One Size Doesn't Fit All: Varying Factors of Success in Small-, Medium- and Large-sized Fragrance Manufacturers

Part 1 of 3: Benchmarking the fragrance industry—examining current trends and future growth

By Kevin McGann, Marcum LLP; research and analysis performed by Shan Chen, Eva Yee Wong, Lani Shufelt and Adam Burke, Samuel Curtis Johnson Graduate School of Management, Cornell University

In 2011, students at the Samuel Curtis Johnson Graduate School of Management at Cornell University, in conjunction with Marcum LLP, a public accounting and advisory services firm, conducted a survey of the fragrance industry in the United States. The Cornell student researchers conducted this survey independently; subsequent analysis is the product of their collaboration with Kevin McGann, a partner at Marcum LLP and its fragrance industry practice leader.

The three-part series resulting from this research will examine collected data by size of surveyed company (based on revenue) and respondents' rates of growth over five years, and will offer the author's conclusions based on answers to three industry-specific questions:

- What drives growth?
- What are the key competitive challenges?
- Where are the growth opportunities?

In this first analysis, the Marcum/Cornell team divided the industry into three size categories based on revenue—small, medium and large—representing manufacturers with $1–10 million, $11–80 million and $80+ million in revenue, respectively.

Survey Methodology

The survey construction was shaped via quantitative research with industry experts. Those that took the survey were offered modest incentives. The data discussed in this article series comprises feedback from 70 companies. This total was achieved after the elimination of bad data (ex: participants that took less than 15 minutes to fill in the survey or skipped vital information such as revenue or number of employees).

A Brief Snapshot of Industry Lifecycle

Survey results reinforced the impression that the fragrance and flavor industry, a $19–22 billion business worldwide, is composed of a large number of companies across fragmented segments. However, upon a closer look, it became clear that market share is not remotely evenly distributed among them (**F-1**). In fact, the top six flavor and fragrance companies account for ~75% of total global revenue.

When compared against the global GDP, results show that the overall growth in the fragrance industry, with 2007 as a notable exception, was tracking at or around the same percentage. This similarity is a benchmark of maturation in a given industry segment. That, combined with the increasing downward pressure on margins due to commodity price volatility (ingredients), has sufficiently suppressed industry profits to a growth of 4–5% in 2010.

Slow growth, or even stagnation, as well as decreased profit margin and reliance on commodity markets, stand out as indicators of an industry well into its maturity. Companies in mature industries have their own rules for success that vary depending on the size of the organization and its market share position.

Another leading indicator of maturation is a trend toward consolidation. Based on the Marcum/Cornell survey, 75% of large company respondents experienced a merger or acquisition in the last five years, compared to only 21% of small companies. The ultimate effect of this, simply put, is that the big are getting bigger, while the small will have a continually more difficult time competing with larger, more efficient organizations capable of unmatchable economies of scale.

Analysis by Size

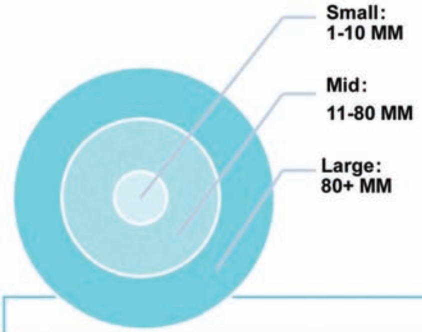
Members of all three size categories were posed 26 questions throughout the survey process, each answering according to their particular perspective relative to the size of their company. Similar in many ways, there were distinct variations among the size categories in a few important areas. By extension, these areas appear to be points of differentiation worth noting.

