COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 60/LM/Aug02

In the large merger between:

JD Group Limited

and

Profurn Limited

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Reasons for decision

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CONDITIONAL APPROVAL

1. The merger between the JD Group Limited ("JD") and Profurn Limited ("Profurn") was approved subject to conditions in an order issued on the 12 December 2002. The reasons for this decision follow.

THE TRANSACTION

2. FirstRandBank is currently the controlling shareholder of Profurn with a 78,8% shareholding.[1] It has entered into an agreement with the Profurn Group in terms of which the JD Group or one of its nominees will acquire from Profurn all the subsidiaries of Profurn, or all the businesses of the subsidiaries as going concerns including their assets and liabilities, or a combination of the subsidiaries, assets and liabilities. At the time of the hearing the parties had not elected which of these mechanisms they

[1] FirstRandBank acquired a shareholding of this significance pursuant to a rights offer in 2002 in which they assumed control over Profurn. This prior transaction was notified to the Tribunal and approved unconditionally in decision FirstRandBank/Profurn Limited case no.32/LM/May02.

would follow but since the exact nature of the structuring is neutral on the merger's effects in terms of the Act, it is not relevant for us to require them to make an election.

3. What is clear is that in return for the sale FirstRand Bank would acquire shares in the JD Group as consideration and that in turn it would on sell 5/6ths of these shares to Daun and Cie a foreign investor.

4. Subsequent to the transaction FirstRand and Daun & Cie would hold approximately 25% of the shares in the JD Group.

5. Presently Old Mutual SA is the largest shareholder in the JD Group with a 27,26% stake.

6. As part of the transaction the JD Group has entered into an interim agreement with FirstRand and Profurn in terms of which the JD Group will provide what it has described as "selected retail expertise and services to Profurn. This agreement, which was approved of by the Commission came into effect on June 28 2002 and was to last until the outcome of the adjudication of this matter before the competition authorities.

7. On the 8 October 2002 the Commission recommended that this merger be unconditionally approved.

The Parties

8. The primary acquiring firm, is JDG Trading (Pty) Limited, a wholly owned subsidiary of the JD Group Limited.

9. The JD Group (whom we shall refer to hereafter as JD) boasts a phenomenal history of growth and expansion and has earned a reputation as the industry's leader in technology and business management systems.

10. David Sussman, the present chairman, founded the group in 1983 when he started the business with two Price 'n Pride stores. Sussman's company was to grow spectacularly from its modest origins through masterly timed acquisitions of troubled firms. In 1986 he acquired the then ailing, but larger Joshua Doore chain from the Russels group. In 1988 he acquired Bradlows and World from W&A and in 1993 he acquired the Rusfurn Group.

11. The acquisitions were all successful and the group acquired a reputation as a successful acquirer and integrator of rival businesses. According to

one analyst, furniture retailers were re-rated after the Rusfurn acquistion and, *"in general, they generated superior earnings growth."*[2]

12. The group's rapid acquisition and successful integration of Joshua Doore, Score Furnishers, World Furnishers and the Rusfurn group saw it become the leading furniture retailer in South Africa.[3] In 2000 an attempt to acquire its most established competitor, Ellerines, was however prohibited by the Tribunal.[4]

13. JD is structured as a holding company listed on the J.S.E. It owns the following chains of stores that are located in South Africa:[5]

    i) Joshua Doore, Joshua Doore is the largest furniture, appliances and home entertainment products discounter in South Africa and Namibia.
    ii) Bradlows, sells branded appliances, home entertainment products and furniture targeted at the LSM 6-8 group.
    iii) Russells, sells furniture, branded appliances and home entertainment products targeted at the LSM 4-6 group.
    iv) Price 'n Pride, sells furniture and appliances targeted at the targeted at the LSM 3-5 group. It has recently positioned itself upwards and now claims to target the LSM 4-6 group.
    v) Electric Express, acquired in 1993, is primarily a discounter of household electrical appliances and home entertainment products.

14. The primary target firm is Profurn Limited. The majority shareholder is FirstRand Bank Limited, a wholly owned subsidiary of FirstRand Bank Holdings Limited.

15. The Profurn Group emerged out of the liquidation of Supreme Holdings in 1992. In 1997 the group acquired Freedom Furniture a Cape based chain. In 1998 it acquired the Morkels chain and in 1999, the appliance retailer Hi Fi Corporation.

16. Between 1994 and 1999 Profurn grew its earnings by not less than 30 %

2 See UBS Warburg Report, Record page 984.

3 JD makes this claim itself. See its Annual report 2001

4 The Tribunal prohibited the merger between the JD Group Limited and Ellerine Holdings Limited in August 2000. See case no. 78/LM/Jul00. We refer to this decision from now on as the Ellerines decision to avoid confusion with the present matter.

5 JD owns businesses that operate overseas but we are not concerned with them here as they do not effect the South African market.

per annum. This earnings growth was the product of an aggressive expansion strategy that fueled an increasingly competitive market and correspondingly a decline in margins, as well as consolidation in the sector resulting from JD' s acquisition of Rusfurn.[6] Because its margins were so squeezed the ambitious group was unable to fund growth internally and so increasingly relied on bank loans. This was to prove its downfall in the next decade when market conditions soured for retailers serving the lower end. In March 2002 the group's chief executive Gavin Walker, said to be at the helm of the growth strategy, resigned. A committee comprising of the chairman, the chief financial officer, the chief operating officer and Mr Theunie Lategan, CEO of FNB Corporate, has since filled the embattled group's CEO role.

17. In June 2002 the group, with the support of its principal banker, FirstRand, undertook a rights offer in an attempt to reduce interest bearing-debt. The poor response to the rights offer resulted in FirstRand, as underwriter of the shares, becoming the controlling shareholder with 78,8% of the equity.

18. Profurn like JD is a holding company listed on the J.S.E. and owns the following chains of stores that are located in South Africa and elsewhere:

i) Protea Furnishers, sells furniture, home audio-visual and household appliances, targeted at LSM 3-5 although like Price 'n Pride it has ambitions of moving upwards to the LSM 4-6 market.
ii) Barnetts is part of the Protea division, focusing on the LSM 3-5 income groups.
iii) Freedom, is also part of the Protea division and its target market incorporates the LSM 4-6 income groups.
iv) Morkels, sells furniture and branded electrical products targeted at the LSM 5-8.
v) Home & Electric, an urban-based chain of specialist discount retailers, offering credit and focusing on key electrical, bedding and built-in furniture products for the home.
vi) HI-FI Corporation, is the largest audio-visual retailer in South Africa, and offers a wide range of imported audio-visual equipment at discount prices.
vii) Supreme Furnishers trades in 11 African countries outside the borders of South Africa under the brand names Supreme, Barnetts, Protea, and Hi-Fi & Electric City. The first three chains are credit outlets and the latter is a cash discounter dealing mainly in electronics.

6 UBS Warburg Report.

The Intervenors

19. A group of independent furniture manufacturers applied, in terms of Section 53(1)(c) of the Act, read with Rule 46(1) of the Tribunal Rules to participate in these merger proceedings. Although the merging parties expressed some reservations, they did not oppose the manufacturers' application, thus leave to participate was granted.[7]

20. Prior to this these intervenors filed submissions detailing their opposition to the merger, with the Commission. Their fundamental opposition to the merger is founded on the ground of the vertical effects of the merger.

The Rationale

21. The fundamental rationale for the transaction is said to be the imminent failure of Profurn. This in turn is a consequence of the general disarray prevalent in the furniture retail industry, as well as the particular expansion and credit granting strategies adopted by Profurn.

22. The parties aver that if not for this transaction, Profurn will exit the market, approximately 7 000 jobs will be lost and a large number of suppliers and services providers will in turn suffer financial losses that may eventually see them exit the market as well.

