

**COMMERCE ACT 1986: BUSINESS ACQUISITION
SECTION 66: NOTICE SEEKING CLEARANCE**

Date: 7 March 2008

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
PO Box 2351
WELLINGTON

Pursuant to s66(1) of the Commerce Act 1986 notice is hereby given seeking **clearance** of a proposed acquisition.

EXECUTIVE SUMMARY

1. EXECUTIVE SUMMARY

- 1.1 Vita New Zealand Limited ("**Vita**") seeks clearance to acquire the Assets of Pacific Brands Holdings (NZ) Limited's ("**Pacific Brands**") Dunlop Foams & Flooring and Sleepmaker divisions, which are respectively active in the manufacture and importation of PU foam, importation of rebonded PU foam flooring underlay, and the manufacture of mattresses.
- 1.2 Vita has entered into a conditional agreement for the acquisition of the Assets.
- 1.3 The proposed acquisition affects the national market for the manufacture and wholesale supply of PU foam ("**PU Foam Market**") and the national market for the manufacture and / or importation for wholesale supply of flooring underlay ("**Underlay Market**"). Vita considers that a substantial lessening of competition will not occur in either of these markets.
- 1.4 In respect of the PU Foam Market, Vita considers that the proposed acquisition will not result in a substantial lessening of competition for the following reasons:
- (a) The combined entity will continue to be constrained by Enviro-foam's substantial excess capacity, rendering it well placed to easily and readily expand.
 - (b) The ability for acquirers of PU foam, such as Sleepyhead [**CONFIDENTIAL**], to establish their own PU foam manufacturing facilities (given the low barriers) means that the threat of a switch to self-supply by any one of the combined entity's larger acquirers will act as a real constraint.

- (c) Local furniture manufacturers who acquire PU foam face substantial import competition and countervailing power of retailers. As such, any attempt by the merged entity to increase the price of PU foam to those manufacturers would inevitably result in the loss of those accounts, either through relocation overseas or through the retailers electing instead to import products directly. Similar issues arise in relation to the use of PU foam in the manufacture of beds, where there is a growing trend of imported beds.
- (d) As the manufacture of PU foam is characterised by reasonably high fixed costs (particularly for continuous foam production plants), a material loss in volume will result in average costs rising and net profit falling.
- (e) **[CONFIDENTIAL]**, there is likely to be little difference between the factual and the counterfactual. Instead, the factual represents a sensible rationalisation of the two businesses.

1.5 In respect of the Underlay Market, Vita considers that the proposed acquisition will not result in a substantial lessening of competition for the following reasons:

- (a) Post-acquisition, the combined entity will continue to be constrained by Sleepyhead, currently the second largest supplier of flooring underlay in New Zealand, and importers of underlay.
- (b) The ease of importation for flooring underlay and its subsequent prevalence in the market means that the combined entity will continue to be constrained by the threat of further import entry post-acquisition.
- (c) The countervailing power enjoyed by large carpet retailers such as Carpet Court and Floor Pride will also constrain the merged entity from being able to raise prices post-acquisition. Given that flooring underlay is something of a 'grudge' purchase, it is highly price sensitive and retailers would face difficulty in passing on any price increase to consumers.

1.6 Accordingly, the proposed acquisition will not substantially lessen competition in either of the PU Foam Market or the Underlay Market.

TABLE OF CONTENTS

EXECUTIVE SUMMARY 1

PART I: TRANSACTION DETAILS 4

PART II: IDENTIFICATION OF MARKETS AFFECTED 12

PART III: CONSTRAINTS ON MARKET POWER BY EXISTING COMPETITION 22

PART IV: CONSTRAINTS ON MARKET POWER BY POTENTIAL COMPETITION 32

PART V: OTHER POTENTIAL CONSTRAINTS 39

DEFINITIONS AND GLOSSARY 43

APPENDIX A 44

 VITA CORPORATE STRUCTURE 44

APPENDIX B 45

 BATCH FOAM PRODUCTION PLANT 45

PART I: TRANSACTION DETAILS

2. THE TRANSACTION

2.1 Clearance is sought in respect of the acquisition by Vita of all of the foam, flooring and Sleepmaker bedding Assets of Pacific Brands, which trade as Dunlop Foams & Flooring ("**Dunlop**") and Sleepmaker respectively.

