COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 10/LM/Mar03

In the large merger between:

Daun et Cie AG

and

Kolosus Holdings Limited

Reasons for decision

CONDITIONAL APPROVAL

1. The proposed transaction between Daun et Cie AG and Kolosus Holdings Limited was conditionally approved by the Tribunal on the 29 July 2003. The reasons for this decision follow.

The Transaction

2. In terms of a sale of shares agreement concluded between Senwes Limited ("Senwes") and Daun et Cie AG ("Daun"), Senwes sold its 62.5% share in Kolosus Holdings Limited ("Kolosus") to Daun for a consideration of R1.31. One of the conditions of the agreement is that Daun concludes an agreement with ABSA to acquire its shares in Kolosus. Daun thus acquired control of Kolosus.

3. Further to this Daun entered into an agreement with a USA producer of automotive leather, Seton, in terms of which Seton will acquire a 25% shareholding in Kolosus. Seton is a major creditor of Kolosus, a debt which arises from lengthy litigation between the two companies. Although this transaction is not a separate merger for purposes of the Act, it is a significant aspect of the analysis of the transaction before us and we return to a detailed discussion of this issue later in the decision.

4. On the 30 April 2003 the Commission recommended that this merger be unconditionally approved.

THE PARTIES

The primary acquiring firm

5. The primary acquiring firm is Daun et Cie AG, a German company controlled by Mr Claas Daun and the Daun family trust. Daun and its subsidiary, Kap Beteiligungs AG ("Kap"), hold controlling interests in approximately 70 subsidiaries worldwide of which at least 30 are in South Africa. The Daun group is particularly active in the textiles, footwear, furniture and automotive supply industries.

6. The group's subsidiaries relevant to this transaction are Springbok Trading, Riverside Tannery and the joint venture Butterworth Tannery.

7. Mr. Daun's entrepreneurial talents are highly regarded. He is a risk taker who has developed a reputation as a successful 'turnaround' specialist, that is, an entrepreneur adept at identifying opportunities for rescuing – often at the behest of anxious creditor banks – ailing businesses. Mr. Daun's record of successful turnaround operations includes Morkels, a national chain of furniture retail stores, East Rand Proprietary Mines, a gold mining company, Da Gama Textiles and Glodina Towels, to name but a few. It appears that Mr. Daun's interventions have frequently impacted dramatically on the structure of entire sectors. The furniture manufacturing industry in which Mr. Daun is said to have initiated the consolidation of the sector and, ultimately, the formation of Steinhof, the dominant player in furniture manufacturing in South Africa, is an example.

8. A successful turnaround generally presupposes the identification and elimination of excess costs and, as such, is frequently accompanied by significant labour retrenchments. Mr. Daun has not escaped some of the controversy and recrimination that inevitably accompanies the process of workforce reduction. However, in addition to laying off labour, Mr. Daun is also associated with some innovative rescues that have presupposed high levels of co-operation with organised labour, the rescue of Mooi River Textiles being one well-known case in point.

The primary target firm

9. The primary target firm is Kolosus, a public company controlled by Senwes. Kolosus controls various subsidiaries, principally active in the meat and leather industries.

10. The subsidiaries relevant to this transaction are the two feedlots, Taaiboschbult and Hurland, African Hide Trading, and the tanneries, Kolosus Automotive Leathers and Mossop Western Leathers.

11. We have already referred to the litigation with Seton that has dogged Kolosus' recent history. This matter has impacted significantly on both the finances of the target company as well as on its ability to compete effectively in a market clouded by the negative sentiment surrounding the litigation. It appears that, absent this transaction, the prospect of liquidation exists.

RATIONALE FOR THE TRANSACTION

12. Daun's assumption of control of Kolosus portends both financial and reputational relief for the ailing company. So powerful is Mr. Daun's reputation, that Seton has, in part settlement of its successful claim, accepted a passive, minority equity stake in the ailing Kolosus simply because, it avers, it expects Mr. Daun's presence and his entrepreneurial flare to be manifest in an upside on the share price over the relatively short term. Furthermore Mr. Daun is a long-standing supplier to the automobile industry and it is hoped that his reputation and connections with the automobile OEMs, particularly the key German owned OEMs, will restore market access for Kolosus' automotive leather operation.

13. It is more difficult to determine with confidence the acquirer's rationale for this transaction. Mr. Daun insists that he is simply attracted by the sheer challenge of turning around the ailing Kolosus and by the profit that he will show in consequence of this. Be that as it may, there are, on the face of it, structural consequences of the transaction that are potentially troubling from a competition perspective.

14. Firstly, as will be elaborated below, the merger of the country's two largest hide traders is, *prima facie*, cause for concern.

15. Secondly, we are mindful of a discernible pattern of vertical integration in Mr. Daun's manufacturing strategy. This is apparent in respect of his interests in the furniture and textiles sector. We must ask ourselves whether this transaction represents a strategic step towards vertical integration of the leather products value chain in which – through his interests in furniture and footwear – he is already a significant player. This, too, may impact on the character and intensity of competition in the affected markets.

16. Mr. Daun denies that considerations related to vertical integration play any part in his decision to acquire Kolosus. Of course it is wholly conceivable that sheer opportunism has driven as consummate an entrepreneur as Mr. Daun. However, his clear affinity for vertical integration speaks for itself.[1] At least,

[1] This affinity for vertical integration was remarked upon by Mr.Patel in his submissions on behalf of SACTWU (page 3 of transcript of 8 June 2003): "The first is I guess less of an opinion than an observation that the main shareholder in the acquiring firm tends to concentrate investment in pipelines or connected investments holding equity in value chains such as the textile clothing

we must be alert to the possibility that the opportunity for turnaround that Mr. Daun discerns is rooted in vertical relations along the value chain and we must examine the competition implications, if any, of that approach.

THE HEARING

17. A pre-hearing was held on 2003 and the hearing was held on the following days:

    8 July 2003
    9 July 2003
    10 July 2003
    14 July 2003
    24 July 2003
    25 July 2003

18. The Commission called the following witnesses:

    1. Mr D Venter, an independent consultant to companies in the meat and leather industries
    2. Mr P Booysen from the Executive Council of the International Meat Secretariat (IMS) and the Meat Exporters of South Africa (MESA)

19. The merging parties called the following witnesses:

    1. Mr P Schouten from Daun et Cie AG
    2. Mr A Bischoff from Kolosus
    3. Mr P Staples from Springbok Trading
    4. Mr H Roets from African Hide Trading
    5. Mr B Keyser from Kolosus Automotive Leathers
    6. Mr C Daun Chairman of Daun et Cie AG
    7. Mr PTrechack Vice-President of Seton USA

20. The Tribunal called the following witnesses:

    1. Mr C O'Neill from Eagle Ottawa SA
    2. Mr N G von Durckheim from Bader SA
    3. Ms J C G Terreblanche from EAC
    4. Mr R Nortje and Ms A. Viljoen from BMW SA
    5. Mr B Lappiner from Cape Produce Company Pty Ltd
    6. Mr H Cilliers from Daimler Chrysler
    7. Mr C Austin from Hidskin Pty Ltd.

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value chain, textile auto industry, textile furniture, textile meaning the fabric making side to home textiles which is the making up of textiles, hides and skin to tanning and tanning to footwear."

21. It is important to note that during the Commission's investigation of the transaction, various industry players raised their concerns regarding the impact of the transaction. The Tribunal thus subpoenaed the abovementioned witnesses as a sample representative of the various players at different levels of activity within the industry.

The Trade unions

22. Mr E Patel and Mr M Bennett represented the South African Clothing and Textile Worker's Union ("SACTWU") during the proceedings.

23. Mr P Motaung from Maserumele Inc represented the South African Food and Allied Trade Union ("SAFATU").

BACKGROUND

24. The transaction is a complex one. At its core is a horizontal merger, that is a merger involving firms in the same market, but it also involves firms that are suppliers and customers of these competing firms. Although, as will be elaborated below, the horizontally related firms are involved in trading and processing both sheep skins and cattle hides, for our purposes it is only cattle hides that are pertinent and then, particularly those hides that are suitable for ultimate use in the manufacture of automobiles. To provide a general background to the merger, we firstly describe the automotive value chain in which the firms are active. We then discuss the relevance of the Motor Industry Development Programme. Thirdly, we provide relevant information on the Seton legal claim against Kolosus, as well as a brief overview of the establishment of Springbok Trading.

The automotive leather value chain

25. The automotive leather industry, the most important component of the South African leather industry, is best analysed as a value chain comprising four levels. [2]

26. These are:

    i. the feedlots;
    ii. the primary tanners;
    iii. the automotive tanners, and
    iv. the original equipment manufacturers (OEMs).

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[2] Auto upholstery makes up 58% of total leather exports. See Morris and Velia, <u>Final Report on Factors Impacting on the Competitiveness of Key Export Value Chains in the Leather Industry, June 2002</u>.