The hearing

23. A pre-hearing was held on the 18 October 2002 and hearing was held on the following days:

25 November 2002
29 November 2002
03 December 2002
04 December 2002

24. The Commission did not call any witnesses.

25. The merging parties called three witnesses:

7 Although papers were filed collectively on behalf of the group, the following individual manufacturers were allowed to participate in the proceedings: Contour Bedding & Lounge CC; General Manufacturing Company; Confurn Sales (Pty) Ltd t/a Imperial Furniture; Khwaja Lounge; Kiran Sales (Pty) Ltd t/a Lylax Bedding; Oaktree Products (Pty) Ltd t/a Pilot Furniture; Serta Bedding (Pty) Ltd; Taurus FBW Furniture (Pty) Ltd; Sheppe Five CC t/a Firwood Furniture; Friedlein Company (Pty) Ltd t/a Friedlein Furniture.

Mr David Sussman, executive chairman JD Group
Mr Derrick Minnie, non-executive chair of Profurn
Mr Mias Strauss, MD JD Group

26. The intervenors called six witnesses:

Mr Roy Pritchard, Oaktree
Mr Eshu Seevnarayan, Lylax Bedding
Mr Khan, Khwaja Lounge
Mr A Seevnarayan, Imperial Furniture
Mr Sewpersad, General Manufacturing
Mr H Salligram, FBW Taurus

27. The Tribunal called three witnesses:

Mr Kevin Boyers, CFO Profurn
Mr Peter Squires, CEO Ellerines
Mr Theunie Lategan, CEO FNB Corporate

Background

28. The background to this merger is the dramatic change in fortunes for the furniture retail groups since 1999/2000. There are a number of reasons for this, but they are most succinctly stated in the Profurn Group's 2000 Annual report, where ironically, its erstwhile executive chairman, Gavin Walker, was to show great prescience about the state of the market, little knowing that his firm was soon to become one of the more spectacular victims:

> **"The retail industry *in South Africa in 2002 has undoubtedly experienced one of its toughest years ever. A spate of profit warnings, SARS investigations, consumer spending on cell phones, lottery tickets and gambling, and petrol price increases have all taken their toll on the sector"***

" *This sentiment not only affects the capital markets but also the ability of retail companies to fund their businesses with debt. The major South African banks are at their prudential limits for retail exposure."*

29. Walker's pessimistic assessment is written even before the general crisis experienced in the micro-financing sector, which comes about in 2001/2 through the collapse of Saambou and the adverse impact of the troubles at Unifer, the micro-loan business acquired by ABSA. These setbacks

further served to alarm banks about their over exposure to retailers who operate as extenders of credit to consumers in the lower end of the market. It is not surprising that they became the catalyst for changes that were to occur in this market and that ultimately led to this merger.

30. In 2002 both Profurn and the Relyant Groups were compelled to re-capitalise through rights issues, while the JD Group had to reconsider its presence in the lower segment of the market.

31. The prospects remain gloomy as a recent JD Report suggests:[8]

"During the period under review, market conditions in the durable credit retail market remained under pressure and the overtraded environment continued to impact negatively on product margin. Huge demands on the disposable income of the Group's target market have further exacerbated the situation."

32. While this is not the first time the Tribunal has had to consider a merger in this industry[9]**, it is patently obvious that the prevailing industry conditions are vastly different from what they were in 2000. In fact in August 2000 Profurn was depicted as a vigorous competitor of both JD and Ellerines, two years later, it is presented to us as the industry's ugly duckling. So much so we are told that all attempts to secure a buyer, other than JD, for the entire group, and not just its more attractive assets, have been in vain.** [10]

Competitive Evaluation

33. We will be considering the merger in two respects -

a) The horizontal effects since it involves the merger of two competitors; and

b) The vertical effects insofar as they effect the merged firm's buying power in the market for the purchase of furniture from manufacturers

Horizontal effects

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8 See the JD Group's Reviewed Interim results for the six months ended 28 February 2002, Record Annexure 5 page 137.

9See of course the Ellerine decision, the Massmart acquisition of Furnex (Sociedad Investments Pty Ltd /Furnex) case no 09/LM/Feb02 and FNB's acquistion of Profurn case no 32/LM/May02.

10 For details of alternative transactions, see the Commission's recommendation p 9-10.

34. As we have seen from our earlier description, the two merging firms are both holding companies that own subsidiary businesses, which compete in the retail market selling furniture and appliances.

35. Their businesses range from dedicated appliance discounters to furniture chains that sell a variety of goods and are aimed at distinct niches in the market.

36. There is no dispute that the merging parties subsidiaries compete with one another. There is, however, some dispute as to the boundaries of the market in which they compete.

37. To understand the differences in approach to defining the market in this case it is first necessary to understand how the retail furniture and appliance sector is structured and then to locate relevant markets for the purpose of competition analysis.

38. Retailers who sell furniture and appliances have, not surprisingly, found many routes to the market.

39. That all compete are in the business of selling furniture is not in doubt. What is in dispute is whether consumers consider these different routes to the market as equivalent offerings, and hence as substitutes for one another.

40. Outlets differ from one another not only in terms of the range of products they sell and their level of prices, but which customers they target, whether they offer credit and where they are located, to name but a few distinctions.

41. Like JD and Profurn, certain retailers have organized themselves in chains - not only to afford themselves a wider geographic exposure, but also so that they encompass, within a single corporate structure, a range of routes to market.

42. One type of store is referred to in the industry as the ‘mass discounter’. Mass discounters are stores whose competitive advantage is on price. They trade in high volumes and can be price competitive because of low margins. In order to operate in this type of market a mass discounter must be able to turn over a high volume of product in a short time, have a regular cash flow and offer consumers a wide choice of product. For this reason mass discounters operate from large stores usually located in urban areas where customer volume densities are more assured, sell on a

cash only basis and offer minimum service.

43. The sale of appliances as opposed to furniture is the dominant product offering of the mass discounter.

44. The next type of store is the furniture retail outlet. This type of store is, in the hands of the chains, organized like a consumer product according to a carefully marketed brand aimed at a targeted group of consumers. Within the JD and Profurn groups we see this as well, as we observed above in the description of the parties. These retail outlets are usually targeted at a range of consumer Living Standard Measure (LSM) categories, typically a brand will target between 3 to 4 LSM bands.[11] The chains' carefully research consumer behaviour to ensure that the particular brand remains aligned to its targeted LSM groupings. This entails different product offerings, price ranges, store location and medium of advertising. These stores not only sell furniture, but also appliances and cell phone services.

45. These stores are smaller in size than the mass discounters but are for that reason more ubiquitous or, in the language of retailers, have a wider footprint. The chains refer in their reports to their roll out of stores in a particular chain. What they mean is that they are continually on the lookout for new locations for their stores whilst at the same time reassessing the location of existing branches. Like skilful chess players the chains' managements are continually moving their pieces to outflank their opposition or to avoid being removed from the board. Hence this type of store is less rooted to any one location than the mass discounter.

46. The management challenge is to match the brand to its targeted market in product, price and location.

47. Within this universe of furniture chains at least three broad segments exist -a mass market, middle market and mid/ upper market.

48. What distinguishes the furniture chains inter alia from the mass discounters is that the former sell to the consumer on credit, a fact particularly important for consumers who are ineligible for credit cards. As they have with targeting their market in terms of product choices, so the chains have developed the granting of credit into an art. They spend vast resources on creating models of likely risk and use sophisticated information technology to assess and reassess their credit policies.

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11 Living Standard Measures or LSM's refer to a method of segmenting consumers into profiles so that marketers can accurately identify their target markets. Retailers use this information to form a picture of their target customers and so to provide for them accordingly.

49. The JD Group has indicated that it has undergone significant changes to its credit granting policies as a result of the decline in the lower end of the market.
They are able to do so through sophisticated IT systems that enable them to develop and continually update sophisticated risk profiles.

50. In a recent report this is described as follows:

> "This process has been successful in predicting the payment behaviour of debtors with a particular status in a specific geographical area. This has resulted in a reduction of risk allowing for greater levels of predictability at store level."[12]

51. The final type of player in the market is the 'independent' store, so called, because they are not part of any chain or group and are usually managed by their owners. The independents are typically single outlet businesses with the largest type of business in this category not exceeding four outlets.[13] Independent stores vary from being specialist outlets e.g. retailers of expensive high- tech equipment to general dealers who sell a bit of everything.

