



Shades for success
Influence in the beauty market

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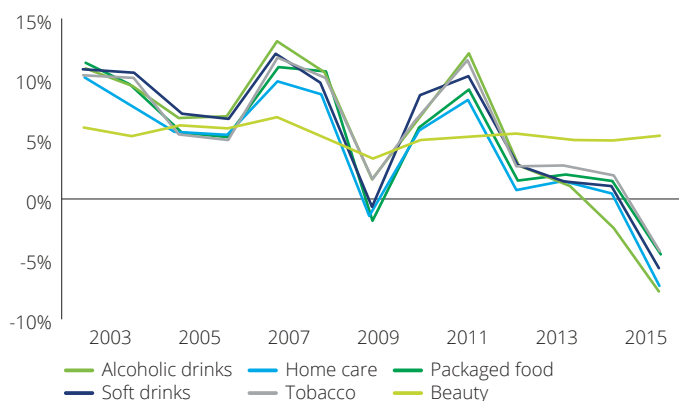
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Introduction

The global 'prestige' beauty market – a broad category of overlapping premium products including body-care, make-up and fragrances – remains one of the most valuable consumer business segments. Top-line growth in prestige beauty has outperformed both mass market beauty and most other consumer categories since 2013 (Deloitte estimates global growth in the prestige market to have been 4.8% CAGR in 2013-15 with total market value now around \$78 billion a year).

At the overall market level growth has been characterised by the rapid emergence of new brands, new geographic markets and new sub-categories, all fuelled by worldwide adoption of digital technologies. But at the company level this growth of digital sales and information channels over the last ten years has brought change and challenge, as traditional brand strategies give way to a new environment of 'influence' mediated by Facebook, Twitter, Snapchat and Instagram – not to mention the all-powerful blog/vlog medium – and as established brands lose ground to upstart challengers. The foundations of success have changed: for the leading beauty brand companies, the challenge has become one of capturing and shaping a kaleidoscopically complex world of influencers and innovators.

YoY; global market size



Source: Euromonitor, Morgan Stanley Research

The old certainties of brand power exercised through traditional media have begun to break down. Brand owners now grapple with a new reality:

- Scale of business and distribution relationships with department stores – formerly the primary sales channel for prestige beauty products – are being challenged by online sales and specialty stores, and new brands that emerge with disruptive capability from a relatively small production or market footprint.
- Traditional cyclical innovation in established corporate brands and the tendency to deprioritise the historically less attractive sub-categories (e.g. masks and cleansers in skincare, brows in make-up) has given way to a rise in “sudden” agile innovation by challenger brands, leading in turn to a higher rate of creation, adoption (and sometimes rapid demise) of sub-category lifecycles.
- Traditional businesses were focussed on maximum category presence – being ‘everything to everyone’ within their category boundaries. This model may now be breaking down as the market becomes more fragmented, and as influencers (whether individuals or specialty retailers) operate a pick-and-mix approach to products, brands and categories.
- Reliance on ‘above-the-line’ advertising on the high street and in traditional print media, celebrity endorsements without engagement, and the persuasive power of in-store beauty consultants is giving way to a much more amorphous marketing environment. The new marketing embraces online opinion sharing, and rating and influencing from a diverse group of product authorities who create a conversation between brands and potential customers through social multimedia.

These change factors which are visible in all geographies and most product categories represent a classic challenge to brand incumbents. Insurgent innovators and new sources of influence have appeared and redefined the market, enabled by changes in the way information is disseminated and shared. The new consumer has taken control of beauty advice through social media tutorials and online peer reviews.

The leading beauty companies have already responded to these changes with an accelerated program of restructuring and acquisition. But this is a work in progress: much more is to come.

The new sources of growth

New demographics

The demographic of beauty consumers is shifting. Firstly the young: millennials are projected to represent 30% of total global retail sales by 2020. The key to capturing this generation is digital engagement: millennials (often defined as the generation born 1980-2000) have little inhibition about using 'digital first' pathways to purchase, they actively seek out online influencers, and they function in a world that is driven by image. These characteristics will only be amplified in the post-millennial 'Generation Z' or iGeneration, individuals born after the start of the internet age. But older consumers also play their part in the redefinition of the market. Older demographic categories are adopting millennial-like consumption habits: the breakdown of traditional consumer age categories is a phenomenon of rising life expectancy and improved late-life health, with the proviso that as well as 'spending young' older consumers are also likely to spend more on niche brands targeted at the consumer who does not want to appear old.

New geographies

Global growth in the beauty market is concentrated in emerging economies. With markets in North America, developed Asia and Western Europe all growing at 3% or less in 2010-15, companies need exposure to the fast growing regions of the Middle East and Africa (10.5%), East Asia (10%) and Latin America (9.8%), as well as Eastern Europe (5.1%). Several of these new geographies are also emerging as sources of innovation, with South Korea for example now widely seen as the most innovative producer of skincare products. But developed markets are improving after a period of low growth, and developed market consumers continue to have premium spending power.