2.2 The Parties executed an Agreement for the Sale and Purchase of Businesses and Assets ("**Agreement**") on 10 December 2007. Completion of that Agreement is conditional on Vita obtaining clearance under the Commerce Act 1986.

3. NOTICE GIVEN BY VITA

3.1 This notice is given by:

Vita New Zealand Limited
670 Rosebank Road
Avondale
AUCKLAND

Attn: Robert Brouwer
Chief Executive Officer
Ph: +64 9 820 1379

3.2 All correspondence and notices in respect of this application should be directed in the first instance to:

Russell McVeagh
Barristers & Solicitors
P O Box 8
Level 30, Vero Centre
48 Shortland Street
Auckland

Attn: Andrew Peterson / Chris Graf
Ph: +64 9 367 8315 / 8232
Fax: +64 9 367 8595

4. CONFIDENTIALITY

4.1 Confidentiality is sought in respect of all items deleted from the public copy of this application ("**confidential information**"). The items are indicated in the non-public version in square brackets ("[]").

4.2 In respect of the confidential information, a confidentiality order is sought under section 100 of the Commerce Act 1986 ("**Act**"), and confidentiality is claimed under section 9(2)(b)(ii) of the Official Information Act 1982, on the grounds that the information is commercially sensitive and valuable information which is confidential to the participants, and disclosure of it is likely to give unfair advantage to competitors of the participants and/or unreasonably to prejudice the commercial position of the persons involved.

- 4.3 Vita requests that it be notified of any request made to the Commission under the Official Information Act for release of the confidential information, and that the Commission seeks its views as to whether the information remains confidential and commercially sensitive, at the time responses to such requests are being considered.

5. DETAILS OF THE PARTICIPANTS

Acquirer

- 5.1 The proposed acquirer is Vita.
- 5.2 Vita is a privately owned company incorporated in New Zealand, active in the manufacture of PU foam and processing of polyester fibre. Vita was established in 1976 and today employs over 400 people at sites in Auckland, Upper Hutt and Christchurch.
- 5.3 Vita's business is divided into two main divisions - Consumer Products and Industrial Products. Its Consumer Products division is focussed on the manufacture of a diverse range of PU foam-based products for consumers. Vita's Consumer Products division manufactures and trades under the Mobilier and Vitality brand names. Vita's Consumer Products division is active in the manufacture of:
- (a) Nursery products;
 - (b) Manchester;
 - (c) Pillows;
 - (d) Upholstered furniture;
 - (e) Bean products;
 - (f) Topper pads (mattress overlays);
 - (g) Healthcare products; and
 - (h) Beds and mattresses.
- 5.4 Vita's Industrial division is focussed on the production and supply of PU foam and polyester fibre based applications to industrial customers. Vita's industrial division produces much of its output under the C-Tech brand name. More specifically, it is active in the production of:
- (a) Polyester fibre;
 - (b) Polystyrene;
 - (c) Moulded foam;
 - (d) Wool waddings; and
 - (e) Underlay.
- 5.5 The acquisition concerns Vita's activities in both of its Consumer and Industrial divisions.
- 5.6 More information concerning Vita's activities can be found at www.vita.co.nz

