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GENERAL NOTICES

NOTICE 2729 OF 2004

COMPETITION COMMISSION

NOTIFICATION TO PROHIBIT THE TRANSACTION INVOLVING:

BONHEUR 50 GENERAL TRADING (PTY) LTD
AND
KOMATILAND FORESTS (PTY) LTD

The Competition Commission hereby gives notice, in terms of Rule 38 (3)(c) of the 'Rules for the Conduct of Proceedings in the Competition Commission, that it has prohibited the transaction involving the above-mentioned firms on 22 September 2004.

The Commission has found that the merger is likely to substantially prevent or lessen competition and that the alleged efficiency gains resulting from the proposed merger are not likely to offset its anti-competitive effects. Furthermore, the Commission has found that the proposed merger cannot be justified on substantial public interest grounds.

The transaction

The proposed transaction entails an acquisition by Bonheur of control over the business of KLF. Bonheur is a special purpose vehicle established for the purpose of acquiring KLF. KLF is controlled by South African Forestry Ltd ("Safcol"), which is wholly owned by the government of South Africa. The transaction entails the privatisation of KLF by government.

Activities of the parties

Via Bonheur, the ultimate acquiring party is involved in the forestry industry through Global Forest Products (Pty) Ltd ("GFP") and Global Sawmills (Pty) Ltd ("Global Sawmills"). GFP is a vertically integrated operator in the forestry industry. It operates softwood and hardwood plantations, while Global Sawmills operates three sawmills in the Mpumalanga province. GFP is also involved in the production of seed and seedlings, softwood and hardwood saw logs and sawn timber.

KLF is involved in the production of seed, seedlings, softwood saw logs, softwood woodchips and sawn timber and is therefore also vertically integrated.

The Commission found overlaps in the activities of the parties in the production of seedlings, softwood saw logs, sawn timber and softwood woodchips.

Horizontal analysis

KLF is one of only two producers and suppliers of seeds to seedling growers in South

Africa. Mondi Ltd ("Mondi") is the other producer and supplier of seeds. GFP is not involved in this market. However, GFP manages Mondi's production and supply of seeds. The merger will not result in a change in the market for the supply of seeds and the Commission therefore had no concerns in this regard,

Both KLF and GFP are involved in the market for the production and supply of softwood seedlings in South Africa. There are a number of competitors in the market. In addition, barriers to entry into the seedlings market are low. The Commission, therefore, had no concerns in this regard.

Both KLF and GFP produce softwood saw logs in Mpumalanga. However, GFP's saw logs are used in-house, whilst KLF primarily supplies saw logs to independent saw millers. GFP has, however, in the recent past supplied some softwood saw logs to the open market. GFP's stated intent is to use its softwood saw log supply to manufacture sawn timber. The Commission therefore does not consider GFP as a competitor of KLF in the market for the supply of softwood saw logs, However, GFP's production of softwood saw logs is important in the vertical analysis of the effects of the transaction, discussed further below.

The Commission's investigation revealed that saw logs are generally transported within a radius of approximately 100km. Beyond 100km it becomes expensive to transport saw logs. The Commission thus concludes that the geographic market for the supply of saw logs is Mpumalanga and Limpopo ("Mpumalanga"). GFP and KLF respectively produce approximately 24.8% and approximately 50.4% of the softwood saw logs in Mpumalanga. Numerous small producers provide the balance of the supply of softwood saw logs. The merged entity will produce approximately 75.2% of sawlogs in Mpumalanga post-merger. This presents vertical concerns, which are discussed further below.

Saw logs can be processed into veneer, plywood, softwood pulpwood and woodchips- Both GFP and KLF are involved in the production of veneer. However, the veneer produced by GFP and KLF are used for different applications. The Commission therefore considers this not an overlap.

In respect of plywood, GFP is involved in the production of plywood, while KLF is not. The Commission therefore found that there is no overlap between the parties in this respect. However, the Commission considered vertical concerns arising from the merger, which are discussed further below.

Both GFP and KLF produce softwood pulpwood, a product used for the production of pulp, which in turn, is used for the production of paper. The market for the production of softwood pulpwood is competitive, as there are many suppliers. The Commission therefore had no concerns in this regard.

Both GFP and KLF produce softwood woodchips, a by-product of their sawmilling operations. However, the Commission's investigation revealed that there are numerous suppliers of softwood woodchips. The Commission therefore had no concerns in this regard.

Saw millers process softwood saw logs into sawn timber. Both GFP and KLF produce and supply sawn timber in South Africa. The parties contended that the market for the supply of sawn timber is international as it is possible to import sawn timber. However, the Commission's investigation revealed that the landed cost of imports is significantly higher than the domestic price for sawn timber and that imports constituted a small percentage of the market. In addition, imported structural sawn timber would require SABS certification and to be cut to the correct dimensions, giving rise to volume losses. The Commission therefore concluded that imports do not pose a competitive constraint on the domestic suppliers of sawn timber, and therefore concluded that the market for the supply of sawn timber is national.

