COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 69/AM/Dec01

In the appeal in the intermediate merger between:

Astral Foods Limited

and

National Chick Limited

Reasons for Decision – Non-Confidential Version

Introduction

This is an intermediate merger, which has been brought to the Tribunal by the parties to be considered in terms of section 16(1)(a) of the Act.

The Competition Commission prohibited the merger because it would substantially lessen competition in the relevant markets. It found that the horizontal combination of Astral and Natchix would remove Nutrex, an effective competitor, from the animal feed market and would, furthermore, foreclose independent broiler breeders from the day-old chicks market as a result of Astral's vertical integration with Natchix.

The Tribunal Hearing

The Competition Commission issued a Prohibition of Merger Notice on 6 December 2001 and the Parties filed a request for Consideration with the Tribunal on 14 December 2001.

A pre-hearing was held on 21 January where we requested additional information from the Commission as well as the parties. Hearings took place on 19 February and 20 March 2002.

Mr E. Waters, Managing Director of Nutrex who acted on behalf of the Minority

Shareholders in Nutrex, Mr R. Sclanders, Chairman of the East Coast Broiler Association, Mr N Wentzel, the Managing Director of Astral and Mr Tom Pritchard, the Financial Director of Astral, were called as witnesses by the Competition Commission and the merging parties.

Mr Michael Brown, an executive member of the Investment Analyst Society intervened in the merger proceedings before us focussing his comments on the adverse effect a negative Tribunal decision would have on future investments in South Africa.

After hearing the matter on 19 February and 20 March 2002 the Competition Tribunal decided to approve the transaction subject to these conditions:

Conditions in relation to the Broiler Industry

1. Astral must supply any independent customer on the following basis:

    1.1. Subject to sub-paragraphs 1.3 and 1.4 below, in terms of a standard form contract approved by the Competition Commission.

    1.2. In the case of any disease or other form of force majeure, Astral must reduce its supply to all customers, including entities within the Astral group, pro rata to their ordinary volumes purchased

    1.3. In the event that an independent customer does not wish to enter into the standard contract with Astral, then Astral must supply that customer in accordance with the principles set out in sub-paragraph 1.4 below, except for those that relate to notice periods.

    1.4. Astral may not discriminate in its conditions of supply between entities in its own group and its independent customers for equivalent transactions. In particular it may not discriminate between them in relation to price, discounts or rebates offered. The determination of prices remains in the discretion of Astral. Astral may not impose any condition on an independent customer that requires them to purchase exclusively from Astral. The parties to the agreement must each be required to give notice to the other if they do not wish to renew the contract. The length of this period must be the same for both parties and must be reasonable having regard to the nature of the industry. The contracts must be of a five year duration.

2. The conditions set out in clause 1 above shall apply for five years from date of this order.

3. The Commission's discretion in approving the standard form contract is limited to ensuring that it complies with the principles set out in sub-paragraph 1.4 above.

Conditions in relation to the Animal Feed Industry

1. Astral must divest itself of its entire shareholding in Nutrex (KZN) (Pty) Ltd (the "interest") to an independent purchaser, approved by the Commission.

2. Within [confidential] of the date of this decision Astral must advise the Commission of the name of the proposed buyer and the terms of a binding agreement to purchase the interest.

3. Within [confidential] thereof the Commission must indicate whether it approves of the buyer.

4. The transaction must be concluded and the shares transferred within [confidential] of the date of the Commission's approval.

5. Astral must not be involved in the management of the business nor have access to the books or records of Nutrex (KZN) (Pty) Ltd, during the period contemplated in 4 above.

6. The Commission may not withhold its approval unless it is reasonably satisfied that the buyer is -

   6.1. not independent of Astral; or
   6.2. not a viable purchaser.

7. If Astral has failed to secure a binding offer within the [confidential] period, or if the Commission does not approve the proposed buyer, then the Commission must appoint a trustee with a mandate to sell the interest at a price to be determined by the Trustee.

