Public Competition Assessment

25 October 2010

Scandinavian Tobacco Group A/S - proposed acquisition of Swedish Match AB

Introduction

1. On 30 September 2010, the Australian Competition and Consumer Commission (**ACCC**) announced its decision not to oppose the proposed acquisition of Swedish Match AB by Scandinavian Tobacco Group A/S (**proposed acquisition**), subject to section 87B undertakings accepted by the ACCC. The ACCC was of the view that the proposed acquisition, when considered in light of the undertakings, would be unlikely to have the effect of substantially lessening competition in any relevant market in contravention of section 50 of the *Trade Practices Act 1974* (the **Act**).

2. The ACCC formed its view on the basis of the information provided by the merger parties and information arising from its market inquiries. This Public Competition Assessment outlines the basis on which the ACCC has reached its decision on the proposed acquisition, subject to confidentiality considerations.

Public Competition Assessment

3. To provide an enhanced level of transparency and procedural fairness in its decision making process, the ACCC issues a Public Competition Assessment for all transaction proposals where:
   - a merger is opposed;
   - a merger is subject to enforceable undertakings;
   - the merger parties seek such disclosure; or
   - a merger is not opposed but raises important issues that the ACCC considers should be made public.

4. This Public Competition Assessment has been issued because the proposed acquisition is subject to a court enforceable undertaking.

5. By issuing Public Competition Assessments, the ACCC aims to provide the public with a better understanding of the ACCC's analysis of various markets and the associated merger and competition issues. It also alerts the public to the

circumstances where the ACCC's assessment of the competition conditions in particular markets is changing, or likely to change.

6. Each Public Competition Assessment is specific to the particular transaction under review by the ACCC. While some transaction proposals may involve the same or related markets, it should not be assumed that the analysis and decision outlined in one Public Competition Assessment will be conclusive of the ACCC's view in respect of other transaction proposals, as each matter will be considered on its own merits.

7. Public Competition Assessments outline the ACCC's principal reasons for forming views on a proposed acquisition at the time the decision was made. As such a Public Competition Assessment may not definitively identify and explain all issues that the ACCC considers arise from a proposed acquisition. Further, the ACCC's decisions generally involve consideration of both non-confidential and confidential information provided by the merger parties and market participants. In order to maintain the confidentiality of particular information, Public Competition Assessments do not contain any confidential information or its sources.

The parties

The acquirer: Scandinavian Tobacco Group A/S

8. Scandinavian Tobacco Group A/S (**STG**) is a privately owned Danish company employing approximately 3400 staff in 14 countries.

9. STG's manufactures and supplies cigars, pipe tobacco, roll-your-own tobacco (**RYO**) and tobacco accessories (e.g. rolling papers). STG also supplies a small range of cigarettes in Norway and smokeless tobacco products (e.g. chewing tobacco and Swedish snus[1]) in Denmark.

10. Internationally STG supplies tobacco products under the following brands:

- **Cigars:** *Café Crème, Henri Wintermans, Colts, Nobel Petit, Mercator, CAO* and *Corps Diplomatique*.

- **Pipe tobacco:** *Clan, Danske Club, Erinmore, Orlik, Sail, Stanwell, Sweet Dublic, WO Larsen* and *Alsbo*.

- **RYO:** *Bali, Crossroad, Escort* and *Tiedemanns.*

11. In Australia, STG supplies cigars, pipe tobacco and RYO tobacco. STG does not operate any manufacturing, distribution, wholesale or retail sales facilities in Australia.

[1] Snus is a moist powder tobacco product that is typically consumed by placing it under the lip for extended periods of time.

12. STG's tobacco products are distributed on a wholesale basis by third party wholesalers/importers in Australia, as below:

- STG's cigar products are distributed on a wholesale basis in Australia by Stuart Alexander Pty Ltd (**Stuart Alexander**); and
- STG's pipe tobacco products are primarily imported and distributed in Australia by Swedish Match Australia Pty Ltd.

The target: Swedish Match AB

13. Swedish Match AB (**SM**) is a publicly listed company headquartered in Sweden, employing approximately 11,000 people in 22 countries.

