IN THE COMPETITION APPEAL COURT
REPUBLIC OF SOUTH AFRICA

Case No. 28/CAC/May

In the appeal of

JD GROUP LIMITED

and

PROFURN LIMITED **Appellants**

In re:

COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

In the large merger between:

JD GROUP LIMITED

And

PROFURN LIMITED

JUDGMENT

DAVIS JP:

INTRODUCTION

On 12 December 2002 the Competition Tribunal ('the Tribunal') approved a large merger between appellants ('JD Group' and 'Profurn') subject to certain conditions. The effect of the conditions was that the Profurn and JD components of the merged entity were not permitted for a period of three years, to purchase a lower percentage of their stock from independent furniture manufacturers than they had so purchased prior to the merger. In the Tribunal's order independent manufacturers were defined as any manufacturer other

than Steinhoff International Holdings Limited ('Steinhoff').

Appellants appealed to this Court on 28 May 2003 and the matter was heard on 25 September 2003. At the end of argument, the Court upheld the appeal and ordered that the order of the Competition Tribunal should be set aside and be replaced with an order that the merger be approved without conditions. The reasons for this order are now set out.

THE TRIBUNAL'S REASONS FOR ITS DECISION.

The merger between the appellants can be briefly described thus:

First Rand Bank was the controlling shareholder of Profurn with 78,8% shareholding therein. It entered into an agreement with the Profurn Group in terms of which the JD Group, or one of its nominees would acquire all the subsidiaries of Profurn or all the businesses of the subsidiaries as going concerns including the assets and liabilities or a combination of the subsidiaries, assets and liabilities.

At the time that the Tribunal heard argument on the proposed merger, the exact mechanism for the transaction had not been finalised. In return for the sale, First Rand Bank would acquire shares in the JD Group as consideration and in turn would sell 5/6ths of these shares to a foreign investor Daun et Cie. As a result of this transaction, First Rand and Daun et Cie would hold approximately 25% of the shares in the JD Group. Prior to the transaction, Old Mutual SA was the largest shareholder in the JD Group with a 27,26% stake. As part of the transaction, the JD Group entered into an interim agreement with First Rand Bank and Profurn in terms of which the JD Group would provide, what was described as 'selected retail expertise and services to Profurn'. The agreement was approved by the Competition Commission ('the Commission') and came into effect on 28 June 2002. It was intended to last until the outcome of the adjudication by the competition authorities. On 8 October 2002 the Commission recommended that the merger be unconditionally approved.

In its determination, the Tribunal examined the merger from two perspectives, namely the horizontal effects and the vertical effects insofar as they affected the merged firms' buying power on the market for the purchase of furniture from manufacturers.

Dealing with the horizontal effects, the Tribunal noted that there were essentially three types of stores which were all in the business of selling furniture. The first type of store was described as 'the mass discount' store trading in higher volumes and are price competitive because of low margins. Thus 'for these reasons mass discounters operate from large stores usually located in urban areas where customer volume densities are more assured, sell on a cash basis only and offer minimum service'.

The next type of store was described as the furniture retail outlet. This type of store is in the hands of chains and are organised in a manner specifically targeted to a group of consumers. The JD and Profurn groups usually target a range of consumers who fall within consumer Living Standard Measure (LSM) categories, typically LSM 3 to 4. These stores are smaller than the mass discounters but there are more of them in the market. Within the category of furniture chains there are at least three broad segments namely a mass market, a middle market and a mid/upper market. They sell to the consumer on credit but, according to the Tribunal, spend vast resources on creating models of likely risk and use sophisticated information technology to assess credit policies.

The third category of business is the 'independent' store which is neither part of a chain nor a group and is usually managed by the owner. Typically, independents constitute single outlet businesses and the largest type of independent business does not exceed four stores. Independent stores vary from being specialist outlets such as retailers with expensive 'high tech' equipment to general dealers who sell all forms of furniture.

The Tribunal had dealt previously with a merger in the furniture market between the JD Group Limited and Ellerines Holdings Limited (case No. 78/LM/Jul00). It had then defined the relevant market as: 'The relevant market is composed of furniture shops (with a product mix of furniture and appliances) directed at credit sales to consumers in the LSM3-5 category'.

The merging parties contended in the present dispute that the same market definition should not be adopted but that the relevant market was composed of all furniture and appliance retailers aggregated together into a national geographic market. The Tribunal did not make a definitive finding in relation to the applicable market. It did suggest that unlike the Ellerines merger, the merging firms in the present dispute also had a 'strong footprint' in the mass discount market. The Tribunal found that the independents did not act as a counterveiling power to the market behaviour of the chains and their plurality notwithstanding, they should be excluded from any relevant market determination. On this basis and employing the relevant 3-5 LSM category the Tribunal concluded 'The

merged firms have 24,2% of the post merger market. The HHI (Herfindahl – Hirschman Index of market concentration) is 2113 pre-merger and 2380 post merger, yielding a change in HHI of 267, suggestive of a concentrated market'. Viewed accordingly, the Tribunal came to the conclusion 'that it is probable that this concentration would have occurred even absent the merger'.

