

5 Financial aspects

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Scope of the chapter

5.1. In this chapter we first indicate how the amounts paid by customers for fine fragrances are divided between the manufacturers, the fragrance houses which act as the UK distributors, and the retailers. We do so by setting out the cost and price profiles of a number of individual products, known in the trade as SKUs. We then tabulate, and comment on, the financial results of eight of these fragrance houses. Finally, we examine the profitability of the retailing of fine fragrances. In doing so we consider a number of authorized retailers, such as leading department stores, chemists and operators of duty-free shops, and also three unauthorized retailers who obtain their supplies from the grey market.

The eight listed distributors

5.2. No single fragrance house dominates the wholesale distribution market but we have identified those listed below as being the eight largest distributors of fine fragrances in the UK. In 1992 each of them had over 4 per cent of wholesale supplies of fine fragrances (excluding sales to duty-free outlets and the grey market) and between them they accounted for almost 70 per cent of those supplies.

- Calvin Klein Cosmetics (UK) Limited
- Chanel Limited, its connected company Bourjois Ltd and the latter's subsidiary, Parfums Ungaro Limited, which three companies operate as a single economic unit (Chanel)
- Parfums Christian Dior (UK) Ltd
- Elizabeth Arden Limited
- Estée Lauder Cosmetics Ltd
- Prestige & Collections (UK) Ltd
- Parfums Givenchy Limited
- Parfums Yves Saint Laurent Limited

5.3. In the remainder of this chapter we refer to the above distributors as 'the eight listed distributors'.

5.4. While Chanel and its connected companies, as noted above, operate as a single economic unit, other companies among the eight listed distributors, although in some cases members of the same group, do not operate in this way. Klein and Arden, for example, are subsidiaries of Unilever. Dior and Givenchy are subsidiaries of LVMH. YSL and Sanofi, another leading fragrance house, are subsidiaries of SNEA. P&C is a subsidiary of L'Oréal, as are Parim and Golden, two other companies which distribute fine fragrances. We were told, however, that the subsidiary companies referred to above are separately managed (although in some cases they may share common services) and we have therefore treated them as separate entities for the purposes of this chapter.

Cost and price profiles

5.5. Table 5.1 sets out the price breakdowns (ie the percentages of the VAT-inclusive RRP's represented by the manufacturers' prices, by the gross profits of the UK distributors and retailers and by the Government's share in the form of VAT) of six typical SKUs.

TABLE 5.1 Typical price breakdowns

	<i>per cent</i>					
	<i>Women's EDT spray 100 ml</i>	<i>Women's EDP splash 50 ml</i>	<i>Women's EDT spray 50 ml</i>	<i>Women's EDT spray 30 ml</i>	<i>Men's EDT spray 50 ml</i>	<i>Men's aftershave 50 ml</i>
Manufacturing costs	9.3	12.3	7.8	12.9	3.1	7.0
Manufacturers' gross profits	<u>12.9</u>	<u>7.6</u>	<u>13.3</u>	<u>1.6</u>	<u>7.4</u>	<u>9.6</u>
Manufacturers' prices	22.2	19.9	21.1	14.5	10.5	16.6
Gross profits:						
UK distributors	31.2	33.3	30.6	40.6	42.2	35.2
Retailers	31.7	31.9	33.4	30.0	32.4	33.3
Government (VAT)	<u>14.9</u>	<u>14.9</u>	<u>14.9</u>	<u>14.9</u>	<u>14.9</u>	<u>14.9</u>
	100.0	100.0	100.0	100.0	100.0	100.0

Source: MMC using the distributors' data.

5.6. The gross profits stated are before deduction of certain costs borne by companies in the chain of manufacture, distribution and retailing. Manufacturers' costs generally include such items as research and development, the design of advertising campaigns, product development, central marketing, royalties to the owners of house names, administration and finance charges. Distributors' costs normally include advertising, sales promotion, selling, marketing, freight and insurance, distribution, administration, settlement discounts and finance charges. In the case of retailers, in addition to the general costs of running their businesses and maintaining their premises, they may incur costs on special promotions, the employment of specialist sales staff

(known as 'consultants') and the provision of special sales counters (although part of these costs may be met by distributors.)

5.7. More detail is given in Appendix 5.1, which shows, for each of the eight listed distributors, the cost and price profiles of their three principal SKUs (on sales other than those made on special terms). It sets out the manufacturing cost of those SKUs, and the margins achieved on them by the manufacturers, distributors and retailers, and also shows their price breakdowns.

