COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 23/LM/Apr02

In the large merger between:

Pioneer Foods (Pty) Ltd

and

SAD Holdings Limited

Reasons for Decision

APPROVAL

On 2 July 2002 the Competition Tribunal issued a Merger Clearance Certificate approving the merger between Pioneer Foods (Pty) Ltd and SAD Holdings Limited in terms of section 16(2)(a). The reasons for the approval of the merger appear below.

The Parties

1. The acquiring firm is Pioneer Foods (Pty) Ltd ("Pioneer"), a wholly owned subsidiary of the Pioneer Food Holdings Ltd.

2. The target firm is SAD Holdings Limited ("SAD"). It has various subsidiaries including SAD Wingerdvrugte (Pty) Ltd, SAD Boomvrugte (Pty) Ltd, SADOR Boerdery (Pty) Ltd, Elim Veldblomme (Pty) Ltd, Cape Dried Fruit (Pty) Ltd and Laeveld Neute (Pty) Ltd, to name a few.

The Merger Transaction

3. Pioneer will purchase all of the shares in SAD. Accordingly Pioneer will,post-merger, own SAD and all its subsidiaries.

Rationale for and Background to the Transaction

4. Pioneer was formed from the merger of the Sasko and Bokomo co-operatives. Sasko was primarily active in milling and baking, while Bokomo had diverse interests in milling, baking, poultry, animal fees and branded consumer goods. Today, milling and baking still account for 70% of

Pioneer's activities, despite it being a highly diversified food group, housing 20 well-known brands.

5. As part of its strategic diversification, Pioneer seeks to further broaden its offering of consumer products in order to become more competitive. In a highly competitive retail market, shelf space is everything and it is hard to compete with a limited range of brands. Since SAD has a thriving export business, Pioneer hopes to expand internationally. It states that with its economies of scale as a result of their sales and merchandising, marketing and distribution activities in the market, it will complement the activities of SAD.

6. SAD was founded in 1908 and operated until 1993 as a dried fruit farmers' co-operative. In 1993, under the spectre of deregulation, the group decided to expand into a food business and, to this end, started acquiring a variety of other businesses. SAD views the merger as enhancing its ability to compete effectively in the food sector by boosting its status from a medium-sized enterprise to achieve the critical mass necessary to be able to compete effectively as a large player, both vis-à-vis other food manufacturers, as well as retailers. It cannot continue to stand alone if it wants to complete its capital expansion programme for manufacturing.

7. Nature's Source started operating in the early 1990's as a small-scale, entrepreneurial home-based operation. Founded by two South African entrepreneurs who developed a unique-mix quality muesli formula, the business quickly expanded in response to ever-increasing consumer demand for its product. In 1998, a private equity firm, Aquila, acquired a 40% stake in the company, in order to enable it to raise finance. SAD then bought Nature's Source in 1999 and it became SAD's wholly-owned subsidiary. Nature's Source was acquired to complement its existing range of food products, providing it with much needed manufacturing finance. They retained the existing management until this year. Nature's Source will however not be able to finance further growth if the status quo is retained.

The relevant product markets

8. Presently, Pioneer owns five business divisions, namely **Sasko Milling and Baking** (producing wheaten flour, maize flour, breads, bake mixes, pasta and rice), **Pioneer Agri** (farming and selling of commercial eggs and broilers, manufacture of animal foods), **Bokomo Branded Foods** (hot and ready-to-eat cereals and other breakfast products, frozen foods, jams and preserves, glazed fruits and bottled fruit and vegetables, **Bokomo Africa** (chicken farming, milling and baking in other African countries) and **Craft Box Packaging** (corrugated carton production).

9. SAD operates in various business areas through its various subsidiaries. These markets include nuts, vinegar, dried flowers, dried fruit, wine, food enhancers, soup, beans, noodles, dehydrated vegetables and salads.

10. The focus of analysis is on only two markets where there is a product overlap, namely the breakfast cereal market, particularly **ready-to-eat (RTE) cereals** and **jar vegetables (salads)**. The relevant market is therefore the **ready-to-eat (RTE) cereals** market on the one hand and the **jar vegetables (salads)** market on the other.

Geographic market

11. Products are sold to retailers throughout the country, with minimal import competition, therefore the relevant market is South Africa.

A. The Jar Vegetable/Salad Market

12. SAD manufactures and sells its jarred vegetables under the Werda brand. Pioneer too prepares bottled salads, through its Sugarbird division, but only house brands for the supermarkets (retail chains) and does not sell under its own brand name.