The parties' post-merger combined market share in the national market for the supply of sawn timber will be approximately 15,4% with GFP and KLF having market shares of approximately 11.S% and approximately 3.8% respectively. The merged entity's involvement in the sawn timber market is important in the vertical analysis of the effect of the merger and is discussed further below.

Vertical analysis

As stated above, both GFP and KLF are vertically integrated firms in that both produce softwood saw logs (upstream) and process this into sawn timber (downstream).

The merger will result in a combined post-merger market share for the parties in the upstream market of approximately 75.2% (50.4% and 24.8% for KLF and GFP respectively) of the production of softwood saw logs in Mpurnalanga. In respect of the downstream market for the production and supply of sawn timber, the parties' combined market share in the national market will be approximately 15.4%.

However, as the merged entity would produce approximately 51% of the total softwood saw logs in South Africa, the Commission's concern was that the merged entity would be able to leverage this upstream production to a 51% share in the downstream market for the supply of sawn timber in South Africa through self dealing, thereby foreclosing input of saw logs io independent saw millers. Alternatively, the merged entity would be able to raise rivals' costs by increasing the prices for saw log inputs.

The parties argued that the merged entity would not be able to foreclose input to the independent saw millers, as the saw millers could turn to hardwood saw logs as an alternative to softwood saw logs. However, the end products for the two types of saw logs differ significantly. Sawn timber from softwood is a commodity product, whilst sawn timber from hardwood is used for higher value purposes. Moreover, the capital and variable costs of establishing and running a hardwood operation are higher than for the softwood saw log mills.

The Commission's investigation revealed that even if hardwood saw logs were included in the relevant market, such an inclusion would not significantly dilute the parties' sawn timber production; as the supply of hardwood saw logs in South Africa is limited.

The parties further argued that steel could be a viable alternative for (structural) sawn timber, specifically with regard to roof trusses, and would thus constrain the behaviour of the parties post-merger. The Commission's investigation, however, revealed that steel is not an economic alternative to sawn timber. Steel is mainly used in large construction projects, whereas sawn timber is used in the construction of residential properties. Furthermore, steel roof trusses are more expensive than structural timber trusses. Steel price increases have also been higher than corresponding price increases in wood roof trusses, widening the price gap between the two products.

The Commission was concerned that the merged entity's command of 51% of the market for sawn timber in South Africa would enable it to increase prices to customers. Competitors to the merged entity in the sawn timber market would be unable to react to price increase by expanding production and capturing market share, as they would not have access to the saw log quantities required for such an expansion. This is compounded by high barriers to entry in the market for the production of saw logs. Further, there are regulatory barriers into the production of saw logs (plantations), which include long lead times for the plantations to grow to the size where they can be harvested for saw milling purposes. The lead time is 25 – 30 years. Thus, even in the event of securing a new forestry permit, no competitive constraint could be exercised by a new entrant within the first 30 years of production.

In addition, a permit from the Department of Water Affairs and Forestry ("DWAF") for establishing a saw log plantation is required. The investigation also revealed that there is a limited availability of land for plantations, that the DWAF has decided to reduce the planned forestry surface and has identified exit areas, i.e. areas not suitable for commercial forestry, as a result of environmental concerns, in particular, scarce water resources and the land being too marginal to secure proper returns on commercial scale.

The Commission thus found that the transaction is likely to substantially prevent or lessen competition in the market for sawn timber in South Africa.

Efficiencies

The parties stated that the transaction would result in the following efficiency gains: rationalisation, economies of scale and scope, technological progress, slack reduction and social benefits.

The parties did not provide data to quantify the alleged efficiency gains. The Commission found that some of the efficiencies could be achieved by means other than the merger. The Commission further found that in the post-merger market structure, it is unlikely that the alleged efficiency gains resulting from the proposed merger would be passed on to customers. The alleged efficiency gains are thus not likely to offset the anti-competitive effects of the proposed merger.

Public interest

The Commission identified three public interest concerns resulting from the merger, namely the effects of the transaction on employment, the ability of small businesses to become competitive and the effect on the particular industrial sector or region.

As stated above, the transaction is likely to lead to the foreclosure of saw logs to saw millers, some of whom are small businesses. The foreclosure of saw logs would result in the saw millers exiting the market. The estimated job losses resulting from the exit of the independent saw millers are approximately 2 000.

Regarding the effect of the merger on a particular industrial sector or region, the Commission's investigation revealed that the forestry industry is a significant source of employment and economic activity in the Mpumalanga region. The effect of employment losses and the exit of small businesses would have a significant effect on the local communities. The small businesses and employees affected by the transaction would not likely be absorbed into alternative economic activities in the area, as such activities are limited.

The patties alleged that the merger would have a positive effect on the public interests provided for in the Competition Act. They argued that through the shareholding in Bonheur by a firm awned by previously disadvantaged persons, the transaction would lead to broad based black economic empowerment. In addition, the parties undertook to place a three-year moratorium on retrenchments in KLF, thereby protecting employees in KLF. The parties also submitted that jobs would likely be created, and that the transaction would have a positive effect on the region in terms of tourism and the development of downstream-related activities.

