



## *Public Competition Assessment*

*13 March 2008*

### *Sumitomo Forestry Company Limited - proposed acquisition of certain assets of Carter Holt Harvey Limited's Woodproducts Australia business*

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#### **Introduction**

1. On 27 February 2008, the Australian Competition and Consumer Commission (**ACCC**) announced its decision to oppose the proposed acquisition (**proposed acquisition**) of certain Carter Holt Harvey Limited assets (**CHH**) by Sumitomo Forestry Company Limited (**SFC**). The ACCC was of the view that the proposed acquisition would be likely to have the effect of substantially lessening competition in the national market for the manufacture and supply of raw medium density fibreboard (**MDF**) and was also likely to foreclose competition downstream in the supply of value added MDF 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 approved but raises important issues that the ACCC considers should be made public.
4. This Public Competition Assessment has been issued because SFC's proposed acquisition of CHH's assets was opposed by the ACCC.
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, because of developments.

6. Each Public Competition Assessment is specific to the particular transaction proposal 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. Many of the ACCC's decisions will involve consideration of both non-confidential and confidential information provided by the merger parties and interested parties. In order to maintain the confidentiality of particular information, Public Competition Assessments do not contain any confidential information or its sources. While the ACCC aims to provide an appropriately detailed explanation of the basis for the ACCC decision, maintaining confidentiality will be the ACCC's paramount concern. Accordingly, a Public Competition Assessment may not definitively explain the analysis of all issues.

### **The parties**

#### *The acquirer: Sumitomo Forestry Company Limited*

8. SFC is one of Japan's largest timber product and housing businesses. In Australia, SFC owns (through a wholly owned subsidiary) Alpine MDF Industries Limited (**Alpine**). Alpine is a manufacturer and supplier of raw MDF. Alpine manufactures raw MDF from its plant located near Wangaratta, Victoria and supplies to both the domestic and export markets.
9. In addition to its Australian operations, SFC manufactures and supplies raw MDF and laminated veneer lumber (**LVL**) in New Zealand through its wholly owned subsidiary Nelson Pine Industries Ltd (**Nelson Pine**) and has other wood processing investments in Indonesia manufacturing particleboard, plywood and value added wood products.
10. SFC supplies its wood panel products in Australia through a network of third party distributors.

#### *The target: Carter Holt Harvey Limited – Woodproducts Australia assets*

11. CHH is a forest products company operating in Australasia, with significant interests in wood products, pulp, paper and packaging.
12. CHH's wood products businesses include Woodproducts Australia and two New Zealand businesses: Woodproducts New Zealand and Carters. CHH is currently seeking to sell several of its wood products businesses in Australia and New Zealand, including the assets of Woodproducts Australia.

SFC - proposed acquisition of certain assets of CHH's Woodproducts Australia business

13. Woodproducts Australia operates predominantly in the softwood products segment of the building materials industry. Its main products include: softwood sawn timber, LVL, plywood, particleboard, raw MDF and value added MDF products including MDF mouldings and low pressure melamine (**LPM**) decorative panels.
14. CHH manufactures raw MDF at its Oberon plant in New South Wales (**NSW**). CHH supplies raw MDF to both the domestic and export markets.

#### **Other Market Participants**

15. There are currently three manufacturers/suppliers of raw MDF in Australia: SFC, CHH and Laminex Group Pty Ltd (**Laminex**).
16. Laminex is currently Australia's largest producer of raw MDF and has its own downstream secondary MDF manufacturing operations which produce decorative MDF panel products. Laminex supplies raw MDF and value added MDF products through its own distribution network as well as third party distributors. Laminex supplies raw MDF to both the domestic and export markets.

#### **Areas of overlap**

17. SFC and CHH overlap in the manufacture and supply of raw MDF.
18. The proposed acquisition would see the number of raw MDF manufacturers/suppliers in Australia reduced from three to two.