Impact on competition

Salads/Jar vegetables

Tiger Brands	44%
Pioneer (house brands)	12%
SAD	24%
Others	20%
Post-Merger	**36%**

13. Despite high concentration levels in this market, the Tribunal was persuaded by further investigation which revealed that entry barriers into this market are low, since technological requirements and set-up costs are minimal. As a result, there are many speciality stores and home industries which service this market. Supply elasticity is high for any producer already having bottling capability, of which there are several. Of significance is the fact that Pioneer only manufactures house brands for the retailers and has no brand equity in this market. Accordingly, the merging parties pointed out that Pioneer is disincentivised from raising prices, since should they do so, retailers could easily find another producer to manufacture their own brands, and Pioneer would lose market share. A final persuasive factor is that the size of the bottled salad market is very small, relative to the formal retail food market and since Tiger Brands is the dominant player in this market, the instant merger will not change the status quo.

14. Accordingly, the Tribunal's focus of consideration in this merger falls on the RTE cereal market.

B. The Ready-To-Eat (RTE) Cereal Market

15. SAD operates in the RTE market through its Nature's Source subsidiary. Pioneer manufactures hot and ready-to-eat (RTE) cereals through its Bokomo branded food division.

16. The evidence further revealed that breakfast cereals comprise hot cereals, and muesli products, based on consumer preferences. If one takes the cereal market as a whole, specifically because of its dominance in the hot cereal market, Tiger Brands would be the prominent player. On the other hand, looking at the branded cereal market, Kelloggs is dominant. However, in the muesli market, Nature's Source is dominant. Therefore, the market positions vary depending on how we define the market. We could, strictly speaking, define the market more narrowly. However, there is evidence of a high degree of substitutability between these different cereal types, particularly between muesli and RTE cereals.[1] The evidence revealed that consumers prefer, and indeed tend, to select from a wide array of cereals within the RTE market, and this includes different types of muesli products. Consumer demand is very elastic and they will readily switch to substitute products in response to price increases. Furthermore, though muesli might occupy a separate "niche" market, in any event, as will be discussed later, the barriers to entry into this market are quite low.

Impact on competition

17. As evident from the market share figures below, the merging parties are the number two and three manufacturers in the RTE market. This, together with the high concentration levels, necessitated a closer evaluation of the RTE cereal market.

Market Shares

RTE Cereals

Kellogg	51.5%
Pioneer (Bokomo)	35%
SAD (Nature's Source)	8.5%
Own Brands	3.5%
Others	1.5%
Post-Merger	**44%**

[1] The parties went to great length, by means of price and cross price elasticity studies, to persuade us that the relevant market is RTE cereals, with no further subdivisions into narrower markets based on product categories, in other words, consumers regard all RTE cereal products as interchangeable. Other jurisdictions have also accepted this market definition of the cereal market (see State of New York v Kraft General Foods Inc, Nabisco Cereals 1995 926 F. Supp. 321)

Barriers to Entry

18. Generally, large-scale cereal manufacturers face high entry barriers in the form of costly capital equipment ("process technology") and huge investments in advertising and promotional activities. From the oral evidence presented at the hearing, it appears that, to the extent to which the local RTE market is brand-driven, brands, too, constitute significant entry barriers. The Kelloggs "premium" brand is internationally well-established, thanks to significant advertising expenditure and many years of reputation-building.

19. However, what is peculiar about the South African RTE cereal market is that though all products in this market are readily substitutable, there are products which compete in the "mainstream" and those which compete on the fringes. Small-scale producers, notably producers of muesli, differentiate their products by catering to a health conscious or higher-income niche market. On the other end of the scale, large manufacturers mass produce products to meet the volume and consistency of supply requirements of the large retail chains. Not only the volume supply requirements of the retailers, but the brand-driven nature of the market, the high capital expenditure on "process" technology, as well as costly marketing and promotional strategies, mean that the smaller, single brand products are faced with a limited ability to compete at this mainstream level. This is an industry in which critical mass *is* crucial in order to capture market share from reputable and established players.

20. On the other hand, in their favour, the smaller cereal manufacturers face lower entry barriers relative to their larger, mainstream competitors, who must invest huge amounts on both technological process equipment and advertising. According to the Commission, barriers to entry in the manufacturing of muesli are very low.[2] The inputs are primarily raw products such as flaked oats, which are then mixed and possibly baked in either microwave or conventional ovens. Therefore, the opportunities for new entrants to enter this market are fairly good. Further, the evidence at the hearing revealed that retailers actually support these smaller competitors to roll out new brands, in the form of affording them greater shelf space at lower cost, to offset the might of their larger counterparts. Therefore, muesli manufacturers who operate at the periphery of the market, can enter the market relatively easily. The parties advised that there are in fact a number of small-scale muesli manufacturers in the market already, including Post Muesli; CMC, selling through retail only under the name Alpen; Tristar Foods, which sells through retail stores such as Pick 'n Pay and is designed for diabetic consumers; Vital Health; TL Sugar-free Muesli, mainly sold in fruit and vegetable city stores and finally Pouyoukas Foods recently acquired by the Steers Group. However, once

[2] This market was described as the most volatile in the RTE market.

they have entered, there is a wide chasm they have to cross before they can compete at the Kelloggs and Pioneer Foods' level.