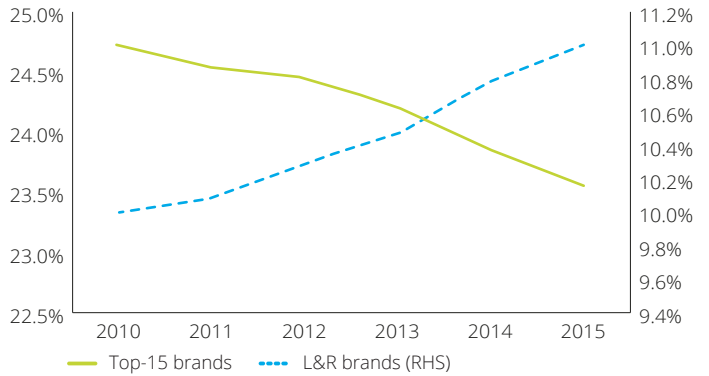
New business models

Service, experience, and convenience are key to future growth in the beauty market. These factors lie behind the poor relative performance of traditional channels to market and the growth of digital channels (online sales despite still accounting for less business than any other traditional channel is still the only channel to have grown its share significantly since 2005). Digital has enabled on-demand beauty services such as US GlamSquad, BeGlammed and Vênsette, or UK Blow Ltd. It has supported the customer databases behind the ever-growing range of beauty box services from low-end Birchbox to near-luxury Mintd. It has enabled crowd-funded innovation from companies like Julep and online-only start-ups like cult brand Glossier.

Global growth in the beauty market is concentrated in emerging economies.

Small is the new big

Global brands are losing shares as small brands/disruptors are gaining



Source: Euromonitor and J.P. Morgan.

The market shift to make-up

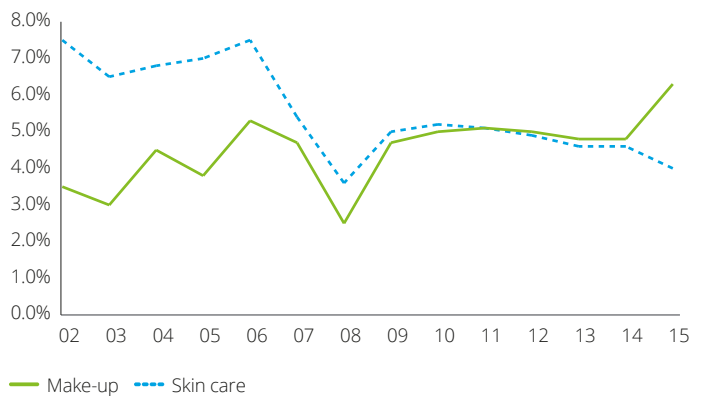
Make-up has become the fastest-growing beauty category since 2012, taking over from skincare. This appears to be one of the many effects of the growing importance of digital image and opinion sharing among consumers of beauty products.

Skincare is a higher margin business that does not lend itself so readily to promotion via online imagery. Make-up by contrast is primarily about colour: its growth has been driven not only by smartphone technologies that allow colours to be virtually tested and shared, but also by difficult-to-predict sub-category and trend booms including brows, contouring, and cushion foundations. Brands that are able to originate or quickly embrace new sub-categories have demonstrated the highest growth.

However, the structure of the market is favourable for skincare in the longer term: ageing populations will consume more skincare products, and the growth markets of Asia (excepting Korea) and Latin America have low per capita consumption of skincare products compared to mature markets, indicating future growth potential. The next wave of growth may well be seen in the 'hybrids' category which blends skincare and make-up products to deliver the immediacy of make-up with the long-term benefits of pharmaceutical-like skincare.

Make-up on the up












Make-up has become the fastest growing category boosted by digital activation whilst skin care is sagging










Source: Euromonitor and J.P. Morgan

























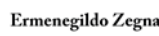








Key players












‘Prestige’ beauty is a fairly consolidated industry with around 45% of the market dominated by global multinationals across the skincare, make-up and fragrance categories. The ranking of the world’s top beauty multinationals has changed with P&G’s sale of its beauty portfolio to Coty, making four of the five of the top businesses European, with US Estée Lauder the remaining US exception.

