

13 March 2019

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Australia

Attention: Neil Anderson
Sebastian Templeton
Prudence Smith
Matthew Whitaker

Dear Partners

Letter of Issues – Proposed merger of Gebr. Knauf KG and USG Corporation

1. We refer to the application from Gebr. Knauf KG (Knauf) and USG Corporation (USG) (together, the Applicants), dated 20 December 2018, seeking clearance for the two to merge (the proposed merger).
2. At this stage, we are not satisfied that the proposed merger would not give the merged entity the ability to profitably raise prices and/or reduce quality to customers in New Zealand by removing a competitor in the manufacture and supply of modular suspended ceilings.
3. In reaching the preliminary views set out in this letter, we have considered information provided by Knauf, USG,¹ and other industry participants. We have not yet made any final decisions on the issues outlined below (or any other issue). Our views may change, and new competition issues may arise, as our investigation continues.
4. We will advise you if we identify any further issues during our investigation of the proposed merger that are not discussed in this letter.

¹ When we refer to USG throughout this document, we include USG Boral.

5. We are available to meet with the Applicants to discuss this letter.

Timeline

6. The Commission would like to receive submissions and supporting evidence from the Applicants and any interested parties on the issues raised in this letter by close of business on 27 March 2019, including a public version of any submission/s.
7. If the Applicants do not consider they will be able to adequately respond by this date, please contact us to discuss timing.
8. The public version of submissions received will be published on our website. Any cross-submissions, including a public version, will need to be received by close of business on 3 April 2019.

Market Definition

Product dimension

9. The Applicants submitted that the relevant market is the national market for the wholesale supply of modular suspended ceilings.
10. We currently agree that the relevant product market is likely to be defined in terms of modular suspended ceiling systems, as opposed to separate markets for grids and tiles. While some suppliers in New Zealand offer only grids or only tiles, our understanding is that competition between the merging parties occurs primarily between systems containing both.² For example, it appears to be the preferred practice of architects and specifiers to specify a modular suspended ceiling system containing both grids and tiles from the same manufacturer.
11. The merging parties appear to produce ceiling tiles from a range of materials. We have heard from industry participants that substitutability between tiles made from different materials may be limited. For example, we understand that mineral fibre is by far the most common tile material used in modular suspended ceilings and that office spaces often require mineral fibre tiles due to their ability to absorb noise and prevent sound from travelling between enclosed spaces. Other materials such as metal appear to have comparatively little acoustic value, are much more expensive, and appear to be used only in limited circumstances for aesthetic purposes. At this stage we have not reached a view as to whether it would be appropriate to define separate markets for different tile materials.
12. The Commission continues to test these issues and has not yet reached a final position on product market definition.

Geographic dimension

² The Commission defines markets in the way that best isolates the competition issues that arise from the merger.

13. Manufacturers of modular suspended ceilings supply products in New Zealand through distributors, most of which operate nationwide. At this stage, we agree with the Applicants that the geographic scope of the relevant market appears to be national.

Factual and counterfactual

14. We agree with the Applicants that it is appropriate for our competition analysis to treat the New Zealand businesses of Knauf and Armstrong World Industries (AWI) as consolidated. The Commission currently considers that, in the absence of the proposed merger, Knauf (including AWI) and USG would continue their respective business activities in competition with each other.

Competition assessment (unilateral effects)

15. The proposed merger would bring together New Zealand's top two suppliers of modular suspended ceiling systems (AWI and USG), along with the third-largest supplier of ceiling tiles (Knauf).

Current state of competition

16. The Commission currently considers Knauf (including AWI) and USG to be each other's closest competitors in the supply of modular suspended ceilings in New Zealand for the following reasons.
- 16.1 Both AWI and USG offer complete modular suspended ceiling systems, which customers appear to prefer over mixing different suppliers of grids and tiles. Industry feedback supports the contention that mixing components from different manufacturers typically raises costs through the need for additional sign-off from engineers. This reduces the competitive constraint provided by alternative suppliers that offer tiles or grid only.
- 16.2 Both AWI and USG offer a wide range of commercial and office tiles and are known and trusted by industry specialists. Several other suppliers are more specialised and limited in range, such as SAS International, which supplies only metal tiles, and Rockfon, which supplies only rock wool tiles.
- 16.3 AWI and USG are the two largest suppliers in New Zealand and are the main offerings of Potters and Formans (the two largest New Zealand distributors of modular suspended ceiling systems). Our inquiries suggest that AWI and USG compete for jobs closely through these two distributors.
- 16.4 AWI and USG appear to have an advantage over other suppliers as they are well established as the preferred options for modular suspended ceiling systems in the building industry; we understand that AWI and USG are much more likely than other suppliers to be specified by an architect or specifier.

