
The effects of vertical restraints and online sales in the cosmetics industry

A report for Cosmetics Europe

RBB Economics, 31 October 2019

Contents

1	Introduction and executive summary	4
1.1	Introduction	4
1.2	Executive summary	5
2	The preservation of presale services provided offline is important for consumer welfare	13
2.1	Consumers value strongly the services offered in stores when selecting cosmetic products, due to the characteristics of these products.....	13
2.1.1	The ability to smell, touch and feel the products is an important service for consumers in the cosmetic industry	13
2.1.2	The importance of personal advice from a professional.....	16
2.1.3	The importance of the promotion and protection of brand image.....	18
2.2	These important services are expected by consumers to be provided in physical stores.....	21
2.3	The reduction of presale services would lead to inefficiencies in the cosmetics markets and to a reduction in consumer welfare	24
2.3.1	Entry and innovation would likely be hampered	24
2.3.2	Brand image would likely be deteriorated.....	26
2.3.3	Product quality would likely decrease.....	26
2.3.4	The size of the market would likely become smaller, lowering consumer welfare	27
3	The growth of online sales is likely to result in under-provision of the important services provided offline	29
3.1	The online channel has been increasing quickly in recent years and is expected to continue growing in the coming years.....	29
3.1.1	Online sales have been growing quickly in the last few years in the cosmetics industry and are expected to continue growing in the near future	30
3.1.2	The online channel is increasingly used by brands and retailers to share information about products and reach new customers.....	33
3.1.3	A combination of both online and offline channels is increasingly used during the purchasing process.....	34
3.2	The growth of online sales contributes to the weakening of the network of physical stores and the services provided instore	35
3.2.1	The showrooming (or “free-riding”) behaviour of consumers is widespread and growing	35
3.2.2	In comparison to online sales, offline sales generate limited economies of scale	38
3.2.3	The growth of online sales can result in overall decrease of the level of services provided offline	40
3.3	Certain websites can be detrimental to brand image	43
3.3.1	Some characteristics of the online channel, if uncontrolled, may harm the brand image of luxury and high quality products	44
3.3.2	The brands need to have a minimum control over the websites that display, promote and sell their products	45
4	More flexible rules on vertical restraints could preserve the important services provided offline without causing consumer harm	47
4.1	Vertical restraints can solve the free-riding problem, with differing efficacy	48

4.2	There are low risks that vertical restraints lead to anticompetitive effects in the cosmetics markets, due to strong inter-brand competition	50
4.2.1	When inter-brand competition is strong, there are very low risks that vertical restraints lead to anticompetitive effects	51
4.2.2	There is strong inter-brand competition in the cosmetics markets	54
Annexes		61
A	Cosmetics Distribution Channels in France and Italy	61
B	Survey methodology note	63
C	Consumer survey results: Other countries	64
C.1	Evidence of Consumer Showrooming	64
C.2	Reasons Not to Purchase Online At All	66
C.3	Reasons to Purchase Offline.....	67
C.4	Reasons to Purchase Product Never-Tested and Never-Previously-Purchased Online	68
C.5	Last Offline Purchase Driver	69
C.6	Last Online Purchase Driver	70
D	Analysis of Market Concentration	71

1 Introduction and executive summary

1.1 Introduction

This report has been prepared by RBB Economics at the request of Cosmetics Europe, in the context of the European Commission's public consultation on the revision of the Vertical Block Exemption Regulation ("VBER").

The aim of this report is first to assess, ten years after the last revision of the VBER, the degree of development of online sales in the cosmetics markets and consumer behaviour and preferences in relation to the online and offline channels. Based on this assessment of the market evolution, this report analyses if the current regulation is still "fit for purpose" to enable cosmetics markets to function effectively to the benefit of consumers by fostering sales and effective competition, including on non-price factors such as quality and variety of products, innovation and brand image. Moreover, we have been asked to assess whether adjustments to the current regulation would better deliver on these objectives.

The scope of the assessment presented in this report is approximately the next ten to fifteen years, as we may not expect a new revision of the VBER before this time and online sales are likely to keep growing in the cosmetics markets during this period. This time scope of course inevitably involves some extrapolation and uncertainty.

In order to better understand the evolution of customers' purchasing behaviour and the services and other factors that are important to them, RBB has conducted a detailed consumer survey with the help of survey firm KANTAR in five European countries, whose results are presented in this report to complement existing market studies and available data.¹

The present report and the accompanying consumer survey (hereafter "the consumer survey") focus on the products sold online and offline through selective distribution networks (hereafter "the selective market" or "selective cosmetics"), as opposed to the "mass market", which accounts for 80% of sales of cosmetic products.^{2, 3} In the selective market, competition on non-price factors that are highly valued by consumers – services, quality, brand image, innovation – is particularly important and vertical restraints play a crucial role in enabling firms to compete effectively on these dimensions.

This report relates to three main categories of cosmetic products⁴: fragrances, also called "perfumes"⁵, skincare/bodycare products, which also include "dermo-cosmetics" (hereafter

¹ Namely, France, Germany, Italy, Poland and Sweden. See Annex B for the survey methodology

² Xerfi Global (2018). "The Global Perfumes and Cosmetics Industry: the Market", Page 20

³ In recent decisions on market definition taken by European Commission, it is suggested that the "mass" and "prestige" markets are distinct, though the question is ultimately left open: See for example *Coty/P&G* (Case COMP/M. 7726 (16/02/2016)) Paragraphs 36 and 60

⁴ A "cosmetic product" is defined by the European Cosmetic Regulation as "*any substance or mixture intended to be placed in contact with the external parts of the human body (epidermis, hair system, nails, lips and external genital organs) or with the teeth and the mucous membranes of the oral cavity with a view exclusively or mainly to cleaning them, perfuming them, changing their appearance, protecting them, keeping them in good condition or correcting body odours*".

Retrieved from: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009R1223&from=EN>

⁵ Which include eau de parfum, eau de toilette and eau de Cologne.

“skincare”)⁶ and makeup products, also called “colour cosmetics”. Since consumer behaviour can differ across each of these three categories, the present report and consumer survey analyse each of these categories separately.

1.2 Executive summary

Global sales of cosmetic products, including both mass and selective, reached more than 300 billion euros in 2017 globally and in 2018, retail sales in Europe amounted to 78.6 billion euros.⁷ In the selective market, which is the focus of the present study, fragrances account for the large majority of sales in value (67%), far above skincare (18%) and makeup (15%).⁸

The main conclusions of this report are summarised below.

Section 2 of this report shows that the services offered by cosmetic brands in the offline channel are strongly valued by consumers and are in many cases ill-suited to being provided online. Such services are **important** to foster sales, innovation, competition, brand image, a positive shopping experience, and the quality of products. Therefore a reduction in the quality or availability of these services would negatively impact consumer welfare.

Cosmetic products have specific characteristics that make them particularly dependent on services that, for the most part, can only be provided offline:

- One of the most valuable services sought by consumers of cosmetics goods is the **ability to smell, touch and feel the products** before purchasing them, which cannot be achieved online. In the consumer survey, across all countries, approximately 50% of consumers (60% in Sweden) listed the ability to smell, touch and test the product as a reason to purchase offline.⁹ Across all countries this was the most commonly cited reason for using this channel. Furthermore, 70%-85% of consumers marked the ability to test as important when buying for themselves cosmetic products that they have never tested before.¹⁰ Cosmetic products are so-called “experience goods”, which require consumers to use or test the product to establish their valuation. And unlike other experience goods that can better accommodate a lack of offline services, in this market consumer tastes are personal and subjective; furthermore, these products mainly refer to the sense of smell and touch, and less to the sense of sight.
- Another feature of cosmetic products is the **importance of personal advice**, which can be provided in part online but is nonetheless also better suited to the offline channel.¹¹

⁶ Which include for instance facial and body treatments, creams, masks, sun screens, haircare and hygienic products such as deodorants, toothpaste, shaving cream, etc.

⁷ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 7 for global figure and <https://www.cosmeticseurope.eu/cosmetics-industry/> for European figure.

⁸ Statista Research Department (2019). « Répartition de la valeur du marché de la parfumerie sélective en France en 2016, par catégorie de produits » (Translation : « Share of the market value of selective perfumery in France in 2016, by product category »). Retrieved from <https://fr.statista.com/statistiques/608643/parfumerie-selective-repartition-marche-en-valeur-par-categorie-france/>

⁹ Consumer survey response to “**What are the main reasons for buying the following beauty products in physical stores rather than online?**” Base: Check online price in store

¹⁰ In response to “**How important to you are the following criteria when buying a [cosmetic product] that you have never tested before...?**”

¹¹ In France, Poland, Italy and Sweden, 20-35% of consumers identified “Receiving personal advice on the products” as a reason to purchase offline, while this share only amounts to 13% in Germany. Consumer survey: **What are the main reasons for buying the following beauty products in physical stores rather than online?**

For instance, finding the right tone of foundation depending on the colour of the skin and the appropriate cream adapted to a specific skin type requires expertise and this service is more difficult to provide remotely.

- Many cosmetic products sold in the selective market are **luxury or quality products**, and personal advice received instore and the atmosphere of the physical stores are an important way to convey a luxury or quality brand image.¹² Even though the online channel is also an important channel to build and maintain brand image, brand owners need both channels as these complement each other with respect to the benefits they offer to consumers.

A reduction in the availability of these services offered by the offline channel, due to a potential decrease in the number of offline stores and/or a reduction in the services they provide, would have several detrimental consequences on the functioning of the selective cosmetic markets, which are likely to harm consumers. Firstly, the reduced ability to test new products would increase the likelihood that consumers continue to purchase brands and products they already know. This would likely raise barriers to entry for quality products and reduce innovation. Secondly, as demonstration services and personalized advice by trained staff in physical stores are important tools to convey brand image, a lack of these services could affect brand image, which is an essential dimension of competition in the selective cosmetics sector. Finally, the absence of these services may also reduce consumers' ability to assess quality differences between products, leading them to focus more on price, which is easily comparable online, than on non-price dimensions, even though non-price dimensions may be important for them. To the extent that a significant proportion of consumers (i.e. those who currently buy luxury or quality products) prefer high quality/high service/ high price products to low price/low quality products, a reduction in their ability to assess quality difference would harm consumer welfare.

Moreover, if competition were to focus increasingly on price and away from non-price dimensions, **the difference between selective and mass market cosmetics would tend to become increasingly less relevant**, harming both consumers and the selective cosmetics sector in general.

Section 3 of this report explains why the growth of online sales – which is expected to continue over the next ten to fifteen years – is likely to weaken the provision of the services provided offline and highly valued by consumers.

Online sales of selective cosmetic products have grown significantly since the VBER was last revised and **are expected to keep growing** over the next ten to fifteen years.¹³ It is estimated that in 2018 online sales accounted for approximately 10% of sales of cosmetics

¹² See the European Commission in the Staff working document accompanying the Final report on the E-commerce Sector Inquiry (2017): *"The required high level of quality of the selling environment does not only ensure that the customer gets the product that he or she wants, but also allows the customer to understand the key features of the products as well as key differences compared to other products/brands. Products which are sold without meeting the customer expectation will trigger complaints and dissatisfaction and negatively impact the reputation of the products and brands."* (§ 478). Retrieved from: https://eur-lex.europa.eu/resource.html?uri=cellar:9d1137d3-3570-11e7-a08e-01aa75ed71a1.0001.02/DOC_1&format=PDF

¹³ Which constitutes the scope of the present study.

globally.¹⁴ In 2018, online sales accounted for [Confidential] of the revenues generated by the selective cosmetics in Germany and [Confidential] or around 8% (depending on sources¹⁵) in France (the largest selective market in Europe).¹⁶

The online and offline channels can be viewed as complementary. The online channel is increasingly used for advertising and to disseminate product information, and many consumers use both channels in combination during the purchasing process. The growth of online sales constitutes an opportunity for cosmetic suppliers to reach new customers, increase sales and use different media to convey brand image and inform consumers about the specificities and qualities of their products.¹⁷ As a consequence, every major cosmetics brand has developed its own digital store and considers online sales important and complementary to the shopping experience and presale services they are offering instore to meet customer expectations. Online sales also offer benefits to consumers, for example by making a broader range of products available, enabling purchases 24/7, facilitating price comparison, etc.

The benefits of the online channel notwithstanding, well-functioning selective cosmetics markets require both online and offline channels and in particular will continue to depend critically on the services provided by offline stores. In other words, even as the proportion of the market accounted for by the online channel grows, **the successful sale of selective cosmetic products will continue to depend on the ability to offer presale services, which for the most part are only feasible offline.**

There are several reasons why **online sales are expected to continue growing in the coming years:**

- **Repeat purchases:** while testing the product may be important for consumers when they purchase it for the first time (or when they consider switching to an alternative they do not know already), it is much less relevant when the consumers purchase a product they already know – for example because they are replenishing supplies that have been used-up. Evidence from the consumer survey and other sources suggest that repeat purchases account for a high share of both online and offline sales.¹⁸
- **Improvements in deliveries and other current obstacles to online sales:** the cost and time required to deliver online purchases are expected to decrease, thereby increasing

¹⁴ Xerfi Global (May 2018), The Global Perfumes and Cosmetics Industry: the Market, Page.10

¹⁵ The source of the [Confidential] figure is The NPD Group, BeautyTrends, E-commerce, Total Market, all Categories (Fragrance, Makeup, Skincare) and the source for the figure of 8% is FFPS Report attached to the answer to the questionnaire issued by the European Commission on the assessment of Regulation no.330/2010 (§28).

¹⁶ By comparison, the average percentage of turnover from e-commerce for all enterprises outside the financial sector, which employ 10 persons or more in the European Union is 17% (source: Eurostat, isoc_ec_evaln2)

¹⁷ For instance in areas with a low density of population

¹⁸ « Tous canaux confondus, les acheteuses de produits cosmétiques cherchent le plus souvent (67%) des produits précis, typiquement pour renouveler ceux qu'elles ont terminés » Translated from French by RBB: "For all distribution channels, buyers of cosmetics products are most of the time looking for a specific product (67%), typically, to renew their consumed ones" Fauconnier, F. (27/07/2016). Beauté et e-commerce : ce que veulent les femmes. *Journal du net*. Retrieved from <https://www.journaldunet.com/ebusiness/commerce/1181798-la-beaute-progresse-dans-l-e-commerce-et-sur-youtube/>

« 70% des femmes qui achètent sur le Net renouvellent en fait leurs produits de beauté. » Translated from French by RBB: "70% of women buying through the internet are actually renewing their beauty products" (04/10/2014). E-commerce : les sites marchands peuvent mieux faire. *CosmétiqueMag*. - Retrieved from <https://www.cosmetiquemag.fr/business/e-commerce-les-sites-marchands-peuvent-mieux-faire/>

the attractiveness of online sales.¹⁹ Moreover, as consumers become more accustomed to buying all sorts of products online, we can expect the share of online sales to continue to grow also in the cosmetics markets.

- **Technological progress:** an improvement in the services offered by the online channel is likely to lead to an increase in online sales even if this experience still lags that of the offline channel. For example, cosmetics suppliers can, to some extent, convey brand image through the development of websites which emphasise strong visuals and a variety of media.²⁰ Similarly, cosmetics suppliers also now use AI and AR technology²¹ to allow customers to try products remotely, though this is still far short of the instore experience.^{22,23}
- **Cost advantage:** the online channel has a cost advantage over the offline channel which enables it to offer products at lower prices.²⁴ While this cost advantage is not a new development to the online channel, it will become increasingly important as other elements of the online channel improve. Furthermore, this cost advantage may get larger. If the sales of physical stores decrease, they will become less profitable and may need to set higher retail prices, making consumers even more likely to purchase online. Importantly, this cost advantage stems at least in part from the fact that when purchasing online, consumers are not receiving the same shopping experience and the same services as when purchasing offline. The cost advantage of the offline channel enables retailers to set lower prices online than offline, and this price differential can compensate for potential disadvantages related to delivery of products purchased online.

The cost advantage and improvements in deliveries will significantly impact the proportion of online sales and make the sales of cosmetic products likely to become increasingly disconnected from presales services offered offline. In other words, consumers can easily smell, touch and feel the products and/or receive personal advice offline and then purchase the products online if they find better prices. This so-called **“showrooming” behaviour** enables **online retailers to freeride on services provided offline** and, evidence suggests, this consumer behaviour is already widespread. Based on the results of the consumer survey, 65% to 80% of shoppers have checked prices online while visiting a physical store and over 75% of shoppers who have done so say they will purchase online if the price is lower.²⁵

¹⁹ “The variety of delivery options and the perceived quality of the delivery service are major decision criteria for online customers and hence directly impact e-commerce players’ success in the marketplace. With this in mind, vendors are working hard to provide their customers with the best customer experience possible, especially by improving delivery times.” McKinsey & Company (September 2016), Parcel delivery The future of last mile. Page 9. Retrieved from: https://www.mckinsey.com/~/media/mckinsey/industries/travel%20transport%20and%20logistics/our%20insights/how%20customer%20demands%20are%20reshaping%20last%20mile%20delivery/parcel_delivery_the_future_of_last_mile.ashx

²⁰ Okonkwo, U. (2009). Sustaining the luxury brand on the Internet. *Journal of brand management*, 16(5-6), 302-310. See page 307

²¹ AI – Artificial Intelligence. AR – Augmented reality

²² CB Insights, “How Sephora Built a Beauty Empire to Survive the Retail Apocalypse” Retrieved from: <https://www.cbinsights.com/research/report/sephora-teardown/>

²³ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 72

²⁴ See for instance the European Commission “Preliminary Report on the e-commerce sector inquiry” (2016), Paragraph 131. Available online at: http://ec.europa.eu/competition/antitrust/sector_inquiry_preliminary_report_en.pdf

²⁵ Consumer survey response to “When in store to purchase a beauty product, do you check the price online?”
Base: Have purchased in selective channels,
Consumer survey response to “If while checking you find a lower price online for the same beauty product, how likely is it that you will purchase it online instead of purchasing it directly in the store where you are?” Base: Check online price in store

Consumer showrooming is most problematic if online purchases are not made through official suppliers and instead consumers buy through the “grey” market. Grey market products are likely to be found by consumers when searching online as products will be priced lower than on official outlets. This form of showrooming is particularly damaging for brand image and is the most extreme case of freeriding: unauthorised retailers do not provide any of the services offered by the authorised retailers, and the low price offered for the product could signal a lower level of quality. Non-authorised grey market players can easily gain a large exposure online throughout the EEA through particularly prominent marketplaces or price comparison tools.

The growth of online sales is likely to **decrease the profitability of physical stores**. Absent compensation for the services they provide, there is a risk that brick and mortar stores reduce or stop altogether their costly investments in presale services and in offering a unique shopping experience that foster sales and maintain brand image. While, initially, growth of online sales may lead offline stores to increase their services in order to remain attractive for consumers in comparison to online channel, there is a risk that at a later stage the loss of sales would result in many physical stores becoming financially unable to provide these services and many of them even being forced to close down. This loss of presale services, in turn, would harm consumers.

While freeriding by the offline channel on presale services offered online also exists, also called “reverse free-riding” or “webrooming”, this type of free-riding is less likely to lead to suboptimal investments in presale services (and hence consumer harm), such that there is no need to address this type of free-riding in the context of cosmetics markets. First, the offline channel offers services that consumers regard as very important during the selection process and which cannot be provided online. Second, as the online channel has lower costs than the offline channel, freeriding by online retailers on services provided offline threatens offline stores’ profitability, while the reverse is much less likely. Third, even when consumers use the online channel to find information on products, this is not necessarily freeriding. The information available online is not necessarily provided by retailers, but can be disseminated by the brand owners themselves, by consumers, or any other stakeholder of the industry. Thus, the level and quality of services provided by these players is not dependent on the realisation of transactions on their websites and is thus not likely to decrease if the consumers purchase their products offline.

Section 4 explores several solutions to avoid suboptimal levels of investment in important presale services and the deterioration of brand image by the sale of products in certain online outlets. It shows that in the context of strong inter-brand competition in the cosmetics markets, these solutions are unlikely to harm competition. Moreover, in the context of a rapidly evolving and competitive market, the best way to maximise consumer surplus is to leave suppliers ample freedom to experiment and decide which vertical restraints are most appropriate.

Existing legislation allows cosmetics suppliers to establish a **selective distribution network applied to both online and offline channels**. This is a very important tool to protect non-price dimensions of competition (service, product variety, in-store experience, innovation, guarantee of authenticity, brand image). However, it is insufficient in itself to eliminate the risk

of freeriding by online outlets on services offered offline and to maintain the economic ability of offline stores to provide the high level of presale services sought by consumers.

There are several types of vertical restraints which can be helpful, with varying levels of efficacy.

- **Resale price maintenance (RPM).** This is probably the most powerful tool to solve the risk of freeriding. By setting a minimum or a fixed retail price, a supplier ensures that retailers who invest in costly presale services will not be undercut and thus limits consumers' "showrooming" behaviour. Broad parity of prices will help the high-service segment of the offline channel to generate enough sales to cover their costs. It will also foster competition between retailers on non-price dimensions as consumers will tend to visit and purchase from the outlets offering the best presale services.
- Flexibility for suppliers to demand that online players contribute to and invest in an instore shopping experience and in presale services through **brick & mortar requirements**.²⁶ Imposing that online retailers which have no offline presence must contribute to and invest in the development of a physical stores network and offline presale services limits the asymmetry in costs between online and offline discussed above. However, freeriding can still occur as this solution only alleviates the most extreme cases of freeriding. Retailers can still generate the majority of their revenues online.
- **Dual pricing.** Allowing suppliers to charge different wholesale prices and/or different commercial conditions depending on whether the subsequent retail sales are made online or offline, can ensure that retail prices do not differ too much between online and offline, thereby eliminating free riding by the online channel and providing sufficient compensation to the offline channel for the services provided. An alternative to dual pricing would consist in imposing fixed compensation by suppliers to their offline retailers to support their presales services. While this alternative is currently allowed in the guidelines of the European Commission on vertical restraints, in practice it is seldom used because it is extremely complex for suppliers to define in a non-discriminatory manner fixed fees for each of their retailers that reflect the variety of store sizes and the variety of services provided by each of them.²⁷
- **Marketplace bans.** The fact that products appear on marketplaces can be detrimental to brand image in some cases. This is because the absence of a direct relationship between the suppliers and the marketplace prevents suppliers from controlling the presentation of products on the website. In particular, high quality products may appear on the website alongside other products of lower quality, or even counterfeit products. Therefore, banning authorised retailers from selling their products on marketplaces if they do not comply with the supplier's selective criteria can be important for the protection of brand image.
- **Comparison tools bans.** Even though consumers do not purchase any product on comparison tool websites, some of these websites can still be very harmful to brand image

²⁶ Suppliers who are willing to include pure players in their networks of authorised retailers, at least for some products, should of course have the flexibility to do it.