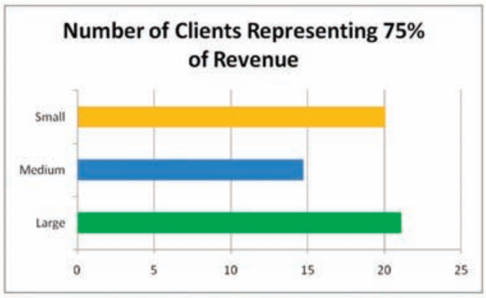
Commodity pricing and its varying effects on market segments: When asked, "do volatile commodity prices significantly impact your profit margins," one-third of the respondents in the medium and small categories strongly agreed with that statement, while three-quarters of all large company category members strongly agreed (**F-2**). This vulnerability to relatively small fluctuations in the costs of materials is an unintended consequence of the

Breakdown of flavor and fragrance firms by size

F-1

Methodology: We divided the industry into three segments based on fragrance manufacturing revenue and then looked at how the firms are structured





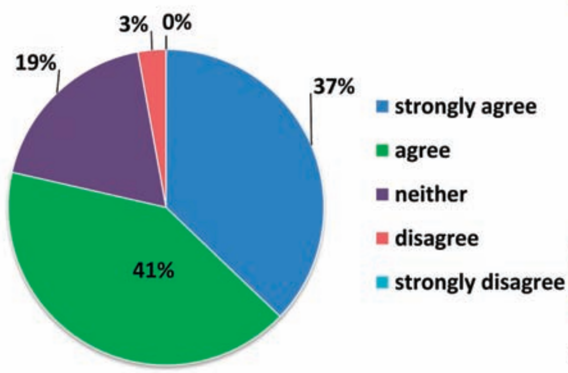
	Large	Middle	Small
Amount of revenue coming from fragrance manufacturing	$81MM+	$11-80MM	<$10MM
# of Employees in fragrance division	183	41	53
Average # of outside sales people	35	9	12
Average # of inside sales people	18	6	7
Average # of senior perfumers on staff	7	2	2
Average # of total perfumers on staff	22	7	7
Average inventory turnover	4.5	2.5	2

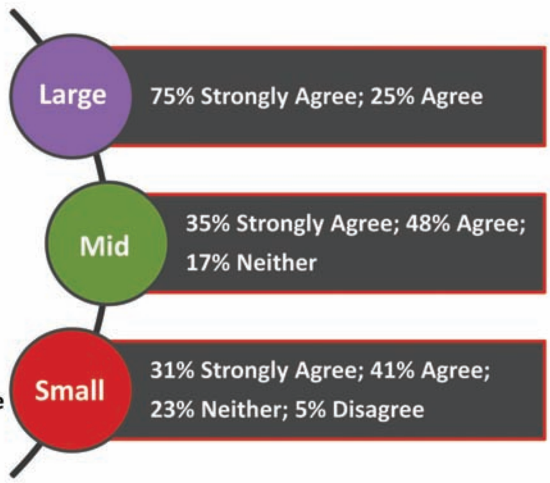
Structurally, firms of all sizes appear similar based on the relative size of each division and diversification of revenue sources

Volatile commodity prices impact large companies' profit margins the most

F-2

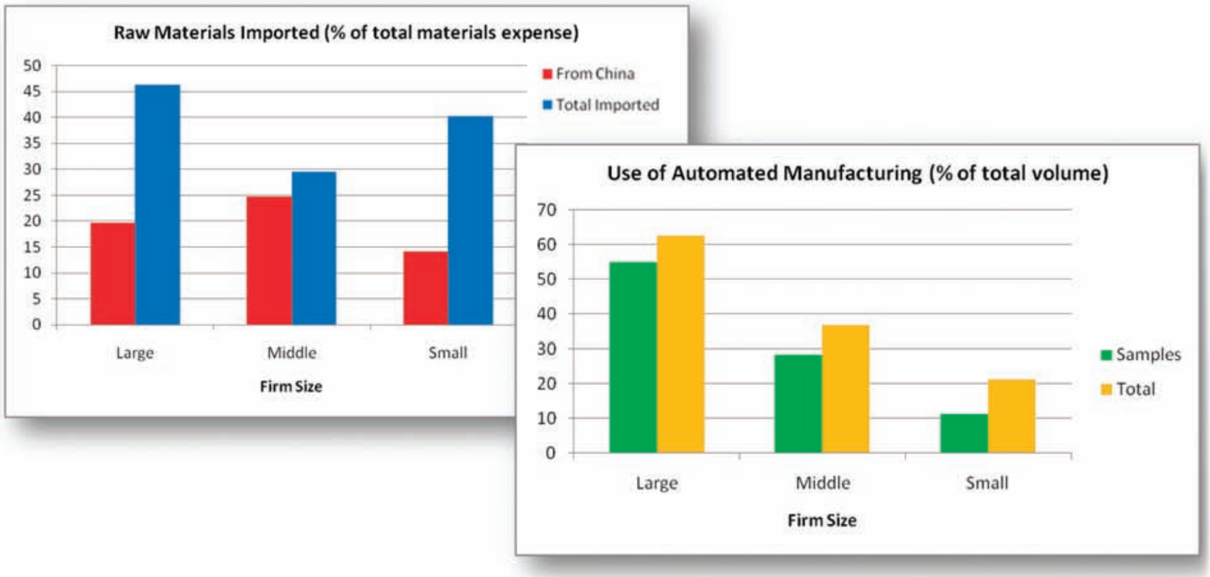
"Volatile commodity prices significantly impact my profit margin":





