
Completed acquisition by Research Machines Plc of Sentinel Products Ltd

The OFT's decision on reference under section 22(1) given on 23 July 2004

PARTIES

Research Machines plc (RM) supplies information and communication technology software, systems and services and also educational services to a wide variety of educational establishments. RM's turnover in the fiscal year ending 31 October 2003 was £215 million. **Sentinel Products Limited (Sentinel)** supplies computer software. Sentinel's turnover in the year ending 31 December 2003 was £1.39 million.

TRANSACTION

RM acquired Sentinel on 27 February 2004. The statutory deadline, extended by agreement, is 23 July 2004. The administrative deadline is 30 July 2004.

JURISDICTION

As a result of this transaction, RM and Sentinel ceased to be distinct. The parties overlap in the supply of network management software for use in the education sector and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. A relevant merger situation has been created.

RELEVANT MARKET

RM has acquired Sentinel's product range of network management software (NMS) aimed at the education sector and sold through a network of independent dealers.¹ This range, marketed under the 'Ranger' brand family, comprises products offering various functionality (including user management, system backup and restore, quota management and security products). RM's equivalent NMS is marketed under the 'Connect' brand for secondary schools and 'Classmate' for primary schools and is sold

¹ There are approximately 40 such dealers. Sentinel products include: Ranger Suite Network, Ranger for Primary Networks, Ranger Print Manager; Ranger Solo; Ranger Remote Control; and Network Offline.

direct to customers (though generally as part of a larger solution). RM estimates UK schools and Further Education Colleges spend £21.4 million on NMS software annually.

The IT needs of a Local Education Authority (LEA) or individual educational institution extend well beyond NMS, whose utility presupposes a network of IT hardware and software. Accordingly, NMS is often purchased as one component in a larger IT solution. Such solutions are offered by single source vendors (such as RM) or third parties, including Sentinel's dealers supplying Sentinel's NMS as one component in a bundled solution of IT products from different sources.

Customers seeking to assemble their own solutions can purchase NMS on a stand-alone basis. Their supply choices, among others, include RM (direct from RM) or Sentinel (from a dealer).

Product Market

The parties submit that general NMS is a substitute for NMS aimed specifically at educational institutions (education-sector NMS) and that there is substitution of all such NMS used in the primary, secondary and tertiary sectors.

Education-sector and other NMS

On the demand side, RM contends that there is significant substitutability between education-sector and general NMS as they meet the same needs. Responses from third parties have been mixed. Some support RM's views that many schools rely simply on network management tools available with their operating system (OS) software, e.g. Microsoft Windows Server 2003 or Apple's Mac OS X (hereafter: OS network tools). RM and several third parties also identified products that are marketed both to the education and general sector, e.g. NDI Technologies' WinSuite.

Other respondents consider the educational sector distinct because of the particular NMS requirements of such customers. These include: (i) additional security functions (to protect against student hacking), (ii) the ability to cope with constantly changing network users (unlike e.g. a corporate workplace) and (iii) functionality adapted to the lower IT expertise of the educational – as opposed to corporate – setting. A majority of customers also maintain that they are unlikely to switch to general NMS following a 5 -10 per cent increase in price of education-sector NMS.

In light of these responses, the OFT considers it appropriate to exclude network management tools available with the OS and to treat education-sector NMS separately from general NMS for the purposes of identifying the frame of reference. Potential supply-side constraints are addressed in the competitive assessment (below).

Primary, secondary and tertiary sectors

The differing degrees of IT expertise on the part of network users have led to variants of educational NMS targeted at the level of the institution: primary schools need quite simple and user friendly NMS; the secondary sector needs a (relatively) more complex product with increased functionality, e.g. greater control of the network to prevent misuse; for the tertiary sector, requirements are further enhanced as networks are generally larger.

The majority of supplier responses suggest quite a strong case for supply-side substitutability between the primary and secondary sectors, but not in respect of the tertiary sector. As between the former, product design is similar, various players, including the parties, are active in both segments already (sometimes with different brands or brand variants) and some responses, contradicted by others, suggested that adaptation of a product from secondary to primary schools' needs may entail relatively little cost (£30,000) and time (6 months).

Given the lack of clarity on these issues and the fact that the competitive assessment does not alter materially under any definition, it is appropriate to take a cautious view and consider the primary, secondary and tertiary sectors separately.

Geographic market

Market participants took the view that the UK is the relevant geographic frame of reference.

Conclusion

In light of the above considerations, the relevant frames of reference are the supply of education-sector NMS for each of primary, secondary and tertiary education institutions in the UK.

HORIZONTAL ISSUES

The potential for a direct lessening of competition at horizontal level appears limited to stand-alone sales of education-sector NMS, the only sector in which both parties are active (in Sentinel's case, via a dealer network).

Shares of supply

Share of supply data based on revenue are unavailable. The evidence RM has been able to provide relates to suppliers' installed base on a 'headcount' basis for NMS in the three classes of educational institution.²

On the basis of these RM estimates RM will post-merger represent approximately half of total UK supply of NMS in both the primary and secondary sectors, and about a quarter of the tertiary sector. Sentinel's pre-merger share (i.e. the increment) was in the range of 10-20 per cent. A leading rival in primary and secondary is Viglen (in a similar range to Sentinel) while in the tertiary sector, Novell's ZenWorks has over half of total supply.

