COMPETITION TRIBUNAL OF SOUTH AFRICA

Case No: IM077Aug16

In the matter between:

Italtile Limited	First Applicant
Ceramic Industries (Pty) Ltd	Second Applicant
Ezee Tile Adhesive Manufacturers (Pty) Ltd	Third Applicant

and

The Competition Commission	Respondent

In *re* the intermediate merger between:

Italtile Limited	Acquiring Firm

and

Ceramic Industries (Pty) Ltd	
Ezee Tile Adhesive Manufacturers (Pty) Ltd	Target Firms

Panel	: Norman Manoim (Presiding Member) : Yasmin Carrim (Tribunal Member) : Andiswa Ndoni (Tribunal Member)
Heard on	: 10 – 14 July 2017, 31 July 2017 & 18 August 2017
Order Issued on	: 21 August 2017
Reasons Issued on	: 08 May 2018

Reasons for Decision (Non-Confidential)

Request for Consideration of an Intermediate Merger

[1] This was an application for consideration of an intermediate merger that had been prohibited by the Competition Commission ("Commission") on 26 July 2016. The intermediate merger was duly considered by the Tribunal and was conditionally approved on 21 August 2017. The reasons for doing so are detailed below.

[2] This application had been brought by the parties to that merger in terms of section 16(1)(a) of the Competition Act 89 of 1998 ("the Act"), read with Rule 32 of the Tribunal Rules. The application was filed on 11 August 2016.

[3] The applicants are the acquiring firm, Italtile Limited ("Italtile"), and the target firms, Ceramic Industries (Pty) Ltd ("CIL") and Ezee Tile Adhesive Manufacturers (Pty) Ltd ("Ezee Tile"). For the sake of clarity we will from now on refer to the applicants, collectively, as the merging parties and when relevant, by their respective names.

[4] In their consideration application the merging parties originally sought to overturn the prohibition and to seek an order approving the merger without conditions. As we explain later, their position changed during the course of the litigation and they sought to have the merger approved subject to certain conditions that were tendered. The Commission however did not change its position and continued to defend its decision to prohibit the merger.

Background

The merging parties

[5] In brief this was a merger where a retailer seeks to acquire control of its upstream supplier, a manufacturer.

[6] The primary acquiring firm is Italtile, a public company listed on the Johannesburg Securities Exchange ("JSE"). Italtile is controlled by Rallen Proprietary Limited ("Rallen").[1] Italtile indirectly, through its wholly-owned subsidiary, Italtile Ceramics (Pty) Ltd ("Italtile Ceramics"), currently owns approximately 20% of the issued share capital of CIL.

[1] We discuss the ownership of Rallen below.

[7] Italtile does not manufacture any products in South Africa. The Italtile Group[2], is involved in the retail supply of grout and adhesives, tiles, laminated boards, brassware and accessories, sanitary ware, décor, baths, and showers. Italtile owns and operates retail outlets comprising Italtile Retail, CTM and Top T, each targeting a specific market segment throughout South Africa. Italtile imports and distributes Grade A products to its Italtile-owned retail outlets.

[8] The primary target firm is CIL. CIL, like Italtile is controlled by Rallen. The second target firm is Ezee Tile. CIL's shareholders currently directly control Ezee Tile. This means, Rallen indirectly controls Ezee Tile, since it ultimately controls both CIL and Italtile Ceramics, which jointly hold 71% of the issued share capital of Ezee Tile; Italtile Ceramics has 35.5% and CIL 35.5%.

[9] The CIL Group[3] manufactures and supplies ceramic tiles, sanitary ware and baths to retailers of these products (including the Italtile Group).

[10] CIL is the largest manufacturer of ceramic tiles and glazed porcelain sanitary ware in South Africa, comprising of seven (7) manufacturing facilities in South Africa and one (1) in Australia. Samca Floor, Samca Wall, Vitro, Pegasus, Gryphon and the Australian-based Centaurus (the tile factories) manufacture a combination of pressed and extruded tiles in various sizes, textures and finishes, while Betta (the sanitary ware factory) manufactures a wide range of vitreous china sanitary ware.

[11] CIL owns three (3) factory shops that sell some of its B-grade produced tiles, sanitary ware and baths, grout and adhesives, directly to consumers. Further, CIL owns its own clay quarries, situated in Vereeniging and Limpopo. Clay is an input material for the production of tiles and sanitary ware.

[12] The Ezee Tile Group[4] manufactures and supplies grout, adhesives and related products to retailers of these products (including the Italtile Group and the CIL factory shops). The Ezee Tile Group does not own or operate any retail outlets.

[2] The Italtile Group is Italtile and the firms directly or indirectly controlled by Italtile.
[3] The CIL Group is CIL and the firms directly or indirectly controlled by CIL.
[4] The Ezee Tile Group is Ezee Tile and the firms directly or indirectly controlled by Ezee Tile.

The history of Italtile and CIL

[13] From the outset, it is important to define the role of Rallen when interpreting the proposed transaction, and in particular, the role of the director and chairman of Rallen, Mr Giovanni Alberto Mario Ravazzotti ("Ravazzotti").

[14] Rallen is the majority shareholder in Italtile and CIL, and Ravazzotti acts as a director and chairman of both Italtile and CIL.

[15] Ravazzotti established both the Italtile and CIL businesses and has been responsible for their development since inception and has an intimate knowledge of the two businesses, built up over the last 50 or so years.

[16] Italtile was launched in 1969 by Ravazzotti and the company model, at that time, was to import tiles from Italy. Sometime during 1976, Ravazzotti decided that Italtile should branch out into manufacturing, and Italtile accordingly began to manufacture tiles after constructing the Samca Floor tile factory (Samca 1). At this point in time Johnson Tiles and Pilkington Tiles were the only two manufacturers of tiles in South Africa.

[17] Certain shareholders did not agree with the decision to branch into manufacturing, but Rallen purchased their shares and Italtile proceeded to establish a manufacturing facility. It is important to note that from the outset the tiles manufactured by Samca were also sold to other customers and Italtile did not simply self-supply.