The manufacturers

5.8. The manufacturing costs shown in Table 5.1 vary between 3.1 and 12.9 per cent of the VAT-inclusive retail selling prices of the SKUs. The manufacturers' gross profits also vary substantially, between 1.6 and 13.3 per cent of VAT-inclusive retail selling prices. According to Appendix 5.1, which sets out the position in more detail, the manufacturers of the [*] brands and two of the [*] brands show gross margins of around 60 per cent of their prices to distributors, and the manufacturer of the [*] 50ml EDT spray shows a gross margin of 70.2 per cent, but the manufacturers of the [*] and [*] brands show gross margins of only 11 to 12 per cent. The other manufacturers fall between these extremes, the exception being [*] *Details omitted. See note on page iv.* [*], which shows gross margins of around [*] per cent on its [*] *Details omitted. See note on page iv.* [*].

The distributors

5.9. The UK distributors' gross profits on the SKUs shown in Table 5.1, expressed as percentages of the VAT-inclusive retail selling prices, vary between 30.6 and 42.2 per cent. Appendix 5.1 also shows the gross margins of the eight listed distributors, expressed as percentages of their selling prices to retailers, to be mostly in the 60 to 80 per cent range.

The eight listed distributors-profitability

5.10. When we asked the eight listed distributors for statements showing their profitability on reference products for their five most recent financial years, only Dior was able to account separately for fine fragrances. The others told us that they were unable to do so because most of their expenditure in connection with fine fragrances, in particular their advertising, sales promotion and marketing expenditure, was incurred as part of their overall expenditure on a brand and could not be disaggregated. A brand might include items, such as soaps, bath gels and body lotions, which did not fall within our terms of reference. We therefore accepted financial information from these distributors on a brand basis. We refer to brands which consist wholly or mainly of fine fragrances as 'reference brands'. Fine fragrances accounted for 85 per cent of the total sales of reference brands by the eight listed distributors in the periods covered by the profitability statements they provided.

5.11. Appendix 5.2 shows the financial results (ie the sales exclusive of VAT and net of returns and discounts, the operating profits and the capital employed on reference brands) of each of the eight listed distributors, together with profitability ratios, for their most recent five accounting years (but see below regarding Arden). Monetary amounts are stated at nominal prices and are also restated at 1992 prices, based on the average retail price index for the years in question. (Arden, however, told us that it was able to supply figures covering only its last three years because of the failure of a computer software system commissioned before Unilever acquired the business. It was also unable to provide meaningful apportionments of its capital employed between reference and non-reference products as its UK factory produced mainly non-reference products for sale throughout Europe, whereas the majority of its reference products sold in the UK were produced in France.)

5.12. The figures in Appendix 5.2 are derived from profitability statements submitted to us by the eight listed distributors, which agree, or have been reconciled with, their statutory accounts. A pro forma of the profitability statement that each of the eight listed distributors was asked to provide is set out in Appendix 5.3. As noted above, except in the case of Dior, reference brands include products other than fine fragrances as defined in our

*Details omitted. See note on page iv.

terms of reference. Costs which are not directly attributable to reference brands have been apportioned between reference brands and non-reference products on a turnover basis.

5.13. Table 5.2, which so far as 1992 is concerned covers some 65 per cent of authorized domestic wholesale supplies of reference brands, shows the consolidated results of seven of the eight listed distributors (it excludes Arden for the reasons explained in paragraph 5.11) for the last five years at both nominal and 1992 prices, and the profitability ratios based on those consolidated figures.

TABLE 5.2 Consolidated profitability of seven of the eight listed distributors

	<i>£'000</i>				
	1988	1989	1990	1991	1992
<i>At nominal prices</i>					
Sales*	115,048	127,757	136,413	124,356	122,351
Gross profit	74,517	87,675	95,667	84,845	83,492
Advertising and sales promotion directly attributable to brands	25,562	33,035	35,583	32,462	32,157
Selling, marketing and distribution costs and non-brand attributable advertising and sales promotion	25,435	28,180	31,693	31,462	30,543
Administration and other costs	8,834	10,545	12,704	11,202	11,696
Operating profit	14,686	15,915	15,687	9,719	9,096
Average capital employed		16,167	17,518	20,183	18,526
<i>At 1992 prices</i>					
Sales*	149,962	154,649	151,099	129,561	122,713
Gross profit	97,109	106,105	105,922	88,380	83,723
Advertising and sales promotion directly attributable to brands	33,282	40,022	39,418	33,835	32,259
Selling, marketing and distribution costs and non-brand attributable advertising and sales promotion	33,257	34,253	35,287	32,850	30,684
Administration and other costs	11,486	12,728	14,017	11,650	11,715
Operating profit	19,084	19,102	17,200	10,045	9,066
Average capital employed		19,517	19,336	20,975	18,544
<i>per cent</i>					
<i>Percentage of sales</i>					
Gross profit (gross margin)	64.8	68.6	70.1	68.2	68.2
Advertising and sales promotion directly attributable to brands	22.2	25.9	26.1	26.1	26.3
Selling, marketing and distribution costs and non-brand attributable advertising and sales promotion	22.1	22.1	23.2	25.3	25.0
Administration and other costs	7.7	8.3	9.3	9.0	9.6
Operating profit (return on sales)	12.8	12.5	11.5	7.8	7.4
Return on average capital employed		98.4	89.5	48.2	49.1

Source: MMC using the distributors' data.