Target

- 5.7 Pacific Brands is a wholly owned subsidiary of Pacific Brands (Australia) Pty Limited, an Australian incorporated company whose parent company¹ is listed on both the Australian Stock Exchange (ASX) and the New Zealand Exchange (NZX). The Pacific Brands Group is headquartered in Melbourne and, in addition to operations in Australia and New Zealand, also has operations in the United Kingdom, Malaysia, China and Indonesia.
- 5.8 Pacific Brands is active in New Zealand across four divisions:
- (a) Underwear and Hosiery;
 - (b) Outerwear and Sport;
 - (c) Home Comfort; and
 - (d) Footwear.
- 5.9 Of these divisions, the acquisition only affects parts of Pacific Brands' Home Comfort division.
- 5.10 The acquisition of the Assets affects the following Pacific Brands Home Comfort division's brands:
- (a) Dunlop Foams - a manufacturer and converter of PU foams;
 - (b) Dunlopillo - a manufacturer of latex bedding;
 - (c) Dunlop Flooring - an importer of carpet cushion, adhesives, and rubber flooring;
 - (d) Simmons - Pacific Brands manufactures beds and mattresses under licence from American bedding company Simmons; and
 - (e) Sleepmaker - manufacturers of inner sprung beds.
- 5.11 These activities are carried out by Pacific Brands through:
- (a) wholly owned or leased sites located in:
 - (i) East Tamaki, Auckland (owned by Pacific Brands);
 - (ii) Sockburn, Christchurch;
 - (iii) Henderson, Auckland; and
 - (b) the importation of speciality PU foams and PU foam underlay from Pacific Brands (Australia) Pty Limited's manufacturing plants located in Sunshine, Victoria, Wetherill Park, New South Wales, and Dandenong, Victoria. Pacific Brands exports scrap PU foam derived from its PU foam manufacturing processes to Australia for use in the manufacture of PU foam underlay and sources all of its underlay requirements from its Australian manufacturing operations.

¹ Pacific Brands Limited.

5.12 Contact details for Pacific Brands are:

Pacific Brands Holdings (NZ) Limited
 C/- Pacific Brands Limited
 Level 3
 290 Burwood Road
 Hawthorn, Vic 3122
AUSTRALIA

Attn: Karl Woodcock
 Group Corporate Development Manager
 Ph: +61 3 9947 4962
 Fax: +61 3 9947 4953

5.13 Further information concerning Pacific Brands' operations may be found at www.pacificbrands.co.nz.

6. INTERCONNECTED AND ASSOCIATED PARTIES

Vita

6.1 Vita is majority owned by Rangatira Limited ("**Rangatira**"), which directly or indirectly holds 80 percent of the shares in Vita. The remaining twenty percent of Vita is held by the two previous 100 percent owners of the business, through the Adams Family Trust and the Ineke & Michael Trust (each holding 10 percent of the shares in Vita).

6.2 Rangatira is a New Zealand incorporated company that holds investments in a number of New Zealand companies. Rangatira holds interests in the following companies:

- (a) Auckland Packaging Co Ltd (100%);
- (b) Contract Resources Holdings Ltd (50%);
- (c) Heller Tasty Ltd (50%);
- (d) PDS Ltd (100%), which holds 50.5% of Precision Dispensing Systems Ltd;
- (e) Polynesian Spa Ltd (51%);
- (f) Romney (No.19) Ltd (100%);
- (g) Romney (No.36) Ltd (100%);
- (h) Tecpak Industries Ltd (79%);
- (i) Te Kairanga Wines Ltd (34%);
- (j) Tongariro Investments Ltd (100%);
- (k) Wainui Investments Ltd (100%); and
- (l) Watt Land Co Ltd (100%).

6.3 However, none of the above companies are active in industries affected by Vita's acquisition of the Assets which this Application relates to.

6.4 A diagrammatic representation of the corporate structure of Vita is set out at Appendix A.

Pacific Brands

6.5 The Assets subject to the proposed acquisition are all owned and controlled by Pacific Brands. As noted above, Pacific Brands is a wholly owned subsidiary of Pacific Brands (Australia) Pty Limited. Pacific Brands (Australia) Pty Limited is in turn a wholly owned subsidiary of Pacific Brands Limited, the entity which is dual listed on both the ASX and NZX.

