COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 41/LM/Aug03

In the large merger between:

Boart Longyear (a division of Anglo Operations Limited)

and

Huddy (Pty) Ltd and Huddy Rock Tools (Pty) Ltd

Reasons for decision

CONDITIONAL APPROVAL

The proposed transaction between Boart Longyear, a division of Anglo Operations Limited, and Huddy (Pty) Ltd and Huddy Rock Tools (Pty) Ltd was conditionally approved by the Tribunal on the 8 December 2003. The reasons for this decision follow.

The Transaction

This is a horizontal merger in terms of which Boart Longyear, a division of Anglo Operations Limited ("Boart"), will acquire the businesses of Huddy (Pty) Ltd and Huddy Rock Tools (Pty) Ltd (collectively known as "Huddy"). In terms of the heads of agreement , Boart will acquire the businesses as going concerns.

On 24 October 2003 the Commission recommended that this merger be approved subject to the condition that Boart divest of the Kempe business acquired from Huddy. The 'Kempe business' refers to that part of Huddy's business in which the Kempe pneumatic drill is produced.

THE PARTIES

Both parties to the merger manufacture diamond based drilling consumables and capital equipment used in the mining, construction and quarrying industries.

The primary acquiring firm

The primary acquiring firm is Boart Longyear, a division of Anglo Operations Limited. Anglo American PLC ultimately controls Anglo Operations Limited.

Boart, established in 1936, pioneered the use of poor quality diamonds (known as "boart"), and, some time later, the use of synthetic diamonds in the production of drilling equipment.

With its headquarters in South Africa, Boart has 60 companies worldwide, encompassing a presence in some 38 countries.

The primary target firm

The primary target firms are Huddy (Pty) Limited and Huddy Rock Tools (Pty) Limited. Both are wholly owned subsidiaries of Industrial Diamond Products (Pty) Limited.

Huddy was formed in 1944 by Jack Huddy. Initially it produced only the components that are attached to a mining drill. Later it successfully expanded its production to include a wider range of drilling equipment including pneumatic drill machines. Although Murray and Roberts, the large building and engineering group, controlled Huddy for a time, it has, since 1997, reverted to the control of its management, including the founding family, who now wish to dispose of the businesses.

RATIONALE FOR THE TRANSACTION

The parties submit that the economies of scale required to be efficient in the industry necessitate both rationalisation of production facilities and the upgrading of these facilities.

The recapitalisation that Huddy requires to upgrade its facilities, did not appear feasible to its shareholders, many of whom wish to retire. Thus, for Huddy this transaction represents an alternative to costly recapitalisation.

Boart, on the other hand, asserts that it has excess capacity at its Springs plant and this transaction will enable it to increase its capacity utilisation. Thus the acquisition of the Huddy business will assist Boart to achieve the necessary economies of scale.

THE HEARING

A pre-hearing was held on 3 November 2003 and the hearing was held on the following days:

26 November 2003
27 November 2003

The Commission called the following witnesses:

1. Mr O'Neill, the Managing Director of GSG Mining Supplies (Pty) Ltd, and
2. Mr Rice, the General Manager of Atlas Copco Exploration Products, a division of Atlas Copco.

The merging parties called Mr Richardson, the Regional Director of Boart Longyear and the Global Director for Capital Equipment for Boart Longyear.

A representative of the National Unions of Metalworkers of South Africa (NUMSA) attended the pre-hearing. On 25 November 2003 we received a written submission from NUMSA outlining its view of the employment effects of the merger. However, NUMSA did not attend the hearing of the matter.

BACKGROUND

In recent years a number of large-scale cross-border acquisitions have occurred in the markets in which the merging parties are active. This has resulted in the emergence of a number of significant global competitors. These include Atlas Copco Secoroc formed as a result of the merger of Atlas Copco with Secoroc (Pty) Ltd and is also evidenced by Boart's own acquisition of Bradley Brothers, a Canadian manufacturer.

Globalisation is manifest in further trends in the industry, most notable of which is the consolidation and rationalisation of manufacturing facilities at a small number of key international sites, coupled with the establishment of networks of sales and distribution outlets – frequently in the form of independent agents - in all the major national markets. The ease with which this has been achieved is attributable to the absence of significant trade barriers, the global procurement policies of large mining houses and the fact that most of the products are internationally standardised. However, it must be noted that while most of the consumable products are internationally standardised, some of the equipment, such as drilling machines, is often developed to suit particular environmental and other countryspecific requirements. Pertinent to this transaction – and elaborated below – is the pneumatic drill which is uniquely utilised in the South African mining sector.