Most industry players agree that volatile commodity prices affect profit margins; the profit squeeze appears to be most pronounced for large firms

Larger firms are gaining cost efficiencies through input cost sourcing as well as automation **F-3**



We recommend that small and midsize firms with strong financial positions consider making greater investments in automation

overall success and, more specifically, the scale of operations of members of the large group.

The other side of this coin is the reasonable safe decoction that, based on this information, medium and small companies are making their money on products that generate larger profit margins, such as luxury items or specialized items. For example, the profitability of hand soap, the single largest product in this industry category, will hinge in both directions based on the pricing of the raw materials and the value of its production.

The price of success: Another key area of differentiation is the selling, general and administrative (SG&A) expense structure at the designated size categories. As they reach upward, small and medium firms must dedicate a significant portion of their resources to research and development, necessary to remain competitive and enhance their differentiation in the market. This is not the case with the large category, which makes its money on the high volume production of widely salable goods. The Marcum/Cornell survey demonstrated that the relative burden of SG&A for small- and medium-sized companies, due to the need to innovate, is much greater when compared to the large category, even though larger companies generally pay higher salaries.

The single largest segment of SG&A costs are employee salaries, ranging from 30–40% depending on the size category. Interestingly, 50% of large respondents said that roughly 11–25% of their employees are unionized, while about the same percentage of small- and medium-sized companies said that none of their employees were unionized. Incidental to these inquiries, the

Marcum/Cornell team discovered that common benefits offered by all three company size tiers include 401K, defined benefit and defined contribution. Smaller companies, however, tend to offer profit sharing and employee share option plan opportunities. In addition, most firms credit their successes to a strong sales team, regardless of size. Here again the large company category, having the advantage of the ability to pay higher salaries, has an advantage of access to top talent in these key areas.

As small and medium category members become large companies—either through innovation or acquisition—the increased burden of labor, based on the survey results, is a key pain point. According to respondents, the most effective mitigating measure is the increased use of automation in the manufacturing process. This is evidenced in the results wherein responses show the large companies are automated to 60% of total volume, while the medium category is in the high 30th percentile and the small category barely breaks 20% of total volume (**F-3**).

Market share: When looked at overall, 50% of the surveyed companies either strongly agreed or agreed when asked the following statement: "Within the United States the majority of growth comes from taking competition's market share." This is a highly competitive environment where growth is not being created, but being taken. When looked at in the three company size segments, 87% of large category companies agreed or strongly agreed with this statement. Meanwhile, only 30% and 49% of the medium and small companies agreed or strongly agreed, respectively. Based on these results, it seems that the burden of innovation, and the hopeful growth that would accompany it, falls largely on the small companies and, to a lesser extent, the medium-sized companies.

According to the surveyed companies, three critical trends have emerged throughout the industry: innovation, emerging markets and natural ingredients.

Upcoming Analysis

What causes a company to experience 6% growth and another 1% growth? Are the factors that make a company an overachiever the same for an $80 million company as they are for a $10 million company? In the next article in this series, the authors will take a different approach to sorting the respondents and look at the data through the prism of companies experiencing high percentage growth versus those experiencing low percentage growth over the past five years. Ultimately, the final installment in the series will address all of the study findings and endeavor to unlock the answers to those three original key questions regarding fragrance industry growth, challenges and opportunities.

Address correspondence to Kevin McGann, Marcum LLP; 750 Third Ave. New York, NY10017; kevin.mcgann@marcumllp.com.