

## Anticipated acquisition by Chemring Group plc of Comet GmbH

The OFT's decision on reference under section 33(1) given on 13 October 2005. Full text of decision published 20 October 2005.

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**Please note that square brackets indicate information excised, or exact figures replaced by a range, at the parties' request.**

### **PARTIES**

1. **Chemring Group plc (Chemring)** is a UK company listed on the London Stock Exchange. It operates in three principal sectors: countermeasures, military pyrotechnics and marine safety. Chemring's wholly-owned subsidiary McMurdo Ltd (McMurdo) manufactures a number of leading brands in the marine electronics and safety products sector, such as Pains Wessex, ICS NAVTEX and McMurdo.
2. **Comet GmbH (Comet)** is currently owned by Diehl Group, a German corporation. It is active in the supply of marine pyrotechnics, life saving appliances and military products. Comet's UK turnover in 2004 was £84,000.

### **TRANSACTION AND RATIONALE**

3. Chemring has agreed to acquire the entire issued share capital of Comet from Diehl for a consideration of £6.7 million. The transaction does not involve the acquisition of any UK assets.
4. Chemring submitted that the Comet business is currently not very profitable. It considers that combining its production facilities with Comet's will save costs by eliminating duplicated operational overheads and using Comet's lower cost facilities in Germany. It also submitted that its main interest in the acquisition is related to Comet's military products division.

### **JURISDICTION**

5. As a result of this transaction Chemring and Comet will cease to be distinct. The parties overlap in the supply of marine pyrotechnics and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met since the combined share of supply to the UK market is [60-70 per cent]. The Office of Fair Trading (OFT) therefore

believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

## **RELEVANT MARKET**

6. Pyrotechnics are a chemical explosive device that involves a production process similar to fireworks. The parties overlap in the manufacture and supply of marine and military pyrotechnics and these two segments were considered separately.

## **MILITARY PYROTECHNICS**

### **Product scope**

7. The parties do not overlap in the supply of any military pyrotechnic products in the UK given that, although Comet does manufacture and supply some of the product categories supplied by Chemring<sup>1</sup> elsewhere in Europe, its products do not meet the UK Ministry of Defence (MoD) technical requirements and are not sold to any other UK customer.<sup>2</sup> The only Comet products that meet MOD's standards are its proprietary MECS tank simulation system and the ammunitions for it; they are purchased by the MoD and generated a turnover of less than £20,000 in 2004.
8. Chemring submits that significant research and development investments would be necessary in order for Comet to develop products that meet MoD's current technical requirements and that Comet does not plan to make any investments aiming to meet them.
9. The assessment of the impact of this transaction on the supply of military pyrotechnics was conducted based on the assumptions that (i) the products supplied by the parties within the same product categories are substitutes; and (ii) each product line where the parties overlap constitutes a separate segment. Given that no competition concerns were raised under this very narrow frame of reference, it was not necessary to reach a conclusion on whether the product market should be any wider.

### **Geographic scope**

10. Although the MoD's five main suppliers of military pyrotechnics are based in the UK, it submits that it would consider bids from manufacturers based abroad. Therefore, it may be the case that the geographic scope of the military pyrotechnics market is wider

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<sup>1</sup> I.e., smoke grenades, tripflares, miniflares and aircraft decoys.

<sup>2</sup> The MoD is the main purchaser of military pyrotechnics in the UK but there are also some other buyers, mainly in the aviation industry.

than the UK; nonetheless, given that no competition concerns arise in this segment as a result of the transaction it is not necessary to conclude on this issue.

### **Horizontal issues**

11. The MoD is not concerned with the merger as it is satisfied that there are a number of suppliers of military pyrotechnics able to meet its needs and that it is able to switch suppliers. The other two UK customers of military pyrotechnics that responded to our questions purchased only Chemring's products and were not concerned about the merger.
12. Customers of military pyrotechnics tend to be large organisations and it seems to be the case that they have significant buyer power.
13. Given the number of remaining competitors in the market, the fact that Comet does not appear to be a significant constraint on Chemring in relation to UK customers and the lack of customer concerns, it is not expected that this transaction will lead to a significant lessening of competition in this sector.

### **MARINE PYROTECHNICS**

14. Marine pyrotechnics encompass products used as sea distress signals as well as devices for rescuing a person in the water. Marine pyrotechnics are sold to customers in the commercial and in the leisure sectors. Liferaft manufacturers also purchase marine pyrotechnics, which will then form part of their own product offering.