8. The costs of the Trustee will be for Astral's account.

9. Astral must co-operate fully with the trustee in this regard in order to give effect to this mandate.

10. Astral must provide the Trustee all reasonable assistance and information required for the Trustee to carry out this order, including copies of all relevant documents and access to appropriate personnel.

11. The time periods in this order are confidential and may only be disclosed to the Commission, Astral and the Trustee and their respective advisors.

Our reasons for the conditional approval are set out in the following paragraphs.

Background information

The transaction

The primary acquiring firm is Astral, an investment holding company listed on the industrial foods sector of the JSE. The Astral Group controls Meadow Feeds (Pty) Ltd, Nutec SA, Ross Poultry, County Fair, Earlybird and Central Analytical Labs.

The primary target firm is Natchix an investment holding company listed on the JSE. The current shareholders in Natchix are:

- Astral Foods 34.9%
- Management 35%
- Old Mutual 9.8%
- Other Shareholders 20.3%

Natchix, who holds 55% of the shares[1], controls Nutrex, which operates in the animal feed market.

Astral, which currently owns 34.9% of the issued share capital of Natchix intends to acquire the remaining 65.1% of the issued share capital of Natchix by way of the scheme of arrangement. The proposed transaction will also result in Nutrex being acquired by Astral.

The transaction is both a horizontal and a vertical merger, horizontal because of the product overlap in the animal feed market[2] and vertical through the acquisition of Natchix, the independent producer of day-old chicks.

We will focus most of our analysis on the vertical aspect of the merger since the parties have indicated in the hearings that they have no interest in Nutrex, which they offered to sell if the merger is approved. We will, however, for the sake of completeness, discuss the horizontal leg of the merger briefly.

Rationale for transaction

According to Astral its 34.9% shareholding in Natchix has a book value of R 17 million, which represents a large portion of Astral's investments. It says that as an operating rather than an investment company it is uncomfortable with the large, yet minority stake in Natchix. It avers that it should ideally hold 100% of the shares in Natchix in order to obtain the maximum value from its shareholding.

1 The shareholding in Nutrex are: Natchix 55% and R. Clarke, A Venter and E Waters collectively own the remaining 45%, the minority shareholders.

2 Both Astral and Natchix, through their respective subsidiaries Meadow and Nutrex operate in the animal feed market.

Aviagen (Ross Scotland) has made it clear in discussions with Astral that in order for Aviagen to obtain an adequate return on its South African investment in Ross Poultry Breeders (RPB), RPB would have to acquire a greater market share. Coupled with the aforegoing imperative to capture an even greater market share is a drive to continually reduce costs and inefficiencies within RPB. Furthermore, Natchix, which has a 55% shareholding in Nutrex, is responsible for 85% of all funding of Nutrex. Put another way, the Nutrex minorities enjoy 45% benefit and carry only 15% of the risk. Nutrex minorities are therefore assisted, and in fact enabled to continue to conduct the Nutrex business, by the loan funding made available by Natchix. The parties submit that this situation is untenable.

The Broiler Industry

There are two dominant breeds of chickens that are used worldwide in the broiler production industry, the one being the Ross Breed, supplied by Aviagen, also referred by the parties as Ross Scotland, and the other is the Cobb Breed, supplied by The Cobb Breeding Company in England.

Typically the holder of the intellectual property such as Aviagen and The Cobb Breeding Company would sell grandparents to a distributor (usually through a franchise arrangement) who will then breed grandparents to supply day old Parent Stock into the market place. The customers of this Parent Stock will either be fully integrated broilers who sell their product to the retail market or they will be day old broiler chick producers who in turn supply independent broiler producers that sell their product in the retail market.