[18] In 1983 Ravazzotti saw an opportunity in the market to establish retail outlets that operated on a cash-and-carry basis, selling a less expensive product than Italtile Retail. Italtile, at the behest of Ravazzotti, opened CTM. Various minority shareholders were nervous that the cash-and-carry model would not work, and again Rallen subsequently bought out their interests.

[19] In 2008, faced with surplus production as a result of manufacturing overcapacity at CIL, Italtile, again at the behest of Ravazzotti, opened Top T, to sell the surplus stock at a lower price than that of CTM.

[20] As a consequence, Italtile now consists of the following retail businesses:

a) Italtile Retail which is the most upmarket retail brand, selling imported and more expensive tiles, sanitary ware, baths and taps.
b) CTM that sells less expensive products including tiles, baths, basins, toilets, showers, cabinets, taps, related tools, adhesives and tile care products.
c) Top T that sells low-cost tiles, sanitary ware, baths and ancillary interior decorating products.

[21] Up until 1992 the retailing and manufacturing businesses were both conducted through Italtile. In that year Ravazzotti decided to separate the manufacturing and retail businesses. The manufacturing business was transferred into a separate company (CIL). Shareholders held the same percentage in CIL as they held in Italtile. Rallen retained a controlling shareholding in CIL of approximately 56%.

The structure of the transaction and prohibition

[22] On 29 April 2016, the applicants notified the proposed transaction to the Commission as an intermediate merger.

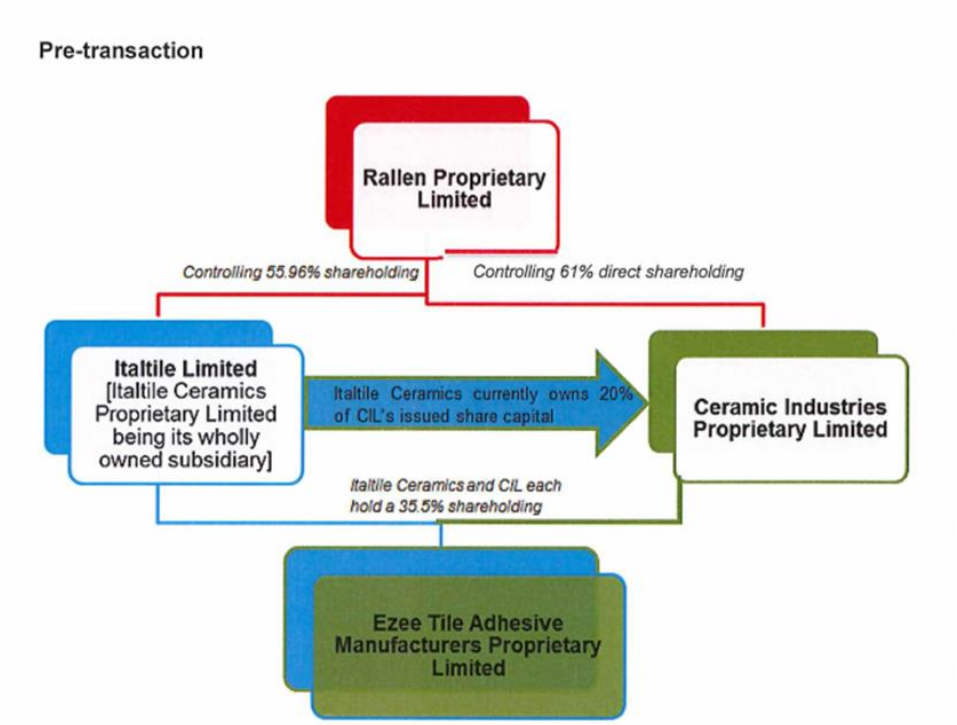
[23] In terms of the proposed transaction, Italtile intended to acquire (through its wholly owned subsidiary, Italtile Ceramics, which owned 20% of the issued share capital of CIL) all of Rallen's CIL shares, as well as most of the shares of CIL's remaining shareholders. This would result in Italtile (through Italtile Ceramics) holding more than half the issued share capital of CIL.

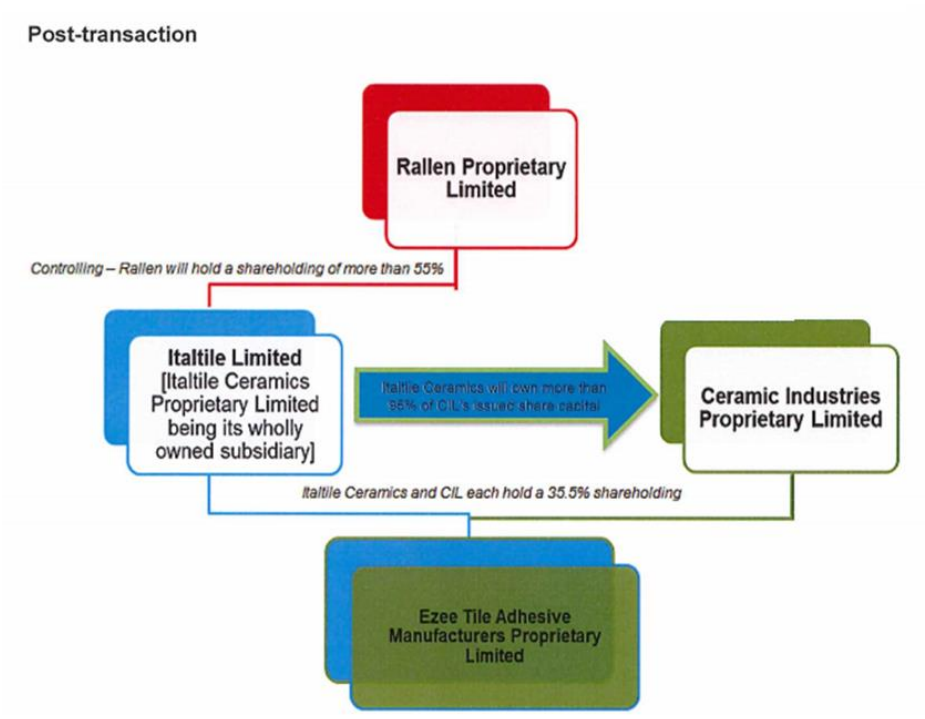
[24] The proposed transaction would further result in Italtile indirectly acquiring more than half of the issued share capital in Ezee Tile by virtue of its existing shareholding in Ezee Tile (through Italtile Ceramics), together with CIL's direct shareholding in Ezee Tile (as Italtile would indirectly acquire more than half of the issued share capital of CIL).