#### **The proposed acquisition**

19. SFC proposed to acquire the following assets of Woodproducts Australia:
  - raw MDF manufacturing plant located in Oberon, NSW;
  - MDF moulding manufacturing plant in Oberon, NSW;
  - particleboard manufacturing plants located at Gympie, Queensland (**QLD**), Tumut and Oberon, NSW and Mt Gambier, South Australia (**SA**);
  - decorative panel manufacturing plants located at Oberon and Tumut, NSW and Mt Gambier, SA; and
  - chemical resins manufacturing plant located at Oberon, NSW.

#### **Industry Background**

20. MDF is a wood-based panel product. Applications include kitchen and bathroom cabinets, furniture and office and shop fit outs. MDF is formed by combining fine wood chips with wax and resin, applying high temperature and pressure and running through a hot press to produce raw MDF panels.

21. The wood inputs for raw MDF in Australia (largely pine) are usually sourced through long-term contracts with private and government-owned plantations that last up to 30 years. MDF manufacturing plants tend to be located in close proximity to the relevant wood resources due to high transport costs.
22. The amino resins used to manufacture raw MDF can currently be sourced from three domestic manufacturers: Hexion (VIC and QLD), Woodchem<sup>1</sup> (NSW) and Dynea<sup>2</sup> (WA). Due to transportation costs and the short shelf life of amino resins, the resins manufactured in WA are generally not supplied to raw MDF customers on the eastern seaboard.
23. Raw MDF manufacturers/suppliers produce raw MDF sheets in a variety of types (including moisture resistant, standard and low formaldehyde) and a range of sizes which are then supplied to distributors and/or secondary MDF manufacturers. In some instances, raw MDF manufacturers/suppliers also perform the distribution and/or secondary MDF manufacturing function.
24. In particular, Laminex is vertically integrated such that it has significant secondary MDF manufacturing operations and distributes a significant proportion of its value added MDF products through its own distribution network. CHH performs some secondary MDF manufacturing through its MDF mouldings and decorative panel operations, but generally uses third party distributors. SFC only produces raw MDF.
25. Value added MDF products can broadly be divided into:
  - aesthetically finished boards - including melamines, veneers and vinyl which are largely used for kitchen and bathroom cabinets, wall units, tables, chairs, wardrobes, doors and desks; and
  - partitions and mouldings (architraves, skirting boards, door jambs) which involve cutting and shaping raw MDF boards.
26. In addition to producing value added MDF products, some secondary MDF manufacturers also act as distributors of raw MDF and value added MDF products.
27. The three main categories of customers that purchase raw and value added MDF include:
  - cabinet makers - producing kitchen and bathroom cabinets;
  - furniture manufacturers - producing furniture including dining tables, chairs and wardrobes; and
  - office and shop fit out installers - producing office furniture and shop fittings.
28. These customers then sell their products to retail outlets and tradespeople.

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<sup>1</sup> Woodchem is currently owned by CHH.

<sup>2</sup> Dynea is a joint venture operation between Dynea Australia Pty Ltd and Laminex.

## Timing

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

Date	Event
30-Nov-2007	ACCC commenced its review under the Merger Review Process Guidelines.
14-Dec-2007	Closing date for submissions from interested parties.
18-Dec-2007	ACCC requested further information from SFC. ACCC timeline suspended.
11-Jan-2008	ACCC received further information from SFC. SFC indicated intention to provide additional information to the ACCC.
16-Jan-2008	ACCC published a Statement of Issues outlining preliminary competition concerns.
23-Jan-2008	Former proposed date for announcement of ACCC's findings, amended to allow for provision of additional information from SFC and receipt of responses to Statement of Issues.
30-Jan-2008	Closing date for submissions relating to Statement of Issues. ACCC received additional information from SFC. ACCC timeline recommenced.
31-Jan-2008	ACCC timeline suspended pending receipt of additional information from the merger parties. Former proposed date for announcement of ACCC's findings of 13 February 2008, amended to 27 February 2008 to allow for receipt of additional information.
27-Feb-2008	ACCC announced it would oppose the proposed acquisition.

