NERA ECONOMIC CONSULTING

Public Version

THL/Apollo: review of certain aspects of the Commerce Commission’s Statement of Preliminary Issues

A report for MinterEllisonRuddWatts

18 February 2022

Project team

James Mellsop
Kevin Counsell
Kate Eyre

Contents

Public Version

1. Introduction

1. The New Zealand Commerce Commission is assessing the proposed merger of Tourism Holdings Limited (**"THL"**) and Apollo Tourism and Leisure Limited (**"Apollo"**) and has issued a Statement of Preliminary Issues (**"SoPI"**) dated 28 January 2022. We have been asked by MinterEllisonRuddWatts, counsel to THL, to review certain aspects of the SoPI.

2. Confidential information in this report is identified in square brackets and shading as follows:

   a. Purple shading is information confidential to THL;

   b. Blue shading is information confidential to Apollo;

   c. Green shading is information confidential to NERA and the Commission; and

   d. Yellow shading is counsel-only information that should not be seen by either THL or Apollo.

2. Market definition

3. At [18], the SoPI states the Commission will consider whether a national market for motorhome rentals is the appropriate market, or whether:

   there might be separate or differentiated markets based on:

   18.1 different types or sizes of motorhomes;

   18.2 the quality of motorhomes (eg, whether there is a separate market for budget and "premium" motorhomes);

   18.3 motorhomes rented from 'traditional' motorhome rental operators versus privately owned vehicles rented via online peer-to-peer RV rental platforms; and/or

   18.4 different geographic areas, including motorhomes available for rent from depots located at or close to international airports (in major cities) versus other regional locations.

4. In order to analyse the propositions in [18.1] and [18.2], we requested and analysed pricing data from THL. These data are captured in Figure 1 and Figure 2. Figure 1 shows the average daily "yield" for each different brand and size across almost five years, as supplied by THL.[1] To make the results slightly easier to review, Figure 2 shows our calculation of the monthly average[2] of these average daily yields.

Figure 1: [ ]

Figure 2: [ ]

5. We make the following observations from Figure 1 and Figure 2:

   a. [ ];

   b. [ ];

   c. [ ]

   d. [.]

[1] "Yield" is the term used by THL to describe the data. We understand that this is the effective price received by THL through its various channels. This will include a combination of retail and wholesale prices.

[2] The monthly average is the unweighted arithmetic average of the average daily yields in a given month.

6. It is difficult to draw any strong conclusions from these data on market definition. While distinct prices would be consistent with separate markets, they can also be consistent with a single market if a SSNIP imposed by a hypothetical monopolist (of say a 4-6 berth motorhome) would not be profitable due to switching on either the demand- or supply-side (to or from, for example, a 2-3 berth motorhome).

7. As noted, [ ], which would be consistent with a single market. We have calculated a correlation matrix [ ]

8. In our view the most important market definition factor in the present case is the supply-side substitutability.

9. In particular, it is difficult to see why a rental provider of one type of motorhome (e.g., a 2-3 berth one) could not quickly expand into supplying a different type (e.g., a 4-6 berth one) in response to a profit incentive. It would simply be a matter of acquiring the larger vehicles and marketing them. The vehicles are not sunk – they can be used for the rental provider's other brands as they age and/or be sold to private owners.

10. Likewise, it is hard to see why a (say) provider of budget recreational vehicles (RVs)[3] could not expand into higher quality RVs (or vice versa) if there is a profitable opportunity to do so. This may or may not involve separate branding, e.g., McRent offers different quality under the same brand, whereas Tui operates under different brands.[4]

11. We also note the statement by Apollo[5] to the Commission that [ ]

12. We next consider whether motorhomes rented from 'traditional' motorhome rental operators are in the same market as privately owned vehicles rented via online peer-to-peer RV rental platforms ([18.3] of the SoPI).

13. We know that peer-to-peer platforms (the "sharing economy") have been disruptive in other industries, e.g., ride sharing on taxis.[6] We also note that:

    a. The Camplify IPO prospectus listed traditional RV rental operators as being competitors;[7] and

    b. Grant Webster stated to the Commission that THL [ ] [8]

14. In theory we might be able to quantitatively test the impact of Camplify's entry into New Zealand on THL (and Apollo). However, in practice this is likely to be difficult, because of the other simultaneous factors that would likely have affected THL's demand since Camplify's entry in 2019. In particular, Camplify only entered New Zealand shortly before Covid-19 hit at the beginning of 2020.

15. Clearly there is a level of differentiation between the product of traditional motorhome operators and peer-to-peer operators. Different consumers will place different weights on the differentiators. However, unless the hypothetical monopoly traditional motorhome provider has an ability to price discriminate on the basis of customers' openness to using a peer-to-peer platform, it would not take many switching customers to make a SSNIP unprofitable.

---

[3] We use the terms "motorhomes" and "RVs" interchangeably throughout this report.

[4] See the *Clearance Application*, 10 December 2021, at 5.33(a) and 5.33(e).

[5] Statement by Luke Trouchet to Commission staff during 15 February 2022 interview.