[25] The applicants submitted that the transaction constituted an intra-group restructuring of firms, who are all ultimately controlled by the same shareholder, namely Rallen.

[26] According to the merging parties, there would be no change in the ultimate control of CIL or Ezee Tile (there will also be no direct change in direct control over Ezee Tile), as both firms, as well as Italtile, are ultimately solely controlled by Rallen, both pre-merger and post-merger.

There will merely be a change in direct control over CIL as illustrated by the pre- and post-merger illustration[5] below:





[5] Ravazzotti witness statement, page 3.

[redacted]

[28] In his view the restructuring would not result in any foreclosure concerns because production capacity at CIL already exceeded what Italtile could purchase. Only approximately [redacted] of CIL's production can be bought by Italtile or the CIL factory stores. Thus it would not make commercial sense for CIL to refuse to supply any downstream competitors of Italtile or Top T.

[29] Despite this, the Commission proceeded to prohibit the merger, its main reasons for doing so were:

a) Despite the ultimate controlling entity, Rallen, remaining the same post-merger, there will be a change in the quality of control arising as a result of the change in management structure of CIL and Ezee Tile and that the proposed transaction was not exempt from notification in terms of section 12(1)(a) of the Act.[8]
b) The merging parties have an ability to foreclose downstream rivals in relation to the supply of tiles as they have high market shares in the upstream markets for the manufacture and supply of tiles and an incentive to foreclose rivals and self-supply due to the significant

[6] See Transcript page 452, lines 10-15, where Lance Foxcroft confirms this strategy of Ravazzotti.
[7] a) In 1998, the NCI vitrified split tile factory was acquired.
b) In 1989, Samca 2 was built as a new wall tile factory.
c) In 1995, Samca 1 was demolished and completely rebuilt with the latest technology, making it the first single-fired tile factory in the country.
d) In 1999, the Vitro vitrified punch tile factory was acquired.
e) In 2001 the Vitro facility was upgraded by the addition of two full production lines.
f) In 2002, the first phase of Pegasus was built as a green fields project with one kiln to manufacture floor tiles.
g) In 2003, NCI was closed and its production was moved to Vitro, thereby decreasing production costs and increasing volume relative to the original Vitro production line.
h) In 2003, a second kiln was commissioned in the first phase of Pegasus, thereby doubling the capacity of Pegasus.
i) In 2007 the second phase of Pegasus, comprising of two full production lines and clay preparation plant, was installed, again doubling the capacity of Pegasus.
j) In 2016, the Gryphon porcelain tile plant commenced operations, further increasing tile volumes.
[8] Commission's reasons for decision, par 7.

volumes of sales supplied to Italtile and to other customers and the merging parties' rationale to integrate the management of CIL and Ezee Tile post-merger.[9]

c) No competitive constraints exist on the merged entity to self-supply or increase prices of tiles. Although there are two other alternative suppliers of tiles in the domestic market they do not have sufficient capacity to meet the demands of all market participants.[10]

d) It was unlikely that new entrants with sufficient scale will be able to enter the market and place a competitive constraint on CIL post-merger.[11]

e) Imports are not a constraint due to higher import prices.[12]

f) The degree of countervailing power post-merger was not sufficient to offset the adverse effects of the proposed transaction.[13]

Commission's Theory of Harm

[30] As noted earlier, the basis of this transaction was that it is a vertical merger between a downstream retailer (Italtile), and an upstream manufacturer (CIL). Vertical mergers tend to raise fewer competition law concerns, and often generate larger pro-competitive gains, than horizontal mergers. The primary reason for this is that, unlike horizontal mergers, vertical mergers do not remove any direct competitive constraint on the market and often result in incentives to lower prices or increase quality.

[31] However, there are circumstances in which vertical mergers might result in a lessening of competition, for example where they are likely to result in the foreclosure of inputs or customers. This was the Commission's theory of harm.

[32] The Commission was of the view that Italtile, as a result of the merger, would be able to foreclose the supply of tiles from CIL to third party customers and thereby lessen competition in the downstream retail market for tiles. The Commission's theory of harm was one of partial input foreclosure and raising rivals' costs. Partial input foreclosure occurs when the merged entity's upstream division takes some action that falls short of an outright refusal to supply, but nonetheless results in the worsening of terms of offer to rivals of its downstream division.

[9] Commission's reasons for decision, par 16.
[10] Commission's reasons for decision, par 17.
[11] Commission's reasons for decision, par 19.
[12] Commission's reasons for decision, par 20.
[13] Commission's reasons for decision, par 21.

[33] The European Commission *Guidelines on the assessment of non-horizontal mergers*[14] provide that the following three factors must be assessed when assessing the likelihood of an anticompetitive input foreclosure scenario:

a) Whether the merged entity would have, post-merger, the ability to substantially foreclose access to inputs;
b) Whether it would have the incentive to do so; and
c) Whether a foreclosure strategy would have a significant detrimental effect on competition downstream.

[34] With the above in mind, the merging parties provided two defences to the Commission's theory of harm. They submitted that there was no basis for the Commission's theory of harm because the merged entity would:

a) Have the same incentive as it had pre-merger because even if direct control changes, there was no change in indirect control; and
b) Aside from the control issue, assuming the firms were independently controlled pre-merger, the normal post-merger potential to foreclose does not exist on the facts of this case.

[35] We go on to discuss both of these defences below.

Primary defence of the merging parties

[36] The merging parties' primary defence to the Commission's theory of harm was that there was no change in its incentives to foreclose as although there was a change in direct control over CIL, there was no change in indirect control.

[37] The merging parties submitted that the Commission had provided no explanation of why its foreclosure theory was merger-specific. They submitted that, the Commission's expert, Dr Hariprasad Govinda was unable to advance any credible reason as to why or how the merger was likely to bring about (a substantial change in) the ability and/or incentive on the part of the merging parties to engage in a foreclosure strategy.