52. As mentioned above we have previously had to deal with a merger in this industry in the Ellerines case. In that decision we adopted the following market definition:

> *"In summary then we conclude that the relevant market is composed of furniture shops (with a product mix of furniture and appliances) directed at credit sales to consumers in the LSM 3 –5 category)"*

53. The merging parties have urged us not to adopt the same market definition in this merger and have argued instead for a relevant market that is composed of all furniture and appliance retailers aggregated together into a national geographic market.

54. Using the Ellerines decision as their point of departure, they go on to consider the possible ways of segmenting this market. These according to them might be based upon:

a) Price and Quality differences
b) Furniture store – cluster or product cluster

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12 See JD Group's Reviewed Interim results for the six months ended 28 February 2002, record Annexure 5 page 138.
13 See Parties Competitiveness Report, record page 536 paragraph 11.4.17.5.

c) Credit sales
d) LSM customer grouping

55. They conclude after an examination of each of these possibilities that there is no valid basis for finding narrower markets by applying any of these criteria.

56. As to the geographic market they make the contention, whose logic is not easy to follow, that:

"The geographic market is local, includes independents and can, for reason of practicability, be aggregated into a national geographic market."[14]

57. The Commission has followed this approach to the market definition basing its analysis largely on the parties' submissions. For this reason and given that the Commission has not opposed the merger, we shall confine our analysis to the parties submissions.

58. The parties have, as is their want in mergers of this kind, sought to adopt the most expansive view of the market. The reason for this is that they feared that if we were to follow approach in the <u>Ellerines</u> case, concentration levels would again, as in that case, exceed thresholds for concern. On the other hand, if the universe of the market is expanded by the addition of the mass discounters and the independents (both were excluded from the market on the <u>Ellerines</u> definition) and not segmented by LSM bands, this would have the effect of diluting concentration levels.

59. The parties' supposition about the consequences of the contending market definitions for concentration levels turns out to be correct when we examine these below. If the <u>Ellerines</u> definition is adhered to, then the merger would result in an already highly concentrated market becoming more so – if the parties' definition is followed the market is moderately concentrated post merger.

60. It seems to us that the issues that need to be decided upon in order to delineate a relevant market in this merger are:

a) whether mass discounters are part of the same market as furniture retailers if they sell some overlapping products such as appliances;

b) whether the chains compete in a furniture retail market that includes the independent furniture retailers; and

14 See Parties' Competitiveness Report, Record page 478 paragraph 2.7

c) whether the furniture retail market is a universal one or a series of markets comprising bands of stores aimed at particular groups of consumers approximating LSM classifications.

61. The mass discounters as we observed above are distinguishable from the furniture chains in that they -
    (i) are primarily sellers of appliances not furniture;
    (ii) primarily sell on a cash basis;
    (iii) have larger stores in fewer locations and hence are less ubiquitous than the chain stores;
    (iv) offer a greater breadth and depth of those products they sell;
    (v) offer better prices but less frills including reduced service;
    (vi) are targeted at LSM groupings that are higher than the range of many of the chains. Thus according to Perry and Associates the Massmart chains have found in a survey that 88% of their customers in the case of Makro fell into LSM 7-8 and in Dions and Game, LSM 6-8.

62. Whilst the fact that they do not offer credit may not be a disincentive to purchasers of inexpensive items they constitute a bar to more expensive items to low-income consumers who have no easy access to credit. This was an important conclusion that we came to in the Ellerines decision and despite the parties contentions they have not convinced us otherwise.

63. For instance in the marketing report of Barnetts, one of the Profurn chains which is targeted at males in the LSM 4 – 6 category it states:

> "Credit usage and the availability of various credit options are essential in this target market."[15]

64. They go on to say*:*

> *"All retail furniture groups which are located in the black rural areas, are considered competitors. Stores like Ellerines, Town Talk and Savells, Faideals and OK Furniture, all of which offer the customers easier terms and purchase facilities such as ' No deposits and Cash Back Offers" compete and share the same customers base."*

65. Nevertheless unlike in the Ellerines merger, the merging firms in this case will also have a strong footprint in the mass discount market due to the combination of Hi Fi Corporation and Giddys Electrical Express.

15 See Barnetts marketing plan for 2002/3, Record page 1102

66. The next element is how to regard the presence of independents. The parties devoted considerable attention to this issue recalling that in the Ellerines case we had excluded independents from the relevant market. Since independents may account for up to 17 % of the market according to the parties and may consist of up to 10 000 stores, their presence in the market not only dilutes concentration levels, but also suggests the existence of firms well situated to expand their market shares if the merger leads to unilateral or co-ordinated effects that result in higher prices.

67. To this end the parties produced lengthy spreadsheets of the names of these firms and their location. Their conclusion was that these stores were plentiful and ubiquitous. The parties also argued that the independents have a competitive advantage in that they have lower overheads (no mass advertising, marketing and head office expenses) and to the extent that they have size disadvantages in extending credit to customers and getting rebates from furniture manufacturers, this has been cured for some independents who can become members of buying groups like Furnex and The Shaw Group and can get credit for their customers through credit groups such as Consumer Credit.[16]

68. The parties acknowledge that both merging firms set prices for their chains nationally. This is because it is impractical for groups with such an extensive network of stores and which engage in national advertising campaigns to leave pricing to be determined at a local level. This of course is perfectly rational. What is harder to accept is that groups which set prices nationally can then be said to compete on price at a local level with independents when their local managers lack the authority to respond to pricing of their immediate competitors. Rather what seems to happen is that the chains determine the success of a local operation on an ongoing basis against a nationally determined return. If a store is under performing the response is to either close the store, relocate it or to re-brand it so that it is targeted at a different LSM group, as the minutes of both JD and Profurn show. The annual statements contain statistics of all three occurring not infrequently. It is this type of move that is the response to competition in the local market not price competition.

69. On the other hand the documents that we have suggest that the chains do respond to the pricing moves of rival chains, which they appear to monitor. Independents may be perceived by local managers as competitive, but

[16] The parties adduced evidence that a random sample of consumers who had had credit applications rejected by the JD system qualified for credit according to the credit check of Consumer Credit, who provide credit verification for some independent stores.

they do not operate to constrain price increases by groups which set prices in accordance with national not local dictates. The firms that will compete on price with chains are other chains not the independents.

70. **Another example of the fact that chains to respond to one another rather than the behaviour of mass discounters or independents was the "industry's free gift give-away madness", alluded to by Mr Squires of Ellerines in his testimony, referring to the aggressive campaigns virtually every furniture chain store embarked on, hot on the heels of rival stores.[17] Other than the consecutive sequence in which each chain launched its give-away campaign, the similarities in the marketing and in the actual give-away products, are clear evidence that these campaigns were directed at customers of the opposition furniture stores, and not at those of either the discounters or the independent furniture retailers.**

71. The parties were not able to produce any contemporaneous evidence of the manner in which they compete with the independents. All the evidence was produced specifically for the hearing and when challenged by the intervenors was open to some doubt.

72. Roy Pritchard from Oak Tree testified that he had attempted to verify a sample of this evidence and he found that certain stores listed were no longer in business whilst the extent of outlets owned by other stores was overstated. Using the sample and the error data he extrapolated this on a national basis to come to his own estimate of the number of independent stores. He also attempted to get from the independent buying groups their best guess of the number of independents and came up with a number that accorded with his own. Thus on Pritchard's evidence the size of the independent retail market is vastly reduced. In his estimation there are a maximum of 400 "real" independent furniture stores.[18]

73. The parties' riposte was to send a photographer around to Pritchard's sample area, who purportedly found far more independent stores than Pritchard. Pritchard did not have time to verify this new evidence, but a perusal of some of the photos shows that judging by their names and appearance, some stores claims to being classified as furniture shops was open to serious doubt.[19]

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17 See transcript of hearings, 29 November 2002, p15-18.

18 As stated in Mr Pritchard's witness statement page 5, paragraph 9.3.

19 For instance some appeared to sell only music. Stores listed included "Audio Den"; "Franks Radio", and "Selglo Radio and TV".

