



COMMERCE COMMISSION

Decision No. 726

Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving:

NEW ZEALAND COMFORT GROUP LIMITED

and

DUNLOP LIVING LIMITED

The Commission: Mark Berry
Sue Begg
Anita Mazzoleni

Summary of Application: The acquisition by New Zealand Comfort Group Limited of all of the business assets of Dunlop Living Limited.

Determination: Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for New Zealand Comfort Group Limited to acquire all of the business assets of Dunlop Living Limited subject to the divestment undertaking dated 22 June 2011 provided by New Zealand Comfort Group Limited to the Commission pursuant to section 69A of the Commerce Act 1986.

Date of Determination: 24 June 2011

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THE PROPOSAL

1. A notice under s 66(1) of the Commerce Act 1986 (the Act) was registered on 5 May 2011. The Notice sought clearance for New Zealand Comfort Group Limited (Comfort Group or the Applicant) to acquire all of the business assets of Dunlop Living Limited (Dunlop).
2. On 27 May 2011, the Commission raised a number of competition concerns in relation to the manufacture and supply of foam underlay. On 31 May 2011, the Commission received a draft divestment undertaking from Comfort Group in respect of the manufacture and supply of foam underlay. If divestment undertakings are accepted by the Commission, they are deemed to form part of the clearance given.
3. The Commission received and accepted the Applicant's ultimate divestment undertaking on 22 June 2011. Accordingly, the divestment undertaking forms part of the proposed acquisition.

PROCEDURE

4. Section 66(3) of the Act requires the Commission to either clear or decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and Comfort Group. Accordingly, a decision on the application was required by 24 June 2011.
5. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's Mergers and Acquisitions Guidelines.¹

ANALYTICAL FRAMEWORK

6. The Commission uses an analytical framework for assessing a substantial lessening of competition in the context of an acquisition. The first step is to determine the relevant market or markets. To do this, the Commission identifies the areas of overlap between the acquirer and the target, and then considers what, if any, products and geographic regions, constitute relevant close substitutes from both a customer's and a supplier's point of view.
7. The Commission uses a forward-looking type of analysis to assess whether a substantial lessening of competition is likely, so an important subsequent step is to establish the appropriate hypothetical future with and without scenarios, defined as the situations expected:
 - with the acquisition in question (the factual); and
 - in the absence of the acquisition (the counterfactual).
8. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the proposed acquisition.²
9. A comparison of the extent of competition in the relevant markets in the factual and counterfactual scenarios enables the Commission to assess the probable extent of the lessening of competition under the proposed acquisition, and whether that contemplated lessening is likely to be substantial.

¹ Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.

² *Decision No. 277: New Zealand Electricity Market*, 30 January 1996, p 16.

10. Under section 69A of the Act, the Commission, in giving a clearance, may accept undertakings to dispose of assets or shares. Under section 69A(2) of the Act the Commission is only able to accept structural undertakings. If divestment undertakings are accepted by the Commission, they are deemed to form part of the clearance.
11. As set out in the Commission's Mergers & Acquisitions Divestment Remedies Guidelines (Divestment Guidelines) upon receiving a divestment undertaking, the Commission will first consider whether, absent the divestment, the proposed acquisition is likely to result in a substantial lessening of competition in the relevant market, namely the carpet underlay market in this instance.
12. The Commission will then consider whether the proposed divestment undertakings would be sufficient to remedy that likely substantial lessening of competition.
13. The Commission's analytical framework for assessing divestment undertakings is set out in the Divestment Guidelines. The Commission's assessment of the market and divestment undertakings will be on a case by case basis to ensure that the divestment undertakings are sufficient to remedy the specific competitive harm. As set out in the Divestment Guidelines, the Commission assesses the risks associated with divestment undertakings within the analytical framework that comprises:
 - composition risks;
 - asset risks; and
 - purchaser risks.
14. Overall, the Commission must be satisfied that the divestiture package remedies the competitive harm that would occur absent the divestment.

KEY PARTIES

Comfort Group

15. Comfort Group (formerly known as Sleepyhead Manufacturing Limited) manufactures and supplies beds. It also manufactures polyurethane foam (foam). Most of this foam is for use in its own bed manufacturing. Comfort Group also manufactures foam carpet underlay and latex foam.
16. The Turner family, which are the owners of Comfort Group, also have ownership links with Beds R Us Limited. Beds R Us is a retailer of beds with stores throughout New Zealand.

Dunlop

17. Dunlop is a manufacturer and supplier of beds. Like Comfort Group, it manufactures foam which it then uses in its own bed manufacturing. Dunlop also manufactures foam carpet underlay. There are no common shareholders or directors between Comfort Group and Dunlop.

OTHER PARTIES

Sealy New Zealand Limited (Sealy)

18. Sealy is a local manufacturer of beds. It is partly owned by its licensor in the United States; the world's largest bed company. Sealy sells its beds through a range of retailers, including Harvey Norman, Bed Post, Big Save and Furniture City.

AH Beard Limited (AH Beard)

19. AH Beard is a local manufacturer of beds, which it sells beds under a range of brands, including King Koil and Nature's Rests. AH Beard sells its beds through Harvey Norman, Waitemata Sleep Solutions and other independent retailers.

Joyce Foam Pty Limited (Joyce)

20. Joyce is a large Australian foam manufacturer. It produces a wide range of foams including foams for the bedding industry. Joyce's foam is imported into New Zealand by Nexus Foams (Nexus).

Auckland Foams Limited and Mainland Foams Limited

21. Auckland Foams and Mainland Foams (companies with a common ownership) manufacture and convert foam for supply to various end users. These companies operate plants in Auckland and Christchurch.

Nexus Foams Limited (Nexus)

22. Nexus is a local foam converter. Foam converting involves cutting foam blocks into various shapes and sizes to meet the requirements of end users. Nexus supplies a wide range of industries including the furniture and bedding industries.

Jacobsen Creative Surfaces Limited (Jacobsen)

23. Jacobsen is a large supplier of various flooring products. Of relevance to this acquisition is its importation and supply of rubber and foam underlay.

