# Mergers & Acquisition Review

*What Corporations Need To Do To Satisfy*

*The Competition Watchdog?*

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## Introduction

The answer to the title of my address is that corporations can easily satisfy the Australian Competition and Consumer Commission.

Most satisfy the Commission by observing the provisions of the *Trade Practices Act 1974* (the Act) and trading fairly. They resist the temptation to use market power to drive smaller competitors out of business or deny them the opportunity to compete.

However, there are people in the corporate world who tell their colleagues, the media and anyone prepared to listen that the Commission is an ogre that, through the application of the Act and, in particular, the merger provisions is harming the Australian economy. Companies are stopped from achieving the size essential to compete on international markets and against imports and this is driving them offshore. Australia, it is claimed, will become a branch office economy.

To listen to some critics you would think the Commission was accountable to no one. The truth is no regulator is more accountable than the Commission.

It cannot obtain a fine, injunction or court order without proving its case before the Federal Court. In most cases, it is opposed by a well-resourced opposition. But whether opposed or not, the Federal Court requires proof that a law has been breached. The Commission is not a dictator; it is the guardian of the *Trades Practices Act*.

No agency has been more accessible or provided more information about its decisions and the reasoning behind them.

Some of the Commission’s critics are so wide of the mark that you must question their motives. Is it possible they are out to convince politicians that merger laws must be watered down and that the Commission needs it wings clipped for having the temerity to question the motives of the Chief Executive Officers of some large corporations.

Some Chief Executive Officers, who will not rest until they have created a market monopoly, ignore the fact that they are beneficiaries of a competitive economy. Would Australian companies be internationally competitive if they had to secure their raw materials from monopoly suppliers? How would they fare if they had to export through a monopoly transport company or raise finance through a monopoly bank?

Would they be better off if they purchased their products from a monopoly retailer, 'Colesworth'?

Big companies are the major winners from competitive markets. Strong domestic competition lowers their costs and enables them to compete internationally.

## National Champions

It is claimed that if we don't change the merger provisions of section 50 of the *Trade Practices Act* then Australian companies will be prevented from reaching a size big enough to compete in global markets. Some of you will have heard this called the 'critical mass' or 'national champion' argument.

The Commission's initial response to the national champion argument is that obstacles to export growth are not necessarily overcome by firms creating dominance in the domestic market. A certain size is not a prerequisite to export success, a fact often demonstrated by the overseas success of moderate-sized and even small Australian firms. Observers of the rural economy have noted the drive and initiatives of rural cooperatives and individual farmers following the dismantling of statutory marketing schemes.

Domestic rivalry is the critical factor in export success. It is more important than rivalry with foreign competitors because strong domestic competitors create highly visible pressures on each other to improve. Domestic firms are under pressure to export so they can grow. There is also pressure to innovate.

The merger provisions of the *Trade Practices Act* are not an obstacle to firms achieving the economies of scale necessary to be internationally competitive. The key is that there must be public benefits.

In deciding whether to authorise a merger, the Commission considers all the potential public benefits. Under the *Trade Practices Act*, public benefits are specified as a significant increase in the real value of exports and significant import substitution.

The Commission must also take into account all relevant matters relating to the international competitiveness of Australian industry. They include whether a proposed merger would have adversely effect the ability of smaller companies to expand or develop export markets.

The authorisation provisions of the Act are available to those firms wanting to ensure international competitiveness through acquisition.  A merger can be authorised even if it lessens competition providing there are compensating public benefits. Since 1993, the Act has explicitly stated that export generation, import replacement or contributions to the international competitiveness of the Australian economy are public benefits.

Where local companies have faced significant import competition the Commission has not opposed mergers.  Take the following example, Email's acquisition of Southcorp's whitegoods manufacturing facilities.  In this case, the presence of imports from Europe and New Zealand was sufficient to alleviate any competition concerns.

Here is another, in November1993, the Commission did not oppose the acquisition by Amcor of Associated Pulp and Paper Mills despite making Amcor the only domestic manufacturer of paper and giving it ownership of four of the five largest paper merchants in Australia.  The Commission concluded that strong import competition at the manufacturing end of the market put substantial downward pressure on prices.