### **Product scope**

15. The parties overlap in the supply of the following categories of marine pyrotechnics: (i) hand-flares, (ii) rocket flares, (iii) lifesmoke devices, (iv) mini-flares, (v) man-overboards and (vi) speedlines.
16. Although the end use of each product category is different, Chemring maintains that they are good substitutes for each other due to supply side considerations. There are similarities in the production process of the different categories, and, according to the parties, all main suppliers of marine pyrotechnics parties supply at least the signalling devices (products (i) – (iv)).
17. Due to difficulties in obtaining data for each product segment, and the fact that the competition analysis is similar whether a wide or narrow product definition is used, the starting point for assessing this transaction was taken to be the supply of marine pyrotechnics without any further segmentation.
18. It was also considered whether, as submitted by Chemring, the product scope should be wider than marine pyrotechnics, based on supply and demand side arguments.

19. From the demand side perspective, Chemring submits that marine pyrotechnics form part of a wider market which includes other forms of sea distress signals, from sophisticated Emergency Position Indicating Radio Beacon and Search and Rescue Transponders to the simpler electric distress signals for night use, and flags and sirens for day use. However, commercial users are restricted by regulation as to which marine distress signals they must carry: Safety of Life at Sea (SOLAS) regulations require that commercial vessels carry some marine pyrotechnics devices in addition to other sea distress signals, which indicates that these products are complementary rather than substitutes. Third parties confirmed this view, pointing out the different and specific uses of each of these products and the significant price differences between them, which indicate that these products are complements rather than substitutes also for leisure users.
20. Chemring also submits that marine pyrotechnic devices are part of a wider market which includes the manufacture of pyrotechnics for other end uses. The only third party that replied to our question in this respect (a manufacturer of military pyrotechnics) thought that supply-side substitution is not possible due to differences in the manufacturing process and the need to incur in high levels of investment to build a brand image and to establish a distribution network.
21. Therefore, it was not considered appropriate to assess this transaction against a wider frame of reference.
22. Finally, it was also considered whether commercial and leisure customers constituted different segments of the market that should be analysed separately. However, as this would not substantially affect the assessment and conclusions reached on this case (since Comet has only one customer in the UK – see paragraph 31), both segments were analysed jointly.

### **Geographic scope**

23. Chemring submits that the relevant geographic market is at least EEA-wide. In favour of a UK-wide market are the facts that shares of supply for the different marine pyrotechnics manufacturers vary significantly between different European countries and that transport costs are high due to health and safety considerations involved in transporting pyrotechnics. The need to establish a distribution network in the UK also suggests that the market is national.
24. On the other hand, less than 20 per cent of Chemring's total UK production (of marine pyrotechnics) in 2004 were actually sold within the UK, and Hansson, the second largest supplier of marine pyrotechnics in the UK, supplies its UK customers from its manufacturing facilities in Sweden. Comet itself is based in Germany. It is worth noting that a wider geographic frame of reference could in fact suggest that Comet is a stronger competitor; the increment in the EEA, for example, would be approximately [20-30 per cent] (as opposed to [0-10 per cent] in the UK).

25. The competitive impact of this merger was assessed at both UK and EEA level, and account was taken of the competitive constraint exerted by companies not already present in the UK according to their ability to enter and expand into the UK market.

### **Horizontal issues**

26. The parties' combined UK share of supply of marine pyrotechnics is [60-70 per cent] (increment [0-10 per cent]). Besides Hansson, a Swedish company that has a UK share of supply of [15-25 per cent] according to the parties [ ], we were not able to identify any other competitors who supply the UK market. [ ] The parties submitted, late on in the process, information about one company in Dorset which sells Albatros products online to leisure users, but the OFT was unable to confirm this.
27. It may be the case that Comet's share of supply underestimates the competitive constraint it exerts on Chemring and Hansson for the following reasons.
28. First, at a worldwide and EEA-wide level, Comet is the second largest player in this market (market shares of [25-35 per cent] and [20-30 per cent] respectively, whereas Chemring's shares are of [30-40 per cent] and [30-40 per cent] respectively) which suggests that it may have the financial capability and capacity to expand its UK share of supply. At the same time, it is not clear that other companies operating in this sector outside the UK would have the same capability as they seem to be considerably smaller than Comet.
29. Second, Comet appears to be unique when compared to other potential entrants into the UK in that its products are considered by some customers to be of comparable quality to Chemring's and Hansson's and that it supplies a comparable product range. A number of customers commented that the products of other potential entrants are not of comparable quality even though they may have the adequate accreditations.
30. Given that this is already a very concentrated sector the loss of a potentially strong competitor may be problematic.
31. On the other hand, Chemring and Hansson are clearly each other's strongest competitor in the UK. Comet has only one customer in the UK (a liferaft manufacturer with servicing facilities worldwide) and third party evidence indicates that it does not compete for Chemring's customers. In addition, the fact that Comet has been in the UK market since 1980 and throughout this period held only a [0-10 per cent] share of supply suggests that it is not a powerful competitor in the UK. Chemring submits that, to the best of its knowledge, Comet had no intention to expand its presence in the UK - but no documents were provided to support or explain this contention.