These networks of national distribution offices and agencies allow the manufacturers to penetrate the range of international markets while simultaneously consolidating their manufacturing activities. The distributors' functions clearly extend beyond mere sale and physical distribution and invariably include an element of consultancy, the provision of technical expertise and after sales service.

Boart epitomises these global players. While Boart has manufacturing operations situated globally, it plans to realise opportunities for the strategic consolidation of its major operations into fewer factories. During 2002 it combined its' diamond bit manufacturing operations in Canada and the USA into a single factory.[1] Furthermore, Boart plans to move all production of its taper products to South Africa, while bit manufacturing will be relocated to China.[2]

Huddy, on the other hand, is focused on the South African market. Its manufacturing operations are exclusively located in South Africa and its revenue is largely derived from sales in the South African market, with exports accounting for 15% of it sales.[3]

RELEVANT MARKET

The product markets

Both parties are involved in the manufacture of diamond based drilling consumables and capital equipment for the mining, construction and quarrying industries. These products fall into the following three broad categories:

1. *Industrial Diamond Products*
   The range of products that fall within this category are predominantly used in the construction, engineering and natural stone industries. The products include diamond impregnated saw blades of different sizes, drill bits and grinding wheels.

2. *Diamond Core drilling products*
   This category of products is used extensively in mineral exploration processes and it includes both pneumatic and hydraulic drilling machines, as well as numerous consumable products.

1 See Boart's Global Business Plan 2003-2004 , page 1026 of the record.
2 See Boart's Global Business Plan 2004, page 1059 of the record.
3 See page 418 of the record.

3. *Percussion drilling products* [4]
   These products are used by mining houses and drilling contractors to drill holes into which explosives are inserted to blast rock so that it can be extracted. The products include drills (also known as "jack hammers") and a range of consumables.

The parties have identified a multitude of distinct products within each of these broad categories. They aver that each of these products constitutes an individual relevant market. On this basis the parties identify some 17 relevant markets[5]. Much of the parties' competition analysis then comprises a detailed examination of each of the narrow separate markets for which they contend.

The basis for the parties' contention regarding the relevant markets is that the separate products identified are not functionally interchangeable - that is, each product is used to perform a specific function which cannot be performed by one of the other products identified, even by one falling in the same broad product category. It is acknowledged that many of the products, particularly those falling within the same broad product category, are complements. However, the fact that the consumable products are internationally standardised in terms of size and other technical aspects, means that customers are not restricted to using the same brand of products together. By way of example this means that a Boart drill bit may be used with an Atlas Copco reaming shell and a Fordia drill rod.

In support of their argument the parties also submit that not all manufacturers produce an entire category of products and that it is not uncommon to find a firm that produces only diamond drill bits or a firm that specialises in the manufacture of drilling equipment rather than consumable products.[6] However, this latter contention is not persuasive. The evidence strongly suggests that all of the major manufacturers produce the full range of products within each of the broad categories and that the agents, certainly, distribute products across the range. It is clear that their customers generally require the full range of products within each of the categories.

The Commission has, for essentially the same reasons, recommended that we find the same narrow relevant markets as contended for by the parties.

Finding on the relevant product markets

While we acknowledge that each of the products in the three broad categories are

4 This category of products is also known as "hardrock tools". For a detailed explanation see pages 2-4 of the transcript.
5 See page 100-101 of the record for the parties table of the product overlaps they identify.
6 See Adv. Pretorious' submission on page 29 of the transcript.

not functionally interchangeable, this in itself does not dispose of the analysis of the relevant market for competition purposes. It appears to us that this market is analogous to that found in most major retail markets. Hence in analyzing the retail furniture market we have not distinguished a market for lounge suites from a market for bedroom suites even though the respective products are clearly not functionally interchangeable. We have rather acknowledged that, for the most part, the market is served by retailers, and to a somewhat lesser extent, manufacturers who produce and/or supply the full range of furniture or grocery or clothing products. This coincides, for the most part, with the demands of their customers whose requirements generally cover the full range of furniture or grocery products.