74. Perhaps the most interesting error on behalf of the parties, that Pritchard identifies, is the fact that a firm called Ster Discount Furnishers which the parties initially identified as having 36 stores in fact has only 4 stores of which only 1 is specifically a furniture store. Had it had the 36 stores it would have been the size of a small chain and dwarfed the other independents. The error was acknowledged by JD who attributed the error to one of their agents responsible for compiling the information. We have no reason not to accept their bona fides on this. Nevertheless it illustrates the point that we make above – had the independents been real competitors of JD they would have known all about them. In the Ellerines merger the Commission had identified exactly the same weaknesses in JD lists' of would be competitors.[20] These errors are repeated two years later. Their recurrence proves that the only time independents appear on the JD radar screen is when they are resuscitated as competitors to massage market shares in an otherwise concentrated market. Every other aspect of JD's approach to this case has been meticulous and considered; furthermore its executives demonstrate an encyclopedic knowledge of their market – this anomaly, the apparent deficiency in their knowledge of the independents, can only be accounted for because they do not, in the minds of JD's management, constitute a serious competitive threat.

75. In our view independents do not act to constrain the market behaviour of the chains and their plurality, whether one accepts Pritchard's estimates or JD's, should be excluded from any relevant market determination.

76. The last issue concerns the legitimacy of segmenting stores into LSM bands, the approach we had taken in the Ellerines decision.

77. The parties argue that surveys of customer profiles conducted by the chains, suggest that even though a store may be targeted at a particular segment of consumers, persons outside of the targeted LSM profile still do business at the store. This they use as the basis to argue that there is no such thing as a segmented market defined in terms of LSM groups, or some other function of income or social status, but one universal market. We certainly agree that the fact that a chain of stores is branded at a particular LSM segment does not mean that it becomes hermetically sealed from the ingress of the disavowed class, like the separate

20 See JD/Ellerines decision page 28 where the discrepancy between the figures presented by the parties and those verified by the Commission was noted: " The evidence gathered by the Commission regarding the former grouping of independents is striking. The parties informed the Commission investigators that there were 1251 independents in the 99 local markets in which both parties compete. A survey conducted by the Commission of 202 of these independents in the Eastern Cape, Northern Province and the Free State established that 93 were no longer in business, 12 were not in the relevant product market and four declined to respond."

entrances of an apartheid style segregated institution. The fact remains that the marketing materials and the strategy of the stores suggest that they remain focused on their core group of consumers who form the rump of their business and in so doing they create a differentiated shopping experience not wholly substitutable by one aimed at a different group of consumers.

78. A selection of quotes from the marketing plans of certain of the chains implicated in the merger illustrates this:

In the JD stable:

79. Price 'n Pride, its chain that was previously targeted at the LSM 3-5 group and now intends moving up market to focus on the LSM 4-6, describes this move in its internal documents as positioning itself at "the *top end of the traditional black mass market but below that of the Universal Chains"*[21]

80. Other extracts indicate that the chain will embark on a new merchandise range, which reflects the new market positioning.[22] They also state that the advertising has been changed to reflect the new merchandise.[23]

81. In relation to Bradlows the 2002/3 Business Plan states *"Bradlows remains the leading furniture retailer in the middle /upper end of the mass market. Given the turmoil around the competition Bradlows is well positioned to cement its position as the Number 1 furniture retailer in its market segment. The customer profile is 85% black predominantly in the LSM 6-8 Group"*[24]

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21 See Price 'n Pride launching of a new business, Record page 1060.

22 Record page 1066.

23 Record page 1065.where they state " This process has been substantially successful with a clear change in customer base moving from old LSM 3-5 to LSM 4-6."

24 Record page 1090.

82. In relation to Russels it is stated that the long-term goal is to cater to LSM 5-7 [Russels present position is said to be 4-6]

83. In the Profurn stable we see the same approach in its internal plans.

> *83. In the Protea furnishers marketing plan for 2002/2003 Protea targets LSM 3 to lower end LSM 5. Protea introduced a status store concept in 2002 aiming at upper 5 to LSM 6 market.* [25]

84. Similar sentiments are expressed in the Barnetts material about its focus on the LSM 4-6 category, which we quoted earlier.[26]

85. In the Profurn Annual report Morkels is described as targeted at LSM 5-7 customers.

86. The approach in all these internal documents, which were prepared for the purposes of preparing strategy not merger notification, is consistent in its emphasis of the distinctiveness of each respective chain's bands of targeted customers.

87. As we observed in our decision in the Distell merger where we adopted a similar approach to vertically segmenting a retail market:

> "...the vast price differential within each of the various categories" (of spirits), provides for market segmentation, so that a "multi-million rand Rolls Royce could not sensibly be placed in the same market as a humble Opel Corsa." [27]

88. The existence of well-defined sub-markets in a broader market is something that has long been recognised in antitrust law. [28]

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25 Record page 1099. At page 1100 it says Protea says its main competitors are " retail furniture chains operating in the LSM 3 to lower 6 market, black consumer market, these chains offer credit terms and similar purchase facilities also having similar merchandise. Main competitors are Barnetts, Ellerines., Town Talk, Fair Deal, Savells, Price and Pride, Lewis Stores." " Protea Status stores competitors are Furncity, Oxford, O.K. Furnishers, Russels and Lubners." They go on to say that Markinor has identified Proteas main competitors as Ellerines, Lewis and Joshua Doore. " This will be focused on the best learned from them, introduced and improved."

26 Record page page 1102

27 Distillers Corporation SA Limited and Stellenbosch Farmers Winery Group Ltd, case no 08/LM/Feb02 page 38

28 See Brown Shoe v United States, 370 US 294, 325 (1962)

89. In Federal Trade Commission vs Staples Inc. and Office Depot Inc[29] the Court recognised that

"The mere fact that two different classes of retail vendors both sell a particular type of merchandise does not mean that they are in the same product market."[30]

90. In support of the above the Court quoted from State of California v American Stores [31], a case involving supermarkets:

" …even if convenience stores competitively price a few food items such as bread and milk, in direct competition with supermarkets, such is not sufficient to justify inclusion of all retail grocery sales from whatever outlet in the relevant product market."

91. And later on the Staples Court follows a similar approach to the evidence that we have when it concludes:

"The documents reviewed by the court show that the merging parties evaluate their competition as the other office superstore firms, without reference to other retailers, mail order firms, or independent stationers."

92. In our view this case is an appropriate instance for defining a sub-market that constitutes a relevant market – the practice, language of the industry and documents of the parties all support this conclusion. This does not constitute gerrymandering by the Tribunal, these are sub-markets carved out by the practices of the industry's players.[32]

93. How then do we approach the issue of concentration in view of this controversy? Most usefully, the parties have calculated market shares using the various permutations that have been considered in the prior analysis– one is a segmentation based on two possible LSM bands,

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29 Case no. 1:97CV00701, pages 18-20.

30 Page 19

31 State of California v American Stores 697 F Supp (1998) at 1129

32 The phrase "gerrymandering" is borrowed from Gavil et al, who in their discussion of the Staples case state " If the loss of head-to-head competition among merger partners would permit the firms to raise price regardless of the response by other sellers in the market, the competitive concern could be described equivalently as a unilateral competitive effect within a broad market, or as a merger to near monopoly within a narrow sub-market. Framing the case in the latter terms may make it more appealing, at least if the submarket definition can be simply stated, so as not to appear to reflect result-driven gerrymandering. (See Antitrust Law in Perspective: Cases, concepts and problems in Competition Policy. Andrew Gavil, William Kovacic and Jonathan Baker, Thompson West, 2002, at page 522.

another separates out appliances from furniture and finally the market shares that emerge based on their 'total universe' market.

94. They also then take furniture market shares that are provided in two analysts reports and show, after some adjustments they deem appropriate, that the combined shares post merger of the parties will, on whichever market definition is adopted, be in a range between 25,5% to 27,5%.

95. Yet we need to approach these figures with caution. Unfortunately the Commission in not opposing the merger did not go out to test this information or find new sources. The parties' working of the figures is based on assumptions, estimates and calculated guesses. Thus figures for Profurn are based on reworking done to provide for envisaged store closures whilst OK/ Hyperama is considered still to have 70% of its turnover in the LSM 3-5 range, based on the assumption that because this was the approach adopted in 2000 in the Ellerines merger that assumption is still valid today. Thus the parties' figures show flexibility when adjusting the merging firms shares down to meet current conditions, but their rivals' shares receive no current reappraisal and are assessed on historical assumptions.