14. SM manufactures and supplies cigars, pipe tobacco, smokeless tobacco products and lights. Internationally, SM supplies tobacco products under the following brands:

- **Cigars:** (US premium) *Macunado, Partagas, Punch, Hoyo de Montery, La Gloria Cubana, Cohiba, Helix, Don Tomàs*; (US machine-made) *White Owl, Garcia y Vega, Game by Garcia y Vega*; and (European machine-made) *La Paz, Wee Willem, Willem II, Salsa, Hollandia, Bellman, Oud Kampen, Justus van Maurik, Hejanius, Hofnar*.
- **Pipe tobacco***: Borkum Riff.*

15. SM Australia Pty Ltd (**SM Australia**) is the Australian based operating division of SM with an office and warehouse located in Melbourne. SM Australia imports and wholesales SM cigar and pipe tobacco products and also imports and wholesales a range of other manufacturers' cigars and pipe tobacco products, including for STG (pipe tobacco).

Other industry participants

16. There are no cigar or pipe tobacco manufacturers with production facilities in Australia – all cigars and pipe tobacco currently supplied in Australia are imported from overseas. Australian sales are estimated to account for around 0.5% of global cigar sales and 0.25% of global pipe tobacco sales.

Pipe tobacco

17. **Imperial Tobacco** (**Imperial**) is the largest supplier of pipe tobacco in Australia and the only significant supplier of pipe tobacco in Australia other than STG and SM. **Mac Baren, Japan Tobacco International** and **Oettinger** also import pipe tobacco into Australia, albeit on a much smaller scale than Imperial, STG and SM.

Cigars

18. There are a number of large global cigar manufacturers which supply the Australian market but few with significant sales volumes in Australia. After STG and SM, **British American Tobacco** (**BAT**) is the largest supplier of cigars in Australia, largely due to their high selling *Captain Black* brand. **Habano**, the leading supplier of premium hand-rolled cigars in Australia, has a significant market share in terms of sales revenue, reflecting the premium price paid for their products, but a relatively low market share in volume terms. Other suppliers of cigars in Australia include **Burger & Sohne, Swisher** and **Imperial.**

The proposed transaction

19. The proposed acquisition involved a global merger of the parties' cigar, pipe tobacco and accessories businesses. The proposed acquisition was considered by a number of international competition agencies and the ACCC consulted closely with the New Zealand Commerce Commission (**NZCC**) regarding the proposed acquisition and divestitures occurring at the international level.

ACCC review timeline

20. The following table outlines the timeline of key events in this matter.

Date	Event
24 June 2010	ACCC commenced review under the Merger Review Process Guidelines. Market inquiries commenced.
15 July 2010	Closing date for submissions from interested parties.
23 July 2010	ACCC requested further information from the parties. ACCC timeline suspended.
3 August 2010	Former proposed date of 26 August 2010 for announcement of ACCC's findings amended to allow for provision of further information by the merger parties. ACCC timeline remained suspended.
31 August 2010	Draft 87B undertaking proffered by the parties. ACCC commenced market inquiries. ACCC timeline recommenced.
10 September 2010	Closing date for submissions relating to draft 87B undertaking.
30 September 2010	ACCC announced it would not oppose the proposed acquisition, subject to court enforceable undertaking offered by the parties. Section 87B undertaking concerning cigar brands accepted by ACCC.

Market inquiries

21. The ACCC conducted market inquiries in relation to the proposed acquisition with a range of industry participants, including Australian representatives of international tobacco manufacturers, importers, wholesalers, distributers and retailers of tobacco products. Submissions were sought in relation to the substantive competition issues and proposed undertakings.

Areas of overlap and market definition

22. In Australia, the merger parties overlap in relation to the wholesale supply of cigars and pipe tobacco. Both of the merger parties currently only supply cigars and pipe tobacco on an import/wholesale basis and have no retail supply operations in Australia.

Market definition

23. The ACCC considered the proposed acquisition in the context of the following markets:

- the wholesale supply of cigars in Australia (**cigar market**); and
- the wholesale supply of pipe tobacco in Australia (**pipe tobacco market**).

Substitution between different cigar types

24. On the demand-side, market inquiries indicated that there may be some demand-side substitution between different types of cigars by consumers. However, a number of market participants noted the differences between small (typically dry and machine made) and large (typically hand-rolled) cigars – due to significant price differences (i.e. large cigars are usually more expensive) and the manner in which each type is typically consumed (i.e. large cigars are consumed less frequently). On this basis, large hand-rolled cigars are not considered to be close substitutes for small machine-made cigars and vice versa.