Airstep Australia Pty Limited (Airstep)

24. Airstep (formerly Bridgestone) is an Australian company that currently manufactures and distributes rubber carpet underlay. It supplies rubber underlay in New Zealand through Jacobsen. Airstep is presently establishing a foam underlay plant in Australia.

James Halstead Flooring New Zealand Limited (James Halstead)

25. James Halstead distributes flooring products, including carpet underlay. Previously, it imported underlay from China, but is no longer doing so.

Large Carpet/Underlay Buying Groups

26. New Zealand has four large carpet and underlay buying groups. These are Carpet One, Flooring Xtra, Flooring First and Flooring Brands.³ These groups seek tenders and pricing from underlay suppliers approximately once a year.

INDUSTRY BACKGROUND**Bedding**

27. Box base beds are a mattress and bed base set. These are manufactured using foam, latex, springs and other inputs in various combinations. Imports of box base beds have increased in the last five years.
28. Bed manufacturers supply their products to retailers for on-sale to consumers. Retail channels include national retail chains, such as Harvey Norman, Farmers, Smith City, and national or regional specialist bed retailers, such as Bed Post and Beds R Us.

³ Flooring Brand trades under various names, the most well known which is Carpet Court.

Foam

29. Foam can be produced in a wide range of grades of varying hardness, stiffness and densities. There are a wide range of uses for foam, including upholstered furniture, car seats, mattresses, underlay, or in garments. The principal end users of foam in New Zealand are bedding and upholstered furniture manufacturers.
30. In recent years, the size of the domestic foam industry has decreased. The applicant states that in 2000, about 4,700 metric tonnes of foam was used in New Zealand per annum, but that is now down to just over 3,000 tonnes per annum. This follows a reduction in the demand for foam from large downstream users. This is especially evident in the furniture industry which has seen a significant increase in the importation of finished products that use foam as an input. Accordingly, there is a high level of excess capacity in the foam industry in New Zealand.
31. In New Zealand, foam is produced using either a continuous slab foaming process or a box foaming process. Comfort Group and Dunlop use the continuous slab foaming process. This process enables a manufacturer to produce foam in much greater volumes and ensure more consistent quality.
32. Mainland Foams and Auckland Foams use the box foaming process. Industry participants advised the Commission that the box foaming process is unable to produce foam in significant volumes and may be more susceptible to variations in quality.
33. Foam off-cuts are a by-product of foam production. Foam off-cuts are the key input in the manufacture of foam underlay.
34. As noted in *Decision No 641: Vita Foam New Zealand Limited/Pacific Brands Holdings(NZ)* 24 April 2008, imports of foam have previously been confined mainly to speciality grades, but in the last two years foam imports have extended to bedding and furniture grades of foam. Joyce, a large Australian foam producer, supplies bedding foams to two bed manufacturers (Sealy and AH Beard), through Nexus. In addition, Joyce is supplying Nexus with foam which Nexus converts and/or supplies to other end users.

Carpet Underlay

35. Underlay is the thin layer of cushioning that is laid beneath carpet. In New Zealand around 95% of underlay is manufactured from scrap foam. Rubber underlay accounts for the balance of sales.
36. Comfort Group and Dunlop both manufacture underlay using foam off-cuts. Both source 90% of their foam off-cuts from overseas. The remaining 10% comes from their own foam manufacturing plants.
37. Small volumes of foam underlay from Asia are imported into New Zealand on an intermittent basis.
38. Large buying groups purchase underlay directly from either Comfort Group or Dunlop. Smaller independent retailers acquire underlay from a wholesaler/distributor, such as Gilt Edge Industries Limited or James Halstead.
39. The Applicant estimates that four customers (Flooring Brands, Flooring Xtra, Carpet One and Gilt Edge Industries) account for at least []% of carpet underlay sales. Flooring Brands and Carpet One accounted for []% of Dunlop's underlay revenue in 2010/2011.
40. Industry participants advised the Commission that underlay can account for around 20% of the installed cost of carpet.

MARKET DEFINITION

41. The Act defines a market as:⁴
- a market in New Zealand for goods or services as well as other goods or services that as a matter of fact and commercial common sense, are substitutable for them.
42. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit maximising, sole supplier of a good or service, not constrained by the threat of entry would impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.
43. Comfort Group submitted that, consistent with Decision 641, the markets affected by the proposed acquisition are the national markets for the manufacture and/or importation and wholesale supply of:
- foam; and
 - carpet underlay.
44. In addition, Comfort Group submitted that the national market for the manufacture and/or importation and wholesale supply of box base beds is also relevant for the purpose of the current application.
45. The Applicant submitted that foam and rubber underlay are substitutable on the basis of functionality and price. Some market participants advised the Commission that most rubber underlay is not substitutable for foam underlay because it is considerably more expensive and is of a lesser quality.
46. For the purposes of the analysis, the Commission considers that it is appropriate to adopt a market definition that includes both foam underlay and rubber underlay. This is because:
- while a niche product, rubber underlay continues to be offered for sale by some carpet retailers; and
 - rubber underlay represents around 5% of the underlay market and the competition analysis is unlikely to be different irrespective of which market definition is adopted.

Conclusion on the Relevant Markets

47. The Commission concludes that the markets relevant to the present application are the national markets for the manufacture/importation and wholesale supply of:
- box base beds (bedding market);
 - foam (foam market); and
 - foam and rubber underlay (underlay market).

⁴ Section 3(1A) of the Act.