As already indicated the evidence before us indicates that, for the most part, purchasers of the products implicated in this transaction require the full range of products within each of the three broad categories identified above. It is not surprising then that the manufacturers as well as independent distributors who service this market produce and trade across a similarly broad range of categories.

This is not to say that we do not acknowledge the existence of narrow segments within a broader relevant market. Nor is it to deny the central role of functional interchangeability in distinguishing these segments. When the competition analysis is undertaken and, particularly, when, in the event of an adverse finding on competition grounds, a remedy is considered, the question of functional interchangeability may directly influence the findings. For example a merger in furniture manufacturing may give rise to fewer concerns in, say, the segment for kitchen units (because of the existence of a large number of specialist producers of kitchen furniture) than in the lounge or bedroom suite segments, however the merger's impact on the broader furniture market (itself composed of a number of distinguishable segments) may lead to the condemnation of the merger as a whole. Conversely, a competition problem in a single segment will inevitably lead to a search for a remedy designed to cure the narrow problem in preference to outright condemnation of the merger. However, these considerations do not, on their own, determine the boundaries of the relevant market. There are a range of factors at play in this determination of which functional interchangeability is but one, albeit important, consideration.

Accordingly, in contrast with the contentions of the parties and the Commission for a multiplicity of narrow relevant product markets, we find three relevant product markets, these being the market for industrial diamond products, the market for diamond core drilling products and the market for percussion drilling products. Within each of these relevant markets there are a number of distinguishable segments or sub-markets. These are depicted in the table below.

Table: relevant product markets and sub-markets

THE PRODUCT MARKETS	**1. INDUSTRIAL DIAMOND PRODUCTS**	**2. DIAMOND CORE DRILLING PRODUCTS**	**3. PERCUSSION DRILLING PRODUCTS**
The sub-markets within each product market	• Diamond grinding wheels. • Concrete core drill bits. • Diamond impregnated saw blades < 250mm (hand tools). • Diamond impregnated saw blades > 250 mm (construction industry).	• Underground pneumatic screw fed drills. • Underground hydraulic screw fed drills. • Underground hydraulic drills (non-screw fed < 600m). *CORE DRILLING COMPONENTS* • Drill rods • Diamond drill bits • Reaming shells	*LONG HOLE PERCUSSION DRILL CONSUMABLES* • Extension rods. • Threaded drill bits. • Shank adaptors. • Couplings. *SHORT HOLE PERCUSSION DRILL CONSUMABLES*

		• Wire line core barrels	• Non-carburised taper rods. • Knock-off bits.

The geographic market

The parties argue that consistent and extensive trade flows into SA together with the movement towards centralised global production facilities, the development of networks of national sales and distribution agents, internationally standardised products and global customers establish the international character of the geographic market. They do however concede that the markets for pneumatic and hydraulic drills and non-carburised taper rods are national markets.[7] The reasons for this reside in the peculiarities of the South African mining industry.

Although pneumatic drills are widely considered to be less efficient, environmentally unfriendly and more hazardous than hydraulic drills, South African mining houses continue to use these drills. Internationally, pneumatic drills have been almost completely replaced by hydraulic drills. South Africa is far and way the largest market for pneumatic drills.

In his testimony Mr Rice offered a persuasive explanation for this apparent anomaly. It appears that South African drilling companies pay relatively little attention to skills development and training of its labour force. This predisposes against utilization of the more technologically sophisticated alternatives and in favour of the utilization of inexpensive, technologically unsophisticated equipment such as the pneumatic drill. [8]

Following the global trend away from pneumatic drills, all the manufacturers, except the South African producers, Boart and Huddy, stopped production of pneumatic drills. Thus these pneumatic drills are only available locally from either Boart, which produces a drill called the Metereter, and Huddy, which produces the Kempe machine.

Accordingly the parties define the geographic market for pneumatic and hydraulic drills as a national market, while they aver that the geographic markets for the remaining products are international. The Commission agrees with this geographic market delineation.

7 Note that the markets for pneumatic and hydraulic drills fall within the broader category of diamond core drilling products and the market for non-carburised taper rods falls within the broader category of percussion drilling products.
8 See Mr Rice' testimony on page 64 of the transcript.

Finding on the geographic market definition

We find the parties submission on the geographic dimension of the markets to be consistent with the evidence of both Mr O'Neill and Mr Rice. [9]

It is clear that imported products are widely used in South Africa and that the products of both Boart and Huddy compete with those of international manufacturers such as Atlas Copco, JKS Boyles and Fordia. However, it is equally clear that within the diamond core drilling product category, the pneumatic drill is the one product that is still exclusively manufactured and sold in South Africa.