| | Global Brand Portfolio | |
|---|--|--|
|  Unilever | | |
| Skincare and Cosmetics |  Murad <small>BETTER EVERY DAY</small> | Kate Somerville  REN <small>CLEAN SKINCARE</small>  dermalogica <small>developed by the International Dermal Institute</small>  Dove |
| |  POND'S  badedas  CLEAR <small>NOTHING TO HIDE</small>  mod's hair <small>PARIS</small>  Neutral | |
| Fragrance Brands |  BRUT | |

| | Global Brand Portfolio | |
|--|---|---|
|  Beiersdorf | | |
| Skincare and Cosmetics |  NIVEA |  la prairie <small>SWITZERLAND</small>  8x4 [®]  Eucerin [®] |
| |  Florena |  atri xo |

| Global Brand Portfolio | |
|-----------------------------------|---|
| L'ORÉAL | |
| Skincare and Cosmetics | <p> <i>Acquired 2011</i> </p> <p> <i>Acquired 2012</i> <i>Acquired 2013</i> <i>Acquired 2017</i> <i>Acquired 2016</i> </p> <p> </p> <p> <i>Acquired 2014</i> <i>Acquired 2014</i> <i>Acquired 2010</i> <i>Acquired 2014</i> <i>Acquired 2014</i> </p> |
| Fragrance Brands | <p> <i>Acquired 2016</i> </p> |
| Professional/ Salon Brands | <p> </p> <p> <i>Acquired 2014</i> <i>Acquired 2014</i> </p> |
| Beauty Retail | <p> </p> |

| | Global Brand Portfolio | | | | | | |
|----------------------------|--|---|---|---|---|---|---|
| |  | | | | | | |
| Skincare and Cosmetics | ESTÉE LAUDER | CLINIQUE | LAB SERIES | aramis | TOM FORD BEAUTY | | |
| |  <small>DESIGNED FOR ALL SKIN, ALL WOMEN</small> |  |  |  <small>PARIS</small> |  <small>HOLLYWOOD, CALIFORNIA</small> <small>Acquired 2015</small> |  <small>Acquired 2016</small> |  |
| |  |  |  |  |  <small>Acquired 2014</small> |  <small>Acquired 2016</small> | |
| Fragrance Brands |  |  |  |  |  |  <small>GRASSE - NEW YORK</small> <small>Acquired 2014</small> |  |
| |  |  |  <small>NEW YORK</small> |  |  | | |
| Professional/ Salon Brands |  |  |  | | | | |
| Beauty Retail |  |  |  |  | | | |

| | Global Brand Portfolio | | | | |
|----------------------------|--|---|---|---|--|
| |  | | | | |
| Skincare and Cosmetics |  |  <small>SAN FRANCISCO</small> |  |  | |
| |  <small>PROFESSIONAL - PARIS</small> |  | | | |
| Fragrance Brands |  |  |  | | |
| Professional/ Salon Brands | None | | | | |
| Beauty Retail |  | | | | |

| Global Brand Portfolio | |
|---------------------------------|--|
| Total Brands | SHISEIDO |
| Skincare and Cosmetics Brands |   <i>Acquired 2010</i>    <i>Acquired 2000</i>          |
| Fragrance Brands |       |
| Professional Hair Care Brands |    |
| Beauty Retail | Other areas: Health care products/supplements (8 brands); stores and services (5 brands); Restaurants (4 brands) |

| Global Brand Portfolio | |
|--|--|
| Skincare and Cosmetics |  |
| |    |
| |    |
| |    |
| |     |
|      | |
| Fragrance Brands |      |
| |     |
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| |     |
| |     |
| |      |
| |     |
|     | |
| Beauty Retail | No presence in retail |