## Market inquiries

30. The ACCC conducted extensive market inquiries with a range of interested parties, including actual and potential competitors, raw MDF customers, raw MDF input suppliers, relevant industry bodies and other regulatory agencies. Submissions were sought in relation to the substantive competition issues.

## Statement of Issues

31. After an initial round of market inquiries, the ACCC published its Statement of Issues on 16 January 2008 identifying a number of competition issues including:

- the potential for the proposed acquisition to substantially lessen competition in the manufacture and supply of raw MDF in Australia; and
- the potential for the merged entity to have the ability and incentive to foreclose downstream competition in value added MDF products including MDF mouldings.

32. The ACCC sought further submissions from interested parties regarding the issues outlined in the Statement of Issues.

## **Manufacture and supply of raw MDF**

### *Market definition*

33. The ACCC considered that a relevant market for the consideration of the proposed acquisition was the national market for the manufacture and supply of raw MDF.
34. The ACCC's market inquiries indicated that whilst other wood panel products, such as plywood and particleboard, may be considered alternatives to raw MDF in certain circumstances, they are generally not close substitutes for raw MDF.
35. On the demand-side, market inquiries indicated that other wood panel products do not have the same functionality including, from the perspective of secondary MDF manufacturers.
36. Raw MDF is often used in applications which require it to be shaped, or routed. Particleboard is constituted of large wood chips which are not suitable for shaping or routing. Furthermore, particleboard does not have the same profiling abilities as raw MDF. Consequently, particleboard was not generally considered a close substitute for raw MDF by interested parties, as it would not be suitable for a substantial proportion of applications.
37. Interested parties suggested that interior plywood does possess similar characteristics to raw MDF, making it capable of use in many of the same applications as raw MDF. However, the significant price difference between the two products means that interior plywood was unlikely to pose a significant constraint on the manufacturers/suppliers of raw MDF.
38. On the supply-side, market inquiries indicated that both manufacturers of particleboard and plywood would not be able to adapt their existing production facilities to produce raw MDF without significant capital investment. In particular plywood utilises a completely different manufacturing process such that new machinery would be required.

### *Market concentration*

39. Market inquiries indicated that the merged entity would be likely to have a very strong position in the manufacture and supply of raw MDF, with a substantial share of raw MDF manufactured and supplied in Australia. The proposed acquisition would result in the number of raw MDF manufacturers/suppliers reducing from three to two, with Laminex being the only alternative, with a significantly smaller share of the market than the merged entity.
40. The proposed acquisition would result in the HHI increasing by approximately 2350 to 6050 in the manufacture and supply of raw MDF domestically. Accordingly, the ACCC considered that the proposed acquisition would result in a significant increase in concentration in an already highly concentrated market.

*Alternative suppliers*

41. The proposed acquisition would result in Laminex being the merged entity's only rival manufacturer of raw MDF in Australia.
42. Market inquiries indicated that Laminex manufactures and supplies significant volumes of raw MDF in Australia. However, market inquiries indicated that there are raw MDF customer segments in which Laminex does not have a significant presence such as larger secondary MDF manufacturers that compete with Laminex in the downstream supply of value added MDF products.
43. Market inquiries indicated that Laminex would be likely to have weakened incentives to impose a competitive constraint on the merged entity due to:
  - the lessening of competition arising from the removal of CHH, creating an environment in which tacit collusion with respect to price increases would be more likely; and
  - the potential advantage to Laminex's competitive position in the supply of value added MDF products as a result of an increase in the price of raw MDF supplied to rival secondary MDF manufacturers.
44. The ACCC considered that Laminex would be likely to impose some constraint on the merged entity, particularly with respect to the supply of raw MDF to distributors and small secondary MDF manufacturers. However, in the absence of other competitive constraints, the incentives faced by Laminex meant that it was not considered an effective competitive constraint for the purpose of assessing the proposed acquisition.