ASSOCIATION

48. A preliminary question the Commission must determine is whether the Applicant is associated with any other parties in the relevant market. Section 47(1) of the Act refers to an acquisition by a person. A person is defined as including two or more persons that are interconnected or associated under section 47(2) of the Act.
49. Sections 47(3) and (4) of the Act set out when two or more persons are associated. Two corporate entities are associated if one, either directly or indirectly, is able to exert a “substantial degree of influence” over the activities of the other. The Commission is of the view that, in this context, a substantial degree of influence means being able to bring real pressure to bear on the decision making process of the other, even if that pressure falls short of control.⁵
50. In determining whether parties are associated, each case must be considered in light of its particular facts. Typically, the Commission takes into account the:
- nature and extent of ownership links between the companies;
 - presence of overlapping directorships;
 - rights of one company to appoint directors of another; and
 - nature of other shareholder agreements and links between the companies concerned.
51. The Commission also considers the interaction between these various factors. For example, the Commission assesses the nature and extent of the communications between those persons, and the apparent influence of one person on the key strategic decisions of the other.⁶
52. [
-]
53. Nevertheless, the Commission considers that for the time-being Beds R Us Limited and Comfort Group are currently associated.

COUNTERFACTUAL

54. While several parties have been approached by Dunlop to buy its assets, with the exception of Comfort Group, there are no other serious bidders at this time.
55. Absent the transaction, Comfort Group and Dunlop would []. Accordingly, the Commission considers that the likely counterfactual is the status quo.

COMPETITION ANALYSIS

Bedding Market

56. The Applicant submitted that it would continue to face constraint in the bedding market from:

⁵ Commerce Commission, *Decision No.278: Air New Zealand/Ansett Holdings Ltd/Bodas Pty Ltd*, 3 April 1996.

⁶ Commerce Commission Decision No. 388: *New Zealand Seafood Investments Ltd/Basuto Investments Ltd*, 23 March 2000.

- significant New Zealand bedding manufacturers, Sealy and AH Beard;
- smaller New Zealand manufacturers;
- imports; and
- the countervailing power of large bed retailers.

57. Table 1 outlines the market shares for the major firms in the bedding market.

Table 1: Market Shares for the Bedding Market 2010/2011

Company	NZ\$ million	%
Comfort Group	[]	[]
Dunlop	[]	[]
Merged Entity	[]	[]
Sealy	[]	[]
AH Beard	[]	[]
Others	[]	[]
Imports	[]	[]
Total	[]	100

Source: Industry participants and Commission estimates

58. Table 1 shows that post acquisition, the merged entity would have a market share of []% and the three-firm concentration ratio would increase from []% to []%. In addition, the acquisition would result in the removal of the [] competitor.
59. Sealy and AH Beard compete directly with Comfort Group and Dunlop products. Harvey Norman stocks Sealy and AH Beard products along side Dunlop products. Glenn Wahlstrom, General Manager of Sealy and Pam Slater, New Zealand Branch Manager for AH Beard advised the Commission that they []].
60. There are at least five other small bed manufacturers in New Zealand. Although individually small in size, industry participants advised the Commission that these smaller players provide some constraint on the larger bed manufacturer's pricing to large retail chains. []].
61. Bed retailers had little concern regarding the transaction. Michael Power, CFO of Farmers, informed the Commission that []].
62. The Applicant submitted that imports form a significant proportion of the relevant market and would continue to act as a constraint post-acquisition. Most industry participants canvassed by the Commission agreed, advising that imports are extremely competitive on price despite freight costs.

63. [] raised concerns that the merged entity would have significant exposure at the retail level due to the exclusive arrangement between Comfort Group and Beds R Us stores.
64. The Commission considers that the strengthening of vertical integration that would arise as a result of the acquisition would be unlikely to cause competition concerns, as post-acquisition, the Applicant would be unlikely to have market power at any of the affected functional levels. While the merged entity would have the largest market share in the bedding market, the threat of expansion by existing competition and the ease of switching for large retail chains would prevent the exercise of any market power that might exist.

Co-ordination in the bedding market

65. The Applicant submitted the proposed acquisition would not increase the likelihood of co-ordination in the bedding market. The Commission notes that the acquisition would reduce the number of large competitors from four to three. However, the large number of fringe competitors combined with the ease and competitiveness of imports would continue to make co-ordination unlikely in the factual.

Overall Conclusion on the Bedding Market

66. The Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the bedding market. This is because the combined entity would be constrained by a combination of:
- two strong existing competitors, Sealy and AH Beard, who each have the ability and incentive to expand;
 - the ease of importing beds;
 - the fact that smaller players provide some constraint on the larger bed manufacturer's pricing to large retail chains; and
 - the ability of large retail chains to easily switch between suppliers.
67. Additionally, the Commission considers that the scope for coordination in the bedding market is unlikely to be enhanced in the factual.

Foam Market

68. The Applicant submitted that:
- there is little difference in competition between the factual and counterfactual because []% of the foam manufactured by Comfort Group is used in-house;
 - it is not feasible for Comfort Group to expand its foam plant to supply external customers; and
 - even if it could expand its plant, its ability to compete in foam would be limited because the significant foam customers are competing bed manufacturers who are reluctant to purchase foam from a competitor.
69. Table 2 provides market shares for the firms that manufacture and supply foam.⁷

⁷ The Commission considers it appropriate to measure foam market shares by tonnage. This is because there is a wide variety of foam density grades each with different levels of pricing.

Table 2: Market Shares for Foam Market 2010/2011

Company	Tonnes per annum	%
Comfort Group	[] ⁸	[]
Dunlop	[] ⁹	[]
Merged Entity	[]	[]
Auckland Foams and Mainland Foams	[]	[]
Joyce (imports)	[]	[]
Total	[]	100

Source: Industry Participants.

70. Table 2 shows that post acquisition, the merged entity would have a market share of []%, an increase of []%. The three-firm concentration ratio would increase from []% to 100%.
71. The Commission has given consideration to the extent to which Comfort Group's potential to supply foam would provide constraint on the foam market post acquisition. Some industry participants considered that it would not be difficult for Comfort Group to expand its foam plant to produce a greater variety of grades. This would enable it to sell to external customers such as competing bed manufacturers.
72. However, Comfort Group advised the Commission that its foam production plant is specifically configured to produce long blocks of a relatively narrow range of bedding grade foam. It does not have the storage capacity for hot stocks¹⁰ or the equipment to convert non-bedding grade foams. []].
73. The Commission []].
74. The Commission therefore concludes that Comfort Group would be unlikely to be a significant competitor in the foam market either with or without the transaction.
75. The Commission also considers that Australian foam manufacturer Joyce, which supplies foam into New Zealand via Nexus, would provide a constraint on the merged entity. Joyce advised the Commission that []].