21. Nature's Source lies somewhere on the cusp between these large mainstream brands and the small fringe brands. The Managing Director of SAD stated at the hearing that Nature's Source is a high-quality premium product, compared to other muesli products. It caters for low fat, diabetics and low cholestrol diets. It is manufactured slightly differently in that it undergoes microwave baking. However, not having the money to invest in marketing makes passage into the main line cereal business very difficult, as explained below.

Is an Effective Competitor being removed?

22. Post-merger, Pioneer will have approximately 44% of the RTE cereal market. As mentioned already, Nature Source is not an effective competitor per se, since it does not have the technology nor the differentiated product range available to compete at the large-scale, mass producer level. Although Nature's Source is a number three competitor which is being acquired, being a medium-sized player with a limited product range, it does not compete in the mainstream, large-scale end of the RTE market, as do Pioneer and Kelloggs.

23. Moreover, the evidence reveals that Nature's Source has in fact been losing market share over the last few years. The parties attribute this to a lack of capital financing for dedicated advertising and investing in brand-building. This lends credence to the argument that its status as a strong, independent competitor to the established brands is doubtful. Large companies such as Nabisco, CPW and General Mills can enter the SA market very easily, if there is enough of a margin for them. The parties further maintain that Pioneer's acquisition of it will improve the competitiveness of the RTE market since it will be able to more effectively compete with Kelloggs.

24. The parties also stated that they are not getting equity from the Nature's Source brand in terms of the margins it currently commands. The parties advised that despite its being a premium product, Nature's Source is a single product company. Products with single brands find it very difficult to compete in supermarkets, especially since they cannot command greater shelf space.

25. The parties' graphs of own price and cross price elasticity show that the elasticity of demand for Kellogg's products is relatively low. In other words, Kelloggs can extract a premium price for its products because of consumers recognition of and loyalty to its brand. However, by contrast, the elasticity of demand for Nature's Source and Bokomo products is relatively high as they have not until now built up brand recognition to the same degree as Kelloggs. Therefore consumers will respond by buying

substitutes if prices for these products rise. What is significant is that this merger will not strengthen the Nature's Source or Bokomo brands.

Countervailing Power

26. The parties made much about the countervailing power of the retailers. Consumers react to price increases, as they are very price sensitive and will switch to another brand. This reaction, in the form of reduced turnover for a particular product, is acutely felt by the retailers, who have the ability to exert pressure on manufacturers in terms of bargaining tactics, for instance, a fall-off in sales is penalised by reduced shelf space.

27. The parties maintain that the retailers have huge negotiating power. Manufacturers negotiate for discounts from them and retailers yield considerable power when it comes to bargaining for shelf space and discounts. As a second brand to the market leader, Pioneer has to fight for shelf space since retailers favour the market leader in terms of margins. However, there is no convincing evidence to suggest that retailers will not pass on price increases to consumers. What *is* significant is that retailers' power and negotiating tactics add to the difficulty of medium-sized players to compete in the market. This is because of the importance of critical mass to make a noticeable imprint on retailers' shelves.

Potential for Collusion

28. The products on which there could ostensibly be collusion, are not homogenous, each having different pricing structures, based on input costs, which makes it difficult to engage in co-ordinated conduct in respect thereto. Price collusion is also made difficult by the relationship that the firms have with retailers. Firms are offered the opportunity to run promotions with a retailer on dates determined months in advance with the particular retailer. A collusive strategy requires the ability to track a rival's pricing changes and to react quickly to them. The promotions system makes such a strategy more difficult, because of its inflexibility and the fact that pricing information is less transparent. We accordingly accept the parties' argument that collusion amongst the two most prominent cereal manufacturers in the RTE market is not feasible, and hence unlikely.

Vertical Integration

29. Although the Pioneer group is vertically integrated, in that it supplies much of the inputs that go into RTE products, it does not appear that the merged firm could embark on a successful foreclosure strategy. It appears that rivals can source equally successfully from other firms including via imports as Nature Source does currently.

Conclusion

We conclude that the merger will not lead to a substantial lessening of competition in the RTE cereal market. In respect of mainstream cereal products, there will be no change occasioned by this merger. The only change is in respect of muesli products – Pioneer is acquiring an established brand which cannot effectively compete on its own in any event.

It is possible for small players to continue to enter the market by developing niche brands. The merger is not likely to adversely affect the potential small scale or niche entrants to the market.

The Tribunal therefore approves the transaction unconditionally. There are no public interest concerns which would alter this conclusion.

______________	17July 2002
N. Manoim	Date

Concurring: D.Lewis, M. Holden