²⁷ Guidelines on Vertical Restraints, paragraph 52(d).

as well. Similarly to marketplaces, the main problem comes from the fact that suppliers do not have a direct relationship with the comparison tool website and can therefore neither control the way products are presented, nor what other products are presented on the same website. If, for instance, comparison tools list retailers selling counterfeit products and unauthorised retailers (also called “grey market players”) selling either counterfeit or authentic products, the products sold by these retailers will appear among authentic products sold by authorised retailers. And the likely lower price of counterfeit products and grey market products are likely to be selected by consumers. In addition to harming brand image, it would help unauthorised retailers (who do not provide any of the services offered by authorised retailers) to freeride on the services offered by authorised retailers either online or offline.

A key policy question is to what extent suppliers should be free to negotiate contracts with retailers to reduce freeriding effects and the resulting underinvestment by retailers in important presale services that are more appropriate for being provided in physical stores. Differently put, if suppliers were at liberty to implement vertical restraints, is there a risk that they would put too much emphasis on non-price factors of competition at the expense of price, while in fact consumers would be better off with lower prices and lower quality, or even to reduce competition on both price and non-price factors?

Well-established economic literature shows that regulators do not need to have this knowledge of consumer preferences. As long as inter-brand competition is strong – such as in the selective cosmetics markets²⁸ – suppliers will necessarily act in a way that maximises consumer surplus. If a supplier implements vertical restraints which reduce consumers’ welfare (in terms of price, quality, services, etc.), consumers can easily switch to a competing supplier.

Inter-brand competition is a powerful tool to align suppliers’ actions with consumers’ interests. For instance, if product quality and brand image are of much higher importance to some consumers than price, suppliers will try to implement vertical restraints that enhance quality and brand image to attract these customers, while charging higher prices as required to recover the costs of making high-quality products and the investments in brand image. Conversely, if consumers instead prefer low prices and lower product quality, then this will be the focus of suppliers. The wide variety of products existing on the market (even within the luxury segment) reflects the large spectrum of preferences of consumers. Therefore, **at least when inter-brand competition is strong, suppliers should be granted flexibility to implement the vertical restraints that they consider the most appropriate to their business and brand image.**

The existence of strong inter-brand competition in the selective cosmetics markets is supported by factual evidence and well recognised in the case law.²⁹ Annex D accompanying

²⁸ Illustrated by low concentration, a high degree of innovation and low barriers to entry and development. This lively competition in the cosmetics markets has been recognised by the European Commission in several recent merger decisions: *Coty/P&G* (Case COMP/M. 7726 (16/02/2016)), *L’Oréal/YSL* (Case COMP/M.5068 (17/06/2008)), *L’Oréal/The Body Shop* (Case COMP/M.4193 (31/05/2006)).

²⁹ See for instance the 2016 decision M.7726 *Coty / Procter & Gamble Beauty Business*, where the European Commission indicated, about the fragrances markets, that: “*The competitive landscape in the fragrances markets is characterised by*

this report shows that market concentration is low across European cosmetics markets.³⁰ This strong interbrand competition is also illustrated by the importance of innovation and the high frequency and success of new products launches, as well as by the low barriers to entry.

While this report only focuses on situations in which inter-brand competition is strong, because this is in line with the market conditions in the cosmetics markets, there are many other market situations in which vertical restraints do not raise anticompetitive effects even in the absence of strong inter-brand competition.

a high number of strong global players, which are active across the EEA and in most of the national affected markets."
(\$200).

³⁰ Euromonitor International data and RBB calculations.

2 The preservation of presale services provided offline is important for consumer welfare

Selective cosmetic products have several characteristics which require services that are strongly valued by consumers and therefore are also key dimensions of competition (Section 2.1). Firstly, to optimally choose products consumers need to smell, touch and feel the products. Secondly, consumers value personal advice received from a professional. Finally, consumers value strongly brand image, in a context where most cosmetic products sold in the selective distribution are luxury or high quality/ high tech goods.

These services offered by retailers to consumers or to brand owners (when conveying the brand image) are better served and more effectively provided by the offline channel (Section 2.2).³¹ If the provision of these services is reduced, consumer welfare can be harmed (Section 2.3). Under-provision of these services would weaken competition along non-price dimensions, leading to a reduction in product quality, the shopping experience and innovation, and ultimately reducing sales and undermining the sector as a whole.

2.1 Consumers value strongly the services offered in stores when selecting cosmetic products, due to the characteristics of these products

The cosmetic products have several characteristics that distinguish them from many other goods and require specific retailing services. The need for these services at least in part explains why these products have historically been sold in a wide and dense network of physical stores (see Annex A).

The possibility to smell, touch and feel the products, the personal advice provided by a professional, as well as the brand image are important factors determining appeal of cosmetic products and competition in these markets is focused on these attributes.

Each of these main dimensions of competition in the cosmetics markets are detailed successively below.

2.1.1 The ability to smell, touch and feel the products is an important service for consumers in the cosmetic industry

First, for each of the three categories of cosmetic products – perfumes, makeup and skincare - it is very important for consumers to **be able to smell, touch and feel the products** when selecting an item.

Fragrances and, to some extent makeup and skincare, are “experience goods”, which means that the consumers need to try these products to be able to know the utility they derive from the product and, thus, their willingness to pay.^{32, 33} The high price of these products in the

³¹ In which case they increase the consumer surplus indirectly, if consumers value brand image.

³² As explained below, this utility depends on the tastes of the consumer, but also on whether the products matches their skintype.

³³ See Nelson, P. (1970). Information and consumer behavior. *Journal of political economy*, 78(2), 311-329.

selective markets makes it rather inefficient for consumers to buy the products in order to test them.

Some experience goods such as restaurants or hotels for example are purchased by consumers even though there is not the possibility of testing beforehand. However, advice from friends or reviews posted by other consumers may help a consumer determine ex ante if he is likely to enjoy a restaurant or hotel, while fragrances, makeup and skincare are subjective and personal products:

- preferences regarding the smell of the products, their colour and their texture on the skin are very heterogeneous across customers, even among customers that have similar tastes regarding other types of goods;
- the effect of perfumes and makeup is also heterogeneous when applied to different skin types. With fragrances, what matters most is not just the scent of the product, but also how the fragrance reacts to a consumer's skintype. This is not uniform; the same fragrance applied to different people can smell very differently.³⁴ This information cannot be obtained prior to trying the product. Similarly, for colour cosmetics, consumers need to know how a certain product will match their skintone and how the product feels on the skin.³⁵ For these goods, the ability to test instore and the presale services provided by staff helps consumers understand which products are best-suited to them. This also applies to skincare, though to a lesser extent, as products can react differently to various skin types.

While tastes and adaptation of the products to the body are also subjective for other experience goods, such as clothes, these other goods mainly refer to the senses of sight and touch. Hence, a large part of the utility derived by consumers from these goods can be assessed by looking at the products online, so consumers can make a first selection by comparing products online.³⁶ If, after trying on clothes when receiving them at home, consumers are disappointed or notice that the product does not fit well, they can return the products.^{37,38}

³⁴ See Cooper A. Body chemistry has everything to do with fragrance. *Lifestyle.howstuffworks*. Retrieved from: <https://lifestyle.howstuffworks.com/style/body-scents-fragrances/body-chemistry-has-everything-to-do-with-fragrance.htm>.

See also Behan, J. M., Macmaster, A. P., Perring, K. D., & Tuck, K. M. (1996). Insight into how skin changes perfume. *International journal of cosmetic science*, 18(5), 237-246. Retrieved from: <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1467-2494.1996.tb00154.x>

³⁵ See Patulny L. (2019) Makeup artists cringe every time they see this common foundation mistake. *Byrdie*. Retrieved from: <https://www.byrdie.com/makeup-artist-foundation-mistakes>

³⁶ Yet, even for these products, when they have a high value (such as luxury clothing), consumers can have a strong preference for testing them instore before purchasing them.

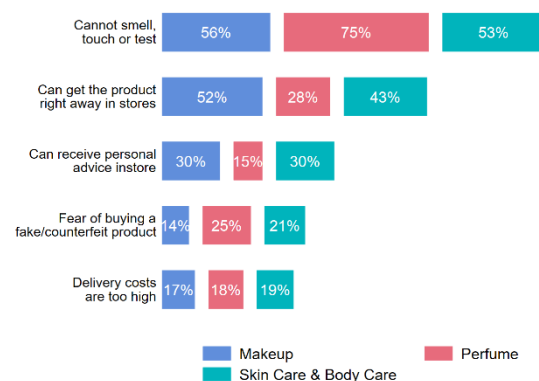
³⁷ While the share of online sales of clothing and footwear reached 35% in OECD countries, it is lower (10%) for cosmetic products. See OECD, Implications of E-commerce for Competition Policy - Background Note (February 2019), Figure 3

³⁸ See <https://www.doofinder.com/fr/blog/6-produits-les-plus-vendus-sur-internet> : « Curieusement, la mode est le secteur qui vend le plus, dans presque tous les pays. Même s'il s'agit d'un produit délicat et que les tailles peuvent varier d'une marque à l'autre, la mode est sur le trône des ventes en ligne. **L'augmentation de la demande dans ce secteur du e-commerce est principalement due aux améliorations réalisées en termes de retours de produits.** Avant, peu de personnes se risquaient à acheter un tee-shirt, un pantalon ou une veste sans la certitude que le vêtement irait. Aujourd'hui, les retours sont gratuits dans presque toutes les boutiques. Il est possible d'essayer ses habits chez soi, sans faire la queue et avec la possibilité de les retourner s'ils ne conviennent pas. » Translated from French by RBB: "Interestingly, fashion is the sector that sells the most in almost every country. Even though clothing is a delicate product and sizes can vary from one brand to another, fashion is on the throne of online sales. **The increase in demand in this sector of e-commerce is mainly due to the improvements made in terms of product returns.** Before, few people would buy a T-shirt, pants or a jacket without the certainty that the garment would look good. Today, returns are free in almost every store. It is possible to try clothes at home, without waiting in line and with the possibility of returning the items if they are not suitable."

This process is much less easy with cosmetic products. Even though the visual elements of the product are also important (the bottle of fragrance, the colour of the makeup, etc.), consumers cannot select the cosmetic products that they like a priori by looking at them online, unlike for other experience products such as clothes. In addition, unlike many other products, consumers cannot return a cosmetic product if they do not like it after testing it at home.³⁹ Consumers could test the products at home if retailers provided samples, and return them if they did not like them, but sending samples for every cosmetic products sold by a retailer online can be extremely costly and inefficient.

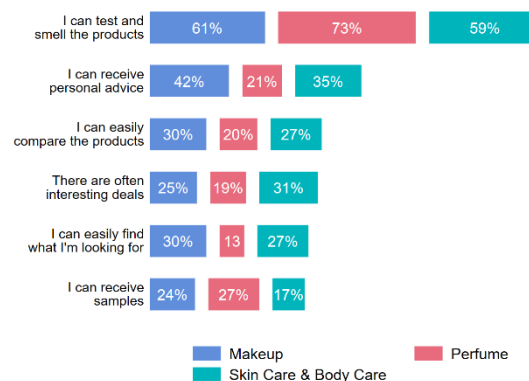
The importance of being able to smell, touch and feel the products offline is reflected by the replies to the consumer survey. It is consistently listed as the principal reason to purchase offline rather than online for each of the three product categories. Across all countries, approximately 50% of consumers (60% in Sweden) listed the ability to test as a reason to purchase offline. As regards the reasons why some consumers have no intention to purchase online, the numbers are similar: product testing is listed by approximately 50% to 70% of all consumers across all countries (see Figure 1 and Figure 2 below for Italy and Sweden, by way of example. Figure 29 to Figure 36 in Annex C present similar results for all the countries analysed in the consumer survey).⁴⁰

Figure 1: Reason why no intention to buy beauty products online in Italy⁴¹



Source: Consumer survey
Base: No intention to buy beauty products online

Figure 2: Main reasons to buy beauty products offline in Sweden⁴²



Source: Consumer survey Base: Have purchased offline

³⁹ See for instance the Returns Policy of the brand Urban Outfitters, selling various products: "If you simply change your mind about the item you have bought from us online, you can return it to us [...] Items must, however, be in a resalable condition and [...] in the interests of hygiene, cosmetics and pierced earrings cannot be returned." Retrieved from https://www.urbanoutfitters.com/en-gb/help/return-policy?optin_cookies=true
See also Sephora's Returns Policy: <https://www.sephora.fr/cgv.html>

However, some brands have very lenient returns policies. For instance, Glossier, which is a brand only distributed online, allows its customers to ask for a reimbursement in case they are not satisfied with the product, without the need to return the used product, as it would in any case be destroyed (<https://returnpolicyhub.com/glossier-return-policy/>). Likewise, Kiehl's, which is also distributed offline, allows to return products in the points of sale within 28 days, and provided the product has been used only marginally by the customer (<https://www.kiehls.co.uk/shipping-and-returns.html>).

⁴⁰ Figure 1: Consumer survey response to "Why would you not purchase your beauty product online?" Base: No intention to buy beauty products online.

Figure 2: Consumer survey response to "What are the main reasons for buying the following beauty products in physical stores rather than online?" Base: Have purchased offline

⁴¹ For responses to "Why would you not purchase your beauty product online", product testing is listed by 50-70% of consumers as the most important in all countries except for Germany, with delivery time being the second most important in most countries. In Germany, delivery time is listed more frequently than testing.

⁴² For responses to "What are the main reasons for buying the following beauty products in physical stores rather than online" largest reasons to purchase offline are the ability to test the product (approx. 50%, Sweden 60%) and easy comparison of products (23-33%). Personal advice is more important in Sweden (35%), France, Italy and Poland (20-30%) than Germany (13%).

Additionally, the large majority of consumers consider the ability to test and smell the products as “essential” or “important” before purchasing a product never tested before, both when buying for themselves (70%-85%) and when buying as a gift (65%-75%), particularly for perfumes.⁴³

The importance of the ability to smell, touch and feel the products in the stores for selective cosmetics products is also reflected in some third-party market studies.⁴⁴ For instance, a survey conducted jointly by the FFPS and the survey institute IFOP in France in 2019 confirms these results: in this survey, the ability to “see” and “test” the products appear as the first and second motivations respectively for consumers to go in a physical store (selected by 63% and 44% of the interviewees respectively).^{45, 46}

2.1.2 The importance of personal advice from a professional

When selecting makeup or skincare products, the expertise of sellers instore is often required and is valued by consumers.

For makeup, as explained in section 2.1.1 above, the personal advice of a professional is often valued by consumers to select the products that match the skintone or eye colour of the consumer to obtain the consumer’s desired effect. For these goods, the presale services provided by duly trained staff helps consumers understand which products are best-suited to them. Sometimes, the seller demonstrates the product on the consumer, to show the effect of the product and to provide personal advice on how to best apply the product. These services are very personal, take time and require expertise and training to follow the latest product innovations and consumer habits.⁴⁷

For skincare, the requirements of consumers are individual, and the expertise of the seller is often necessary to determine which products are best-suited for the consumer’s particular requirement, as a given product may have a different effect on different skin types. The seller may also play a “diagnostic” role in determining which product the consumer should be using based on information provided by the consumer. Consumers may have to ask for advice from qualified staff who can see and/or touch the customer’s skin to know which product is best

⁴³ Consumer survey response to “**How important to you is the ability to test and smell when buying a [cosmetic product] that you have never tested before...i) when buying for yourself ii) when buying for a gift? Base: Have purchased in selective channels.** As regards the sub-question “when buying for yourself” for perfumes, 90% of consumers in all analysed countries except Germany consider that it is “essential” or “important” to be able to test and smell the product.

⁴⁴ Xerfi France (May 2019). « La Distribution de Parfums et Cosmétiques », Page 68 “[...] *la découverte du produit en magasin (couleur, aspect, odeur, etc.) reste primordiale dans l’acte d’achat [...]* », Translated from French by RBB: “[...] *the discovery of the product instore (colour, aspect, scent, etc.) remains essential in the purchasing decision [...]*”.

⁴⁵ “Fédération française de la parfumerie sélective” (French Federation of Selective Perfumery).

⁴⁶ Source: FFPS Report attached to the answer to the questionnaire issued by the European Commission on the assessment of Regulation no.330/2010

⁴⁷ See for instance the services offered on request available in all M·A·C Cosmetics’ stores in France: from a 10 minutes targeted basic makeup lesson (Eyes, eyebrows, contouring, lips) to a 20 to 25 min workshop to discover the products and techniques to use to complete a look or make it more glamorous, with the help of a professional M·A·C makeup artist. <https://www.maccosmetics.fr/makeup-services>

See also the “In-Store Experience” described on the Estée Lauder Companies’ website: “*Pampering consumers with our unique in-store services, and offering them valuable ‘me time’ — a respite from their daily routines [...] ‘Me time’ can mean discovering the proper skin care regimen at a Clinique counter or experiencing a luxurious crème for the first time at a La Mer counter. It might include visiting an Origins store for a complimentary mini facial or creating a custom fragrance gift box with a Jo Malone London stylist.*” <https://www.elcompanies.co.uk/en-GB/who-we-are/retail-channels/in-store-experiences>

suited to their specific problem (such as wrinkles, acne, etc.) and whether the product could cause any potential problem to the skin.⁴⁸

Consumers' valuation of a product will increase if it is prescribed by a qualified seller or beauty adviser whom they trust and recognise as offering expert advice, for the following reasons. Skincare products can be categorised in some cases as "credence goods".⁴⁹ That is to say, consumers cannot determine the quality of the product *ex ante* (i.e. before purchasing and using the product), and in some cases they may even be unable to assess it perfectly *ex post*.⁵⁰ In other words, there is an information asymmetry between the buyer and seller; the seller analyses the needs of the consumer and then suggests a particular product based on its expertise, allowing scope for fraud.⁵¹ Therefore, the consumer is likely to be reliant on the expertise of the seller, and the proposed advantages of the prescribed product may only become apparent much later. A trusting relationship between the seller and consumer is thus necessary for these products, making the reputation of the seller particularly important.⁵² Evidence of this is provided in the consumer survey, where, in all countries except Poland, pharmacies are the favourite distribution channel to purchase skincare products.⁵³ A key benefit for consumers from shopping at pharmacies and parapharmacies⁵⁴ is the medical guarantee that their products are safe to use.⁵⁵

As illustrated in the consumer survey, consumers can benefit from the advice provided instore by employees who are likely to be more knowledgeable than the consumer about the product. Some countries value the advice received instore more than others. For example, in France, Italy, Poland and Sweden 20-35% of consumers identified this as a reason to purchase offline, while this share only amounts to 13% in Germany.⁵⁶

The aforementioned survey conducted by the "*Fédération française de la parfumerie selective*" and IFOP in France in 2019 supports these findings by showing that, among the motives to visit a physical store, the possibility to receive expert advice instore is quoted by 41% of interviewed consumers.⁵⁷ As well as direct advice, the attitude of staff working instore is important; satisfactory customer service and courteous store employees are an attractive feature of physical stores.⁵⁸

⁴⁸ For instance, some moisturizing creams increase acne problems for consumers that have oily skin.

⁴⁹ They also fall under the category of experience goods given above.

⁵⁰ Dulleck, U., Kerschbamer, R., & Sutter, M. (2011). The economics of credence goods: An experiment on the role of liability, verifiability, reputation, and competition. *American Economic Review*, 101(2), 526-55.

⁵¹ Mimra, W., Rasch, A., & Waibel, C. (2016). Price competition and reputation in credence goods markets: Experimental evidence. *Games and Economic Behavior*, 100, 337-352.

⁵² Ibid

⁵³ Consumer survey response to "**And among these channels, which are your favourite ones to buy the following products?**" **Base: Have purchased category in past 12 months.** Note: Preferred selective category, not including super market

⁵⁴ Parapharmacies sell products usually found in pharmacies but which do not require a prescription

⁵⁵ Xerfi France (May 2019). « La Distribution de Parfums et Cosmétiques », (concerning the French market) Page 5 « [...] les pharmacies et les parapharmacies restent le premier circuit concurrent du circuit sélectif. » and Page 70 « S'appuyant sur leur image de caution médicale, les parapharmacies bénéficient notamment du succès croissant des dermocosmétiques auprès des Français. », Translated from French by RBB : "[...], pharmacies and parapharmacies remain the first competing circuit of the selective circuit." And "Based on their medical guarantee, parapharmacies benefit in particular from the increasing success of dermocosmetics with the French."

⁵⁶ Consumer survey response to "**What are the main reasons for buying the following beauty products in physical stores rather than online?**" **Base: Have purchased offline** Consistent across all countries is the view that advice provided instore is seemingly least relevant for perfumes

⁵⁷ Source: FFPS Report attached to the answer to the questionnaire issued by the European Commission on the assessment of Regulation no.330/2010

⁵⁸ Liu, X., Burns, A. C., & Hou, Y. (2013). Comparing online and instore shopping behavior towards luxury goods. *International Journal of Retail & Distribution Management*, 41(11/12), 885-900.

2.1.3 The importance of the promotion and protection of brand image

Brand image is another important characteristic of selective cosmetic products. For perfumes and makeup, the products sold in the selective distribution are luxury and high quality products. The skincare products sold in the selective distribution also, typically, belong either to luxury or quality brands.⁵⁹

The importance of brand image in cosmetics markets is highlighted in market studies, and is pointed out, for instance, in a recent decision of the European Commission:⁶⁰

*“The majority of respondents to the market investigation have indicated that **brands play a paramount role as a driving force for competition in the fragrances markets.***

*This is particularly the case in the **prestige segment, where brand name appears to be the most relevant factor that explains competitive success.** As explained by one competitor “In terms of prestige we consider that **building Brand is the most important criteria to have success in EEA**”⁶¹ (bold characters added). (§239-240)*

The benefits of brand image for consumers have long been recognised by regulators of competition law, and has for instance been referenced in the Coty judgement of the CJEU:⁶²

*“With particular regard to the question whether selective distribution may be considered necessary in respect of luxury goods, it must be recalled that the Court has already held **that the quality of such goods is not just the result of their material characteristics, but also of the allure and prestigious image which bestow on them an aura of luxury, that that aura is essential in that it enables consumers to distinguish them from similar goods and, therefore, that an impairment to that aura of luxury is likely to affect the actual quality of those goods** (see, to that effect, judgment of 23 April 2009, Copad, C-59/08,*

⁵⁹ In comparison to luxury brands, quality brands focus less on the prestige of the brand image.

⁶⁰ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 81 **“Brand value plays a considerable role at all levels of the cosmetics market, although it is particularly pronounced at the prestige end of the scale.”**

⁶¹ European Commission decision COMP/M.7726 Coty/P&G.