25. However, market inquiries indicated that there is a high degree of supply-side substitution with cigar suppliers typically offering a range of cigar products for which the same marketing and distribution channels are utilised.

26. Accordingly, the evidence before the ACCC did not indicate that more narrowly defined markets based on types of cigars should be adopted and instead the ACCC concluded that the relevant product market is the supply of cigar products.[2]

Substitution between different types of tobacco products

27. Market inquiries indicated that consumers generally do not switch from the type of tobacco product they usually consume and that there is limited switching between cigarettes and cigars, or pipe tobacco and other tobacco products (such as RYO). This reflects differences in the product characteristics, their prices and the manner in which they are typically consumed.[3]

[2] The ACCC's definition of a cigar product market is consistent with previous ACCC matters and overseas regulatory precedent. For example, the European Commission, Italian Competition Authority and the Portuguese Competition Authority all considered it inappropriate to further segment the cigar market based on product differences – and concluded a product market for cigars.

[3] The ACCC's definition of a pipe tobacco product market is consistent with overseas regulatory precedent. For example, the European Commission (EC) considered that "…market investigations

28. The ACCC considered it unlikely that a supplier of other types of tobacco products would switch to the supply of cigars or pipe tobacco in response to an increase in prices for cigars or pipe tobacco products.

Conclusion – market definition

29. In conclusion, market inquiries indicated that there is limited demand and supply-side substitution between different types of tobacco products. Accordingly, the ACCC determined that the cigar market and pipe tobacco market are distinct and separate product markets rather than within any more broadly defined tobacco product market.

Pipe tobacco market competition analysis

30. The ACCC considered that the proposed acquisition was unlikely to substantially lessen competition in the wholesale market for the supply of pipe tobacco for the reasons outlined below.

31. Generally, market participants did not raise competition concerns in relation to the pipe tobacco market. The Australian pipe tobacco market is in decline and is characterised by limited market activity.

32. Under an informal arrangement between SM and STG that has been in place since STG acquired the *Erinmore* brand from BAT in 2007, STG supplies the *Erinmore* brand to SM for distribution in Australia. As a result SM undertakes all of the marketing activities and price-setting in relation to STG's *Erinmore* in Australia.

33. On the basis of the distribution arrangement outlined above, STG and SM are not, nor are likely to be (should the merger not go ahead), in competition with each other for the supply of pipe tobacco in Australia. Accordingly, the proposed acquisition, other than to remove the potential competition between SM and STG, would not result in any change from the factual to the counterfactual. The ACCC further noted that STG has never distributed the *Erinmore* brand in Australia and would not be likely to commence doing so. On this basis the ACCC considered that there was a low likelihood that this potential competition between the merger parties would translate to actual competition in the foreseeable future.

34. For these reasons, the ACCC considered that the proposed acquisition would not result in a substantial lessening of competition in the pipe tobacco market as there is no material difference between the factual and the counterfactual.

Cigar market competition analysis

35. The ACCC considered that the proposed acquisition was likely to substantially lessen competition, in the absence of the section 87B undertaking, in the wholesale market for the supply of cigars for the reasons outlined below.

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revealed that competitors and consumers broadly agree that pipe tobacco forms a market separate from other tobacco products": see Case COMP/M.4581, Imperial Tobacco / Altadis, paragraph 15.

36. The acquisition would result in a highly concentrated market with the merged firm accounting for a significant majority of Australian cigar sales, with BAT being its only significant competitor, with a much smaller market share.

Barriers to Entry and Expansion

37. The ACCC considered barriers to entry and expansion in the wholesale supply of cigars to be high. In forming this view, the ACCC had regard to the following factors.

Regulatory restrictions on the advertising and display of tobacco products

38. All Australian states and territories have expressed a commitment to banning the display of tobacco products in general retail outlets by 2012-2013, with transitional regulations requiring that displays be limited to a small specified area. In practice, this means that by 2012-2013 retailers will not be able to openly display tobacco products anywhere on their premises except in response to an express request by a customer.