The South African Broiler Industry

Astral has a franchise agreement with Aviagen, and through its Ross Poultry Breeders division (“RPB”), supplies breeding stock to the South African broiler industry. RPB’s market share in South Africa is 69% with its main competitor, Cobb, having a market share of 26% of the Great Grandparent Stock market. Cobb sells its product in South Africa mainly to Rainbow, but has also, in the past year, entered the market through a breeding facility in Carolina. The balance of the market, comprising 5%, is supplied by Pioneer, which holds the franchise for the Hybro bird. Pioneer supplies day old chicks to its downstream operations as well as to independent broiler breeders.

In addition to the aforegoing, a partnership exists between County Fair Foods[3] (Pty) Ltd (holding 53%) Natchix (holding 29%) and Country Bird[4] (holding 18%) called Elite Breeding Farms[5]. This partnership supplies parent broilers to Natchix, County Fair and Country Bird.

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3 County Fair is a fully owned subsidiary of Astral.
4 Country Bird is a subsidiary of Senwes.
5 RPB currently manages Elite breeding farm.

The following diagram shows Astral's direct and indirect involvement in the poultry, including the animal feed industry:

Diagram 1

Astral

100% **100%**

Meadow Feeds (Pty) Ltd

Ross Poultry Breeders SA (RPB)

100% **34.9%**

50%

County Fair

Natchix Early Bird

53% **29%** **55%**

Elite Breeding Farm Nutrex Holdings

The Female Ross Bird, Ross 308, is supplied by Aviagen. Astral, through RPB has developed Ross 788 a male bird, which has been specifically bred for broiler production at high altitude.

Astral, through RPB, exclusively imports great grandparent stock ("GGP") from Aviagen and sells the grandparent stock ("GP") and parent stock ("PP") produced by them to downstream participants in the broiler products production chain. RPB supplies GP stock to Elite, which in turn supplies 8600 parcels[6] of PP stock to Natchix and 5000 parcels of PP stock to County Fair. RPB supplies 9300 parcels of PP stock to Early Bird[7] and 11400 parcels of PP stock to the independent broilers. In short, RPB currently supplies 38% of its PP stock to its in-house broilers[8] and 62% to independents broilers[9]. RPB's

6 There are 120 birds in a parcel, 104 female and 16 male parents.
7 Early bird is a joint venture between Astral and OTK.
8 I.e. Early Bird and County Fair.
9 I.e. Natchix, Country Bird and other independents.

market share in the national market is 69% with its main rival Rainbow[10] at 26%.

Natchix uses the PP stock to breed day old chicks, which it sells to independent broiler producers who compete with Early Bird, County Fair, Rainbow and Country Bird. Natchix is the leading supplier of one day-old chicks in both KwaZulu Natal (68% market share) and Gauteng (24% market share).

Early Bird and County Fair, Astral's subsidiaries, buy PP stock from RPB and Elite respectively but do not sell one day-old chicks. They use the chicks for their own integrated operations, which they then sell to abattoirs or the retail market. Independent Broilers that buy PP stock directly from RPB either sell day old chicks to independent day old broilers or raise their own birds, which is then sold to abattoirs or the retail. The following diagram shows the vertical aspects of the poultry industry and on which levels the main players compete:

Diagram 2

788 GGP 308GGP - Ross Breed

Imports Cobb GGP

RPB
GP/PP

Rainbow
GP/PP

Elite
PP

Natchix

Independent
Broilers (**X**)

competing
with Natchix

Early Bird* Country Bird* County Fair*

Independent
day old

Independent
Broilers (**X**)
competing

Rainbow
Broilers

10 Rainbow has an exclusive franchise agreement to import the Cobb bird and Astral the Ross bird.

broilers with integra-
(**Y**) ted

broilers*

Abatoir /
Retail

<u>Key</u>:

Grand Parents: GP
Parents: PP
* fully integrated broiler operations

Independent broilers (**X**) buy PP stock from RPB. Some of **X** sell one day-old chicks and, therefore, compete with Natchix, while others are fully integrated and, therefore, compete with Early Bird, Country Bird, County Fair and independent day old broilers (**Y**).