Inside the changing market

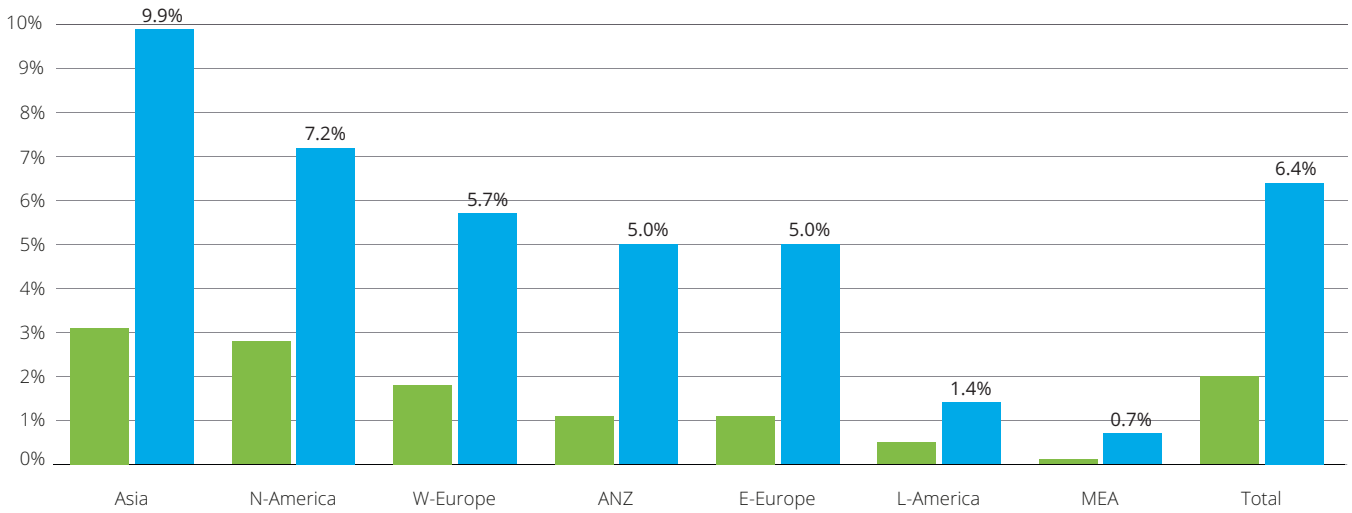
Digital excellence is at the heart of change in the 'prestige' beauty market. Although pure online sales still account for only a small part of the beauty market (with online sales accounting for 6.4% of the total market – mass and prestige – in 2015) this does not capture the effect of online influence in the prestige market. Although the great majority of prestige beauty sales still take place in department stores, pharmacies and specialty stores, digital channels have become the primary arena for consumer decision-making. Established and challenger brands alike are now primarily authenticated by online influencers. Competition for new market share is now fought largely below-the-line, in the world of online blogs and vlogs, tutorials, testing salons and consumer reviews.

- **Challenger brands, challenger regions.** Digital channels have lowered the barriers to entry into the prestige beauty market, with the inevitable result that new brand challengers have proliferated. The replacement of pure brand power with online influencer power has encouraged more brand switching, as has the rise of beauty box distribution and the growth of specialty retailers. Over the past few years, niche and 'indie' brands such as NYX, Charlotte Tilbury or Glossier have been the most important drivers of prestige beauty growth, encouraging more M&A from global beauty brand companies as they seek to acquire small but successful players to either fill in their category offers or expand into new categories. Several challengers have emerged in Asia, the region that already accounts for 32% of the global beauty market. South Korea is now established as the global innovation leader in skincare with brands like Tony Moly and Too Cool For School registering global growth, while established regional brand companies like Shiseido, Kao, and Kose of Japan and Amorepacific of Korea together with local brands like Shanghai Jahwa in China and Godrej in India are growing faster than their global peers.
- **Experience & customisation.** This is the age of beauty 'retailtainment' – customers now expect peer tutorials, in-store digital playgrounds (found in specialist retailers such as LVMH's Sephora with its 'Color IQ' system, and own brand retailers such as KIKO Milano), make-over mobile apps (such as the L'Oreal Makeup Genius allowing users to apply 'looks' virtually and using machine learning technology to improve product recommendations over time). The concept of customisation is also demonstrating a strong come-back: although customised skincare and make-up is not new with Estée Lauder's Prescriptives brand dating back to the 1970s, brand companies found the initial technology requirements cumbersome and expensive. New technologies have changed that, with the emergence of applications for routine personalisation such as the L'Oreal sun exposure monitor patch and the Kerastase smart hairbrush, as well as tech-enabled skin analysis products. Significantly Estée Lauder has rebooted the Prescriptives brand as a premium online service; at a lower price point brands like MatchCo and Melange are offering on-demand customisation.

- **Convenience is a sales driver.** Fast and cheap delivery and ease of access to brands seen as luxury have become increasingly important to the beauty market. Exclusivity is giving way to convenience; 81% of beauty shoppers use digital prior to or during their shopping journey, with the majority citing "ease" as the key driver. In beauty, convenience embraces aspects like easy-to-navigate stores and intuitive website layout, ease of trialling the product and getting the right advice or recommendation quickly, allowing simplified decision-making.
- **Alternative distribution.** Despite a relatively low share of all beauty sales, online is the only sales channel that is growing fast. Online sales are being boosted by the rise of 'social commerce' via the leading social media sites, and the industry is watching closely the performance of Amazon's partnerships with both local and multinational brands through its Beauty Channel with its promise of super fast delivery. Regionally Asia has the largest share of online sales, and by segment skincare is the largest online seller, followed closely by make-up. Within the bricks-and-mortar distribution segment there has also been a shift away from the traditional department store channel to faster-growing multi-specialty retailers. Department stores have been characterised by stagnating growth and lack of investment in digitally-led consumer engagement, leaving specialty retailers the most likely drivers of high street retail growth – the sales of LVMH's Sephora have more than doubled since 2006, while sales at Ulta have quadrupled.

Although the great majority of prestige beauty sales still take place in department stores, pharmacies and specialty stores, digital channels have become the primary arena for consumer decision-making.

