

Entry and expansion

Introduction

1. In this appendix we consider which, if any, barriers to entry or expansion exist in the market, and the likelihood of such entry or expansion occurring in response to an increase in available margins for the merged entity. We first consider the possible barriers to entry, and the types of retailers they might affect, in relation to (a) retail of mint gaming products; (b) retail of pre-owned gaming products; and (c) Internet retail of gaming products. We then consider: (d) the effect that the merger may have had on these possible barriers through changing the balance of buyer power; (e) the speed at which entry may occur; (f) possible barriers to exit; (g) past examples of entry and exit; and (h) identity of potential entrants.

Barriers to entry and expansion

Mint gaming products

Small-scale entry

2. We first consider small-scale entry, for example as a single bricks and mortar shop.
3. The most basic potential barrier to entry or expansion in the retail of mint (and pre-owned) products is the capital cost of acquiring retail premises and storage space. The parties told us that this cost of entry was low and as such should not be considered a relevant barrier, because of low floor space requirements and good availability of requisite properties.¹
4. The parties suggested that 20 sq metres (200 sq feet) of floor space was sufficient to accommodate 200 SKUs, and these chart titles would cover the majority of the market. The parties' average store size is larger than this figure—GAME's average store size is [redacted] sq metres while Gamestation's is [redacted] sq metres.
5. The parties put to us that an independent retailer could set up a reasonably sized high street retail outlet for games for less than £200,000. The parties' average store costs in 2007 were approximately £[redacted] for GAME and £[redacted] for Gamestation.
6. The parties argued further that no intrinsic or regulatory barriers existed to the acquisition of requisite retail property, since such space was readily available and it was not subject to planning restrictions. They point out that sufficient premises were available. Furthermore, no planning permission was required to turn financial or professional properties, or cafes or restaurants, into GAME/Gamestation-style retail businesses; permission to change the shop front was required, but neither GAME nor Gamestation had been refused such permission in the last five years.
7. Another potential barrier to entry is that the terms and discount rates from suppliers can vary according to the size of the customer. Smaller retailers can obtain supply

¹The parties noted that 'shopproperty.com' listed (as at August 2007) 3,600 properties of between 90 and 280 sq metres (1,000 and 3,000 sq feet) and that the British Council of Shopping Centres estimated that there was 8 million sq metres (84 million sq feet) of potential retail space in the pipeline.

through wholesalers and distributors. We found that there was some variation in the terms suppliers offer to different retailers, but the range was not unusually large—see paragraph 7.98 in the findings.

8. There is mixed evidence on the performance of independent retailers. According to some market reports and third party submissions, the numbers of independents, and their market shares, have steadily fallen at the expense of larger retailers.² However, according to GAME the parties' shares in mint software have fallen commensurately with that of the independents. We note that some chains of independents, such as Chipsworld and Grainger Games, are expanding.
9. We did not find that the parties were given preferential stock allocation, nor was access to exclusive products or special editions a significant barrier in our judgement.

Large-scale entry

10. We also considered entry or expansion to a large-scale or national level. The parties told us that the level of expansion of other market players demonstrated the potential for further expansion in the market. We note the market is growing.
11. The parties said that in this context availability of retail space need not be a barrier. They highlighted instances of significant entry in other countries where there were opportunities to purchase chains of shops from retailers going into administration or looking to reduce their property portfolio; GAME acquired 50 stores from a book chain and converted them, and GameStop acquired 141 stores from a PC retailer in Spain. Blockbuster had recently purchased 59 Choices stores in the UK.
12. GAME noted its own success in expanding nationally: between 2003 and 2007 GAME opened 123 stores (which included 17 store relocations) and Gamestation opened 157 stores. During the same period GAME closed [redacted] stores and Gamestation closed [redacted] stand-alone stores. The parties pointed out that margins in DVDs and music were shrinking and that expansion in video games was both attractive and feasible for multiple retailers such as HMV, Virgin and Woolworths.
13. Another important factor is expansion through the opening of franchised shops; the two salient examples of this are CEX and Chipsworld. Chipsworld has 41 outlets in the UK, 20 of which are franchises, selling both mint and pre-owned products. The company seeks further franchising partners on its website, and estimated that a fully fitted, fully stocked store cost in the region of £80,000, depending on location. Chipsworld franchises by charging a management services fee of 7 per cent of sales, a marketing fee of 2 per cent, and a 1 per cent stock distribution contribution.³ CEX now has over 40 outlets, four of which are franchises, selling pre-owned only, and seeking further franchise partners. Its estimate of the cost of a fully equipped store is between £120,000 and £150,000.⁴
14. Third parties have challenged the parties' arguments for the ease of entry and expansion, both at the local and national level. [redacted] argued that there might be significant barriers to entry or expansion on a small and large scale. In particular, [redacted] undertook a greenfield market entry analysis, designed to judge the potential for expanding its presence in the UK market beyond the [redacted] stores it currently ran. The