Co-ordination in the foam market

76. The Applicant submitted that the acquisition would not increase the likelihood of co-ordination in the foam market because of low barriers to entry, imports, asymmetry of market shares and a variety of cost structures and the countervailing power of acquirers.

⁸ Comfort Group's external sales of foam.

⁹ Dunlop's external sales of foam.

¹⁰ After foam is poured, it must be stored for a number of days while it cools.

77. The Commission considers that import competition and the presence of excess capacity in the industry would continue to make co-ordination unlikely in the factual.

Overall Conclusion on the Foam market

78. The Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the foam market because:
- Comfort Group would be unlikely to be a significant competitor in the foam market either with or without the transaction; and
 - the merged entity would be constrained by Joyce, which has the ability and incentive to expand.
79. Additionally, the Commission considers that the scope for coordination in the foam market is unlikely to be enhanced in the factual.

Carpet Underlay Market

80. As stated in paragraph 11, the Commission will first consider whether, absent the divestment, the proposed acquisition is likely to result in a substantial lessening of competition in the underlay market. If this is the case, then the Commission will then consider whether the proposed divestment undertakings would be sufficient to remedy that likely substantial lessening of competition.

81. The Applicant submitted that:
- the merged entity will continue to face potentially enhanced competition from local underlay manufacturers (Padco and Pinnacle);
 - importing underlay is relatively easy and there are a number of importers (actual and potential) that could start importing or increasing their existing level of imports;
 - there are no impediments to prevent an underlay customer from switching suppliers;
 - entry into the underlay market can be effected either by importing underlay or by establishing a new manufacturing plant; and
 - acquirers have countervailing power.

82. Table 3 provides estimated market shares for the carpet underlay market.

Table 3. Estimated Market Shares for Foam Underlay Market

Company	\$ Revenue 2010/2010	%
Comfort Group	[]	[]
Dunlop	[]	[]
Merged Entity	[]	[]
Padco	[]	[]
Pinnacle	[]	[]
Imports	[]	[]
Total	[]	100%

Source: Industry participants and Commission estimates.

83. Table 3 shows that post acquisition, the merged entity would have a market share of around []%. The three-firm concentration ratio would increase from []% to []%.

Existing Competition

Loss of competition between Comfort Group and Dunlop

84. Comfort Group estimates that there are four underlay customers who collectively account for at least []% of the underlay market. Those parties comprise three large carpet retail chains and one large distributor. Industry participants advised the Commission that Comfort Group and Dunlop compete strongly for the business of the major carpet retailers, most of which purchase through a competitive tendering process.
85. When considering tender bids, a number of factors are considered by large retailers including competitive price, consistency of quality and the ability to supply large volumes on a continuous and timely basis.
86. Comfort Group and Dunlop are the only entities that currently participate in the tender rounds. [], stated that Dunlop and Comfort Group are the only suppliers that can satisfy the company's purchasing criteria. [] advised the Commission that if the acquisition proceeded it "would be disastrous for us because we would have lost any leverage we had to drive a good deal."
87. [] noted that it currently receives a []% rebate from Dunlop, its current underlay supplier. It considers that if the acquisition proceeded, the merged entity would significantly reduce its rebate. [] considers that its terms of trade would be "levelled out with everyone else" (i.e. not reflect [] purchases).
88. [] also told the Commission that there are no alternatives to the merger participants. [] considered that the merged entity would increase prices. [] noted it "would become difficult" if the merged entity raised its prices post acquisition. [] stated:
- Right now, I couldn't give you an option as I don't know of anyone that is bringing underlay into the country that would be a trustworthy source.
89. [] advised the Commission that Dunlop is pricing very competitively at present, and that Dunlop has reduced the price for one type of underlay. [] noted that there are currently no alternatives to Comfort Group and Dunlop.
90. Comfort Group and Dunlop are also the only suppliers of underlay to wholesalers that on-supply to smaller retailers. Wholesalers consider that aside from the merged entity there are unlikely to be any effective options post acquisition.

Competition from Padco and Pinnacle

91. The only other existing domestic producers of underlay are Padco and Pinnacle.
92. Padco produces a foam underlay made of solid foam. It is made on a small scale and not made from foam chip, which is scrap product. These factors make it considerably more expensive than foam chip underlay.¹¹ Pinnacle manufactures rubber underlay from recycled tyres, which is also a more expensive product than foam underlay. Padco and Pinnacle currently supply a limited number of retailers in the North Island.
93. Industry participants told the Commission that Padco and Pinnacle are niche or "top end" producers. Carpet retailers such as Carpet One and Flooring Brands stated that neither represent a competitive option given their small size.

¹¹ For example, Padco advised the Commission that the retail price for its prime foam underlay is \$31.00 per broadloom metre while the price of high end foam chip underlay is \$21-23 a broadloom metre.

94. Russell Morgan, Director of Padco, told the Commission []. Roger Brady, Managing Director of Pinnacle, told the Commission that [].
95. Accordingly, the Commission considers that neither Padco nor Pinnacle would be likely to provide any effective constraint on the merged entity in the factual.

Import Competition

96. The Commission notes that there have been imports of foam underlay in recent years. Pacific Brands imported significant volumes of foam underlay from a related party until 2008. It ceased importation following Dunlop's (then called Vita New Zealand) acquisition of Pacific Brands in 2008. []

[].¹²

97. The Commission therefore concludes that Pacific Brands Australia does not represent a potential competitive constraint in respect of actual or potential importation of underlay.