### **Barriers to entry and expansion**

32. The analysis of barriers to entry in the marine pyrotechnics sector had as a starting point the assumption (based on history of entry in this sector) that completely new

entry by a company setting up production facilities and a distribution network in the UK would not be likely or timely. Therefore, the assessment is focused on whether foreign manufacturers of marine pyrotechnics offering a full range of accredited products may be able to start selling products in the UK. To offer a full range of products is important due to the fact that a number of service stations and chandlers only wish to stock one brand of marine pyrotechnics, and therefore this one brand must offer all marine pyrotechnic products.

33. Transport costs appear to pose a barrier to entry into the UK market in view of the explosive nature of marine pyrotechnics. On the other hand, Hansson seems to be competing effectively supplying the UK market from its plant in Sweden; Comet supplies its sole UK customer from Germany; and Chemring exports some 80 per cent of its UK production.
34. Whereas the need to establish a distribution network in the UK is a barrier to entry in the market, this may not be a problem in terms of replacing the competition lost by Comet due to the fact that [ ] (Comet's only customer in the UK) already has an established network of service stations that are approved to service its liferafts. If [ ] switches to a different brand post merger, this brand will have access to [ ] network as it specifies which brand of pyrotechnics is to be replaced in its liferafts.
35. Another characteristic of the market that may operate as a barrier to entry is customer inertia, since chandlers and local dealers may be reluctant to stock new products not known to customers. This indicates that an aggressive market strategy and one-to-one negotiations are necessary to have the product marketed widely. Chemring agrees with this view.
36. In addition, reputation for quality seems to be an issue and customers tend to prefer brands they know well, such as it is the case with Chemring's brand Pains Wessex. Chemring contends that quality is not an issue once a product has the adequate accreditations, but this view is not consistent with the result of our investigations.
37. The balance of this evidence suggests that barriers to entry in this sector are high.
38. We have not been able to identify a potential entrant offering at the same time products of similar quality / reputation and a complete product range. It appears that post merger there will be only two companies that possess all these characteristics: Chemring and Hansson.

### **Buyer power**

39. Due to the fact that marine pyrotechnics are costly to transport and that they have a working life of between 3-4 years and cannot be stored for long periods, customers (particularly those in the leisure sector) tend to purchase them from local service stations or chandlers in small quantities. Therefore, it seems to be the case that end

customers in both the commercial and the leisure sector are unlikely to have buyer power.

40. Large commercial users and life raft manufacturers which purchase in bulk and directly from wholesalers may have more buyer power, especially as they may be able to source products from abroad.

## **VERTICAL ISSUES**

41. This merger does not give rise to any vertical issues.

## **THIRD PARTY VIEWS**

42. Almost all third parties that responded to our questions commented that the products supplied by the parties and by Hansson are of superior quality in comparison to other brands. As mentioned above, Chemring disputes this view and claim that quality is not an issue provided the products have the appropriate accreditations. Many customers also commented that Chemring is the main UK supplier and that the market nowadays does not offer many choices of supplier.
43. Only one customer had substantial competition concerns with the merger; it believes that it will reduce competition due to the fact that only two competitors will offer the whole range of marine pyrotechnics and that it is unlikely that any new entry would be timely, so that the incumbents will not have an incentive to reduce prices.<sup>3</sup>

## **ASSESSMENT**

44. The parties overlap in the manufacture and supply of military and marine pyrotechnic products. The merger does not raise any concerns in the military sector, where there will remain a number of competitors in the UK and worldwide able to supply the products in question. In addition, Comet does not appear to be a significant constraint on Chemring when it comes to UK customers, and there were no customer concerns.
45. In the marine sector, Chemring will have a UK share of supply of [60-70 per cent] ([0-10 per cent] increment) following the transaction. We consider below whether Comet's small UK share of supply understates the competitive constraint it is able to exert on its UK competitors in view of its competitive position in the EEA, as well as of its reputation for offering a full range of quality products. The OFT was not able to identify potential entrants to the UK market based elsewhere in Europe offering a full range of products of the same quality / reputation as Comet's. Furthermore, barriers to entry in this sector seem to be high in view of the need to set up a distribution network and to establish the reputation of a product as being of good quality.

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<sup>3</sup> Some third parties mentioned that Chemring already charges higher prices than the other competitors.

46. Nevertheless, there are a number of factors that lead the OFT to believe that the merger will not have a significant adverse impact on competition in the UK. First, Comet has been active in the UK market since 1980 and has only achieved a [0-10 per cent] share of supply; there is no evidence that it would grow in the UK market in the near future and Chemring denies that Comet had any plans to target the UK market. Second, Comet has only one customer in the UK and therefore it currently faces high barriers to expansion as it would have to establish a distribution network if it were to attempt to gain a broader customer base and so market share. In sum, there is no evidence that Comet has been or would become an effective competitive constraint to the other UK players and therefore the merger does not significantly change the competitive situation of the UK market for marine pyrotechnics.
47. Consequently, the OFT does not believe 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**

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