COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case no.: 44/LM/Aug03

In the large merger between:

Fluxrab Investments No 58 (Pty) Ltd

and

Seven Eleven Africa (Pty) Ltd

Reasons

Introduction

On 3 December 2003 the Tribunal conditionally approved the merger between Fluxrab Investments No 58 (Pty) Ltd, a subsidiary of the Metcash Group, and Seven Eleven Africa (Pty) Ltd. The conditions, which relate to the relationship between the newly acquired Seven Eleven franchisees and their franchisor, Metcash, are set out in the annexure to this decision.

The reasons for the decision are set out below.

The parties

The primary acquiring firm is Fluxrab Investments No 58 (Pty) Ltd ("Fluxrab"), a newly formed company. Fluxrab is a wholly owned subsidiary of Metcash Trading Limited ("Metcash"), which in turn is wholly owned by Metcash SA limited ("Metcash SA"). Metcash SA is a wholly owned subsidiary of Metro Cash & Carry Limited, a company listed on the JSE Securities Exchange.[1]

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[1] The two largest shareholders of Metro Cash & Carry are Stanlib Asset Management Limited with a shareholding of 26.87% and RMB Asset Management (Pty) Ltd with 20.55%. No single shareholder exercises control over the company.

The primary target firm is Seven Eleven Africa (Pty) Ltd ("Seven Eleven") and certain assets of Seven Eleven Corporation (Pty) Ltd ("Seven Eleven Corporation").[2]

The transaction

Fluxrab will acquire (1) the entire issued share capital in, and all claims on loan account against, Seven Eleven Africa on the basis that some retail store businesses of Seven Eleven Africa shall not be acquired by Fluxrab, but shall be taken over by Seven Eleven Corporation and made franchisees of the Metcash group, (2) the rights of Seven Eleven and Seven Eleven Corporation in respect of the Seven Eleven franchises, (3) the intellectual property in respect of the trade mark Seven Eleven and (4) the stock-in-trade in the Seven Eleven Epping Warehouse as well as the stock situated in the Seven Eleven stores which are to be owned and retained by Seven Eleven.

Seven Eleven Corporation, which will not be part of the sale transaction and will remain controlled by the Hadjidakis family, has in terms of the agreement an option to acquire from Metcash, within 30 days after the effective date of the transaction, up to 20% of the shares in Fluxrab. It has also undertaken, as part of the merger agreement, to sell, over the next three years, at least 25 stores per annum of the 92 stores that Seven Eleven Corporation currently owns.

Rationale for the transaction

Seven Eleven was placed under provisional liquidation on 19 June 2003 when Metcash intervened and undertook to settle the company's debts to its creditors in full.

According to Metcash there has, in recent years, been a growing trend in the fast moving consumer goods market towards a mixed business model that contains both wholesale and retail businesses. It has, thus, become necessary and desirable for Metcash, a wholesaler, to strategically establish a franchise chain in the retail environment to strengthen its competitive options against existing corporate owned stores and corporate directed franchises. The transaction will also enable its Distribution Division to achieve much needed critical mass.

Competition Analysis

Both Metcash and Seven Eleven trade in the wholesale, distribution and retail markets for fast moving consumer goods. We will consider the competitive effect that the merger would have on each level of the supply chain.

<u>The wholesale/ distribution market</u>

Seven Eleven Corporation owns a distribution centre in Epping, Western Cape, from which fast moving consumer goods ("FMCG") are supplied in-house to its 231 Seven Eleven franchisees throughout the country. The franchise stores are predominantly situated in the Western Cape.

Metcash, one of the largest wholesale distributors in South Africa, distributes FMCG to its Friendly Shoppe and Friendly Everyday franchise stores through its Distribution Divisions in Gauteng, Kwa-Zulu Natal and Western Cape. It also wholesales FMCG to independent traders through 123 wholesale Cash and Carry stores and 11 Trade Centre stores in the country. It also owns a buying group called Unitrade Management Services (Pty) Ltd, which sells to independents.