6.6 Pacific Brands (Australia) Pty Limited owns, through a number of subsidiary companies, all of the shares in the following companies incorporated in New Zealand:

- (a) Yakka Apparel Solutions Limited;
- (b) Yakka New Zealand Limited;
- (c) Neat N' Trim Uniforms Limited; and
- (d) Dowd Corporation (NZ) Limited.

Collectively, these companies are involved in the design, manufacture and importation of workwear and corporate apparel and are therefore not relevant to the acquisition of the Assets by Vita.

6.7 Pacific Brands is the sole shareholder of Sheridan N.Z. Limited ("**Sheridan**"). Sheridan is active in the manufacture of bed linen and towels and is therefore not relevant to the acquisition of the Assets by Vita.

7. BENEFICIAL INTERESTS

7.1 Neither Vita nor Pacific Brands holds any relevant beneficial interest.

8. LINKS BETWEEN PARTICIPANTS

8.1 **[CONFIDENTIAL]**

9. BUSINESS ACTIVITIES OF EACH PARTICIPANT

9.1 Both Vita and Pacific Brands import and/or manufacture PU foam and import or manufacture PU foam underlay. Both parties supply PU foam in 'slab' form to industrial customers, and also 'convert' slab foam into shapes for industrial and consumer oriented customers. In addition, both parties are also vertically integrated and produce consumer PU foam products, albeit in different product categories.

Vita

9.2 Vita manufactures PU foam at its Auckland and Christchurch continuous foam production plants. Vita's site in Upper Hutt takes supply of slab PU foam from its

Auckland plant which it converts for downstream acquirers. Vita's Auckland and Christchurch sites also convert slab PU foam into shapes, block foam, and peel foam². Vita also supplies slab PU foam to conversion companies such as Greenpark Limited. More information is set out on Greenpark in paragraph 16.1(b) of this Application.

- 9.3 Vita manufactures 36 grades of foam at its Auckland plant and 22 grades of foam at its Christchurch plant. It produces its PU foam using a chemical blend comprised predominantly of TDI, water and polyol. **[CONFIDENTIAL]** For example, its Auckland continuous production foam plant **[CONFIDENTIAL]**.
- 9.4 Vita also manufactures a range of furniture and consumer products at its Auckland plant. This involves all aspects of the furniture manufacturing process including assembly of wooden frames and sewing of coverings. Vita also manufactures polystyrene 'bean' products at its Christchurch and Upper Hutt plants.

Pacific Brands

- 9.5 Pacific Brands produces PU foam at its East Tamaki plant using a continuous production verti process³. This method of production is unique in New Zealand to Pacific Brands, and while it does produce foam with slightly different properties to that of other continuous production methods, these are not so great so as to differentiate its output from that manufactured at other continuous foam plants. **[CONFIDENTIAL]**
- 9.6 Pacific Brands produces close to 30 grades of foam at its East Tamaki site. Of these grades, **[CONFIDENTIAL]** grades dominate Pacific Brands' production. Further information on Pacific Brands' PU foams can be found at www.dunlopfoams.com.au/Files/Tec-Spec07.pdf.
- 9.7 Pacific Brands also has a conversion plant at its East Tamaki site. Pacific Brands' Christchurch site does not produce PU foam. Rather, it operates a conversion plant which converts slab foam into shapes and peel foam for downstream users.
- 9.8 Pacific Brands manufactures beds under its Sleepmaker division. Its Sleepmaker manufacturing sites are located in Henderson (Auckland) and Sockburn (Christchurch). It manufactures finished inner sprung beds and manufactures or imports beds that utilise other technologies (eg air and gel) which it supplies on a wholesale basis to bedding retailers. Pacific Brands' foam division supplies PU foam to its Sleepmaker division on an arm's length commercial basis.

