

Anticipated acquisition by Geest Foods Limited of New Primebake Limited

The OFT's decision on reference under section 33 given on 27 June 2006. Full text published 10 July 2006.

Please note that square brackets indicate figures or text which have been omitted or replaced with a range for reasons of commercial confidentiality.

PARTIES

1. **Geest Foods Limited (Geest)** is a wholly owned subsidiary of the Icelandic Bakkavor Group hf. Geest is active in the preparation of convenience foods and meal accompaniments and produces own label food items for supermarkets in the UK.
2. **New Primebake Limited (New Primebake)** is a wholly owned subsidiary of Primebake Limited. New Primebake is a producer and supplier of own-label speciality breads for national multiples. It is also a supplier of fresh prepared foods in the UK.

TRANSACTION

3. Geest is proposing to acquire the entire issued share capital of New Primebake. The parties notified the transaction on 28 April 2006 and therefore an administrative deadline of 27 June 2006 applies.

JURISDICTION

4. As a result of this transaction Geest and New Primebake will cease to be distinct. Post-merger the parties will have a combined share of supply of [70-80] per cent in chilled speciality breads in the UK. Therefore the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

FRAME OF REFERENCE

Product Frame

5. The parties overlap in the supply of chilled speciality breads. According to a recent Mintel Report,¹ there are two major types of bread: traditional breads and other breads, referred to in this decision as 'speciality breads'.
6. Traditional breads include white, brown and wholemeal/granary bread, mostly sold in sliced or whole loaves. Speciality breads² differ from traditional breads due to different shapes, flavours and influences from European or International trends.
7. Suppliers indicated they would not switch from the production of traditional to speciality breads if the price of speciality breads rose by 5-10 per cent because speciality breads involve the use of a wide variety of product lines with very short lead times. In addition, customers suggested that speciality breads and traditional breads were not substitutable, as speciality breads tend to be bought as meal accompaniments for specific meals, whereas traditional breads are often used as a meal (for example a sandwich). Therefore, based on the evidence available, it would not appear appropriate to include traditional breads within the product frame of reference.
8. Speciality breads are supplied in ambient, frozen and chilled forms. On the demand side, customers have indicated that there is limited substitutability between the ambient, frozen and chilled speciality breads. A key consideration in consumer demand for speciality breads is the consumers' perception of freshness: ambient speciality breads are bought by consumers for consumption within one or two days of purchase; chilled speciality breads are bought for consumption within five to six days; and frozen speciality breads are usually purchased as a larger stock item and kept for infrequent use. This differentiation is further supported by the fact that each type of bread is sold in a different area of the supermarket: chilled speciality breads will usually be sold in a chilled cabinet next to a complementary chilled ready meal; whereas ambient speciality breads are sold near the traditional breads and frozen breads are sold in the frozen section of the store.
9. Customers also explained that different types of consumers buy each of the speciality breads. For example, consumers regard chilled products as premium

¹ Mintel International Group Limited: *Bread, Market Intelligence, February 2005*.

² Speciality breads include breads such as Vienna rolls, French baguette, pain de campagne, ciabatta and focaccia, naan and chapatti, pitta, soda bread, tortillas and wraps, and US-style sourdough bread; and functional breads including newer type breads such as low-carbohydrate, low-salt, gluten-free and nutrient-enriched breads.

products compared with either ambient or frozen equivalents. Conversely, frozen products are seen as a slightly inferior product and of a lower price. Customers indicated that while consumers would switch within a category of speciality bread (e.g. chilled for alternative chilled) they would not switch from chilled speciality breads to frozen or ambient speciality breads in the presence of a permanent 5 - 10 per cent increase in the price.

10. On the supply-side, however, competitors suggested that the ingredients and the manufacturing process for the production of all types of speciality breads are broadly the same, and it is only the final process which determines whether the product sold is ambient, chilled or frozen. There may therefore be a degree of supply side substitutability between different types of speciality breads.
11. One customer argued that the product scope could be further segmented into chilled inject and cut, and chilled craft breads. However, the production line for cut and inject breads includes a section for manual intervention, such as dropping poppy seeds onto a bread or hand scrunching ciabatta, which implies that cut and inject speciality breads and craft speciality breads may be produced on the same line. Thus, on the supply side, chilled craft speciality breads and chilled 'cut and inject' breads appear interchangeable. Similarly, customers have indicated that consumers view these two types of chilled speciality breads as part of the same market.
12. Third parties claimed that there are very few branded speciality breads (92 per cent of the sector is dominated by own label products) and that the brands which are present compete directly with own label speciality breads. It would appear that consumers are less sensitive to brand in this sector and choose speciality breads predominantly on the basis of the varieties available at any given time, rather than on the basis of the presence of a particular brand. This would suggest that own-label and branded products compete with one another and should be included in the same frame of reference. However, there was no need to reach a conclusion on this: in light of the small number of sales of branded goods relative to own-label, there is not a significant affect on the outcome of our analysis whether or not brands are included.
13. Overall, it would appear that other types of speciality breads are not effective demand side substitutes for chilled speciality breads. There is some indication that competitors may be able to switch production between the different types of speciality breads. However, it is unclear whether this switching would be sufficiently timely to justify including other types of speciality breads in the frame of reference. Therefore, a conservative approach has been adopted and the narrow product scope of chilled speciality breads has been used. The constraint exerted by producers of frozen and ambient speciality breads will instead be

considered in the context of barriers to entry (discussed below).