[14]European Commission Guidelines on the Assessment of Non-Horizontal Mergers (2008/C 265/07).

[38] The merging parties submitted that, whatever their alleged ability and/or incentive to engage in input foreclosure post-merger might be, that was unlikely to be materially affected by the merger given that:

a) The merging parties are solely controlled by the same ultimate controlling shareholder, namely Rallen (Pty) Limited ("Rallen"), both pre- and post-merger; and
b) The incentives of Italtile, as the direct controller of CIL post-merger, will be no different from those of Rallen as the direct controller of CIL pre-merger.

[39] With the above in mind, we then turn to examine the facts regarding the control of Rallen over both the merging firms.

Legal Control

[40] Rallen is the controlling shareholder of both Italtile and CIL. Rallen has a direct shareholding in Italtile of approximately 55.96% and a direct shareholding in CIL of approximately 60.99%. Italtile indirectly, through its wholly-owned subsidiary Italtile Ceramics, currently owns approximately 19.6% of the issued share capital of CIL.

[41] The merging parties submitted that no aspect of the proposed transaction will affect the existing legal control by Rallen of both Italtile and CIL. Italtile will be the direct controller of CIL but Rallen will control Italtile and as such will continue to control the operations of both companies post-merger as it did pre-merger.[15]

(i) Pre-merger control

[42] Prior to the implementation of the proposed transaction, Rallen as the controlling shareholder of both Italtile and CIL has the power:

a) To unilaterally nominate and elect every director to the boards of both Italtile and CIL and to prevent any other nominated director from being elected to either such boards; and
b) To unilaterally pass ordinary resolutions at general meetings of both Italtile and CIL.

[15] Ravazzotti witness statement, Witness Statement Bundle page 6, par 21.

(ii) Post-transaction control

[43] Rallen's control of Italtile and CIL will not be diminished as a result of the proposed transaction. Following the implementation of the proposed transaction, Rallen will continue to have the power:

a) To unilaterally nominate and elect every director to the board of Italtile and prevent any other nominated director from being elected to such board; and
b) To unilaterally pass ordinary resolutions at general meetings of Italtile.[16]

[44] In addition, Rallen, through its subsidiaries, Italtile and Italtile Ceramics (as the holder of approximately 95% of the shareholding in CIL), will be able to indirectly:

a) Elect every director to the board of CIL and prevent any other nominated director from being elected to such board; and
b) Pass ordinary and special resolutions at general meetings of CIL.

[45] Rallen will therefore continue to have the ability to exercise the majority of the voting rights associated with the shares of CIL and to elect all the directors of the board of CIL after the implementation of the transaction, albeit indirectly.

[46] The merging parties submitted that it was clear that Rallen enjoys sole legal control of both CIL and Italtile pre-merger, and that would continue to be the case post-merger.

Factual Control

[47] The merging parties submitted that Ravazzotti is ultimately involved in the operations of both businesses and exercises ultimate factual control over their strategic direction and activities, including in relation to the supply of product to third party customers. This would include the implementation of any foreclosure strategy as postulated by the Commission. Any strategy of that sort will have to be ultimately approved by Rallen as a factual matter. Nothing about Rallen's ultimate factual control over the strategy of CIL will change as a result of the proposed

[16] Rallen has agreed that, for a two year period post-transaction, the existing CIL board will remain in place for continuity purposes, but Italtile will have the right to appoint an additional director and alternate director to the CIL board.

transaction. Neither Rallen's ability, nor its incentive, to impose a foreclosure strategy would change as a result of the proposed transaction.

[48] It was common cause between both the Commission's economic expert and the merging parties' economic expert that Rallen is the sole controller of both CIL and Italtile pre-merger, and that Rallen will remain the sole direct controller of Italtile, and the sole ultimate controller of CIL, post-merger. All that will change as a result of the merger is that direct control of CIL will move from Rallen to Italtile.[17]

[49] There was thus no dispute of fact that Rallen (which effectively means Ravazzotti's interest) controls both the acquiring and target firms pre-merger and will post-merger continue to control the acquiring firm and indirectly the target firm.

[50] However, what was in dispute was a possible change of incentives from a Rallen controlled CIL to an Italtile controlled CIL. The Commission submitted that the change in the *quality* of control was relevant to the foreclosure assessment.

[51] The Commission submitted that the quality of control would be affected as a result of the transaction. Post- merger, Italtile a retailer would be able to exercise full control over a manufacturer, CIL, which it was not able to pre-merger.[18]

[52] As we understood the Commission, the merger would not have created a new potential for foreclosure but would enhance or perfect a pre-merger inclination to do so.

[53] This was best explained by Govinda, in the following terms:

"*We say the merger will either facilitate collusion or if it is already existing, enhances existing collusion. Similar analogy can be drawn here. If it is already happening, it will only enhance such behavior given the capacity constraints and the incentives and the ability.*"[19]

[54] The Commission attempted to illustrate this harm by putting up facts relating to the pre-merger history of supply shortages and an apparent preference for CIL to supply Italtile at times of supply shortages.

[17] Expert minute, Witness Statement Bundle page 338, paras 7-8.
[18] Commission's Heads of Argument page 2, par 2.
[19] Transcript page 1168, lines 10-22 & page 1169, lines 1-4.

[55] To rely on this proposition, the Commission put up a witness, Mr Dave Botha, a flooring buyer at Massbuild, who happens to be a customer of CIL and a competitor of Italtile.

[56] Botha raised two concerns. The first concerned supply shortages. He testified that Massbuild had experienced supply shortages in the peak months of October, November and December from CIL over the last two years that he has been doing the buying.[20] Massbuild, he testified, was increasing its sales during their period.

[57] Botha testified that they get told there is a certain volume of tile production allocated to Massbuild by CIL and that they order quantities against that.[21]

[58] Botha said that when he raised this with CIL personnel they had stated that all customers had increased sales during this period and it could not increase his orders beyond the pre-allocated volume.[22] Under cross examination however Botha conceded that he had never asked for more than he was allocated.[23] Nor could he explain why he had not increased his orders to CIL.