The counterfactual

- 9.9 In this instance, the counterfactual is shaped by the **[CONFIDENTIAL]**. As set out at paragraph 10.6 below, the foam industry has faced increased financial challenges over the past two to three years. Steep increases in chemical costs (predominantly in TDI), coupled with a decrease in demand in downstream industries (particularly the furniture manufacturing industry), have seen PU foam manufacturers' margins squeezed to historically low levels. As the industry has become increasingly characterised by overcapacity, **[CONFIDENTIAL]**.
- 9.10 **[CONFIDENTIAL]** it is unlikely that in the counterfactual, the acquisition would be attractive to any other serious potential purchasers. The synergies and cost savings which Vita considers it will derive from the transaction are unique to Vita in an industry which is characterised by low margins and overcapacity.

² Peel foam involves 'peeling' a slab of foam into a relatively thin run of PU foam.

³ A verti process is a form of continuous foam production plant in that it produces slabs of PU foam by pushing the relevant mix of chemicals up a 'verti tower' during which the chemical reaction process occurs.

9.11 [CONFIDENTIAL]

9.12 [CONFIDENTIAL]

9.13 In summary, Vita does not consider that there are likely to be any serious or viable alternative purchasers of the Assets in the counterfactual. Vita further notes that, [CONFIDENTIAL]. Vita considers that this further reduces the attractiveness of the operation to any alternative purchasers.

Comparison with the factual

9.14 In the factual, Vita will acquire the Assets and will [CONFIDENTIAL]. This will, in turn, result in the more efficient production of high quality PU foams which are required for furniture and bedding manufacturers to continue to manufacture locally.

9.15 [CONFIDENTIAL] In addition, Vita has identified further gains in [CONFIDENTIAL]. These synergies and efficiencies will allow Vita to pass on the benefits of more efficient supply to its customers.

9.16 Vita's acquisition of Sleepmaker will increase its internal demand for foam and this, coupled with increased external demand in foam brought about by the acquisition, will lower costs and at the same time combat against the significant overcapacity between the two plants.

9.17 As is the present case, in the factual, the merged entity will remain constrained by existing competition, the threat of imports, and the tight margins in the downstream markets of furniture and bedding manufacture which will see them respond to increases in the costs of materials by closure or a switch to offshore manufacture.

10. THE REASONS FOR THE PROPOSAL

10.1 Vita's key rationale for the acquisition is to [CONFIDENTIAL]. This enhanced scale will, in Vita's view, deliver synergies and other efficiency related benefits (mentioned in part in paragraph 9.15). [CONFIDENTIAL]

10.2 [CONFIDENTIAL] This is crucial to Vita's long term requirement to reduce its costs.

10.3 The PU foam industry is also facing severe over-capacity in New Zealand, with the effect that all market participants' production facilities are operating well below capacity. Vita estimates that the PU foam industry has annual capacity of [CONFIDENTIAL] tonnes. At present, supply is only around [CONFIDENTIAL] tonnes nationally, or just [CONFIDENTIAL] percent of potential capacity.

10.4 In addition, the acquisition will see Vita become vertically integrated in bedding through the acquisition of Pacific Brands' Sleepmaker business. Supplying foam to what post-acquisition will be its vertically integrated bedding operator will ensure that the acquisition provides the opportunity for increased production volumes of PU foam.

10.5 Furthermore, at a wholesale level, beds and furniture tend to be sold to the same acquirers. As a combined vertically integrated bed and furniture manufacturer, Vita considers that it will be better placed to deal with large 'big box' retailers such as Farmers and Harvey Norman, who have a considerable degree of countervailing power.

10.6 Vita also sees the acquisition as a means of protecting against a further downturn in the PU foam industry. The rapid advancement of China in the global foams market, coupled

with declining sales and volumes leading to decreased profitability, means that the industry is looking increasingly marginal in the future. The combined entity would provide the volume required to lift profitability, most notably as substantial fixed costs are spread across a much greater volume.