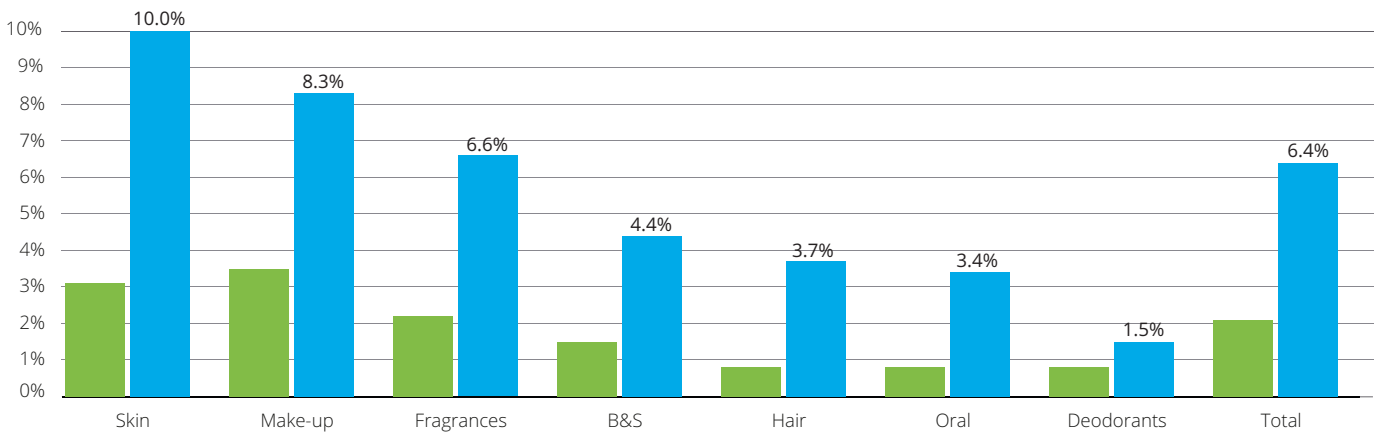
Contribution from online (% of total), 2005-15



■ 2005 ■ 2015

Source: Deutsche Bank

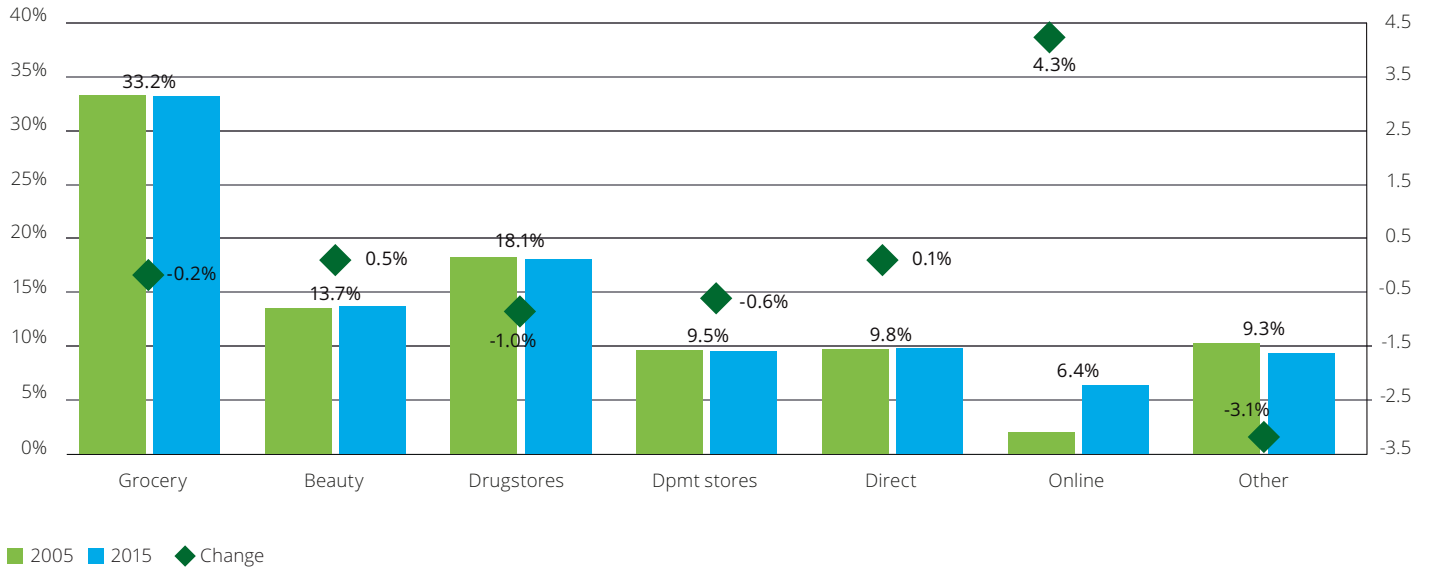
Contribution from online (% of total), 2005-15