[6] For a recent survey of the broad literature, see Amir Reza Khavarian-Garmsir, Ayyoob Sharifi and Mohammad Hajian Hossein Abadi, "The Social, Economic, and Environmental Impacts of Ridesourcing Services: A Literature Review", (2021), https://www.mdpi.com/2673-7590/1/2/16/htm.

[7] Section 2.5.

[8] Statement by Grant Webster to Commission staff during 8 February 2022 interview.

16. To see why this is the case, note that the financial statements of THL and Apollo suggest their rental businesses in particular have high fixed costs, and therefore relatively high gross margins to fund the fixed costs. For this reason, even only a relatively small loss of volumes can be damaging.

17. As a means of assessing this, we have undertaken critical loss analysis, which is a quantitative tool used to assess the extent to which a price increase by the hypothetical monopolist would be constrained by volumes switching to other firms. The calculation of the critical loss is based on data on the merged entity's gross margins.[9] To estimate gross margins we use data from the published accounts of THL and Apollo. Each firm earns revenue from both rentals and vehicle sales. The main variable cost identified in the accounts is the cost of goods sold, which are predominantly the costs of the vehicles being sold.

18. Gross margins will be relatively high when a firm has high fixed costs (and low variable costs), because it will need a higher margin to earn a competitive return on its investment.[10]

19. Calculating gross margins based on rental and sales revenue less cost of goods sold yields:

    a. Gross margins in the range of 69%-73% for THL, for financial years 2016-2020.[11] The 2021 financial year gross margin is materially lower, at 48%, which is likely due to the influence of the Covid-19 pandemic; and

    b. Gross margins in the range of 80%-85% for Apollo, for financial years 2016-2020.[12] The 2021 financial year gross margin is materially lower, at 47%, which again is likely due to the Covid-19 pandemic.

20. We note that the cost of goods sold relates to revenue from motorhome *sales*, and there appears to be no similar category of costs identified in the annual accounts that relates to motorhome *rentals*. Accordingly, these gross margins are likely to an understatement of the gross margins on motorhome rentals only.

21. Using the pre-Covid-19 data on gross margins for the 2019 financial year, the average gross margin across both THL and Apollo is 79%. With this gross margin, the critical volume loss for a 5% price rise of the merged entity would be 6.0% of the merged entity's annual volumes. That is, the merged entity would only need to lose 6.0% of its volumes following a price rise, in order for that price rise to be unprofitable.

22. The gross margins here, as with firms with similar high fixed costs, are substantially higher than what we have seen from our experience analysing gross margins in other (typically manufacturing) markets, where we have found gross margins typically in the range of [ ].[13,14]

---

[9] We use the breakeven critical loss approach and a linear demand curve. See Gregory Werden (2002), "Beyond Critical Loss: Tailoring Applications of the Hypothetical Monopolist Paradigm", US DOJ Antitrust Division Economic Analysis Group Discussion Paper No. 02-9.

[10] See, generally, Robert H. Bork and J. Gregory Sidak (2013), "The misuse of profit margins to infer market power", *Journal of Competition Law and Economics,* 9(3), 511-530.

[11] The cost of goods sold in THL's annual accounts is not able to be split by business segment. Accordingly, the gross margins shown are an aggregate gross margin across all of THL's business segments (NZ Rentals, Action Manufacturing, Tourism Group, Australia Rentals and US Rentals), and for motorhome rentals and motorhome sales combined.

[12] The revenue and cost of goods sold in Apollo's annual accounts is split by country, and therefore the gross margins shown are for New Zealand only, for motorhome rentals and motorhome sales combined.

[13] The exception is gross margins in [ ], for which there are very few variable costs, and gross margins tend to be higher.

[14] While these data and analyses are confidential, they relate to transactions the Commission has analysed and has the data for already. We can provide further details to the Commission privately.

Accordingly the merged entity (and the hypothetical monopolist) would be more sensitive to volume loss than many other firms we have analysed.

23. In other words, it would not take many switching customers to undermine a SSNIP.

24. Finally regarding [18.4] of the SoPI, it is not completely clear to us what the Commission is testing. If it is that traditional motorhome rental operators tend to have depots in just a handful of cities versus peer-to-peer platforms that can offer motorhomes from anywhere, then this is definitely a point of differentiation. In fact, it is a feature that gives peer-to-peer operators a competitive advantage – they can have a distributed footprint without having to invest in a depot at each location.