²See, for example, Verdict (2006): 'independent video games and consoles specialists have struggled in recent years against competition from larger retailers—specialists, non-specialists, and online operators alike—and this has caused many independent retailers to go out of business'. [redacted]

³www.chipsworld.co.uk/news/franchise.asp.

⁴www.CEX.co.uk/franchising.

analysis was partly based on past experience in establishing operations in [X] and a number of other countries, and simulated a gradual expansion to 100 stores in the specific circumstances of the UK market with one or two incumbents owning 600 stores.

15. The conclusion of the analysis was that while capital availability was not a barrier, in a tight property market a large-scale expansion would be economically unfavourable compared with other territories. [X] analysis suggested that there were not enough profitable locations available where it could compete effectively, and that an expansion rate of 20 stores per year might not be possible or sufficient for profitability relative to the required investment. [X] also told us that it would not be able to pick up sufficient business in a 'saturated' market.
16. This analysis is based on a large number of assumptions, particularly about the extent to which a new entrant could attract custom from GAME and Gamestation. It assumed that customers would be reluctant to switch, but we are not convinced that customers are so immobile (see Section 7 of the findings).

Scale

17. [X] argued that, in addition to expansion being difficult, it was hard to run a very small number of stores profitably. This is in line with the submissions from small independents that margins were increasingly tight and unprofitable for small chains or single stores. These submissions suggested that there might be a minimum scale requirement for a successful entry into the market.
18. The parties argued that they too had lost market share primarily due to pressures from non-specialist retailers, and that there were no additional pressures on small retailers. They argued that their own survey work suggested that independent retailers considered that pricing pressure was imposed by the online retailers and supermarkets.

Staff

19. The parties told us that a skilled and trained workforce was not required in order to compete effectively with the merged entity; they pointed to their own research data,⁵ which suggested that quality and expertise of staff was of low importance for customers' purchasing decisions and that consumers were far more motivated by price. This is corroborated by similar research from Mintel (2006).
20. Training requirements are not unusual for this sector compared with other retailing, and whilst gaming retail knowledge and enthusiasm may be helpful, especially for a specialist, it is not necessary. In a supermarket environment even this may not be requisite. It seems that there is little evidence that the requirement for a skilled workforce could be a barrier to entry in the retail of mint goods.

Pre-owned gaming products

Staff

21. HMV and Woolworths, both of which have attempted to enter into retail of pre-owned gaming products and decided not to pursue it further, pointed out that expansion into

⁵For example, GAME's loyalty card survey and Gamestation's brand tracker.

pre-owned required a significant marketing investment and specialized staff, as well as costs associated with switching supply, price setting, distribution networks etc.

22. It was suggested that, in order to run an effective pre-owned operation, a retailer needed staff who were also gamers or who had some knowledge of games in order to check the quality of products and its packaging thoroughly, sort them properly, recognize correctly what the traded games were and so on, although there was conflicting evidence on how important this factor was rated by the retailers who had tried entry.
23. The parties told us that no special skills were required in any way to handle the trade-in process effectively. Staff determined trade-in prices by scanning the bar code and quality checks were perfunctory. They said that there was no special mechanism through which games were sorted. Once the price label had been stuck on the product, the game was placed immediately on the shelf for sale. The parties further suggested that setting the price would be straightforward through benchmarking pre-owned prices against the mint prices in store and mint and pre-owned prices of other competitors.