96. A better proxy for market share might be using the number of stores in the relevant 3-5 segment since store numbers are current and in the public terrain. On the assumption that each store is of an equivalent size and has a comparable turnover then market shares based on number of stores in the LSM 3-5 category would look like this:

Participant	**No. of stores in LSM 3-5**	**% of market**
JD Group	**123**	**8.5**
Profurn	**226**	**15.7**
Relyant	140	9.7
Ellerines	399	27.7
Lewis	420	29.1
Other	134	9.3
TOTAL	1442	100

97. On this basis the merged firms have 24,2% of the post merger market. The HHI is 2113 pre-merger and 2380 post merger, yielding a change in HHI of 267, suggestive of a concentrated market.[33]

33 The Herfindahl-Hirschman Index ("HHI") of market concentration is calculated by

98. Approached from a different perspective the UBS Warburg analyst suggests that Profurn, JD, Relyant and Ellerines collectively account for 87 % of sales to consumers in the LSM 3 – 5 market.[34]

99. On the parties' turnover figures, the HHI's lead to a highly concentrated market for the LSM 3-5 market, that excludes independents and mass discounters, but is not concentrated using their universal definition i.e a market spanning LSM 3-8 stores, independents and mass discounters. [35]

100. However for reasons that we advanced above the universal market definition is based on three fallacious assumptions and cannot be correct. Even if the Ellerines definition is too narrow, it yields such high concentrations that even if slightly diluted by stretching LSM boundaries by another band, or allowing for some hypothetical independents, one would still have a concentrated a market post merger.

101. It is not necessary for us to definitively conclude whether this will result in a substantial lessening of competition because, as we explain below we have concluded that it is probable that this concentration would have occurred even absent the merger.

102. The conclusions about concentration are however indirectly pertinent to the vertical effects of the merger which we deal with below.

103. **Because we make no adverse finding against the parties in respect**

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summing the squares of the individual market shares of all the participants. The spectrum of market concentration as measured by the HHI is divided into three regions that can be broadly characterized as unconcentrated (HHI below 1000), moderately concentrated (HHI between 1000 and 1800), and highly concentrated (HHI above 1800). A merger that results in an increase in the HHI of more than 100 points is likely to raise competition concerns.

34 See UBS Warburg report, Record page 949. The CR 4 model for concentration levels suggests that a market can be regarded as concentrated if the top four firms enjoy more than 75 % of the market and the merged firm will supply at least 15% of the relevant market.

35 The market shares in the LSM 3-5 excluding independents are given as: Ellerines 26.1%; Relyant 15.67%; JD Group 9.35%; Profurn 12.35%; OK/Hyperama 25.6% and Lewis 10.36%. On this basis the HHI is calculated at 2189 pre-merger and post-merger the HHI is 2446. On our calculation the HHI pre merger is 1959 and post merger 2190. In the LSM 3-8 market (excluding discount stores) the pre-merger HHI is calculated as 1093 and post merger 1356, including discount stores the pre merger HHI is 876 and post merger the HHI is 1027. These market shares were adjusted by the parties to account for the planned store closures and in LSM 3-5 the pre merger HHI is then calculated to be 2073 and post merger 2218. In LSM 3-8 the pre merger HHI is 1066 and 1232 post merger (excluding discount stores). Including discount stores in LSM 3-8 the pre merger HHI is 861 and post merger the HHI is 956.

of the horizontal aspects of the merger, it is unnecessary for us to come to some definitive conclusion on the boundaries of the relevant market. Whether we follow the definition we applied in the Ellerines case or, the universal market favoured by the Commission and the parties, or some permutation in between the two, the choice of classification in the present case will not result in different legal consequences. We would observe in passing that despite the diligent efforts of the parties to the contrary we are not persuaded on the present facts that the market definition adopted in the Ellerines case does not still seem the best template to apply.

104. *Causal link between the concentration and the merger.*

105. Section 12A requires there to be a causal relationship between the merger and the substantial lessening of competition in the implicated market. This is because of the clear language which states that:

"…the Tribunal must initially determine whether or not *the merger is likely to substantially prevent or lessen competition*…"

106. If the loss of competition would have occurred in any event due to other factors, absent the merger, then the merger should not be enjoined because the remedy would be pointless.

107. This approach has been followed by the European Court of Justice in - France v The Commission:[36]

> *"If a concentration is not the cause of the creation or strengthening of a dominant position which has a significant impact on the competitive situation on the relevant market, it must be declared compatible with the Common Market."*

108. The parties have alleged that Profurn was a failing firm and rely on this factor to sanitise the merger lest it be otherwise be found to be anti-competitive (see our decision in Iscor/ Saldanha where we held that the failing firm is not a defence, as it is in some other jurisdictions, but a factor amongst others to be taken into account in the assessment of a

36 France v EC Commission, cases C-68/94 and C-90/95 [1998] ECR I - 1375, [1998] 4 CMLR 829. See also Whish, R. Competition Law, 4th edition.

merger).[37]

109. If Profurn was failing, and its market share then went to the remaining firms in the market, in some permutation leading to concentration levels in the market and an increase in market share by the merged firm no worse than they would be in the post-merger scenario if the merger goes ahead, then at least on one version of the failing firm doctrine the merger should not be enjoined because of its lack of causative effect.[38]

110. Was Profurn a failing firm?

111. Profurn's fall from grace in the past few years is attributable to two major factors- firstly, the deteriorating business environment faced by firms extending credit to the mass market, and secondly a lack of strategic management focus that made the firm particularly susceptible to misfortune in an adverse environment.

112. We have referred to the change in the business environment in the Background section and we need not repeat it again here. Profurn was ill placed to weather the storm because its previous executive chairman Gavin Walker had pursued an aggressive management strategy to expand the group as rapidly as possible.

113. It is instructive to note that in 2000 when we considered the Ellerines merger we quoted from Profurn's 1999 Annual report where they made the point that the quality of their debtors book was improving and that this was also enhancing cash flow. Two years later this sanguine sentiment has proved ill founded. The retail industries' swan had now become its ugly duckling.

114. Profurn's cash flow had not improved to fund its growth largely because it was a credit not a cash business. The roll out was financed by a steadily rising mountain of debt extended by a consortium of banks principally, First National Bank. The UBS Warburg report suggests that Profurn was growing at rates that exceeded the capacity of its balance sheet and at the same time it was experiencing gross margin pressure. In five of the eight years that they analysed they had negative to negligible operating free cash flows.[39]

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37 ISCOR Limited / Saldanha Steel (Pty) Ltd case no. 67/LM/Dec01

38 This is the approach taken in the European Union. See the discussion in the Iscor decision supra.

39 See UBS Warburg report page 965 of the record (page 25 of actual report).

115. In the course of 2001, FNB alarmed at the decline, began to canvass other firms that might be interested in purchasing Profurn. Buyers that were interested wanted only parts of the business, and not the whole, and the matter was not pursued.

116. In 2002 FNB decided to recapitalise the business by way of a rights offer that led to FNB assuming control with a stake of 78,8%. Once it had assumed control over the business, FNB resumed its search for a buyer. This appears to have been known in the market and led, according to FNB's Theunie Lategan, to a surprising, unsolicited approach from JD to purchase the entire business, something no one else had been willing to do, in exchange for shares in JD.

117. Serendipitously, this overture was followed by an approach from a prominent entrepreneur, Claus Daun of Daun et Cie who agreed that if the deal with JD went ahead he would be willing to purchase five sixths of the shares in JD that FNB acquired from the sale.

118. It is not difficult to see why the deal was so attractive to FNB. Not only was the ugly duckling to be taken off its hands, but also it received shares in an expanded more viable group in a less concentrated market. The Daun leg had the added virtue of reducing its exposure to the furniture retail industry.[40]

119. Subsequent to the deal being announced the parties approached the Commission for permission to allow JD to act in a consultative capacity to the Profurn board until such time as the merger had been cleared. The Act does not allow parties to implement a merger prior to approval. The Commission approved the plan. It appears to have been agreed that the Commission would be provided all minutes of the Board to enable it to monitor the decision- making processes, presumably to ensure that JD had not precipitately assumed control.[41]

120. When the merger was notified to the Commission the parties relied on the fact that they considered Profurn to be a failing firm as part of their case. The supporting information was provided by Lategan, from FNB, who although at that time a member of the Profurn Board, was a non-executive

40 FNB had also been heavily exposed at this time to Relyant, which was at the same time going through reconstructive surgery.