The Tribunal then engaged in an enquiry mandated by section 12 A of the Competition Act 89 of 1998 ('the Act'), in terms of which the Tribunal is required to determine 'whether or not the merger is likely to substantially prevent or lessen competition'.

The parties had argued that Profurn was a failing firm and hence contended that the 'concentration is not the cause of the creation or strengthening of a dominant position which has a significant impact on the competitive situation on the relevant market'. See **France v the European Community Commission** [1998] ECR 1-1375.

The Tribunal held that, although not all the elements of the failing firm doctrine had been established, 'we are persuaded by the evidence that certain businesses of Profurn would have exited the market if there had either not been a merger, or if another firm with a less competitively adverse profile had been the purchaser'. The Tribunal concluded that, although the merger would have increased concentration and therefore reduced competition in the market (however so defined), this development would have occurred, absent the merger, and accordingly the merger could not be held to be the cause of the defect of the present state of the market. Having made no adverse finding against the parties in respect of the horizontal aspects of the merger, the Tribunal turned to the vertical effects thereof.

The key issue with regard to vertical effects concerned the role of Steinhoff, the country's largest furniture manufacturer. According to the Tribunal, it was common cause that Steinhoff was the dominant firm in manufacturing of furniture as well as in the bedding industry. It cited figures provided by the independent firms to the effect that Steinhoff enjoyed 54% of this market.

The Tribunal then engaged in an analysis of the evidence, the key conclusions of which were:

1. Steinhoff was the dominant supplier of bedding and furniture in the South African retail market.

2. It enjoyed particularly close relationships with at least two of the key chains being the JD Group as well as Relyant.

3. It had over the past decade grown dramatically due to a series of acquisitions while at the same time the role of independent manufacturers had declined markedly.
4. Retailers had fewer manufacturers to procure core product, thereby inhibiting their ability to secure best prices and product choices.
5. Independent manufacturers were dependent for their survival on preserving the custom of the chains in order to achieve some economies of scale and therefore retain their competitiveness.
6. The chains needed to secure high volumes of product and could only so achieve this at best prices by securing rebates from Steinhoff.
7. Profurn was identified by the independents as being one of the chains that had 'championed the cause of independent manufacturers'.
8. Of all the chains, JD had the closest relationship to Steinhoff.
9. Within the merged group it was likely that JD would alter Profurn's purchasing powers in favour of Steinhoff and to the detriment of the independents. This would lead to a further reduction in the role of the independents and consequently increase concentration in the manufacturing sector.
10. The demise of the independent manufacturing sector was likely to raise barriers to entry to the increasingly concentrated retail sector.

On the basis of this reading of the evidence, the Tribunal concluded that the adverse effect 'can be remedied by placing conditions on the merger – outright prohibition is not warranted'. Pursuant to this finding, the conditions which had been summarised above were imposed by the Tribunal as a condition of its approval of the merger.

APPELLANTS CASE

Mr Subel, who appeared together with Mr Blou on behalf of the JD Group, began his argument by summarising the steps taken by the Tribunal in arriving at its decision to impose conditions on the merger:

i) Steinhoff dominated the market as defined in that it enjoyed some 54% market share.

ii) Steinhoff enjoyed an extremely close business relationship with the JD Group.

iii) Because of the merger, business would be diverted by Profurn to Steinhoff from the independent manufacturers which would only increase the market share of Steinhoff. This would result in increased prices charged to competitors, a reduction in the choice of goods available on the market and hence an increase in the barrier for entry in both vertical and horizontal markets.

According to Mr Subel, all of these steps were flawed. He contended that Steinhoff's market share was nowhere near the figure of 54% claimed by the independent manufacturers and seemingly accepted by the Tribunal. He referred to a document of 14 November 2002 from the Competition Commission in which it was calculated that the share of Steinhoff was in the region of 24.4% for the market for local furniture comprising case goods, bedding and upholstery.

Mr Subel also referred to the cross-examination of Mr Pritchard, and in particular the latter's evidence regarding Steinhoff's 54% market share. When cross-examined by Mr Pretorius on behalf of Profurn, Mr Pritchard had no satisfactory answer to the proposition that Steinhoff's market share was closer to 20% than the 54% which he had informed the Tribunal. Mr Subel submitted that, as there was no satisfactory explanation from Mr Pritchard or any of the other witnesses, the Tribunal's conclusion that 'Steinhoff is a dominant supplier of bedding and furniture to the South African retail industry' based upon the figure of 54%, market share had to be treated with a considerable measure of qualification.