[59] His second complaint related to the supply of entry level tiles which make up most of Massbuild's sales in the tile market and which they purchase from CIL.

[60] Botha testified that the merged entity would have an added incentive to make Massbuild less competitive than they are at present, by using CIL to increase its prices, in order to make the Italtile-owned CTM, Massbuild's competitor more attractive to customers and divert them to their own stores.[24]

[61] In support of this contention he said CTM had been favoured over Massbuild's Builders Warehouse store in Bloemfontein. At this locale, CTM had an entry level R59.00 tile versus Builders Warehouse' entry level R69.00 tile. But Botha conceded that he never asked CIL about the availability of the R59.00 tile.

[20] Transcript page 648 lines 1 to 22 to page 649 lines 1 to 22.
[21] Transcript page 651 lines 15 to 22 to page 652 lines 1 to 2.
[22] Transcript page 650 lines 11 to 16.
[23] Transcript page 720, lines 19-21 & page 721, lines 1-5.
[24] Transcript page 719, lines 6-9.

[62] Apart from Botha's oral testimony the Commission also sought to rely on documents of the merging parties to sustain an argument that pre-merger, foreclosure of downstream rivals was already taking place. These documents were put to the merging parties' factual witnesses Messrs. Nicholas Booth, the previous CEO of Italtile, and Lance Foxcroft, the CEO of CIL, for comment during cross examination.

[63] The first related to a new tile CIL had developed branded the Metrotec tile. The Commission's reading of the document was that the tile had been given preferentially to CTM during the second quarter and withheld from third party customers until the fourth quarter. The Commission suggested that CTM had not only been given prior access to this tile but also during a peak demand period. Foxcroft conceded that it was given to CTM during a high demand period but eschewed any suggestion of anticompetitive preference.

[64] His explanation was that the product was new and untested and that CTM had agreed to take the product on risk by ordering forward and that it was the only retailer willing to do so hence its preferential supply. The Commission disputed this alleging the product was a relaunch and that there was no risk at all.

[65] A similar example of delayed supply to a customer was also put to the merging parties' witnesses. This involved Cashbuild, another large retailer. [redacted]

[66] The merging parties' witnesses' explanation was that the supply shortage to Cashbuild was brief and was occasioned because CIL had moved Cashbuild from one plant to another. Notably no evidence from Cashbuild was led on this point.

[67] The merging parties submit that even if a permanent shortage of product were to occur, the Commission has not demonstrated that incentives to self-supply would be any different from what they currently are, given the structural relationship that already exists between the merging parties pre-merger, hence prohibiting this merger would serve no purpose.

[68] Finally the merging parties submitted that neither of the factual witnesses called by themselves, nor the other third parties who made submissions to the Commission during the course of the investigation, provided any evidence that the merger will bring about a substantial change in the likelihood of foreclosure by the merging parties.

[69] They relied on the evidence of Mr Shane Keith McLeod of Norcros SA (Pty) Ltd ("Norcros"), whose evidence is discussed in greater detail below, who testified that he had no reason to believe that the merging parties have a different strategy or business model to that of Norcros (which is not to engage in self-supply),[25] and that he also has no reason to believe that Italtile will have a different view in this regard as a result of the merger.[26]

[70] The merging parties also relied on written submissions that certain customers of CIL had made to the Commission during its investigation.

[71] Union Tiles, which had prepared a witness statement but was not called by the Commission, stated:

"*Union Tiles does not believe there will be a material change in the relevant markets due to the merger.*"[27]

[72] Tile Crazy stated in its submissions to the Commission that its concerns regarding supply by CIL are not related to the proposed merger.[28]

[73] Cashbuild also stated in its submissions that "*[t]he transaction is not going to change the supply dynamics as the [merging parties] will continue to supply Cashbuild*".[29]

Second defence of the merging parties

[74] The second defence put up by the merging parties was that even if one ignores the fact that ultimate control does not change, there would still be no likelihood of foreclosure post-merger. The merging parties submitted that there are three reasons as to why input foreclosure was unlikely to occur in the downstream tile market following the merger:

a) The past behaviour of the parties;[30]

[25] Transcript page 808, lines 15-22; page 809, lines 1-22; page 810, lines 1-16.
[26] Transcript page 809, lines 15-19.
[27] Trial Bundle Vol 7, page 6518.
[28] Tribunal Record, pages 2624-2625.
[29] Tribunal Record, page 2588.
[30] Merging Parties Heads of Argument page 4, par 9.

b) Numerous alternative sources of supply for tiles currently exist to which third party customers could turn if the merged entity ever sought to engage in a foreclosure strategy.[31]
c) The merged entity would have no incentive to engage in a foreclosure strategy because it would be unprofitable for it to do so.[32]

[75] Through the hearing of evidence; this defence gave rise to three main disputes:

a) The viability of import competition;
b) The ability of CIL's manufacturing rivals to expand; and
c) The merged entity's ability to foreclose rival retailers due to their ability to absorb capacity themselves.

The viability of imports

[76] The merging parties submitted that there are very considerable volumes of tile imports into South Africa that will constrain the merging parties. Various estimates contained in submissions made to the Commission during its investigation in this matter suggest that tile imports are in the range of [redacted] annually.[33] This range suggests that tiles represent between [redacted] and [redacted] of the upstream tile supply market in South Africa.[34]

[77] The actual size of imports could not be accurately determined as the Commission and the merging parties could not agree on how to interpret the appropriate SARS codes.[35] The Commission was of the view that these codes were over-inclusive as they include, in addition to floor and wall tiles, other products such as flags, paving and hearth tiles and mosaic cubes.