41 That this undertaking seems to have been more honoured in the breach appears from two entries in the minutes of the period. One indicates that the minutes need to be written so as to reflect that the Profurn Board not JD is making the decisions (minutes of meeting held on 5 August 2002 at point 9). The other is an observation that the minutes have not been sent to the Commission and that this must be rectified (board minutes 19 September 2002).

director. This was later to become a controversial issue within Profurn Board as Kevin Boyers, the financial director, vehemently denied Profurn was a failing firm and made his views known at a Board meeting questioning why the report had been made without input from either the executive directors of Profurn or the Board.[42]

121. A month later Boyers was given an opportunity by the Profurn board to present his own conclusions as to why Profurn was not a failing firm. He was not able to influence the board at this subsequent meeting to change its submission.

122. It was for this reason that we called Boyers as a witness in our hearing. Boyers testimony was cautious and inconclusive on the issue of Profurn being a failing firm. This is not surprising given the invidious position in which he now finds himself as the dissident opinion on a Board wholly committed to the merger. He still appears to stick to his view that at the time of the submission (2 August 2002) Profurn was not a failing firm although at the time of the hearing (25 November 2002) he conceded that it probably was.

123. One of the difficulties that also makes the assessment difficult, and which is raised by Boyer's evidence, is the change in accounting policy by Profurn at the end of December 2001, when the company changed its policy for reflecting debtors to an arrears basis and as a result it recorded an additional provision of R477 million.

124. According to UBS Warburg:

> *"We believe that the substantial increases in debtors provisions by Profurn and Relyant, are at least in part attributable to a change in their accounting policies with regard to arrears."*[43]

125. Although JD in its cross-examination sought to establish that Boyers was influenced by his alleged animosity to the new owners over a compensation issue and that as a director for obvious legal reasons he was disinclined to concede the firm was failing in a public filing, we have no reason not to accept Boyers testimony; indeed it would have been much easier for him like other members of the Board to accept uncritically the tide of history and to support all steps to facilitate what appeared an inevitability – the merger with JD.

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42 See Board minutes of Profurn dated 5 August 2002.
43 See UBS Warburg report op cit, Record page 946.

126. This rendition of the facts is not intended to record a saga of corporate infighting. The relevance of the dispute is how much value to attribute to the claim that Profurn was a failing firm.

127. The reason for our concern is that the dominant influences on Profun during the periods of this assessment were FNB and, later after the Commision assented to the interim arrangement, JD and FNB. Both were committed to the deal and doubtless wary in the light of the Ellerines decision as to how the transaction would be viewed by the Competition authorities. The failing firm assertion would importantly create the basis not only for distinguishing the present notification, from that in Ellerines, but would also help to fast track it.

128. An examination of the board of directors during the period for which we have access to the minutes, demonstrates the extent to which it had become dysfunctional. The exit of the tarnished wonder boy Gavin Walker as executive chairman saw no serious subsequent attempt to replace him with anyone as CEO whilst the two Chairman who followed were all interim appointments. The non execs, who included among them the founder of the group, left as well and soon the company during the time of its restructuring was effectively run by a board composed of FNB appointees, executive directors of the pre- FNB era who were either disgruntled and disillusioned or time servers waiting for their moment to jump ship. Little wonder that the FNB execs and the JD people, after the commencement of the interim agreement, who whilst not on the board attended the meetings that mattered and although in the side chairs proclaimed on issues with all the authority of a crown prince in waiting, were able to mould Profurn in its last pre-merger months to suit their desired end – the sale of Profurn to JD. It is not surprising that Profurn never explored the alternative purchasers other than a sale to a rival because with Walker's exit they never acquired a leadership committed to rescuing the group.

129. Noteworthy is the fact that on 20 May 2002, prior to the JD offer, the board minutes of Profurn record that First Rand had agreed to the following:

- *"reconstitute the board*
- *decide what to do with Profurn after they became the majority shareholder*
- *appoint in consultation with the board a CEO"*

130. Of these three undertakings the first was served largely by the appointment of its own people to the board, rather than new blood

committed to turning the company around, the second was answered by the sale to JD and the third was never fulfilled.

131. To what extent then is Profurn's final demise a function of difficult market conditions coinciding with historically ill -considered management choices or the desire of its final custodians to rid themselves of it and take no steps short of sale to a rival to revive its fortunes.

132. We cannot answer this question with any certainty as to the Profurn business as a whole. In all failing firm cases managements are in some way responsible for their firm's demise. In this case our concern is not that, but whether the failing firm factual scenario, is either not credible on the figures, in view of the dispute with Boyers, or if it was, has Profurn been conveniently allowed to further wither into decline, unhindered by any haste in remedial action from its custodian shareholder, FNB, which showed great activity in selling the firm, but conversely only passivity in trying to resurrect it.

133. Although we cannot resolve this dispute of fact on the evidence before us we can say with more certainty that the businesses that Profurn had in the lower end of the market were in terminal decline and even had Profurn found another owner it is unlikely to have been a buyer for these businesses. This is not only corroborated from the testimony of other would be buyers such as Ellerines, but also the minutes of the board in 2002 and JD's subsequent stance toward these stores.

134. Since these are the sub-markets where we see competition being most seriously impaired the inevitable exit of these brands means that the merger is not the agent of their demise.

135. Perhaps the best exposition of this theory of the inevitable consolidation of the industry comes in a 2002 report prepared by an analyst with UBS Warburg appropriately titled *"Consolidation is coming"*.

136. In the report the analyst observes what he terms the "dissaray in the industry" and the fact that industry profitability and balance sheets are under pressure. He notes that ;

> "the excessively competitive environment resulting from Profurn's aggressive strategy has also eroded margins."[44]

137. Later on at 944 says:

[44] Page 941

“ We believe that the key driver of this negative trend in cash flows was the aggressive expansion strategy adopted by Profurn. The effect was to increase *the degree of competition within the industry, which, in our opinion led to gross margin pressure.”*

… “ We believe that the closure of these stores and bringing Morkels and Hi FI Corporation under JD Groups management should reduce competition within the industry and benefit all participants.”

138. The report which is written in September 2002, prior to the Commission’s recommendation, goes on to state that whatever the Commission’s decision:

“ Protea will be closed and so a reduction in competition in the lower end of the market is unavoidable.”

139. According to the analyst consolidation would take place anyhow and the only difference is how quickly it would come about. [45]

Conclusion

140. For reasons we set out above we do not find that all the elements of the failing firm doctrine have been established. Nevertheless we are persuaded by the evidence that certain businesses of Profurn would have exited the market if there had either not been a merger or if another firm with a less competitively adverse profile had been the purchaser.

141. Although the exit of certain of the Profurn chains will lead to an increase in concentration in the market in those segments of the market in which those effects might be most pronounced namely the LSM 3-5 segment, and where entry is less likely (this is conceded by the parties), the inevitable exit of some of Profurn’s stores in this end of the market, suggests this would have occurred in all probability absent the merger. Consequently that market share would inevitably have gone to the remaining chains, with Ellerines best placed to be the major beneficiary. The merger is thus not the causative effect of the present state of the market.

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45 UBS Warburg conclude that Ellerine has the most store overlaps with Profurn in the lower end of the market – for this reason its elimination will mean that they will be the main beneficiary of the merger

142. The merger at worst shifts the calculus in favour of JD, which is smaller than both Ellerines and Lewis in this segment. In the other segments implicated by the merger namely the appliance sector and the mid/upper furniture market, concentration is less pronounced, although entry because of the higher margins and lower risks is more likely.

143. On this basis we find that the merger itself will not lead a substantial lessening of competition hence we do not impose any conditions in relation to the horizontal aspects of the merger.