39. Under the proposed legislative restrictions on the display of tobacco products retailers will only be permitted to display basic information about tobacco products such as prices and names, through the use of price tickets or a single price board. Consequently, there will be significant limitations on the ability of retailers to promote any new or relatively less well-known brands of cigars to consumers. In this regard, the regulatory restrictions on the promotion of tobacco products may significantly limit the extent to which any new or less well-known brand would be able to establish brand awareness with consumers and to therefore capture or expand existing sales volumes in Australia.

Customer brand loyalty

40. Market inquiries indicated that strong customer brand loyalty is a characteristic of cigar consumers and effectively limits the extent to which consumers switch from the brands with which they are familiar. The ACCC therefore considered that this strong customer brand loyalty represented a significant barrier to entry and expansion, given that the majority of consumers would be unlikely to switch brands even in the event that the merged firm instituted a price increase for its cigar products.

Ability to access retailer shelf space

41. Market inquiries indicated that retailers are generally reluctant to stock new or relatively unknown brands of cigars due to the regulatory restrictions on advertising in the tobacco market (which limits their ability to promote new or relatively unknown brands) and the declining nature of the tobacco market generally.

42. Retailers typically seek to stock cigar brands that have established sales volumes (by virtue of their established brand recognition) and have no incentive to stock brands without established names, particularly given the limited display space available under various state legislation. Tobacco retailers generally favour other

faster moving tobacco products with higher relative sales volumes, such as cigarettes, over cigar products without established Australian brands.

43. The ACCC therefore considered that the ability to access retail shelf space represented a significant barrier to entry or expansion.

Capital cost and lead time required for new entry or expansion

44. The ACCC considered that the sunk costs and lead time to develop and establish a cigar brand in Australia are significant. The key cost elements included the sunk cost to develop a new product, manufacturing (including the cost of packaging that is compliant with Australian law), hiring of sales staff, logistics and distribution, customer rebates/discounts (to incentivise retailers to stock the products), and other brand development costs. The ACCC further found that the lead time required to launch a new cigar brand on a substantial scale would be significant and would be difficult to recover given the declining demand in this market.

New entry by existing Australian cigarette companies and overseas cigar manufacturers

45. The ACCC considered that the large cigarette companies with existing Australian operations (e.g. BAT, Imperial and Philip Morris) would likely be able to leverage their existing local distribution networks and relationships with retailers to facilitate entry or expansion to the supply of cigars in Australia. However, these companies would continue to face many of the barriers to entry or expansion outlined above. In particular, such firms would still face the very significant barriers represented by the regulatory advertising and display restrictions in the tobacco market and strong customer brand loyalty. The ACCC considered that these barriers would be likely to significantly limit the potential for such entry or expansion occurring.

46. Additionally, there was no evidence indicating that entry or expansion in the Australian cigar market by cigarette companies was likely in the foreseeable future, even in response to a price increase post-acquisition.

47. The ACCC considered that incumbent overseas manufacturers of cigars would be unlikely to be able to leverage their existing overseas product brands to facilitate entry or expansion into the supply of cigars in Australia. As for existing Australian cigarette suppliers, these firms would continue to face many of the barriers to entry or expansion outlined above. This view is supported by a number of examples of unsuccessful entry by established overseas cigar or cigarette brands into Australia.

48. With the exception of BAT’s Captain Black brand, there have been numerous cigar product launches in recent years that have failed to gain any significant share of Australian sales, supporting the ACCC’s view that there are high barriers to entry and expansion. Many of the cigar brands recently launched in Australia failed to gain any significant share of Australian cigar sales despite being associated with (or being variants of) established and successful cigar brands already supplied in Australia.

49. The ACCC considered the high barriers to entry and expansion outlined above significantly limits the preparedness of wholesale customers to sponsor the new entry of an overseas cigar manufacturer, or expansion of a tobacco product manufacturer with existing Australian operations. In this regard, wholesale customers have limited incentives to sponsor new entry or expansion, even in the event that the merged firm instituted a price increase, given the low likelihood that any new or relatively unknown brand would be successful in gaining any significant volume of Australian sales.

50. In support of the above, major customers typically only source cigar products that have established brands and sales volumes and would be reluctant, or unwilling, to support the entry or expansion of any new or unestablished cigar brands.