Distribution networks

24. The parties have a centralized system whereby pre-owned stock, traded in at a local store, can be centrally accounted for and redistributed across the country from stores that have too high a stock to stores that are falling low. Expanding local entrants or national entrants may require a significant capital investment to develop such a network and this may act as a barrier to expansion/entry.
25. HMV and Woolworths indicated that a viable national sales operation required a distribution network to maintain similar stock levels across the country. A central distribution network for trade-in stock might constitute an additional significant investment even if one already existed for mint stock because of the specialist gaming knowledge required in sorting, pricing and understanding traded-in products.
26. Gamestation estimated the cost of running its redistribution system at £[redacted] (of which £[redacted] represented freight) from May 2007 to the end of January 2008. This included costs of running the warehouse, security, staffing, equipment, insurance, and freight and packaging, with a nominal upkeep cost.
27. However, the parties told us that such a network was not necessary for successful pre-owned software sales. They pointed out that they operated 29 stores that could not redistribute because they were concession stores operating on different systems, and suggested that only a very small proportion of sales were redistributed. GAME told us that [redacted] per cent of trade-in was sent back to central distribution, and of that the [redacted] per cent from above is immediately redistributed; of the remaining [redacted] per cent up to [redacted] per cent is discarded. It appears that around [redacted] per cent of traded-in stock is centrally redistributed for Gamestation.
28. Gamestation told us that it distributed its mint products through a third party. Using third-party warehouses would be an option for other retailers considering expanding or establishing a distribution network.
29. The parties suggested that smaller independent retailers could redistribute pre-owned goods through the Internet, and backed this up with the evidence from their survey of independents which suggested that [redacted] per cent of independents actively bought and sold through eBay. The parties asserted that the cost of a distribution

system in pre-owned retail would be negligible if such a system already existed for other goods.

Reputation

30. [X] put to us that UK customers would be cautious of buying hardware, especially from unknown retailers as they might be unsure of pre-owned quality or their ability to return new or pre-owned faulty items. This is supported to a certain extent by evidence from customer surveys, including some conducted by the parties, that consumers display a degree of brand loyalty.⁶ Reputation might also play a role in the difficulties faced in obtaining sufficient traded-in products; both HMV and Woolworths commented on the difficulty in obtaining an adequate amount of trade-in to supply pre-owned sales.
31. The parties did not think that reputation could act as a barrier to entry. They pointed out that eBay traded-in a substantial amount of hardware when no inspection was possible. They also put to us that the local independent was not unknown to a local consumer.

Internet retail

32. The parties suggested that independents could enter the Internet through affiliate schemes offered by eBay and Amazon.
33. The parties estimated the cost of an Internet address and web development at around £[X]. They said that advertising on the Internet would be cheap and efficient. However, others suggested that these costs were likely to be higher when trying to achieve an effective awareness.

Effects of the merger on conditions for entry/expansion

34. We considered how the merger might affect conditions for entry by increasing the parties' buying power to the relative disadvantage of retail competitors, and the ability to secure exclusive rights to special editions of software and hardware from suppliers. As mentioned above, the merged entity makes up a significant proportion of business for the large publishers; Ubisoft, for example, estimated that the merged entity would account for 30 to 50 per cent of UK publishers' business. However, consoles and many 'must-stock' titles are supplied by just three large international companies, Microsoft, Nintendo and Sony. These companies deal with retailers on a global level and the share accounted for by the merged entity in their world sales is small.
35. The parties argued that they had no benefits of scale. They pointed out that suppliers had no incentive to allow a dominant purchaser to develop and that it was highly unlikely that they could induce suppliers to foreclose the supply of inputs to other channels. The parties said that special editions represented a negligible proportion of their revenues. GAME said that over the last three years exclusive editions represented as little as [X] per cent of GAME's revenue.