*Barriers to Entry*

45. The ACCC's market inquiries suggested that the capital costs associated with establishing a greenfield raw MDF manufacturing plant are substantial (in the order of over \$100 million for a facility meeting minimum efficient scale). Market inquiries indicated that sunk costs are likely to constitute a substantial proportion of capital costs. In addition, existing MDF manufacturing capacity in Australia is significantly greater than domestic demand for raw MDF. Adding further capacity would likely depress domestic raw MDF prices, further reducing the likelihood of new entry.
46. In terms of raw inputs, market inquiries indicated that Australian wood resources (and in particular, pine resources) are not easily accessible because most resources are currently contracted for extended periods with existing raw MDF manufacturers/suppliers and manufacturers of other products. These wood resources are also used in the manufacture of paper and packaging such that raw MDF manufacturers/suppliers must compete with these firms which may have the ability to pay more for wood resources because of their higher margins.

47. In addition, market inquiries indicated wood resource owners are likely to be reluctant to contract with new, less established manufacturing entrants because the nature of the long-term contracts require an ongoing relationship with the wood resource owner. In entering into a supply relationship, wood resource owners are likely to consider a prospective customer's financial viability, level of experience, long term commitment to the supply relationship and commitment to environmental sustainability such that existing players are likely to be given preference over new entrants.
48. Accordingly, the ACCC considered that barriers to entry are high and that new entry was unlikely to occur in the foreseeable future.

#### *Import competition*

49. The ACCC considered whether actual or potential imports were likely to act as a constraint on the merged entity.

#### Current MDF imports

50. Market inquiries indicated that the current level of MDF imports into Australia equates to approximately 5%<sup>3</sup> of raw MDF supplied in Australia. These MDF imports are primarily from Malaysia, and to a lesser extent, New Zealand.<sup>4</sup>
51. The ACCC notes that the available data does not distinguish between raw MDF imports and value added MDF imports. Market inquiries indicated that MDF imports are likely to be predominantly value added MDF products.
52. Accordingly, the ACCC considered that actual imports of raw MDF are currently limited and that, at this level, imports would be unlikely to impose an effective competitive constraint on the merged entity.

#### Potential raw MDF imports

53. In terms of the availability of potential raw MDF imports, there is currently significant global trade in raw MDF, with 13.5 million m<sup>3</sup> traded in 2006, accounting for 30% of global capacity.<sup>5</sup> Independent sources indicate that global MDF production capacity has increased substantially over recent years and that international trade is relatively fluid with products traded between the Americas, Asia-Pacific and Europe.
54. However, market inquiries indicated that the majority of raw MDF being produced and traded internationally, particularly in South-East Asia and China, was not of comparable quality to Australian product in terms of wood inputs and formaldehyde emission standards, suggesting that they would not act as an effective competitive constraint on the merged entity. Although such quality issues were acknowledged by all interested parties, market inquiries confirmed

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<sup>3</sup> ABARE, 2007 statistics.

<sup>4</sup> Imports from Malaysia constituted 12,000m<sup>3</sup> and NZ constituted 2,000m<sup>3</sup> according to ABARE 2007 data.

<sup>5</sup> Food and Agriculture Organisation of the United Nations, 2008

that some quantities of raw MDF of suitable quality may be available both from South East Asia, South America<sup>6</sup> and New Zealand for import into Australia.