Our assessment of the vertical issues

In the Schumann/Sasol merger[11] the Tribunal pointed out that vertical mergers, in general, are viewed with sympathy because they raise fewer competition concerns and generate larger pro-competitive gains than horizontal mergers. However, if one or both of the parties dominate their respective markets it would send out warning signals to antitrust authorities because such transactions might, inter alia, raise barriers to entry and enable a party to protect its existing dominant position.

Does this case fall within those categories of vertical mergers that raises competition concerns? It clearly does. The dominant supplier, RPB, is buying its largest independent customer Natchix. However, our inquiry doesn't stop here, we need to establish whether competition will be affected substantially and, if so, whether remedies exist that could address our concerns without outright prohibiting the vertical merger.

In short, the Commission, in its main argument, raises the possibility of vertical foreclosure. The parties argue that circumstances exist that makes foreclosure highly unlikely. We'll now discuss these arguments in more detail.

The Competition Commission raised concerns about upstream and downstream foreclosure by RPB. They allege that before the merger independent broiler breeders

11 See Tribunal Case no: 23/LM/May01.

absorbed approximately 60% of PP stock, whereas, if the merger were approved, independent broiler breeders would only be absorbing around 40% of the total quantity of PP stock. The present structure allows for a competitor to easily enter the market as opposed to a post-merger situation where a sizable chunk of the supply of PP stock will be foreclosed. Astral could use its dominant position as sole supplier of Ross parent breeding stock to foreclose markets downstream to those independent entities that breed parent broiler chickens to produce broiler-hatching eggs and one day-old chicks. Currently the largest independent buyer is Natchix, which has its own breeding facility but also purchases hatching eggs from independent breeders.

The Commission is also concerned that the vertical structure that would emerge post the merger would provide Astral with the ability to price discriminate in favour of its own downstream operations in the market for the supply of day-old chicks. Whether or not this would result in a lessening of competition would, according to them, depend on the extent to which Cobb (Rainbow) could take up excess demand. Evidence gathered by the Commission suggests that over the next few years Cobb would be very limited in this regard and that, in the event of a price squeeze, many independent breeders would find themselves without an alternative source of supply of PP stock.[12]

The Chairman of the East Coast Broiler Association[13], the members of which are, on diagram 2 above, independent broilers (**X**), expressed concern that the merger would result in its members becoming both the customers and the competitors of Astral. In the event of a shortage of chicks as a result of disease or market shift the possibility exists for RPB to divert chicks from the independent customers who rely on Natchix to provide 68% of its needs to Astral's in-house businesses. The independents would not have the means nor the time to source alternative chicks and this situation renders them vulnerable[14].

Astral's reply to this is that it is in any event in a position to foreclose the supply of Ross parent stock to independent broiler breeders competing in the market without the proposed merger, should it wish to. However there would be no commercial sense in foreclosing the supply of stock to independent breeders downstream because it is in their best interest to maximise the sale of Ross parent stock. Furthermore, Ross international would, very rapidly, terminate Astral's franchise if it lost sales revenue due to foreclosure. RPB spends R27 million annually on research and development[15] of the

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12 Cobb's management told the Commission that they currently do not have the capacity to meet the demands of the independent broilers. They estimate that it would take them close to 5 or 6 years before they could make significant inroads into the South African market.

13 The East Coast Broiler Association represents in excess of 300 broiler growers in the KZN region. Members range in size from one producing approximately 100000 chickens, six producing 20000 to 100000 per week and the balance producing from a few hundred a month to several 1000 a month. Included in the last category are a substantial number of emerging farmers.

14 According to industry players it takes 18 months from the moment one receives Great Grandparent stock to get to the stage where you have day-old chicks.

15 According to Astral it is an ongoing genetic process by which the best bird available on the floor is selected for breeding purposes to give the highest growth rate and the best weight within a limited period.