⁶² See for instance Court of First Instance, Leclerc v Commission Judgement (Case T-88/92 (12/12/1996)): “ [...] those products enjoy a ‘luxury image’ which distinguishes them from other similar products lacking such an image; and, [...] that luxury image is important in the eyes of consumers, who appreciate the opportunity of purchasing luxury cosmetics, and luxury perfumes in particular.” (§108) and “The Court considers that it is in the interests of consumers seeking to purchase luxury cosmetics that the luxury image of such products is not tarnished, as they would otherwise no longer be regarded as luxury products.” (§114)

See also: French Conseil de la Concurrence (13/03/2006) Décision n° 06-D-04 on practices in the luxury perfume sector. The French Competition Council indicated that « L’image et la notoriété de la marque constituent, pour les sociétés qui les exploitent, des actifs immatériels essentiels au maintien d’un niveau élevé de rentabilité » (§4) Translated from French by RBB: “The image and reputation of the brand constitute, for the companies that exploit them, immaterial assets essential to the maintenance of a high level of profitability” (§4)

EU:C:2009:260, paragraphs 24 to 26 and the case-law cited).” (bold characters added). (§25)⁶³

While brand image is present and often important in many markets, it takes on a specific importance in the luxury and quality industry: unlike in other sectors, brand image is aimed not only at guiding consumer choice, but it is an integral part of the products themselves:⁶⁴

“For luxury goods, the right brand image is an inherent characteristic of the product.”⁶⁵

In particular, brand image conveys a signal about the socio-economic standing of the consumer.⁶⁶ The brand generally appears on the product, either through the brand logo or through other, more discrete signs of the brand and, as such, is part of the product itself and adds value to the product.

Brand image in the luxury and quality sector is also related to the imaginary world of the brand: purchasing a product of a luxury brand is often perceived by consumers as a way to enter the brand universe.⁶⁷ In this sense, consumption of luxury and quality products has an important hedonistic component and the “shopping experience” plays a key role in this respect.⁶⁸ The shopping experience includes aspects such as the size and feel of the store, attention paid by the sales force and other presale services which are valued by the consumer.⁶⁹

As stated by the European Commission in the Staff working document accompanying the Final report on the E-commerce Sector Inquiry, the high quality of the selling environment also serves the reputation of the products and brands:⁷⁰

“The required high level of quality of the selling environment does not only ensure that the customer gets the product that he or she wants, but also allows the

⁶³ Coty Germany GmbH/Parfumerie Azkente GmbH Judgement (Case C-230/16 (6/12/2017)), Paragraph 25

⁶⁴ This is what emerges from the sector inquiry of the European Commission on e-commerce: “Although there are some differences between product categories in terms of the importance of each parameter, product quality, brand image and the novelty of the product are given the greatest importance by manufacturers in all product categories (with the exception of media products).”

European Commission (2017). “Commission Staff Working Document Accompanying the document Final report on the E-commerce Sector Inquiry”, §138.

⁶⁵ See Buccirossi P. for the OECD Roundtables (2013). “Vertical Restraints for On-line Sales”, OECD.org. Page 26

⁶⁶ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy: Break the rules of marketing to build luxury brands*. Kogan page publishers. Page 117 “The brand is therefore the social visa, the ‘star-maker’, both of the product and the person. To be expensive is not enough to qualify as luxury: it must also be inscribed with a cultural hallmark accepted as a social stratifier. This hallmark is the brand, when the brand itself has a reputation with the cultural, political and financial powers.”

⁶⁷ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 200: “The moment of purchase is only one step, although of course a vital one, of the process through which the client enters the brand universe.” And Page 20 “In addition to this key social function, luxury is an access to pleasure: it should have a very strong personal and hedonistic component. [...] A luxury brand relies on as large as possible a core of faithful clients thoroughly imbued with the brand’s culture and appreciating its world, its identity, and its philosophy.”

⁶⁸ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 193 “The watchword of luxury brand management nowadays is ‘experience’, the multi-sensory total of what is lived and felt at each point of contact with the brand. The shop is where the client can live the brand.”

⁶⁹ Liu, X., Burns, A. C., & Hou, Y. (2013). Comparing online and instore shopping behavior towards luxury goods. *International Journal of Retail & Distribution Management*, 41(11/12), 885-900. Page 7: “The in-store shoppers trust the physical luxury store and value salesperson professionalism, which make them feel that they can enjoy shopping.”

⁷⁰ Coty Germany GmbH/Parfumerie Azkente GmbH Judgement (Case C-230/16 (6/12/2017)), Paragraph 25. See footnote 63. See also: Court of First Instance, Leclerc v Commission Judgement (Case T-88/92 (12/12/1996))

customer to understand the key features of the products as well as key differences compared to other products/brands. Products which are sold without meeting the customer expectation will trigger complaints and dissatisfaction and negatively impact the reputation of the products and brands.” (§ 478)⁷¹

Therefore, the geographic location of the stores, the quality of the staff and the personal advice provided instore, as well as the aesthetics of the premises and the presentation of the products, are essential components of the promotion and protection of the brand reputation.⁷² If these aspects of the consumer experience are not appropriate for the brand, the brand image may suffer considerable damage. Crucially, the harm to the brand does not affect only cosmetics products, but also all the other types of products sold under the same brand (e.g. clothes, accessories, etc.).⁷³

The importance of the hedonistic component of the purchasing process for cosmetic products, shopping in a pleasant environment with good interactions with sellers and beauty advisers, is illustrated by the consumer survey accompanying this report, in other third-party consumer surveys and also marketing reports on the cosmetics sector.⁷⁴ In all countries, approximately 15% to 20% of consumers listed “enjoying the purchasing experience” as a reason to buy in the offline channel, and in all countries approximately 15% of consumers (26% in France) valued the more “human” interactions offered offline.⁷⁵ These results are consistent with previous survey results. For example, in a previous survey, a respondent wrote *“For some people, just to be seen in an expensive store is half of the thrill. Shopping is often entertainment, not just purchasing a necessity”*.⁷⁶

⁷¹ European Commission (2017). “Commission Staff Working Document Accompanying the document Final report on the E-commerce Sector Inquiry”. Retrieved from https://eur-lex.europa.eu/resource.html?uri=cellar:9d1137d3-3570-11e7-a08e-01aa75ed71a1.0001.02/DOC_1&format=PDF

⁷² This has been recognised a long time ago in the European Commission decision *Parfums Givenchy system of selective distribution* (Case No IV/33.542 (24/07/1992)). Page 6 “Thus, the criteria governing the location, fitting-out and window-dressing of the retail outlet constitute legitimate requirements by the producer, since they are aimed at providing the consumer with a setting that is in line with the luxurious and exclusive nature of the products and a presentation which reflects the Givenchy brand image.”

⁷³ Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31992D0428&from=EN>
Herbig, P., & Milewicz, J. (1993). The relationship of reputation and credibility to brand success. *Journal of consumer marketing*, 10(3), 18-24. Retrieved from <https://www.emeraldinsight.com/doi/abs/10.1108/EUM0000000002601>

“While the reputation of the established brand name can facilitate the introduction of a new product, any problems with the new product can, conversely, affect the salability of all items bearing the same name. If consistency in new product quality is not maintained, user dissatisfaction may result which may carry over to older, successful brands in the line. Family branding, therefore, places high demands on quality control because every single item is considered representative of the entire line. A lower quality item may hurt sales of the better quality products. Promotion of a better quality product may result in credibility gaps among potential buyers. **A new product failure may well tarnish the reputation of sister products carrying the same brand name. One bad egg may well spoil the entire basket.**” (bold print added)

⁷⁴ « En mai 2017, le baromètre des achats multicanaux CSA/Fullsix/LSA s'est intéressé aux catégories parfum et cosmétique et a révélé l'existence d'un marché empreint d'une mixité importante des canaux d'achat. Si l'étude note que "les catégories parfum et cosmétique sont des catégories éminemment émotionnelles et sensorielles où la notion d'expérience consommateur est fondamentale" -ce qui confère au magasin un rôle central- "le online est en revanche fortement utile pour s'inspirer, dénicher les nouveautés, rechercher avis et informations mais également comparer les prix » Translated from French by RBB: “In May 2017, the CSA / Fullsix / LSA multi-channel shopping barometer looked at the perfume and cosmetics categories and revealed the market had a significant mix of buying channels. The study notes that “perfume and cosmetics categories are eminently emotional and sensory categories where the notion of consumer experience is fundamental” -which gives the store a central role- “online is however highly useful for inspiration, to find out what's new, search for reviews and information but also compare prices” Baromètre des achats multicanaux CSA/Fullsix/LSA : les catégories parfums et cosmétiques penchent pour les magasins, (“CSA / Fullsix / LSA multi-channel shopping barometer: fragrance and cosmetics categories for stores.”), (09/05/2017)

⁷⁵ Consumer survey response to “What are the main reasons for buying the following beauty products in physical stores rather than online?” Base: Have purchased offline

⁷⁶ Liu, X., Burns, A. C., & Hou, Y. (2013). Comparing online and instore shopping behavior towards luxury goods. *International Journal of Retail & Distribution Management*, 41(11/12), 885-900. Retrieved from https://www.researchgate.net/publication/263377186_Comparing_online_and_instore_shopping_behavior_towards_luxury_goods

2.2 These important services are expected by consumers to be provided in physical stores

The ability to smell, touch and feel the products, the importance of the personal advice and the investments of retailers in brand image, for the most part, are better provided offline.

Firstly, the ability to smell, touch and feel the cosmetic products is an exclusive attribute of the offline channel.⁷⁷ The technology to communicate the subtle scents of perfumes, makeup or creams through the internet does not yet exist and is not likely to be available in households in the next ten to fifteen years, which corresponds to the scope of this study. Scent is a complex sense that has been part of many failures in the history of attempts to add smell to media.^{78,79} Similarly, consumers need to test makeup and skincare products on their skin to determine whether they like the product. Assessing the texture of a complex product is not possible via a picture or a description, and technology is not available to transmit this over the internet. It would also be very costly to send samples by mail and inefficient to send the whole collection of products which can be tested instore, as explained in the previous section.

Secondly, while personal advice and recommendation by a professional can also be provided online, they are generally less effective than offline due to the absence of physical contact and interaction with the seller and/or beauty adviser. Online, the colour and aspect of the consumer's skin may differ from reality, which may prevent a seller providing accurate advice remotely to determine the appropriate tone of a foundation or makeup, for instance.⁸⁰ Even though technology has been developed to allow customers to find the best cosmetic item for their shade of skin remotely and then virtually test the product using AR⁸¹ technology, this technology is still in its relative infancy and is not as effective as offline recommendations and testing, especially for luxury and quality products, which require nuance and refinement, but also for skincare products for which the seller/beauty adviser will adapt its recommendations directly after observing the consumer's skin.^{82,83}

⁷⁷ See for instance Zhang, T., Ge, L., Gou, Q., & Chen, L. (2018). Consumer showrooming, the sunk cost effect and online-offline competition. *Journal of Electronic Commerce Research*, 19(1), 55-74. "Online technology is still limited in demonstrating product attributes that involve touch, smell, or fit -- attributes that are essential for selling certain products, such as perfume or shoes. Consumers might have difficulty evaluating these products through the online store alone and thus be discouraged from online shopping."

⁷⁸ For instance, one of the essences of Chanel n°5 perfume is the jasmine of Grasse, a hybrid between the grandiflorum jasmine and the medicinal jasmine, which is only cultivated in Grasse and in the Estérel by small producers using traditional techniques such as hand-picking.

⁷⁹ Parry, W. (27/11/2018). 'Digital smell' technology could let us transmit odours in online chats. *nbc news*. Retrieved from <https://www.nbcnews.com/mach/science/digital-smell-technology-could-let-us-transmit-odors-online-chats-ncna940121>

⁸⁰ For instance, the colour of a foundation can change depending on the skin complexion. See Lukas E., (2018). 5 Things You Need to Consider When Choosing Foundation. *InStyle*: "Foundation oxidizes with wear, and naturally gets darker with the mixture of elements and the oils on your face [...] Whatever method you choose, both pros say it's important to test foundations in good natural lighting." Retrieved from <https://www.instyle.com/beauty/makeup/how-choose-foundation>

See also Arps B., (2017). *Insider*. About purchases on Glossier' website, a brand selling products exclusively online: "Unfortunately, however, I have not reached Glossier maven status. My collection of half and barely-used Glossier products on my beauty vanity is proof. [...] The Priming Moisturizer (\$25), a lightweight face creme, didn't mesh well with my oily skin. The Stretch Concealer (\$18) oxidizes, turning a completely different shade when I wore it." Retrieved from <https://www.insider.com/why-i-dont-love-glossier-2017-6>

⁸¹ Augmented Reality

⁸² For example, L'Oréal has recently launched an innovation so that instore expertise is available remotely. L'Oréal's application MatchMaker developed by True Match allows customers to determine the best cosmetic item for their shade of skin. The application then lets consumers know the nearest store where this product is available.

Xerfi Global (2018). "The Global Perfumes and Cosmetics Industry: the Market", Page 73.

⁸³ Chanel contribution quoted in footnote 85 Page 25. §61: "It is important to underline that these limitations may be acceptable in other product sectors, but they represent a major problem for the sale of luxury goods because nuance, refinement, taste, feel and optimal matching are quintessential to the luxury concept."

Thirdly, conveying a luxury or high quality image of the brands and the products can be achieved in part via the online channel, but only to some extent. In particular, there are elements that cannot be provided online, which remain important to convey the luxury or quality image of a brand:

- The **high level of service** provided by the sellers in the store and the courtesy of the staff can contribute to the brand image.⁸⁴ The level of service is part of the shopping experience, and brick and mortar stores can offer special services instore as well as a face-to-face connection between the buyer and seller, which consumers value as they “want to feel special and unique”.⁸⁵ Qualification and training of sales staff (diploma, significant level of experience, etc.) are qualitative criteria found in some selective distribution contracts for cosmetics products. According to the consumer survey, consumers from Italy, France, Poland and Sweden on average agree that the value of a brand can be judged by the quality of the environment in which it is sold (53%-64%) and on the quality of the service delivered to sell the product (59%-72%).⁸⁶
- The **atmosphere of the stores** offers a multisensorial experience: light effects, the smells, the organisation of the space in three dimensions, the background sound, etc., all “allow for a theatrical *mise en scène* of the brand universe”, which cannot be offered in an equivalent manner by a website and is crucial to the shopping experience (see Figure 4 below).^{87,88} Some qualitative criteria included in selective distribution contracts for cosmetic products are directly related to the quality of the selling environment in physical stores: for instance, there are requirements regarding the quality of the lighting, of the pieces of furniture, the quality of the ceiling and the floor, the arrangement of the point of sale and the ease of circulating within the store, etc.
- **Some stores are particularly high-end and help build and maintain an image of prestige and luxury.** This is the case for selective cosmetic chains in particularly luxurious areas and corners of department stores or mono-brand retailers. The high-end positioning of these stores gives consumers a sense of importance and power upon entry.⁸⁹ Multiple studies confirm that this is one of the main reasons for shopping in luxury stores.⁹⁰ This feeling of exclusivity is difficult to achieve online, as online websites are, by definition accessible to everyone, while prestigious physical stores are generally located in specific areas.

⁸⁴ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Pages 194-195 “The personal advice aspect of the sale is very important in luxury”

⁸⁵ Salans (2008). Selective Distribution of Luxury Goods in the E-commerce age: Position paper submitted on the behalf of Chanel. Page 27. Retrieved from http://ec.europa.eu/competition/consultations/2008_online_commerce/chanel.pdf

⁸⁶ For consumers from Germany however, less than half agree with either statement, (44.4%) and (47.5%) respectively. Consumer survey response to “To what extent do you agree with the following statements: The value of a brand can be judged by the quality of the service delivered to sell the product (qualified staff / demonstration provided instore, etc.)” and “To what extent do you agree with the following statements: The value of a brand can be judged by the quality of the environment in which it is sold” Base: All

⁸⁷ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 151 “It is therefore a perceptible universe that can be recognised by other means than through the glimpse of a logo: the brand shop is a multisensory vision of the brand”. See also Page 21 “Luxury has to be multi-sensory”

⁸⁸ Chanel contribution quoted in footnote 85 Page 25.

⁸⁹ Liu, X., Burns, A. C., & Hou, Y. (2013). Comparing online and instore shopping behavior towards luxury goods. *International Journal of Retail & Distribution Management*. 41(11/12), 885-900. See page 8 of the paper : “For consumers to be able to purchase expensive items makes them feel financially successful, while being seen in the store gives customers the feeling of social success, fame, uniqueness and sophistication”.

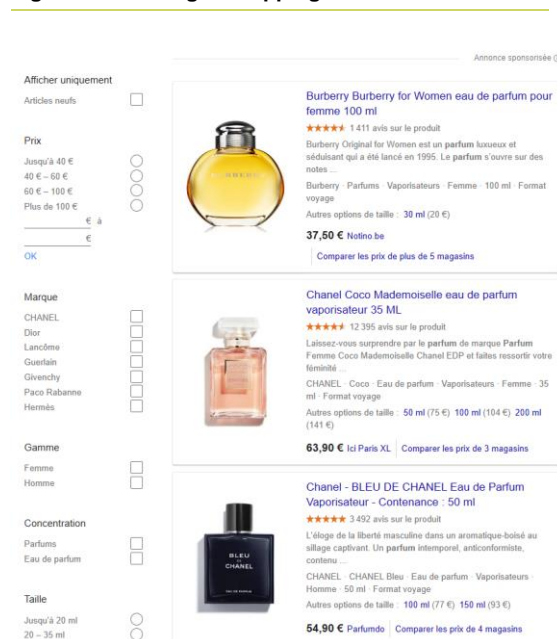
⁹⁰ Ibid and Corneo, G., & Jeanne, O. (1997). Conspicuous consumption, snobism and conformism. *Journal of public economics*, 66(1), 55-71.

To achieve the elements of luxury that a website can accommodate, it must still fulfil certain criteria. Luxury website creation has placed emphasis on strong visuals, and a variety of media to engage the consumer.⁹¹ The website must also have an integrated design which is consistent with physical points of sale with a balanced approach towards functionality, content and relevance.⁹² When a website does not adhere to these criteria, it can significantly harm brand image, which is the case of non-authorised grey market players that can easily gain a large exposure online in the whole EEA through the most prominent marketplaces or price comparison tools.

However, whatever the standard level of qualitative criteria required for online sales are under a selective distribution system, they cannot at this stage offer the same shopping and interactive experience as offered in physical stores. So both channels are still viewed as complementary from both the supply side and the consumer side.

Figure 3 below shows an example from Google shopping where the products are presented in grids and the price is the only means of comparison. In comparison, the physical store of an authorised retailer can convey brand image by using three dimensions, lighting effects and “mise en scène” of the products (see Figure 4).

Figure 3: Google Shopping Search



Source: Results when searching « Parfums » on Google Shopping :
<https://www.google.com/search?q=Parfums&sa=X&hl=fr-BE&tbs=shop&tbs=vw:l&ved=0ahUKEwj-w9TapNDjAhXJRBUIHSddDFoQvQ0lhgc&biw=2021&bih=1018&dpr=0.9>

Figure 4: Chanel fragrance boutique



Source: https://luxurylaunches.com/fashion/chanel_unveils_fr_agrance_boutique_at_selfridges_store.php

⁹¹ Okonkwo, U. (2009). Sustaining the luxury brand on the Internet. *Journal of brand management*, 16(5-6), 302-310. See page 307

⁹² Ibid

In comparison, the presale services offered online are generally also available offline (or can be provided easily offline),⁹³ while the opposite is not true.

An aspect of shopping online valued by consumers is the ease of gathering information on products, allowing easy comparison as well as accessing reviews made by other customers.⁹⁴ These presale services that are mainly provided online lead suppliers to see both channels as complementary and essential for the implementation of their commercial and marketing strategy as they enable brands to meet the broadest consumer base possible and to meet expectations of all potential consumers.

However, as explained above, product information found online is insufficient for the majority of consumers of cosmetic products during product selection, and, as shown in the results of the consumer survey, is not a reason often quoted by consumers to use this channel. Approximately 30%-45% of online customers cited the convenience or time-saving aspects as reasons to shop online, while only 10%-20% of online shoppers cited either the ease of comparison of products or the comments of users as reasons to use this channel.⁹⁵ Furthermore, the ease of product comparison is not unique to the online channel and is actually an aspect which is valued more offline. As shown in the consumer survey, ease of comparison is one of the most significant reasons to purchase offline, valued by 23%-33% of offline consumers.⁹⁶

2.3 The reduction of presale services would lead to inefficiencies in the cosmetics markets and to a reduction in consumer welfare

This section analyses the likely impact of the absence of the important services listed in the previous sections on the products sold and the functioning of the cosmetics market. We find that:

- Entry and innovation would likely be hampered (section 2.3.1)
- Brand image would likely be deteriorated (section 2.3.2)
- Quality of the products would likely be affected (section 2.3.3)
- The size of the market would likely become smaller, lowering consumer welfare (section 2.3.4)

2.3.1 Entry and innovation would likely be hampered

If consumers cannot smell, test and touch the products, consumers would have to rely on samples received or testing their friends' cosmetic products when selecting a new product. As shown by the consumer survey, absent the ability to test new products, consumers will either

⁹³ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Pages 194-195. Page 208 "Today's internet world is a sensually reductive world: it is not experiential enough. If the eyes and ears are well served, which is useful for presenting a hotel room or a concert, the senses of smell, taste and touch are ignored, or served in such a reduced, summary manner that the refinement and the multisensory component of luxury are excluded."

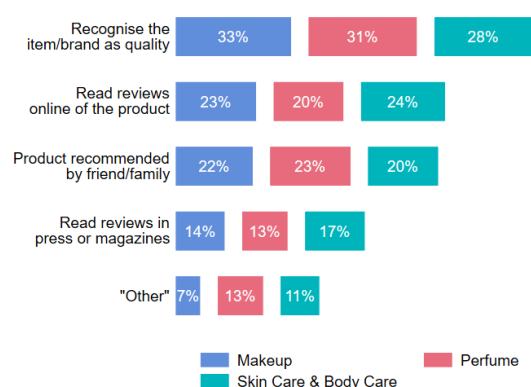
⁹⁴ European Commission (2017). "Final report on the E-commerce Sector Inquiry", See pages 4-5

⁹⁵ Consumer survey response to "What are the main reasons for buying the following beauty products online rather than in physical stores?" Base: Selective distribution and purchase online

⁹⁶ Consumer survey response to "What are the main reasons for buying the following beauty products in physical stores rather than online?" Base: Selective distribution and purchase offline

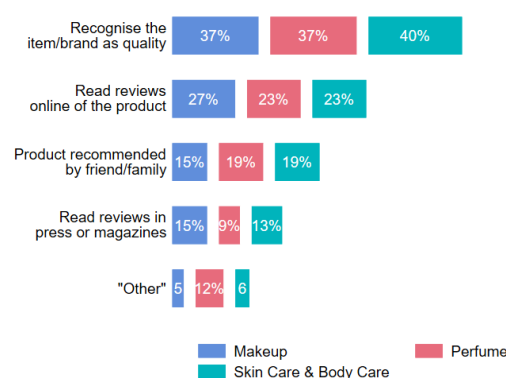
repurchase items they are familiar with or rely on well-known brands or “blockbusters”. For example, in all countries except for Poland, the number one reason to buy a product never purchased and never tested online in the consumer survey is the recognition of the item and brand as well-known quality (30% to 38% of consumers across all countries except Poland, with 24%), see Figure 5 and Figure 6 below for France and Germany. (Figure 37 to Figure 39 in Annex C present the same results for all the other countries analysed in the consumer survey).⁹⁷ This is similar to the behaviour demonstrated by consumers when purchasing perfumes for gifts.⁹⁸ For example, during the Christmas period, when sales of fragrances increase dramatically (fivefold compared to the rest of the year), the top three selling perfumes for women achieve their maximum share.⁹⁹

Figure 5: Reason to buy a product never purchased and never tested online - France



Source: Consumer survey
Base: Would purchase online even if have never tested it

Figure 6: Reason to buy a product never purchased and never tested online – Germany



Source: Consumer survey
Base: Would purchase online even if have never tested it

These results suggest that, if consumers no longer have the ability to smell, touch and test the products or to receive personal advice instore, they are likely to repurchase items they have already bought or rely on the brand image as a sign of quality. Without being able to test the product, or without receiving personal advice, consumers are less likely to take a gamble on a new product which perhaps does not have a reputable brand name. As a consequence, the lack of product testing will ultimately reduce the size of the accessible market to a supplier when considering launching a new product. As the launching of a new product represents a high sunk cost, for a luxury perfume this is on average one year’s anticipated turnover, a reduction of volumes on which these investments can be recovered would decrease the profitability for each new product and thus lower the number of products launched.¹⁰⁰

⁹⁷ Consumer survey response to “What helped you in taking the decision of buying the following beauty product online when you have never purchased it before and not previously tested it?” Base: Would purchase online even if have never tested it

⁹⁸ The current behaviour of consumers when purchasing a gift can be viewed a proxy of their behaviour in the absence of ability to smell, touch and test the products, as they are in a position to select a product without knowing the very personal tastes of the receiver of the gift. This is only a proxy, as the person making a gift can select a perfume that she likes by smelling it or select a perfume that has the highest probability to be liked by the receiver of the gift, i.e. a blockbuster. The behaviour of the consumers may be different when choosing a perfume for themselves, but without the ability to smell and test it: they may discard blockbusters for themselves by principle if they don't like to have the same perfume as everybody, etc.