When examining a merger proposal the first thing the Commission does is look at actual and potential import competition.  It has never opposed a merger where imports make up more than 10 per cent of the market and sometimes approves when smaller than that. Australian merger law is more flexible that that of most other countries and this is clearly demonstrated by the Commission's approach to recent banking mergers.

## Banking Mergers

In 1995, the Commission examined the proposal by Westpac to acquire Challenge Bank of Western Australia.  At that time it took the view that it was appropriate to consider banking as a cluster of banking services delivered to customers as a bundle. This approach was similar to most overseas regulatory agencies.  There was little evidence in the mid 1990s that consumers unbundled their banking requirements and used a range of service providers.

However, by 1997 when the Commission looked at the Westpac/Bank of Melbourne case it identified six product categories for 'retail banking' and associated geographic elements.  They were:

- home loans (moving to a national market)

- personal loans (State based)
- deposit/term savings products (State based)
- small business banking products (probably more local than State based, but State based figures were used for analysis due to lack of reliable regional based figures)
- credit cards (State based)
- transaction accounts (State based)

A market for corporate banking was also identified as a national market but this was not relevant to the merger because to Bank of Melbourne had no significant national presence.

So what had changed between Westpac / Bank of Melbourne merger and the Westpac / Challenge Bank merger for the Commission to believe that the cluster had broken up? First, the 1997 Wallis report[1] found that the bundle was starting to unravel.

Second, when the Commission examined the Westpac / Bank of Melbourne merger in that same year it found that a sufficient proportion of customers were by then prepared to unbundle key components of the cluster and to shop around for the best price – especially for home loans.

During 1996 and 1997, mortgage originators enjoyed rapid growth and began making serious inroads into the banks' market share for home loans. Banks could no longer sustain an interest rate premium over the mortgage originators and home loan lending margins were competed away.

This meant that while customers continued to use the banks for everyday banking they shopped around for mortgage finance

However, the Commission was mindful that the increased use of technology-driven service delivery channels and changing consumer behaviour may have altered some of the geographic market definitions.

The Commission considered the impact of this merger in product markets for large corporate banking, retail banking services and non-banking financial services. It

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[1] Commonwealth of Australia, Financial System Inquiry Final Report, March 1997.

concluded that there was, in fact, a national market, largely due to mortgage originators and regional banks providing mortgage loans in States and Territories where they had little or no physical presence. For credit cards, customers were becoming less reliant on existing bank relationships.

However, a majority of customers preferred a local banking service, especially those living in non-metropolitan areas. Branch networks were important to generate large volumes of transactions and deposit accounts.

In May last year, the Commission decided not to oppose the acquisition of Colonial Limited by the Commonwealth Bank subject to significant undertakings to minimise any decline in competition. After intensive inquiries it concluded that the merger was unlikely to significantly lessen competition in areas such as retail insurance, retail investment and retirement savings, wholesale funds management and large corporate banking.

There was concern about less competition for deposit/term products in Tasmania, transaction accounts in both regional New South Wales and Tasmania and small and medium enterprise banking in those areas. However, undertakings were given that promised to minimise any anti-competitive effects of the merger and it was not opposed.

## Finding Solutions

Another example of the way undertakings can ensure mergers was the attempt by the British American Tobacco Company (trading in Australia as WD &HO Wills) to take over Rothmans. In Australia there were only three companies, Wills, Rothmans and Philip Morris and imports were below one per cent. The Commission believed the merger of tow of the three big players would reduce competition. It opposed the merger but the two companies decided to release 17 per cent of the total brands of cigarettes on the market. The brands were acquired by Imperial Tobacco, a major international organisation, which has now entered the Australian market with its initial 17 per cent share and the introduction of its own brands to Australia. Some coincidental changes in the tax law will also boost imports.

As a result, there remains three strong credible market players and the proposed merger has gone ahead in Australia as well as in other countries.

The point is that very often practical solutions can be found for seemingly difficult problems. The critics who claim that the Commission judges the level of competition by simply counting the number of players left standing are wrong. There are well-known cases where the Commission has not objected to just one or two players left standing in Australia after a merger.