- 10.7 In short, Vita seeks to acquire the Assets from Pacific Brands to bring scale, synergies and efficiencies to its PU foams business and [CONFIDENTIAL] therefore continues as a source of demand for PU foam. Vita considers that the acquisition will equip it to weather the future challenges of the industry and provide security of employment to those in the industry.

The Parties' financial performance

- 10.8 [CONFIDENTIAL] Chemical costs comprise approximately 75 to 80 percent of the cost of goods sold for PU foam and over the past two years, prices of TDI (the main chemical ingredient in PU foam) have increased by 125 percent.⁴⁵ [CONFIDENTIAL] This pressure has intensified in recent years due to a downturn in domestic demand for PU foam.

Vita

- 10.9 [CONFIDENTIAL]

- 10.10 [CONFIDENTIAL]

- 10.11 However, Vita considers that in the medium term, profitability in the industry will remain tight. Increasing pressure on local furniture and bedding manufacturers from imports, together with high chemical costs and the need to maintain volume to achieve economies of scale, means that without the acquisition, Vita's operations will come under increasing financial pressure.

Pacific Brands

- 10.12 [CONFIDENTIAL] Pacific Brands does not keep separate balance sheets for its flooring and foam business units, however, [CONFIDENTIAL]

- 10.13 [CONFIDENTIAL].

- 10.14 [CONFIDENTIAL].

- 10.15 [CONFIDENTIAL]

- 10.16 [CONFIDENTIAL]

- 10.17 [CONFIDENTIAL]

⁴ Pacific Brands advises that its cost of TDI per tonne has increased from [CONFIDENTIAL] in the fourth quarter of 2005 to [CONFIDENTIAL] in the fourth quarter of 2007. Chemicals such as TDI are traded as a world commodity in US dollars, and there are accordingly no cost savings to be obtained by sourcing from alternate offshore markets.

⁵ Chemical costs have increased due to higher demand from growing industries in China and India, as well as due to damage caused to plants by Hurricane Katrina in 2006 which saw suppliers use force majeure clauses to breach contractual prices and seek substantial price rises.

PART II: IDENTIFICATION OF MARKETS AFFECTED
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11. HORIZONTAL AGGREGATION**Market Definition**

11.1 Four categories of products are affected by this acquisition. These product categories are:

- (a) PU foam;
- (b) PU foam underlay;
- (c) Upholstered furniture; and
- (d) Mattresses.

11.2 As Vita is not currently involved in the manufacture or importation of inner sprung mattresses, the acquisition will not result in any aggregation in respect of the manufacture or wholesale supply of inner sprung mattresses⁶. Similarly, as Pacific Brands does not manufacture or import any upholstered furniture, the acquisition will not result in any aggregation in respect of the manufacture of upholstered furniture.

11.3 Accordingly, only PU foam and PU foam underlay product markets are considered further in this application.

Product Dimension*Manufacture of polyurethane foam generally*

11.4 PU foam is a petrochemical product produced from two raw materials (a polyalcohol and a polyisocyanate) that undergo a chemical reaction which leads to an expansion in volume.⁷ PU foam can be produced either by pouring the mixed chemicals onto a moving conveyor (continuous foam production as utilised by Vita) or by batch production, which sees the chemicals poured into an open-topped mould to produce moulded or slab foam (as utilised by Enviro-foam). In addition, as identified above, Pacific Brands uses a verti pipe production process, which sends the chemicals up a vertical tower in which they expand to produce slab foam.

11.5 Once the chemical reaction required to form the PU foam is complete, the foam must be left to 'cool' off due to the volatility of the chemical reaction and the heat which is produced during the chemical process. Once the foam has cooled, the resulting slab foam can then be 'peeled' to create peel foam, cut into block foam for use by industrial customers or 'converted' into shapes required by downstream users.