⁹⁹ LECG (2009). “Selective Distribution in the Fragrances and Cosmetics Industry”, Report for the FEBEA in the context of the revision of the VBER, Pages 26-27.

¹⁰⁰ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 257 “The cost of launching is very high (for a luxury perfume, on average one year’s anticipated turnover)”

As a result, **the absence of ability to smell, touch and feel and the absence of personal advice provided instore would likely prevent or hamper the entry and growth of new products of both existing and new brands.** This is both detrimental to competition and consumer welfare, as consumers of cosmetic products value strongly the ability to discover new products, which is illustrated by the constant innovation and launching of new products in the cosmetics market (see section 4.2.2.2 below).

In a less extreme case in which consumers would still be able to smell, touch and feel the products, but less easily because stores would be less numerous, entry and innovation would likely also be hampered, though to a slightly lower degree.¹⁰¹ For instance, if, due to store closures, consumers visit a physical store only once a year instead of four times a year, they will have less opportunity to discover new products, which reduces accordingly the frequency of purchase of new products and the size of the market for new products. **This would have the same effect as in the total absence of these services – yet to a lesser degree - on innovation, entry, competition and consumer welfare and eventually on the size of the market.**

2.3.2 Brand image would likely be deteriorated

As explained in section 2.2 above, even though the online channel, if properly managed, can partly convey the luxury or quality image of the products, the component of the brand image provided by physical stores is difficult to replace. The physical store is an important medium for sharing the brand image with the consumers, offering a comprehensive and multidimensional experience of the brand. As well as the smells, light effects and organisation of the space, the presentation of the products themselves is carefully managed and consistent with the rest of the brand image. The same holds true for personal advice and information given by the sellers of the products.

Therefore, a reduction in the number of physical stores would necessarily negatively impact brand image as it reduces or removes this channel of influence for luxury brands. Moreover, some online websites can represent a risk for brand image, which is explained in section 3.3 below.

2.3.3 Product quality would likely decrease

The absence or lack of ability to smell, touch and feel the products or the lack of personal advice could affect the ability of consumers to assess the quality of the products. By “quality” of products, we mean for instance a long lasting effect which is pleasurable for consumers, and good ingredients for the skin.¹⁰² The availability of a large variety of products and the ability to find the right match, i.e. the product that is best suited to the skin of a customer as well as her tastes also constitutes as part of the quality of products.

¹⁰¹ Because for instance, there would be a lower density of physical stores, and the frequentation of cosmetics stores would thus be reduced.

¹⁰² Regarding the last item, for some products and specific customers, a lack of personal advice may even raise possible risks of allergies to some ingredients of the products.

Online, consumers cannot appreciate all the varieties of colours and textures and they cannot smell the products. While consumers can read comments and reviews on the products that help appreciating the quality of products, personal advice (direct, immediate and interactive) provided in the stores is key to find the right match for the consumer needs and tastes and can also be important to understand the intrinsic quality of the products.

The online channel tends to draw the attention of consumers to prices rather than the other important aspects of the products, due to the absence of personal advice and a presentation that is purely visual and in two dimensions. As a result, there is a risk that consumers select products based on criteria other than quality, such as the visual appearance and the price, even if they value product quality. **This may result in suboptimal investments in the quality and variety of products.**

2.3.4 The size of the market would likely become smaller, lowering consumer welfare

A lack of the important presale services provided offline is likely to decrease total sales volumes. **Selective distribution networks in the selective cosmetics markets are designed to drive sales, which would be lower in the absence of the services provided by retailers.** There is both a direct and an indirect reason for this:

- Presale services offered by retailers in the selective distribution network enable transactions that would otherwise perhaps not take place. The ability to smell, touch and feel the products and the personal advice provided by trained staff (sellers and beauty advisers) can lead consumers to purchase selective cosmetic products. In the absence of these services, some consumers may instead opt not to purchase.¹⁰³
- A more indirect reason is that the presale services offered by the authorised retailers improve several non-price characteristics of the products that are valued by consumers in the selective cosmetics markets, such as brand image, quality and the level of innovation of products (see developments above). Therefore, a lack of such services would affect these non-price parameters and decrease the utility derived by consumers and therefore also the demand for these products.

The risk of lost sales posed by the lack of presale services offered by retailers in the selective markets explains why suppliers pay so much attention to these services. For suppliers, these services reflect a key component of success and survival, as competition between suppliers takes place on these non-price factors as well.

A reduction of the size of the selective market would ultimately be detrimental to consumer welfare, as each additional transaction generates a surplus for the consumers.¹⁰⁴ One could wonder whether consumers would not be better-off with lower presales services and lower

¹⁰³ In the response to the consumer survey, 35-50% of consumers indicate that testing a product is essential prior to purchase, with 50-65% of consumers marking testing as essential for perfumes. (Consumer survey response to “**How important to you is the ability to test and smell a beauty product that you have never tested before, before buying, for yourself?**” Base: Have purchased in selective channels). In this case, the absence of this essential service **would reduce the size of the market.**

¹⁰⁴ The consumer surplus for one transaction is equal to the maximum price at which a consumer would be ready to pay for a product (its “willingness to pay”) and the actual price of the product.

prices. However, strong interbrand competition in the cosmetics markets and the high degree of product differentiation means that suppliers need to find the right balance between price and non-price factors that corresponds to their customers' expectations. In other words, excessive prices resulting from an excessive level of presale services would immediately result in lost sales for suppliers. As such, interbrand competition disciplines suppliers' actions in the sense of the consumer interest (see section 4.2 below).

Finally, consumers already have the possibility to purchase products that have a lower price and a lower level of services in the mass market. Even in the selective markets, consumers currently have access to a large spectrum of products with different levels of prices and non-price elements. A reduction of services delivered offline would affect primarily the suppliers requiring the highest level of services to satisfy their customers' expectations. A decrease in the sales for these suppliers due to a lack of services offered offline may lead consumers either to reduce their purchases of these products or to switch to lower service / lower prices brands, which was not their initial choice.¹⁰⁵ In both cases, consumer welfare would be reduced.

¹⁰⁵ I.e. the choice maximising their utility.

3 The growth of online sales is likely to result in under-provision of the important services provided offline

As shown in this section, the growing importance of the online channel in the cosmetics markets, in line with the digitalisation of the global economy, is evident when observing the proportion of sales now accounted for by this channel and the proportion of consumers using this channel to purchase cosmetic products. Evidence available suggests that the proportion of online sales will continue to rise. As well as being a distribution channel, suppliers also extensively use the online channel for marketing and advertising. Consumers have now become accustomed to the use of online, which has altered purchasing behaviour and it is becoming increasingly common to use both offline and online channels during the purchasing process. This has been facilitated also by the cosmetics industry which has taken steps to embrace the online market and facilitate online transactions (Section 3.1).

Despite the growth in online sales, the majority of selective cosmetics products are still currently purchased offline which reflects the importance of presale services provided through this channel. Growth in online sales therefore likely reflects, at least in part, an increase in consumer “showrooming”: benefiting from presale services offline before searching for the best price online. We show below that this behaviour is already widespread, and as consumers become more accustomed to shopping online, will likely become even more common. With consumer showrooming, services provided offline are detached from the sale of the product. Thus, showrooming is likely to lead competition to become more focused on price. However, in comparison to online retailers, physical stores tend to have lower economies of scope, in particular as their turnover is typically limited to the catchment area around the store, and thus will struggle to compete. Thus, an increase in the significance of the online channel may however weaken the network of physical stores and more generally the level of presale services provided offline (Section 3.2).

Finally, certain online distribution channels can be detrimental to brand image. Certain characteristics of the online channel, if uncontrolled, can harm the brand image of luxury and quality products. The suboptimal presentation of products as well as the other products listed in some websites harm brand image. (Section 3.3)

3.1 The online channel has been increasing quickly in recent years and is expected to continue growing in the coming years

In this section, we explore the growing influence of the online channel, which is not limited to its use as a sales channel. This section is organised as follows:

- Section 3.1.1 shows evidence of the growing importance of the online distribution channel, and explains why recent growth is likely to continue;
- Section 3.1.2 shows that as well as offering an alternative distribution channel, suppliers also use the internet to market products, particularly via social media;

- Section 3.1.3 presents the growing combined use of online and offline channels by the consumers during the purchasing process.

3.1.1 Online sales have been growing quickly in the last few years in the cosmetics industry and are expected to continue growing in the near future

While the large majority of selective cosmetic products purchases in Europe still takes place offline, reflecting the importance of presale services provided offline, the share of online sales has grown significantly in recent years.

During the past decade in the global cosmetics market (selective and mass market), online sales have grown three times faster than the total cosmetics market, and now make up nearly 10% of global sales - twice its share in 2008.¹⁰⁶ The increase in online sales is occurring not only in the mass segment but also in the selective market – the focus of this report.¹⁰⁷ The figure below shows that the revenue share of e-commerce in the selective cosmetics segment has grown considerably in recent years and is already notable in both France, Germany and the United Kingdom,¹⁰⁸ where online sales accounted for **[Confidential]**. Another source suggests that online sales have reached around 8%¹⁰⁹ in the selective cosmetics markets in France.

Figure 7: Share of online sales in the total sales of cosmetic products sold in the selective segment in France, Germany and the United Kingdom (2016-2018)

[Confidential]

Source: The NPD Group, BeautyTrends, E-commerce, Total Market, all Categories (Fragrance, Makeup, Skincare) - France, Germany, UK.

Results from the consumer survey indicate that when considering the total cosmetics market, the proportion of consumers who use the online channel is much greater than suggested by the revenue share in the selective market. In Poland and Sweden, 55% of interviewees have purchased cosmetic products online over the last year, while they account for 35%-40% of the interviewees in France, Germany and Italy.¹¹⁰

Across all countries surveyed, customers who purchase cosmetic products online estimate that their online purchases account for a high proportion of their cosmetic product purchases (45%-70%).¹¹¹ And a high proportion of them have increased the share of cosmetic products purchased online in the past two years.¹¹² When we evaluate the results filtered by age we

¹⁰⁶ Xerfi Global (2018). "The Global Perfumes and Cosmetics Industry: the Market", Page 19

¹⁰⁷ Ibid, Page 36: "Online sales are on the up, even for premium products, defying the previous belief that perfumes and cosmetics were not adapted to this distribution channel."

¹⁰⁸ The NPD Group. France, Germany and the United Kingdom are the three largest countries in the EU in terms of the size of the cosmetics market <https://www.statista.com/statistics/382100/european-cosmetics-market-volume-by-country/>

¹⁰⁹ See FFPS Report attached to the answer to the questionnaire issued by the European Commission on the assessment of Regulation no.330/2010 (§28).

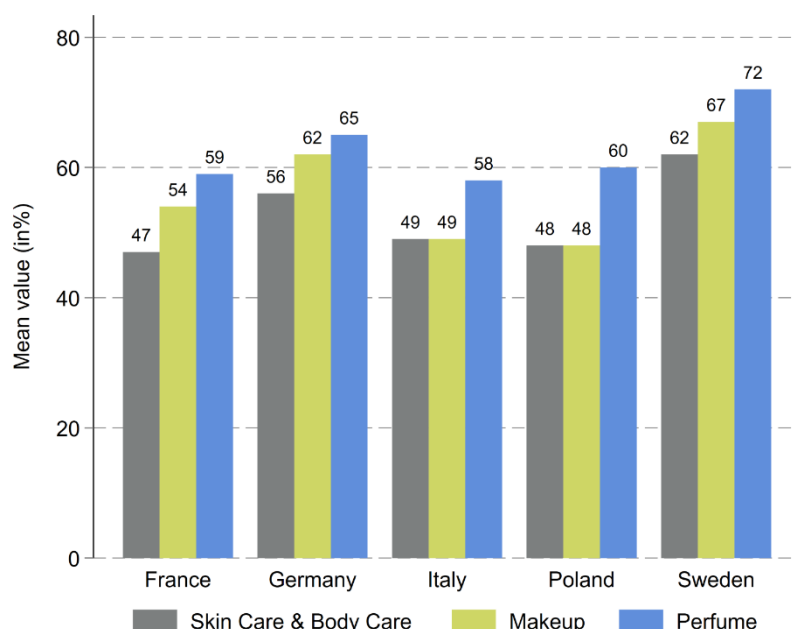
¹¹⁰ Consumer survey response to "Where have you bought the following products over the past 12 months?" Base: Have purchased the category in the past 12 months. Note this result includes both mass market and selective market consumers.

¹¹¹ Consumer survey response to "Among 100% of your purchases of beauty products over the past 2 years, what is the percentage that you bought online?" Base: Have purchased online

¹¹² 30-40% of consumers in France and Germany, and 40-50% of consumers in Italy, Poland and Sweden have increased their online purchases of cosmetic products over the past two years. Consumer survey response to "Over the past 2 years would you say that the share of your purchases of beauty products online has...?" Base: Have purchased online

show that similar percentages for the use of the online channel are found across the different age ranges.¹¹³

Figure 8: Percentage of the cosmetic products purchased online over the past two years – estimation by online purchasers of cosmetic products



Source: Consumer survey Base: Have purchased online - Question: "Among 100% of your purchases of beauty products over the past 2 years, what is the percentage that you bought online?"

The large share of online purchasers in comparison to the share of online sales is consistent with the figures found on average in all markets in the OECD countries.¹¹⁴

Evidence from multiple sources indicate that the share of the market accounted for by online sales will keep growing in the coming years.

- Industry reports expect the online sales channel to grow "rapidly" in the cosmetics markets. For example, Estée Lauder reported that it expects double digit e-commerce growth over the next three years, while e-commerce already accounts for approximately 30% of its business in its top markets.¹¹⁵ This is consistent with the forecast of a multi-industry report, which states that luxury consumers are increasingly shopping online, and predicts that the online channel will represent 25% of all luxury good market value in 2025, up from 10% in 2018.¹¹⁶
- The consumer survey also shows that consumers who currently do not purchase (or have not purchased in the past year) cosmetic products online are increasingly willing to

¹¹³ Cross results from the consumer survey responses to: "What is your intention to buy the following products online in the future?" Base: Have not purchased online, And: "How old are you?" Base: All

¹¹⁴ See the OECD roundtables of June 2018 on "Implications of E-commerce for Competition Policy", Background note, Figure 1 page 5. Retrieved from: [https://one.oecd.org/document/DAF/COMP\(2018\)3/en/pdf](https://one.oecd.org/document/DAF/COMP(2018)3/en/pdf)

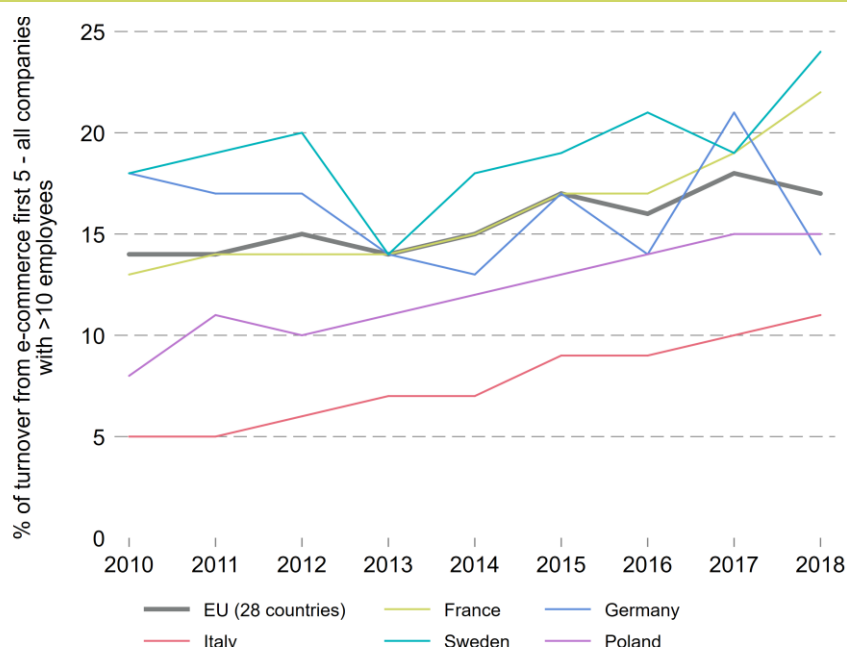
¹¹⁵ See for instance: <https://coresight.com/core100/estee-lauder-investor-day-2019-share-in-prestige-beauty-growing-online-30-of-business-affirms-three-year-6-8-net-sales-outlook/>

¹¹⁶ Bain & Company, "Luxury Goods worldwide market study, Fall-winter 2018", Page 13. Retrieved from : https://www.bain.com/contentassets/8df501b9f8d6442eba00040246c6b4f9/bain_digest_luxury_goods_worldwide_market_study_fall_winter_2018.pdf

purchase online. In France, Italy and Poland, 60%-70% of consumers who have not purchased cosmetics online reported that they are likely to do so in the future.¹¹⁷

- There is substantial scope for growth in some European countries, as the online share in cosmetics markets such as France is considerably lower than in the United States or the United Kingdom.¹¹⁸ For example, in 2018, e-commerce represented **[Confidential]** of total cosmetic products sales in the selective segment in the United Kingdom – significantly above the levels in France (**[Confidential]**) or around 8% depending on the sources) and Germany (**[Confidential]**).¹¹⁹
- Growth of online sales in the cosmetics industry would be consistent with what is observed in other retail industries (see Figure 9 below). Consumers will grow accustomed to purchasing products online, which drives online sales in all retail industries.

Figure 9: Percentage of turnover from e-commerce – all companies with more than 10 employees, 2010 – 2018



Source: Analysis of Eurostat data (isoc_ec_evaln2)

Future growth of online sales in cosmetics markets will likely be aided by the reduction in importance of current obstacles faced by the online channel:

¹¹⁷ Consumer survey response to “What is your intention to buy the following products **online** in the future?” Base: **Have not purchased online**. These numbers were smaller in Germany and Sweden, but still high (Germany 43%, Sweden 56%).

¹¹⁸ See for instance: <http://ffps-ffps.fr/actualites/parfumerie-selective-les-ventes-en-ligne-ont-augmente-de-27-en-2017/>
 « Le potentiel de l'e-commerce sur la beauté est énorme même si nous sommes encore très loin en France de ce que ce circuit peut représenter dans d'autres pays, comme les Etats-Unis ou le Royaume Uni [...] À date, la montée en puissance du online ne compense pas complètement les pertes des magasins physiques. » Translated from French by RBB: “The potential of e-commerce in the beauty market is considerable, even if in France it is still a long way from the importance this channel constitutes in other countries such as the United States or the United Kingdom [...]. Today, the rise of online does not fully offset the loss of the physical stores.”

¹¹⁹ Source: The NPD Group, BeautyTrends, E-commerce, Total Market, all Categories (Fragrance, Makeup, Skincare) - France, Germany, UK. See also Figure 7. The source of the figure of 8% is FFPS Report attached to the answer to the questionnaire issued by the European Commission on the assessment of Regulation no.330/2010 (§28).

- While delivery times and problems with deliveries are quoted as key obstacles to online purchasing currently, online players are developing and improving their delivery services.¹²⁰ As explained in a study by McKinsey & Company, *“The variety of delivery options and the perceived quality of the delivery service are major decision criteria for online customers and hence directly impact e-commerce players’ success in the marketplace. With this in mind, vendors are working hard to provide their customers with the best customer experience possible, especially by improving delivery times.”*^{121,122}
- There has been a relative convergence of the online and offline channel driven by suppliers and technological progress.¹²³ An improvement in the services offered by the offline channel can lead to an increase in online sales even if this experience still lags that of the offline channel (Sections 3.1.2 and 3.1.3).
- If the sales of physical stores decrease, they will become less profitable (see section 3.2.2 below) and may need to set higher retail prices. However, if the price differential grows between the online and offline channels, consumers may become even more likely to purchase online.
- Growth in online sales of cosmetics products has been aided by consumer “showrooming” behaviour, which we show to be already widespread. As consumers become accustomed to purchasing online this behaviour will become more common facilitating further growth in online sales (section 3.2.1).