Ross bird, which forces them to be a volume driven business. To not continue to maximise sales volume does not make commercial sense because a 10% loss in turnover will result in a loss of [confidential] in profit before interest and tax. Another important factor to take into consideration is Cobb International, its main rival, which enjoys a 50% share of the international market and is rapidly emerging as a competitor in the South African market. Should Astral endeavour to foreclose the market such an attempt would provide Cobb, and their smaller rival Hybro, with the perfect opportunity to penetrate the South African market.[16]

However to address the Commission's foreclosure concerns Astral indicated that it was willing to conclude a 5 year supply contract with each of its existing customers, and they will reduce supply to all customers pro-rata their ordinary volumes in case of desease etc. They also made proposals on equal pricing and the termination of agreements. Finally, Astral offered to implement an audit procedure, to be conducted by Astral's external auditors, PriceWaterhouseCoopers, to ensure that all and any sales by Astral of Ross PP stock to Natchix are sold at the same price as same is sold during the period in question to independent day-old chick manufacturers and broiler producers in South Africa.

In reply to the proposed remedies the Commission cautioned against setting remedies that address conduct rather than structure. They argue that these remedies are likely to be sidestepped and as such are inferior to a structural remedy such as prohibition or divestiture.

Our finding

Scholars such as Areeda suggests that there is only one set of circumstances in which vertical mergers can be presumptively condemned on the basis of structural evidence alone. The set of circumstances requires that (1) both markets are highly concentrated; (2) each market independently has significant entry barriers; and (3) insufficient independently owned (that is, non-integrated) capacity exists at the B level to support efficient entry or operation at the A level. Absent one of these factors a vertical merger cannot cause significant foreclosure of existing firms, increase significant barriers to entry that already exist, or significantly raise the cost of existing rivals.[17]

We find that all these factors are present. Firstly Astral, the dominant supplier of PP stock, is acquiring Natchix, the dominant supplier of one day-old chicks in KwaZulu Natal. Secondly, entry barriers into both the upstream and downstream market are high and entry would not be timely to prevent anti-competitive effects. It would take Cobb at least 5 years to position itself as a competitor of Ross in the upstream market and it would take downstream broilers at least 18 months to get to the stage where they could

16 Cobb has already approached one of Ross' largest customers, Chubby Chick and is already supplying one of Ross' former customers Feruchi in the Western Cape.
17 See Antitrust Law, Volume IVA, par.1032, page229

sell day-old chicks. Thirdly, the remaining broiler producers, which post merger will represent 39% of the independent non-integrated competitors of Natchix and integrated firms competing with Astral, seem to be small farmers that could not expand overnight to ensure the efficient entry of Cobb.

So why then do we, in light of the above, attach conditions and not prohibit the merger?

We agree with the Commission that in most cases it is preferable to have remedies that address structure rather than conduct. But there are, in our view, circumstances where the presence of certain market factors together with conditions imposed by the antitrust authorities will effectively address specific competitive concerns. These are circumstances where either divestiture or prohibition might be too drastic a remedy and where other remedies exist that could address the anti-competitive effects adequately without imposing an unreasonable burden on the Competition authority to monitor.[18] In our opinion the present case falls within that category.

The parties informed us that all of the perceived difficulties are temporary structural problems, which should disappear in the long run.[19] The parties argued that this is a volume driven business and that Natchix does not have excess capacity to take on more customers.[20] They say that it would be illogical to foreclose close to 40% of the market when the franchisor, Aviagen, insists on increased sales volume and the main rival, Cobb, is threatening the desired growth in sales volume. Cobb has indicated that it wishes to rapidly expand into the market within the next 5 years and it has already succeeded in certain instances into luring some of Astral's customers away.

In addition Astral enjoys its highest margins upstream, i.e. in the market for the supply of PP stock and it is thus incentivised to expand supply as widely as possible rather than embark on a foreclosure strategy. The fact that Cobb is now moving away from an exclusive supply relationship with Rainbow to one where they will now also be supplying independents suggest that this is prevailing conventional wisdom in the industry.