*Exclusive of VAT and net of returns and trade discounts.

5.14. The financial results of the eight listed distributors for their 1992 accounting years are set out in Table 5.3.

TABLE 5.3 Financial results of the eight listed distributors for 1992

	<i>Klein</i>	<i>Chanel</i>	<i>Dior</i>	<i>Arden</i>	<i>Lauder</i>	<i>P&C</i>	<i>Givenchy</i>	<i>YSL</i>
								£'000
Sales*	[
Gross profit								
Advertising and sales promotion directly attributable to brands								
Selling, marketing and distribution costs and non-brand attributable advertising and sales promotion								
Administration and other costs								
Operating profit]
								<i>per cent</i>
Percentage of sales								
Gross profit (gross margin)	[
Advertising and sales promotion directly attributable to brands								
Selling, marketing and distribution costs and non-brand attributable advertising and sales promotion								
Administration and other costs								
Operating profit (return on sales)]

Figures omitted. See note on page iv.

Figures omitted. See note on page iv.

Source: MMC using the distributors' data.

*Exclusive of VAT and net of returns and trade discounts.

5.15. Table 5.2 shows that, although sales by seven of the eight listed distributors, at nominal prices, increased over the five-year period from £115.0 million in 1988 to £122.4 million in 1992 (after having been £136.4 million in 1990), they fell by 18.2 per cent, from £150.0 million to £122.7 million, when restated at constant (1992) prices. However, these comparisons are distorted by the fact that Dior stopped supplying the duty-free market from the UK from 1990 onwards (see paragraph 5.29). As 1988 sales included £5.4 million sales to the duty-free market, the comparison on a like-with-like basis at 1992 prices would be between £143 million in 1988 and £122.7 million in 1992, a fall of 14.2 per cent.

5.16. Consolidated operating profits at nominal prices, after having been £14.7 million, £15.9 million and £15.7 million in the first three years, fell back to £9.7 million and £9.1 million in 1991 and 1992 and were thus 39 per cent lower on average in the last two years of the period under review than in the first three years. If restated at 1992 prices, average consolidated operating profits in the last two years were 48 per cent lower than in the first three years.

Return on average capital employed

5.17. We have given some thought as to how best to assess the profitability of the eight listed distributors. The MMC's current practice in monopoly inquiries is to regard both return on capital employed (ROCE) and return on sales (ROS, being the operating profit, ie profit before interest, non-operating items and tax, expressed as a percentage of sales) as useful indicators. While we comment briefly below on the consolidated ROCE of seven of the eight listed distributors, and individually on the ROCE of two of them, Chanel and YSL, which showed relatively high returns, we do not regard this measure as an entirely useful or reliable guide for the purposes of this inquiry.

5.18. This is because, with the exception of Chanel, the eight listed distributors are not engaged in manufacturing. As a result many of them have relatively low or, in one case, negative capital employed (see Appendix 5.2, Tables 1, 5, 6 and 7).

5.19. According to Table 5.2 the consolidated ROCE of seven of the eight listed distributors was 98.4 per cent in 1989. Although this declined subsequently it was still 49.1 per cent in 1992. The main factor in the decline was the fall in sales at 1992 prices from £154.7 million in 1989 to £122.7 million in 1992. This had the effect of reducing gross profits by some £22.4 million. While costs also fell in real terms by £12.4 million, this was less than the fall in gross profit. Operating profits at 1992 prices therefore fell from £19.1 million to £9.1 million. The small reduction in average capital employed at 1992 prices, from £19.5 million to £18.5 million, was not enough to offset this so as to maintain the ROCE at its 1989 level.

Chanel

5.20. Appendix 5.2, Table 2, shows that Chanel had a ROCE of [*] per cent in 1989 which had declined to [*] per cent by 1992. Chanel told us that, whereas in 1988 and 1989 it was enjoying the benefits of the recent successful launch of its Coco brand, with that brand's launch costs behind it, the years following 1989 saw the start of the recession coupled with the need to incur costs on the launching of further new brands.

5.21. Chanel also told us that while its supplies of EDP, EDT and aftershave were manufactured in the UK, its supplies of perfume were imported from a connected company in France. Transfer prices in respect of these imports were set by arm's length negotiations and the arrangements had not been varied during the five-year period under review. The same prices were charged by the French connected company to all its overseas markets, including the UK. Inland Revenue had investigated the transfer pricing arrangements from time to time and, Chanel told us, was satisfied on each occasion that transactions between Chanel and its connected companies overseas had been properly conducted on an arm's length basis.