3.1.2 The online channel is increasingly used by brands and retailers to share information about products and reach new customers

As well as offering a new channel for sales, the internet and in particular social media is increasingly being used by the brands as a marketing tool. Consistent with the recommendations of marketing experts, suppliers now interact directly with their customers online to promote new products, educate consumers and maintain brand loyalty.^{124,125} In

¹²⁰ In the consumer survey, respondents listed delivery costs and the immediacy of the offline channel as key reasons for not shopping offline (see Figure 2 above). Product testing listed by 50-70% of consumers, with delivery time the second most important in most countries. In Germany, delivery time listed more frequently than testing. Consumer survey response to **“Why would you not purchase your beauty products online?”** Base: No intention to buy beauty products online

¹²¹ McKinsey & Company (September 2016), Parcel delivery The future of last mile. Page 9. Retrieved from: https://www.mckinsey.com/~/media/mckinsey/industries/travel%20transport%20and%20logistics/our%20insights/how%20customer%20demands%20are%20reshaping%20last%20mile%20delivery/parcel_delivery_the_future_of_last_mile.ashx

¹²² For instance, the French post service La Poste is consolidating its subsidiary specialised in e-commerce through partnerships with selective distributors of beauty products such as the French group Nocibé. The group La Poste is committed to meeting the high requirements of the selective beauty sector so that the content of a package can deliver part of the offline experience (for instance by customizing each parcel with silk paper, samples or correct arrangement of the products to communicate customer care). In 2014, the cosmetics market accounted for almost 15% of the turnover of Viapost, the subsidiary of La Poste specialised in logistics for e-commerce, with expectations that this will grow in the future. « E-commerce : le spécialiste de la logistique Viapost se renforce dans la beauté ». *Cosmétiquemag*. *“This customer has chosen us for our expertise, we can customize orders with samples, silk tissue paper, gift cards [...]”, says Franck Limousin, National Sales Director of Viapost. It’s been eight years since the company works for cosmetics. A particularly demanding sector, where the content of a single package must be able to make an experience that reminds one in the shop.*” Retrieved from <https://www.cosmetiquemag.fr/business/e-commerce-le-specialiste-de-la-logistique-viapost-se-renforce-dans-la-beaute/>

¹²³ <https://www.loreal-finance.com/en/annual-report-2017/worldwide-advances/e-commerce> “Consumer enthusiasm for e-commerce is a valuable opportunity for the Group, which is a digital pioneer at every stage of the value chain. Online customers expect a sales experience akin to or better than what they find in stores. Our brands are revamping their marketing and communications to showcase their best products and convince consumers via digital platforms.”

¹²⁴ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*, Page 208.

¹²⁵ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 37

recent years, leading cosmetic groups have started to undertake projects to increase their online presence, indicating that the shift towards digital marketing will continue.

For example, in 2016 major groups such as Coty and Avon both made large investments to increase their social media presence. Coty purchased a digital media marketing group to grow consumer engagement and Avon Products announced a 300-million-euro transformation plan to increase its media and social marketing activities.¹²⁶

It is now extremely rare for a firm providing cosmetic products to not have a website, and the majority now have click and collect functionality and/or an app for mobile use.¹²⁷

3.1.3 A combination of both online and offline channels is increasingly used during the purchasing process

As consumers become better adapted to the digital channel for cosmetic products, it is increasingly common for them to use both online and offline channels for a single purchase. For consumers, there is no longer a clear distinction between online and offline as there are several ways in which consumers can mix and match between channels to tailor a purchasing process which best matches their preferences. They can for instance:

- Test and select products instore and then purchase online;
- Purchase online and collect instore ("Click and collect");
- Reserve online, buy instore;
- Research a product online before testing it and buying instore;
- Purchase a new product offline, and then repurchase it online when it is used up.

The growing tendency of consumers to use both online and offline channels during the purchasing process is recognized by the suppliers and the retailers, who have adapted and innovated their business strategies to combine both channels. For example, L'Oréal has recently launched an innovation to make instore expertise available remotely, at least in part. L'Oréal's application MatchMaker developed by True Match allows customers to determine the best cosmetic item for their shade of skin, the application then informs consumers the nearest store where this product is available.¹²⁸ Similarly, Sephora has recently invested in "Sephora Visual Artist", which uses AI and AR¹²⁹ technologies to give customers located instore the experience of virtually trying on make-up and smelling fragrances through touch screens and scented air (extracted from real bottles of perfumes available in the store), which allows consumers to try several fragrances, available in certain stores.^{130,131} Companies are

¹²⁶ Xerfi Global (2018). "The Global Perfumes and Cosmetics Industry: the Market", Page 74

¹²⁷ Xerfi France (May 2019). « La Distribution de Parfums et Cosmétiques », page 61

¹²⁸ Xerfi Global (2018). "The Global Perfumes and Cosmetics Industry: the Market", Page 72

¹²⁹ Artificial Intelligence and Augmented Reality

¹³⁰ It is also available as an app <https://www.techrepublic.com/article/how-sephora-is-leveraging-ar-and-ai-to-transform-retail-and-help-customers-buy-cosmetics/>

¹³¹ CB Insights, "How Sephora Built a Beauty Empire to Survive the Retail Apocalypse" Retrieved from: <https://www.cbinsights.com/research/report/sephora-teardown/> "In 2015, Sephora furthered its fragrance technology by partnering with cloud-based scent system Inhalió to develop InstaScent. The sensory technology uses a dry air delivery system that lets users explore fragrances emitted from a nozzle."

also currently investing in virtual store navigation, so consumers can locate specific products instore more easily.¹³²

3.2 The growth of online sales contributes to the weakening of the network of physical stores and the services provided instore

This section describes the free-riding problem at stake in the context of growing online sales in the cosmetics markets. As the showrooming behaviour of consumers is already widespread and growing in the cosmetics markets (see section 3.2.1), and as the important services that the online retailers provide represent costly investments that are not incurred by the online retailers (see section 3.2.2), the growth of online sales can result in suboptimal investments in the important services provided offline and potentially in a reduction in the number of physical stores (see section 3.2.3) which could ultimately lead to a reduction in consumer welfare (as explained above in section 2.3).

3.2.1 The showrooming (or “free-riding”) behaviour of consumers is widespread and growing

There is currently a dense network of physical stores selling cosmetic products (see Annex A). This dense network is adapted to consumer needs to visit offline stores and receive presale services in order to choose the products. The profitability of these stores relies on the ability to convert store visits into sufficient instore sales. However, as shown below, the growing tendency for consumers to “showroom”, i.e. benefit from presale services offline but purchase online if they find a lower price, means that this is no longer a given. This risk is greater for repeat purchases which do not require the ability to smell, touch and feel the products. Besides, this growing tendency is favoured by the development of price comparison tools, that are more and more sophisticated and exhaustive, and help consumers find the lowest price for a specific item they may have selected before based on presale services offered by the retailers.

The consumer survey shows that it is common for consumers to check prices online while instore prior to purchase, and, if found cheaper, most of the consumers who check prices online while instore will purchase online. As illustrated in Figure 10 and Figure 11 below for Poland, 81% of consumers check prices online at least occasionally while being in the store and 84% indicate that they are very likely or likely to purchase the product online if they find a lower price online.^{133,134} As a result, **the consumer survey suggests that physical stores in Poland can potentially lose 68% of their customers due to this show-rooming behaviour.**

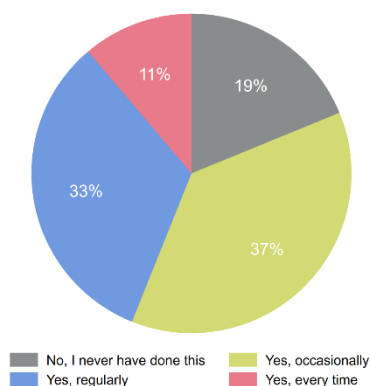
¹³² Ibid Page 71

¹³³ I.e. “Occasionally”, “Regularly” and “Every time”.

¹³⁴ Figure12: Consumer survey response to “When in store to purchase a beauty product, do you check the price online?” Base: Have purchased in selective channels.

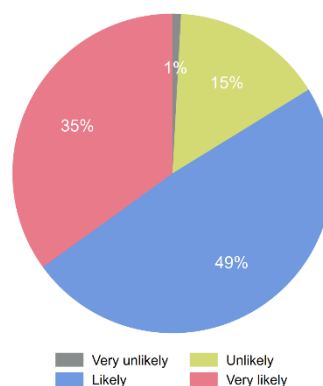
Figure13: Consumer survey response to “If while checking you find a lower price online for the same beauty product, how likely is it that you will purchase it online instead of purchasing it directly in the store where you are?” Base: Check online price in store

Figure 10: Online price check when in store - in Poland



Source: Consumer survey
Have purchased in selective channels

Figure 11: How likely will purchase online if a lower price is found online - in Poland

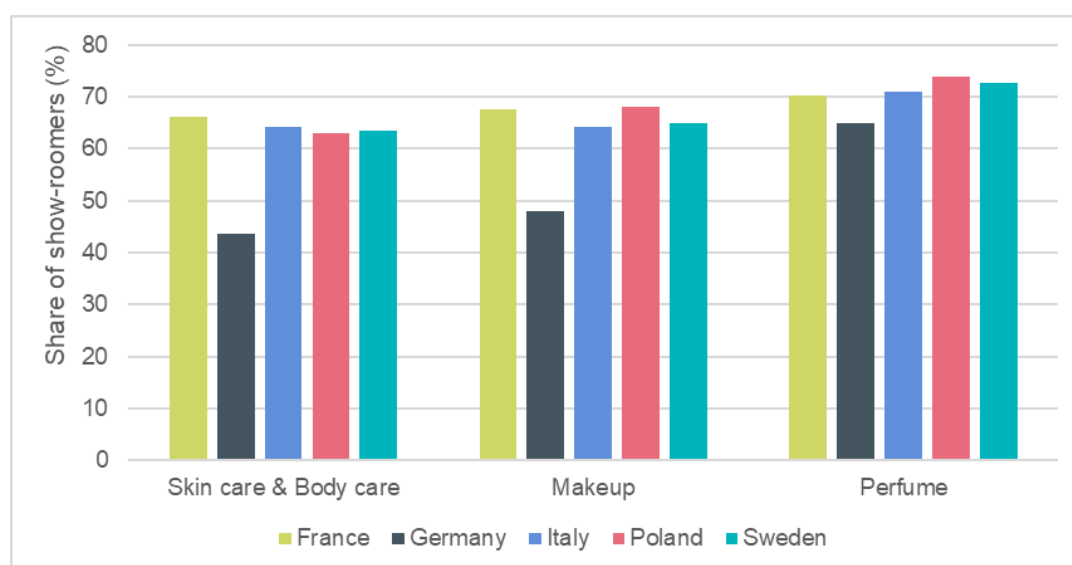


Source: Consumer survey
Check online price in store

This result is consistent across countries and product categories, as shown in Annex C (Figure 21 to Figure 28), which presents the results for the four other countries of the consumer survey and in Figure 12 below, and we can expect a substantial increase in “showrooming behaviour” as current obstacles to online sales become less relevant (section 3.1.1).¹³⁵

¹³⁵ It is also consistent with Figure 14, which shows that it is rather common for consumers to purchase a product online while having previously tested the product instore.

Figure 12: Shares of “show-roomers” for each segment (%)



Source: Consumer survey responses to “When in store to purchase a beauty product, do you check the price online?” Base: Selective and “If while checking you find a lower price online for the same beauty product, how likely is it that you will purchase it online instead of purchasing it directly in the store where you are?” Base: Check online prices instore. “Showroomers” are denoted combination of “check prices instore” and “likely to purchase online if found cheaper”. Base: Selective

Moreover, **physical stores also lose repeat purchases**, for which consumers do not need the presale services provided offline. In a separate survey it was found that 70% of women buy cosmetics that they have previously purchased using the online channel.^{136,137} Even though these consumers have no need to test the product instore and might gain limited benefit from other presale services, there still exists a problem of free-riding for repeat purchases. The service provider is only rewarded once for its efforts - provided there is no showrooming at this stage - which reduces the expected value of the sale and the profitability of providing these services. Low-service providers who operate principally online can to some extent “free-ride” on the service provision when selling products for repeat purchases. Whilst the problem of freeriding on repeat purchases already exists between different physical stores, it is aggravated by the growth of online sales because of the different costs incurred by retailers for online sales and offline sales (see section 3.2.2 below) and the increased price transparency online, which makes it easier for consumers to identify the cheapest e-store.

It is important to consider the likely growth of repeat purchases made online, as these are central for the profitability of physical stores:

- Firstly, repeat purchases account for an important share of turnover: the consumer survey shows that for 40%-60% of consumers, their last purchase in the offline channel was an

¹³⁶ JS., (2018). Parfumeries sélectives : quand online et retail marchent main dans la main. *CosmeticOBS*. “online shopping is very practical, especially for skincare products that are better adapted to repeat purchase” Retrieved from <https://cosmeticobs.com/fr/articles/lactualite-des-cosmetiques-7/parfumeries-selectives-quand-online-et-retail-marchent-main-dans-la-main-4456/>

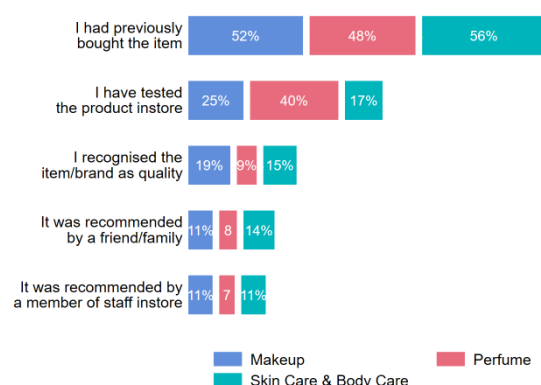
¹³⁷ (01/12/2016). Tendances Packaging : des pack adaptés au e-commerce. *CosmétiqueMag*. Retrieved from <https://www.cosmetiquemag.fr/business/tendances-packaging-des-pack-adaptes-au-e-commerce/>

item that they had previously bought (see Figure 13 and Figure 14 below)¹³⁸. Losing these sales would severely reduce revenues for offline retailers.

- Secondly, repeat purchases can also be a means of generating further sales of other products, for example if a consumer enters a store to make a repeat purchase and while instore buys another item.

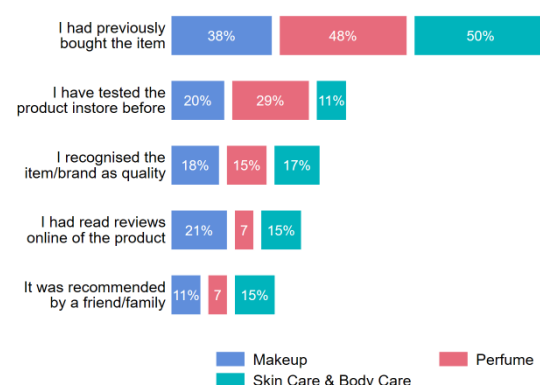
Figure 13 and Figure 14 below show the high share of repeat purchases, based on the consumer survey, both for online and offline purchases in France (Figure 40 to Figure 47 in Annex C present the same results for all the countries analysed in the consumer survey). The share of repeat purchases ranges approximately from 45% to 60%, both for online and offline purchases, in all the countries surveyed. This is by far the most important explanation of the last purchase made by surveyed consumers.¹³⁹

Figure 13: Last offline purchase drivers in France



Source: Consumer survey
Base: Have purchased offline, Top 5 answers

Figure 14: Last online purchase drivers in France



Source: Consumer survey
Base: Have purchased online, Top 5 answers

3.2.2 In comparison to online sales, offline sales generate limited economies of scale

When “show-rooming” behaviour is widespread among consumers, **competition for the final purchase destination becomes centred on price**, as the services provided offline are detached from the sale of the product and price transparency and aggressive price competition is important online. However, there is a fundamental asymmetry in the profitability of physical stores and online retailers related partly to the services provided by the offline stores, therefore offline outlets may struggle to compete and survive.¹⁴⁰

¹³⁸ Figure14: Consumer survey response to “Considering your last purchase of the following beauty product made **offline**, what helped you when taking the decision to purchase it?” Base: Have purchased offline, Figure15: Consumer survey response to “Considering your last purchase of the following beauty product made **online**, what helped you when taking the decision to purchase it?” Base: Have purchased online

¹³⁹ Having tested the product before is the second most important driver, including for online purchases (15%-30% for online purchases and 20%-30% for offline purchases in all countries surveyed when considering an aggregate across all product categories), which is further evidence of the importance for showrooming behaviour, as it means that 15%-30% customers who have done their last purchase online have tested the product instore before.

¹⁴⁰ In this section, we consider for simplicity offline stores and online retailers as two distinct entities. In reality, most retailers are “click and mortars”: they operate both online and offline. But even if click and mortars can increase turnover by selling products online, the incentive to provide offline presale services will be assessed by retailers by comparing the costs of offering these services (which correspond to the costs of physical stores) to the turnover they earn thanks to these services (i.e. the turnover made offline). If turnover is lower than costs, stores may decide to either reduce the level of services provided instore or to close the store and focus on the more profitable online activity. In addition, if

The economies of scope can be very high for online sales, while they are much more limited for offline sales. Typically, while an online retailer with a single website, hotline and warehouse can cover the related costs by selling in a potentially unlimited geographic area, a chain of cosmetic products like Sephora needs 320 physical stores to cover a country like France, as the turnover of each store is limited to the catchment area around the store.¹⁴¹ For each physical store, the following costs are incurred and thus replicated for the entire network of physical stores:

- **Real estate costs**, which are generally high, as stores are typically located in expensive areas of cities to heighten brand image;
- **Equipment of the stores**: the retailers need to invest in expensive pieces of furniture and lighting in order to convey brand image and they need to spend time on the presentation of the products within the store;¹⁴²
- **Staff**: the high level of personal advice provided in these stores requires the hiring of qualified staff and investment in their training;¹⁴³
- **Product inventories**: in order to offer a large choice of products to their customers, each physical store needs to stock many products that are purchased scarcely.¹⁴⁴

The differences in costs can be material between online and offline stores. Based on FFPS¹⁴⁵ estimates, if we exclude the costs of purchase of the products:

- The costs of a physical store (including staff, rental costs and equipment for the store) account for 40% to 45% of the turnover;
- The costs of an online website (including staff, warehouses, deliveries and IT equipment) account for 25% to 30% of the turnover.

In its sector inquiry on e-commerce (dated 2012), the French Competition Authority,¹⁴⁶ based on the pieces of information gathered from retailers, also found that the costs were lower for online sales than offline sales. By excluding the costs of purchase of the products, the costs of the pure players (including payroll, logistic, marketing, IT and real estates costs) accounted for 15% to 20% of their turnover, while the costs of the click & mortars (i.e. retailers selling both online and offline) accounted for 25% to 30% of their turnover. The most important differences regard the costs of staff and real estate. The French Competition Authority¹⁴⁷ and

services provided by a retailer offline do not generate enough sales for this retailer, either online or offline, the retailer may renounce providing the same level of services offline.

¹⁴¹ <https://www.lsa-conso.fr/sephora/>

¹⁴² Some qualitative criteria included in selective distribution contracts for cosmetic products are directly related to the quality of the selling environment in physical stores: for instance, there are requirements regarding the quality of the lighting, of the pieces of furniture, the quality of the ceiling and the floor, the arrangement of the point of sale and the easiness to circulate within the store, etc. (see section 2.2).

¹⁴³ Some qualitative criteria of the selective distribution contracts for cosmetic products impose a minimum level of diploma and experience for the sellers (see section 2.2).

¹⁴⁴ Some brand owners ask their authorised retailers to sell a large scope of products, even products that are scarcely sold, in order to offer a large choice to the consumers.

¹⁴⁵ Fédération Française de la Parfumerie Sélective, information shared by FEBEA (Fédération Française de la Beauté).

¹⁴⁶ Sector Inquiry of the French Competition Authority on e-commerce (Avis 12-A-20, 2012), Paragraphs 98 to 100.

¹⁴⁷ Retrieved from: <http://www.autoritedelaconcurrence.fr/pdf/avis/12a20.pdf>

Ibid.

the European Commission¹⁴⁸ however also indicate that online retailers incur higher costs of logistics (deliveries and inventories) and marketing (keywords on search engines and comparison tool websites, online advertising costs, platform commissions and payment transaction fees).

One could consider *a priori* that if physical stores are less efficient than the online channel then an increase in online sales in replacement of offline sales is the result of effective competition and would benefit consumers. However, as explained in detail in section 2, the higher costs of the offline stores are partly due to the important presale services they provide (both to enable consumers to select the products and to enhance brand image). These presale services benefit consumers and competing retailers, including retailers that are generating most of their turnover online and who do not offer the same level of services and thus save the corresponding costs.

3.2.3 The growth of online sales can result in overall decrease of the level of services provided offline

The freeriding problem is well identified in the economic literature and recognised by the European Commission as potentially leading to suboptimal investments in services, even when the profitability of the service provider is not jeopardised.¹⁴⁹ As described in the OECD roundtable on “Vertical Restraints for Online Sales”:

“There are also pro-competitive reasons why manufacturers might impose vertical restraints which are particularly relevant in an online world. These can mitigate service-related free-rider problems where, for instance, an online retailer of TV sets may free-ride on the services delivered by an off-line shop. Although the price paid by the customer for the TV set may be lower, this can lead to the off-line store no longer stocking this brand in the future or even to the shop closing down. Vertical restraints can help address this problem by providing incentives for the retailers to engage in costly demand-enhancing activities like servicing or advertising.” (Paragraph 3)¹⁵⁰

The limitation of freeriding between different brick & mortar stores is one of the reasons why suppliers choose to establish these selective distribution networks, and why the European Commission presumes these agreements to be welfare enhancing below a certain level of market power, and therefore provides block exemptions. If the level of free-riding is high, absent vertical agreements, retailers have strong incentives to minimise sales efforts and

¹⁴⁸ European Commission “Preliminary Report on the e-commerce sector inquiry” (2016), Paragraph 131. Retrieved from: http://ec.europa.eu/competition/antitrust/sector_inquiry_preliminary_report_en.pdf

¹⁴⁹ The free-riding argument for vertical restraints was first developed by Telser (1960). “Why should suppliers want fair trade”, *Journal of Law and Economics* 3: 86-195.

¹⁵⁰ OECD, “Policy Roundtable: Vertical Restraints for On-line Sales” (2013), Page 7
See also: European Commission, “Guidelines on Vertical Restraints” (2010), Paragraph 107: “The following reasons may justify the application of certain vertical restraints: To “solve a “free-rider” problem”. One distributor may free-ride on the promotion efforts of another distributor. [...] The product will usually need to be relatively new or technically complex or the reputation of the product must be a major determinant of its demand, as the customer may otherwise very well know what he or she wants, based on past purchases. And the product must be of a reasonably high value as it is otherwise not attractive for a customer to go to one shop for information and to another to buy.”

freeride on the investments made by other retailers to offer services that help consumers select the products and enhance brand image. When profitability is jeopardised, retailers can have no choice other than to decrease their levels of service or even to close some of their stores.

It is important to recognise that the incentive to lower the level of services in the presence of free-riding depends on the extent of free-riding and on the profitability of the retailers providing the presale services. In markets where free-riding is still limited and profitability of the offline retailers high enough, offline retailers may have an incentive to increase their presale services in order to remain attractive in comparison to the other channels.

In the present context of a low share of online sales in the selective cosmetics markets, competition between the online and offline channels has led, to some extent, to an increase in the quality of services provided offline. For example, as customers become accustomed to buying and searching for products online, the level of information they require from a salesperson found instore has increased. Thus, the sellers must be able to provide more insight than what can be provided by a quick search on the internet. Stores are therefore now actively managing their staff so that they are more knowledgeable.¹⁵¹ This is just an example of how the online channel is now an integral part of cosmetics retailers marketing strategy. Retailers are aware of the impact of the online channel on consumer purchasing behaviour and adapt both their online and offline strategies accordingly. For instance, Sephora is investing in its brick and mortar network as a way to better engage with customers as part of an omnichannel approach.¹⁵² However, this high level of consumer expectations regarding the services provided offline is likely to make it even more difficult for physical stores to remain profitable in the long run as the share of online sales grows and showrooming becomes even more commonplace.