Turning to the conclusion reached by the Tribunal that, after the merger, JD was likely 'to alter Profurn's purchasing power policies away from independents in favour of Steinhoff', Mr Subel referred to the only express evidence tendered in relation to the future purchasing policy of the merged entity in relation to Profurn Group. This testimony was given by Mr Strauss of the JD Group, the relevant passage of which reads thus:

"MR STRAUSS: Sir there is certainly no reason for any one of the intervenors to feel that we are not going to do business with them. It is common practice in any industry that you have relationships with certain suppliers. It is true that JD, on an annual basis, go to the major suppliers within a group where we actually sit down and we plan our projections for the year ahead. In order for them to be able to meet our requirements one has to do those things.

And I've stated that before, in terms of the way we run our businesses and the way we see it going forward, if we take two more chains, which is certainly the plan right now and that is Morkels and Protea/Barnetts as a combined unit, we are going to need differentiation. Now we've stated that before and there is certainly no intention that we want to go wholesale and close accounts. We have not that intention. It is not our strategy. The only strategy that we have stated before that we have is that we sell branded bedding, and that is the only reason why my friend on my right, we are no longer doing business with him."

Mr Subel suggested that, by contrast to the evidence, the reasoning employed by the Tribunal to the effect that the JD Group would shift Profurn's purchases away from independents and to Steinhoff, was based on nothing more than speculation. The key passage in the Tribunal's decision reads thus: 'Almost all of the intervenors testified that they had lost the custom of the JD Group presumably to Steinhoff. Profurn, in contrast to JD, was a chain that purchased overwhelmingly from the independents. Their underlying fear was therefore that post merger, the merged entity would favour Steinhoff at their expense given JD's current purchasing policies.

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

Never were any of these difficulties put expressly to Mr Strauss nor was Mr Strauss asked about the consequences of conditions to be imposed and which the Tribunal ultimately did impose nor did the Tribunal in any way deal with the fact that JD was in no contractual relationship with Steinhoff and hence that a 'close business relationship' could not be equated with a series of contractual obligations which would have imposed a duty upon the JD Group to ensure that Profurn secured its product from Steinhoff.

Mr Subel also referred in the finding of the Tribunal that: 'We are persuaded by the evidence that certain businesses of Profurn would have exited the market if there had either not been a merger or if another firm with a less competitively adverse profile had been the purchaser'. Without the merger, it appeared that at least three of the four Profurn chains would have ceased operations which would have placed the independent

manufacturers in precisely the same position as they would have been, absent the merger. There was no evidence provided by the independent manufacturers which gainsaid the contention that, absent the merger, the independent manufacturers would have suffered serious consequences in their ability to sell their products.

EVALUATION

In my view, there are significant further defects in the reasoning employed by the Tribunal in addition to those set out by appellants. Although the Tribunal engaged in some detail with the definition of the appropriate market, it ultimately desisted from providing a clear finding, concluding that 'Because we make no adverse finding against the parties in respect of the horizontal aspects of the merger, it is unnecessary for us to come to some definitive conclusion on the boundaries of the relevant market'.

That may well have been a satisfactory side step if the dispute had turned exclusively on the horizontal aspects of the merger. Once the Tribunal was required to engage with the significant vertical implications of the merger, clarity in respect of the definition of the market was clearly required.

This problem of market definition is not only common to South Africa. In **France v The Commission** (case No.68 – 94, C –34/35, a judgment of the European Court of Justice given on 31 March 1998) the court states 'A proper definition of the relevant market is a necessary precondition for any assessment of the effect of concentration on competition'. Similarly, in a case which has been cited often by this Court and the Tribunal, **Brown Shoe Company v United States** (1962) 370 US 294, the court held 'Thus as we have previously noted: 'determination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act because the threatened monopoly must be one, which will substantially lessen competition within the area of effective competition. 'Substantiality' can be determined only in terms of the market affected'. See also **Lantec Inc v Novell** (146) F.Supp 2d 1140.

The absence of clarity in respect of the appropriate market then leads to the further difficulty with the reasoning employed by the Tribunal. The Tribunal acted in terms of

section 12 A(1)(a) which provides:

1) Whenever required to consider a merger, the Competition Commission or Competition Tribunal must initially determine whether or not the merger is likely to substantially prevent or lessen competition, by assessing the factors set out in subsection (2), and –

   (a) if it appears that the merger is likely to substantially prevent or lessen competition, then determine –

      (i) whether or not the merger is likely to result in any technological, efficiency or other pro-competitive gain which will be greater than, and offset, the effects of any prevention or lessening of competition, that may result or is likely to result from the merger, and would not likely be obtained if the merger is prevented.