## The Franklins Arrangement

This was a difficult matter for the Commission's consideration, given Franklins' decision to exit the market due to unsustainable losses. In short, the Commission has obtained the best outcome possible under the circumstances, boosting the market share of independent grocery retailers, while also facilitating the entry of two new competitive players in the eastern Australian supermarket industry.

Late last year Franklins, through its owner Dairy Farm International, approached the Commission indicating its intention to exit from its involvement in food and grocery retailing in Australia. The Commission was provided with confidential information on the financial state of the Franklins' business and considered its future in light of that information. This information included statements from the owners, supported by financial documentation, that the losses they were incurring were unsupportable and that the decision had been made not to invest further in the Australian enterprise. The information provided backing for the Dairy Farm's contention that it would exit and sell its operations regardless of the Commission's views on the managed sell down.

That is, if the Commission saw a managed sell down as anti-competitive in light of section 50, then the company would exit through other means.

To enable this exit, Franklins proposed a managed sell down of its stores, warehouses, distribution facilities and other related assets to various parties. An integral part of the proposal was the participation of a major chain. Franklins wanted the Commission to provide its opinion on whether the proposals put forward by it would contravene section 50 of the *Trade Practices Act*.

The parties argued that a managed sell down involving one of the major chains was necessary to under-write the process, providing certainty to suppliers and ensuring the maintenance of the individual Franklins' businesses. Should the wider industry and consumers begin to doubt the ability of Franklins to maintain its operations many of the suppliers would likely reduce or eliminate services while customers would migrate to Franklins' competitors. A managed exit as proposed, therefore, would ensure that damage to competition that may occur with Franklins announced withdrawal was at best maintained and at worst suffered as little damage as possible.

In addition to considering the consequences of a managed sell down, the Commission considered the possible consequences of an un-managed sell down by Franklins. It concluded that the likely effect on competition would be far more severe than any outcome arising from an agreed managed exit. In particular, the Commission was of the view that significantly less stores would have been able to be acquired by independents, as a substantially higher number would have gone to the major chains.

On 22 May 2001, the Commission announced that it had reached in-principle agreement with Dairy Farm for the sale of stores in the Franklins supermarket chain. On 7 June 2001, the Commission announced that it had accepted section 87B Undertakings from Dairy Farm, Franklins and Woolworths in relation to the package for the sale of Franklins stores, that it had accepted in-principle. The Undertakings deal with issues including utilisation of the brands owned by Franklins, the number of stores to be acquired by various purchasers, a requirement for Woolworths to divest a number of stores and non-interference by Woolworths in the process to sell stores to independent operators.

The managed exit plan will result in Franklins' stores being offered and/or sold as follows:

- 67 stores in New South Wales, Victoria, Queensland and South Australia to Woolworths;
- 35 stores in New South Wales and northern New South Wales to Action;
- 51 to 60 stores in New South Wales to Pick 'n Pay, a South African company; and
- 112 stores in New South Wales, Victoria, Queensland and South Australia through the Joint Independent Divestiture Alliance (JIDA) between Franklins and Metcash Trading Limited Australasia ("Metcash") to various independent operators.

The sale of stores to all independent retailers, other than FAL and Pick 'n Pay, will be conducted through the Joint Independent Divestiture Alliance (JIDA) between

Metcash and Dairy Farm.  The JIDA process is the process for the sale of JIDA stores as set out in an agreement between Franklins and Metcash.  JIDA stores are directly offered for sale to independent operators, not being Coles or Woolworths.

While not required, the Commission did assess the ability of the two independent operators, FAL and Pick 'n Pay, to finance their respective acquisitions.  Although an in depth analysis was not conducted the Commission spoke with all parties to ensure the operators' bona fide's.  This was seen to be important due to the large number of stores being acquired and their role in the managed sell down.

At a micro level the Commission is involved in ensuring that Franklins complies with the Undertakings it has given the Commission in relation to the managed sell down. Included in the Undertakings is a commitment by Franklins to do everything reasonable within its power during the period of the JIDA process to effect the transfer of JIDA stores to Independent Operators.  In monitoring Franklins' compliance with its Undertakings, the Commission will audit the sale process, including financial matters where applicable.