While there are circumstances in which modular suspended ceilings other than those specified are installed, we understand this to be fairly uncommon.

- 16.5 Feedback from market participants to date has supported the estimates provided in the application showing high market shares for the merging parties and comparatively low shares for other suppliers.
17. The Commission is concerned that this close competition between AWI and USG would be lost with the proposed merger. Our inquiries suggest that alternative suppliers of modular suspended ceilings have a significantly smaller presence in New Zealand than AWI and USG, and a smaller presence than Knauf. Other suppliers do not appear to offer the combination of scale, distribution presence, established brand and seismic testing that would be necessary to provide enough competitive constraint on the merged entity to prevent a price rise or reduction in quality post-merger.

Imports/new entry and expansion

18. The Applicants submitted that the merged entity would be constrained by the significant volume of independent imports and that barriers to entry are low.
19. The Commission's inquiries to date have not indicated that imports or the threat of new entry from third parties are likely to provide material constraint post-merger.
20. Our current view is that to provide an effective constraint, a supplier of modular suspended ceilings would need to at least provide:
- 20.1 a well-established brand name with a reputation for reliability;
 - 20.2 a system comprising both grids and tiles;
 - 20.3 the ability to demonstrate the seismic strength of its ceiling systems meets the New Zealand Building Code and gain trust with architects and specifiers;
 - 20.4 a physical distribution presence or access to a major nationwide distributor; and
 - 20.5 a comparable range of acoustic tiles to the merging parties.
21. To date, we have not seen evidence that there are likely new entrants with the ability to satisfy these requirements. Nor have we seen evidence that existing competitors are likely to undertake the necessary investment to expand to an extent that would constrain the merged entity within a sufficient timeframe.
- 21.1 We have heard from industry participants that alternative overseas manufacturers may not be viable alternatives to the merging parties. Importing from less well-known overseas manufacturers is seen in the industry as a significant risk that is likely to increase costs.

- 21.2 Industry feedback to date has suggested that reliable alternatives to the merging parties for modular suspended ceilings are limited, in part due to the importance of seismic considerations in New Zealand. Products that are fit for use overseas are often untested in relation to New Zealand seismic requirements and may not be suitable for use here.
- 21.3 There appear to be costs to switching to a product that has not been specified on building plans, making it difficult for alternative products to disrupt established industry preferences.

Countervailing power

22. The Applicants submitted that significant countervailing power is exercised by distributors through their ability to supply from a range of sources, and by architects, specifiers and installers, in their ability to influence purchasing decisions.
23. At this stage, the Commission is not satisfied that any such countervailing power would likely constrain the merged entity. We have not yet seen evidence to suggest that distributors would be able to discipline a price increase or reduction in quality from the merged entity by sponsoring entry from alternative suppliers of modular suspended ceiling systems. Rather, the Commission's inquiries to date suggest that the merged entity is likely to have significant leverage over its New Zealand distributors due to the limited availability of credible alternative suppliers as outlined above.
24. As discussed above, it does not appear to us that there are viable alternatives to the merging parties, particularly in the supply of mineral fibre modular suspended ceiling systems (which, as mentioned, account for the majority of the market). While other manufacturers exist, they are often specialised and do not possess the scale, reputation, range and reliability of the merging parties in New Zealand. We do not consider that distributors have adequate alternative options in terms of manufacturers, to which they could turn in the event that prices increased or quality decreased post-merger.
25. The Commission does not currently consider that architects, specifiers, sub-contractors and installers would exercise countervailing power to constrain the merged entity. Our inquiries have not indicated that these parties would be incentivised to use their influence on product selection to discipline a price increase by the merged entity. Further, it appears that any influence currently exercised by industry parties in terms of choice of supplier would be diminished post-merger, as the availability of alternative suppliers would be greatly reduced.

Next steps

26. We are continuing to undertake inquiries and seek information from industry participants about the impact of the proposed merger in New Zealand. However, we

welcome any further evidence and other relevant information and documents that the Applicants can provide regarding the issues identified in this letter.

27. Please contact me if you have any questions about this letter.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R May', with a stylized flourish at the end.

Richard May
Principal Investigator