The Feedlots (raw hide supply)

27. Since feedlot cattle are kept in enclosures, their hides have fewer defects and blemishes. Hence, while the feedlots are not the only source of raw hides, they do provide the main source of hide for the automotive industry, which requires high quality hides. There are approximately 60 commercial feedlots in South Africa. The South African Meat Industry Council estimates South Africa's annual total hide production to be between 2.2 and 2.4 million, of which 60% (1.32 million) is suitable for the automotive industry. The industry requires approximately 3 million hides annually and imports are therefore necessary to satisfy the shortfall.

28. Many of the feedlots have structural links with hide traders and primary tanneries. Kolosus owns two feedlots, namely Taaiboschbult and Hurland Feedlots, both of which exclusively supply raw hides to African Hide Trading. Although the acquiring firm is not structurally linked to any feedlot, it enjoys a supply relationship with an independent feedlot, Sparta.

The Primary Tanners

29. The primary tanners procure hides from feedlots and commercial cattle farmers. The raw hides undergo a chemical process, which transforms them into "wet-blues". A wet-blue is a hide that has been washed in chemicals and limestone to remove excess fat and hair. Although this is a tanning process, further beneficiation is required to transform these wet-blues into leather. The better quality wet-blues are sold to automotive-tanners and the lower quality ones are sold to tanneries that manufacture other leather products such as shoes and handbags.

30. The primary tanners thus undertake three related activities. Firstly, they procure raw hides from the feedlots and commercial farmers. Secondly, they process these raw hides into wet-blues. Thirdly, they then on-sell the wet blues to the secondary tanners who produce finished leather for a variety of industrial applications. The primary tanners, though performing a basic processing function, are principally engaged in the process of intermediating, of trading hides, between, on the one hand, owners of the raw hide, and, on the other hand, those secondary tanners who convert these raw hides into leather used in the process of manufacturing a wide range of products from automobile seats to handbags. Accordingly, the primary tanners are widely referred to as "hide traders" since their principal role is the purchase of raw hides and their on-sale in the form of wet-blues to the secondary tanners.

31. The Daun group operates at the primary tanning level through its subsidiary, Springbok Trading, the largest South African hide trader. Springbok Trading owns the Riverside tannery and, together with an independent feedlot, Sparta, the Butterworth tannery. Although these tanneries provide Springbok

with a limited primary tanning capacity, it appears that most of the raw hides that it procures are tanned under contract by hide traders who have primary tanning capacity in excess of that required by their level of hide procurement.

32. Kolosus is also active at this level of the industry through African Hide Trading. In contrast with Springbok Trading, African Hide's primary tanning capacity significantly exceeds the volume of hides that it procures. Accordingly, it undertakes primary tanning under contract from other hide traders including Springbok.

33. There are three other significant participants at this level of the value chain, namely Cape Produce Company (Pty) Ltd, EAC and Hidskin (Pty) Ltd. Both EAC and Hidskin own feedlots.

34. Primary tanning is characterized by significant excess capacity. As already intimated, African Hide, in particular, is said to possess significant excess primary tanning capacity.

Automotive Tanners

35. The automotive tanners further process the wet-blues to create finished leather seat kits, or "cut-kits", which are then sewn and sold to the motor manufacturers in the form of complete car seats.

36. While the Daun group is not active at this level of the industry, Kolosus Automotive Leathers (KAL), previously known as Ladysmith Leather, operates an automotive tannery.

37. There are five automotive tanners active in South Africa. With the exception of KAL, all are subsidiaries of international companies. These are Bader SA, a German-owned company, the Italian-owned Mario Levi, and the two US-owned producers, Eagle Ottawa and Seton.

The original equipment manufacturers (OEMs)

38. The OEM's – the multinational automobile manufacturers - are the ultimate consumers of automotive leather products. The OEMs contract automotive tanners to produce finished leather car seats. BMW's local subsidiary is the largest player in this sector of the local value chain. Daimler Chrysler, Audi and Volkswagen are the other major customers. Note that the locally-based OEMs do not only procure car seat kits from the locally-based automotive tannery for installation into locally produced models. Although procurement of locally produced leather car seats is undertaken by the locally-based OEMs, many of these are on-sold to production facilities elsewhere in the world. In other words South Africa's automotive tanners are part of the global procurement networks of the multinational OEMs. The Motor Industry

Development Programme (MIDP), the programme that effectively underpins South African participation in these supplier networks, is described below.[3]

39. This four-part value chain is illustrated graphically in Diagram 1 on the next page.

[3] Note that an OEM does not have to undertake manufacturing in this country in order to take advantage of the MIDP subsidies. Hence Renault has no production facility in this country but is a large producer of catalytic converters which are then utilized in its international manufacturing plants and the duty credits earned are then used to support the importation of Renault's into this country. It is not clear whether this is so with respect to leather car seats but there appears to be no reason why it should not be so.

Diagram 1

PARTICIPANTS IN AUTOMOTIVE LEATHER VALUE CHAIN

LEVEL ONE

				Daun	Kolosus
FEEDLOTS	Karan	EAC	Beefkor	**Sparta** **contractual arrangement with Daun**	**Taaiboschbult & Hurland**

LEVEL TWO

Merging parties

				Daun	Kolosus
PRIMARY TANNERIES	Cape Produce Company (CPC)	EAC	Hidskin	**Springbok Trading** ***Butterworths & Riverside Tanneries**	**African Hide**

LEVEL THREE

					Kolosus
AUTO TANNERS	Eagle Ottawa	Mario Levi	Bader SA	**Seton** **25% equity stake in Kolosus**	**Kolosus Automotive Leathers** ***The other tannery is Mossop**

LEVEL FOUR

O.E.M's	BMW	Daimler Chrysler	Volvo	VW & Audi	Delta

The Motor Industry Development Programme (MIDP)

40. Introduced by government in September 1995, the MIDP effectively constitutes a package of incentives aimed at enhancing the international competitiveness of the domestic auto assembly sector. The programme encapsulates a structural shift in trade policy away from tariff and import control measures towards the provision of a range of supply side support initiatives.

41. Of the five incentive packages that make up the MIDP, it is the import–export complementarity scheme that is pertinent with respect to the automotive leather industry. Essentially the scheme rewards OEMs and component manufacturers with duty credits calculated on the basis of the local content value of exported vehicles and components. These credits are then used as rebates on the import duties payable on vehicles or components. These rebate certificates are tradable on the open market.[4] Practically, in the leather industry this translates to the OEM's earning rebate credits on the value of local content of leather car seats. This includes the value of the hide itself (where it is a locally sourced hide). It also includes the value of hide processing including the primary and secondary tanning processes as well as the sewing of the hides. The greater the value of the local content the greater the total percentage rebate earned. It is anticipated that these duties and rebates will be gradually phased down until 2012. [5]

42. The automotive leather industry in South Africa largely owes its existence to the MIDP. Since its inception the MIDP has resulted in almost all major OEM's procuring leather upholstery from South African suppliers. This has reduced the duty payable on the import of those models that are not locally produced thus enabling the OEMs to specialise in the production (for both local and international markets) of selected models.

43. However, critics charge that the MIDP has also inflated the price of local hides. Hide traders are able to charge a premium over the international price of raw hide because the rebates earned on local content make it attractive for the OEM's to procure hides locally, even at a premium on the internationally traded price. However, as elaborated below the procurement policies and practices of the OEMs appear to circumscribe the size of the premium charged, that is, while the MIDP creates a degree of differentiation between the prices of local and imported hides, the international market in which the OEMs purchase their inputs nevertheless exerts discipline on local price levels.

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[4] Morris, M and Barnes, J, An Analysis of the endogenous and exogenous factors impacting on the success of the motor industry development programme, CSDS Working Paper No. 27, March 2000, page 3.

[5] The MIDP initially meant to end in 2007 was extended to 2012

44. The phasing down of the rebates presents a challenge to the automotive industry, in that it must remain globally competitive independently of the MIDP in order to survive.

The Seton Claim

45. Mr Daun initially owned a company known as Silveroak Industries (Pty) Ltd ("Silveroak"), which operated in the automotive leather industry through its subsidiary Ladysmith Lindgens Leathers ("LLL"). During 1994 Seton USA, a major global manufacturer of leather automobile seats, purchased a 49% holding in Ladysmith Leathers and thus jointly held LLL together with Silveroak. Silveroak and Seton entered into a non-compete agreement that provided that neither company nor their subsidiaries and associated companies would compete with LLL .

46. In September 1995 Mr Daun sold his controlling share of Silveroak to Kolosus. At the time Kolosus operated in the automotive tanning business through its subsidiary, King Tanning, situated in King Williams Town. Seton then alleged a breach of the non-compete clause arising from the activities of Kolosus' subsidiary, King Tanning, which competed with LLL, the joint venture between Silveroak and Seton. The agreement provided for dispute resolution under the auspices of the International Chamber of Commerce. Seton was successful in arbitration proceedings held in Paris. The arbitration award of over $13 million was subsequently made an order of the South African High Court. During these proceedings, the relationship between Seton and the Kolosus management continued to deteriorate. Seton, dissatisfied with the manner in which Kolosus, as controlling shareholder, managed Ladysmith Leathers, offered to purchase Kolosus' share in LLL. However, bv invoking the 'texan clause' in the joint venture agreement, Kolosus elected to purchase Seton's share at the same price.