The following theoretical example demonstrates how a reduction in volumes can lead to stores becoming rapidly unprofitable, if fixed costs are high in proportion of turnover. Let us assume that the turnover of a physical store is 100K€, that the fixed costs amount to 40K€ and that variable costs account for 45% of turnover (45K€ in this instance). If turnover decreases, the fixed costs remain the same (40K€) and variable costs will decrease accordingly. The table below shows the results of simulations with different percentages of decrease of the turnover of the physical store and the impact on profitability. It shows that, when fixed costs are high, as in the case of the physical stores in the cosmetics industry, a reasonable decrease in turnover can quickly lead to the store being unprofitable. This example shows that with a margin on fixed costs of 60% and a margin on total costs of 15%, a decrease in turnover of 27% or more will lead to the store becoming unprofitable. In response, the store will either need to close or reduce its level of services to lower cost.

¹⁵¹ Joost van Velzen, "Winkels worstelen ondanks economische opleving", February 2019. Retrieved from <https://www.trouw.nl/nieuws/winkels-worstelen-ondanks-economische-opleving-b96b8610/>

¹⁵² Agnew H, Sephora ramps up store openings as it taps 'beauty revolution', Financial Times 2019. Retrieved from: <https://www.ft.com/content/9c12372e-7bd5-11e9-81d2-f785092ab560>

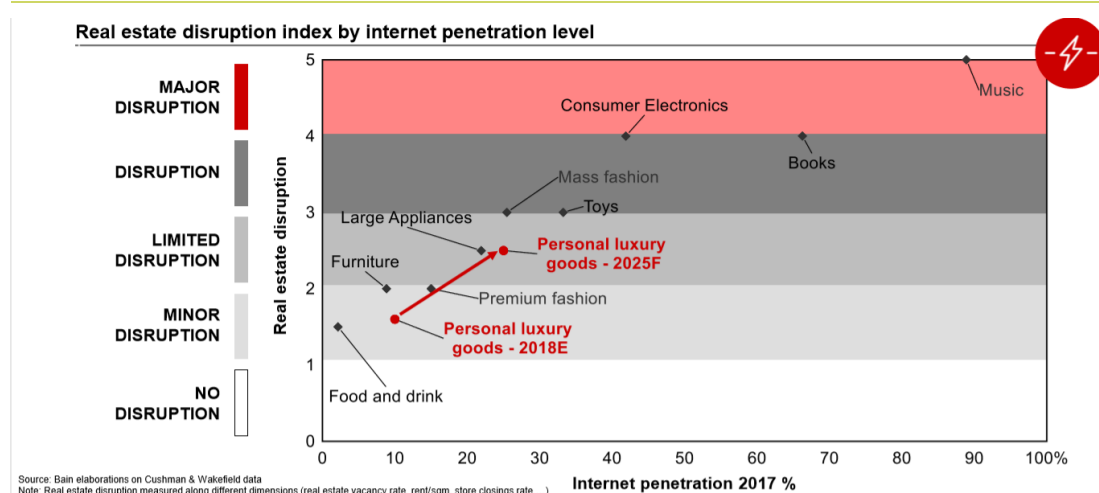
Table 1 Simulation of the effect of a decrease in the turnover of a physical store on its profitability

	Original	-27% decrease in turnover	-40% decrease in turnover
Fixed costs (K€)	40	40	40
Variable costs (K€)	45	33	27
Turnover (K€)	100	73	60
Margin on fixed costs	60%	45%	33%
Margin on total costs	15%	0%	-12%

Source: RBB calculations based on a theoretical example

The effect of the growth of e-commerce on store vulnerability and closure is observed in several sectors and countries. Over the past ten years in the United States, according to some market observers, the growth of e-commerce in a sector was correlated to store closure.¹⁵³ This phenomenon is not exclusive to the United States; the United Kingdom is also particularly affected by the rise in e-commerce and its impact on store closures, and more broadly, across Europe, vacancy rates are rising across the retail sector.¹⁵⁴ The chart below shows the clear correlation between store “disruption” - a composite measure which includes real estate vacancy rate, rent per square meter, rate of store closure etc.- and internet penetration in a sector.

Figure 15: Disruption of offline channel due to increase in e-commerce



Source: Bain & Company & Altagamma, “Altagamma 2018 Worldwide Luxury Market Monitor” Page 23. Retrieved from : https://altagamma.it/media/source/WORLDWIDE%20LUXURY%20MARKET%20MONITOR_BAIN.pdf

Note: Store disruption is a composite measure which includes real estate vacancy rate, rent/sqm, rate of store closure etc

¹⁵³ Nielsen article, “Assessing Retail Store Size and the Impact of E-Commerce”, 6 December 2019. Retrieved from: <https://www.nielsen.com/us/en/insights/article/2019/assessing-retail-store-size-and-the-impact-of-e-commerce/>. : “In looking at store count trends over the past 10 years, we’re able to forecast which categories are most vulnerable to future e-commerce growth. That’s because store count changes across the U.S. have moved in sync with the adoption of e-commerce across categories”

¹⁵⁴ Judith Evans, “Death of the high street weighs on landlords around the world”, Financial Times, 21 June 2019. Retrieved from: <https://www.ft.com/content/4e5e1022-8df3-11e9-a1c1-51bf8f989972> “The UK may be the worst affected country, but it is not alone. In Europe, vacancy rates are rising across the retail sector, according to the Royal Institution of Chartered Surveyors. In the US, retailers have announced more than 6,900 store closures so far this year, more than in the whole of 2018, with a further threat looming from the trade war with China.”

To prevent a worst-case scenario of store closure, brick and mortar retailers may instead opt to reduce their level of costly presale services which are subject to freeriding by low-cost outlets. There are several ways by which a store can reduce its costs in presale services. A store can hire a lower number of sellers or beauty advisers, lower skilled sellers, reduce the opening hours, reduce the surface dedicated to the sale of products, do less frequent refurbishment, pay less attention to the presentation of the products, choose a location in a less expensive area, limit the number of samples, etc. All these cost savings would lead to a lower level and quality of the services provided by the offline stores, which would negatively affect brand image and could ultimately lead to a reduction in consumer welfare (e.g. due to a reduction in product range or innovation).

3.3 Certain websites can be detrimental to brand image

As discussed in section 2.1.3, brand image is a key dimension of competition for high-end cosmetic products; it is an intrinsic part of luxury and quality products, strongly valued by consumers and provides a signal of quality. Supplier of luxury and high quality/ high technicality products carefully manage brand image, by investing heavily both in the creation and quality of their products and by making important efforts in marketing and sales strategies, as explained by Chanel in a previous contribution to a public consultation by the European Commission:

*"[...], in order to maintain their lustre, luxury brands must ensure that **every link in the chain**, from the creation of the product to the moment of purchase, and even beyond with after-sale, is up to luxury standards and coherent with the image of the brand".¹⁵⁵*

The growth of the online channel can harm brand image in two ways:

- first, free-riding by online retailers on services provided by offline retailers that are important to build and maintain brand image may lead to underinvestment in these services and thus a deterioration in brand image (see section 3.2);¹⁵⁶
- second, **some online websites can have a direct detrimental effect on brand image.**

The aim of this section is to analyse this second type of risk raised by the growth of the online channel on brand image. Section 3.3.1 shows that several characteristics of the online

¹⁵⁵ Salans (2008). Selective Distribution of Luxury Goods in the E-commerce age: Position paper submitted on the behalf of Chanel. Paragraph 13. Retrieved from http://ec.europa.eu/competition/consultations/2008_online_commerce/chanel.pdf

¹⁵⁶ See Iacobucci, E. and R. A. Winter, (2014). "European Law on Selective Distribution and Internet Sales: an Economic Perspective", *Antitrust Law Journal* : "Once we accept that demand depends not just on price and manufacturer investment in product and image, but also on retailer decisions such as investment in image as well as the provision of point-of-sale ("touch-and-feel") information, the explanation for restricted distribution is clear. Without such restrictions, brick-and-mortar stores fail to capture the full marginal value of their investment in either image or information. Buyers can travel to a store to obtain information about the product and then purchase from an Internet retailer. Buyers are influenced in their demand by the brand image that has been built up in part by retailer investment in its own image, which is then transferred to product image. With respect to both information and image, the failure of stores to capture their full investment means that they will provide less of this investment or simply be discouraged from carrying the product at all. The product demand will suffer. This is the free-rider, or positive externality, theory of restricted distribution."

channel, if uncontrolled, can be incompatible with a luxury and quality brand image. Section 3.3.2 explains why suppliers need to be able to control the websites on which their products are sold.

3.3.1 Some characteristics of the online channel, if uncontrolled, may harm the brand image of luxury and high quality products

As already explained in section 2.2, in comparison with the online channel, the offline channel is particularly well-suited to conveying a brand image of luxury or quality, due to the high quality of the services delivered instore and the courtesy of the sellers, the possibility to present the products in a nice way in three dimensions, the atmosphere of the stores and the multisensorial aspect, as well as the high selectivity of some points of sales, which serves to create a feeling of exclusivity, essential for consumers of luxury products.

In addition to being less qualified than the offline channel to convey a luxury brand image through multisensorial aspects and personal advice for instance, the online channel, can also have an excessive focus on prices and discounts, which can be harmful to brand image of luxury and quality products even if this generally benefits consumers (albeit potentially only in the short term).¹⁵⁷

The online channel is often valued by consumers as offering cheaper prices and facilitating price comparison.¹⁵⁸ While this characteristic may bring a positive contribution to consumer welfare in many industries, **an excessive focus on prices, discounts and deals in the online channel can be harmful to brand image for luxury and high quality goods and lead to a decrease in sales of these products.** Indeed, the luxury or high quality brands generally avoid communicating on prices and discounts, for several reasons¹⁵⁹:

- For many consumers, luxury products are so-called “**Veblen goods**” - whose demand increases with the price on a part of the demand curve.^{160,161} This is partly because consumers of luxury products seek a social distinction by purchasing products that only a few people can afford, and also because the price is a signal of the intrinsic and the perceived quality of the products.^{162,163}

¹⁵⁷ FFPS Report attached to the answer to the questionnaire issued by the European Commission on the assessment of Regulation no.330/2010 Page 6 “Similarly, purchases made online are motivated by prices (60%) and promotions (47%), or even the ability to complete a sale at any time, day or night.”

¹⁵⁸ Approximately 30-50% of consumers marked either “There are often interesting promotions or good deals” or “It is cheaper online for the same product” Consumer survey response to “**What are the main reasons for buying the following beauty products online rather than in physical stores?**” Base: Online and selective.

¹⁵⁹ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 70 “It is a telling fact that advertisements for luxury products often show only the product, without any blurb, and certainly no prices. In the luxury world, price is something not to be mentioned. [...] As a general rule, the imagined price should be higher than it really is. [...] In luxury, when an imagined price is higher than the actual price, that creates value.”

And Page 190 “In general, the price level (not the exact price) of the brand’s flagship products should be known, not only by potential clients, but also by a broad fringe of the population, as broad as possible”

¹⁶⁰ Corresponding to the name of the economist and sociologist Thorstein Veblen, who has defined this category of product in the book “Theory of the leisure class” (1899).

¹⁶¹ See Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 180 “Objects or services for which demand increases along with the price are called ‘Veblen goods’, [...] This behaviour of ‘Veblen goods’ is very frequent in luxury and is somewhat counterintuitive, particularly as it is in flagrant contradiction of what occurs with ordinary products.”

¹⁶² See for instance Leibenstein, H. (1950). Bandwagon, snob, and Veblen effects in the theory of consumers’ demand. *The quarterly journal of economics*, 64(2), 183-207. Retrieved from <https://academic.oup.com/qje/article-abstract/64/2/183/1931945>.

¹⁶³ See Bagwell, K., & Riordan, M. H. (1991). High and declining prices signal product quality. *The American Economic Review*, 224-239. Disponible en ligne sur https://www.jstor.org/stable/2006797?seq=1#page_scan_tab_contents and Inderst, Roman, “An ‘Image Theory’ of RPM”. (April 2019). *CEPR Discussion Paper*. No. DP13639. Retrieved from SSRN: <https://ssrn.com/abstract=3368136>.

- Consumers of luxury and high quality products derive a higher utility from consumption of those products if other people know or believe that they are expensive.¹⁶⁴ **The economic literature on conspicuous prices shows that the utility of the consumers of luxury products may be higher if the conspicuous price is higher than the real price.**¹⁶⁵
- Pricing is necessarily simplistic and leads consumers to pay less attention to the other characteristics of the products. Suppliers compete on numerous factors other than price such as quality, design and innovativeness, the services surrounding the purchase and the exclusivity of the brand. All these parameters are of high importance for luxury and high-quality goods and can be overlooked when considering price in isolation..
- Luxury and quality products are generally timeless and are conceived to last, while sales and discounts involve an obsolescence or a temporary nature of the products.¹⁶⁶

Despite these characteristics and risks raised by online sales on the brand image of luxury and quality products, the luxury and quality brands generally benefit from the online channel and are very willing to make the most of this channel, which enables them to increase their sales and to convey their brand image in another form, potentially to new customers. Therefore, there is today no incentive for selective brands to limit the rise of the online channel as a complementary channel to the offline stores, provided that online sales are made in a selling environment compatible with the brand reputation.

3.3.2 The brands need to have a minimum control over the websites that display, promote and sell their products

To avoid damage to brand image that can result from the appearance of luxury and quality brands on certain websites, **brand owners must be able to control the way their products are presented online.** Similarly to the way they engage with offline stores in selective distribution, brand owners must be able to modify or prohibit online content which could deteriorate their brand image and implement a selective distribution model online.¹⁶⁷ However, when brand owners do not have a direct relationship with the store in the online channel, they can no longer control the presentation of their products on this player's website. This can occur when products are sold by an authorised retailer on a marketplace, or appear on a comparison website, with which the brand has no contract. This is recognised in the *Coty* judgement of the CJEU:

The internet sale of luxury goods via platforms which do not belong to the selective distribution system for those goods, in the context of which the supplier

¹⁶⁴ If they communicate on a price, they may rather decide to communicate on the highest price. For instance, when Alain Ducasse opened a restaurant in New-York, he claimed that it was the most expensive restaurant of the city. See Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 178

¹⁶⁵ Leibenstein, H. (1950). Bandwagon, snob, and Veblen effects in the theory of consumers' demand. *The quarterly journal of economics*, 64(2), 183-207. Retrieved from <https://academic.oup.com/qje/article-abstract/64/2/183/1931945>

¹⁶⁶ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 189

¹⁶⁷ See the European Commission guidelines on Vertical Restraints: "Under the Block Exemption the supplier may require quality standards for the use of the internet site to resell its goods, just as the supplier may require quality standards for a shop or for selling by catalogue or for advertising and promotion in general. This may be relevant in particular for selective distribution", paragraph 54.

*is unable to check the conditions in which those goods are sold, involves a risk of deterioration of the online presentation of those goods which is liable to harm their luxury image and thus their very character.*¹⁶⁸

In addition to how their own products are presented on a website, the selection of other products and brands sold in the same space can also affect how a certain brand is perceived. This is illustrated by the fact that the qualitative criteria in some cosmetic products contracts address the other products sold at the same point of sale.¹⁶⁹ This is also confirmed by the consumer survey, which reveals that in nearly all countries, approximately 55%-70% of the interviewees think that the value of a brand can be judged by the value of the other brands sold in the same space.¹⁷⁰ Furthermore, in response to a report and questionnaire in 2016 prepared for the CMA, three luxury goods manufacturers stated that they wanted their products to be displayed in stores next to the best similar brands.¹⁷¹ According to this study, such a requirement is a signal sent to consumers that the brand in question is of high-quality.¹⁷² Therefore, if a luxury or quality cosmetic product available online is marketed next to a non-premium product, for example, this risks damaging the brand image and perceived quality of the item.

It can also severely harm brand image if counterfeit products or authentic products sold by unauthorised retailers (“grey market players”) are sold or appear on the same website¹⁷³ as authentic products sold by authorised retailers and if consumers cannot distinguish between the two. Firstly, consumers may purchase counterfeit products believing that what they are purchasing is authentic. It is likely in this instance that they will be disappointed by product quality, which will negatively impact their perception of the brand. Secondly, counterfeit products and authentic products from the grey market can be sold at very low prices which are not consistent with the typical prices of luxury goods. Price is a signal of quality as well as a way to reserve products to an exclusive group of customers that can afford to purchase them. Therefore, lower prices can affect both the perception of quality¹⁷⁴ and the feeling of exclusivity desired by consumers when buying luxury or quality products. When a brand is worn or used by people that the usual customers of this brand do not recognise as being of the same social group – which can happen when prices are too low – the brand image is distorted and, as a

¹⁶⁸ Coty Germany GmbH/Parfumerie Azkente GmbH Judgement (Case C-230/16 (6/12/2017)), Paragraph 59

¹⁶⁹ The following examples can be found in the selective distribution criteria of cosmetic producers : the size of the area dedicated to cosmetic products, the proportion of sales of cosmetic products in the point of sale, the number of prestige brands of the selective cosmetic market referenced in the physical point of sale or website, the brand image of the point of sale if it is not a website or a physical store specialized in cosmetics to make sure it is compatible with the selective brand, etc.

¹⁷⁰ Consumer survey response to “**To what extent do you agree with the following statements The value of a brand can be judged by the value of other brands which are sold in the same space**” Base: All Result for Germany: 48%

¹⁷¹ Vertical restraints: new evidence from a business survey - Prepared for the Competition and Markets Authority by Oxera Consulting LLP and Accent - 24 March 2016, Page 17

¹⁷² Ibid

¹⁷³ A marketplace, a comparison tool website or a social media.

¹⁷⁴ An abundant economic literature shows the link between the price, the perceived quality and the actual quality of products. This literature is related to Michael Spence’s work on signalling in the labour market (Spence, M. (1978). “Job market signalling”. In *Uncertainty in Economics* (pp. 281-306). Academic Press. See for instance:

Milgrom, P., & Roberts, J. (1986). Price and advertising signals of product quality. *Journal of political economy*, 94(4), 796-821.

Bagwell, K., & Riordan, M. H. (1991). High and declining prices signal product quality. *The American Economic Review*, 224-239.

Inderst, Roman, “An ‘Image Theory’ of RPM”. (April 2019). *CEPR Discussion Paper*. No. DP13639.

Völckner, F., & Hofmann, J. (2007). The price-perceived quality relationship: A meta-analytic review and assessment of its determinants. *Marketing Letters*, 18(3), 181-196.

result, the brand can be abandoned by its usual customers and sales can collapse. For example, this has happened to Burberry in the United Kingdom and Lacoste.¹⁷⁵

As a result, in addition to controlling the way their own products are presented on websites, **the owners of luxury or quality brands also need to be able to control the other brands and the other products sold on the same websites.** This may be very difficult to do when the products are sold by an authorised retailer on a marketplace or appear on a comparison website.¹⁷⁶

4 More flexible rules on vertical restraints could preserve the important services provided offline without causing consumer harm

The two previous sections of this report show that the offline channel provides different services that remain important for consumer welfare and the growth of online sales is likely to lead to an underinvestment in these services putting at risk the existing dense network of offline cosmetics stores. This section shows that more flexible rules on vertical restraints could preserve the important services provided offline without causing consumer harm.

Section 4.1 analyses several vertical restraints – namely resale price maintenance, brick and mortar requirement, dual pricing, marketplace bans and comparison tool bans - and compare their relative efficacy in protecting brand image and solving the free-riding problems identified in section 3.

Section 4.2 explains why there are low risks that vertical restraints create anticompetitive effects, in the context of strong competition between suppliers (called “inter-brand competition”) that characterises the cosmetics markets. The economic literature on vertical restraints shows that, as long as there is strong interbrand competition, suppliers’ decisions will be aligned with consumers’ interest. As suppliers are the best placed to appreciate consumers’ preferences for the products they sell, the right balance between price and non-price factors should be defined and adapted over time by the suppliers themselves in these competitive circumstances.

¹⁷⁵ Kapferer, J. N., & Bastien, V. (2009). *The luxury strategy*. Page 135 and Page 156

¹⁷⁶ French Conseil de la Concurrence (08/03/2007) Décision n° 07-D-07 on practices in the cosmetic and personal hygiene sector. the French Competition Council indicated, « *S’agissant plus particulièrement des vendeurs agréés dans le cadre d’un réseau de distribution sélective, la question se pose avec acuité des “faux” vendeurs professionnels qui ne sont pas agréés par les fabricants dont ils vendent donc les produits de manière illicite, notamment, par le biais des plates-formes. Dès lors, le Conseil ne peut que constater qu’existent, à l’évidence, des circuits de commerce parallèles, voire de contrefaçons, qui portent atteinte à l’intégrité des réseaux et à l’image des produits en cause. Pour ces raisons, le Conseil estime que les craintes des fabricants de produits dermo-cosmétiques suscitées par ces pratiques illégales peuvent légitimer l’interdiction de ce canal de vente, tant que les plates-formes n’apportent pas de garanties supplémentaires sur la qualité et l’identité des vendeurs.* » (§104).

Translated from French by RBB: “As regards the specific case of authorised dealers within the framework of a selective distribution network, the imperative question arises of “fake” professional dealers that have not been authorised by the manufacturers producing the products they are unlawfully selling, more particularly, through platforms. Hence, the Council can only acknowledge the undeniable existence of parallel traders, or even counterfeiting, jeopardising the integrity of selective distribution networks and the products’ image. For these reasons, the Council believe that cosmetics manufacturers’ concerns induced by these illegal practices can legitimate the prohibition of this distribution channel, as long as platforms cannot provide better additional safeguards about the quality and the sellers’ identity.” (§104)

Hence, this section shows that flexibility should prevail as regards the vertical restraints chosen by the suppliers, at least in the markets where interbrand competition is strong, such as the cosmetics markets.

4.1 Vertical restraints can solve the free-riding problem, with differing efficacy

As explained in section 3, despite the clear benefits of this channel, the unchecked growth of online sales can create market failures in the cosmetics markets in two ways:

- First, the freeriding by online sales of presale services provided by offline retailers may lead the latter to reduce or even stop investing altogether in important services that enhance sales and are crucial for the brand image (see section 3.2).
- Second, certain online websites can be detrimental to brand image (see section 3.3).

Existing legislation allows cosmetics suppliers to establish a selective distribution network applied to both online and offline channels. This is a very important tool for suppliers to protect non-price dimensions of competition (service, variety of products, instore shopping experience, innovation, guarantee of authenticity, brand image), however in itself is insufficient to eliminate the risk of freeriding by online outlets on services offered offline and to maintain the economic ability of offline stores to provide the optimal level of presale services sought by consumers.

Several types of vertical restraints can be used – in combination or alone- by suppliers to reduce or eliminate these market failures which result in inefficiencies and, ultimately, reduce sales for the suppliers and consumer surplus.

These vertical restraints and their respective efficacy in solving these two problems are assessed in turn below.