In light of the fact that Seven Eleven's wholesale and distribution activities are limited to supplying its own franchisees, we find that it does not compete with wholesalers such as Metcash that distribute FMCG to independent third parties. We, therefore, find that the merger will not substantially lessen competition in the wholesale/distribution market for fast moving consumer goods.

The transaction also has a vertical effect on the wholesale/distribution and retail markets for FMCG. Metcash's involvement in the retail market is limited and

[2] The entire issued share capital in Seven Eleven is held by Mr. George Hadjidakis and the Hadjidakis

although it does have franchised retail outlets, it mainly supplies independent traders through its wholesale and distribution division. Post the merger Metcash will also supply all the Seven Eleven Franchisees in addition to its own franchisees and independent retail traders. Should Metcash decide, post the merger, to only distribute supplies in-house to its own retail franchisees, it will effectively foreclose third party retailers from buying from a large player in the wholesale market. However, the Commission found this an unlikely scenario because Metcash generates more than 50% of its sales from supplying independent retailers on a wholesale basis. Moreover, the independent retailers told the Commission that they could source their product from alternative wholesale sources, or from the manufacturers directly and that, in most cases, Metcash supplied less than 20% of their stock.

We therefore agree with the Commission that the vertical integration will also not substantially prevent or lessen competition in the relevant markets.

The retail market

The retail market for fast moving consumer goods concerns the narrowly defined market for convenience shopping. The geographic market for retail is local, being the immediate vicinity surrounding each store of the merged firm.

Convenience retail stores for FMCG are stores that have extended business hours, are easily accessible and are normally situated within neigbourhoods. Customers will usually only buy their daily small requirements from convenience stores with their monthly grocery shopping bought from supermarkets. The shops are smaller than supermarkets, offer a smaller range of products, have a lower turnover and do not have as extensive logistical and administrative infrastructures as supermarket franchised stores. Evidence from Metcash employees suggests that most of the convenience store turnover derives from the sale of cigarettes, beverages and lottery tickets.

Children’s Trust holds 51% of the shares in Seven Eleven Corporation.

Metcash owns the Friendly franchise brand that consists of three different trading concepts. The first is the Friendly supermarket franchise stores and the other two the Friendly Shoppe and Friendly Everyday. The Friendly Shoppe and Friendly Everyday stores are convenience stores that compete with the Seven Eleven franchises. The Friendly Shoppe and the Friendly Everyday stores differ in respect of size, the amount of product lines they carry and therefore also in the amount of turnover they generate.[3] Metcash has established 44 independent Friendly Shoppe stores and 40 independent Friendly Everyday stores and 6, which are owned by the Franchisor.

Seven Eleven has 230 Seven Eleven franchise stores, 140 of which are independently owned and 92 that are owned by the Franchisor, Seven Eleven Corporation.

Other competitors in the market are, inter alia, independent convenience stores, various garage forecourt stores, Kwikspar stores, OK minimarkets and Pick ‘n Pay Mini-Market stores.

The merged firm will own about 28% of the entire franchising market in the retail convenience market for FMCG. The Commission, in its investigation, found that 17 of the geographic markets in which both parties owned convenience stores overlapped. In 11 of these geographic markets the merged entity would have market shares above 20%, with the highest market share reaching 50%.

The table below sets out the number of stores owned by the merged entity, number of competitors, the total number of players and the market shares of the merged entity for each of these relevant geographic markets:

[3] Friendly Shoppes are smaller than Friendly Everyday stores and has a smaller turnover.