55. While raw MDF of suitable quality is manufactured in New Zealand, the structure of the New Zealand raw MDF industry means significant quantities of this raw MDF capacity is unlikely to be available for independent imports to Australia.<sup>7</sup> In particular, two of the three raw MDF manufacturers/suppliers in New Zealand are related entities of SFC and CHH. The only other New Zealand raw MDF manufacturer, Dongwha Patinna NZ Limited (**Dongwha**), is a related entity to Laminex<sup>8</sup>. Based on market inquiries, the ACCC considered that Dongwha would be unlikely to act as an effective competitive constraint on raw MDF manufacturers/suppliers in Australia.
56. The ACCC noted that raw MDF is an internationally traded commodity and there may be sources of raw MDF of a suitable quality in South East Asia and South America which are available for imports to Australia. However, as discussed below, the price of such imported raw MDF is unlikely to be within a range that would impose an effective competitive constraint on the merged entity.
57. Some interested parties expressed concerns in relation to the reliability and operational issues associated with importing raw MDF. However, market inquiries indicated that some wood panel importers and many of the larger raw MDF distributors are currently importing wood-based products including particleboard, plywood and value added MDF products and could be expected to have the expertise, information and relationships necessary to explore importing raw MDF to Australia.
58. In terms of the price of potential raw MDF imports, market inquiries indicated a significant variability in the landed cost of raw MDF as a result of differences in the price of raw MDF from particular suppliers, differences in shipping costs and exchange rate fluctuations.
59. However, market inquiries indicated that the landed cost of suitable quality imported raw MDF is unlikely to be within a range that would impose an effective competitive constraint on the merged entity. In particular, market inquiries indicated that price increases in excess of 5-10% by the merged entity would be necessary before there was any possibility of significant and suitable quality raw MDF being imported to Australia from South-East Asia or South America.
60. Accordingly, the ACCC considered that potential raw MDF imports would be unlikely to impose an effective competitive constraint by acting as a viable

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<sup>6</sup> For instance, Chilean raw MDF manufacturers utilise radiata pine in the manufacturing of low formaldehyde raw MDF of comparable standards to Australian raw MDF.

<sup>7</sup> The position in relation to the availability of raw MDF manufactured in New Zealand may change in the event SFC's acquisition of Woodproducts New Zealand and Carters does not proceed. However, regardless of whether or not this acquisition proceeds, it would be unlikely to impact upon the ACCC's conclusions in relation to potential import competition or the proposed acquisition.

<sup>8</sup> Fletcher Building Ltd (Laminex's parent company) has a 20% interest in Dongwha with an option to acquire a further 30%.

alternative for raw MDF customers in response to an increase in domestic prices by the merged entity.

*Downstream competition*

61. The ACCC also considered indirect constraints on the merged entity that may arise from downstream competition with respect to the wholesale and/or retail supply of raw MDF and value added MDF products (including imports). In particular, the merged entity could be constrained by a potential reduction in raw MDF sales in the event that it sought to increase prices to raw MDF distributors and secondary MDF manufacturers above competitive levels. The ACCC considered that downstream competition would be unlikely to impose an effective competitive constraint on the merged entity.

**Conclusion – manufacture and supply of raw MDF**

62. The ACCC concluded that the proposed acquisition was likely to result in a substantial lessening of competition in the manufacture and supply of raw MDF in Australia.

**Foreclosure of competition in downstream value added MDF products**

63. The proposed acquisition would result in SFC acquiring CHH's secondary MDF manufacturing assets with respect to MDF mouldings and LPM. Raw MDF is a necessary input for the value added MDF products manufactured by CHH and its competitors.
64. Market inquiries indicated that SFC would be likely to have the ability and incentive to leverage the market power it gained in relation to the manufacture and supply of raw MDF. For example the merged entity could either:
- restrict supply of raw MDF to its downstream rivals in the manufacture and supply of value added MDF products; or
  - raise the costs of downstream rivals in the manufacture and supply of value added MDF products by increasing the price of raw MDF.
65. Market inquiries indicated that these concerns are likely to arise in relation to competition for the supply of value added products in which CHH currently has operations (MDF mouldings and LPM) as well as a broader range of value added MDF products in the event that the merged entity elected to further vertically integrate. The ACCC did not consider it necessary to precisely define each of the value added markets.
66. The ACCC considered that the merged entity's ability to exercise market power in the manufacture and supply of raw MDF as a result of the proposed acquisition would be likely to provide it with the ability and incentive to foreclose downstream competition in relation to the supply of value added MDF products.

**Conclusion**

67. The ACCC formed the view that the proposed acquisition would be likely to result in a substantial lessening of competition in the national market for the manufacture and supply of raw MDF and downstream value added MDF products in contravention of section 50 of the Act.