Resale price maintenance (RPM): resale price maintenance is probably the most powerful tool to prevent free-riding. By setting a retail price or a minimum retail price, a supplier ensures that retailers which provide important services are not undercut by those (including online retailers) that do not. Hence, retailer's sales efforts are not discouraged by the loss of subsequent sales to undercutting competitors, as prices will be the same for all retailers.¹⁷⁷ If RPM is implemented, consumers are more likely to purchase from retailers that provide

¹⁷⁷ This efficiency gain related to RPM is recognised in the guidelines of the European Commission on Vertical restraints: "In some situations, the extra margin provided by RPM may allow retailers to provide (additional) pre-sales services, in particular in case of experience or complex products. If enough customers take advantage from such services to make their choice but then purchase at a lower price with retailers that do not provide such services (and hence do not incur these costs), high-service retailers may reduce or eliminate these services that enhance the demand for the supplier's product" (§225).

See also OECD Policy Roundtable: Resale Price Maintenance, 2008: "RPM solves the free riding problem by making retail prices uniform, so that customers no longer have a reason to shop at one store but buy in another. With no possibility to compete with each other on the basis of price, retailers that operate under RPM conditions will focus on non-price factors, i.e., services." Page 10

See also Leegin Creative Leather Products Inc v PSKS Inc, 2006: "Though each side of the debate can find sources to support its position, it suffices to say here that economics literature is replete with procompetitive justifications for a manufacturer's use of resale price maintenance ... A single manufacturer's use of vertical price restraints tends to eliminate intrabrand price competition; this in turn encourages retailers to invest in tangible or intangible services or promotional efforts that aid the manufacturer's position against rival manufacturers" Pages 9 and 10.

presale services and product information, with fewer sales going to the low-cost/low-service retailers.

Significantly, the efforts of sales-people (their courtesy, availability, knowledge about the products, etc.) are not necessarily easy to observe and monitor (there is so-called “moral hazard”). In such cases, a common result from the economic literature is that providing retailers with personal incentives to undertake these efforts by rewarding them with a sufficiently high margin for each successful transaction is an optimal strategy.¹⁷⁸ RPM is therefore an efficient way to incentivize retailers to provide all these unobservable efforts that enhance sales and brand image. In the current context where online sales remain fairly limited, suppliers may not need to monitor their retailers very closely in order to be sure that they provide an appropriate level of services and selective distribution may be sufficient. However, as online sales and free-riding are expected to rise, the retailers may become more and more reluctant to offer these services and suppliers may need to find a way to provide the right incentives to the retailers.

In conclusion, RPM allows the suppliers to avoid the complexity of using most other vertical restraints. Selective distribution may however be needed in addition to RPM, in order to make sure that products are sold in an environment that is not detrimental to brand image.

Brick & mortar requirement, i.e. the flexibility to oblige online players to contribute and invest in an instore shopping experience and in presale services through the brick & mortar requirement.¹⁷⁹ Imposing that online retailers which have no offline presence must contribute and invest in the development of a physical stores network and offline presale services limits the asymmetry in costs between online and offline discussed above. However, freeriding can still occur as this solution only alleviates the most extreme cases of freeriding because retailers can still generate the majority of their revenues online. Hence, an important asymmetry between retailers can remain with this vertical restraint. For instance, a retailer can choose to operate a minimal number of offline stores to comply with the selective distribution criteria, and still generate the majority of its sales online. To prevent store closure and underinvestment in important presale services, it may therefore be necessary to establish a link between a retailer's online revenues and the number of offline stores for instance.

Dual-pricing: this vertical restraint allows the setting of different wholesale prices and/or commercial conditions to the same retailer, depending on whether the subsequent retail sales are made online or offline.¹⁸⁰ In principle, this could fix the distortion of competition between the online and offline channels and compensate the offline channel for the services they provide. Dual-pricing can allow offline retailers to set prices similar to online retailers and reduce the risk of being undercut.

¹⁷⁸ Klein, B. and K.M. Murphy (1988). “Vertical Restraints as Contract Enforcement Mechanisms.” *Journal of Law and Economics*, pp.265-298.

¹⁷⁹ Suppliers who are willing to include pure players in their networks of authorised retailers, at least for some products, should of course have the flexibility to do it.

¹⁸⁰ A supplier can of course set different prices to different retailers.

In its guidelines on vertical restraints, the European Commission prohibits dual pricing but allows suppliers to determine a *"fixed fee (that is, not a variable fee where the sum increases with the realized offline turnover as this would amount indirectly to dual pricing) to support the latter's offline or online sales efforts"*.¹⁸¹ However, in practice, this vertical restraint is seldom used, as it is extremely complex for suppliers to define in a non-discriminatory way fixed fees for each of their retailers that reflect the variety of sizes and services provided by each retailer.

Marketplace bans: as explained in section 3.3 above, some online websites provide a selling environment that is detrimental to brand image, both because of the website presentation and because of the products that are sold on it, which may include less prestigious, counterfeit or grey market products. Selective distribution allows suppliers to select retailers based on qualitative criteria, and there is no reason to limit this to the offline channel. Suppliers should be able to extend the selectiveness of their distribution network to the online channel and control this network through contractual relationships. In the absence of a contractual relationship with marketplaces, a supplier would not be able to control the presentation of products if an authorised retailer sold through a marketplace. Therefore, products could be displayed in a manner which is detrimental to brand image.¹⁸²

Comparison tools bans: comparison tools present an equivalent risk for brand image as marketplaces. The products of a supplier can appear on websites that do not satisfy the selective criteria set by the supplier for its own retailers because there is no contractual relationship between the supplier and the comparison tool website. Even though consumers do not purchase any product on comparison tool websites, these websites can still be very harmful to brand image. If, for instance, comparison tools list retailers selling counterfeit products and unauthorised retailers (also called "grey market players") selling either counterfeit or authentic products, the products sold by these retailers will appear among authentic products sold by authorised retailers. And the lower price of counterfeit products and grey market products are likely to be selected by consumers.¹⁸³ In addition to harming brand image, it would help unauthorised retailers (who do not provide any of the services offered by authorised retailers) to freeride on the services offered by authorised retailers either online or offline. Therefore, there is no reason to consider comparison tools as less harmful to brand image and presale services than marketplaces.

4.2 There are low risks that vertical restraints lead to anticompetitive effects in the cosmetics markets, due to strong inter-brand competition

While section 4.1 above shows that several vertical restraints are particularly efficient in protecting brand image and solving the free-riding problem identified in section 3, this section shows that when interbrand competition is strong, the vertical restraints implemented by the

¹⁸¹ Guidelines on Vertical Restraints, paragraph 52(d).

¹⁸² Coty Germany GmbH/Parfumerie Azkente GmbH Judgement (Case C-230/16 (6/12/2017)), Paragraph 51

¹⁸³ The prices presented on comparison tools do not necessarily correspond to the actual prices. In October 2016, the European Commission and EU consumer protection authorities launched a coordinated screening of 352 price comparison and travel booking websites across the EU. Based on the information shared by one member of Cosmetics Europe, this inquiry showed that prices were not reliable on 235 websites, representing 2/3 of the screened websites. For example, additional price elements were added at a late stage of the booking process without clearly informing the consumer or promotional prices did not correspond to any available service. According to the Commissioner for Justice, "[...] if the reviews on comparison websites are biased or prices are not transparent, these websites are misleading consumers".

suppliers are aligned with the interests of the consumers, which supports a *laissez-faire* approach towards vertical restraints in this context (section 4.2.1). While the economic literature shows that vertical restraints can also be welfare enhancing and are unlikely to harm competition in many situations where there is no competition or limited competition (a monopoly or a market with a dominant supplier) or where there is an oligopoly of suppliers who have the temptation to collude, these situations are not explored in the present report, as they do not characterise the markets for cosmetics products, where interbrand competition is strong.¹⁸⁴

Section 4.2.2 provides evidence that the cosmetics markets are characterised by strong interbrand competition.

4.2.1 When inter-brand competition is strong, there are very low risks that vertical restraints lead to anticompetitive effects

The sub-sections below first describe the general results of the economic literature on vertical restraints in the context of strong interbrand competition (section 4.2.1.1), before analysing the potential anticompetitive effects of several vertical restraints one by one (section 4.2.1.2).

4.2.1.1 The economic literature shows that vertical restraints are not likely to harm consumers when inter-brand competition is strong

It is widely recognized in the economic literature that when inter-brand competition is strong, a reduction in intra-brand competition is not likely to harm consumers. Furthermore, if intra-brand competition was restricted by suppliers in these circumstances, it could be expected to generate efficiency gains, which serve both suppliers' and end-consumers' interests.¹⁸⁵

This finding from the economic literature is consistent with the European Commission's Guidelines on vertical restraints:

¹⁸⁴ For a literature review, see Rey, P. and T. Vergé, (2008) Economics of Vertical Restraints. *Handbook of Antitrust Economics* edited by P. Buccirossi, MIT Press.

Also see Iacobucci, E. and R. A. Winter, (2014). "European Law on Selective Distribution and Internet Sales: an Economic Perspective", *Antitrust Law Journal*.

¹⁸⁵ See for instance Rey, P. (2012), "Vertical Restraints – an economic perspective". Report for Chilean Competition Authority "In contrast, in the case of strong interbrand competition among numerous manufacturers, so that consumers face many alternative offerings, increasing retail efforts and prices is unlikely to be harmful since most of the consumers that might be hurt could instead turn to alternate solutions. In that case, restraints used by the manufacturer and the distributor for the sole purpose of achieving a better coordination on retail prices and services are likely to benefit consumers as well, and thus, a fortiori, to increase total surplus. In other words, enhancing vertical coordination between manufacturers and retailers is likely to benefit consumers and society when markets are fragmented, [...]."

Motta, M. (2004). "Competition Policy: Theory and Practice", Cambridge University Press, chapter 6 : "Since the only vertical restraints that raise welfare concerns are those adopted by firms which enjoy enough market power, the main policy conclusion is that only the vertical clauses adopted by firms enjoying large market power are worth investigating, and a rule of reason approach should be used on them.", Page 306.

Bishop, S. and Walker, M. (2010). "The Economics of EC Competition Law: Concepts, Application and Measurement", Sweet & Maxwell : "Where inter-brand competition is vigorous, it is unlikely that a vertical restraint will have a significant anti-competitive effect even if it reduces or removes intra-brand competition.", Page 210.

Buccirossi P. for the OECD Roundtables (2013). "Vertical Restraints for On-line Sales", OECD.org. "It is generally believed that a reduction in intra-brand competition is unlikely to harm consumers if there is a strong inter-brand competition.". Retrieved from <http://www.oecd.org/daf/competition/VerticalRestraintsForOnlineSales2013.pdf>

“The market position of the supplier and his competitors is of central importance in assessing possible anti-competitive effects, as the loss of intra-brand competition can only be problematic if inter-brand competition is limited.” (§177)

We explain below why a reduction of intra-brand competition is not harmful to consumers when there is strong inter-brand competition.

Strong inter-brand competition ensures that the decision taken by suppliers with regard to the balance between price and non-price competition will maximise consumer welfare. If competition focuses on price, for example, suppliers have no interest in increasing retail prices above competitive levels as they would lose sales. Similarly, if consumers value non-price factors, such as the important services mentioned in section 2, then a supplier equally would not lower service provision to provide lower prices as this would also result in lost sales. Therefore, in the context of strong inter-brand competition, a supplier will implement a vertical restraint if it improves its competitiveness consistent with consumer preferences. For example, if the vertical restraint reduces intra-brand competition, it may lead to higher retail prices. However, this vertical restraint might also be essential to provide high quality customer services, maintain brand image, etc. The supplier must make a judgement depending on which parameter is most valued by consumers and, on the expected effects of the restraint on retail prices and non-price elements.¹⁸⁶

In brief, with strong inter-brand competition, the supplier will lose sales to competitors if this does not align with consumer welfare.¹⁸⁷

4.2.1.2 The likely effect on competition of several vertical restraints in the context of strong inter-brand competition

As explained above in section 4.1, several vertical restraints can be used to ensure that retailers have the incentive to provide important services to the consumers and invest sufficiently in brand image, by protecting retailers from free-riding by low-cost retailers who do not make sufficient efforts to provide these services. These vertical restraints and their likely effects on competition in the context of strong inter-brand competition are analysed in turn below.

Resale price maintenance (RPM): when there is strong inter-brand competition, in order to attract consumers to their products, suppliers have an incentive to set the lowest possible prices given consumer expectations on quality and other non-price parameters (such as brand image, services accompanying the sale, etc.). In this context, suppliers are likely to implement RPM because it helps them to be competitive on non-price elements (see section 4.1 above).

¹⁸⁶ Buccirossi P. for the OECD Roundtables (2013). “Vertical Restraints for On-line Sales”, *OECD.org*. “[...] manufacturers will also compete by offering consumers the lowest possible price. Because consumers pay the retail price, manufacturers have no reasons to limit price competition among their own retailers, unless this is the only way to induce retailers to provide ancillary services or to invest in promotional activities that benefit consumers more than a limited price reduction.”

¹⁸⁷ Buccirossi P. for the OECD Roundtables (2013). “Vertical Restraints for On-line Sales”, *OECD.org*. “[...] consumers derive most of their welfare from the characteristics of the products they consume. Inter-brand competition guarantees that manufacturers will strive to innovate their products and to choose the features that meet consumers’ preferences.”

The two main theories of harm related to RPM (extraction of monopoly rent upstream,¹⁸⁸ collusion between suppliers¹⁸⁹) do not hold when inter-brand competition is strong: there is neither a monopoly nor a firm with significant market power upstream and competition is too strong for suppliers to have the incentive and ability to collude.¹⁹⁰ A third theory of harm relates to pressure downstream retailers can exert on their suppliers to implement RPM to enable collusion between retailers and/or to exclude new entrants on the retail market. However, unless retailers have particularly strong bargaining power, the suppliers are not likely to implement a vertical restraint in favour of their retailers if it does not serve their own interests. In a market where RPM has clear benefits in terms of competition on highly valued non-price elements (such as in the cosmetics markets), there is no reason to presume that RPM is anticompetitive and instead a rule of reason should be applied.

Brick & mortar requirement, i.e. flexibility to oblige online players to contribute and invest in an instore shopping experience and in presale services through the brick & mortar requirement. The insistence of suppliers that retailers invest in presale services may lead to the exclusion of low-price retailers, which may harm consumers by raising the price level. In the context of strong inter-brand competition, this would lead to lost sales for the supplier if consumers valued low prices instead of a high level of quality and service as consumers would switch to a lower-priced alternative. Therefore, the insistence on the contribution of retailers to presale services must serve non-price parameters of competition which are valued by consumers. In other words, suppliers can accept less fierce intra-brand price competition (if this is a consequence of the vertical restraint), if this is a condition to ensure a balance between price and non-price parameters which leads to the highest sales of the product and thus the highest utility for consumers.

However, unlike RPM, this vertical restraint does not eliminate price competition between retailers: price and non-price competition remains between authorised click and mortar retailers (i.e. retailers selling both online and offline). As such, this vertical restraint is even less likely to lead to a price rise than RPM. Neither does this vertical restraint prevent online sales, as click and mortars within the selective distribution network have the right to sell online. As such, it is not likely to have a foreclosure effect on potentially more efficient and innovative retailers.

Dual-pricing: according to the European Commission, this vertical restraint could amount to a general ban on online sales and is therefore considered as a hardcore restriction under the current regulation.¹⁹¹ However, such a risk does not justify a blanket prohibition of dual-pricing.

¹⁸⁸ See Hart, O. and J. Tirole (1990), "Vertical Integration and market foreclosure," *Brookings Papers on Economic Microeconomics*: 205-86

O'Brien, D. and G. Shaffer (1992), "Vertical Control with Bilateral Contracts," *RAND Journal of Economics* 23: 299-308.
¹⁸⁹ See Mathewson, Frank and Ralph Winter, "The Law and Economics of Resale Price Maintenance", *Review of Industrial Organization* 13 (nos. 1-2), April 1998: 57-84.

Jullien, B. and P. Rey, (2007), "Resale Price Maintenance and Collusion", *Rand Journal of Economics*, vol. 38, n°4, Winter 2007, p. 983-1001.

¹⁹⁰ OECD Policy Roundtable: Resale Price Maintenance, 2008 "Moreover, RPM does not have to result in a supra-competitive price. In fact, interbrand competition might prevent manufacturers from setting the retail price any higher than the competitive level. In any event, manufacturers will rarely have a rational interest in simply padding resellers' profits by requiring them to charge supra-competitive prices to consumers." Page 33

See also *Leegin Creative Leather Products Inc v PSKS Inc*, 2006 "Interbrand competition would divert consumers to lower priced substitutes and eliminate any gains to retailers from their price-fixing agreement over a single brand" Page 17

¹⁹¹ European Commission (2017). "Commission Staff Working Document Accompanying the document Final report on the E-commerce Sector Inquiry", §597: "*Charging different (wholesale) prices to different retailers is generally considered a*

There are many kinds of commercial conduct which competition law assesses under the rule of reason, because they are competitive neutral or pro-competitive in many circumstances, but can be anticompetitive in others. For instance, margin squeeze can amount to refusal to deal, fidelity rebates can amount to exclusive dealing, etc., and yet these practices are not prohibited *per se*. In practice, it may not be more complex to assess whether dual pricing is likely to exclude online retailers than assessing whether a margin squeeze is likely to foreclose competing firms on a downstream market. In addition, suppliers will not have any interest in foregoing online sales by setting wholesale prices too high for this channel to be competitive, especially in a context of strong inter-brand competition. Therefore, this vertical restraint should be treated under the rule of reason.

Marketplace bans: this vertical restraint has approximately the same effect on competition as selective distribution: it excludes one type of “retailer” that does not comply with the qualitative criteria of the selective distribution network.¹⁹² However, like selective distribution, this vertical restraint does not prevent price competition between the retailers in the selective distribution network. Marketplaces have the effect of strengthening intra-brand competition by increasing transparency on the various available offers of the retailers and by guaranteeing services such as payment and deliveries. Therefore, a ban on marketplaces could have the effect of reducing intra-brand competition. However, and again, when inter-brand competition is strong, a supplier has no interest in a reduction of intra-brand competition, as intra-brand competition can decrease the retail prices of its products and improve its attractiveness in comparison to competing suppliers, unless it improves non-price parameters of competition that are valued by consumers. As explained in section 4.1 above, marketplace bans have very strong efficiency effects, as recognised in the *Coty* judgment. Therefore, this vertical restraint should be presumed lawful, unless a competition authority provides evidence that it has anticompetitive effects.

Comparison tools bans: this vertical restraint, like marketplace bans, can have the effect of reducing intra-brand competition, though to a lower extent than marketplace bans. Comparison tools increase transparency between the offers of various retailers, but do not facilitate the transactions with the retailers, by offering payment and delivery services. However, comparison tools bans have, like marketplace bans, important efficiency reasons and it can therefore be presumed lawful, especially in the context of strong inter-brand competition.

4.2.2 There is strong inter-brand competition in the cosmetics markets

The cosmetics industry is characterised by fierce inter-brand competition and is a typical example of markets where vertical restraints create efficiency gains to the benefits of consumers (see previous section) without harming competition. This section provides evidence of the strong inter-brand competition in the cosmetics industry. Notably:

- The markets are characterised by low levels of concentration (section 4.2.2.1),

normal part of the competitive process. Dual pricing for one and the same (hybrid) retailer is generally considered as a hardcore restriction under the VBER.”

¹⁹² Even if marketplaces are not (or not only) retailers, the consumer view them as a virtual place where they can purchase the products.

- The importance of innovation and the high frequency and success of new products launches illustrate the lively competition in the cosmetics industry (section 4.2.2.2)
- The barriers to entry and expansion are low (section 4.2.2.3)

4.2.2.1 The cosmetics markets have a low market concentration and are characterised by the presence of many atomistic players

Evidence from Euromonitor International data

Based on Euromonitor International data, concentration is low in each of the three segments of the selective cosmetics markets analysed in the report (i.e. perfumes, makeup and skincare), even when market shares at a national level are considered. These data show that market shares at the group level are almost always below the threshold of 30% and rarely higher than 25% at the national level in each of the European countries considered in the report (Figure 16 to Figure 18 below). In addition, there are a large number of firms active with less than 5% market share, which collectively account for a high market share.

Annex D presents further evidence of the low market concentration, based on the HHI and concentration ratios. It shows that almost all HHIs are below 1,600 and for several markets the HHI is below 1,000. As a benchmark, when evaluating a merger, if the HHI post-transaction is below 2,000 (and here, all values are below 2,000), the European Commission is unlikely to identify horizontal competition concerns, provided the delta HHI is below 250, which corresponds to a significant increment of market shares.¹⁹³ Markets which have a HHI of under or around 1,000 are very lowly concentrated as a HHI of 1,000 corresponds to the threshold below which the European Commission is unlikely to identify any horizontal competition concern related to a horizontal merger.¹⁹⁴ Similarly, the concentration ratios show

¹⁹³ Paragraph 19 and 20, *Guidelines on the assessment of horizontal mergers*, European Commission (2004).

¹⁹⁴ Ibid

that in many cases, a large number of firms constitute 50% of sales, and in almost all cases a very high number of firms cover 80% of the market.

**Figure 16: Market shares by group – Premium -
Fragrances – France (2018)**

[Confidential]

Source: Euromonitor International

Note: Groups with market share lower than 5% are presented in the "Others" category. Firms with >2% share in "Others" listed below graph

**Figure 17: Market shares by groups – Premium -
Make-up – Italy (2018)**

[Confidential]

Source: Euromonitor International

Note: Groups with market share lower than 5% are presented in the "Others" category. Firms with >2% share in "Others" listed below graph

**Figure 18: Market shares by groups – Premium
Skincare – Sweden (2018)**

[Confidential]

Source: Euromonitor International

Note: Groups with market share lower than 5% are presented in the "Others" category. Firms with >2% share in "Others" listed below graph

Evidence from competition authorities

The low concentration in the cosmetics markets is recognised by the European Commission and often mentioned in industry reports.

In its 2008 decision M.5068 *L'Oréal/YSL*,¹⁹⁵ the European Commission noted about each of the three selective product markets – perfumes, makeup and skincare - that they are "fragmented" (see §23, 31 and 51).

In its 2016 decision M.7726 *Coty / Procter & Gamble Beauty Business*,¹⁹⁶ the European Commission indicated that: "*The competitive landscape in the fragrances markets is characterised by a high number of strong global players, which are active across the EEA and in most of the national affected markets.*" (§200).

The low concentration of the cosmetics markets is also confirmed by industry reports,¹⁹⁷ which describe the cosmetics markets as very competitive: "*Competitive rivalry in the perfumes and cosmetics industry is multi-faceted and intense*".¹⁹⁸ According to this report, the world's ten largest perfumes and cosmetics companies account for 26% of the global revenues in 2017, a lower share than in 2010 (30.7%).¹⁹⁹

4.2.2.2 The cosmetics markets are characterised by a high degree of innovation

Innovation is a key driver of competition in the cosmetics industry. Brands frequently launch new products to maintain customer attention and awareness.²⁰⁰ Such innovations have the potential to overturn existing market positions. The need for constant innovation suggests

¹⁹⁵ Available online at http://ec.europa.eu/competition/mergers/cases/decisions/m5068_20080617_20310_fr.pdf

¹⁹⁶ Available online at http://ec.europa.eu/competition/mergers/cases/decisions/m7726_1808_3.pdf

¹⁹⁷ Xerfi Global (2018). "The Global Perfumes and Cosmetics Industry: the Market"

¹⁹⁸ Ibid. page 54.

