FMCG Issues

A series addressing fast moving consumer goods issues

HOW THE KRAFT/CADBURY BID CLEARED DESPITE A HIGH MARKET SHARE

On 6 January 2010, the European Commission cleared the hostile bid for Cadbury plc (Cadbury), by Kraft Foods Inc. (Kraft Foods), subject to divestments in Poland and Romania. The most striking aspects of the Commission's decision concern its rationale for clearing the transaction without requiring remedies in three key markets where combined market shares were very high: the UK, Ireland, and France. Arnold & Porter (UK) LLP represented Kraft Foods in this case. This advisory assesses the Commission's approach, based on the public version of the Commission's decision (the Decision).

The Decision shows a willingness on the part of the Commission to clear transactions which give rise to high combined market shares, provided the parties are able to provide strong evidence supporting their assertions that no competitive harm is likely even in the face of high increments leading to high combined shares.

The hostile bid for Cadbury was conducted under the UK Takeover Code, which provides that, should the Commission decide to open a Phase II investigation, the bid must automatically lapse. The Decision is also therefore remarkable because of the limited Phase I timeframe in which the Commission was able and willing to assess the volume of complex legal and economic evidence presented to it, with little pre-notification preparation. Ultimately however, it must be viewed as further clear evidence of the Commission's resolve to adopt a fully effects-based approach to merger control, and its ability to take complex economic analysis into account in Phase I in order to clear transactions with seemingly high combined market shares. As such, it is of interest for transactions involving fast-moving consumer goods, as well as in markets outside this sector

In this advisory, we briefly outline the facts of the Decision and highlight the key takeaways for the Commission's notable approach to this case.

London
+44 (0)20 7786 6100

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

THE KEY FACTS

The proposed acquisition by Kraft Foods of Cadbury would affect the wholesale markets (i.e., for sale to retailers) of chocolate confectionery, sugar confectionery, biscuits, soft cakes, and chocolate drinks in various European Economic Area countries and in travel retail/duty free. The most significant impact of the proposed transaction would arise in relation to chocolate confectionery in the UK, Ireland, France, Portugal, Poland, and Romania, where both Kraft Foods and Cadbury are active (Cadbury with the *Cadbury* brand or with local brands).

Despite high combined shares in the wholesale markets in the United Kingdom, Ireland, France, and Portugal, the Commission cleared the proposed transaction without conditions relating to those countries, on the basis that Kraft Foods and Cadbury were not each other's closest competitors. Additionally, in France, the Commission relied on the fact that private label brands were strong in the downstream, retail, market. Remedies were required in Poland and Romania, where the combined shares were particularly high and the Commission found that the brands of the parties were close competitors. The remedies comprised the disposal of target businesses in those countries. We do not discuss the Commission's analysis in Poland and Romania, nor do we discuss Portugal, where Cadbury had a very small market share and where the Commission's analysis rested on arguments discussed in more detail for the UK and Ireland.

CHOCOLATE CONFECTIONERY MARKET DEFINITION

Relying on its earlier findings in *Kraft/Danone Biscuits*,[1] the Commission found that the chocolate confectionery market should be segmented into three broad categories, which it identified as being separate relevant product markets. These three categories are countlines (individually wrapped chocolate snack bars weighing under 60 grams), tablets (moulded chocolate blocks), and pralines (indulgent individual chocolates sold in a box or bag). The bulk of the overlap between the activities of the two companies would be in tablets.

1 Case No COMP/M.4824, *Kraft/Danone Biscuits*, 9 November 2007.

The Commission focused on the wholesale markets, being the only markets in which Kraft Foods and Cadbury operated, but as in other cases in the sector, did acknowledge that private label and branded products are generally in competition with each other at retail and that they are to a large extent of similar quality. Therefore, the competitive interaction at retail between branded products and private label was taken into account in the analysis. Although in a number of previous consumer goods transactions,[2] the Commission has relied purely on wholesale shares, in this case the Commission also presented retail shares on the basis that they would be useful to capture the dynamics of competition at the level where end-consumers make their choice from a range of products—including both supplier brands and private labels.