5.22. Chanel submitted that ROCE was an unreliable guide to its profitability, given that its capital employed was low in relation to turnover, historical cost values were in many instances substantially less than current values and intangible assets were not included. It attributed its apparently higher than average profitability partly to its manufacturing in the UK many of the products which it distributed, and partly to its not engaging in certain types of promotion, such as GWPs.

Yves Saint Laurent

5.23. According to Appendix 5.2 Table 8, YSL's ROCE was [*] per cent in 1989 but had fallen to [*] per cent by 1992. Its sales at nominal prices, after rising from £[*] million to £[*] million between 1988 and 1990, fell to £[*] million in 1991 and £[*] million in 1992. If restated at 1992 prices, its sales fell by [*] per cent, from £[*] million to £[*] million, between 1988 and 1992. YSL attributed this fall in sales to the recession, which it said had especially affected men's fragrances where it was the market leader. Other factors affecting its ROCE were, it said, an increase in its capital employed following a factory extension in 1989 and a decline in its gross profit which, after fluctuating around [*] per cent, fell to [*] per cent in 1992 as a result of losses on exchange.

5.24. YSL told us that it obtained its supplies from its French parent company, whose prices were set on the basis of manufacturing cost plus 10 per cent for indirect overheads and 4 per cent for distribution. The same prices were charged to connected companies in other countries.

Return on sales

5.25. In view of what we have said regarding ROCE, we regard ROS as a more useful measure of profitability for the purposes of our inquiry. Considering first the consolidated results set out in Table 5.2, these show ROS, like ROCE, to have been in a declining trend. After being 12.8 per cent in 1988 it had fallen to 7.4 per cent by 1992.

*Figures omitted. See note on page iv.

Chanel and Yves Saint Laurent

5.26. We have commented above on the ROCE of Chanel and YSL. These two suppliers also showed the highest ROS if their results are viewed over the entire five-year period, although they both suffered declines in profitability during that time for the reasons already explained. Chanel's ROS, for example, having been [*] per cent in 1988, was [*] per cent in 1992 (Appendix 5.2, Table 2). YSL's ROS was [*] per cent in 1988 and stayed at around that level in the three following years before falling to [*] per cent in 1992 (Appendix 5.2, Table 8).

Calvin Klein

5.27. Klein told us that it was a subsidiary of Unilever which had acquired the world-wide Calvin Klein business in 1989. It showed the most significant upward trend in profitability among the eight listed distributors during recent years (Appendix 5.2, Table 1), its ROS rising from a [*] per cent in 1988 to a [*] per cent in 1992. This largely reflected a substantial increase in turnover, from £[*] million to £[*] million at nominal prices, during the period. As a result, although its costs, especially its advertising, sales promotion and selling costs, also rose substantially in money terms, the ratio of such costs to sales fell significantly.

5.28. Klein also told us that, except for some imports from France in 1992, all imports into the UK were from a US-connected company and were now invoiced at wholesale prices less [*] per cent. However, because of factors such as returns, cash discounts and movements in exchange rates, the actual UK gross profit was [*] per cent in 1992. The objective was that [*] per cent of the overall profit on UK operations supplied from the USA should be taken in the USA and [*] per cent in the UK, [*Details omitted. See note on page iv.*

]. The same pricing policy was used between the US company and its other connected company distributors.

Christian Dior

5.29. Dior showed [*] ROS figures, including, for example, a [*] per cent in 1991 and a [*] per cent in 1992 (Appendix 5.2, Table 3). [

Details omitted. See note on page iv.

]. (Supplies by Dior itself to duty-free retailers had amounted to £[*] million in 1988 and £[*] million in 1989.) [

Details omitted. See note on page iv.

]

5.30. Dior told us that the transfer prices charged to it by its French parent company were comparable to those charged to independent agents elsewhere in Europe, although variations arose in the short term because of exchange rate fluctuations. [

Details omitted. See note on page iv.

]

Elizabeth Arden

5.31. Arden said that it was seeking to rebuild its fragrance business under its new ownership and management. This had necessitated heavy expenditure on the launch of new brands such as Narcisse and White Diamond, as a result of which it had showed [*] per cent in the last three years (Appendix 5.2, Table 4). Heavy promotional expenditure on new brand launches was likely to continue to be necessary.

5.32. It also told us that the world-wide Elizabeth Arden business was, like the Calvin Klein business, acquired by Unilever in 1989. Arden itself had two divisions: a factory manufacturing fine fragrances and other products and exporting them to the group's distribution centre at Lille in France, and a sales and marketing division, which obtained its supplies from Lille. Supplies to the Lille distribution centre were also made by

*Details omitted. See note on page iv.

connected companies in the UK and USA and by a third party company in France. The UK and US companies added [*] per cent to their production costs to cover overheads and provide a [*] per cent profit margin. Lille added a further [*] per cent to cover its costs and provide a [*] per cent profit margin. These arrangements applied to all markets and had not been changed in the last three years.