Area	Number of Seven Eleven franchise stores	Number of Metcash franchise stores	Number of Competing convenience stores	Total Number of convenience retail stores	Market share of merged entity
Kleinmond	1	1	11	13	15.4%
Belville Verdelust/Boston	2	2	4	7	42.9%
Blomtuin Oak Glen	1	2	9	13	30.8
Dieprivier	1	1	10	13	23%
Ceres	2	1	14	17	17.7%
Gansbaai	1	1	5	7	28.6%
Gardens T'Kloof	2	1	11	14	21%
Kraaifontein	2	2	11	15	26.7%
Brackenfell Protea Heights	1	1	2	4	50%
Bothasig	1	1	5	7	28.6%
Richwood	1	1	3	5	40%

Area	Number of Seven Eleven franchise stores	Number of Metcash franchise stores	Number of Competing convenience stores	Total Number of convenience retail stores	Market share of merged entity
Rugby	1	1	5	7	29%
Kuilsrivier	3	2	16	21	23.8%
Good Hope Vasco	3	1	8	12	33.3%
Weltevreden Park	2	1	10	13	23%
Pietermaritzburg	1	1	10	12	16.7%
Despatch	1	1	12	14	14.3%

The Commission argues that the merger would not substantially lessen competition in any of the geographic areas, as there are alternative stores that do not fall within the narrowly defined product market to which customers can turn to in each area.

It also found that in the Belville Vredelust/Boston, Richwood and Brackenfeld areas, in which the merged entity would have market shares of 42.9%, 40% and 50% respectively, consumers fall in those income brackets likely to own their own cars. According to the Commission they are thus able to travel to other neighborhoods to do their shopping. The Commission also found that there were supermarkets or large shopping centres just outside these areas where the residents could shop which, when one considers the profile of the consumers, in all probability extended the relevant market.

As a rationale for not having competitive concerns, we find this reasoning questionable, as it appears to contradict the very basis for the market definition which both the Commission and the merging parties were agreed upon, namely, that convenience stores are characterized by their proximity to the buyer. The fact that some buyers have easier access to transport does not mean that they will in the face of higher prices forego convenience in favour of more travel, indeed if anything such a buyer may be less likely to travel further to save on a small purchase.

In our view the second basis for the Commission's conclusion is the better one; namely that barriers to entry in this market are low. In affluent areas it stands to reason that entry will be more likely. A second basis for not being concerned is that there still remains potential for inter-brand competition between franchisees in the Metcash Group post merger. Since the franchised stores will not be owned by the Metcash Group the incentives to compete will remain, albeit that this depends to a large extent on the ability of Metcash, as the franchisor, to determine the basis on which its franchisees are able to compete with one another.

Whilst we agree with the Commission's conclusion that the merger will not substantially prevent or lessen competition in the relevant markets we are concerned about inter-brand competition between the Metcash and the Seven Eleven franchisees due to the fact that they might not be competing on level playing fields.

We will now address these concerns.

<u>The merger concerns</u>

There are currently two separate complaints pending before the Tribunal that were referred to the Tribunal, the first was referred by the Commission against the Seven

Eleven franchisor, and the second by the Foodies franchisees[4] against Metcash, their franchisor. In both cases the franchisees complained that the franchisor was, inter alia, engaging in an exclusionary act by appointing itself as the only designated supplier to the franchisees, without giving it the option to buy from other independent wholesale suppliers at lower price. The required level of loyalty obligations stipulated by Metcash and those stipulated by Seven Eleven differ and this could affect the post-merger competitiveness of the Seven Eleven Franchisees vis-à-vis the Metcash franchisees.

In light of the complaints before the Tribunal, Seven Eleven franchisees indicated to us that they were concerned about being placed in a worse competitive position than the Metcash francisees, specifically with regard to the different loyalty obligations required by each franchisor. A matter that further complicates this issue is the fact that there exists more than one standard franchise agreement within each franchise group. Seven Eleven told the Tribunal that up to 11 different agreements exist within the Seven Eleven Group. The upshot of this is that a franchisee that wants to be treated in the same way with regard to the loyalty discount may lose some other benefits by being treated on a non-discriminatory basis.

