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Consumer Packaged Goods

What beauty players can teach the consumer sector about digital disruption

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As many consumer businesses struggle to deal with the pace of change, the beauty sector shows the way.

After many decades of stable outperformance, the fast-moving consumer-goods (FMCG) sector is at a crossroads. Consumer preferences have upended the long-standing FMCG marketing playbook, while digital technologies are revolutionizing the way consumers engage with brands and shop. In this context, many FMCG companies are getting serious about change.

As they look for inspiration, they will find that one FMCG industry—beauty—is way out in front, serving as a bellwether of changes to come elsewhere. The beauty-industry case study reveals how profoundly consumer preferences and behavior are changing, how "born digital" challenger brands use new marketing messages and outlets to capitalize on these changes, and how some incumbents are adapting their competitive advantages to win.

The beauty sector is advanced because of the way beauty-loving consumers engage with the category. For decades, they have sought out innovations, embraced the stories behind brands, and enjoyed the shopping experience, solo and with others. For decades, these characteristics have shaped how beauty brands marketed and sold their products. But today, digital is dramatically expanding the beauty consumer's connection with brands and products. A strong case could be made that the influence of digital marketing and social media has gone further, faster, in beauty than in any other FMCG industry. The others can therefore benefit from its experience.

The rise of born-digital challengers

The global beauty market—including bath and shower, fragrances, hair care, makeup, and skin care—is a $250 billion global business, according to Euromonitor. Historically, large legacy brands have ruled the industry, both in market share and in prestige. Recently, however, born-digital brands have become the big growth story, particularly in color cosmetics, a category well suited to digital marketing because of its visual nature. From 2008 to 2016, color-cosmetics challenger brands grew by 16 percent a year, four times as fast as legacy companies. They now account for 10 percent of the color-cosmetics market, up from 4 percent in 2008 (Exhibit 1).

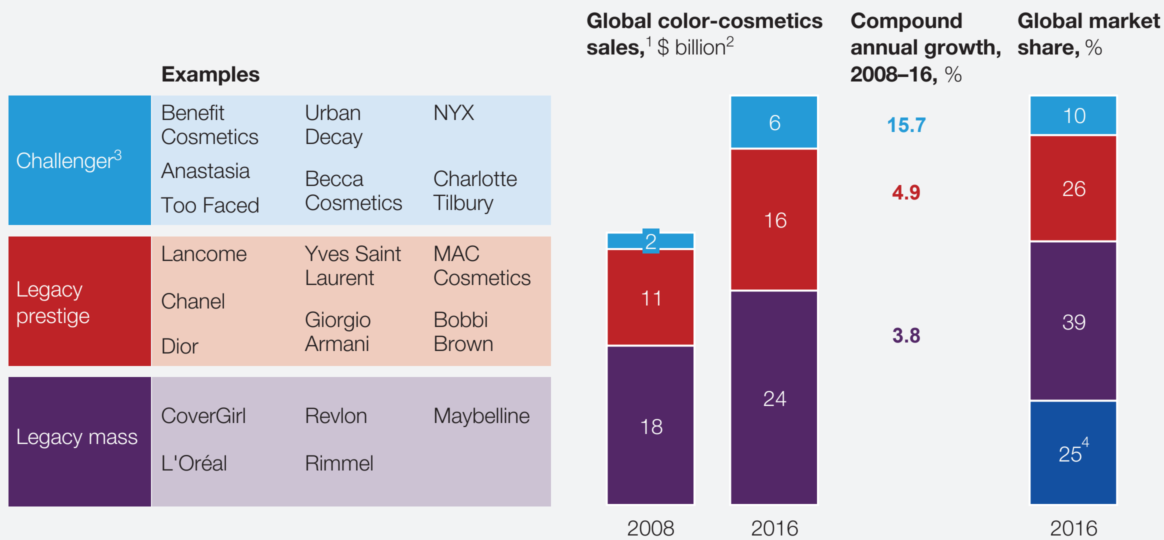
Dig a little deeper and other themes emerge. One is that, according to McKinsey analysis, the upstarts are almost all single-brand beauty companies, which account for almost 50 percent of the $2.7 billion in venture-capital (VC) investments the beauty industry has received since 2008 (Exhibit 2) and 80 percent of VC funding in 2017. Another is that 31 percent of the beauty companies that get VC funding emphasize "conscious consumerism"—they use natural or organic ingredients and commit themselves to following certain social or environmental standards. Another 5 percent focus on minority groups. Finally, the growth of born-digital challenger brands is accelerating: more than 70 percent of the $2.7 billion in VC investments were made from 2014 to 2017.