Estée Lauder

5.33. Lauder showed a [*] per cent in 1992 (Appendix 5.2, Table 5). *Details omitted. See note on page iv.* The cause of this declining profitability was a fall in sales, in real terms, from £[*] million in 1988 to £[*] million in 1992, which was not matched by a fall in costs. Although gross margins were held at over [*] per cent, gross profit at 1992 prices fell during the five-year period by £[*] million, reflecting this fall in sales. Costs, including advertising and sales promotion costs, fell by only £[*] million in real terms over the period, so profitability at operating level declined from a £[*] (at 1992 prices) in 1988 to a £[*] in 1992.

5.34. Lauder told us that it obtained its supplies from connected companies in the UK, Switzerland and Belgium. Prices were set at the beginning of each year to provide the supplier with a margin of [*] per cent to cover non-operational items, such as bank interest and profit. Prices to all Lauder group companies were set on the same basis. Lauder also paid to connected companies abroad royalties of [*] per cent on sales for the use of trade marks, and technical service fees of [*] per cent on sales in consideration of information, advice and assistance on a wide range of subjects. Inland Revenue had investigated these arrangements from time to time and had appeared satisfied.

5.35. Lauder amplified the information it had given to us about its relations with connected companies overseas by providing us with statements of profitability of the Estée Lauder group sales companies in the principal European markets for the year ended 30 June 1992. These showed that Lauder's [*] (including sales of cosmetics and other non-reference products) was similar to the [*] ([*] per cent) and less than [*].

Details omitted. See note on page iv.

Prestige & Collections

5.36. [*]

Details omitted. See note on page iv.

]

5.37. P&C told us that supplies of all its reference products except Polo, a Ralph Lauren brand, were obtained from a connected company in France. Polo was supplied by a connected company in Puerto Rico. Transfer prices were based on costs and technical assistance, which included royalties payable to the owners of the house names under which its products were sold, and overhead expenses. The world-wide L'Oréal group operated on the basis that all profits should arise in the subsidiary companies. The margin added to manufacturing costs was to cover the parent company's costs in addition to the product cost. This margin varied by house name but was the same for all countries for any given house name and averaged around [*] per cent. The principles governing the setting of transfer prices had not changed in the last five years.

*Details omitted. See note on page iv.

5.38. In amplification of its evidence, P&C submitted to us a table showing that the profitability (ROS) of the L'Oréal group's businesses (including cosmetics and other non-reference products) in the principal European markets in 1992 was [*] per cent in France, [*] per cent in Italy and [*] per cent in Germany, compared with [*] per cent in the UK. It also provided us with a statement, which we reproduce in Table 5.4, showing the average elements of cost, expressed as percentages of its own average wholesale selling price, of the supplies (also including cosmetics and other non-reference products) it obtained from its overseas connected companies.

TABLE 5.4 P&C: cost structure of supplies from overseas connected companies

	%
Factory cost	[
Operating cost	
International marketing	
Royalties and technical assistance	*
Transport	
P&C gross margin]
	100.0

Source: P&C.

Givenchy

5.39. Appendix 5.2, Table 7, shows that [

Details omitted. See note on page iv.

]

5.40. Givenchy told us that these transfer prices had been fixed to provide it with the following gross margins:

- Until mid-November 1990-[*] per cent ([*] per cent on promotion products).
- From mid-November 1990 until June 1992-[*] per cent.
- Since July 1992-[*] per cent, or the margin available to Parfums Givenchy, if less.

5.41. Givenchy said that Parfums Givenchy had, since 1990, agreed to bear the cost of media advertising expenditure undertaken by it (Givenchy) in the first two years following the launch of a new product. Givenchy had, however, adjusted the figures in the profitability statements submitted to us so as to show this media advertising expenditure as a charge against its own revenues. The amounts involved were £[*] million in 1990, £[*] million in 1991 and £[*] million in 1992. But for these adjustments Givenchy would have shown a [*] per cent in 1991 and [*] per cent in 1992.

5.42. Givenchy also provided us with figures to show that Parfums Givenchy made a [*] on UK fine fragrances in 1992. This compared with the £[*] made by Givenchy itself, after adding back the recharge of media advertising referred to in the preceding paragraph. The Givenchy group therefore made an overall [*] (in sterling terms) on its UK fine fragrances business in 1992. If the media advertising referred to above had been treated as a cost to Parfums Givenchy, £[*] would have accrued to Givenchy itself while a [*] would have been incurred by Parfums Givenchy.