Huddy and Boart are the only current manufacturers of pneumatic drills. Mr Rice testified that JKS Boyles stopped producing pneumatic drills almost seven years ago.[10]

For this reason we find that the geographic market for industrial diamond products and percussion drilling products is international. In respect of diamond core drilling products we find that the market for the narrower sub-markets is also international, except for the pneumatic drill, which is national.

The table below depicts our finding on the geographic markets for the three relevant product markets and indicates which major market participants are active in the specific markets.

Table: geographic dimension and market participants

PRODUCT MARKET	**MARKET PARTICIPANTS**	**GEOGRAPHIC MARKET**
1. Industrial diamond products	AEG Tyrolit Hilti Other	International
2. Diamond core drilling products		
• **Pneumatic and hydraulic drill machines**	**Boart Longyear** **Huddy**	**National**
• Various	PDDE	International

9 See Mr O'Neill' s testimony on pages 33-50 and Mr Rice' testimony on pages 50-74 of the transcript.
10 See page 63 of the transcript.

consumable products	GSG Mining Other	
3. Percussion drilling products	Atlas Copco Secoroc Sandvik Robit Rock Tools Tungroc	International

Impact on Competition

Section 16(1) of the Act requires an assessment of whether the transaction is likely to substantially prevent or lessen competition in the relevant market.

It is common cause between the parties and the Commission that the transaction does not result in a substantial lessening of competition in the majority of the relevant sub-markets within the three categories. The primary reason for this is that theses markets are international.

However, as noted above, the market for pneumatic drills is conceded as the exception, since it is accepted that this market is a national market. In respect of this market the parties concede that the transaction will lead to a substantial lessening of competition.

The merged entity would then enjoy a monopoly in the market for pneumatic drills. Nonetheless, the parties submit that this is a declining market and that there are no patents that would prevent other manufacturers from producing these drills.[11] Hence they argue that the merged entity will not be in a position to exercise market power.

Given these low barriers to entry, they also argue that any other international manufacturer with an established network of agents in South Africa could enter this market, particularly Atlas Copco/ Secoroc. In fact at the hearing, the parties stated that Atlas Copco's catalogues advertised a competing product called the Bazooka.

11 The parties submit that 3 years ago there were approximately 1100 pneumatic machines operative in South Africa, currently there are only approximately 700operative machines. See page 94 of the record for the parties submission on the declining state of the market.

This claim was refuted by the representative from Atlas Copco. He averred that this product had long since been withdrawn from their range, that the rights have been sold and that Atlas Copco are unlikely to ever manufacture a pneumatic drill for sale in South Africa.

The Commission's view remains, however, that the transaction would lead to a substantial lessening of competition in the market for pneumatic drills in South Africa, hence its recommendation that this be remedied by a divestiture order.

We are satisfied that the transaction will not lead to a substantial lessening of competition in the markets for industrial diamond products and percussion drilling products. In respect of the international market for diamond core drilling products, we accept that there is no substantial lessening of competition in respect of all the sub-markets, except in respect of the national market for pneumatic drills.

These are clearly well-established international markets in which active cross-border trade is powerfully underpinned by well-established distribution networks, generally in the form of appointed agents, by the global procurement policies of mining houses and the lack of trade obstacles such as cross-border transportation of these products.

The agents undoubtedly play a vital role in ensuring these markets remain competitive. Both Mr Rice and Mr O'Neill testified that they sell or distribute products on behalf of various manufacturers and that they may at times procure goods from Boart of Huddy should their customers so require. We acknowledge that there is clearly active trade in these markets and there is no indication that this will change. In fact, it appears that these markets are rapidly being penetrated by low cost producers in the Far East, gaining access to customers through electronic media and who themselves benefit from the presence of established agents.

This, however, does not apply to the market for pneumatic drills.We have already found that this is a national market, with Boart and Huddy being the only two producers of these drills. Although there does not appear to be potential for growth in this market, we take no comfort from the parties' insistence that, because it is a market in decline, the anti-competitive consequences should be overlooked.