98. Imports of foam underlay have also been made from China periodically. Jacobsen imported a large volume of Chinese foam underlay over a two year period (2008/09). However, Jacobsen ceased doing so in 2010 because:

[]

99. Jacobsen advised that a price increase of [] for domestic underlay would be necessary for it to recommence importation. []

100. The Commission is aware that other parties have been involved in importing small volumes of foam underlay from China. These include Flooring Wholesale, James Halstead and Greig and Esterman. However, these parties are no longer importing underlay.¹³ [] cited quality and logistical factors as reasons for discontinuing imports from China.

101. The only party the Commission is aware of that is importing foam underlay at present is Real Value Marketing (RVM). RVM imports small amounts of underlay from China. It currently imports approximately [] per month which it distributes to retail stores in the top half of the North Island. []

].

102. []

]

103. The Commission considers that RVM []

]. In addition, the

¹² []

¹³ []

]

volume of underlay it is importing is negligible compared to the volumes that Comfort Group and Dunlop manufacture. Although RVM could expand its current volume of imports, the Commission is of the view that obstacles are likely to remain, including []. The Commission therefore considers that RVM would be unlikely to constrain the merged entity in the factual in the next two years.

104. Carpet retailers have not expressed any interest in importing themselves, or sponsoring entry. For example, [] advised the Commission that it has considered importing underlay. However, it was deterred due to the quality issues and the “logistical nightmare” of importing large volumes, warehousing the product and distributing it to its retail outlets. Similarly, [] has considered importing underlay from China. It advised the Commission that it was not straightforward due to logistical, “just in time” delivery requirements.

105. [] advised the Commission that importing underlay was not feasible. It stated:

There have been many retailers and importers / distributors who have attempted to bring underlay in from Asia over the years. On the face of it this plan appears to be a very good way of saving cost. We have looked at it ourselves on a number of occasions, including again quite recently with the NZD such as it is. However, none of those that have tried it have kept going with the plan. Importing underlay has turned out to be a very difficult and a largely unsuccessful exercise for everyone that has ever tried it. Underlay is a cheap bulky product. Shipping underlay is like shipping bags of candy floss. A whole container load of underlay is only worth \$20-\$25K, yet the shipping costs from Asia are \$3K-\$4K. It is therefore difficult for suppliers in Asia to compete in New Zealand. All those that have tried have stopped after the first one or two containers because any perceived price advantage has turned out to be less significant than it first appeared, and there invariably ends up being quality control and other supply issues.

[] consumes around [] containers of underlay a year,[] has never attempted to bring in even one container of underlay from outside of New Zealand; the current pricing of NZ manufactured product is such that the risk is too great for the likely reward.

106. One large carpet retailer, [] advised that it has explored pricing from China. While it accepts quality issues arise in respect of underlay sourced from China, if the price was significantly lower than a domestic supplier, this could compensate for quality issues.

Overall conclusion on existing competition

107. The Commission considers that there would be a significant loss of competitive constraint post acquisition because:

- the strong competitive rivalry between Comfort Group and Dunlop would be lost;
- the constraint from existing competitors Padco and Pinnacle would be negligible;
- imports would be unlikely to constrain the merged entity; and
- most large customers would be unwilling to import underlay themselves.

Potential Competition

108. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry. The Commission’s focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any impediments they might encounter should they try.

109. The Applicant submitted that new entry into the underlay market can be affected either by importing underlay or by establishing a local manufacturing capability.

Imports

110. The Applicant submitted that there are very few requirements for potential importers to enter the market. It has identified two Australian foam manufacturers, Airstep and Regen Foam as potential entrants via imports and has also referred to the previous history of imports from Australia through Pacific Brands.

111. As discussed above, the Commission does not consider that imports, whether by existing parties or previous importers would be likely to constrain the merged entity post acquisition.
112. However, the Commission was advised by Airstep (previously Bridgestone), a large rubber underlay manufacturer in Australia, that it is in the process of establishing a foam underlay plant in Melbourne. It intends to commence manufacturing in Australia shortly. Airstep stated that it expected to be supplying some of its foam underlay from this plant to New Zealand by []. It intends to use Jacobsen as its distributor as they have a long association in respect of the distribution of Airstep's rubber underlay products in New Zealand.

113. [

]

114. The Commission also discussed Airstep's proposed entry with Jacobsen. Jacobsen advised that:

- [];
- [];
- [];
- []; and
- []

115. Jacobsen stated that:

[

]

116. []

117. [] considers that Airstep would find it very difficult to enter the New Zealand market. It states:

[

]

118. While [] expressed confidence about the ability of Airstep to compete, others advised that they had the following concerns:

- uncertainties in respect of price competitiveness;
- uncertainties about quality; and
- the lack of a track record.

119. The Commission is of the view that while it is possible that Airstep will enter the underlay market, in the absence of any documentation of entry plans and the reservations expressed by [], there is insufficient information available at this time for the Commission to be satisfied that Airstep would likely to be an effective constraint on the merged entity.

120. The Commission also spoke with Regen Foam about the potential for entry into New Zealand underlay market via greenfields entry or imports. Regen Foams is a manufacturer of foam underlay. It has a manufacturing plant in Victoria and considers itself to be the third largest producer of underlay in Australia after Dunlop Australia and Airstep. Regen Foams supplies foam throughout Australia and has excess capacity.

121. [

]

122. [

]

Greenfields Entry

123. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and effect of market conditions that impede entry.

124. The Applicant considers that greenfields entry could be readily achieved, although it notes that this option would be more difficult than imports. The applicant stated that an underlay plant could be acquired and installed for approximately NZ\$965,000. Access to foam off-cuts would also be a requirement, but it considers foam off-cuts can be easily imported as demonstrated by Comfort Group and Dunlop. In addition, the Applicant provided a financial model to demonstrate that establishing a new underlay plant could be profitable with a []% market share on current prices, and even more profitable if prices were []% higher than current levels.

125. Industry participants advised the Commission that the Applicant's figure of NZ\$965,000 understates the likely cost of entry. [

]

126. [] considered that given that underlay is a high volume/low margin product, it believed that the time horizon to recover its investment would be too long and so did not pursue greenfields entry. In any event, its sales of underlay diminished significantly due in part, to loss of business to other distributors. It believes that a price increase of 20% for underlay in the New Zealand market would be necessary if it were to reconsider entry.