Geographic Frame

14. The parties submitted that the geographic market should be at least as wide as the UK. This is because the parties' customers, who are nearly all national multiples, are supplied across the UK rather than on a regional basis. They further contended that the geographic market may be wider than the UK and gave an example of a competitor outside the UK that supplies chilled speciality breads. However, this competitor has a very low share of supply in the chilled speciality sector.
15. Competitors stated that the supply of chilled products requires a national presence, as they have a short shelf life and orders are sales based, therefore lead times are shorter. Most customers confirmed that they source chilled speciality products on a national basis in order for their logistical requirements to be met.
16. Given these factors, the geographic scope for the purposes of this decision would appear to be no wider than the UK.

HORIZONTAL ISSUES

17. Third parties indicated that competition in this market takes place on price, quality of service and ability to deliver within a short time frame.

Non-coordinated effects

18. The parties overlap in the supply of chilled speciality breads. As a result of the acquisition, the merged entity's combined share of supply will be [70-80] per cent (increment [30-40] per cent). All other competitors each have a share of supply of less than 10 per cent. The merging parties also appear to be each other's closest competitors in the supply of chilled speciality products. Some competitors said that the merging parties were capable of supplying a much larger range of products than other suppliers. Customers also indicated that they often play off the two companies against each other in order to secure more competitive supply contracts.
19. One customer raised concerns that, post-merger, there would be a loss of close competition between Geest and New Primebake, suggesting that remaining competition would not be sufficient to prevent the merged entity from raising prices or reducing quality of service.
20. Notwithstanding the high shares of supply that would result from this merger, it is

not considered that the merging parties will be in a position to exercise market power vis-à-vis its customers in chilled speciality breads, for a number of reasons.

21. First, current competitors in the supply of chilled speciality breads have told us that they currently have spare capacity and could easily expand production. As customers have suggested that switching is relatively easy, the presence and extent of the spare capacity - enough to supply all of the merging parties' current orders - suggests that customers would be able to source their requirements from other competitors in response to an increase in price or reduction in service quality. This is supported by the shift to other suppliers following a fire at Geest's Barton site in 2005.
22. Secondly, the same fire also provided evidence of the ease of new entry as Geest met its supply obligations to the national multiples by sub-contracting supply to its competitors.
23. Thirdly, there would appear to be a high degree of buyer power in this sector. Indeed, the majority of customers stated that although the parties were the main suppliers of chilled speciality breads, they were not concerned by this merger as they considered they would be able to develop their relationships with alternative suppliers if the parties' service was no longer acceptable.

Barriers to entry by existing suppliers of ambient/frozen speciality breads

24. The parties submitted that barriers to entry by existing bakeries, in particular those currently producing frozen and ambient speciality breads, are low. This is because the production of chilled speciality bread is a relatively simple process and is, for the large part, the same process as the production of both traditional and other speciality breads. The parties claim that many bakeries would already possess the ovens and chilling equipment necessary or could acquire the additional equipment at relatively low cost. Competitors suggested that the main obstacle to entry was the logistical issues surrounding the daily production and distribution of a wide range of products using short production runs. The parties also submitted that existing bakeries currently supplying the national multiples will be familiar and already compliant with the terms and conditions required by the national multiples.
25. Existing bakeries confirmed they would be willing to enter the chilled speciality foods sector, although views differed as to the time and the cost for an existing bakery to enter the chilled speciality breads sector. Competitors estimated that entry would cost between £1-2m and would take approximately 1 year. This suggests that entry by an existing bakery would be sufficiently timely likely and of sufficient scope to constrain the merged entity.

26. Indeed, since the fire at Geest's Barton site in 2005, a number of bakeries did switch capacity to producing chilled speciality breads; Geest told us that within days of the fire, producers of frozen speciality breads had offered to supply Geest to make up its shortfall in capacity. We also have evidence of imminent entry into the chilled speciality breads segment by a current supplier of speciality breads.