47. Kolosus then embarked on a rationalisation plan aimed at integrating the Silveroak businesses, properties and subsidiaries into Kolosus. The upshot was that Silveroak was effectively stripped of its assets. As the major creditor, Seton instituted liquidation proceedings against Silveroak. In the meantime Kolosus undertook a capital reduction, disposing of the loan account owing to Silveroak. In further legal proceedings, Seton, alleged that the capital reduction was unlawful, and was therefore able to establish Kolosus' liability for the arbitration award against Silveroak.

48. At the hearing before us Mr Trechack, a Seton executive, revealed that this saga had cost his company some $8.4 million in out-of-pocket, principally legal, expenses. Kolosus, for its part, suffered not only direct financial costs, but also indirectly, and perhaps even more severely, from the grave negative perceptions that permeated the industry. The OEM's insist on stability and long term supply relationships, and were therefore, it seems, increasingly

unwilling to rely upon a supplier whose financial stability was put under severe pressure by the outcome of the Seton litigation. Hence, we know, for example, that BMW ended its relationship with Kolosus, while other OEM's have shown reluctance to place large orders with Kolosus. In consequence Kolosus Automotive Leather's (previously LLL) currently enjoys a relatively insubstantial market share of approximately 5.5% of the automotive leather market.

49. Settlement of the Seton claim and the related litigation was thus effectively a precondition for establishing Kolosus on a sound footing. This was achieved when, on the 1st April 2003, Seton, Kolosus and Daun concluded a settlement agreement.

50. In terms of the settlement agreement Seton will receive an amount of US$ 5 million and 24.5% of the issued share capital in Kolosus. In return Seton will withdraw all legal action pending against Kolosus and its subsidiaries. The agreement also provides for the withdrawal and abandonment of all the liquidation claims against Kolosus and its subsidiaries.

51. Seton's shareholding in Kolosus is a passive one, it will not be entitled to board representation or participation in the management of Kolosus. In fact, the agreement stipulates that Seton is obliged to follow the vote of Daun in all shareholders' votes. Seton is granted a put option, which may be exercised at any time and in terms of which Daun is obliged to repurchase Seton's shares for an amount of US$ 1 million.

The establishment of Springbok Trading

52. In 1996, while the legal battle between Seton and Kolosus raged on, a group of African Hide employees, having secured financial backing from Mr Daun, severed ties with African Hide and formed Springbok Trading which rapidly established itself as the largest purchaser of raw hide in South Africa.

53. Kolosus was thus dealt a double blow. Firstly, it had lost heavily as a result of the Seton litigation. This not only imposed substantial direct financial costs on the group but it also seriously impaired the access of its automotive tanner, Kolosus Automotive Leather (KAL), to the OEM market. Secondly, while it was forced to grapple with the consequences of the arbitration award against it, it also had to contend with the rise of Springbok Trading and its attack on African Hide Trading, Kolosus' hide trading and primary tanning arm.

RELEVANT MARKETS

54. There are several distinct product markets implicated in this transaction.

55. As already noted, the merging parties are both active in the skins market (that is, sheep skin) as well as the hide market (that is, cattle hide).

The skins market

56. Both parties are active in the procurement of dorper and merino skins. The Commission's investigation into this market revealed that it is a highly competitive export market. We are satisfied that the transaction does not lead to a substantial lessening of competition in the skins market.

The hides market

57. Within the hide hide market there is, firstly, the market for the 'production' and sale of raw hides, which we will refer to as the **raw hide market**. The target company, Kolosus, participates in this market by virtue of its ownership of two feedlots, although it appears that these feedlots trade only with African Hide, Kolosus' subsidiary in the hide trading and primary tanning market. The acquiring company has, it appears, an exclusive trading arrangement with another feedlot, Sparta.

58. Although there is some importation of raw hides, they are perishable products and so, it appears, most of the raw hides tanned in the local primary tanneries are locally sourced. All indications are then that the raw hide market is a **national** market. Indeed several witnesses indicated that the premium, if any, on the price of hides that is generated by the local content requirements of the MIDP accrues principally to the sellers of raw hide.[6] That is, to say, at the raw hide level there is limited discipline exerted by the international market, in contrast with 'wet blue' hides, the product at the next level of the value chain. It appears that prices of raw hides are negotiated and hides are procured on a week-by-week basis.[7]

59. Secondly, there is the market in which the primary tanning activity is undertaken, which we will refer to as the **wet blue market**. This comprises three discrete activities. Firstly, the purchase of raw hides. Secondly, the conversion, through the primary tanning process, of the raw hide into a 'wet blue. Thirdly, the sale of the wet blue to the secondary tanners, who, in a

[6] See for example the testimony of Mr O'Neill on page 288 of the transcript of 9July 2003.

[7] In his testimony Mr Staples, stated that the bulk of Springbok's hides are negotiated for and purchased weekly. Page 574 of the transcript of 14 July 2003.

further tanning process, convert the wet blues into leather for particular industrial applications, most notably for our purposes, for the auto industry.

60. It appears that all those with primary tanning facilities are also traders in hides, that is, they purchase raw hides for on-sale as wet blues. However, not all hide traders necessarily own their own primary tanning facilities. African Hide has significant primary tanning capacity at which all raw hides purchased by it are processed into wet blues. As already indicated African Hide's primary tanning capacity exceeds its own requirements and so it undertakes contract tanning on behalf of other hide traders. Springbok Trading, on the other hand, although the largest trader (procurer of raw hides and seller of wet blues) has limited primary tanning facilities and rather contracts out this function to those who own these facilities including, it appears, African Hide.[8] Springbok Trading does, however, appear to be the exception. That is, the norm is for the larger traders to do most of their own primary tanning.

61. Both the Commission and the merging parties aver that the wet blue market is an international market. They point out that a significant portion of wet blues purchased by the automotive tanners for conversion into car seat kits is already imported and that the price of domestic wet blues is thus effectively disciplined by the international price of the product. They argue that, should the merged entity attempt to exercise market power in the wet blue market, their customers – the auto ('secondary') tanners – or even the OEMs themselves will procure their wet blue requirements on the international market.

62. We agree with this view of the geographic market for wet blues. Local demand for wet blues significantly exceeds the supply of wet blues converted from locally sourced raw hides which, as we later indicate, is determined by conditions in the red meat market. The Commission and the merging parties also point out that the prices of local wet blues are set at import parity. In fact the available evidence suggests that while prices do approximate import parity, if anything, local wet blues trade at a slight price premium. This is to be expected given the rebates earned by the OEMs and hence their preference for utilizing locally sourced wet blues. The MIDP obviously accounts for a built-in preference on the part of the South African-based OEM's for locally produced wet blues since these attract significantly enhanced MIDP benefits. On the other hand, all the evidence confirms that imported wet-blues are of a superior quality and yield than local wet-blues.[9]

[8] According to Mr Staples, Butterworth tannery produces 800 wet-blues a day and Riverside tannery produces approximately 1000 a day. This is significantly less than the capacity necessary to meet Springbok's requirements. Page 578 of the transcript of 14 July 2003.

[9] In the case of BMW for example, we are told that the demand is that no less than 75% local wet-blues are contained in any given order.

63. In summary, it appears that the **market for wet-blues is an international market.** However, locally produced wet-blues are afforded some protection by the MIDP benefits they attract. It is therefore predictable that a slight premium over the international price of wet blues is payable for locally sourced wet-blues. However, as we shall elaborate below, the size of the premium is kept firmly in check by the international procurement practices of the OEMs because while the local branches of the OEMs may have a strong interest in locally procured wet blues, their international companies – who are ultimately responsible for procurement – will have an overwhelming interest in an internationally competitive price and quality rather than in the level of subsidy that accrues to their South African operations.

64. Thirdly, there is the market in automotive – or, 'secondary' – tanning, the **automotive leather market**. The participants in this market purchase wet blues and convert them, through a tanning process and a sewing process, into car seats. The target company, Kolosus, is active in this market though its subsidiary, KAL.

65. As already indicated, the locally-based OEMs do not only procure car seat kits from the locally-based automotive tannery for installation into locally produced models. The rebates offered through the MIDP have enabled the locally based producers of automotive leather to participate in the OEMs' global procurement networks because they encourage the locally based OEMs to export as high a level of local componentry as possible. However, as already intimated, it seems clear that the procurement decisions for components, including seats, are made centrally by the various OEM parent companies who make their purchasing decisions purely on the basis of the price and quality of the product on offer. They will not make their decisions with a view to the rebate on local content potentially earned by their South African operation.[10] In summary then, while the local OEM subsidiaries have a clear incentive in ensuring procurement of South Africa produced components for the global operations of their companies, it seems that this can only be achieved by ensuring that local component producers are internationally competitive. It is therefore clear that if local producers of automotive leather do not price competitively, the international purchasing departments of the OEMs would simply purchase their automotive leather requirements elsewhere.