There are five major reasons for the recent success of challenger brands in the beauty industry.

The growth of consumer engagement on social media

The consumer has spoken. According to the WaR Agency, a London-based marketing firm, seven out of ten people surveyed said they want to learn about products through content rather than advertising. To a large degree, consumers seem to be acting on that idea: beauty was the third-most-searched topic on Google in 2016, and the number of views of

Exhibit 1 **In makeup, challengers account for 10 percent of the market and are growing almost four times faster than legacy companies.**



[1] Excludes smaller brands aggregated by Euromonitor into an "Other" category.
[2] Retail selling price, at fixed exchange rates.
[3] McKinsey analysis.
[4] Other, such as private-label brands.

Source: Euromonitor

beauty videos on YouTube rose by 67 percent from 2015 to 2016. YouTube is already the world's leading beauty platform, with more than 1.5 million beauty videos (accounting for 4.6 billion views) uploaded each month. Color-cosmetics products particularly appeal to the selfie generation because of their visual nature. Online videos (or "vlogs") not only teach consumers how to apply makeup but also promote the rise of "micro-influencers"—those with 10,000 to 100,000 followers.

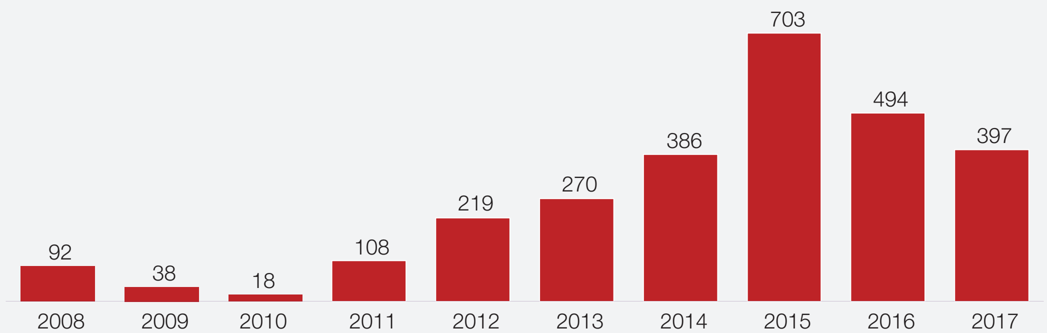
Traditional brands account for a relatively small share of YouTube views; born-digital brands are at the top of most social leaderboards. Anastasia, founded in 1997 as an eyebrow specialist (and now with annual net sales of $340 million), has 16.2 million followers on Instagram, more than any other beauty company. On its social-media platforms, Anastasia averages more than 60 posts a week, led by 600 influencers. Its online sales in the United States increased by 150 percent in 2016, faster than those of any other player in the industry, and retail sales rose more than 100 times from 2012 through 2015. And four-year-old, UK-based Charlotte Tilbury has ten times as many YouTube subscribers as the average legacy brand.

The evolving product and shopping preferences of the millennial generation

A devotion to social media isn't the only way millennials—people born from the early 1980s through the late 1990s—differ from their elders. According to McKinsey research, they are three times more likely than baby boomers to assume that newer brands are better or more innovative and three times more likely to say they typically learn

Exhibit 2 **Venture-capital firms invested $2.7 billion in the beauty sector from 2008 through 2017.**

Venture-capital investment, $ million



Examples	Beleza	Drybar	Birchbox	The Honest Company	Memebox	Deciem	Glossier	Milk Makeup	Glissed	Prose

Source: Pitchbook; McKinsey analysis

about new products or brands from social media. Traditional FMCG marketing vehicles, such as in-store displays, print advertising, and television commercials, therefore influence millennials less. As beauty consumers, they are quick to try new products, and they change their preferences often. Asked “when was the last time you purchased a new cosmetics brand?,” 48 percent of millennials active in the category replied, “in the last month,” versus 19 percent of boomers. Millennials place a higher priority on what they consider to be authentic and personal. They expect to be able to try anything once—free of charge. They crave newness in beauty; they want the experience to be fun and prefer informal interactions.

A new marketing formula made possible by digital

By engaging with consumers—mostly millennials—directly through social media rather than traditional advertising, challenger brands have created a new way of marketing (Exhibit 3). It is more than transactional; rather, it is about creating a relationship. Encouraging the exchange of product experiences via Facebook, Instagram, and YouTube is a powerful way of building a community around a brand and can help to enhance its perceived quality. By encouraging these practices, brands cultivate the sense that consumers are present at the creation. Importantly, this new approach to marketing allows born-digital players to charge relatively high prices.