The Commission found that the public interest arguments presented by the parties do not justify the anti-competitive effects of the proposed transaction. In addition, the Commission found that the transaction is likely to have a negative effect on employment, small businesses and the industrial sector or region.

Remedies

The parties proposed remedies purporting to address the Commission's concerns about the transaction. The parties proposed that the Commission should approve the merger, in essence, subject to conditions that secure a supply of saw logs to the independent saw millers and bolster the black economic empowerment component of the transaction. These conditions included:

- In each KLF financial year KLF will supply to third party saw millers an amount of saw logs equal to at least the lower of fifty percent of KLF's actual production of saw logs in the KLF financial year in question; or 675 000 m^3; for a period of 25 years;
- Any offer submitted to KLF by a third party for the purchase of saw logs other than by virtue of long-term log-supply agreements at a price that *is* 5% or more below the prevailing price at which KLF sells saw logs in terms of long-term log-supply agreements at the time when such offer is received by KLF will not be counted as an offer by a third party; and
- At least 49% of the issued share capital of Bonheur must be owned directly of indirectly by a firm or firms controlled by historically disadvantaged persons.

The Commission found that the proposed condition regarding the supply of saw logs to independent saw millers would not adequately address the concerns raised by the merger. First, the proposed quantity is less than the pre-merger saw log use of independent saw millers, thereby still leading to a partial foreclosure of the market under circumstances where expansion in the upstream saw log market is highly unlikely given the significant barriers to entry. The Commission, however, found that the proposed remedy would maintain the existence of a number of independent saw millers in the market.

Second, the Commission found that the parties would post-merger still be able to raise independent saw millers' costs, who would not have adequate alternative sources of supply, by charging higher prices for saw logs. The condition thus did not adequately address the Commission's concerns that the transaction is likely to substantially prevent or lessen competition in the market for sawn timber.

The Commission considered whether a further condition attempting to maintain competitive prices in the upstream market would alleviate the concerns in the downstream market, but came to the conclusion that price regulation is undesirable as it impedes the optimal functioning of the market.

Regarding the increased shareholding in Bonheur by firms controlled by historically disadvantaged persons, the Commission found that the public interest condition does not justify the anti-competitive effects of the proposed transaction.

The Commission also considered the following alternative remedies:

- The divestiture of GFP's plantations and saw milling operations; and
- The divestiture of GFP's plantations coupled with a condition that the merged entity supplies a minimum quantity of saw logs to independent saw millers and a condition that the merged entity be precluded from purchasing supply from the divested GFP plantations.

The Commission considered the divestiture of GFP's plantations and saw milling operations as a possible remedy for the cornpetition concerns, as it would maintain the pre-merger market structure. However, given the parties' stated intention to increase their downstream production of sawn timber, they are likely to expand their saw milling capabilities and self supply saw logs, thereby effectively foreclosing independent saw millers from the supply of saw logs. Thus, the Commission's concerns with the effects of the transaction on employment losses, small businesses and the industrial sector or region resulting from the exit of independent saw millers from the market remains. In addition, the parties stated that the proposed condition was not acceptable to them.

The Commission also considered the divestiture of GFP's plantations (alternatively an equivalent portion of the KLF plantations) coupled with a condition that the merged entity supply a minimum quantity of saw logs to independent saw millers, and a condition that the merged entity be precluded from purchasing supply from the divested GFP plantations, as a possible remedy. The Commission was of the view that the divestiture of plantations to a third party would likely secure a supply of saw logs in the market. However, the Commission took cognisance that the third party could vertically integrate and enter the sawn timber market, therefore utilising the saw logs for its own purposes. This would foreclose independent saw millers from supply, thereby failing to address the concerns raised by the merger.

The Commission attempted to address the foreclosure concerns with the additional condition that the merged entity supply saw logs to independent saw millers. This, however, raised issues of placing the merging parties in a position that they would have access to less saw logs than they had pre-merger, a situation not intended by merger regulation.

In the light of the parties indicating that divesting of plantations would not be a suitable remedy to them, this was not pursued.

Conclusion

The Commission found that the transaction is likely to substantially prevent or lessen competition in the market for sawn timber in South Africa and that the alleged efficiency gains are not likely to offset the anti-competitive effects of the proposed merger. The Commission further found that the public interest arguments presented by the parties do not justify the anti-competitive effects of the proposed transaction and that the transaction is likely to have a negative effect on employment, small businesses and the industrial sector or region of Mpumalanga.

The Commission considered alternative remedies for the negative effects of the transaction, but found no remedies that adequately addressed the concerns raised. White some of the remedies partially addressed the competition concerns, they failed to address public interest concerns, and vice versa.

The Commission therefore prohibits the transaction.

Enquiries in this regard may be addressed to Ms E. Strydorn at Private Bag X23, Lynnwood Ridge, 0040. Telephone; (012) 394 3286, or Facsimile: (012) 394 4286. (Reference: 2004Jun1077)