66. It appears then that the **geographic market for automotive leather is international**.

67. In conclusion then, there are three relevant markets implicated in this transaction. Firstly, there is a national market for raw hides. Secondly, we

[10] Ms Viljoen testified on behalf of BMW that in order to get the business from the parent company of the OEM, the finished leather must be priced competitively. See testimony on pages 176 ;180 and 190 of 9 July 2003.

have an international market for wet blues. Thirdly, there is an international market for automotive leather.

THE IMPACT OF THE TRANSACTION ON COMPETITION IN THE RELEVANT MARKETS

68. Viewed from a competition perspective, this merger embodies both vertical and horizontal dimensions.

69. Firstly, the merging parties compete in the wet blue market, hence the horizontal dimension. Indeed, they are – through the Daun subsidiary, Springbok Trading, and the Kolosus subsidiary, African Hide - the two largest South African participants in the wet blue market. That is to say both parties are active at the second level of the value chain as described in the diagram reproduced above. They procure raw hides from the feedlots at the first level of the value chain and secure their conversion, though the primary tanning process, into wet blues, that is, into hides suitable for further processing into automotive leather. African Hide processes into wet blues the raw hides that it procures at primary tanning facilities owned by it. In the case of Springbok Trading much of the primary tanning of those raw hides that it procures is contracted out to companies with the appropriate facilities, including African Hide.

70. Secondly, apart from its activities at the second level,the target company, Kolosus, is also active at the first and third levels of the value chain, hence the vertical dimension. At the first level Kolosus owns two feedlots. At the third level, that is, at the level of the automotive tanners who procure wet-blues from the primary tanners for further processing, Kolosus is represented by KAL.

71. Additional competition dimensions may arise from the purchase by Seton, another participant at the automotive tanning level, of a significant minority stake in the Kolosus group. Recall that Seton acquired its equity stake in Kolosus from Daun in part settlement of its (Seton's) claim against the target company. Seton's stake in Kolosus potentially embodies a horizontal dimension arising from Seton and KAL's presence in automotive tanning and a vertical dimension arising from Kolosus' presence in the first – the raw hide market - and second – the wet blue market - levels of the value chain.[11]

[11] Note that Kolosus owns two feedlots and Springbok has a contractual relationship with Sparta, another feedlot, that apparently gives Springbok privileged access to Sparta's raw hide supply. Sparta and Springbok also jointly own a tannery. This may suggest a horizontal dimension in the raw hides market as well arising from Kolosus' ownership of Taaiboschbult and Hurland and Springbok's relationship with Sparta. Although this represents such a small share of raw hide output that it does not portend a competition concerns, we will, for the sake of completeness, note this in our competition evaluation set out below.

72. The questions that must be answered are, firstly, whether market power is likely to accrue to the merged entity in the wet blue market. It may manifest market power in this market by monopsonistic conduct, that is, by forcing the price of its key input, raw hides, to sub-competitive levels. Alternatively, given the presence of the merged entity in the upstream raw hide market, we must ask whether it is likely to leverage power from the wet blue market to the raw hide market by imposing discriminatory purchasing and pricing practices that will favour its group interests in the raw hide market. That is, it may engage in input foreclosure.[12]

73. Secondly, we must ask whether the merged entity is likely to behave monopolistically in relation to its customers in the automotive leather market. That is, will it be able to impose an increase in price or reduction in the output of wet blues. Moreover, given the presence of the merged entity in the automotive leather market (conceivably exacerbated by its recent link up with Seton, a competitor in that market), we must ask whether the merged entity is likely to engage in customer foreclosure. That is, whether it is likely to leverage its power in the wet blue market in favour of its interest – KAL and, conceivably, Seton – in the downstream market, the market for automotive leather.

74. Note the centrality of the *wet blue* market in the core questions posed above. This is simply because, on the face of it, it is only in the wet blue market that the post-merger market shares portend a unilateral exercise of market power. As elaborated above, we must examine whether it will use its post-merger market share monopsonistically (in relation to its suppliers) or monopolistically (in relation to its customers). In addition it may use its post-merger position in the wet blue market to support its interests in the upstream raw hide market or in the downstream automotive leather market at the expense of its competitors in those markets. Although, as already intimated, there are minor horizontal impacts in the raw hide market and Seton's acquisition of a stake in Kolosus demands that we examine a possible horizontal dimension in that market, there is no prospect of the merged entity being able to exercise market power in those markets as a result of the transaction. We must however examine the prospect of a leverage of market power from the wet blue market to the raw hide and automotive leather markets.

75. We proceed to examine the impact of this transaction on competition in each of these markets.

[12] For a detailed discussion of foreclosure effects see the seminal work of Michael H. Riordan and Steven C. Salop – Evaluating Vertical Mergers: A Post-Chicago Approach (Antitrust Law Journal Vol 63, Winter 1995).

Competition Impact: the market for raw hides

76. Raw hides are offered for sale by the feedlots, commercial farmers and abattoirs. As already noted, the target firm owns two feedlots, namely Taaiboschbult and Hurland, both of which exclusively supply raw hides to African Hide Trading. The acquiring firm apparently enjoys an exclusive supply relationship with an independent feedlot, Sparta.

77. Even the combination of the three feedlots mentioned above accounts for but a small share of raw hides available on the market. In any event, it is clear from the evidence before us that, because the hide accounts for a relatively small share of the total value of the carcass, the supply of raw hides is a derivative of conditions in the market for red meat.[13] This alone would severely limit the likelihood of the merged entity restricting output from its feedlots even if, by so doing, it was able to price hides at supra-competitive levels.

78. By the same token there is no prospect of the merged entity utilising its position in the raw hides market to foreclose sources of raw hide supply to its competitors in the wet-blue market. In any event it appears that, to all intents and purposes, the supply of hides from the merging parties' feedlots is already dedicated to the respective parties to the transaction. The feedlots connected to the merging parties do not currently supply their competitors in the wet blue market with raw hides. Accordingly, the access of other hide traders to the output of these feedlots is already limited and so the prospect of the merged entity foreclosing its competitors in the primary tanning market does not arise.

79. This market will not be analysed further. We should however note the disturbing allegations made regarding the conduct of participants in this market. In particular, we note the evidence of Mr Venter and Mr Roets, which suggests that the feedlot owners regularly collude in fixing price and output levels.[14] While the merger does not increase the prospect of collusion in the raw hide market and so is not relevant to this evaluation, it remains a particularly disturbing allegation because, if true, it reflects on conduct in an important segment of the broader food market. The Commission is accordingly urged to investigate these allegations as a matter of urgency.

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[13] Mr Staples testified that the economic benefit of the carcass to the hide industry is approximately 12%. See page 595 of the transcript, 14 July 2003. See also Mr Venter's testimony on page 61 of the transcript, 8 July 2003.

[14] See page 7of the report of Mr Venter provided to the Commission during the investigation, which is page 433 of the record. Mr Roets also tesitified that his experiences with feedlots indicated to him that feedlots "talk to each other and they try to hold the prices up." See page 527 of the transcript of 10 July 2003.

Competition Impact: the market for wet blues

80. Wet blues are produced in the primary tanning process. The principal raw material inputs in this process are raw hides. These are purchased by hide traders and converted by them through the primary tanning process into wet blues. These, in turn, are on-sold to the automotive tanners. As noted the norm is for the larger hide traders to undertake the primary tanning process at their own facilities although the level of hide procurement of Springbok Trading vastly exceeds its primary tanning capacity and so it contracts out this function to other hide traders, notably including African Hide, also party to this merger. However, Springbok Trading retains ownership of the hide from the time that it purchases it from the feedlots – the first link in the value chain (its upstream market) - until such time as it disposes of the wet blue hide to the automotive tanners, the next link in the chain (its downstream market).

81. Springbok Trading and African Hide – respectively the hide traders within the Daun and Kolosus groups – occupy a powerful position within the wet blue market. There is some dispute regarding the precise market share of each of these firms. Market shares are outlined in the table below.

82. The Commission avers that between African Hide and Springbok Trading they procure slightly under 51% of all raw hide traded on the South African market. This includes imported raw hides. As already noted, the vast majority of raw hide processed in South African is locally sourced although there is some importation, almost entirely from the southern African region. The parties themselves undertake some importation of raw hides.[15]

[15] See Mr Roets testimony on page 512 of the transcript of 10 July 2003.