By contrast, some younger consumers view older brands as lacking an authentic story. That makes it more difficult for brands to connect with them through social media, despite their increased efforts.

The growth of omnichannel and online-only beauty retailers

A major part of the value proposition of omnichannel beauty retailers and online-only beauty sites is access to different brands, including new ones, and the ability to interact with a community larger than a friend or two in front of a mirror. Sephora, Ulta Beauty, and other omnichannel retailers that let consumers sample their products are growing rapidly. So are some online-only beauty retailers. This

Exhibit 3 **Social media opens new ways to market to consumers.**

How beauty consumers use social media

- **1.5 million** beauty videos uploaded to YouTube each month in 2016
- **4.6 billion** monthly views of beauty videos in 2016
- **67 percent** growth in views of beauty videos from 2015 to 2016
- Beauty was the **third-most-searched** topic on Google in 2016

How social media creates new marketing opportunities	Example
Tapping into influencers and generating buzz through social media	**Anastasia**
Creating an authentic story linked to its founder's persona and makeup artistry	**Charlotte Tilbury**
Translating fame as a beauty blogger/influencer into a global beauty brand	**Huda Beauty**
Using direct-to-consumer channels to build a brand and then expanding to select retail outlets	**ColourPop**
Crowdsourcing innovation and getting real-time feedback	**Glossier**
Developing subscription models that allow customers to sample up-and-coming brands	**Birchbox**

Source: McKinsey analysis

growth is expected to continue. In the United States, Sephora's same-store sales are rising by 7 percent a year, and the company plans to open 20 new stores a year through 2020. Ulta Beauty, whose same-store sales are growing by 14 percent annually, has a goal of opening 100 new stores a year through 2019.

These companies encourage people to try products in a fun, unintimidating environment that allows them to experiment across a wide range of different brands, from mass to prestige, eliminating yesterday's compartmentalization. According to the research firm L2, 60 percent of Sephora.com's users and 47 percent of Ulta.com's users shop by product category. That practice encourages exploration—a significant change from the past, when people tended to shop by brand. New technologies, such as augmented-reality apps, allow consumers to upload selfies and then to experiment digitally with different products. The truly daring can upload pictures and ask others to "like" (or not) the result. In addition, subscription services, such as Ipsy ($103.5 million in VC funding in 2015) and Birchbox ($86.9 million in 2016), offer a regular stream of new products, often from smaller brands.

These trends have supported the rise of direct-to-consumer brands, such as ColourPop and Glossier. ColourPop began in 2014 as an online-only cosmetics brand that offered high-value "wallet friendly" products and a fast innovation cycle. This proved to be a winning formula. ColourPop, one of the fastest-growing beauty brands ever, now offers an exclusive collection for Sephora.

Glossier, which evolved from the popular beauty blog Into the Gloss (founded in 2010 by Emily Weiss), has become an influential cosmetics brand beloved by social-media influencers. It offers a relatively small collection of products—albeit sometimes with waiting lists 10,000-people long—so it can't afford to miss the mark. Glossier turns for ideas to its customers and works with 100 of its top ones to get real-time feedback.

The sophisticated use of contracting

Challenger brands tend to concentrate on marketing and to outsource most other aspects of the business, including product innovation. This strategy of concentrating on the brand's development keeps fixed costs low and provides for rapid innovation cycles. It also means, however, that new formulations are often the intellectual property of the manufacturers, rather than the brands themselves, and can therefore also be used by competitors.

The majors respond

The major beauty companies still lead the market: annual sales of the biggest are several times those of all the upstarts combined. Of course, the changing dynamics are well known to them. While some were slow to react, others have capitalized on digital opportunities, often with excellent results. The big players have adopted three major strategies.

- Acquisitions. In 2016 alone, Bloomberg estimates, traditional companies made 52 acquisitions of beauty-related companies, many of them small ones with digital expertise.

  Consider Estée Lauder's 2017 purchase of a minority stake in Toronto-based skin-care company Deciem. Founded in 2013, it has a cult following among millennials and a reputation for innovation and marketing savvy. Estée Lauder has also bought digitally oriented make-up companies such as BECCA (2016) and Too Faced (2016). L'Oréal has made three major acquisitions of challenger brands in the past five years—Urban Decay (2012), NYX (2014), and IT Cosmetics (2016).

  While the fate of some of these acquisitions is still unclear, especially given their high multiples, the purchase of Urban Decay looks like a winner, with sales tripling from 2012 to 2015. So does the purchase of NYX, where sales, driven by international expansion and healthy growth in the United States, quadrupled from 2014 to 2016.