127. Regen Foams confirmed that the manufacture of underlay is a high volume/low margin business and considered that there are substantial costs in establishing a new plant []. [

]

Conclusion on Potential Competition

128. The Commission concludes that the merged entity would face no real constraint from potential competition.

Countervailing Power

129. In some circumstances the potential for the merged entity to exercise market power may be sufficiently constrained by a buyer or supplier to eliminate concerns that an acquisition may lead to a substantial lessening of competition.
130. As discussed previously, there are currently four large carpet retailing groups and some large wholesalers/distributors which are large purchasers of underlay and are well informed about the sources of supply. The large retailers secure their supply of underlay through a competitive tendering process.
131. The large retailers have established satisfactory supply arrangements with one or either of the two major underlay suppliers. They advised the Commission that they consider the only companies that can meet their requirements are Comfort Group and Dunlop. Currently, they are able and prepared to switch between Comfort Group and Dunlop, or credibly threaten to switch, when faced with a price rise. This option would be removed in the factual.
132. The Commission has given consideration to three options that the underlay purchasers might have when switching suppliers. These are:
- existing domestic underlay manufacturers (Padco or Pinnacle);
 - imports either directly or through an importer/distributor; and
 - entry either directly or through sponsoring another party to enter.
133. As discussed above, the Commission considers that none of these options would be likely to represent an effective alternative if the merged entity were to increase its prices by 15 to 20%, which industry participants estimated would be necessary to encourage entry. The reasons are as follows:
- neither Padco nor Pinnacle constitutes an alternative source of supply as they produce a more expensive underlay and in any event are unlikely to have the capacity to meet the volume requirements of the large carpet retailers;
 - as discussed, imports from China have been rejected by most purchasers on quality, logistical and price grounds. While imports from Australia (via Airstep) may take place, most purchasers place little weight at this time on those imports as a potential constraint on the merged entity because Airstep has yet to produce any foam underlay and establish a record as a credible supplier; and
 - greenfields entry would be unlikely.

Overall Conclusion on the Underlay Market

134. The Commission has considered the impact the acquisition would have in the underlay market.
135. Currently, Comfort Group and Dunlop provide a strong competitive constraint on each other. This rivalry would be lost in the factual.
136. The Commission considers that, absent the divestment, there would be few constraints on the merged entity in the factual compared with the counterfactual because:
- the merged entity would have around []% of the underlay market and would be the only supplier to key retail and wholesale channels;
 - the small existing competitors are specialist and are not considered to be credible alternatives;

- current imports are sporadic, and in very small volumes compared to Comfort Group and Dunlop's output;
- most large customers would be unlikely to directly import themselves;
- there is insufficient information available at this time to conclude that Airstep would be an effective competitor;
- greenfields entry would be unlikely; and
- the lack of any countervailing power from large customers who would have no credible alternatives.

137. Accordingly, the Commission considers that absent the divestment, it cannot be satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the underlay market.

The Divestiture Package

138. The Applicant has offered to divest the polyurethane foam underlay manufacturing business presently operated by Dunlop, together with all of the assets of that business (the Divestiture Package). The Divestiture Package is attached as Appendix One.

139. Overall, the Commission considers that the Divestiture Package would restore competition in the underlay market to the status quo due to:

- its []% market share of the underlay market; and
- the [].

140. The Commission assesses the risks associated with divestments by analysis of composition risks, asset risks, and purchaser risks. These are discussed in turn below.

Composition Risks

141. These are risks that the configuration of a divestment proposal may be too constrained, or not appropriately configured, to either attract a suitable purchaser or to allow a successful business to be operated in competition with the merged entity.

142. As discussed above, the Commission considers that the business in the Divestiture Package is a well established business with a leading market share that will be supported by large customers.

143. Accordingly, the Dunlop underlay business is likely to attract a suitable buyer. Currently, [].

144. The Commission is also satisfied that the Divestiture Package contains all the relevant assets, plant and equipment, stock and corporate knowledge necessary for a new owner to manufacture the underlay products.

145. Overall, the Commission is satisfied that there are no significant composition risks based on:

- the []% market share of the divested brand;
- the fact that Dunlop is the market leader for underlay in New Zealand;
- [];
- the fact that all assets, plant and equipment, stock and corporate knowledge necessary for a new owner to manufacture the underlay products are included in the divestiture package.

Asset Risks

146. Asset risks are risks that the competitive capability of a divestment package will deteriorate prior to completion of the divestment.
147. The Commission considers that the Divestiture Package is unlikely to contain any significant asset risks because the Applicant has undertaken to:
- divest the Dunlop underlay business within [] of the completion of the acquisition;
 - the Applicant has undertaken to take all reasonable steps to preserve and maintain the business including the maintenance of :
 - the goodwill and reputation of Dunlop’s underlay business;
 - the standard of manufacture, distribution and marketing; and
 - maintaining staffing levels.
 - “hold separate” Dunlop’s underlay business.
148. Accordingly, the Commission considers that there are no significant asset risks.

Purchaser Risks

149. The Commission analyses two main purchaser risks, namely that:
- a purchaser acceptable to the Commission may not be available; and/or
 - the Applicant has an incentive to sell to a weak competitor for a low price rather than to a strong competitor.
150. In some cases there may be little or no interest from potential purchasers. This might indicate that the assets are unattractive to potential purchasers which may cast doubt on the effectiveness of the undertaking.
151. A buyer acceptable to the Commission may need to have certain attributes that enable it to be an effective competitor in the relevant market. Examples of attributes that may make a buyer acceptable are:
- it is independent of the merged entity;
 - it possesses or has access to the necessary expertise, experience and resources to be an effective long term competitor in the market; and
 - the acquisition of the divested shares or assets by the proposed buyer does not raise competition concerns.
152. [].
The Applicant stated:
[]
153. The Applicant further advised the Commission that:

[
]

154. [

]

155. In light of [], the Commission considers that there are no significant purchaser risks.

Overall Conclusion on Underlay Market

156. Having considered the proposed divestment, the Commission considers that the Divestiture Package is likely to remedy the competition concerns in the underlay market by providing sufficient constraint on the merged entity. The Commission has found no significant risks associated with the Divestiture Package.