[31] Merging Parties Heads of Argument page 4, par 10.
[32] Merging Parties Heads of Argument page 4-5, par 11.
[33] Genesis report, para 16 (Witness Statement Bundle page 220); Webber Wentzel letter to the Commission dated 20 June 2016, Annexure "K", tab "Tiles. Etc." (DB, Item 28); Norcros submission, para 4.2 (DB, Item 5); Minutes of teleconference with Tiletoria, 11 April 2017, para 2.4 (Trial Bundle 7/6016-17); Email from Tile Crazy to Commission, para 3.1.3 (Trial Bundle 7/6003).
[34] Genesis report, Table 7 (Witness Statement Bundle page 232).
[35] **HS 690790**: "*Unglazed ceramic flags and paving, hearth or wall tiles; unglazed ceramic mosaic cubes and the like, whether or not on a backing, excluding tiles, cubes and similar articles, whether or not rectangular, the largest surface area of which is capable of being enclosed in a square the side of which is less than 7 cm*"; and **HS 690890**: "*Glazed ceramic flags and paving, hearth or wall tiles; glazed ceramic mosaic cubes and the like, whether or not on a backing, excluding tiles, cubes and similar articles, whether or not rectangular, the largest surface area of which is capable of being enclosed in a square the side of which is less than 7 cm*."

[78] The merging parties submitted that when one has regard to the evidence of Booth and McLeod (one a merging party witness and the other a Commission witness), these other non-tile products are imported into South Africa in such small quantities that the SARS codes are still used by their respective firms as a reliable indicator of floor and wall tile imports into South Africa.[36]

[79] Irrespective of the actual size of imports, the merging parties submitted that even the lower-bound estimate of import volumes reflects a substantial volume of tile imports into South Africa, representing approximately [redacted] of the upstream tile supply market.

[80] While the Commission did acknowledge that there are significant tile imports coming into South Africa - which was a development from its position when it prohibited the merger - it argued that all of these imports are of niche, high-end tiles that are not manufactured in South Africa, and which therefore do not constrain the prices of locally-manufactured tiles.[37]

[81] To this the merging parties submitted that tile imports cover a wide variety of sizes, formats, fashions and prices, including equivalent products to those sold by CIL and at similar prices.

[82] The merging parties relied on the testimony of Foxcroft that CIL regards tile imports as a significant competitive threat to local production. This threat relates not only to high-end luxury tiles from countries like Spain and Italy, but also to lower-price tiles from China and Brazil.[38] According to him the quality and level of the tile products imported into South Africa cover the needs of the entire market, from low-end to high-end products.[39]

[83] In his oral evidence, Foxcroft testified that "*import competition is something we run into on a daily basis*", and that imports "cap" the prices that CIL can charge for its tiles.[40] As Foxcroft explained: *"we certainly would like to charge higher prices, but we are constrained by the availability of imports to charge those higher prices"*.[41]

---

[36] Booth, Transcript page 560, line 18 – page 562, line 10; Minutes of meeting with Norcros, 10 March 2017, para 5 (Trial Bundle 7/6181); McLeod Transcript page 775, lines 2 - 21.
[37] Genesis report, paras 118-119 (Witness Statement Bundle 251-252); Competition Commission, Mergers and Acquisitions Report, 26 July 2016, para 112.
[38] Foxcroft Witness Statement, para 41 (Witness Statement Bundle 21).
[39] Foxcroft Witness Statement Bundle, para 46 (Witness Statement Bundle 21).
[40] Foxcroft, Transcript page 413, lines 1 - 8. See also T471, lines 12 - 16.
[41] Foxcroft, Transcript page 447, lines 15 - 17. See also T449, lines 15 - 19.

[84] The merging parties submitted that Foxcroft's testimony as to how pricing decisions were made at CIL was clear evidence that its pricing was constrained by imports.

The ability of CIL's competitors to expand[42]

[85] In the financial year ended 2016, CIL sold approximately [redacted] of tiles to third parties in South Africa, accounting for approximately [redacted] of its sales.[43] It was not necessary for this purpose that imports and alternative domestic manufacturers can replace all of CIL's sales, or even all of CIL's sales to third party customers.[44]

[86] The merging parties submitted that CIL's ability to foreclose rivals was constrained by the presence of two other local upstream players – Rayal[45] and Johnson Tiles.[46] Johnson is a producer of glazed porcelain and ceramic floor tiles.

[87] There was agreement among the economic experts that, whilst Johnson may not have any spare capacity, Rayal does.[47] Correspondence from Rayal indicates that they currently have [redacted] in operation which has a designed maximum capacity of [redacted] a day (which equates to approximately [redacted] of tiles per annum). However, depending on how Rayal's correspondence is read, this plant produced either only [redacted] or only [redacted], in 2016 (i.e. approximately [redacted]).[48] This suggests available spare capacity of [redacted] or [redacted] ([redacted] or [redacted]) per annum.[49]

---

[42] It is common cause between the economic experts that the relevant question for purposes of considering CIL's ability to foreclose is whether, in the event of a foreclosure strategy, CIL's third party customers could purchase a sufficient amount of this volume of [redacted] from imports and/or alternative domestic manufacturers in order to enable them to continue to be effective competitors in the downstream market. If they are able to do so, that would defeat any attempted input foreclosure strategy by CIL.

[43] Genesis report, Appendix A (Witness Statement Bundle 296).

[44] Genesis report, para 112 (Witness Statement Bundle 250); Govinda, Transcript page 1173, lines 7 - 23.

[45] Rayal is a recent entrant into the South African market which only began selling floor tiles from its Bronkhorstspruit plant in 2013. Rayal is owned by China-based Jiangxi Yaxing Textile Industrial.

[46] Johnson is the longest-standing tile manufacturer in South Africa and has been in operation since 1952. Johnson forms part of the larger Norcros group which also includes TAL (which is involved in the manufacturing of tile adhesive and grout) and Tile Africa (which is a retailer of tiles, baths, sanitary ware, adhesives and grouts and associated products).

[47] Expert minute, para 14 (Witness Statement Bundle 339).

[48] Genesis report, para 150.1 (Witness Statement Bundle 260 - 261); Email to the Commission from John Zhu dated 11 November 2016 (Trial Bundle 7/5930 - 5932).

[49] This estimate of maximum capacity is based on producing [redacted] a day for (apparently) [redacted] days. The merging parties however typically assume that a plant runs for 345 days a year which would yield a significantly higher maximum capacity of [redacted] per annum, and a spare capacity in excess of [redacted]. On this basis it appears that Rayal's estimate of spare capacity provided to the Commission is conservative (Genesis report, footnote 173 (Witness Statement Bundle 261).