■ 2005 ■ 2015

Source: Deutsche Bank

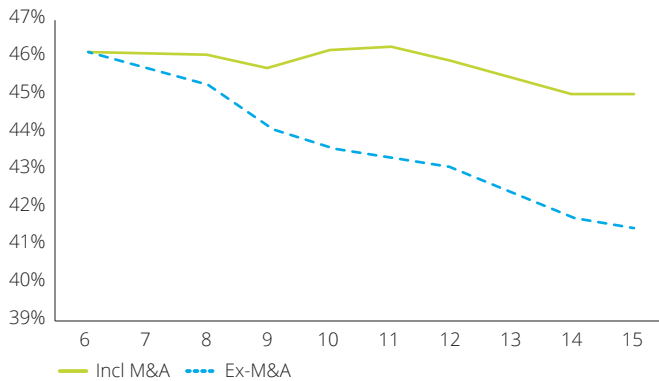
Category sales by channel, 2005-2015



Source: Deutsche Bank

The M&A surge is only beginning

Top-10 beauty players losing share excluding M&A



Source: Euromonitor and J.P. Morgan. Top-10 players include: L'oréal, Unilever, P&G, EL, Coty, Beiersdorf, J&J, Avon, Shiseido and Kao.

... in a changing world where as many as 90% of beauty product launches fail within a year, acquisition remains the short route to maintaining a viable brand portfolio.

As global brands are confronted with the growth of niche and indie disruptors and the likely loss of some market share to these new brands, acquisitions have gained popularity as a reliable source of growth. Investors like the M&A strategy too: share prices that were formerly closely correlated to like-for-like sales (a measure that excludes the impact of acquisitions) are now more likely to respond to market share through acquisition than to organic top-line growth (or the lack of it). And in a changing world where as many as 90% of beauty product launches fail within a year, acquisition remains the short route to maintaining a viable brand portfolio.

- M&A has focused on skincare.** Some of the most prominent recent acquisitions have been targeted at category trends (such as Korean or 'K-beauty', or masks) and digital-first disruptors that have been able to achieve substantial growth through the use of online influencers, social selling and user generated content (such as L'Oreal's purchases of NYX and IT Cosmetics, or Estée Lauder's purchases of Becca and Too Faced). But over the last 15 years acquisition has been heavily skewed towards skincare, reflecting the industry's preference for skincare's higher margins and growth potential in an ageing global market. Unilever has been the most acquisitive of the large companies by number of skincare acquisitions, acquiring Dollar Shave Club, Murad Skincare, Dermalogica, Kate Somerville Skincare and REN Skincare in the last two years alone, while Coty has been the lead acquirer by value through its acquisition of a large package of Procter & Gamble brands in fragrance, make-up and hair categories, and also through its purchase of the Brazilian Hypermacas body and skincare brands. Other predominantly skincare purchases have been seen from Estée Lauder, L'Oreal and Shiseido.
- M&A brings reputational risks.** Challenger brand acquisition can be a minefield for established companies. Where new brands have evolved without the kind of strict governance that is normal in large companies, challenger companies may carry reputational issues that can be amplified by the very influencer community they depend upon. Recent examples include Julep which was fined \$3 million in 2016 for miss-selling (by using the so-called 'negative option' marketing technique); Tarte Cosmetics which was sold to Kose of Japan but then suffered an influencer backlash because of the Japanese company's animal testing practices; and Honest Beauty which has faced lawsuits over allegedly 'faulty' products and accusations of exaggerated marketing claims.