Nevertheless, we agree with the Commission, that in the short run, the risk of foreclosure is present and that the prospect of increased competition would be diminished if we did

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18 See Antitrust Law Developments (fourth edition) Volume 1, page 372: "Conduct restrictions have also been utilized to prevent unlawful effects of vertical mergers." In 1997 the USA Federal Trade Commission agreed to a consent order to remedy the likely antitrust effects arising from a merger between three media giants Time Warner, Turner and TCI. In this regard see prepared remarks by Robert Pitofsky given at the 24th Annual Conference on International Antitrust Law and Policy: "*Vertical Restraints and Vertical Aspects of Mergers – A U.S. Perspective*" dated October 16, 1997.

19 The Schumann/Sasol merger, a vertical merger, was prohibited by the Tribunal because there was excess capacity available in the downstream markets, barriers to entry were heightened by the transaction, a history of predation was alleged and, most important of all, there were strong indications that the situation in the industry would have worsened post the merger as this was a declining market. The Tribunal could not find any remedies that would address the anti-competitive effects of the merger in the long run.

20 See Astral's response to the Tribunal's further questions dated 28 February 2002.

not impose certain conditions designed to address the antitrust concerns. However, since this merger poses only short term structural problems, there is no necessity to prohibit the merger, provided that the conditions that we impose ensure the maintenance of competition in the short to medium term.

The conditions

We have made it a condition that the Commission must approve a standard supply contract. In doing so we aim to lessen the regulatory role that the Commission need to play post the merger. Once a standard contract is in place it would be the responsibility of the downstream players to complain if Astral does not adhere to it.

We have addressed the concerns of the East Coast Poultry Producers Association by insisting that in case of disease etc., Astral may not stop supplying its independent customers in order to only supply its in-house broilers.

We have addressed the Commissions' concerns on downstream foreclosure by insisting that Astral may not discriminate against independent customers who do not wish to conclude the standard agreement, nor may it discriminate against customers who also wish to sell Cobb birds. Moreover, it may not discriminate against independent customers on price or volume discounts. In five years' time independent broilers should be in a position to source their PP stock from either Cobb or Ross.

Finally, we have addressed concerns of upstream foreclosure. Although Cobb is already present in the market it does not currently have the capacity to supply more chicks. By imposing a condition that facilitates the entry of Cobb over the next 5 years and by obliging Astral to supply independent broilers who also buy from Cobb we are of the view that we adequately address this problem.

The Animal Feed industry

Both Astral and Natchix, through their respective subsidiaries Meadow and Nutrex, operate in the animal feed market, where they supply animal feeds to poultry, pig and dairy producers. This part of the transaction represents the horizontal leg of the merger.

The Commission prohibited this transaction because the animal feed market in the KwaZulu Natal Midlands is highly concentrated and the merger will remove an effective competitor, Nutrex, from the market.

At the start of the hearing the parties indicated to us that they accepted the Commission's decision to prohibit the acquisition of Nutrex and did, therefore, not appeal this part of the Commissions decision. They offered to grant to the Minority Shareholders of Nutrex an option to acquire the shares in and claims on loan account against Nutrex held by

Natchix. At the hearing they requested the Tribunal to consider their proposals and to provide guidance on how to proceed with the divestiture of Nutrex.

Although we accepted their proposal in general we have rephrased some of the conditions. We have ordered that their shareholding in Nutrex may be sold to either the minorities or any other buyer that is independent from Astral, we have changed the time periods that they had proposed and we have ordered the Commission to appoint a trustee if Astral failed to secure a binding offer within the specified time period.

The Commission must draft a mandate for the Trustee on how it must proceed to sell the shares. If the Trustee fails to sell the shares within the time period set by the Commission the parties will have failed to comply with the conditions and will the merger be set aside.

Public interest

Neither the Commission, nor the parties raised any concerns in this regard.

_____________ 16 April 2002

D.H. Lewis **Date**

Concurring: N. Manoim, C. Qunta