Table 2 - Market Shares in the Procurement of Raw Hides

Market Participant	Total hides including imports (annually)	Total market share %
African Hide Trading	***585 684***	***20.37***
Springbok Trading	***870 552***	***30.27***
EAC	312 000	10.85
Hidskin	234 000	8.14
CPC	540 000	18.78
Richard Kane	33 600	1.17
Britz Huide and Velle	180 000	6.26
Hart	120 000	4.17
Total	**2 875 836**	**100.00**

83. According to the Commissions data, as tabulated above, the parties combined market share would be 50.64%. During the hearing the merging parties submitted their revised figures, reflecting market shares of the total procurement of raw hides. On the basis of these figures, the combined market share post merger would be 47.21%

Table 3 - Parties revised Market Shares in the Procurement of Raw Hides

Market Participant	Total hides including imports (annually)	Total market share %
African Hide Trading	***585 683***	***18.95***
Springbok Trading	***873 286***	***28.26***
Total of hides (incl other participants)	**3 090 000**	

84. The combined market share of the merged entity *qua* purchaser of raw hides – as well as the accretion to this market share as a result of the merger - is clearly significant. It is these market shares and this accretion that underlies prima facie concerns regarding this market.

85. Arising from the merged entity's powerful share of the wet blue market, we must, firstly, determine the likelihood of it behaving monopsonistically vis a vis its suppliers, that is, exercising market power by pushing down the prices of raw hides to sub-competitive levels. Secondly, we must examine whether or not the merged entity is likely to practice 'input foreclosure', that is, is it likely to use its power in the wet blue market to exclude suppliers of raw hides other than those with which the merged entity is structurally or contractually bound (that is, the Taaiboschbult, Hurland and Sparta feedlots)?

86. It has not been suggested that the merged entity would be able to determine, through the exercise of monopsonistic power, the price of raw hides. On the contrary, several of the witnesses before us argued that power in the pricing of raw hides resided with the sellers of the product rather than the buyers. The South African based OEMs, incentivised by the rebates available through the MIDP, insist, as far as possible, on the utilization of locally procured raw hides. Largely in consequence of the MIDP incentives, the raw hide market is a sellers market, one in which demand consistently exceeded supply and which was thus characterized by upward pressure on price.

87. As to the prospect of foreclosure, there is no likelihood of the merged entity leveraging power from the wet blue market in order to privilege the raw hide suppliers with which it is linked. The hide procurement activities of the pre-merger Springbok Trading and African Hide significantly exceed the level of raw hide supply available from their 'in-house' feedlots. In fact the primary tanning capacity of African Hide exceeds the raw hide supply from its own feedlots. Accordingly, the post merger entity will remain dependent upon a supply of raw hides from feedlots other than its own and there is accordingly no prospect of it utilizing its power as a customer in order to foreclose the access of suppliers of raw hides to the wet blues market.

88. Arguably of greater *prima facie* concern, is the likelihood of the merged entity conducting itself monopolisitically in relation to its customers and competitors in the downstream market, that is, in the automotive tanners market. Expressed otherwise, is the merged entity likely to decrease the output of, and raise the price at which, the automotive tanners procure their supplies of wet blues? Secondly, is the merged entity like to engage in 'customer foreclosure', that is, is it likely to restrict the supply of wet blues to automotive tanners other than those that are part of its stable, namely KAL and, conceivably, Seton.

89. Again, as is to be expected, the merged entity's share of the wet blue market, that is to say, its share of the quantum of South African-sourced wet blues sold by the primary tanners to the auto tanners, as well as the accretion as a result of the proposed transaction, is considerable. Note that although the merged entity's share of the procurement of raw hides is a reliable indicator of its share of South African sourced wet blues on-sold to the automotive or secondary tanners, they are not identical. This is because not all wet blues produced in the secondary tanning process are suitable for use in the automotive leather tanneries. Hence, differences between the various secondary tanners as to the 'automotive yield' will account for differences between their respective shares of raw hide procurement, on the one hand, and, on the other, their output of automotive wet blues. The market shares revealed by the Commission's investigation are reproduced in the table below.

Table 4 - Market Shares in the Sale of wet-blues

Market Participant	**Total hides including imports (annually)**	**% Destined for automotive industry**	**Number of wet-blues**	**Market share**
African Hide	***585 684***	**80%**	**468 547.2**	**22.07744771**
Springbok Trading	***870 552***	**80%**	**696 441.6**	**32.81559041**
EAC	312 000	65%	202 800	9.555721163
Hidskin	234 000	93%	217 620	10.25402386
CPC	540 000	60%	324 000	15.26653677
Richard Kane	33 600	80%	26 880	1.266557125
Britz Huide and Velle	180 000	50%	90 000	4.240704658
Hart	120 000	80%	96 000	4.523418302
Total	**2 875 836**		**2 122 288.8**	**100**

90. According to the Commission's information, the merged entity's combined market share would be 54.89%. However, during the hearing the parties

disputed the Commission's assumption that the percentage yield of wet blues destined for the automotive market was as high as 80%. Instead the parties submitted that African Hide's automotive yield percentage is 48% and Springbok Trading's is 50%. On the parties calculation the combined market share for the sale of wet blues is 33.4%, less than their combined 47.21% market share of the raw hide market.

91. Although the merged entity will have a significant share of South African sourced automotive wet blues, this is unlikely to enable an exercise of market power vis a vis its customers, the automotive tanners, for the simple reason that the geographic market for automotive wet blues is, as elaborated above, international and not national. That is to say, should the merged entity attempt to increase the price or restrict the output of its product, their customers will source their requirements on the international market.

92. We have consistently adopted a cautious and sceptical response to the often glib claim that international supplies discipline domestic pricing. In this instance, this claim is strengthened by the absence of tariff barriers, but this does not necessarily make for a seamless relationship between the international and domestic markets. First, the MIDP does provide suppliers of locally sourced wet blues with a form of protection. Second, transport and other logistic costs must also be considered and, thirdly, the reliability of supply is inevitably compromised to a degree in those circumstances where a key input is imported. This is particularly significant in a context where the ultimate consumers of automotive leathers – the OEMs – are notoriously unwilling to hold inventories. Indeed, as we shall elaborate below, it is precisely the procurement policies and practices of the OEMs that is dispositive. That is, the OEMs have, largely in consequence of their global procurement practices, the means to prevent an exercise of market power from a nationally based supplier even one located several places up the value chain.[16]

93. Let us summarise the requirements imposed by the OEMs, on their suppliers, the auto tanners, who are the customers of the wet blue producers. Note at the outset that the OEMs source globally. That is to say, when an order for leather car seat kits is placed with a South African based auto tanner, the procurement decision is made at the global procurement office of the OEM. An order is placed for the seating for a model that may be manufactured at several of the OEMs production facilities across the world. One of these sites may be in South Africa but this is not necessarily the case. Or, it is possible that a certain portion of the order is placed in vehicles assembled in South Africa, some of which may be sold on the domestic market, others of which may be exported. As already elaborated, the MIDP provides an incentive for the locally-based subsidiary of these global OEMs to persuade its parent to

[16] Both the representatives from BMW and Daimler-Chrysler testified to the global procurement practices of the OEMs. See page 176; 180 and 256 of the transcript, 9 July 2003.

source as much of its component supply domestically as possible because the local content embodied in the component allows the locally based OEM to rebate the customs duty on imported vehicles. We are not aware that the rebate is necessarily passed on to the local consumers, and so it is wholly conceivable that a significant portion of it accrues directly to the bottom line of the local OEM. However, while the OEM parents may have an incentive to support their South African subsidiaries by procuring, though their international procurement offices, from South African sources, this will not extend to sourcing, for international markets, a component, the price and quality of which, is not internationally competitive.

94. These then are the requirements of the OEMs: a reliable source of automotive leather at internationally competitive prices and quality. Their local subsidiaries have, to be sure, a powerful incentive to export locally produced components to their parent companies and their manufacturing sites elsewhere in the world. But the incentive must, for the most part, translate into the domestic OEMs ensuring that they receive prices and a level of quality that compares favourably with competing products elsewhere in the world. Merely assisting their local subsidiaries to reduce the tariff on imports into what is, for every OEM, a very small market, cannot be sufficient incentive for an international OEM to accept, for its international production, components at uncompetitive prices and of uncompetitive quality.

95. The value of the wet blue hide is the most important part of the domestic value added. This is naturally why most of the OEMs insist on a minimum quantity of domestically sourced wet blues in the orders that they place with local auto tanners. All the evidence suggests that South African wet blues are smaller and of a somewhat lower quality than those available on the international market. It is thus highly unlikely that the local OEMs would tolerate a premium on the price of local leather – their MIDP incentive may incline them in this direction, but the ability of their parent companies to substitute from suppliers elsewhere in the world will place a strict limit on the premium that they will accept.

96. This then will limit an exercise of market power in the wet blue market regardless of the considerable share that the merged entity will enjoy of local wet blue production. The only way that it could exercise market power is if their customers, the auto tanners, were willing to absorb a price premium because the latter could not pass such a premium on to their customers, the OEMs.