Conclusion – barriers to entry and expansion

51. The ACCC considered that the threat of new entry or expansion would not be likely to effectively constrain the merged firm in relation to the supply of cigars due to the barriers represented by:

- state and Commonwealth legislation restricting the advertising and display of tobacco products;
- significant customer brand loyalty;
- limited ability to access retailer shelf space;
- high capital cost and lead time required for new entry or expansion; and
- history of Australian entry that failed to gain significant market share.

Availability of substitutes

Competition between STG and SM

52. The ACCC considered STG and SM to be each other's closest competitor for the wholesale supply of cigars. In particular, STG's leading cigar brand, *Café Crème*, was considered to be the closest competitor to SM's leading *Wee Willem* brand on the basis that the brands share common characteristics (e.g. size, taste and price) and have the same target consumers.

53. In support of the above, market inquiries indicated that STG and SM typically offer discounts and promotional offers in an attempt to gain market share from each other (resulting in lower wholesale prices to customers) and that the pricing of each of the merger parties constrains the pricing of the other.

54. Accordingly, this high level of competition between STG and SM would have been removed by the proposed acquisition, potentially resulting in:

- the removal of pricing constraints on the merger parties leading to increased wholesale prices by the merged firm;

- a reduction in the frequency of discounting or promotional offers at the wholesale level by the merged firm; and/or

- a reduction in the attractiveness of terms and conditions of supply offered to wholesale customers.

55. On the basis of market inquiries, the ACCC therefore considered that the proposed acquisition would result in the removal of SM as STG's closest competitor for the supply of cigars.

Consideration of alternative suppliers

56. As a result of the proposed acquisition, in the absence of an effective merger remedy, the only remaining significant competitor to the merged firm in the wholesale market for the supply of cigars would be BAT.

British American Tobacco

57. BAT currently supplies cigars in Australia under the *Captain Black* and *Dunhill* brands and maintains its own local distribution network through its Australian subsidiary, British American Tobacco Australia Pty Ltd (**BATA**). BAT has a significant market share of Australian cigar sales, which is almost entirely due to its *Captain Black* brand.

58. Although BAT would be readily able to expand its Australian supply of cigars, the ACCC considered that BAT would be unlikely to gain increased sales for its cigar products should the merged firm institute a price increase. The key reasons for this view included that:

- there is limited switching and rivalry between BAT's *Captain Black* cigar and the major cigar brands of the merged firm (such as *Wee Willem* and *Café Crème*) due to significant differences in the products (i.e. they are not close competitors). For example, the *Captain Black* cigar looks more like a cigarette, has a filter and does not use a tobacco wrapper – which yields a different smoking experience and taste compared to the more popular cigars of the merger parties (such the STG's *Café Crème* and SM's *Wee Willem* cigars); and

- the *Dunhill* brand is marketed as a premium cigar product and is already priced above the merger parties' comparable cigar products.

Other wholesale cigar suppliers

59. A significant number of smaller alternative wholesale cigar suppliers would remain post-acquisition. However, given that these other wholesale cigar suppliers each comprise a minimal share of the overall cigar market, the ACCC did not consider that they would provide an effective constraint on the merged firm. The ability for such suppliers to expand and capture increased sales volumes in response to a price increase by the merged firm would be significantly limited by the barriers to entry and expansion outlined above.

Potential for directly importing from an overseas manufacturer (parallel importing)

60. The ACCC considered that parallel imports are not an effective constraint on the merged firm, for the following key reasons:

- firms have the ability to identify the overseas source of parallel imports and to deter their related or third party suppliers to cease supply of such imports by threatening to cease all supply to any firm involved in parallel importing;
- wholesale customers are generally reluctant to source parallel imports, despite their lower price, due to concerns that doing so would threaten any relationship they may have with the original manufacturer – for example, the original manufacturers may threaten to cease supply of all their tobacco products;
- parallel imports cannot be sourced on a consistent basis and volumes available for Australian supply are likely to vary widely from time to time – with periods during which no volumes may be available for particular products;
- the quality of parallel imports may not meet the same quality standards as tobacco products specifically produced for Australian consumption; and
- some tobacco products cannot be parallel imported as they are manufactured specifically for Australian consumption and are not supplied anywhere else in the world. For example, SM's popular *Wee Willem* cigar brand, which is the highest selling cigar brand in Australia, is specifically produced for the Australian and New Zealand markets and cannot be parallel imported.