## The 'Failing Company' Issue

If a target firm in a proposed acquisition is considered to be failing, the Commission will consider the likely effect of the acquisition on competition compared to the effect of the target's assets exiting the market altogether.  Unlike the United States, Australia does not have a formal 'failing firm defence'.  The Commission will, however, consider the arguments associated with failing firm in the context of the section 50 merger evaluation.

Of particular interest perhaps to this group, the Commission does not automatically consider investment ratings as a good indication of a failing firm in the trade practices sense.  Investment ratings simply reflect an assessment of credit risk, and may, for example, cover multiple operations and markets and could simply reflect poor management.

If the firm goes under, other companies in the market will compete for the failing firm's customer based and be divided up on the basis of market forces.  On the other hand, the acquisition of the failing firm would tend to deliver those customers to the acquiring firm.

The Commission considered the failing firm argument in its recent determination on the acquisition of Impulse by Qantas. Impulse claimed that it was a failing firm and would become insolvent on 14 May 2001. The Commission independently evaluated this claim by engaging independent auditors to assess the financial viability of Impulse. The report confirmed Impulse's claim that it was indeed a failing firm with the withdrawal of support by investors preventing the company from remaining viable.

The Commission determined that the company was suffering from a capital drain with little likelihood of alternative investors coming forward. In addition, the company also demonstrated severe cash flow problems, which indicated no future consequent to the investor community's withdrawal of support.

In addition to its audit the Commission staff assessed the business plan and financial statements and also interviewed Impulse's investors to determine the possibility of additional funding.

The likely failure of Impulse and the lack of alternative buyers led the Commission to consider the impact of two alternatives on longer term competitiveness in domestic aviation. These alternatives were to allow Impulse to go into receivership or allow Qantas to acquire the company.

Given the alternatives, after extensive evaluation the Commission concluded that while the acquisition would lessen competition, the competition concerns could be better addressed by allowing the acquisition to proceed accompanied by undertakings designed to improve the competitive position of firms currently constrained in their ability to expand and any potential new entrants. Under the other alternative, that is a receivership for Impulse, a less competitive outcome was likely.

The undertakings related particularly to access to scarce take-off and landing slots at Sydney Airport, terminal access and certain price undertakings.

## Moving Offshore

The Commission can demonstrate it is not a barrier to company growth. However, this has not stopped the Business Council of Australia trying to water down merger law at every opportunity. The latest tactic is to claim that Australia will develop a branch office economy as firms shift head offices off shore.

It's inevitable with globalisation that more Australian companies will move offshore. The Business Council should be aware that the company names it supplied the media as likely to decamp for overseas have had few problems with the Commission. They include BHP that acquired New Zealand Steel without objection, AMP that acquired GIO, Brambles, Lend Lease and NAB none of whom have had a merger blocked.

There is no evidence that companies have been forced overseas because the Commission knocked back their mergers. Nor is there evidence that relaxing merger laws will lead to the creation of large Australian-headquartered firms that will take on the world.

Until 1993, Australian merger law allowed almost any merger. During that time Coles acquired Myer, Ansett acquired east West Airlines and Goodman Fielder and Petersville became giant domestic food companies. Coles Myer has not subsequently become a major international retailer, Ansett is not a global Australian airline and Goodman Fielder languishes with regular talk of a break-up and Petersville is gone.

It is plain wrong to say that companies must be big-almost monopolies- in their home market to survive overseas. A dominant player at home is often a lazy player with home consumers paying high prices to finance overseas forays. No matter how large companies become after mergers there is no guarantee their headquarters would remain in Australia.

There are a variety of reasons why firms go offshore and merger policy is at the bottom of the list. A major reason is taxation policy, others are the need to get closer to customers and that gaining market entry may be difficult for offshore suppliers.

It is claimed that company chiefs, who would like to merge, will not come forward because they fear an inevitable knockback. With a rejection rate for proposed mergers of less than five per cent, arguments that companies will not come forward are wrong. In addition, the Chief Executives of large firms are not shrinking violets. If they are interested in a merger they will quickly sound out the Commission in one way or another.