157. Accordingly, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the underlay market.

OVERALL CONCLUSION

158. Having considered the competition effects of the proposed acquisition, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant markets.

DETERMINATION ON NOTICE OF CLEARANCE

159. Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for New Zealand Comfort Group Limited to acquire all of the business assets of Dunlop Living Limited subject to the divestment undertaking dated 22 June 2011 provided by New Zealand Comfort Group Limited to the Commission pursuant to section 69A of the Commerce Act 1986.

Dated 24 June 2011

Sue Begg
Deputy Chair

APPENDIX 1 – DIVESTMENT

DIVESTMENT UNDERTAKING

by

NEW ZEALAND COMFORT GROUP LIMITED

in favour of

COMMERCE COMMISSION



Simpson
Grierson

THIS DEED is dated the

day of

2011

BY **NEW ZEALAND COMFORT GROUP LIMITED** a company incorporated in New Zealand under registered number 244650 and having its registered office at 41-71 Great South Road, Otahuhu, Auckland (**Applicant**)

IN FAVOUR OF **COMMERCE COMMISSION**, a body corporate established by section 8 of the Commerce Act 1986 (**Commission**)

BACKGROUND

- A.** On 5 May 2011, the Applicant gave notice to the Commission pursuant to section 66(1) of the Commerce Act 1986 (**Act**) seeking clearance for the proposed acquisition by the Applicant of the business and assets of Dunlop Living Limited (**Business**).
- B.** The Applicant offers the Commission the divestment undertakings in the form of this deed pursuant to section 69A of the Act.

WITNESSES AS FOLLOWS:

1. INTERPRETATION

In this deed unless the context indicates otherwise:

1.1 Definitions:

"**Act**" means the Commerce Act 1986;

"**Agreement**" means the agreement for sale and purchase of assets between, among others, Dunlop Living Limited and the Applicant, dated 3 May 2011;

"**Application**" means the notice dated 5 May 2011 submitted by the Applicant to the Commission pursuant to section 66(1) of the Act seeking clearance for the proposed acquisition by the Applicant of the business and assets of Dunlop Living Limited; and

"**Approved Purchaser**" means a purchaser approved by the Commission in accordance with clause 3 (Approved Purchaser);

"**Business Day**" means a day on which banks are open for business, excluding Saturdays, Sundays and public holidays, in Auckland, New Zealand;

"**Divestment**" means the sale of the Divestment Business to an Approved Purchaser pursuant to clause 2 (Divestment);

"**Divestment Business**" means the polyurethane foam underlay manufacturing business presently operated by Dunlop Living Limited and to be acquired by the Applicant under the Agreement, together with all of the assets of that business held by the Applicant at the time of the Divestment), including:

- (a) **Plant and equipment:** its foam rebonding and underlay laminating plant, and any other plant and equipment of that business used in the production of polyurethane foam underlay;

(b) **Stock:** all stock and inventory of that business;

(c) **Trademarks:** all registered trademarks used exclusively in that business []

"**Divestment Period**" means the period of [] after the Applicant completes the acquisition of the Business;

"**Key Customer Contracts**" means any ongoing supply contracts which the Divestment Business has with existing distributors and customers as at the time of the Divestment;

"**Technical Assistance**" means the benefit of the Applicant's knowledge and experience in the conduct of the Divestment Business to such extent reasonably required by the Approved Purchaser to be provided by the Applicant;

"**Transitional Period**" means the period of six months after completion of the Divestment, or such longer period as may be agreed between the Applicant and the Approved Purchaser and approved by the Commission; and

"**Transitional Services**" means such services necessary for the operation of the Divestment as are provided by the Applicant to the Divestment Business during the Divestment Period, and are reasonably required by the Approved Purchaser to be provided by the Applicant.

1.2 **Defined Expressions:** expressions defined in the main body of this deed have the defined meaning in the whole of this deed including the background;

1.3 **Headings:** section, clause and other headings are for ease of reference only and will not affect this deed's interpretation;

1.4 **Negative Obligations:** any obligation not to do anything includes an obligation not to suffer, permit or cause that thing to be done;

1.5 **Parties:** references to parties are references to parties to this deed;

1.6 **Persons:** references to persons include references to individuals, companies, corporations, partnerships, firms, joint ventures, associations, trusts, organisations, governmental or other regulatory bodies or authorities or other entities in each case whether or not having separate legal personality;

1.7 **Plural and Singular:** words importing the singular number include the plural and vice versa;

1.8 **Schedules:** the schedules to this deed and the provisions and conditions contained in these schedules have the same effect as if set out in the body of this deed;

1.9 **Sell:** the word "sell" includes "procure to be sold";

1.10 **Sections, Clauses and Schedules:** references to sections, clauses and schedules are references to this deed's sections, clauses and schedules; and

1.11 **Statutes and Regulations:** references to any statutory provision include any statutory provision which amends or replaces it, and any subordinate legislation made under it.

2. DIVESTMENT

The Applicant will sell all its legal and equitable interests in the Divestment Business to an Approved Purchaser prior to expiry of the Divestment Period. The sale of the Divestment Business will be on terms which include:

- (a) **Transitional Services and Technical Assistance:** if required by the Approved Purchaser, the provision by the Applicant to the Approved Purchaser of the Transitional Services and the Technical Assistance. The provision of the Transitional Services and the Technical Assistance will be:
- (i) provided for no longer than the Transitional Period;
 - (ii) provided on commercial arms' length terms;
 - (iii) provided otherwise on terms which are reasonable for both the Applicant and the Approved Purchaser to accept; and
 - (iv) notified to the Commission prior to the commencement of the Transitional Period.
- (b) **Employees:** if required by the Approved Purchaser, the transfer to the Approved Purchaser of any of the employees of the Applicant who:
- (i) are employed exclusively in the Divestment Business at the time of the Divestment;
 - (ii) are necessary for the operation of the Divestment Business; and
 - (iii) agree to transfer to the employment of the Approved Purchaser (and the Applicant agrees not to directly or indirectly discourage any relevant employee from agreeing to transfer).