The combined market shares arising from the proposed transaction in the UK, Ireland, and France were high, and above the level at which concerns about dominance will normally arise. Within the tablets segment of the confectionery market, the combined wholesale shares of the parties would be between 55–70% in the UK, 45–60% in Ireland, and 35–50% in France.[3]

A FINDING OF LACK OF CLOSENESS OF COMPETITION

Kraft Foods argued that, despite high combined shares in the relevant countries, the transaction would not raise significant concerns because its products were not the closest competitors to Cadbury's products. This argument, supported by the market test, was consistent with the Commission's guidelines on the assessment of horizontal mergers,[4] which state that in differentiated product markets, it is less likely that a transaction will raise a significant impediment to competition where there is closer substitution between the products of the parties to the merger and products of third party rivals than with each other.

2 *See Kraft/Danone Biscuits*, op cit., and Case No COMP/M.4533 SCA/Procter and Gamble.

3 These market share ranges are those that appear in the public version of the Decision.

4 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings.

In the UK and Ireland, Kraft Foods' arguments, which were accepted by the Commission, were based on the fact that continental-style chocolate (Kraft Foods' or Lindt's brands) are regarded by British and Irish consumers as being extremely different from British heritage chocolate such as *Cadbury Dairy Milk*, which competes more closely with Mars' and Nestlé's brands. Also, Kraft Foods argued that its product *Toblerone* did not compete closely with other tablets, given the nature of its taste, its unique format, and its perception by consumers.

In France, the lack of closeness of competition arose from the positioning of the products of the parties in the dark and milk segments of the market respectively, and in the mainstream and premium segments respectively.

THE IMPACT OF THE ECONOMIC ANALYSIS ON THE COMMISSION'S REASONING

As indicated at unusual length in the Decision, Kraft Foods submitted complex economic evidence, in the form of merger simulation and demand estimation models. The merger simulation and demand estimations were made using retail sales and pricing data provided by Nielsen on a stock keeper unit (SKU) level. The Commission tested the robustness of this evidence at length, and described it as providing "further evidence" that the proposed operation would be unlikely to lead to significant price increases in the UK and Ireland. It is not clear from the Decision just how important a factor the economic analysis was in the Commission's ultimate decision to clear the transaction in those countries and in France where similar economic analysis was also presented to the Commission. However, based on the lengthy treatment of the economic evidence in the Decision, it must be concluded that it was a significant, and perhaps critical, factor in the Commission's reasoning. There is little doubt that the ability to present compelling quantitative evidence to the Commission to support strong qualitative arguments on lack of closeness of competition, enables the Commission to clear transactions that otherwise might have given rise to serious doubts—and therefore a Phase II investigation.

It is particularly significant that the Commission was prepared to take sophisticated and lengthy economic evidence into consideration in its initial Phase I review of the case. It is not unprecedented for the Commission to do this and consequently to clear transactions with high market shares.[5] However, the constraints of the UK Takeover Code requirements severely compress the possibility for pre-notification discussions and analysis. Even in these circumstances, where very little pre-notification discussions were possible, the Commission was able to assess, test and conclude on the economic and legal evidence, in order to clear the potential transaction in Phase I. This is a logical extension to the increasing importance accorded to the economic dimension in the Commission's work.

THE APPROACH OF THE COMMISSION TO BUYER POWER—A GOOD SIGN FOR SUPPLIERS OR NOT?

Perhaps one of the disappointments of the decision is that because the Commission was able to rely on the economic evidence to support its findings of lack of closeness of competition, it was not necessary for the Commission to address the issue of buyer power in any detail. The Commission acknowledged in the Decision that Kraft Foods made an argument based on buyer power. However, the Decision did not address the issue in relation to either the UK or Ireland. Given the highly concentrated nature of retail markets in both those countries, and the fact that the UK and Irish competition authorities have found retailers to have significant countervailing buyer power, it would have been helpful for suppliers of consumer goods, had the Commission addressed the question of buyer power in those countries. It is somewhat cheering for branded suppliers, however, that the Commission did take account of the importance of retailer brands in France in its assessment of the transaction there, albeit without any in-depth discussion of how retailer brands impacted on branded suppliers.

CONGLOMERATE EFFECTS WERE NOT ASSESSED

The Decision does not contain any assessment of conglomerate effects, unlike the vast majority of transactions in consumer goods markets in the past five

5 One of the first recorded times the Commission did this was in *Philip Morris/Papastratos* in 2004, where Arnold & Porter represented the acquirer.

years, where the Commission has given at least some consideration to conglomerate effects. This is perhaps one more sign that such theories are in decline.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

Tim Frazer
+ 44 (0)20 7786 6124
Tim.Frazer@aporter.com

Susan Hinchliffe
+44 (0)20 7786 6122
Susan.Hinchliffe@aporter.com