144. Thus although the merger would increase concentration and reduce competition in the market this would have occurred absent the merger and the merger is thus not the causative effect of the present state of the market.

145. This is perhaps the most distinguishing feature between this merger and the JD/Ellerine merger, apart from the dramatic changes the industry has weathered in the interim.[46]

Vertical effects

146. Although several witnesses gave testimony on behalf of the intervenors their evidence was largely consistent and can be approached collectively.[47]

147. The core concern of the intervenors, is that the deep-seated relationship between the JD Group and Steinhoff, the countries largest furniture manufacturer and JD largest supplier, will, in the post merger scenario result in the independent manufacturers losing the custom of the Profurn stores to Steinhoff. 148. In turn this customer foreclosure would see the demise of the independent manufacturers, a concern echoed by the CEO of Ellerines, Mr Peter Squires.

149. The shareholding of Mr Daun in Steinhoff immediately prior to this transaction amplified these concerns, since this transaction would

46 We note however, that given Relyants' precarious financial position the Ellerines group remains the JD Group's most effective rival. Analysts speculate about the appetite of Lewis and OK Furniture for this end of the market. Had the Tribunal permitted its merger with the JD Group two years ago, the demise of Profurn would still have taken place and consumers at the low end of the market would be left with even less choice than they have today.

47 **The independent manufacturers claim they represent 46% of the total furniture manufacturing industry.**

see him acquire JD shares as well. However, as was highlighted by the merging parties and widely reported in the media, Mr Daun disposed of his shares in the Steinhoff Group almost simultaneously with the notification of this transaction.[48] **However, Mr Daun remains at the date of this decision a director of Steinhoff.**

150. **The Commission investigated the submissions of the independent manufacturers, opposing the merger, and found no evidence of the alleged links between Steinhoff and the JD Group, hence the conclusion that these allegations amounted in its opinion to no more than a conspiracy theory.**[49]

151. This view of the close relationships at least between Steinhoff, Relyant and JD is not the sole preserve of the independents. In an article for Money Web, well-known journalist David Gleason, had the following observation about the takeover of Relyant by German group Poco:

"There is a little twist to the tale at this point, however. It seems that Poco's founder Peter Pohlman, is a close friend of one Bruno Steinhoff whose company is, apparently, Relyants biggest single creditor to the tune, I understand, of about R 400 million. So if you're cynical(I am), this could be interpreted as a deal structured, in part at any rate, to protect Steinhoff's interests. Indeed, and given the link between Steinhoff and the JD Group, it looks as though Steinhoff is seeking to establish an impregnable position in the furniture industry."[50]

152. Despite the lack of proof before us of any structural links between JD, Steinhoff and other key players in the furniture industry, we probed the vertical relationship between JD and Steinhoff, to examine the likely impact of the merger on independent manufacturers who have historically supplied Profurn.

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48 Business Report, 1 October 2002. Mr Daun sold Steinhoff shares to finance an interest in Metz Manufacturers and BCM Holdings, in the bedding components industry.

49 In their submission to the Commission the Intervenors refer to Steinhoff, Daun and David Sussman of JD as a syndicate attempting to gain total control over the furniture industry in South Africa.(See Annexure C to their affidavit in support of their application for intervention, Record page 1022. According to the Commission's report, the submissions they received, named Ellerines and Relyant as participants in a collusive arrangement with JD and Steinhoff, aimed at controlling the furniture retail industry, by virtue of unproven family relationships and shareholdings.

50 See article entitled "Relyant shareholders can rely on being told to take a hike." Money Web 10 July 2002.

153. It is common cause that Steinhoff is the dominant firm in manufacturing of furniture and bedding industry. According to the independents Steinhoff has 54 % of this market. They segment this market into three categories as follows:

	LOUNGE	WOODEN	BEDDING	TOTAL
Steinhoff & Associates	55 %	39 %	69 %	**54 %**
Independents	45 %	61 %	31 %	**46 %**

154. Founded in 1964 by Mr Bruno Steinhoff in Germany, Steinhoff is one of the five largest furniture manufacuturers in Europe and the largest in Africa. The group describes itself as manufacturing, warehousing and distributing a *"wide range of household goods (mainly comprising bedding, case goods and lounge furniture) as well as the raw materials used primarily in the manufacturing of household goods."* [51]

155. Steinhoff has grown to its pre-eminent position as a result of a series of mergers of the past decade, which saw it acquire its major rivals. [52]

156. The Steinhoff Annual Report of 2001 contains a list of superlatives describing its extensive penetration of the local market:

- Sealy is described as the " largest bedding manufacturer in South Africa" Edblo one of its other bedding divisions has a long-term contract to manufacture beds under licence from the Relyant Group.

- **Gomma Gommma is the *"biggest producer of showwood furniture in South Africa servicing a broad spectrum of lounge***

51 This information comes from the website for Steinhoff International Holidings Limited.

52 In 1989 M Jooste and M Delport acquired Gomma, in 1991 Gomma acquired Bakker & Styger and Wesco take out Delport, in 1994 Victoria Lewis is acquired, in 1995 Daun takes out Wesco, in 1996 Gomma buys Loungefurn, in 1997 Victoria Lewis, Gomma, Bakker & Styger become Steinhoff Africa, in 1998 Gomma acquires assets of Beechfurn, in 1998 Cornick acquire Afcol and in 1999 Steinhoff Africa merges with Cornick.

markets."

- **Grafton Everest, which manufactures upholsetered lounge suites in fabric and leather is described as *"the largest lounge factory in South Africa."***

157. Steinhoff has grown, largely due to its capacity to cater for the production volumes required nationally by the large retail chains, which have benefited from a shift in the buying power. Correspondingly the number of viable independent manufacturers has declined alarmingly.

158. The decline in the independent furniture manufucturing sector and the consolidation of the larger firms into Steinhoff has meant that there are an insufficient number of local manufacturers capable of supplying the large chains with their needs.

159. In fact Mr Squires, CEO of Ellerines testified that despite a policy of spreading the ratio of purchases between the independent manufacturers (80%) and Steinhoff (20%), Ellerines has difficulty in limiting its purchases from Steinhoff. Despite a decrease in the past year or two, Ellerines' current purchases from Steinhoff are still in excess of 25%[53]. Retailers dependence on Steinhoff gives it the opportunity to exercise market power.

160. Steinhoff acknowledges that it benefits from the consolidation taking place in the SA furniture retail industry. Its managing director**,** Markus Jooste is quoted in Business Report, dated Sept 10 2002, as saying;

"The consolidation of the local furniture retail sector is nearing completion, which is expected to benefit the group."

161. According to the reporter one of the deals he was referring to was JD/ Profurn.

162. During the hearing we were presented with details of the purchase arrangements between JD and Steinhoff. According to Steinhoff, JD accounts for 33.50 % of its sales making JD easily Steinhoff's largest customer.

163. Both JD and Steinhoff deny that there is any supply contract in existence between them so what evidence we have about their

53 See hearing transcript, 29 November 2002, p 7-8.

relationship has to be gleaned from the effect felt by other players in the market at both manufacturing and retail level.[54]

164. According to Ellerines' Mr Squires, not only does JD enjoy volume rebates from Steinhoff, but Steinhoff in turn benefits from a right of first refusal. It is understood that the right of first refusal entitles Steinhoff to either equal or better the cost price of a product. Although Ellerines purchases a substantial percentage of its supplies from Steinhoff, it does not enjoy similar arrangements.

165. Mr Roy Pritchard, one of the intervenors, testified that JD's store merchandisers informed him that they had been instructed to "achieve targets with Steinhoff" and as a consequence "the bread and butter" lines manufactured by independents were substituted with variations made by Steinhoff.

166. Almost all of the intervenors testified that they had lost the custom of the JD Group, presumably to Steinhoff. Profurn, in contrast to JD, was a chain that purchased overwhelmingly from the independents. Their underlying fear was therefore that post merger the merged entity would favour Steinhoff at their expense given JD's current purchasing policies.

167. Despite the parties' insistence that in order to maintain the Profurn stores' brand awareness, they would be compelled to continue sourcing supplies from the independents, we are not convinced that the intervenors fears are unfounded.