Advertising and sales promotion expenses

5.43. The consolidated gross profits of the eight listed distributors shown in Table 5.2 fluctuated between 64.8 and 70.1 per cent during the last five years. Table 5.3 shows that in 1992 the gross profit margins of individual distributors varied from 58.5 per cent for [*] to 74.3 per cent for [*].

5.44. A substantial part of these gross profit margins was absorbed by advertising and sales promotion expenses. Table 5.2 shows the aggregate costs of advertising and sales promotion directly attributable to brands

*Details omitted. See note on page iv.

as being 22.2 per cent of net sales in 1988, and 26.3 per cent in 1992. This was apart from expenditure, amounting to 25 per cent of sales in 1992, on non-brand-specific advertising and sales promotion, and on selling and distribution.

5.45. The evidence we received suggested that high advertising and promotional expenditure is an essential part of the strategy for the successful establishment and maintenance of fine fragrance brands, and also that it tends to vary throughout the life of the brand. Thus, heavy expenditure may be incurred at the launch stage, as with Chanel's Coco brand and the Arden brands recently, but once a brand has been successfully launched, a somewhat lower level of expenditure may be sufficient to maintain demand. If, however, demand shows signs of flagging a decision might be taken to try and revive a brand by increasing its advertising and promotional budget. For these reasons, it is difficult to form conclusions based on the incidence of this expenditure in any particular year.

5.46. We thought it would be useful, however, to consult the recent MMC reports on Soluble coffee¹ and Carbonated drinks² to see if suppliers in these industries also spent such a high proportion of their turnover on costs of this type. In Soluble coffee, Tables 2.3 and 2.9 indicate that in 1989 The Nestlé Company Ltd, the industry leader, spent £30.8 million on advertising and promotion, or 11.4 per cent of £270 million turnover; and that General Foods Ltd, the second largest supplier, which was competing vigorously to maintain and improve its position, spent £29.9 million, or 31.9 per cent of its branded products turnover of £93.8 million. In Carbonated drinks, Table 4.1 and Table 1 of Appendix 4.4 show that in 1989 Coca-Cola & Schweppes Beverages Ltd and its franchisers spent £77.8 million on marketing, advertising and promotional costs, being 13.6 per cent of carbonated drinks sales of £570.8 million.

5.47. While these figures may not be directly comparable, the 26.3 per cent of sales spent on the directly attributable advertising and sales promotion of fine fragrance brands in 1992 is generally higher than the figures for soluble coffee and carbonated drinks, both of which are products where high expenditure on advertising and sales promotion is to be expected. In the case of fine fragrances, non-brand-specific advertising and promotion expenses, together with selling, marketing and distribution costs, also represent a high proportion of sales revenues (25 per cent in 1992, for example).

5.48. We recognize, however, that fine fragrances are entirely different products from soluble coffee and carbonated drinks. Fragrances are high-value products which are marketed and sold with a luxury image. It has been strongly represented to us by the distributors that high levels of promotional expenditure and the provision of expensive facilities and advice at the point of sale are therefore appropriate and, indeed, essential to the successful marketing of such products.

Authorized retailers

5.49. We received evidence from authorized retail distributors for the perfume houses, including department stores, chemists and operators of duty-free shops. Table 5.5 shows the estimated 1992 fine fragrance sales (inclusive of VAT except in the case of the duty-free shops where VAT is not chargeable) and gross margins³ of a representative selection of these retailers. The costs, retail selling prices and gross margins of their principal SKUs, based on RRP, are detailed in Appendix 5.4.

¹ *A report on the supply of soluble coffee for retail sale within the United Kingdom*, Cm 1459, March 1991.

² *A report on the supply by manufacturers of carbonated drinks in the United Kingdom*, Cm 1625, August 1991.

³ We have taken gross margin in the case of retailers to be the VAT-exclusive selling price less the VAT-exclusive cost price, expressed as a percentage of the VAT-exclusive selling price.

TABLE 5.5 Authorized retailers' estimated 1992 VAT-inclusive fine fragrance sales and gross margins

	Sales* £m	Gross margins (%)		
		Average	Highest	Lowest
<i>Department stores</i>				
Debenhams	[
Harrods				
HoF				
Selfridges				
<i>Chemists</i>				
Boots		<i>Figures omitted.</i>		
Lloyds		<i>See note on page iv.</i>		
<i>Duty-free shops</i>				
Allders International				
Harrods International				
Forte]

Source: The retailers.

*Sales are inclusive of VAT except in the case of duty-free sales where VAT is not chargeable.

5.50. The duty-free shops achieved substantially higher gross margins than the department stores and chemists, mainly because they obtain their supplies at much lower prices, in many cases direct from the manufacturers overseas rather than through the UK distributors. In the case of airport duty-free shops, however, these higher margins are largely absorbed by turnover-based payments to the airport authorities. (The margins earned by other duty-free outlets, eg those supplying seagoing passengers, are not generally so high.)

