrade Database & Global Insight, World Economic Service

The figure above illustrates the relative strength of the overall cosmetics industry in the United States. The U.S. has a comparative advantage in every cosmetics product group.

Decorative cosmetics are the only strongly positioned product group in the U.S. and is expected to maintain its comparative advantage. It has a compound annual growth of 11.4% in addition to the highest RCA value of any product in the nation. Despite the apparently high annual growth rate it is important to note that while the overall cosmetics industry has grown at 8.4% annually, decorative cosmetics have grown at a faster 11.4%. The U.S. decorative cosmetics group is well positioned, but less dominant than it appears when compared to the narrower product group.

Perfumes and fragrances, skin and sun care, hair colorants, and toiletries are growing slower than the industry average. As a result, despite RCAs well above zero, each is significantly threatened and in need of repositioning.

Hair care is a mature, declining segment for the U.S., at least from an export perspective. Exports declined by a compound annual rate of -1.3% annually from 1999 to 2005. These positive RCAs may be more a signal of how competitive these product groups once were.

VI. Conclusions and Policy Recommendations

A number of EU countries have developed a large trade surplus and a significant comparative advantage in cosmetics products. This is clear evidence that cosmetics manufacturers in these countries have, over the years, identified the most important consumer trends and have responded with new product offerings that have been successful. These companies have accomplished this task in both domestic and export markets. In the process, these companies have successfully developed strong brand recognition in a highly competitive and dynamic market place.

French and German companies sustain their comparative advantage by allocating more resources to innovative activity and new product development than other countries. The result is a large number of patents and successful new product launches in each company's established markets. Smaller market countries like the Netherlands, Ireland, Belgium and Poland have found non-traditional routes to developing comparative advantage.

The study found that companies in France, Germany, the U.K., Italy and Spain have been at least as successful at developing comparative advantages in cosmetic products as their counterparts in the United States. They have been more successful in this regard than firms in Japan and China.

The most significant threat to the ongoing competitiveness of the industry in most EU countries is relatively low productivity combined with high unit labour costs. Simple productivity comparison across countries exposes a wide gap between EU companies and their counterparts in the U.S. and Japan. Even after making adjustments to the data and taking into account a number of important measurement issues, the productivity gap favouring firms in the U.S. and Japan is still considerable. Clearly manufacturers in these countries have pursued business strategies that have resulted in a more competitive industry. It is also likely that economic policy and the regulatory environment in these countries allows these firms sufficient flexibility to pursue these strategies.

The study found that to-date manufacturing in lesser developed countries has been limited to a few firms. This may be due to government restrictions on firms to relocate. In any one country, unit labour costs are relatively inflexible so the relocation of productive resources of slow growing product segments (toiletries and hair care products) to low labour cost countries like the newer EU member countries and China would have industry as well as social benefits.

This study has found that the impact of counterfeits on industry revenues and profits is significant in the EU. Counterfeits are generally replicas of high-end brand name decorative cosmetics and fragrances. Successful branding is a key factor in the development of comparative advantage and counterfeits can pose a serious threat to brand loyalty. Counterfeits also reduce the return to R&D consequently the impact will be shouldered primarily by firms in France and Germany, where R&D expenditures are the highest. Efforts should be considered to coordinate the enforcement of anti-counterfeiting laws across the EU countries.

In general, EU companies have had little success in penetrating the market in Japan and China. Regulatory barriers may have been an issue for EU firms in the past, however, the study found that the accessibility of the Japanese cosmetics market has greatly improved since it was deregulated. Deregulation included the abolition of pre-market approval, the establishment of a prohibited ingredient list similar to the EU and the abolition of the designated ingredient list. EU firms need to recognize the benefits of deregulation in Japan and pursue more aggressive growth strategies in that market.

Channels of distribution are similar across EU countries and the U.S., however, they operated quite differently in Japan and this has likely formed the most significant trade barrier. Our study found that the retail sector in Japan underwent considerable changes in the recession years of the 1990s which eliminated some of the inefficient practices. The retail sector is now more comparable to retail sectors in Europe and North America. EU firms are now much more likely to be successful exporting into Japan's large market.

Larger companies have acquired strategic assets in fast growing markets like China or in large markets with low barriers to entry like the United States. The acquired firm often is a SME that has brought an innovative product to market. Large companies have begun early stage production in less mature markets to not only reduce production and transportation costs, but also to better understand cultural differences and their impacts on evolving consumer preferences.

Policy considerations may also involve information sharing / education on the evolution of the industry and consumer preferences with SMEs – assuming large companies conduct this research internally. This type of initiative may assist the development of SMEs and their business strategy formation. There are a large number of new natural / organic products brought to market by SMEs. France, Italy, and Spain have a high concentration of SMEs in their markets. Large companies are acquiring SMEs that have successfully introduced products into the fast growing market segments. Clearly there are opportunities for SMEs in the EU, if they are well-informed, to capitalize on their knowledge of this rapidly evolving market.