From the wording of this section it appears that the Tribunal, prior to having imposed any condition on an approved merger (or in the case of the prohibition of a merger) should have considered whether, having found a substantial lessening of competition, there were efficiencies that offset the substantial lessening of the competition. This approach was accepted in the judgment of this Court in **Schumann Sasol S.A.(Pty) Ltd Price Daelite (Pty) Ltd** (case No. 10/CAC/Aug01) which cautioned against speculation unconnected with the record of evidence and where the judgment referred with approval to the case of **Alberta Gas Chemicals EI du Pont de Nemours** F 3d 1235 (3rd Circuit)(1987) at 1244.

There is also very little in the way of justification provided by the Tribunal with regard to the specific nature of the conditions imposed by it. The manner in which the conditions were framed appears to prevent the JD Group from making buying decisions in accordance with its best commercial interests and would seem to have been imposed not to protect other retailers from undesirable consequences of the merger but to protect a group of suppliers against competition from Steinhoff.

The difficulty with the conditions imposed can be illustrated thus:
If the independent manufacturers are unable to deliver sufficient products to the JD Group during the so-called 'Christmas rush' (October to December) the JD Group may well be precluded from making up the shortfall by purchasing from Steinhoff. If the JD Group does seek to increase its purchases of a Steinhoff line of products that is selling particularly well, it would be required to cut back on other Steinhoff products so as not to exceed the permitted Steinhoff ratio. If a Profurn chain closes, which the Tribunal found would have been likely to have occurred in respect of at least three of the Profurn chains but for the merger, the proportion of stock that the other chains must purchase from independent manufacturers would escalate dramatically because they would be required, in terms of the imposed conditions to assume the obligations of the closed stores purchases from the independent manufacturers. This could have the effect of reducing the purchases from Steinhoff to nothing, with serious consequences both for Steinhoff and for the remaining chains which would be obliged to buy uncompetitively priced products, thereby placing their business at risk.

A further concern pertains to the position of Steinhoff which was not placed in a position whereby it could respond to the possibility of conditions being imposed by the Tribunal. Whatever indication may have been given to the Tribunal by Steinhoff's representative, Steinhoff were never notified of the proceedings regarding the order being made which affected their interest regarding the possibility of conditions being imposed. The very nature of the conditions so imposed necessitated Steinhoff being afforded an opportunity of making duly considered representations prior to the final decision by the Tribunal.

CONCLUSION

The imposition of a series of conditions as occurred in the present case, requires at the, very least, a rational justification based on the evidence presented to the Tribunal. In the present case, the Tribunal was not able to point to any clear evidence which justified the imposition of the conditions so imposed. The best that was offered by the Tribunal in the form of an explanation was the speculation that, given a previous buying pattern by the JD Group in respect of Steinhoff products, and the close relationship between these two groups (which was not contractual in nature) it was reasonable to infer, the evidence of JD Group's Mr Strauss and Mr Sussman notwithstanding, that significant changes in

purchases, away from the independents and towards Steinhoff, would inextricably take place.

The Tribunal appears to have had an anxiety that some deleterious set of consequences could follow the merger. It behoved it, on the basis of this anxiety, to have considered the record and if necessary to call for further evidence in order to test whether this 'anxiety' of the consequences was justified in terms of sound evidence which, arguably, could have been obtained by way of questions to directors of Steinhoff.

Even if this evidence had been found and the Tribunal was able to lay a clearly ascertained foundation for its conclusions, far greater attention would have had to be given to the formulation of the conditions so as to ensure that they were designed to restore effective competition in the particular market as a result of the consequences of the merger.

REVIEW APPLICATION.

Following the decision of the Tribunal, Steinhoff brought a review application for the setting aside of the conditions laid down by the Tribunal, pursuant to its decision to approve the merger between the JD Group and Profurn.

Mr Rogers, who appeared together with Mr Campbell on behalf of Steinhoff, contended that the proper approach to be adopted by this Court was to hear the appeal first in that, were the substantive objections to the decision of the Tribunal to be upheld on the broader grounds permissible in terms of an appeal, the review application would be rendered redundant. In support of this proposition, Mr Rogers referred to section 7 (2)(a) of the Promotion of Administrative Justice Act 3 of 2000 which requires the exhaustion of any internal remedy provided for in any other law before judicial review proceedings may be brought, the Act provided for an appeal to this court. The appeal had properly been prosecuted by the appellants and for this reason it was proper for the Court to deal

first with the appeal and then only, if necessary, canvass the issues raised in the review.

After oral argument, this Court agreed with these contentions advanced by Mr Rogers and accordingly decided to hear the appeal first. In the light of the decision to which the Court arrived, there was no need to deal any further with the review application.

In arriving at its decision and in the formulation of the reasons therefore, this Court derived considerable benefit both from the heads of argument and oral argument which was advanced by Mr Arendse, who appeared together with Mr Maenetje on behalf of the **amicus curiae** the request of the Court. To them this Court owes a significant debt of gratitude.

Jali JA & Malan AJA agreed.