97. If faced with an exercise of market power in the wet blue market, the local OEMs, because of the powerful incentive on their part to maintain internationally competitive prices of local wet blues, are likely to support the merged entity's competitors. There is already evidence of some of the auto

tanners directly procuring supplies of raw hide for conversion into wet blues.[17] Although engaging in raw hide procurement and wet blue production is clearly not a preferred activity for the specialist auto tanners, it is a wholly predictable response to an exercise of market power on the part of the merged entity and one that will undoubtedly be encouraged and facilitated by the local OEMs.

98. Similar considerations – and a similar response - would apply in the case of any attempt by the merged entity to foreclose supplies of wet blues, that is to discriminate with respect to prices and supplies in favour of auto tanners that are part of the Daun/Kolosus post merger group as in the case of KAL, or linked to it as in the case of Seton. Moreover, although KAL is operating at significantly below its full capacity, it appears that KAL (or even KAL and Seton) would not, on their own, be able to absorb all of the merged entity's output of wet blues. Nor, insisted several witnesses, would it be commercially viable for the merged entity to hoard supplies of wet blues.[18] In short, the merged entity will continue to rely on the custom of those auto tanners in competition with KAL and Seton. The only way that this could change is if the OEMs elected to favour KAL and Seton for their supplies of automotive leather. And this, as we shall elaborate below, is highly unlikely. We will, in our discussion below of the automotive leather market, further elaborate our grounds for believing foreclosure of wet blue supplies by the merged entity, particularly in favour of Seton, highly unlikely.

99. For the sake of completeness we should mention a third anti-competitive practice that potentially arises from this merger, a practice that potentially occurs in the interface between the two processes that characterise the wet blues market, namely the trading of hides and the tanning of the raw hides.

100. Primary tanning capacity is not consolidated to any significant extent in consequence of this merger. As already noted while one of the merging parties – African Hide – possesses significant primary tanning capacity, Springbok Trading's capacity is slight and thus it relies on contract tanning through, inter alia, African Hide. There is clear evidence of considerable excess tanning capacity at African Hide. The transaction clearly incentivises the Kolosus group to utilise African Hide for all of its primary tanning capacity. Accordingly, it is conceivable that other hide traders who, like Springbok, utilise African Hide capacity will no longer have access to this capacity or that they will only gain access at a price that discriminates between them and those within the merged entity. However, while, on the face of it, this prospect does arise there is no indication that it is, in fact, likely to occur.

101. Indeed the evidence before us suggests that African Hide is beset by excess capacity and, accordingly, that the prospect of this being utilised is a

[17] See the testimony of Mr O'Neill, page 287 of the transcript, 9 July 2003.

[18] See evidence of Mr Venter, page 104,8 July 2003. As well as the evidence of Mr Staples, page 581, 14 July 2003.

significant benefit flowing from the merger. That having been said, we do not know whether all of this capacity will be utilised even with the additional throughput of hides procured by Springbok, that is, there may well still be excess capacity after the merger and, to the extent that this represents a significant capital cost, the incentive to undertake contract tanning on behalf of other hide traders remains. Moreover, we are also not aware that other hide traders are dependent on African Hide for its tanning requirements. On the contrary – and as we have already indicated – the norm appears to be for hide traders to utilise their own tanning facilities and most of the traders of any significance appear to possess these facilities. There will clearly be small traders and new entrants who will be unable to engage in trading if they are unable to access tanning facilities but there is no indication that there is a primary tanning capacity constraint. In any event it appears that most of the very small traders – frequently referred to in the hearings as 'bakkie traders' – act as agents of the larger traders.

102. We conclude then that this transaction is unlikely to give rise to a substantial lessening of competition in the market for wet blues.

Competition Impact: the market for automotive leather

<u>Table 5 - Automotive leather tanners (auto-tanners)</u>

Market participant	% Market Share
Seton	**30.3**
Bader	25.3
Eagle Ottawa	24.3
Mario Levi	14.4
K.A.L	**5.5**
TOTAL	**100**

103. As already elaborated, it is in this market that the wet blues purchased – either locally or on the international market – from the primary tanners are converted, through, *inter alia,* a secondary tanning process, into finished car kits. With the exception of KAL, all of the participants in this market are wholly owned subsidiaries of multinational companies. Note too that market share is spread fairly evenly between the multinationals active in the South African market. Again KAL, with its significantly smaller market share, is the exception to this rule. Recall that KAL's precarious financial position had caused it to lose the custom of key OEMs, notably BMW, the largest procurer of South African produced leather car seats.

104. In relation to this market the transaction generates both horizontal and vertical concerns.

105. From a horizontal perspective, the Daun group did not, prior to this transaction, have a presence in this market, and so, on the face of it, horizontal concerns did not arise. However, the terms of the Seton agreement have resulted in the US multinational owning a significant stake in Kolosus and, hence, in Seton's competitor, KAL. However, Seton's acquisition of this stake is not treated as a separate merger for the purposes of this notification and this because there is no question of Seton having achieved any degree of control over Kolosus or any of its subsidiaries. Seton's stake in Kolosus is a fraction under 25% which means that it does not possess the votes necessary to block special shareholder resolutions. Nor will Seton be represented on the board of Kolosus. Control of Kolosus is firmly in the hands of the Daun group.

106. Nevertheless, we are, predictably, left with a residual degree of discomfort at this arrangement between competitors. The passive nature of Seton's investment in Kolosus notwithstanding, it is difficult to believe that this relationship does not enhance the likelihood of, and opportunity for, co-operation between Seton and KAL. However, it is not clear that co-operation between Seton and KAL – albeit, potentially in contravention of the Competition Act – would assist the competitors in achieving market power. There are three other well-established competitors with significant activity in South Africa. Moreover, as elaborated above, it appears that the OEMs source globally and that their decisions are driven by price and quality considerations. Accordingly, in the unlikely event that the South African auto tanners attempted to exercise market power, the OEMs would turn to the array of alternative sources of supply in the international market. In general it appears that the buyer power of the OEMs – already considerable and qualitatively enhanced by the globalised character of their procurement arrangements – will counteract any attempt to exercise market power, particularly a localized as opposed to globalised attempt at exercising market power.

107. Indeed, the vertical dimensions of this transaction and of Seton's involvement are, if anything, somewhat more disturbing and so we have considered the likelihood of the merged entity foreclosing supplies of wet blues to the auto tanners at some length already in our discussion, above, of the wet blue market. On balance we consider it to be an unlikely consequence of the merger. The Daun group has given us the usual assurances that the various component elements of the Kolosus group will operate at arms length to one another, that, in effect, the performance of each company within the Kolosus group will be assessed by reference to its own profitability rather than by reference to its subsidization of profits earned elsewhere in the group. We are not inclined to assign much weight to these assurances. However, there are other factors that militate against foreclosure.

108. There is no apparent incentive for Kolosus to support foreclosure in favour of Seton – neither Kolosus nor its controlling shareholder, Daun, has an interest in Seton. Foreclosure by the post merger hide traders in favour of Seton and KAL only makes sense as part of a strategy to collectively dominate the automotive leather market. As already elaborated we believe that the OEMs would not accept dominance of this market and, more important, that the structure of both the automotive leather and wet blues market provides both the competing automotive leather producers and the OEMs with the means to resist any attempt by Seton and KAL to achieve dominance of their market through foreclosure.

109. Moreover, our residual discomfort notwithstanding, we are constrained to acknowledge that, Seton's stated rationale for accepting, indeed for insisting upon, a bloc of Kolosus equity in part settlement of its claim against the latter, does appear to make commercial sense. We have been assured by a number of witnesses that KAL possesses world-class plant and equipment. This, in combination with Daun's financial backing and the added value of his well-established relationship with the OEM's, should provide the basis for KAL to compete vigorously in its market. Indeed given the shortcomings attributed by some witnesses to both Kolosus' erstwhile shareholders as well as its management, there is a reasonable expectation that the combination of Daun's entrepreneurial flare, his managerial experience and skill and his financial strength will reap the benefits envisaged by Seton and, hence, vindicate its decision to take a passive equity stake in Kolosus.

110. It is, of course, eminently conceivable that without settlement of the Seton claim, Kolosus – and hence KAL – would not have been rescued at all. In that eventuality KAL may well have exited the market. Although on the face of it, an attractive prospect for Seton, on closer examination the US producer is probably better off with the present arrangement. Certainly this enables it to recoup a significant potion of the costs of its protracted litigation with Kolosus. And if Seton's confidence in Mr. Daun – and in the ability of the stock market to mirror his ability – is vindicated, then, particularly given the present depressed level of Kolosus' share price, considerable upside may be realized on the appreciation of the value of Seton's stake. It should also be borne in mind that KAL's present market share stands at only 5,5%. Given that, had it exited the market, this share would, in all likelihood have been distributed between the remaining players, the increment that would have accrued directly to Seton as a result of KAL's demise would have been very small indeed.