- Adaptation. Traditional beauty-industry leaders are investing substantial resources in digital media and influencer marketing, and they are working to foster engaging user-generated online content. They are also far ahead of companies in other FMCG industries in building digital organizational capabilities: since 2010, for instance, L'Oréal has hired 1,600 digital experts and added a digital officer to the C-suite. This investment seems to be paying off: L'Oréal's Maybelline brand clinched the number-one spot in L2's 2017 Digital IQ Index for beauty—the first mass brand to do so.

  "All of our brands are spending increasing amounts in digital and social," noted Estée Lauder's group president, Jane Hertzmark Hudis, in an online interview with the fashion site Glossy. "It's not about how a brand defines itself today; it's how an audience defines you in their mind.... Consumers tell our stories now." When Estée Lauder launched its new Double Wear Foundation, it therefore did so on Facebook. It has also begun using augmented reality to help consumers with their questions. On the whole, traditional beauty companies are making strides in using social-media influencers and digital channels. Artificial intelligence, augmented reality, and digital technologies will continue to be important tools for both old and new beauty brands.

- Incubation. One characteristic of beauty's 21st-century challengers is the speed and verve of their innovation; then they tell those stories to the world through social media. An internal incubator within a larger business can support and participate in the growth of smaller brands. In 2010, the French luxury brand LVMH created Kendo, a beauty incubator with a mandate to build brands (either from scratch or through acquisition) that could then be sold by LVMH's retailer, Sephora. Kendo and its brands have extensive autonomy, and the managers, many with backgrounds in start-ups, have a distinctively risk-oriented outlook.

  LVMH has accepted this higher degree of risk as the price of doing business in the current environment. Kendo has delivered some big hits, such as Marc Jacobs Beauty, an award-winning brand launched in 2013, and Kat Von D, which is expanding internationally. More recently, Fenty Beauty, started by Rihanna in September 2017, has been hitting a popular nerve, particularly for nonwhite women. An incubator allows larger players to innovate more rapidly and to nurture smaller brands rather than wait to make expensive acquisitions.

Next steps for FMCG companies

From 2012 to 2015, the top 25 US food-and-beverage players accounted for 45 percent of sales but for only 3 percent of sales growth, according to Nielsen. Over the same period, most of the top 25 global FMCG players have experienced declining earnings and below-average shareholder returns.

To do better, and to get ahead of the competition from a rising generation of niche and local players, FMCG companies need to understand how their consumers are changing and should then adapt their marketing and channel strategies to suit. Whether the product is lipstick or diapers, it is essential to engage consumers. That means deploying expertise in digital marketing, social media, and the increasingly important influencer ecosystem, while building the advanced-analytics and channel-management capabilities needed to understand consumer behavior.

The first step for FMCG companies is to examine their portfolios to understand where they are most at risk of disruption. In view of the beauty sector's experience, the most vulnerable areas have several of the following attributes: significant emotional engagement among consumers, high profit margins, low shipping costs as a percentage of average ticket, low regulatory barriers, and the ability to outsource parts of the value chain. In segments that tick at least three of these boxes—including bathroom fragrances, eyewear, mattresses, and men's razors—serious born-digital challengers have already appeared.

Second, like the beauty powers, major FCMG players need to embrace a very different retail environment. The clout of mass retail is diminishing as the e-commerce giants continue to grow—by a robust 26 percent a year since 2011—and as discounters and club stores build market share, particularly in the grocery sector. FMCG companies must learn how to use these new channels and to strengthen their operations and procurement practices to offset pressure on prices.

One approach is to create new organizational structures, such as incubators or corporate VC funds, which can help companies to improve innovation outcomes, develop new brands, and compete with challengers. Many major FMCG companies have built command-and-control structures focused on execution. The operating model of the future, however, is likely to be agile. Inspired by the software industry, it will have a dynamic front end that is close to the consumer and supported by a stable backbone of support functions. This new model will be implemented by networks of multifunctional teams that pursue specific goals and then go on to something else. The culture is not so much about hierarchy as about attracting, engaging, and flexibly deploying talent.

To build this model, top FMCG companies can draw on their historically strong business infrastructure, such as back-office functions, cost-management systems, and supply-chain management. But they also need to build excellence in new areas, such as digital marketing, advanced analytics, and e-commerce.

As the influence of digital technologies works its way through category after category, their importance in the beauty industry isn't expected to diminish. Over the next few years, industry incumbents will probably continue their efforts to get better at managing and scaling small brands; more incubators will emerge; social marketing techniques will evolve; and consumer engagement will continue to rise. Beauty will therefore continue to serve as the bellwether of change within the consumer-goods sector—and will go on showing how companies can adapt to win. ■

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