[88] There was also agreement between the economic experts that Rayal intends [redacted].[50] In this regard, Rayal had stated that [redacted]"[51]

[89] Therefore, the merging parties submitted that spare capacity [redacted] at Rayal will amount to [redacted] - which represents 60% (or 70%) of CIL's current sales of [redacted] to third party customers.

[90] Johnson also considered the expansion of its manufacturing facilities, as set out further below.[52] Johnson currently sells approximately [redacted] tiles per year.[53]

[redacted][54]

[91] The Commission submitted that the ability of the two local competitors to expand and supply the local market is constrained.

[92] The Commission submitted that Johnson Tiles was unlikely to be able to compete with the merging parties post-merger, since CIL's production capacity far exceeds that of Johnson Tiles. [redacted][55]

[93] The Commission then goes on to state that the availability of gas is a major factor in the expansion of the present manufacturing capacity. Foxcroft admitted that the gas from Sasol

[50] Expert minute, para 14 (Witness Statement Bundle 339).
[51] Email to the Commission from John Zhu dated 11 and 29 November 2016 (Trial Bundle 7/5930 - 5932 and 7/5925 - 5928).
[52] 97 Norcros' submission entitled "Johnson Tiles Capacity (Manufactured v Sold)" (Trial Bundle 7/5919).
[53] 96 Norcros' submission entitled "Johnson Tiles Capacity (Manufactured v Sold)" (Trial Bundle 7/5919).
[54] Norcros submission, note 6 (Trial Bundle 7/5919).
[55]Transcript page 734 lines 1 to 11, Par 12 of the summary of fact of Shane McLeod, witness bundle page 195 and Trial Bundle page 5907.

had been utilized fully for a while, and that Sasol does not have gas to supply. He however referred to what he called a couple of programs on the horizon which would increase gas availability. He referred to a group called Africa Rainbow Pipeline (ARP) who were looking to establish a gas pipeline to Springs by 2020.

[94] With regards to Rayal the Commission submitted that although [redacted] will become available from [redacted][56] that capacity is dedicated [redacted] Larger format tiles will not constrain the smaller format where competition concerns in this market arise.

[95] The Commission's expert argued that the local demand would exceed the local supply by approximately 2019, should Italtile and the local market grow at the Commission's forecasted rates. In the event of this happening, the Commission was of the view that CIL would choose to self-supply the Italtile Group in preference to third party customers.

[96] The Commission was of the view that the abovementioned constraints on the other two local suppliers render them incapable of thwarting any foreclosure strategy of the merging parties. It's worth noting here that the merging parties did not share the view of the Commission regarding the forecasted growth rates of the local market.

The merged entity's ability to foreclose rival retailers due to their ability to absorb capacity themselves

[97] The question whether there was an incentive to foreclose then turns on whether such strategy would be profitable compared to a non-foreclosure strategy. In addition to this assessment the Commission would also have to show why the merger would substantially change the profitability of a foreclosure strategy, making it profitable post-merger when pre-merger it was not.

[98] In the financial year ended 2016, CIL sold approximately [redacted] of its volume to third parties and a further [redacted] was exported to third party customers outside of South Africa. A reduction in sales will result in CIL's fixed costs being spread over lower volumes, leading to a rise in CIL's total unit cost of production. It would also reduce the profitability of a tile plant because the margin on those sales would be lost.

[56] Trial Bundle page 5930.

[99] Whilst lower sales reduce the variable cost of the plant, they leave fixed costs unchanged and therefore result in less revenue being earned for the same amount of fixed costs. As such, the larger the portion of fixed costs, the more significant the impact that a fall in sales will have on the business's overall profitability.

[100] The merging parties argued that this loss in upstream efficiency would also result in impacting the cost at which Italtile received its product from CIL, thereby further reducing the effectiveness of any foreclosure strategy. This type of foreclosure strategy could then only be justified if there was a diversion of sales from third-party retailers to Italtile's retail stores. This diversion would need to be of a sufficient magnitude to compensate for the lost profit and efficiency of the upstream operations – otherwise there would be no incentive to foreclose.

[101] The two experts - Govinda for the Commission and Mr Paul Anderson – for the merging parties - agreed that an analysis of the margins made in the upstream manufacturing division and the downstream retail division was crucial to determining the incentive to foreclose. However the experts could not agree on the methodology for calculating the margin and hence this led them to different conclusions about the incentive to foreclose.

[102] Anderson, utilized the businesses' contribution margins, defined as the difference between price and marginal (or incremental) cost, as the appropriate margin to consider as it reflects the profit that would be lost upstream if any volumes of tiles were to be restricted. Govinda found that it was appropriate to use the gross margins instead of the contribution margins.

[103] Anderson, using his method, calculated that the contribution margin earned by CIL on tiles in FY2016 was approximately [redacted] or [redacted]. By contrast, Italtile's percentage margin at the retail level on tiles purchased from CIL was significantly lower at [redacted] and in absolute terms only [redacted] at approximately [redacted]

[104] This means that a [redacted] diversion to Italtile of any foreclosed volumes would need to occur to offset the loss of upstream profit. For instance, based on the formula for estimating the critical diversion ratio (using relative margins of the upstream and downstream operations), approximately [redacted] of all foreclosed volumes would need to be successfully diverted to Italtile's retail operations in order to offset CIL's loss of upstream profits.

[105] Govinda's evidence using gross margins in both the upstream (CIL) and downstream (Italtile) led him to conclude that CIL's profit margins were [redacted] than those of Italtile. Hence on his analysis diversion was a profitable and rational strategy.

[106] Both parties criticized the methodology of the other. The Commission argued that the evidence of both the merging parties' factual witnesses was based on gross margins and supported Govinda's thesis that retail margins were higher than those in manufacturing. The merging parties argued that Govinda had adopted an accounting framework for analyzing margins, and hence incentives, as opposed to an economic approach that Anderson had adopted.

[107] We do not delve into the argument regarding the margins and their method of calculation here as the matter does not turn on such, we merely wish to show the contradictory nature of the evidence put before us.