111. Put against this, of course, is the fact that by agreeing to settle its claim with the new owners of Kolosus, Seton has breathed life into what appears to be a terminally ill competitor. If the pattern of market share that currently prevails between the four multinational auto leather producers extends to cover a reinvigorated KAL, then we would expect the latter to grow up to something

approximating one-fifth of the total market. In the process it will take market share away from all of the existing producers, particularly Seton, Eagle Ottawa and Bader. Again, Seton will, in all probability, give up a relatively small portion of its market share to KAL while through its stake in KAL it will derive a 25% share from the additional business taken by KAL from Seton and all its competitors – that is, while in respect of the business that Seton loses to a post-merger KAL, it will effectively replace a 100% share with a 25% share, in respect of the business gained by KAL from Seton's competitors, Seton will receive a 25% share where previously it had none. The alternative scenario is that KAL is liquidated, falls into the hands of a new entrant, which then gains market share. Clearly , for Seton this would be a less favourable scenario.

112. We conclude, then, that this transaction is unlikely to give rise to a substantial lessening of competition in the market for automotive leather.

Countervailing power

113. Many of the witnesses have argued that the countervailing power of the OEMs will prevent an exercise of market power on the part of the merged entity. While, as already indicated, we agree that the OEMs are able to resist an exercise of market power on the part of a domestic supplier of components – and thus may colloquially be said to possess 'countervailing power' – we should clarify that this power resides not in the mere size of the OEMs and the level of resources at their command, but, rather, in the structure of the market for the sale and purchase of auto components.

114. The notion of countervailing power suggests that large, well-resourced buyers are better placed to resist an exercise of market power on the part of a monopolistic supplier than less well-resourced and more atomized consumers. However, this proposition, although, on the face of it, self evident, requires closer examination. In our view there are two mechanisms uniquely open to larger purchasers that may be employed to resist efforts on the part of their suppliers to exercise market power.

115. Firstly, a powerful buyer, because it often has power in its own market, will, if faced with supra-competitive pricing by key suppliers, generally be able to pass on any increase in the cost of its inputs to its customers. In other words a powerful purchaser is, *because of its power in its own market*, able simply to share in the monopoly rents derived from its supplier's exercise of market power. Certainly, this mechanism appears to have been revealed in some of our earlier merger enquiries.[19] Hence countervailing power, understood as a

[19] For expample in Nestle (SA) (Pty) Ltd and Pets Products (Pty) Ltd and Others, Tribunal case no. 21/LM/Apr01 the Tribunal found that even though the retail buyers were powerful, there was no incentive for them to exercise countervailing power, since any price increase by a manufacturer would simply be passed on to the consumer.

large well resourced purchaser dealing with a monopoly supplier, may well provide comfort to the buyer but it does not necessarily avail the final consumer any.

116. However, it seems reasonable to hypothesise, even in the absence of a detailed market analysis, that although the OEMs are indeed large and powerful corporations, they nevertheless do not individually possess power in their own markets precisely because these are competitive markets. Hence, despite their considerable size and evident power, they would nevertheless be hard put to simply pass through cost increases to their customers. Although it seems counter-intuitive, even slightly offensive, to cast the BMWs and Daimler Chryslers of this world in the mould of victims, the reality is that, if faced with an exercise of market power by a key supplier, they would, like any other consumer, have to stump up the monopoly rent demanded by their supplier. Mere size does not inure a purchaser from the effects of an exercise in market power.

117. Secondly, purchasers with access to the unusual level of resources commanded by the average OEM may, in the face of an exercise of market power on the part of a supplier, elect to produce their own supplies of the monopolized input. But this would be an extraordinary and, most likely, inefficient expedient. It rows against the tide of firmly established developments in manufacturing generally and in the auto manufacturing sector in particular. Long gone are the days of massive fully integrated motor assembly plants producing everything from steel to the final consumer product, the fully assembled automobile – the auto assembler is precisely that, an assembler of a range of component inputs produced by independent firms at hundreds of plants which are located, increasingly, across the globe. In short, the OEMs are not car seat manufacturers and they would be extremely hard put to set up their own auto tanning capacity.

118. A less dramatic alternative – but, arguably, a variant of the same inefficient compromise with the prospect of market power - is for the OEMs to spread their purchases so as to ensure the continued existence of a range of suppliers of each of their components.[20] There is, indeed, already evidence of this in the peculiar symmetry in the auto leather market, in the unusual equality of market share between the various auto tanners. We can clearly infer from this that if the merged wet blue producers attempted to favour the downstream auto tanners to which they are connected, this would meet resistance from the OEMs who would insist on maintaining the even spread of purchases that is already evident. In the event that the OEMs were

[20] In CHC Helicopter Corporation and Helicopter Services Group ASA –case no. CM 4556 (2000) the UK Competition Commission found that the buying power of the oil companies was such that they would and could encourage new entry if they were dissatisfied with existing helicopter operators. The credibility of this threat would influence the behaviour of the helicopter operators, making them less inclined to take advantage of any reduction in competition.

confronted by an attempt to exercise market power in the auto leather market, the OEMs have ensured the existence of a number of well-resourced, stable alternative sources of supply.

119. However, the true site of OEM power vis a vis the South African based auto tanners does not lie in the fact that the former are large and powerful corporations while the latter are relative minnows by contrast. The source of their power is that the market for auto leather is an international market and, whereas the OEMs organize their production globally and procure globally, the local auto tanners are effectively national producers. In short an auto tanner – even one that through merger or by other means achieved a dominant position relative to its national counterparts – would at best attain the status akin to that of a large fish relative to the small pond in which it swam. The OEMs, on the other hand, are large fish in a very large ocean in which there are a number of equally formidable fish. These large swimmers in international oceans may not be able to destroy their counterparts, the other large fish. But they are certainly capable of taking on those whose area of operation does not extend beyond their domestic waters, if necessary by simply deserting a hostile domestic pool for the vast expanse of friendlier oceans elsewhere. In short, the question then of where power resides in this value chain, is answered through a familiar analysis of markets and market power. In an international market, the international players are well placed to counter any pretensions to market power on the part of a domestic supplier.

EFFICIENCIES

120. Since we find that the merger does not lead to a substantial lessening of competition, we do not need to examine the expected efficiencies.

PUBLIC INTEREST

121. The only public interest matter raised by this merger is in the area of employment. In their submissions to the Commission, the parties estimated that, on a worst-case scenario, the merger would give rise to 150 retrenchments. However, at the hearing, Mr. Bischoff revealed that Kolosus had already embarked on a retrenchment programme affecting 107 African Hide employees. He insisted that these retrenchments did not result from the merger and that, accordingly, they were to be distinguished from the 150 merger specific retrenchments, which, he confirmed, remained the parties' worst-case scenario.

122. Two unions – SACTWU and SAFATU – made submissions to the Commission and participated extensively in the hearings. SAFATU initially asked that the merger be approved subject to the condition that there be no employment loss resulting directly or indirectly from the merger for a period of 24 months but later submitted that a period of 12 months would be

appropriate. SACTWU appeared to have recognised that an outright prohibition portended the possible failure of Kolosus and a consequent risk of far greater employment loss. They too asked that we impose a condition protecting employment, essentially requiring that the company maintain pre-merger levels of employment. Even then SACTWU appeared to concede that, should the imposition of a condition unacceptable to the acquiring party cause it to walk away from the transaction, the risk of failure on the part of Kolosus portended a considerably greater scale of job loss than that estimated by the acquiring party. SACTWU's stated preference was for an undertaking from the parties which would then be made part of the order of the Tribunal. It seems clear however, that nothing short of an undertaking to maintain its entire workforce would have satisfied SACTWU's requirement. In any event, no such undertaking was forthcoming from the merging parties.

123. In addition, SACTWU asked for the imposition of conditions relating to the maintenance, at current levels, of wages and employment conditions. They also asked us to impose a condition that would oblige the merged entity to continue its membership of the applicable industry-wide centralised collective bargaining system.

124. The unions have forcibly pointed out that we are obliged to consider the public interest impact of a merger transaction in arriving at our ultimate decision. They are, of course, correct. This is, however, consistent with the view that we have previously taken – and that we confirm here - that it is incumbent on an un-elected, administrative tribunal, principally charged with defending and promoting competition, to approach its public interest mandate with great circumspection.[21] We derive some comfort from the knowledge that each of the elements of public interest that we are obliged to consider are protected and promoted by legislation and institutions specifically designed for that purpose – hence, the merged entity would not be able to alter unilaterally employment conditions and agreed bargaining arrangements. While this cannot provide the basis for us shying away from tough decisions, it does place our own role in these matters in correct perspective. At most, our role is ancillary to these other statutes and institutions; it is supportive of their general thrust and should, by and large, not be employed as a substitute for, and in order to second-guess, these other interventions.