However, as these data do not differentiate between stand-alone purchases and installed NMS product purchased as part of a broader IT solution (reflecting how much of the parties' NMS products are actually sold and find their way into schools) they are unhelpful in clarifying the horizontal impact of the transaction. Other evidence in this regard, discussed below, suggests that the transaction raises no material horizontal concerns.

RM has submitted that both the different price positioning and functionality of Ranger suggest limited competition between the parties' products. The majority of customers' responses (often combining all three education sectors) were unconcerned as regards any sector: a number took the view that various alternatives were available (and RM has provide examples of switching to Viglen and WinSuite). Certain competitors had not heard of Sentinel, while a minority of respondents expressed concerns, which related in essence to RM's strong position in the education IT sector and the prospect that the merger might lessen choice.

The parties' documents suggest that a large proportion of both primary and secondary schools (approximately 37-38 per cent of each) rely upon OS network tools, providing an incentive to continue to price and innovate at a level that would persuade such customers that dedicated NMS is a value-added proposition.

Barriers to entry and expansion

Market participants indicate that an entrant would require staff with software development expertise and experience in the education sector. Once the software is developed, it appears marketing and raising brand awareness, e.g. at exhibitions and brochures, are key to successful entry.

² Some third parties provided unsubstantiated estimates of high (55-80 per cent) combined shares of supply in primary and secondary-sector NMS, which may reflect RM's success at winning LEA-wide contracts.

Views on entry among existing suppliers differ: RM has claimed that 18 suppliers have entered in the last 3 years, including some well-established IT suppliers diversifying into the education sector. Microsoft [has been identified as a] potential entrant.³ Conversely, some other competitors argue that barriers to entry are substantial. However, the history of Sentinel itself – which entered in 1997 with limited resources and staff – suggests that entry barriers are relatively moderate. Further, existing players (such as Viglen, CSE and Ahkter) appear to face few barriers to expansion, as expanded production consists merely of increased software licensing. Overall, the weight of evidence suggests that entry and expansion can be expected to constrain the merged entity effectively.

Buyer Power

Procurement occurs at the LEA and school level and large contracts tend to run for 2-5 years. If schools procure at an individual level buyer power may be limited. For larger LEA contracts, customers believe that they have negotiating strength due to their size, the range of suppliers available, and the OJEC tendering process.

VERTICAL AND CONGLOMERATE ISSUES

A minority of dealers offering Sentinel's software as a component in their portfolio raised foreclosure concerns. The OFT has therefore examined whether the merger creates or increase the ability and incentives of RM to foreclose rivals and harm consumers by:

- Impairing the ability of system integrators (Sentinel dealers) to offer solutions in competition with RM by increasing the price – or retarding or ceasing product innovation – of Sentinel products (i.e., raising rivals' costs); or
- Withholding supply of Sentinel products to dealers (e.g. by terminating the acquired products entirely, or by bundling them with RM products).

The weight of evidence does not support a foreclosure theory in this case.

RM's submissions, supported by internal documents, suggest that the rationale for the acquisition is principally to gain access to Sentinel's distribution channel for other IT products and acquire an additional revenue stream from Sentinel's differentiated products.

Customer views do not support a foreclosure theory. Respondents raised no concerns related to bundling by RM, and did not regard any Sentinel product as a 'must-have', suggesting instead that sufficient alternatives remain. Existing stand-alone NMS

³ Microsoft's Dynamic Systems Initiative includes the launch of 'System Management Server 2003' – intended to simplify and enhance their system management products, though no reference is made to the education sector. Text amended at request of parties.

products such as WinSuite, and low barriers to entry and expansion suggests that rival products could form the NMS component in an IT solution for an educational institution.

Accordingly, it is not sufficiently realistic that customers will be deprived of competing IT solutions that feature an NMS component, as system integrators (e.g. Sentinel dealers) could substitute other NMS if Sentinel NMS were withheld or offered on disadvantageous terms.

THIRD PARTY VIEWS

The majority of third parties did not raise any competition concerns. A minority of competitors and Sentinel dealers raised concerns. Of 165 customers (schools and LEAs) contacted, 22 responded, five of which raised concerns.

ASSESSMENT

The transaction qualifies on the share of supply test under the Act. The parties overlap in the supply of NMS to the education sector. The best-available figures suggest that the parties represent 55 per cent (increment of 10 per cent) of the installed base of NMS in primary schools, 50 per cent (increment of 17 per cent) in secondary schools and 25 per cent (increment of 10 per cent) in tertiary institutions. This excludes those institutions that rely on operating system network tools, which may be a constraint.

At a horizontal level, the majority of customers took the view that alternative NMS are available. There appears to have been little direct competition between the parties (i.e. for sales of NMS on stand-alone basis), and entry from firms active in general NMS and expansion by existing firms supplying education-sector NMS appear to be effective post-merger constraints.

In light of certain concerns raised by competitors, the OFT considered the potential for foreclosure by RM of Sentinel dealers, some of whom offer rival IT solutions to RM in which Sentinel products were the NMS component. The evidence suggests that RM intends to retain the dealer network and, above all, that alternative NMS products are or would quickly become available, denying RM any ability to foreclose rivals. The majority of customers did not raise concerns.

Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.