Barriers to new entry

27. The parties submit that barriers to new entry may be higher than for an existing bakery, but are still low as machinery can be bought 'off the shelf' and technical expertise to enter the market is minimal. While there is some need to engage in product innovation, this is carried out in partnership and under the direction of the supermarkets. Advertising is carried out by the national multiples.
28. Some competitors estimated that new entry could cost up to £5 million and it would take 24 months to enter. One competitor suggested that compliance with supermarkets' standards may be onerous for a new entrant, however this was not supported by other third parties. There has been no new entry into this sector in the past five years.

Countervailing buyer power

29. The four major supermarkets account for over 90 per cent of the combined entity's turnover; the merging parties argue that this gives the supermarkets significant negotiating strength. The parties claimed that this dependence is increased because the national multiples dominate the purchases of all the merged entity's products, not just speciality bread, and could therefore leverage their buyer power across their range of products. They estimated that the sale of speciality breads by the merged entity will amount to only under 10 per cent of its total UK turnover. As such, even if the merged entity were to exercise market power in relation to speciality breads, this would be constrained by the risk of the national multiples threatening to cease purchasing other products supplied by the merged entity.
30. Customers and competitors stated that customers are able to switch easily as most contracts are negotiated on an annual rolling term or are put out to tender for fixed periods of one year to eighteen months. Third parties also submitted that there is considerable transparency with regard to cost structures giving the national multiples a strong negotiating position in relation to their suppliers.
31. Customers also emphasised their readiness to switch supplier should negotiating conditions no longer prove acceptable. Customers added that new product briefs

(for the development of different types of chilled speciality bread) can be offered to any competitor, not just to the holder of the existing contract. Customers also stated that they often award contracts to at least two suppliers of chilled speciality breads at any one time.

32. The parties claim that national multiples frequently switch suppliers for many reasons such as price, product quality, service or merely to negotiate better terms with existing suppliers. They provided examples of supermarkets recent switching between competitors and away from the parties. In addition the majority of the major multiples stated that they would be prepared to sponsor entry.

Conclusion on non-coordinated effects

33. While the merged entity will have a large share of supply of chilled speciality breads, there is spare capacity amongst existing competitors, and barriers to entry/expansion by existing producers of frozen and ambient speciality breads would appear to be low. Customers have also expressed willingness to switch to new suppliers. Based on the available evidence, this threat of expansion/entry combined with countervailing buyer power would appear sufficient to constrain the parties' behaviour post-merger.

Coordinated Effects

34. Given the existence of alternative current and potential suppliers, strong countervailing buyer power and the low barriers to entry (particularly for existing bakeries) there would appear to be sufficient actual and potential competition to de-stabilise any attempted co-ordinated behaviour in the market.

VERTICAL ISSUES

35. One competitor argued that the merged entity would be 'category captain' in terms of innovation and a product leader in chilled speciality breads. It put to us that this advantage would enable the merged entity to control retail space and the timing of promotions in order to increase its sales and prevent its competitors expanding their market position. However, the parties and customers themselves suggested that the national multiples play a lead role in product development and it is they that determine the timing of promotions, not the suppliers. Taken together with evidence of low switching costs and countervailing buyer power, these factors undermine such a theory of harm.

THIRD PARTY COMMENTS

36. Customers were generally unconcerned. Certain smaller customers were

concerned that post merger the merged entity would focus on placating its larger clients at the expense of service quality for smaller customers. One larger customer was concerned about the ability of the merged entity to raise prices post-merger. However most stated that the merger would provide beneficial synergies and economies of scale, the benefits of which would be passed down to them. They also considered that should the merged entity fail to deliver the adequate quality of service or should it raise prices, there would be sufficient alternative suppliers for them to switch to. Some customers emphasized that the merger would lead to increased investment in technical capacity and product innovation and increased supply capacity in the market.

37. One competitor to the parties (currently only active in frozen speciality breads) voiced strong concerns that the merger would significantly harm its chances of entering the chilled speciality breads sector as it would create a very dominant supplier of chilled speciality breads. However, in general competitors were not concerned and in fact viewed the merger as an opportunity to open up opportunities to supply the national multiples who prefer to have a number of different suppliers at any one time.

ASSESSMENT

38. The parties overlap in supply of chilled speciality breads. Post-merger they will have a combined share of supply of [70-80] per cent (increment [30-40] per cent) in the UK. There are a number of other suppliers of chilled speciality breads, many of which have spare capacity and face low barriers to expansion. Barriers to entry by existing bakeries also appear to be low. This, in addition to customers' willingness to switch and the presence of countervailing buyer power, would appear to pose sufficient constraints on the merged entity to prevent it raising prices or reducing service quality. The majority of customers did not have any competition concerns and considered sufficient alternative suppliers (or potential suppliers) remained post-merger.
39. Consequently, the OFT does not consider that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

40. This merger will not be referred to the Competition Commission under section 33(1) of the Act.