Conclusion on vertical effects

168. There is no doubt that the increased buying power of the merged entity will have an effect on the manufacturing industry. The US horizontal merger guidelines recognise the potential harm of this phenomenon:

> **"Market power also encompasses the ability of a single buyer (a "monopsonist"), a coordinating group of buyers, or a single buyer, not a monopsonist, to depress the price paid for a product to a level that is below the competitive price and thereby depress output. The exercise of market power by buyers ("monopsony power") has adverse effects comparable to those**

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54 This denial was made by Steinhoffs secretary in response to questions we asked the Commision to put to them (letter received from Commission dated 14 November 2002) and on behalf of JD by Mr Sussman during his testimony.

associated with the exercise of market power by sellers."[55]

169. What emerges from an analysis of the evidence is the following-

a) Steinhoff is the dominant supplier of bedding and furniture to the South African retail industry. Although the extent of this is disputed on either version this holds true.
b) Steinhoff enjoys particularly close supply relationships with at least two of the chains, JD and Relyant.
c) Steinhoff has over the past decade grown dramatically through a strategy of acquisitions of the major players in the industry as well as securing its position through vertical integration.
d) At the same time the position of the independent manufacturers has declined. Once they enjoyed a position of market power over retailers but this has gone. There has been a decline in the number of manufacturers in recent years and there is reason to believe that this trend will continue in the foreseeable future.
e) The demise of the manufacturer has an impact on the retail industry. It means that retailers have fewer manufacturers to look to inhibiting their ability to secure best prices and product choices. In this industry product variety is part of a firms competitive advantage.[56]
f) Independent manufacturers will depend for their survival on preserving the custom of the chains in order to achieve some economies of scale to retain their competitiveness.
g) However the chains need to secure high volumes of product and can only get this at the best prices by securing rebates from Steinhoff. This has led to even a powerful group such as Ellerines being more dependent on Steinhoff than it wishes to be.
h) Independents claim that the volume rebates offered by Steinhoff are such that they act as a disincentive for large retailers to purchase from them. The Ellerines experience appears to substantiate this.
i) Profurn is identified by the independents as being one of the chains that had *"championed the cause of independent manufacturers"* [57]
j) JD on the other hand has the closest relationship of the all the chains to Steinhoff and is its major customer.
k) Within the merged group JD is likely to alter Profurn's purchasing

55 US Horizontal merger guidelines, US Dept of Justice and Federal Trade Commission, April 1992 (revised 1997) p4.

56 Morkels for instance in its marketing report notes that one of its problems is to overcome consumer views of its 'sameness" with its competitors. Record page1107.

57 See Submission from Independent manufacturers to the Competition Commission entititeld Proposed JD takeover of Profurn, Record page 1022.

policies away from independents in favour of Steinfhoff

l) This will be a further nail in the coffin of the independents and likely to lead to further failure and exit thus further increasing concentration in the manufacturing sector.

m) The demise of the independent manufacturer sector is likely to raise barriers to entry to the increasingly concentrated retail sector. New entrants will be faced with higher supply costs and less choice for their customers. Whilst imports are an alternative they are less attractive to firms that have smaller volumes and those that sell to the lower income groups, precisely the area in which we find competition to be most reduced.

n) The merger is likely to increase concentration in the furniture-manufacturing sector and accordingly increase barriers to entry in the retail sector.

170. The adverse effects referred to above can be remedied by placing conditions on the merger- outright prohibition is not warranted. We discuss these conditions in the next section after first considering the efficiencies claimed by the parties and the public interest issues raised by the merger.

Efficiencies

171. The parties submit that the introduction of JD's management system will result in annual huge efficiency savings, and that additional savings will flow from the store closures. In a report prepared by Deloitte & Touche it is submitted that the annual efficiencies are calculated at R83.4 million.

172. Since we do not intend prohibiting the merger and the efficiencies claimed remain unaffected by the conditions we are imposing, we do not need to pursue the efficiency arguments any further.

Public interest issues

173. ***Employment***

174. As is required in terms of the Act the parties informed two representative trade unions of the proposed transaction. SACCAWU furnished the Commission with a comfort letter in which they indicated their support for the merger. ECCAWUSA met with the Commission but did not provide any written submissions.

175. Essentially the merger, although resulting in potential job losses of

1284, as a result of proposed store closures, is presented as being less harmful than would be the case if Profurn were to exit the market. The parties aver that the merger will save some 5716 jobs (without the merger 7000 jobs would be lost)[58].

176. We were however, not completely convinced that that this claim could be regarded as a substantial public interest ground on which the merger should be approved. Even if Profurn were to exit the market, it is clear that some of its better stores would be bought as going concerns, thus not all of Profurn's workforce would be without employment. On the other hand, it is also not clear what the precise impact of JD's stated rationalisation plans will be. Thus it is extremely difficult to conclude that the merger will result in fewer job losses than would the exit of Profurn.

177. However since we have approved the merger, it is again not necessary for us to come to any conclusion on whether its effect on employment creates a substantial public interest ground, which justifies the merger.

SMME's / Historically Disadvantaged Persons

178. Although the independent manufacturers are not SMME's, historically disadvantaged persons control most of these businesses. We have, however, considered and addressed the potential impact on these businesses, in our conditions, in terms of the vertical integration issue, not as a public interest concern, although its impact will also advance this particular aspect of the public interest.

Remedies

179. The intervenors have argued that the only solution to their competitive concerns would be to prohibit the merger.

180. We are not persuaded by this as a less drastic solution would in some way ameliorate some of the concerns of the sector without being overly solicitous of specific independents who enjoyed a relationship with Profurn in the past.

181. The JD group claims it has a policy of encouraging independents and the figures that it produced were offered as evidence of this. According to it, at the present moment, it is procuring 30% of its lounge furniture, case goods and bedding needs from independents the remaining 70% was from

58 Parties competitive report pages 603-604; Commission's recommendation pages 68-69.

Steinhoff. However they attempted to show that between 1998 and 2002 the share of independents had grown by 57% whilst that of Steinhoff' by only 56%. A closer look at the way these figures were computed showed that they compared Steinhoff only to independents who continue to supply JD and excludes those who no longer do. The true comparison reveals that in total independents supplied 35% of JD's needs in 1998 whilst in 2002 they supply only 30%. In contrast Steinhoff's proportion had gone up from 65% to 70%. At best JD may have increased its purchases from some independents over this period but that increment has been at the expense of other independents not Steinhoff whose overall position continued to improve.

182. Whilst the professed policy is less easy to discern from the numbers produced to support it, and hence the concern voiced by the intervenors has validity, it would seem that the imposition of conditions for a short period that JD purchases from independents in a specified percentage does not run counter to its currently expressed business objectives.

183. For this reason we have imposed conditions on the JD Group in relation to its purchase of supplies from independent furniture manufacturers. The various chains that make up the newly merged firm will be obliged to purchase from independents, at least in the same proportion as they do presently. The conditions will be in force for the next three years, after which they fall away. During the period in which the conditions are in force, independents will have an opportunity to compete for the JD Group's custom whilst adjusting to the changes in the retail sector. The order of the Tribunal obliges the JD Group to submit an annual report from its auditors confirming that the retail chain is abiding by this condition.

184. On the other hand the conditions do not oblige the JD Group to use any particular independents, even those who have traditionally supplied the Profurn group. This means that the JD Group will not be forced to support inefficient suppliers and thus raise its costs in relation to those of its rivals.

185. The conditions will not require detailed monitoring by the Commission beyond ensuring that the merged firm complies with its obligations by the specified dates. Verification becomes the responsibility of the merged firm's auditors. Doubtless as well the vocal lobby of independents will monitor compliance very closely. However this does not detract from the Commission's statutory powers and responsibilities, which it must use to ensure overall compliance with the conditions as set out in the order.

These conditions are set out in Annexure A hereto.

29 April 2003

N. Manoim **Date**

Concurring: D. Lewis, U. Bhoola

For the merging parties:	Adv. W Pretorius instructed by Feinsteins Attorneys.

For the Commission: M. Simelane, Legal Services Division, Competition Commission.

For the Intervenors: Adv. R Meyer SC instructed by Edelstein Bosman Inc.