¹⁹⁹ Ibid. page 66.

²⁰⁰ Ibid. page 71

that competition is effective in this market and is further evidence of strong inter-brand competition.²⁰¹

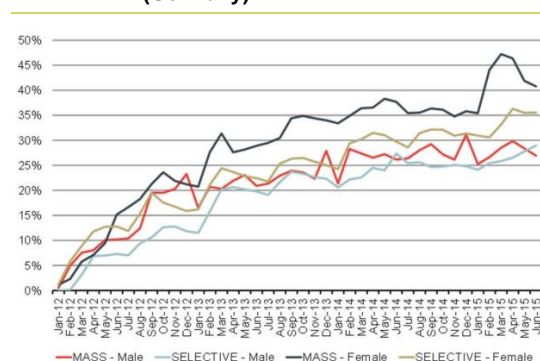
In its competitive assessment of the transaction between Coty and Procter & Gamble, the European Commission emphasised the high degree of innovation in both the fragrance and make-up markets.

*“[The] **fragrances** market is characterised by a high degree of innovation and frequent product launches, which are a key driver of competition in the fragrances market. Each year there is a very large number of line launches coming from a wide variety of suppliers. Without these launches, many brands would observe a decline in their shares as previous lines become less trendy or popular with time.”²⁰² [...]*

*“Novelty also is an important factor in the marketing of **colour cosmetics**. [...] Even established brands need to constantly replace old products with new launches to retain customer attention.”²⁰³*

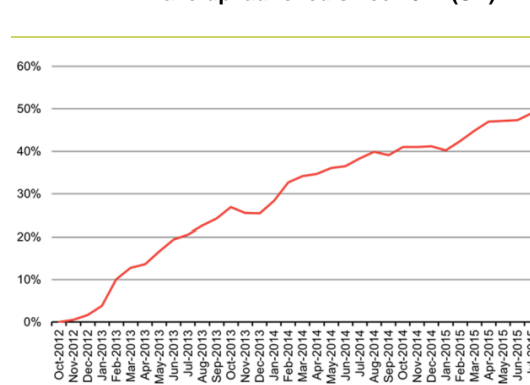
The importance of innovation in these segments is further highlighted by the two charts below, which show the proportion of sales made up of products launched since 2012 in the German fragrance market and the colour cosmetics market in the United Kingdom. The charts show that these new products come to represent a large proportion of sales within the period analysed. For the fragrance market, products launched since 2012 account for nearly 35% of the perfumes for women sold in the selective distribution channels in 2015 and 30% of the perfumes sold for men. For the make-up market, the role of innovation is even greater, as products launched since 2012 come to represent almost 50% of the market by 2015.

Figure 19: Proportion of sales accounted for by perfumes launched since 2012 (Germany)



Source: Figure 1 - Coty/P&G decision (para. 312)

Figure 20: Proportion of sales accounted for by make-up launched since 2012 (UK)



Source: Figure 2 - Coty/P&G decision (para. 313)

²⁰¹ European Commission (2004) *Guidelines on Horizontal Mergers*, Paragraph 8

²⁰² Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 311

²⁰³ Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 313

Whilst the two charts above refer only to the United Kingdom and Germany, the European Commission states that a high degree of innovation and new releases is present across the EEA, suggesting this is a general characteristic of the market.²⁰⁴ This is linked, at least in part, to the finding of the market test that it is “only moderately” difficult to launch a new fragrance or makeup product, and easier still to launch a variant of an existing product.²⁰⁵

Importantly, the significance of innovation is also not isolated to the perfume and make-up markets as it is also present in the skincare market. This is recognised by the French Competition Authority in its decision 07-D-07 regarding practices in the cosmetics and skincare products sector:

“[The] inter-brand competition is strong because of the nature of the products for which innovation plays a major role”.²⁰⁶

The above conclusions presented in decisions by competition authorities are supported by recent examples of successful launches of new products which capture a substantial market share in a short period. Paco Rabanne’s “1 Million” fragrance is one of the most relevant examples. Since its launch in 2008, the perfume has been the top performer in France and present in the top 10 in the United States, and by the end of 2012 it had become the world number one men’s perfume.²⁰⁷ Another interesting example is the Guerlain perfume “La Petite Robe Noire”, which, for a time was only available in Guerlain stores. This fragrance subsequently became available on the selective distribution network and broke a market share record for performance in a launch week in the process.²⁰⁸ The successful entry of Diesel into the fragrance market with “Fuel for Life” in 2008 is discussed in section 4.2.2.3 below.

In addition to examples of previous successful product launches, there are also areas within cosmetics segments within which companies are currently innovating with the view to bringing the next wave of new products to market. Current areas of innovation include tailoring treatments to specific skin types as well as the emergence of organic or natural ingredients products.²⁰⁹

4.2.2.3 Barriers to entry and expansion are low

Incumbents in the cosmetics market face competitive constraints from potential entrants. Firstly, there is evidence of several notable brand entries. Secondly, the market is growing which provides new opportunities to potential entrants. Finally, as mentioned previously in section 4.2.2.1, each of the markets for perfumes, make-up and skincare have large proportions of the market which consist of very small players, showing that it is possible to enter on a small scale.

²⁰⁴ Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 314

²⁰⁵ Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 315

²⁰⁶ French Conseil de la Concurrence (08/03/2007) Décision n° 07-D-07 on practices in the cosmetic and personal hygiene sector. [Translated by RBB] Available online at <http://www.autoritedelaconcurrence.fr/pdf/avis/07d07.pdf>

²⁰⁷ <https://www.cosmetiquemag.fr/business/lancement-invictus-un-parfum-de-victoire-pour-paco-rabanne/>

²⁰⁸ <https://www.cosmetiquemag.fr/business/lancement-guerlain-bat-des-records/>

²⁰⁹ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 71

Examples of successful entry in the cosmetics markets

In its decision regarding the Coty/Procter & Gamble merger, the European Commission noted that it is feasible to overcome potential barriers to entry and that *“likely and timely entry or expansion by competitors would continue to act as a significant competitive constraint”* in the cosmetics market.²¹⁰ This is indicated both by past examples of recent successful entries into these markets, and the finding that it is likely to continue to be easy to enter the market with several *“entry or expansion projects [planned] in the EEA in the coming 2-3 years by competitors and retailers”*.^{211,212}

In the recent past, market entries typically involved brands which already have built up a successful brand image and can use their reputation to enter a new market. This is particularly common for brands already present in a segment of the cosmetics market, which will use their brand image to enter another segment. For example, the Gucci brand image in the fragrance market allowed them to enter, exit and reenter the make-up segment easily.²¹³ Similarly, following the successful launch of a fragrance, Hermès announced its entry in the makeup market.²¹⁴ There are also examples of brands entering the cosmetics market without an existing presence in another cosmetics segment. Recent examples include the successful launch of Diesel into the fragrance market and Kibio into the skincare market.^{215,216}

Regarding future entry, the desire of existing groups in the cosmetics market to expand their selective products offering means there is a strong likelihood of entry.^{217,218} For example, Shiseido and Puig both have the intention of expanding operations in the selective market.²¹⁹ Similarly, Kao is investing to achieve differentiation and boost brand awareness, a strategy most relevant to the selective segment.²²⁰

The cosmetics market is growing – providing opportunities for new entrants

When assessing barriers to entry, the future profitability of the market must be considered. It is more likely that a market experiencing high growth and opportunities for expansion will attract entrants as opposed to a market which is mature or in decline.²²¹ In previous decisions, the European Commission has highlighted the growth of the cosmetics market as a factor which encourages entry.²²² This growth is expected to continue, driven by high-growth areas such as male cosmetics and a growing demand for organic products.²²³

In addition to recent years of growth, the perpetual movement of fashion trends and the demand-driven feature of the cosmetics market also encourage entry. As highlighted by the

²¹⁰ Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 319

²¹¹ Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 318

²¹² Coty/P&G decision (Case COMP/M. 7726 (16/02/2016)), Paragraph 317

²¹³ <https://journalduluxe.fr/gucci-beauty-makeup-2019/>

²¹⁴ <https://journalduluxe.fr/beaute-hermes-loreal/>

²¹⁵ <https://www.cosmeticsdesign.com/Article/2006/10/11/Clarins-and-Kibio-forge-naturals-partnership>

²¹⁶ <https://www.olfactory.com/parfum/fuel-life-pour-lui/composition/>

²¹⁷ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 12

²¹⁸ European Commission (2004) *Guidelines on Horizontal Mergers*, Paragraph 69

²¹⁹ Ibid

²²⁰ Ibid

²²¹ European Commission (2004) *Guidelines on Horizontal Mergers*, Paragraph 72

²²² L’Oréal/The Body Shop decision (Case COMP/M.4193 (31/05/2006)), Paragraph 24

²²³ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 39 and Page 42

European Commission, the cosmetics market is “characterised by frequent and unpredictable fashion trends. This has led incumbents to launch new products as well as frequent new entry”.^{224,225} The success and constant need for new product lines reflects the potential for success of a new entrant.

4.2.2.4 The cosmetics market features a large number of small players

The success of small firms in each segment of the cosmetics market increases the likelihood of entry as it demonstrates that it is not necessary to enter on a large scale for entry to be viable.²²⁶

As explained in section 4.2.2.1, the cosmetics markets are already characterised by low levels of concentration, and there is a large number of firms active in each segment, each with less than 5% market share. In addition, demand trends have changed in recent years away from traditional products and towards more niche products such as organic cosmetics, and cosmeceuticals (for example anti-ageing products).²²⁷ The emergence of these niche segments as well as the digitalisation of marketing stores will allow even more small players to emerge in the coming years.²²⁸

²²⁴ L'Oréal/The Body Shop decision (Case COMP/M.4193 (31/05/2006)), Paragraph 24

²²⁵ The impact on innovation is discussed in the previous section.

²²⁶ European Commission (2004) *Guidelines on Horizontal Mergers*, Paragraph 69

²²⁷ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 66

²²⁸ Xerfi Global (2018). “The Global Perfumes and Cosmetics Industry: the Market”, Page 55

Annexes

A Cosmetics Distribution Channels in France and Italy

Table 2: French cosmetics market distribution channels

Distribution channel	Proportion of sales (%)
Multi-brand perfumeries	44
of which:	
National chains	70
Franchises and Groups	14
Department stores	10
Online sales	6
Own-brand perfumeries	12
Supermarkets	14
Pharmacies/Parapharmacies	15
Department stores	4
Other circuits*	11

Source: Xerfi France, « La Distribution de Parfums et Cosmétiques » (May 2019), Page 71 and 75
 * For example merchant site, or network of shops in name of brand

Table 3: French cosmetics distribution channel – Points of sale

	Number of points of sale
Multi-brand perfumeries	2,010
Own-brand perfumeries	1,482
Supermarkets	9,046
Pharmacies/Parapharmacies	21,604

Source: Xerfi France, « La Distribution de Parfums et Cosmétiques » (May 2019), Page 76, 77, 82, 83 and 85
 Note: Non exhaustive

Table 4: Italian cosmetics distribution channel – Points of sales

	Number of points of sales
Perfumeries	5,000
of which:	
Selective perfumeries	2,750
Non-selective perfumeries	2,250
Pharmacies	19,331
of which:	
Public pharmacies	1,675
Private pharmacies	17,656

Source: Fenapro (National association of perfumery), NPD, Federfarma data, Assofarm data, ISTAT
Note: Non exhaustive

B Survey methodology note

A large part of the evidence quoted in this report originates from the consumer survey undertaken as an accompaniment to this report. This survey was drafted by Cosmetics Europe and RBB Economics and conducted by Kantar. All questions were reviewed by Kantar prior to circulation to ensure their objectivity and appropriateness for addressing the desired topics.

The questionnaire was translated and circulated online in five countries: France, Germany, Italy, Poland and Sweden. All countries have broad access to the internet, so this was not considered to bias the sample. Fieldwork for the survey was actioned between 17-24 May 2019, and the runtime of the survey was eight minutes on average.

The questionnaire was completed by approximately 500 people in each country.²²⁹ As women are overwhelmingly the largest consumers in cosmetics markets, the survey was sent exclusively to women, aged 18 and above.²³⁰

For most questions in the survey, for each category (perfumes, makeup and skincare/bodycare), only respondents who had purchased a product in that category in the past 12 months from the selective distribution channels were retained. When considering these consumers, the sample ranges from approximately 280 to 400 respondents.²³¹ Therefore, for all categories and in all countries, there are enough observations to draw meaningful conclusions.

Importantly, the “Total” of the three categories is the simple sum of responses for each of the three categories, and therefore can be larger than the total number of respondents. For example, if a consumer purchased each of skincare, makeup and perfume in the past 12 months, then when aggregating for the total, the response for each category would be considered individually (i.e. would be counted three times).

All results quoted in this report are from the “weighted” datasets and are therefore nationally representative. This is achieved by assigning a weight to each respondent such that at the end of the survey, the distribution of respondents is consistent with national distributions of the following characteristics: age, region and income.

²²⁹ France (500), Germany (505), Italy (505), Poland (507), Sweden (504)

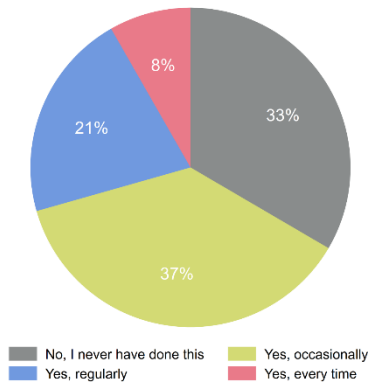
²³⁰ Women account for 90% of sales in France based on Xerfi France (May 2019). « La Distribution de Parfums et Cosmétiques », page 27

²³¹ Apart from perfume in Sweden which has 219 respondents

C Consumer survey results: Other countries

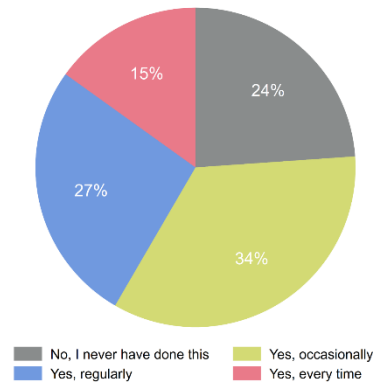
C.1 Evidence of Consumer Showrooming

Figure 21: Online price check when in store - in Germany



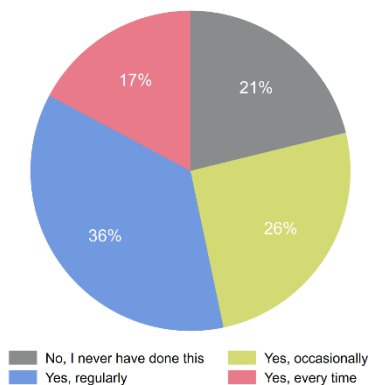
Source: Consumer survey
Base: Have purchased in selective channels

Figure 22: Online price check when in store - in Italy



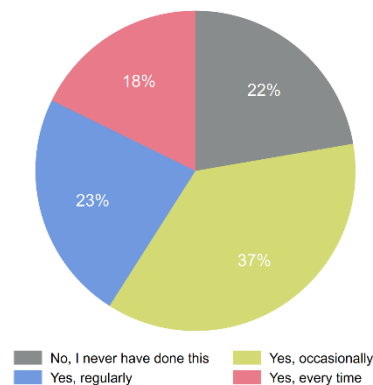
Source: Consumer survey
Base: Have purchased in selective channels

Figure 23: Online price check when in store - in France



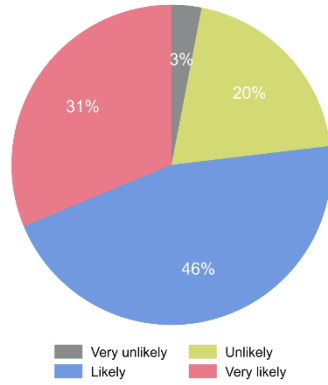
Source: Consumer survey
Base: Have purchased in selective channels

Figure 24: Online price check when in store - in Sweden



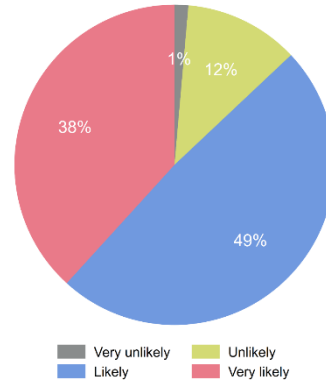
Source: Consumer survey
Base: Have purchased in selective channels

Figure 25: How likely will purchase online if a lower price is found online - in Germany



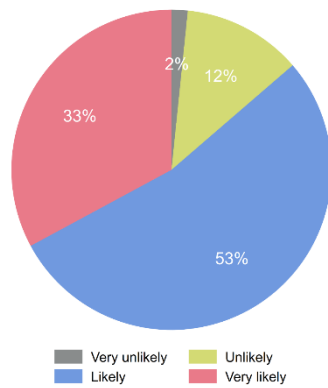
Source: Consumer survey
Base: Check online price in store

Figure 26: How likely will purchase online if a lower price is found online - in Italy



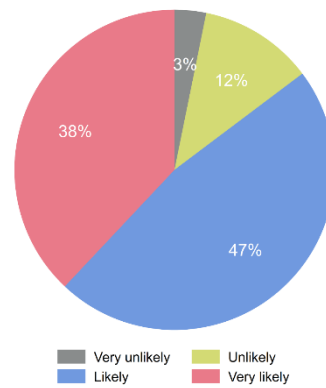
Source: Consumer survey
Base: Check online price in store

Figure 27: How likely will purchase online if a lower price is found online - in France



Source: Consumer survey
Base: Check online price in store

Figure 28: How likely will purchase online if a lower price is found online - in Sweden



Source: Consumer survey
Base: Check online price in store

C.2 Reasons Not to Purchase Online At All

Figure 29: Reason not to buy beauty products online at all in Germany (% of respondents)



Source: Consumer survey
Base: No intention to buy beauty products online

Figure 30: Reason not to buy beauty products online at all in France (% of respondents)



Source: Consumer survey
Base: No intention to buy beauty products online

Figure 31: Reason not to buy beauty products online at all in Poland (% of respondents)



Source: Consumer survey
Base: No intention to buy beauty products online

Figure 32: Reason not to buy beauty products online at all in Sweden (% of respondents)



Source: Consumer survey
Base: No intention to buy beauty products online

C.3 Reasons to Purchase Offline

Figure 33: Main reasons to buy beauty products offline in Germany (% of respondents)



Figure 34: Main reasons to buy beauty products offline in Italy (% of respondents)



Figure 35: Main reasons to buy beauty products offline in Poland (% of respondents)



Figure 36: Main reasons to buy beauty products offline in France (% of respondents)



C.4 Reasons to Purchase Product Never-Tested and Never-Previously-Purchased Online

Figure 37: Reason to buy a product never purchased and never tested online – Italy (% of respondents)



Source: Consumer survey
Base: Would purchase online even if have never tested it

Figure 38: Reason to buy a product never purchased and never tested online – Poland (% of respondents)



Source: Consumer survey
Base: Would purchase online even if have never tested it

Figure 39: Reason to buy a product never purchased and never tested online – Sweden (% of respondents)



Source: Consumer survey
Base: Would purchase online even if have never tested it

C.5 Last Offline Purchase Driver

Figure 40: Last offline purchase drivers in Germany (% of respondents)



Source: Consumer survey
Base: Have purchased offline, Top 5 answers

Figure 41: Last offline purchase drivers in Italy (% of respondents)



Source: Consumer survey
Base: Have purchased offline, Top 5 answers

Figure 42: Last offline purchase drivers in Poland (% of respondents)



Source: Consumer survey
Base: Have purchased offline, Top 5 answers

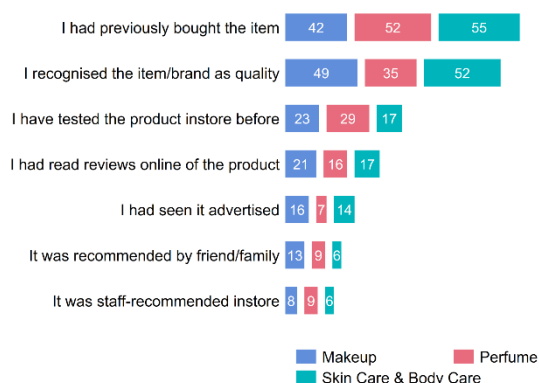
Figure 43: Last offline purchase drivers in Sweden (% of respondents)



Source: Consumer survey
Base: Have purchased offline, Top 5 answers

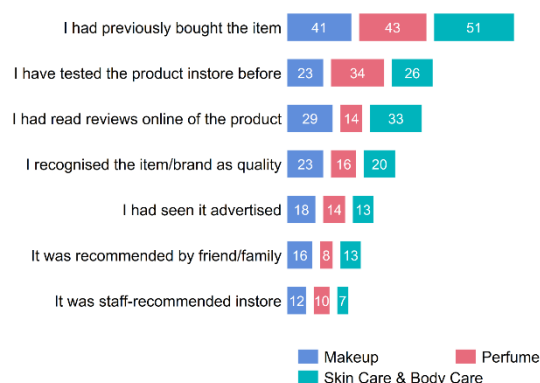
C.6 Last Online Purchase Driver

Figure 44: Last online purchase drivers in Germany (% of respondents)



Source: Consumer survey
Base: Have purchased online, Top 5 answers

Figure 45: Last online purchase drivers in Italy (% of respondents)



Source: Consumer survey
Base: Have purchased online, Top 5 answers

Figure 46: Last online purchase drivers in Poland (% of respondents)



Source: Consumer survey
Base: Have purchased online, Top 5 answers

Figure 47: Last online purchase drivers in Sweden (% of respondents)



Source: Consumer survey
Base: Have purchased online, Top 5 answers

D Analysis of Market Concentration

Table 5: Premium - Skincare HHI and Concentration Ratio (2018)

Skincare	HHI	50% of sales	80% of sales
France	1029	4	16
Germany	621	8	36
Italy	481	9	30
Poland	943	6	32
Sweden	576	8	28

Source: RBB Economics calculations based on Euromonitor International data

Table 6: Premium - Fragrances HHI and Concentration Ratio (2018)

Fragrances	HHI	50% of sales	80% of sales
France	1517	3	6
Germany	1270	4	14
Italy	1010	4	8
Poland	831	4	20
Sweden	819	5	20

Source: RBB Economics calculations based on Euromonitor International data

Table 7: Premium - Make-up HHI and Concentration Ratio (2018)

Make-up	HHI	50% of sales	80% of sales
France	1606	2	6
Germany	1194	3	11
Italy	1134	3	8
Poland	1833	2	8
Sweden	1211	3	9

Source: RBB Economics calculations based on Euromonitor International data