

Statement of Preliminary Issues

Thales S.A. and Gemalto N.V.

10 August 2018

Introduction

1. On 1 August 2018, the Commerce Commission (the Commission) registered an application from Thales S.A., or any of its interconnected bodies corporate (Thales or the Applicant), seeking clearance to acquire all of the issued and outstanding ordinary shares of Gemalto N.V (the proposed acquisition).¹ The clearance application relates to the proposed acquisition to the extent that it affects markets in New Zealand.
2. The Commission will give clearance if it is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.
3. This statement of preliminary issues sets out the issues we currently consider to be important in deciding whether or not to grant clearance.²
4. We invite interested parties to provide comments on the likely competitive effects of the proposed acquisition. We request that parties who wish to make a submission do so by **Wednesday 22 August 2018**.

The parties

5. Thales, which is based in France, supplies electronics and communications equipment for a number of different industries including the aeronautics, space, ground transportation, defence and security industries. In particular, Thales' e-Security division supplies data encryption hardware and software, which is designed to protect and secure electronic information and data. In New Zealand, Thales' encryption products are typically supplied via resellers under the brand names nShield, payShield and Vormetric.
6. Gemalto, which is based in the Netherlands, is a specialised data security company which also supplies data encryption hardware and software. In New Zealand, Gemalto supplies its products through resellers under the brand name SafeNet.

¹ A Public version of the application will be available on our website at: <https://comcom.govt.nz/case-register/case-register-entries/thales-s.a-gemalto-n.v>.

² The issues set out in this statement are based on the information available when it was published and may change as our investigation progresses. The issues in this statement are not binding on us.

Our framework

7. Our approach to analysing the competition effects of the proposed acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.³ As required by the Commerce Act 1986, we assess acquisitions using the substantial lessening of competition test.
8. We compare the extent of competition in each relevant market both with and without the acquisition. This allows us to assess the degree by which the proposed acquisition might lessen competition.⁴ If the lessening of competition is likely to be substantial, we will not give clearance to the proposed acquisition. When making that assessment, we consider, among other matters:
 - 8.1 constraint from existing rivals – the extent to which current rivals compete and the degree they would expand their sales if prices increased;
 - 8.2 constraint from potential new entry – the extent to which new competitors would enter the market and compete if prices increased; and
 - 8.3 the countervailing market power of buyers – the potential constraint on a business from the purchaser’s ability to exert substantial influence on negotiations.

Market definition

9. We define markets in the way that we consider best isolates the key competition issues that arise from the acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Commerce Act, as a matter of fact and commercial common sense.
10. The Applicant advised that, while Thales and Gemalto have a large portfolio of different products and services, the only relevant overlap between the two parties is in the area of data security. The most common way to secure data is to use an algorithm to encrypt the data. An encryption “key” (or secret code) is needed to encrypt and decrypt data.
11. Both Thales and Gemalto manufacture and supply hardware security modules (HSMs) (a type of key management product) and encryption software. To this extent, Thales submits that the relevant markets potentially affected by the acquisition are:
 - 11.1 the supply of enterprise key management products (and associated maintenance services); and
 - 11.2 the supply of enterprise encryption software for data at rest and in use.

³ Commerce Commission, *Mergers and acquisitions guidelines* (July 2013). Available on our website at: <https://comcom.govt.nz/>

⁴ *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

12. We will test whether the Applicant's market definitions for encryption key management products and for encryption software are appropriate or if it is more appropriate to assess narrower product markets.
13. In relation to key management products, Thales submits that customers have a range of encryption key management options available to them and all these options have the same purpose, which is to secure and protect an organisation's data. In the Applicant's view, these options include using:
 - 13.1 encryption software/hardware that comes with the necessary key management capabilities pre-installed;
 - 13.2 dedicated key management software running on a physical or cloud server, used either standalone or in combination with hardware;
 - 13.3 specific HSMs that can be incorporated into a business's existing IT platform or infrastructure;
 - 13.4 specific trusted platform modules (TPMs) which are microprocessors that contain pre-installed key management software; and
 - 13.5 a cloud-based encryption service which includes key management capabilities.
14. Thales submits that all of these options should be included in the relevant key management product market. In testing this view, we will consider:
 - 14.1 whether to define HSMs separately from the other types of key management products; and
 - 14.2 whether the different type of HSMs should be assessed separately, such as:
 - 14.2.1 general purpose HSMs, which are a dedicated hardware appliance running encryption software to generate, protect, and manage keys in a secure tamper-resistant module;
 - 14.2.2 payment HSMs, which are HSMs with an additional software layer that allows them to perform higher frequency operations; and
 - 14.2.3 "as a service" HSMs, which are cloud based HSMs which can be accessed by a customer on a per-use basis.
15. Given the nature of the products, the Applicant considers that the relevant geographic market for these products is global although the same competitive constraints would exist if the Commission were to consider there is a global or a New Zealand market for any of the relevant products or services. We will assess the extent to which the dynamics of competition differ in New Zealand compared to the rest of the world.

Without the acquisition

16. We will consider the likely state of competition if the acquisition proceeds and compare it with the likely state of competition if it does not. We will consider whether the without-the-acquisition scenario is best characterised by the status quo, or whether the parties would seek alternative options, for example, finding a different buyer for the assets.

Preliminary issues

17. We will investigate whether the proposed acquisition would be likely to substantially lessen competition in the relevant market (or markets) by assessing whether horizontal unilateral and/or conglomerate effects might result from the proposed acquisition. The questions that we will be focusing on are:
 - 17.1 unilateral effects: would Thales be able to profitably raise prices to its customers or reduce quality by itself?; and
 - 17.2 conglomerate effects: are there any “must have” products in the range of either of the merging parties that would result in the merged entity having greater ability and/or incentive to prevent or hinder rivals from competing effectively by bundling and/or tying products?