⁶This evidence, however, from various consumer surveys, is not entirely unambiguous.

Speed of entry

36. It is necessary to consider the time frame in which entry might reasonably be expected to occur. If entry can occur only over a very long period of time, it acts less effectively as a constraint on the merged parties, and vice versa. For a high street retailing operation, there do not seem to be reasons to expect entry to take an unduly long time. Further, expansion might well be quicker than entry.

Barriers to exit

37. Costly exit in the case of an unsuccessful entry adds to the financial risk of entry that can deter entry. In this way barriers to exit are also barriers to entry. The parties suggested that exit costs for game retailers included disposal agents' fees of [%] per cent of annual rent, legal fees of £[%], a minimum cost of stripping out of £[%], marketing of about £[%], and a possible contractual premium. In the past five years GAME closed [%] stores, and Gamestation closed [%]; the average costs for those closures range from £[%] in 2004 to £[%] in 2005. We note the decline in the number of independents as evidence for the feasibility of exit. Sunk costs, it seems, are not particularly large in the games retail industry, and the evidence suggests that there are no significant barriers to exit.

Past examples of entry and expansion

38. Examples of significant entry in the last five years are hard to find; there has not been any large-scale entrant of the specialist style model. However, the supermarkets might be considered relevant entrants for the sale of mint products.
39. The parties told us that Tesco had indicated its intention to offer a trade-in proposition and pre-owned products through its online store in early 2008.
40. With regard to expansion, Asda, Morrisons, Sainsbury's and Tesco increased the total space devoted to video games between 2006 and 2007. The parties pointed out that Argos increased the number of pages devoted to gaming products in its catalogue from 19 to 27 in the last year; however, Argos told us that this did not necessarily represent increased presence within the market, but rather reflected product life cycles (ie the number of pages would increase/decrease to reflect product launches such as Playstation 3). According to Mintel and articles in *MCV*, both HMV and Zavvi have increased their focus on games in response to changing market conditions in music.
41. HMV trialled pre-owned game sales from November 2004 to May/June 2005 in 34 stores; it indicated that the requirements for adequate supply were knowledge of the market, store space availability, and considerable marketing investment and stock management (including investment in a nation redistribution network). HMV decided that continuing to sell pre-owned was not feasible, but told us that its decision was under constant review.
42. Woolworths' trial involved 820 stores accepting trade-in and 98 stores additionally selling pre-owned stock. The trial was conducted for a year from September 2006. Woolworths decided that the trial would not be continued due to a number of factors including higher business priorities in relation to use of available store space. [%]
43. Blockbuster is another example of expansion into retailing pre-owned products. Unlike the previous two examples, it has been selling pre-owned for some time.

However, Blockbuster is able to source partly via ex-rental stock, rather than having to provide its pre-owned supply exclusively through trade-in.

44. The parties noted that eBay, Amazon and Play.com had all expanded their propositions to include the sale of video games. In relation to pre-owned product, the parties told us that eBay was the single biggest competitor.
45. Examples of past exit include ChoicesUK, which was a chain of 162 stores, MVC with 82 stores, and Music Zone with 103 stores. HMV and Woolworths stopped pre-owned trials as discussed above.

Potential new entrants

46. There are few obvious retailers with the potential for large-scale new entry, such as major retailers in related industries, or gaming retailers abroad, who are not represented already. The parties told us that Borders and Waterstones had entered the market on a small scale and they suggested that these companies could roll this out on a larger scale.
47. In terms of future expansion, it is possible that some small chains or independent retailers might attempt to expand incrementally; CEX and Chips, for example, are actively looking for new franchise partners. As regards supermarkets and entertainment specialists, the opportunity costs and difficulties with trade-in highlighted above make expansion into pre-owned seem less likely, although [X] and [X] said that they continually reviewed their decisions not to retail pre-owned products.