25. If the Commission is testing whether having a depot particularly close to an airport places a traditional operator at such an advantage that it would be in a separate market from other traditional operators, the evidence we have seen suggests this is not the case. [ ]

3. Effect of merged entity's partial interest in Camplify

26. At [11], the SoPI states (footnotes excluded):

> *After completion of both these transactions, THL is likely to ultimately hold 22-23% of the shares in Camplify and have a seat on Camplify's Board of Directors. As part of the Proposed Acquisition, Camplify and THL would also enter an ongoing strategic and commercial relationship. This relationship will involve:*
>
> *11.1 THL providing vehicle management services to Camplify RV owners in New Zealand and Australia; and*
>
> *11.2 Camplify and THL working together on opportunities to grow each other's businesses, including via cross-promotional marketing benefits such as THL marketing Camplify's peer-to-peer RV rental platform.*

27. In the context of unilateral effects, at [26.2] the SoPI states:

> *In relation to the potential constraint from Camplify's peer-to-peer RV rental platform, we will consider whether THL/Apollo's ongoing relationship with Camplify will impact the incentive of Camplify to compete with a merged THL/Apollo;*

28. Unilateral effects can arise if the merger changes the incentives on the merging parties. The basic logic of a firm's unilateral incentives is that, in making a decision to raise price, the firm will trade-off the increased margin it earns on sales that remain with the firm against the lost margin on sales that switch to rival firms. For a full merger, the merging firms may have an incentive to raise prices because they will recognise that some of the lost sales will now switch to their merger partner. For a less-than-full merger, but where the acquiring firm gains a financial interest in the target firm, there is a similar (albeit weaker) effect: a price rise by the acquiring firm will lead to some sales switching to the target firm, from which the acquiring firm will profit by virtue of its financial interest. This gives the acquiring firm an incentive to "pull its competitive punches" relative to its incentives without the acquisition.[15]

29. However, THL/Apollo's shareholding in Camplify would not affect Camplify's incentive to compete against THL/Apollo. This is because Camplify would not have a financial interest in THL/Apollo. If Camplify raised its price following the merger, it would not benefit from any

[15] The seminal paper on the competitive effects of partial acquisitions is Daniel P. O'Brien and Steven C. Salop (2000), "Competitive Effects of Partial Ownership: Financial Interest and Corporate Control", *Antitrust Law Journal*, 67, 559-614. The language of "pull its competitive punches" is from their later paper: Daniel P. O'Brien and Steven C. Salop (2001), "The Competitive Effects of Passive Minority Equity Interests: A Reply", *Antitrust Law Journal*, 69, 611-625.

renters diverting to THL/Apollo, just as it would not benefit from renters diverting from it to THL or Apollo pre-merger.

30. Likewise, we are not aware of anything in the vehicle services contract that would affect Camplify's incentives when it sets prices on both sides of its platform. In particular, we have not seen any evidence to suggest that any rewards to Camplify relating to that contract would be connected or depend on how Camplify sets prices on its platform.

31. The example given in [11.2] of the SoPI (THL marketing Camplify's peer-to-peer RV rental platform) also would not affect Camplify's pricing calculus, because this cross-marketing would not appear to depend on how Camplify sets prices on its platform. (THL would want to do this (to some degree) anyway, as it is a residual claimant on Camplify.)

4. Foreclosure issues

32. At [30], the SoPI states:

> *We will consider whether the proposed strategic and [sic] relationship between THL and Camplify (as summarised earlier at [11]) could give rise to foreclosure concerns. Such concerns could arise where:*
>
> *30.1 the Parties may have an ability and incentive to prevent THL's rivals in traditional motorhome rentals from accessing at all Camplify's peer-to-peer RV rental platform, or to disadvantage THL's competitors by manipulating search rankings on Camplify's platform to favour THL listings; and/or*
>
> *30.2 the Parties may have an ability and incentive to prevent Camplify's rivals in peer-to-peer RV rental platforms from accessing THL's RV management services or gaining the business of THL's motorhome rental listings.*

33. [30.1] assumes access to Camplify's rental platform is a "must-have" for traditional motorhome operators. This seems unlikely given that, [ ]

34. Indeed, we understand from THL that [ ]. For example, peer-to-peer listings are based on a specific vehicle and so the customer expects a vehicle with a specific registration number. Commercial operators work on the basis that vehicles are interchangeable, and that "upgrades" can be provided, which helps fleet management and maximisation of overall utilisation where there are excess bookings of a particular vehicle type.

35. Even if access to the Camplify platform was a "must-have", Camplify would not have the incentive to foreclose other traditional motorhome operators. Camplify would incur the costs of such a strategy but receive no benefits because it would not have a financial interest in THL/Apollo.

36. It also seems unlikely that the merged THL/Apollo could force Camplify to foreclose other traditional motorhome operators, given THL/Apollo would have a minority shareholding and single director.[16]

37. [30.2] assumes that THL is the only firm that could offer vehicle management services to a peer-to-peer operator. This seems unlikely, as presumably other motorhome rental operators either manage their own vehicles or contract in that management, suggesting that the required skills are not scarce. We are advised by THL that:

    a. All other motorhome operators in New Zealand could supply vehicle management services to Camplify RV owners; and

    b. All that is required is a branch and staff/processes for pick-ups, cleaning and drop offs.

[16] While we are not legal experts, we also understand that directors of Camplify would be obliged to act in Camplify's best interests.

38. [30.2] also assumes that it is important for a peer-to-peer RV rental platform to gain the business of THL's motorhome rental listings. As already noted, this seems unlikely given that, [   ]

NERA
ECONOMIC CONSULTING

NERA Economic Consulting
20 Customhouse Quay
Wellington Central
Wellington, New Zealand 6011
www.nera.com