According to Metcash retail businesses selling FMCG are volume driven because of their low profit rate - the internationally accepted benchmark is 2.5% before tax. Very little profit is made on promotions, which are offered in order to entice customers to visit the stores. Metcash calculates that 15% of sales in franchise stores result from promotions conducted by it. If franchisees were permitted to “cherry pick” the promotions of other suppliers, there would be no purpose pursuing the franchise brand as there would be insufficient funding for collective marketing, promotional activities, competitive pricing and other fixed costs.[5]

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[4] The Foodies franchise name has been changed to Friendly Shoppe and Friendly Everyday Stores.

[5] The franchise model is based on the principle that a franchisee invests in the franchise by buying a retail outlet, which it owns and manages while the franchisor, in turn, permits its trademark to be used by the franchisee. In order to protect its trademark, in which he has invested time and money, the franchisor supplies a complete business plan with which the franchisee must then comply. The franchisor maintains, develops and advertises the brand and also develops distribution centres from which it distributes product to its franchisees to ensure that identical products are available, thereby maintaining the same level of service in each store. In return the franchisee promotes and develops its business, ensures that it adheres to the business plan and complies with the loyalty obligation.

Currently Metcash enforces a loyalty obligation of 63% excluding Coca Cola products.[6] However Metcash wants to increase this percentage to 75% because it has negotiated a new arrangement with Coca Cola, which provides for drop-shipment of Coke Cola products directly to all Metcash franchisees.[7] This means that Coke will not be excluded from the loyalty obligation. The franchisees will thus be able to buy 25% of its supplies from independent suppliers.

Although, after extensive discussion with the parties, the Tribunal considered imposing various levels of loyalty obligations we decided that it was not appropriate for us to set a percentage without having fully investigated its impact on competition. We, therefore, decided that, without finding any anti-competitive practices, it would adequately address the franchisees' concerns about possible competitive asymmetries inter- brand, if Metcash undertook not to discriminate between the Friendly and the Seven Eleven Franchisees on any terms.

In light of this Metcash agreed to renegotiate, within 6 months of this transaction being approved, franchise agreements on the same terms with both its Friendly and the Seven Eleven Franchisees. This undertaking has been made an order of the Tribunal as set out in the order annexed to this decision.

Public Interest

This transaction does not raise any public interest issues.

_____________ 6 January 2004

D. Lewis **Date**

Concurring: N. Manoim and F. Fourie

[6] The present franchisees obtain their Coke Cola products directly from the Bottling company and these purchases fall outside the 63% loyalty obligation.

[7] Drop shipment is the process whereby a store orders products directly from the manufacturer and the manufacturer then delivers such products directly to the store. These products are not physically channelled through the franchisor's distribution system although they are reflected as sales in the accounting system of the franchisor because the franchisor facilitates the granting of credit by the supplier to the franchisee in question. The franchisor also bears the credit risk and the liability for payment to the supplier.

Annexure

1. Further to the recommendation of the Competition Commission in terms of section 14A(1)(b), the Competition Tribunal orders that the merger between Fluxrab Investments No 58 (Pty) Ltd and Seven Eleven Africa (Pty) Ltd be approved in terms of section 16(2)(b), subject to the following conditions:

   (i.) Metcash shall within 6 (six) months of the approval by the Tribunal offer new franchise agreements on the same terms to all Seven Eleven and Friendly Shoppe franchisees.

   (ii.) Metcash shall inform all its present and newly acquired franchisees of the conditions set out above.

   (iii.) A copy of the new franchise agreements referred to in paragraph (i) above must be supplied to the Commission.

2. For purposes of this order Metcash means Metcash SA Limited, Metcash Trading Limited, Fluxrab Investments No 58 (Pty) Ltd or any other subsidiary within Metro Cash and Carry Limited.

3. a Merger Clearance Certificate be issued in terms of Competition Tribunal rule 35(5)(a).