Global M&A deals in Beauty & PC, 2015-2016

| Date | Acquirer | Target | Currency | Value (m) | Sales x | EBITDA x | Comment |
|---------|--------------------|--------------------------|----------|-----------|---------|----------|---|
| Pending | L'Oréal | Atelier Cologne | € | n/a | n/a | n/a | Prestige fragrances |
| Dec-16 | Revlon | Elizabeth Arden | \$ | 870 | 0.9 | -6.2 | Prestige and luxury fragrances, skincare, make-up |
| Oct-16 | Shiseido | P&G: Dolce & Gabbana | € | n/a | n/a | n/a | Prestige clothing, bags, sunglasses, fragrances and cosmetics |
| Oct-16 | Coty | P&G Beauty Brands | \$ | 12,500 | 1.3 | 10.4 | Fragrance, make-up and hair colour |
| Jul-16 | L'Oréal | IT Cosmetics | € | 1,200 | 6.6 | n/a | Skincare and make-up from TSG Consumer Partners |
| Jul-16 | Unilever | Dollar Shave Club | \$ | 1,000 | 6.6 | n/a | Shaving and grooming |
| Jul-16 | J&J | Vogue International | \$ | 3,300 | 11.0 | n/a | Hair care business with natural positioning |
| Jun-16 | Counter Brands | LVMH | € | n/a | n/a | n/a | Sold Nude make-up brands and skincare |
| Jun-16 | Shiseido | Gurwitch acquisition | \$ | 240 | 2.2 | n/a | Laura Mercier, Prestige make-up and skin care, ReVive, Prestige skin care |
| Feb-16 | Coty | Hypermarcas Brands | \$ | 1,000 | 3.9 | n/a | Brazilian Body, Hair, Female Deo, Nail and Skin |
| Dec-15 | Strength of Nature | Unilever | \$ | n/a | n/a | n/a | Sale of 5 brands (Motions, Just for Me, Consort, Groom&Clean, TCB) |
| Dec-15 | Estee Lauder | Have & Be Co | \$ | n/a | n/a | n/a | Korean Skincare |
| Sep-15 | Unilever | Murad Skincare | € | n/a | n/a | n/a | Clinical and holistic skincare products |
| Aug-15 | CVC Capital | Douglas Holding | € | 2,869 | 1.1 | 12.0 | Fragrances and make-up retailer |
| Aug-15 | Unilever | Dermalogica | € | n/a | n/a | n/a | Skin health and treatment |
| Jul-15 | PDC Brands | Cantu & Bodycology | \$ | n/a | n/a | n/a | Leading specialty US bath brand and ethnic hair |
| May-15 | Unilever | Kate Somerville Skincare | € | n/a | n/a | n/a | Premium US skincare dermocosmetics |
| May-15 | Unilever | REN Skincare | € | n/a | n/a | n/a | Premium skincare |
| Mar-15 | Interparfums | P&G – Rochas | \$ | 108 | 2.3 | n/a | Fragrance and fashion brand |
| Jan-15 | Estee Lauder | Glamglow | \$ | n/a | n/a | n/a | Prestige skincare |

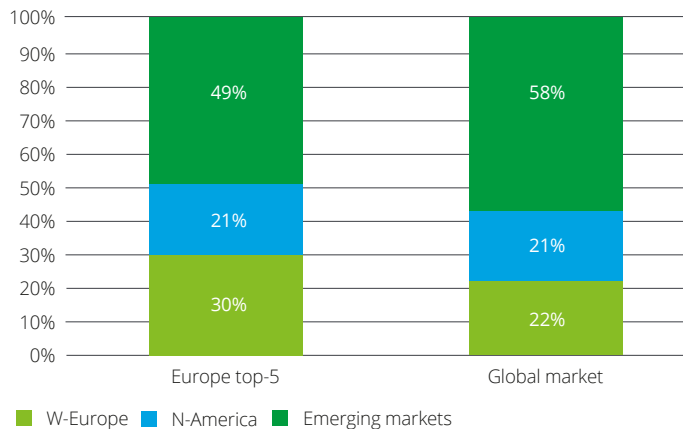
The digital drumbeat is driving change

The digital revolution has increased the cycle speed in beauty, and consumers are coming to expect more rapid innovation. Some established companies have also upped their rate of internal innovation in response (Deutsche Bank estimates that established beauty companies now derive 15-20% of their revenues from products introduced in the last three years, and several companies – most notably L’Oreal which recently invested in the Founders Factory start-up incubator – are now allocating record R&D budgets). But with 90% or more of new product launches failing within 12 months, the fastest and most reliable route to innovation is still acquisition.

- Asset-light models will prosper due to their agility. For example, Charlotte Tilbury and Kylie are characteristic in outsourcing production to manufacturers, creating improved ability to switch formulations, shift product offerings and hold minimal inventory.
- Experience will need to seamlessly align with product as interactions pre and post-purchase are become just as important as important as brand power.