Cigar market competition analysis: conclusions

61. The ACCC considered that the general reluctance of customers to switch from the brands with which they are familiar is likely to limit the constraint provided by available substitutes. Additionally, this customer loyalty (particularly when combined with legislative restrictions on the display of tobacco products) is likely to limit the incentive and ability for alternative suppliers to expand (as outlined under barriers to entry and expansion above), such that the threat of expansion by available substitutes would also be unlikely to effectively constrain the merged firm.

62. The ACCC concluded that, in the absence of appropriate remedies addressing competition concerns in relation to cigars, the proposed acquisition would be likely to result in a substantial lessening of competition in the market for the wholesale supply of cigars in Australia.

Undertakings

63. On 31 August 2010, STG offered undertakings to the ACCC to remedy possible competition concerns in the cigar market and pipe tobacco market.

Pipe tobacco

64. STG offered to divest the *Erinmore* pipe tobacco brand to an approved purchaser in the event that the ACCC had competition concerns in the pipe tobacco market.

65. On 30 September 2010 the ACCC decided not to accept a court enforceable undertaking offered by STG in relation to the market for the supply of pipe tobacco in Australia. The ACCC considered that the divestiture of STG's *Erinmore* pipe tobacco brand offered under the proposed undertaking was not required, given that no substantial lessening of competition would be likely to result from the proposed acquisition in relation to the market for the wholesale supply of pipe tobacco in Australia, as outlined above.

Cigars

66. As noted above, on 30 September 2010 the ACCC accepted a court enforceable undertaking offered by STG pursuant to section 87B of the ACT. The undertaking was offered by STG to address the ACCC's competition concerns in the cigar market.

67. The undertaking by STG is to divest the *Wee Willem* and *Willem II* cigar brands to a purchaser approved by the ACCC. The objective of the undertaking is to address the ACCC's competition concerns by creating or strengthening a viable, effective, stand-alone, independent and long term competitor for the supply of the divested products. A copy of the undertaking is available on the *Undertakings Register (s.87B)* at http://www.accc.gov.au.

68. STG will divest to an approved purchaser the necessary trademarks and other intellectual property rights relating to the manufacture, marketing and sale in Australia of the divested brands. STG's compliance with the undertaking will be monitored by an independent auditor.

69. The ACCC considered that the undertaking satisfactorily addressed the ACCC's competition concerns in the market for the supply of cigars in Australia. The key reasons informing this view included that:

    - the proposed acquisition, with the divestitures offered under the undertaking, would only result in a small increase to the merged firm's share of cigar sales in Australia; and

    - the merged firm would be effectively constrained by the remaining significant alternative wholesale cigar suppliers, including particularly the approved purchaser of the cigar divestiture brands with the top selling *Wee Willem* and *Willem II* cigar brands;

    - since the *Wee Willem* and *Willem II* cigar brands are already established Australian brands, with *Wee Willem* being the number one selling cigar brand in Australia, the approved purchaser would not face the significant barriers to entry and expansion relating to brand recognition and strong customer brand loyalty (as outlined above).

70. In accepting post-acquisition divestitures the ACCC took into account the complexity associated with the global nature of the proposed acquisition and, in particular, that a merger remedy would affect multiple jurisdictions (Australia and New Zealand). The ACCC's review of the proposed acquisition, including resolution of the ACCC's competition concerns, was therefore conducted in consultation with the NZCC. The ACCC's market inquiries also identified a range of potential suitable purchasers for the divestiture brands and a low risk of the divestiture brands being run down during the divestiture period. Thus, in the context of a complex global transaction and the merger remedy accepted by the NZCC, and in light of the ACCC's assessment of low purchaser and asset risks, the ACCC in this case accepted post-acquisition divestitures.

Conclusion

71. On the basis of the above, including taking into account the undertaking, the ACCC formed the view that the proposed acquisition of Swedish Match AB by Scandinavian Tobacco Group A/S would not be likely to result in a substantial lessening of competition in any market in contravention of section 50 of the Act.