Unilateral effects: would Thales be able to profitably raise prices by itself?

18. Where two suppliers compete in the same market, a merger of the two would remove a competitor that would otherwise act as a competitive constraint, potentially allowing the merged entity to unilaterally raise prices or lessen quality. In industries where firms compete to supply innovations to the market, a merger could also reduce the amount of innovation post-merger.⁵

Supply of enterprise key management products

19. Thales and Gemalto overlap in the supply of certain types of HSMs:
 - 19.1 general purpose HSMs. Thales’ products includes the nShield Connect and the nShield Edge. Gemalto’s products include the SafeNet Luna and the ProtectServer; and
 - 19.2 payment HSMs. Thales’ products include the payShield 9000. Gemalto’s products include the SafeNet Luna EFT.
20. In addition, both parties supply encryption software and/or hardware products which contain key management capabilities. Thales’ products includes the Vormetric data security manager and Gemalto’s products include SafeNet KeySecure and SafeNet Virtual KeySecure.

⁵ For ease of reference, we only refer to the ability of the merged entity to “raise prices” from this point on. This should be taken to include the possibility that the merged entity could reduce quality or worsen an element of service (ie, it could increase quality-adjusted prices), and include reduced levels of innovation.

21. Both Thales' and Gemalto's HSMs enable the secure exchange of information in order to protect the privacy of information and guarantee the authenticity of electronic communications. The Applicant stated that these HSMs can be supplied via an external, tamper-resistant device or via a plug-in device that is added to a computer or network server.
22. We will focus on whether the loss of competition between Thales and Gemalto in the supply of HSMs would enable Thales to raise prices. Thales submits that the proposed acquisition would not have the effect of substantially lessening competition because:
 - 22.1 there are a number of other global suppliers of equivalent HSM products who could easily expand their existing presence in New Zealand; and
 - 22.2 existing customers are switching to cloud-based security services, which compete directly with the general purpose and payment HSM products that Thales and Gemalto currently supply.
23. To assess whether the proposed acquisition may enable Thales to raise prices in the supply of the different types of HSMs in New Zealand, we will assess:
 - 23.1 how closely Thales and Gemalto compete against one another, including the extent to which innovation plays a role in any competition between the two parties;
 - 23.2 the degree of constraint that rival producers of HSMs or other key management products such as software or cloud based solutions would provide on Thales;
 - 23.3 if the acquisition would be likely to result in price increases, whether entry or expansion would be likely, timely, and sufficient in extent to defeat those increases; and
 - 23.4 whether customers have special characteristics that would enable them to resist a price increase by Thales.

Supply of enterprise encryption software

24. Both Thales and Gemalto supply a range of enterprise encryption software for data at rest and in use: Thales supplies its range under the brand name of Vormetric; and Gemalto supplies a similar range under the brand name SafeNet.
25. Thales submitted that it would be constrained by a range of large suppliers who all have both a New Zealand and a global presence including: Microsoft; Oracle; Dell EMC; and Seagate Technology.
26. We will assess whether the proposed acquisition may enable Thales to raise prices in the supply of enterprise encryption software, including assessing:
 - 26.1 how closely Thales and Gemalto compete against one another; and

- 26.2 the degree of constraint that rival suppliers of encryption software would provide on Thales.

Conglomerate effects: would the merged entity be able to foreclose rivals?

27. A conglomerate merger is a merger between firms that supply products that may relate to each other (eg, complementary products). A conglomerate merger could enable the merged entity to hinder rivals' ability to compete by:
- 27.1 providing bundled discounts to customers that buy the merging parties' products together rather than separately; or
 - 27.2 tying, where the merged entity refuses to sell one of the merging parties' products (usually a "must have" product) unless customers also buy the other parties' product/s.
28. Such bundling or tying could foreclose rivals through their inability to offer products comparable to the tied or bundled products and ultimately reduce competition in the long-run.
29. The Applicant submits that Thales and Gemalto offer complementary ranges of products. We will consider whether either of the parties has "must have" products and whether the proposed acquisition would likely give the merged entity the ability and incentive to engage in behaviour, such as bundling or tying, which might foreclose rivals in the relevant markets. In doing so we will consider products both within and outside the relevant markets.

Next steps in our investigation

30. The Commission is currently scheduled to make a decision on whether or not to give clearance to the proposed acquisition by **Wednesday 26 September 2018**. However, this date may change as our investigation progresses.⁶ In particular, if we need to test and consider the issues identified above further, the decision date is likely to extend.
31. As part of our investigation, we will be identifying and contacting parties that we consider will be able to help us assess the preliminary issues identified above.

Making a submission

32. If you wish to make a submission, please send it to us at registrar@comcom.govt.nz with the reference "Thales/Gemalto" in the subject line of your email, or by mail to The Registrar, PO Box 2351, Wellington 6140. Please do so by close of business on **Wednesday 22 August 2018**.

⁶ The Commission maintains a clearance register on our website where we update any changes to our deadlines and provide relevant documents: <https://comcom.govt.nz/case-register>

33. Please clearly identify any confidential information contained in your submission and provide both a confidential and a public version. We will be publishing the public versions of all submissions on the Commission's website.
34. All information we receive is subject to the Official Information Act 1982 (OIA), under which there is a principle of availability. We recognise, however, that there may be good reason to withhold certain information contained in a submission under the OIA (eg, in circumstances where disclosure would unreasonably prejudice the supplier or subject of the information).