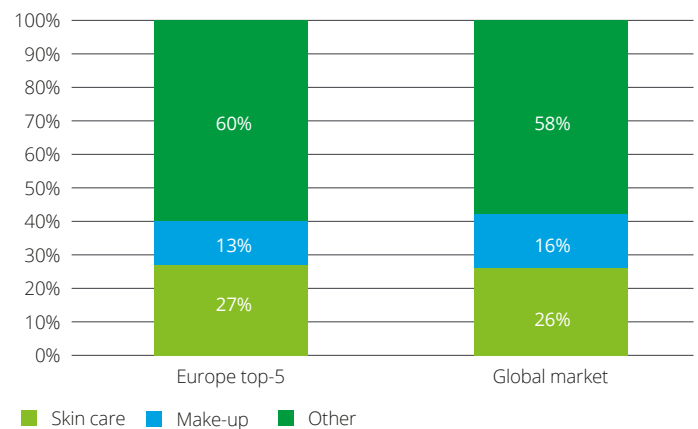
- Personalisation will grow: the market is already seeing offers like foundations that are blended to the exact tone and shade of your skin, and the next steps will be high-margin low-volume offerings to complement value offerings, such as skin creams mixed to personal specifications, blended to order and with personalised packaging.
- Consumer acquisition is key – unlike a product such as mobile phones, there has traditionally been no contract to lock in consumers, so the challenge is one of creating an on-going customer relationship with consumers. We expect to see more use loyalty points and cards, and the continued growth of subscription services such as beauty boxes. Brands that own customer data will be increasingly attractive as acquisition targets.
- Acquisitions that increase exposure to emerging markets will grow. Most large beauty companies – with the exception of Unilever – are somewhat under-exposed to emerging markets, where almost all of the global growth of the middle class will be found over the next 15 years.

European HPC companies are under-exposed to emerging markets – by far the fastest-growing region



Note: The only exception is Unilever, which derives an estimated 64% of Personal Care sales from emerging markets.
Source: Company data, Euromonitor, Deutsche Bank





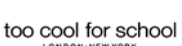






European HPC companies are under-exposed to make-up – currently the fastest-growing category



Note: The two exceptions are LVMH and L’Oréal, which derive 39% and 24% of sales respectively from make-up.
Source: Company data, Euromonitor, Deutsche Bank

Some established companies have also upped their rate of internal innovation in response (Deutsche Bank estimates that established beauty companies now derive 15-20% of their revenues from products introduced in the last three years).

Appendix: The independent brands to watch

| Makeup |  | <p>Julep: crowd-funded products and crowd-sourced product ideas lie behind the success of this skincare, make-up and nail products company. Julep remains based in its home city Seattle and is privately held by founder Jane Park and venture capital backers.</p> |
|----------|---|--|
| |  | <p>Kylie Cosmetics/ColourPop: Kylie Cosmetics is the commercial vehicle for reality TV performer Kylie Jenner, currently expanding the product line following Jenner's successful lip kit. Kylie Cosmetics share manufacturing facilities and management with ColourPop, the value-priced California-based producer driven by collaborations with vlogger Kathleen Lights, and celebrities such as Hunger Games actress Isabelle Fuhrman.</p> |
| |  | <p>Charlotte Tilbury: independent make-up company founded by British make-up artist Charlotte Tilbury, owned by the founder and venture capital investors. The make-up line is celebrity-driven with a menu-card of 'instant looks' backed by how-to videos on YouTube.</p> |
| |  | <p>Anastasia Beverly Hills: independent brand founded by Anastasia Soare in 1998 specialising in brows but now with an extended make-up line. Anastasia Beverly Hills is one of the most successful Instagram-driven brands, using partnerships with prominent vloggers and Hollywood celebrities.</p> |
| Skincare |  | <p>Too Cool For School: Korean skincare and make-up producer founded in 2009 using novel ingredients and signature hand-drawn packaging imagery. Too Cool For School has blended Korean approaches to beauty products and the use of food-based ingredients with US design and marketing talent: artist collaborations are the signature of the brand.</p> |
| |  | <p>Tony Moly: Korean skincare brand established in 2006, Tony Moly is based on a franchised store business model, with skincare products in unrestrained packaging and intense colours.</p> |
| |  | <p>Beautycounter: independent and primarily online seller of skincare and make-up products with green credentials. Beautycounter acquired NUDE skincare from LVMH in 2016, bringing the celebrity power of NUDE's Ali Hewson into the brand.</p> |
| |  | <p>Glossier: 'an online beauty start-up with a fanatical following' reported Buzzfeed in 2016. Glossier was founded by a former Vogue fashion writer and developed from the fashion blog <i>Into The Gloss</i>. Glossier uses Instagram and online tutorials to market its skincare and make-up lines entirely online: the signature is beauty that is high-fashion but accessible.</p> |
| |  | <p>Tata Harper: Vermont-based natural skincare producer Tata Harper has pioneered a total control approach to ingredients and manufacturing that makes the producer of masks, tints and cleansing oils the current leader in alternative beauty products.</p> |
| |  | <p>Goop: jointly owned by Juice Beauty and actress Gwyneth Paltrow, Goop is a leading organic skincare brand driven largely by Paltrow's celebrity power: understated packaging and high prices are brand signatures.</p> |
| |  | <p>Honest: owned by founder Jessica Alba and private equity/venture capital investors, the Honest portfolio of skincare, make-up and hair products has gone from \$10 million sales in 2012 to \$250 million today.</p> |

Notes

Notes



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Fax: +44 (0) 20 7583 1198.

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