[108] The merging parties also relied on the evidence of a Commission witness to suggest that foreclosure was not a rational strategy for a vertically integrated firm. Here they relied on the evidence of McLeod of Norcross who we referred to earlier. Recall that his firm is also vertically integrated with both a factory that manufactures tiles (Johnson) and a retail operation, Tile Africa. Johnson supplies both its own downstream operation and third parties.

[109] McLeod's evidence was that it would be risky for the manufacturer to self-supply and to divert sales from third parties to its own stores. Asked specifically if the strategy might be different for Italtile post-merger, his answer was an affirmative no.[57]

[57] "CHAIRPERSON: *Is there any strategic reason why Italtile should view independence differently to the way that you endeavour?* MR McLEOD: *No, no*." Transcript page 809, lines 17-19.

Analysis

[110] The vertical merger in this case was a very unusual one because, as set out above, a structural relationship *already* existed between the merging parties, with both being ultimately owned and controlled by Rallen pre-transaction. Rallen is the sole controller of both CIL and Italtile pre-merger, and Rallen will remain the sole direct controller of Italtile, and the sole ultimate controller of CIL, post-merger. All that will change as a result of the merger is that direct control of CIL will move from Rallen to Italtile.

[111] Given these unique circumstances in which (i) the sole ultimate control of both CIL and Italtile will remain unchanged as a result of the merger, and (ii) the incentives of Italtile, as the direct controller of CIL post-merger, will be no different from those of Rallen as the direct controller of CIL pre-merger, it was quite unclear how the merger will give rise to any change in the incentive of the merging parties to engage in a foreclosure strategy, thus prohibiting it serves no purpose.

[112] It appears that the Commission may have conflated the question whether the merger gives rise to a change of direct control (which was undisputed), and the question whether the merger gives rise to an anti-competitive effect. The Commission must show why and how the change in control gives rise to a substantial change in the ability or incentive of the merging parties to engage in a foreclosure strategy. This it has not done. The evidence it relied on as past examples of foreclosure or attempted foreclosure were all given an adequate alternative explanation by the merging parties.

[113] It cannot be assumed that a change in direct control, whilst indirect control remains unchanged, results in a lessening of competition. As we held in *Bulmer:*

"*Clearly the legislature intended that the obligation to notify is broadly construed and hence it only invested the Commission with its investigative jurisdiction once the transaction was already considered a merger. Included in this latter investigation would be some residual enquiry into control. Thus it is conceivable that control may have changed for the purpose of section 12(1), but on an examination under section 16 may not bring about a substantial lessening or prevention of competition.*"[58]

[58] *Bulmer SA (Pty) Limited and another v Distillers Corporation (SA) Limited* 94/FN/Nov00 and 101/FN/Dec00 at page 18.

[114] We now turn to analyzing the second defence of the merging parties regarding the ability and incentive to partially foreclose Italtile's rivals in the downstream retail market. As we noted earlier much of this evidence was highly contested. It related to the constraint imposed by imports, the production capacity of rival manufacturers and finally an economic argument about the profitability and hence incentive to divert downstream sales of tiles from third parties to Italtile.

[115] At the end of the hearing much of this evidence was inconclusive. But even if we do decide in favor of the Commission regarding the above disputes, the evidence of the merger "perfecting foreclosure" from the pre-merger scenario, is weak, as it fails to deal with the central issue of merger specificity. If the merger is prohibited the merged firm can engage in foreclosure in any event; the change in direct control does not alter this possibility. If the merged firm has this capacity pre-merger then the fact it has not embarked on such a strategy pre-merger – and here the examples cited by the Commission were unconvincing – we would have expected much stronger customer evidence than was presented despite the Commission's diligent efforts in this regard.

[116] The Commission also ignores the pro-competitive evidence of the merging parties. The merger has been driven by the need to strengthen the balance sheet of the merged firm to enable it to expand production. The merger rationale is one of increasing not decreasing the supply of tiles. The risk to the merged firm of alienating its customer base if it expands production in an industry where economies of scale matter at the production level further makes a partial foreclosure strategy less likely, even if one is skeptical about claims of the effectiveness of import competition and the short term expansion possibilities of rival domestic producers of tiles.

Conclusion

[117] We concluded that the merging parties' primary defence is successful, the Commission could not show why the merger would give rise to an increased ability or incentive to engage in a foreclosure strategy.

[118] With regards to the secondary defence of the merging parties, we find that although it is difficult to make conclusive findings on much of the evidence presented, due to the factual disputes, the core thesis of the merging parties that the incentive to partially foreclose would be irrational is a more probable outcome than the Commission's theory of harm.

[119] We noted that while the merging parties did not admit that the concerns raised by the Commission were justifiable, they tendered conditions in order to address these concerns. These conditions were two-fold and related to the guarantee of supply of ranges of entry level tiles at specific prices to third party customers on the one hand and concerns of information exchange on the other.

[120] We agreed with the Commission that the proposed condition in relation to the guarantee of supply of entry level tiles would be impractical, difficult to monitor, would interfere with the functioning of this market and would not necessarily make customers any better off.

[121] However in relation to concerns regarding information exchange between Italtile and CIL, we consider this to be a legitimate concern as Italtile, through CIL would have access to all the third party customer information (stocks, sales quantities, prices etc.). Hence, we approved the proposed transaction subject only to this information sharing condition which the merging parties had agreed to tender. In terms of this condition, so-called "Chinese walls" will be placed in the IT systems via a SAP access control system, ensuring third party customer information is kept secure from those involved in the downstream market in the merged firm.

[122] In light of the above, we concluded that the proposed transaction is unlikely to substantially prevent or lessen competition in any relevant market or raise any adverse public interest issues. Accordingly, we approved the proposed transaction conditionally, the conditions attached hereto as **"Annexure A"**.

_____ 08 May 2018

Mr Norman Manoim **DATE**

Ms Yasmin Carrim and Ms Andiswa Ndoni concurring

Case Manager : Kameel Pancham

Tribunal Economist : Karissa Moothoo-Padayachie

For the Applicants : Adv. A Subel SC and Adv. J Wilson SC instructed by Hogan Lovells

For the Commission : Adv. R Bhana SC and Adv. T Mafukidze