The Applicant will, with effect from completion of the Divestment, release each relevant employee from any obligation to provide services to the Applicant, and any restraint to the extent that such restraint would otherwise prevent the relevant employee from performing his contemplated role in relation to the Divestment Business after completion of the Divestment; and

- (c) **Business contracts:** such provisions as to the assignment or novation of business contracts as are usual for a transaction of the nature of the Divestment. The Applicant will use all reasonable endeavours to procure any consents that may be required from contractual counterparties to the assignment or novation of the Key Customer Contracts to the Approved Purchaser. If the Applicant has not obtained the relevant consents by the fifth Business Day prior to the date agreed between the Applicant and the Approved Purchaser for completion of the Divestment, the Applicant will provide the Commission with details of those Key Customer Contracts for which consent has not been obtained, including the reasons why consent could not be obtained prior to that date, and what would be required to obtain such consent.

3. APPROVED PURCHASER

The Applicant will sell the Divestment Business to an Approved Purchaser. The Applicant will seek to have a proposed purchaser approved by the Commission. It will provide the Commission with a written notice containing:

- (a) **Contact details of purchaser:** the name, address, telephone number and any other available contact details of the proposed purchaser;
- (b) **Sale and purchase agreement:** a copy of the draft sale and purchase agreement proposed to be entered into in relation to the Divestment;
- (c) **Purchaser's business activities:** a description of the business carried on by the proposed purchaser, including the locations at which the proposed purchaser carries on its business;
- (d) **Purchaser's experience:** details of the proposed purchaser's experience in the relevant market; and
- (e) **Owner and directors:** the names of the owner(s) and director(s) of the proposed purchaser.

The foregoing notice will be given to the Commission no later than 30 days prior to the anticipated completion date of the proposed Divestment. []

4. ACTIONS PENDING DIVESTMENT

Pending the Divestment, the Applicant will use all reasonable endeavours to:

- (a) **Preserve goodwill:** preserve the reputation and goodwill of the Divestment Business;
- (b) **Maintain supply:** maintain the supply of products supplied by the Divestment Business to existing distributors in a manner consistent with the supply of those products as at the date of this deed;
- (c) **Maintain standards:** maintain the standards of manufacture, distribution, promotion or sale of the products supplied by the Divestment Business as at the date of this deed;
- (d) **Maintain staffing:** maintain a level of staffing at the Divestment Business which is materially the same as that at the date of this deed; and
- (e) **Hold separate:** otherwise operate the Business as if it was separate going concern from the remainder of the Applicant's business. This will include obligations on the Applicant to ensure that:
 - (i) the day to day operations of the Divestment Business will be conducted by the present General Manager of Dunlop Living Limited's underlay business (**Divestment Manager**);
 - (ii) all employees employed in the Divestment Business will report exclusively to the Divestment Manager;
 - (iii) the Divestment Manager will report exclusively to Lynn Craig Turner; and
 - (iv) the Divestment Manager will be instructed to continue to maximise the value and viability of the Divestment Business and to continue to

operate the Divestment Business on the basis that the Applicant's underlay business is an arms' length competitor.

5. INFORMATION

The Applicant will:

- (a) **Sale and purchase agreement:** provide the Commission with a copy of the executed sale and purchase agreement relating to the Divestment within one Business Day after that agreement has been executed;
- (b) **Completion of Divestment:** notify the Commission of the Divestment within one Business Day after completion of the Divestment; and
- (c) **Queries:** respond in a timely manner to any queries or requests for information or documents by the Commission about the Divestment Business or any proposed Divestment.

Nothing in this clause 5 requires the provision of information or documents in respect of which the Applicant has a claim of legal professional privilege.

6. NO DEROGATION

Nothing in this deed prevents the Commission from taking enforcement action, including seeking penalties or other remedies under the Act, at any time if the Applicant breaches any term of this deed.

7. CONDITIONS PRECEDENT

The covenants contained in this deed are subject to the following conditions precedent and shall have no effect unless and until such time as such conditions are satisfied:

- (a) **Clearance:** the Commission granting clearance to the Applicant to proceed with the proposed acquisition of the Business pursuant to the Act; and
- (b) **Completion:** completion of the Agreement.

8. TERM

This deed expires on completion of the Divestment (unless the provision of Transitional Services or Technical Assistance in accordance with this deed continues after completion of the Divestment, in which case this deed, insofar as it concerns the provision of Transitional Services or Technical Assistance, expires upon fulfilment of the Applicant's obligations to provide the relevant Transitional Services or Technical Assistance, as the case may be).

9. NOTICES

If any party wishes to give to another party any notice under this deed, the notice will be sufficiently given if addressed to that party and delivered to the address of that party stated below, or to such other address as that party shall have notified to the other for the purpose of this deed.

Commerce Commission

44 The Terrace
P O Box 2351
Wellington
Facsimile: 04 924 3700
email: registrar@comcom.govt.nz

New Zealand Comfort Group Limited

c/- Simpson Grierson
Level 27
88 Shortland Street
Auckland
For: Peter Hinton/Mark Tan
Facsimile: 09 358 2222
Email: peter.hinton@simpsongrierson.com/mark.tan@simpsongrierson.com

10. MISCELLANEOUS

10.1 Binding and Enforceable: The Applicant confirms that in entering into this deed it intends to create binding and enforceable legal obligations in favour of the Commission.

10.2 Governing Law: This deed is governed by the law of New Zealand and the parties accept the exclusive jurisdiction of the New Zealand courts.

Executed as a deed

SIGNED on behalf of **NEW ZEALAND COMFORT GROUP LIMITED** by:

Signature of director

Signature of director

Name of director

Name of director