The impact of anti-competitive mergers and joint ventures can be profound with costs to the economy such of a loss of consumer welfare and an adverse impact on the costs of affected industries. It must be kept in mind that once industry structures are in place, they are difficult to alter and may lead to higher prices, lower quality, poor service and a dearth of innovation.

A merger might create supply bottlenecks for smaller companies and could restrict market entry or access to crucial facilities.  Third parties should have access to supplies at a competitive price.

Barriers to market entry are examined.  If there are no significant barriers to new entry, incumbent firms are likely to be constrained by the threat of entry and behave as if the market is competitive.  A concentrated market often indicates high barriers to new entrants.

We also look at “other factors” including whether the merged firm will face countervailing power in the market, whether the merger will remove a vigorous and effective competitor or whether the merger is pro or anti -competition.

## Westfarmers Takeover of Howard Smith

In a press statement as recent as last Friday, the Commission announced that is would not oppose Westfarmers (the owner of the Bunnings chain of hardware stores) acquisition of Howard Smith (owner of BBC Hardware and BBC Hardwarehouse chain of hardware stores).  Westfarmers announced a full takeover offer for Howard Smith on 13 June 2001.

In its assessment of this takeover, the Commission specifically examined the question as to whether the retailing of hardware from a warehouse style format, as pursued by Bunnings and BBC Hardwarehouse, constituted a separate and distinct product market from other forms of hardware retailing.

Material obtained during market inquiries suggests that the smaller and more traditional hardware stores do compete effectively against the warehouse retailers. There are around 1,200 independent hardware retailers, in addition to a number of small retail hardware chains, and two major retail hardware chains in Mitre 10 and Danks (Home Timber & Hardware, Thrifty Link Hardware and Plants Plus Garden Centres).

The Commission also found that the merged entity would face continuing competition from a large number of category specialty retailers, particularly in the product lines of paint, gardening and nursery products, and plumbing and noted the major expansion plans announced by Mitre 10 in late May.

The primary area of competitive overlap between Howard Smith and Wesfarmers is in the retailing of home improvement, home leisure and building products, often loosely referred to as hardware.

BBC Hardware/BBC Hardwarehouse and Bunnings are two of the largest hardware retailers in Australia.  BBC Hardware/BBC Hardwarehouse has its strongest retail presence in New South Wales and Queensland.  On the other hand, Bunnings has its strongest retail presence in Western Australia and Victoria.

The Commission found that the geographical overlap between BBC Hardware/BBC Hardwarehouse and Bunnings is not significant, and the proposed acquisition did not cross the Commission's concentration thresholds for the exercise of market power in any state.

Given the fairly sparse geographic overlap between BBC Hardware/BBC Hardwarehouse and Bunnings, the Commission concluded that the proposed acquisition of Howard Smith by Wesfarmers is unlikely to result in a substantial lessening of competition.

In applying the merger guidelines, the Commission recognises that many Australian firms operate in a global environment and must consider the global competitive conditions applying in Australian markets.  Domestic mergers of Australian firms are not generally opposed where there is a clear and identifiable constraint from offshore.

The anti-competitive conduct provisions of the *Trade Practices Act*, including the merger provisions, are an attempt to enact economics as law.  For this reason, interpretation of the Act is always going to be somewhat controversial and the Commission's decisions on some mergers will attract criticism and debate.  This is the nature of things and we can live with it.

What should be remembered is that the Commission is the administrator and enforcer of an Act of Parliament introduced to protect the public against anti-competitive forces.  The Courts are the final arbiters on whether breaches of the Act have occurred.  Further, the Commission's authorisation decisions can be appealed to the Australian

Corporation Tribunal. There are ample safeguards for businesses that disagree with the Commission.

## Conclusion

Contrary to the opinions of some commentators from the big end of town the Commission is not hard to satisfy. It is the guardian of an Act of Federal Parliament that has the key role of promotion a fair and competitive operating environment for efficient and innovative businesses. It outlaws anti-competitive mergers, cartels, market sharing and price fixing and the misuse of market power. All of these activities work to the detriment of both business and consumers.

The Commission undertakes its watchdog role with flexibility and understanding. It occasionally bites but refuses to be muzzled.