5.51. We asked these authorized retailers what specific costs, excluding apportionments of general overhead expenses, they incurred in retailing fine fragrances. Debenhams told us that it did not account for fine fragrances separately. It incurred variable and semi-variable costs in retailing fragrances, cosmetics and beauty products amounting to [†] per cent of its VAT-inclusive sales of these products. Although this was equivalent to [†] per cent of its VAT-exclusive sales, which was more than its average gross margin of [†] per cent on fine fragrances, Debenhams told us that it regarded fine fragrances as an intrinsic part of its department store operations which generated traffic and enhanced the store environment.

5.52. Boots estimated that its costs on retailing fine fragrances in the year to 31 March 1992 were £[†] million, which was over 30 per cent of its VAT-exclusive sales of fine fragrances.

5.53. We also asked these retailers about the financial support they received from the fragrance houses. A summary of the replies we received is set out in Appendix 5.5. It will be seen that most of them received retrospective turnover rebates, although these were usually small. Special sales promotions were sometimes wholly paid for by the fragrance houses, sometimes undertaken on a cost-sharing basis and sometimes the subject of a contribution by the fragrance house. Any special counters were normally provided by the suppliers, with the retailer sometimes contributing, say, 50 per cent of the cost. In the case of department stores (mainly in the larger cities), specialist sales staff were generally provided by the fragrance house, which also sometimes contributed to the cost of the retailer's own staff. Damaged and out-of-condition stock and returns as a result of customer complaints were generally replaced free of charge by the fragrance houses, sometimes after a certain amount of negotiation. Testers were invariably supplied free of charge by the fragrance houses.

Unauthorized retailers

Superdrug

5.54. Superdrug told us that its 1992 VAT-inclusive sales of fine fragrances amounted to £8.8 million, equivalent to £7.5 million exclusive of VAT. The cost of its purchases was £[†] million and its average gross margin was therefore about [†] per cent. In February 1993 it provided us with the data in Table 5.6 on the gross margins of the six best-selling SKUs sold through some 20 of its stores selling fine fragrances in 1992, together with estimates of what these gross margins would be if it obtained its supplies from authorized suppliers and sold them either at its current discounted selling prices or at RRP.

TABLE 5.6 Superdrug: gross margins on best-selling SKUs

	[<i>Details omitted. See note on page iv.</i>]	
	<i>EDT spray</i>	<i>Aftershave</i>	<i>Aftershave</i>	<i>Aftershave</i>	<i>EDP spray</i>	<i>EDT spray</i>	
	<i>30 ml</i>	<i>50 ml</i>	<i>50 ml</i>	<i>60 ml</i>	<i>30 ml</i>	<i>50 ml</i>	
RRP (£):	[
Superdrug VAT-inclusive price (£):							
Normal							
Christmas promotion							
Equivalent VAT-exclusive price (£):							
RRP							
Normal Superdrug price							
Christmas promotion							
Average grey-market cost (ex-VAT) (£):							
Normal Superdrug price							
Christmas period							
Gross margin (%):							
Normal Superdrug price							
Christmas promotion							
Estimated cost (ex-VAT) from authorized suppliers (£)†							
Estimated gross margin if bought from authorized suppliers (%):							
On normal Superdrug price							
On RRP]	
<i>Source: Superdrug.</i>							

[*Details omitted. See note on page iv.*]
 †Superdrug arrived at these estimates by taking published price lists less 15 per cent volume discount. We found, however, that the fragrance houses did not give discounts of this size, even to the largest retailers. We have therefore substituted list prices (excluding VAT) and recalculated the gross margins on purchases from authorized suppliers as follows:

Estimated cost (ex-VAT) from authorized suppliers (£)	[
Gross margin if bought from authorized suppliers (%):						
On normal Superdrug price						
On RRP]

It will be seen that the gross margins on RRP, if calculated in this way, are similar to the authorized retailers' gross margins shown in Table 5.5 and Appendix 5.4.

[*Details omitted. See note on page iv.*]

5.55. Superdrug told us that in 1992 it incurred the costs shown in Table 5.7 specifically in connection with selling fine fragrances.

TABLE 5.7 Superdrug: costs specifically incurred in 1992 in connection with selling fine fragrances

<i>Item</i>	<i>Amount</i>	<i>Superdrug's estimates of percentages of fine fragrance sales on an ongoing basis</i>
Specialist staff salaries	[
<i>Details omitted. See note on page iv.</i>		
Fine fragrance counters		
Promotional and advertising]
<i>Source: Superdrug.</i>		

5.56. Superdrug told us that while it could not quantify the effect on these costs of becoming an authorized retail distributor, it would expect to receive ancillary benefits in the form of contributions to the following costs:

- Promotional and advertising expenditure-contribution of 50 per cent.
- Specialist staff salaries and training.
- Counter installations.
- Testers, breakages and returns.