Indeed Mr Rice testified that:

> "I do believe that the Kempe business is a big part of our industry. There are lots and lots of those machines out there and I think it's important from a competition point of view that the machines, the continuity of supply of those machines must be maintained." [12]

12 See page 72 of the transcript.

The very fact that it is a stagnant market makes new entry unlikely. Furthermore the lucrative end of the market is in the provision of parts which appears to be a market comprehensively penetrated by players who sell pirated parts. Mr Rice confirmed that the board of Atlas Copco had indicated to him that it would not be interested in entering this market.[13]

Thus having found that the transaction is likely to lead to a substantial lessening of competition in the sub-market for pneumatic drills, we considered a remedy to cure this limited anti-competitive effect of the merger.

PUBLIC INTEREST

Employment

When the merger was notified to the Commission, the parties submitted that the merger would result in an estimated 145 job losses.

At the pre-hearing the parties further submitted that if the merger was *not* approved, that there would be 120 jobs lost. According to Boart, it's Springs plant requires the additional volumes that are achievable through the merger in order to

13 See page 66 of the transcript.

continue. Hence, if the merger is not approved, Boart's coring division would in all likelihood be moved outside of South Africa, to one of its US plants

In addition, Huddy contends that in the absence of the merger, it would not continue as a manufacturer. Instead it would probably and ultimately be transformed into a distribution entity. This would have further implications for its employment levels.

Given the global dynamic of the industry, we are concerned that in the absence of the merger, both Boart and Huddy would cease certain of their manufacturing operations in South Africa. We are mindful then that to prohibit the merger on employment grounds may have the unintended consequence of exacerbating the employment loss.

CONCLUSION

The remedy / the condition

It is widely accepted that the underlying objective of any remedy should be the creation of conditions for actual competition to subsist and for potential competition to emerge.[14] Having found that the merger does not lead to a substantial lessening of competition except in the narrow sub-market for pneumatic drill machines, a remedy was sought to cure the anti-competitive effect in this specific segment of the market.

The Commission recommended that the merger be approved subject to the condition that the merged entity divest of the Kempe part of the business. However, the Commission had not identified a likely purchaser. It is, moreover, reasonably clear that the Kempe business would not be viable as a stand-alone business, that, in other words, it would have to be maintained in the hands of an established player that would be able to offer the machine together with other products.[15] It appears that the Commission had initially considered Atlas Copco a potential purchaser, however this proved not to be the case.

We have previously noted our scepticism regarding divestiture remedies in circumstances where a buyer has not been identified and where there are solid reasons for questioning the post-merger viability of the divested business.[16]

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14 See the decision of the European Commission of 02.04.2003 in the Newscorp/Telepiu case, case no. COMP/M.2876 at page 228. See also this Tribunal's decision of 30 July 2003 in the Distillers Corporation Limited/Stellenbosch Farmers Winery Group Ltd case, case no. 08/LM/Feb02 at page 3.

15 See the evidence of Mr Rice at page 73.

16 See the Tribunals decision in the JD Group/ Ellerines Limited merger, case no. 78/LM?Jul00 at pages 32 to 37.

At the pre-hearing the parties were invited to provide alternative suggestions for an appropriate remedy. They offered the following alternatives:

i) a behavioural remedy in terms of which Boart would be permitted to acquire the Kempe business subject to a condition that any price increases of the Kempe product are capped to the consumer price index for a period of 3 years, alternatively

ii) that the Kempe business be excluded from the transaction, with Huddy retaining the product.

There seems to be little point in leaving the product in the hands of Huddy's present owners. They clearly intend exiting the market and to leave them with a small remnant of their existing business is to condemn the Kempe product to failure.

We sought to identify a remedy that would ensure that both the Boart product, the Metereater and the Huddy product, the Kempe pneumatic drill, remain in the market. Having considered the features of this market, in particular the important role played by the network of independent distribution agents, we decided to combine the parties proposed behavioural condition with a structural one that aims to ensure the continued supply of the Kempe pneumatic drill by requiring the acquiring party to identify two independent agents who would be entrusted with marketing and distributing the Kempe product, the manufacture of which would remain the responsibility of the post-merger entity.

The details of the remedy are set out in the order, attached hereto as annexure A.

<u>20 January 2004</u>

D. Lewis — Date

Concurring: N. Manoim, M. Holden

For the merging parties: Adv. W Pretorius, instructed by Webber Wentzel Bowens.

For the Commission: Mr M Worseley assisted by Mr M van Hooven, Competition Commission.