Wage, employment conditions and collective bargaining structures

125. In our view this (that is, second-guessing industrial relations policy and practice) is precisely what is asked of us when SACTWU urges the imposition of conditions with respect to the level of wages and working conditions and,

[21] See the following Tribunal merger decisions: Unilever/Robertson Case No: 55/LM/Sep01, Shell/Tepco Case No: 66/LM/Oct01and Distell Group/Stellenbosch Farmers Winery Case No:08/LM/Feb02.

particularly, the structure of collective bargaining. The industrial relations framework in South Africa has moved decisively away from the administrative and statutory prescription of collective bargaining frameworks and outcomes to one that overwhelmingly favours industrial self-governance within a statutory framework. The statutory framework itself was, and continues to be, the product of extensive negotiation involving government and organised labour and business. It cannot be that the legislature, having painstakingly constructed a comprehensive statutory framework for industrial relations, intended that an administrative tribunal, with no expertise or standing in the area of industrial relations, should impose its own framework and substantive provisions on a firm that came before it in order to have an intended merger adjudicated. This would constitute an intolerable level of policy intervention on the part of the Tribunal. We say this cognisant of the evidence presented regarding Mr. Daun's proclivity for disturbing, in the wake of an acquisition, longstanding collective bargaining arrangements and re-opening negotiated wage agreements. What if we were to impose, say, an effective minimum wage only for the parties to later mutually agree that economic circumstances and the particular interests of their respective principals, justified a departure from our order? In short, to enter, in the fashion advocated by SACTWU, the realm of industrial relations would significantly extend our public interest mandate and would, moreover, court conflict in a sensitive area for which we have only a limited responsibility or technical competence.

Level of employment

126. It could reasonably be argued that similar considerations apply to our role in determining, through the imposition of conditions, the level of post-merger employment. Here too, employees could not be retrenched by the merged entity without following the statutory procedures and other negotiated provisions governing retrenchment. However, because of the powerful link between direct employment loss and a restructuring initiative like a merger, it is undoubtedly in this area that the legislature intended a role for the competition authorities. In contrast then with the other conditions proposed by SACTWU we are confident that the Act empowers us to stipulate conditions with respect to the scale of job loss occasioned by the merger.

127. But this, too, is a complex determination. Mr. Daun, in conformity with his reputation as a turn-around specialist, is acquiring a highly distressed company. Although the unions have argued that the intervention of Mr. Daun does portend the revival of the company and, as such, a rosier perspective on employment prospects going forward, there can be little doubt that this eventual turn-around is predicated on a cost-cutting exercise. The parties have pointed out that the ratio of output to employment (that is, labour productivity) at the Kolosus subsidiary, African Hide, is considerably lower than that at Springbok Trading. Hence in the short-term, at least, it is difficult to envisage increasing productivity without some measure of employment

reduction. For this reason, we do not believe that it would be appropriate to for us to impose a condition freezing employment levels at pre-merger levels.

128. With respect to cost-cutting then we must proceed with caution. To prohibit retrenchment altogether, may turn out to be self-defeating insofar as it will likely inhibit the revival of Kolosus and so prove a threat to longer term employment prospects. We insist that we are obliged to take a somewhat longer-term view of the employment question than that contended for by the unions – there cannot be a rosy prospect for maintaining employment levels in an ailing company and, by protecting present employment levels, we may well be storing up greater problems in the medium term. We concede that there is an eminently respectable argument that holds that by placing a floor under wages and employment levels, the merged entity will be encouraged to turn to productivity enhancing measures other than retrenchment. But we cannot judge the capacity for the introduction of these measures in this firm. We note however that this is a determinedly low-tech area of economic activity that does not appear to pre-dispose to the introduction of new technologies or work processes. We also note that the introduction of alternative mechanisms of productivity enhancement, particularly the introduction of new technologies, will, in the short-term certainly, also be at the expense of jobs.

Number of Retrenchments

129. When the transaction was first notified to the Commission on the 13 February 2003, the parties stated in Schedule 2 of the notification :

> *"Kolusus employs a total of 2010 employees. It is difficult to determine the extent of any restructuring. In order to effect a turnaround in certain of the loss making divisions some restructuring may be necessary. It is anticipated that , in a worst case scenario, approximately 150 of the total employees of the Kolosus group will be retrenched as a result of the merger."*

130. It also states that "if the merger succeeds and the appeal (*Seton)* fails, Daun is confident of being able to negotiate an economically viable settlement with all the settlement benefits arising therefrom including employment stability."

131. Kolosus, in its notification did not state that it was considering or undergoing a retrenchment process based on its financial situation and therefore unrelated to the merger . In fact it was only at the pre-hearing conference, on the 22 May 2003 that the parties disclosed, much to the consternation of the trade unions, that Kolosus was initiating the retrenchment of a 107 employees. Given the total labour complement of Kolosus, 150 retrenchments is significant enough to warrant concern, the more so if the 107 retrenchees now revealed worsen the 'worst case'.

132. As noted in their submissions to the Commission, the parties themselves volunteered that employment loss of 150 represented their worst-case scenario. It is, with the level of information at our disposal, naturally very difficult for us to second-guess this assessment and the unions have not been able to assist us. Throughout the hearing the parties pointed out that this figure was submitted without the benefit of a full investigation and they continued to vacillate as to the number of retrenchments. In his closing submission, Mr Le Grange, legal representative of the merging parties, stated that:

> *" The exact nature of these integration activities are not a 100% clear yet. The timing of when the integration may possibly occur is also not 100% clear yet. It is very difficult for the parties to estimate exactly what the effect on employment would be. In the merger documents submitted by the parties, they indicated that they expected that approximately 150 job losses would occur as result of the merger.*
>
> *It was apparent in both Mr Schouten and Mr Bischoff's evidence that, in fact, they were unsure of exactly what the total number of retrenchments would be, taking into account the fact that retrenchments had been necessitated due to operational requirements. We believe that the position at the moment is that the parties have not formally approached the trade unions yet as far as talking about the state of employment or retrenchments after the merger but that there has been a level of informal discussions. "* [22]

133. With regard to whether the 107 retrenchments were included in the 150, Mr Le Grange responded as follows"

> *"As far as the question is concerned of whether the 150 employees, which we estimated initially would be retrenched as a result of the merger, actually includes the 107 which have been identified during the current retrenchment activities. I think that Mr Bischoff and Schouten had difficulty in estimating the extent of those retrenchments and we would request that the Tribunal take notice of the fact that the level of retrenchments, which are required, would depend upon various factors."* [23]

134. In fact, the parties adopted an inconsistent approach in respect of the likely outcome of the merger: On the one hand they were consistently optimistic that the disposal of the Seton claim would be good for the business, on the other hand they remained pessimistic about the impact on labour. Furthermore, we were not persuaded that Daun had insufficient knowledge of

[22] See pages 823-824 of the transcript of 25 July 2003.
[23] See pages 824-825 of the transcript of 25 July 2003.

the target business to enable an exact appraisal of the employment loss, particularly since Daun had assumed the bank debt and, so, has certainly had privileged access to the doings of the target company. It is also clear that the acquiring party is very experienced in this area – not only are Mr. Daun and his managers extremely experienced in identifying cost-cutting opportunities, but the Springbok Trading managers are all former African Hide managers and so possess intimate knowledge of practices at the target firm. In this particular instance, the level of redundancy is ameliorated by the acquiring party's intention to maintain the separate existence of African Hide and Springbok Trading.

135. For these reasons we are unwilling to concede that it is now necessary to up this figure by a further 107 employees as contended for by Mr. Bischoff. If the parties have mis-specified their worst-case scenario to this extent, then there is a clear inference that they intentionally downplayed their worst-case in order to smooth their passage through the Commission.

136. It must be emphasised that the the notification requirements exist precisely to ensure transparent disclosure of all material aspects of the transaction at an early stage. This is intended to allow the competition authorities and, with regard to labour issues, the trade unions to react accordingly. It is improper for the notification forms to be "sugar-coated" merely to ensure a favourable reaction, while later in the process, less favourable facts are disclosed, particularly when the number of retrenchments is as significant as in this case.

137. We also take cognizance that it is rather easy for companies to disguise merger related retrenchments so that it would appear that these would occur even absent the merger.

138. These practices are strongly discouraged and the importance of transparent and bona fide disclosure is once again emphasised. It is these concerns that motivated the imposition of the condition to the merger.

Conclusion

139. We have accordingly elected to hold the parties to their word and have imposed a condition on our approval of the merger limiting retrenchment to 150 people for a one year period from the date of the order, that being the 29th July 2003.

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D. Lewis

17 September 2003
Date

Concurring: N. Manoim, T. Orleyn

For the merging parties:	Mr A le Grange, Hofmeyr Herbstein & Gihwala Inc
For the Commission:	Ms L Mtanga assisted by Mr M van Hooven, Competition Commission.
For SAFATU:	Mr P Motaung, Maserumele Inc.
For SACTWU:	Mr M Bennett and Mr E Patel.