It would also expect to receive retrospective turnover rebates of between 3 and 5 per cent.

5.57. Superdrug estimated that if it were an authorized retailer and sold fragrances obtained through authorized channels at its current prices, its 'total reward' (which it defined as its 'bare margin plus ancillary benefits') could be some 10 per cent higher than the bare margin it would earn on direct supplies and some 20 per cent higher than the total reward earned on grey-market supplies. It added that grey-market supplies tended to be cheaper only for slow-moving lines. (As will be seen from the second footnote to Table 5.6, however, the cost of four out of the six SKUs shown there, if obtained through the grey market, is likely to be less than the cost to Superdrug of such SKUs if purchased from an authorized distributor.)

Tesco

5.58. Tesco told us that fine fragrances were sold through about 50 of its stores with in-store pharmacies. Half of these pharmacies were operated directly by Tesco and the remainder on a concessionaire basis. Tesco was not involved in the procurement of fine fragrances for sale in the concessionaire pharmacies. Total VAT-inclusive sales through its directly-operated pharmacies were running at about £1.2 million a year in December 1992, equivalent on a VAT-exclusive basis to a little over £1 million. Tesco did not employ specialist staff to sell fine fragrances.

5.59. In February 1993 Tesco provided us with the data in Table 5.8 on the current gross margins of its six best-selling SKUs, together with estimates of what these gross margins would be if it obtained its supplies from authorized suppliers.

TABLE 5.8 Tesco: gross margins on best-selling SKUs

	[<i>Details omitted. See note on page iv.</i>]					
	<i>Aftershave</i> 75ml	<i>EDT spray</i> 50ml	<i>EDT spray</i> 50ml	<i>EDT spray</i> 30ml	<i>EDT spray</i> 50ml	<i>Aftershave</i> 100ml
Tesco VAT-inclusive price (£)						
Equivalent VAT-exclusive price (£)						
Cost ex-VAT (£)						
Gross margin (%)						
Estimated cost ex-VAT from authorized suppliers (£)*						
Estimated gross margins if bought from authorized suppliers (%)						

Source: Tesco.

*These costs are lower than list prices as Tesco has deducted the discounts it would expect to receive from authorized suppliers.

5.60. Tesco estimated that in its financial year 1992/93 (ending in February) it incurred the costs shown in Table 5.9 specifically in connection with selling fine fragrances and told us that it would expect to make the savings shown alongside each item if it obtained its supplies from authorized UK distributors. Tesco told us that its 1992/93 costs represented 28.8 per cent of its fine fragrance sales (excluding VAT) in that year.

TABLE 5.9 Tesco: specific costs incurred in connection with retailing fine fragrances

	£'000		
	<i>Costs in</i> 1992/93	<i>Savings</i>	<i>Reduced</i> <i>cost</i>
Testers			
Quality control			
Damage and waste			
Distribution costs			
Merchandising			
Point of sale material			
Local advertising			

Source: Tesco.

5.61. Tesco would also expect retrospective turnover rebates of at least 5 per cent if it obtained authorized supplies direct from the fragrance houses. It estimated that its overall gross margin on fine fragrance sales would then be around [†] per cent at its current discounted retail prices. Its overall net margin, after taking account of all allowances and specific costs, would be around [†] per cent.

Perfume Shop

5.62. The Perfume Shop told us that it had 11 specialist perfume shops selling only fine fragrances and related perfumed toiletries. Its 1992 sales totalled £3.5 million inclusive of VAT (equivalent to about £3 million on a VAT-exclusive basis). They were currently (April 1993) running at about £4 million a year (£3.4 million on a VAT-exclusive basis). Its policy was to sell fine fragrances at discounted prices.

5.63. In April 1993 the Perfume Shop provided us with the data in Table 5.10 on the gross margins of its six best-selling SKUs in 1992, together with its estimates of what these gross margins would be if it obtained its supplies from authorized suppliers.

† Figures omitted. See note on page iv.

TABLE 5.10 **Perfume Shop: gross margins on best-selling SKUs**

	<i>Details omitted. See note on page iv.</i>					
	<i>EDT spray 50ml</i>	<i>EDT spray 50ml</i>	<i>EDP spray 15ml</i>	<i>EDT spray 30ml</i>	<i>Aftershave 50ml</i>	<i>Aftershave 50ml</i>
RRP (£)						
Perfume Shop VAT-inclusive price (£):						
Current						
If authorized retailer						
Equivalent VAT-exclusive prices (£):						
Current						
If authorized retailer						
Cost (ex-VAT) (£):						
Current						
Estimated if authorized retailer						
Gross margin (%):						
Current						
Estimated if authorized retailer						

Source: Perfume Shop.