⁶ Although Vita does manufacture a small amount of foam mattresses, used for example in bunks, and a very small quantity of inner sprung cot mattresses, these comprise a very small part of the bedding industry. Vita estimates that its production of foam mattresses would give it no more than [CONFIDENTIAL] of a wider bedding market.

⁷ Case No IV/M.835 - Recticel / Greiner, European Commission, 19 March 1997, para 11.

- 11.6 PU foam covers a wide range of hardness, stiffness and densities ranging from low density flexible foams used in upholstery and bedding to low density rigid foam used in thermal insulation.⁸ Uses of PU foam include the use of flexible foams in upholstered furniture, automobile seats, mattresses, underlay or in garments, such as in the lining of padded brassieres. Rigid foams are similarly used in a wide range of applications such as for insulation in refrigerators and freezers, and thermal insulation in the construction sector.
- 11.7 Broadly speaking, the degree to which the foam is "blown" during the production process (either by the gas generated during production or the addition of a blowing agent such as methylene chloride) determines the density of the foam being produced, which in turn determines the 'grade' of the PU foam produced. The 'grade' of the PU foam refers to the hardness and density of the foam produced, and the grade of the foam dictates the use of the foam, as well as its manufactured and sale prices. The density of the foam refers to the weight of the foam per cubic metre. The hardness of the foam refers to a foam's ability to withstand compression.
- 11.8 When slab foam is cut into peel, blocks, or converted into specific shapes, a lot of "offcuts" are generated. These are collected and then produced into a reconstituted grade of flexible foam known as rebond which is widely used in the production of underlay and packing materials.⁹

Polyurethane foam

- 11.9 The Commission has not previously considered markets for PU foam or PU polymers more generally.
- 11.10 The European Commission has considered markets for the production of flexible PU foam. In *Case No IV/M.835 Recticel / Greiner*, the parties submitted that separate product markets existed for technical PU foam (used for industrial purposes) and comfort PU foam (used in the furniture and bedding industries). Ultimately, the European Commission did not find it necessary to delineate the product dimension beyond that for PU foams more generally due to an absence of competition concerns in the broader market.
- 11.11 Similarly, the Australian Competition and Consumer Commission ("**ACCC**") has also considered markets relevant to PU foam. In its Public Competition Assessment of Pacific Brands Limited's proposed acquisition of Joyce Corporation Limited¹⁰, the ACCC identified the product dimension of the relevant market to be that for the supply of flexible slab PU foam. In Vita's view, a large number of acquirers require suppliers of PU foam to provide both slab PU foam and converted PU foam. Given that the Commission has recently regarded such demand-side characteristics as highly relevant to product market definition¹¹, Vita submits that in this instance the demand-side characteristics of the market require a wider product dimension than that considered by the ACCC.
- 11.12 The parties broadly agree with the submissions in *Recticel / Greiner* that flexible PU foams differ to an extent in characteristics, use, price and productive process. Indeed, the proportions of chemicals used in the production of PU foam will determine its manufactured cost, density, hardness (together its 'grade') and therefore its end use. The spectrum of grades is wide, with Pacific Brands capable of producing approximately

⁸ <http://en.wikipedia.org/wiki/Polyurethane>

⁹ D. McRobie, *Polyurethane Flexible Foams*, (Union Carbide NZ Ltd)

¹⁰ 22 March 2005.

¹¹ Commerce Commission Decision No. 633: *Air Liquide New Zealand Limited / ASCOGAS Limited*, p 10, paras 57 - 59.

30 grades of PU foam at its East Tamaki plant, and Vita 36 and 22 at its Auckland and Christchurch plants respectively, up to a density of 50kg per cubic metre. In addition, Pacific Brands imports a number of grades (predominantly high density grades) from its Australian foam operations as it is unable to produce these in New Zealand.

- 11.13 However, from a supply side perspective, switching between this wide range of grades of PU foam is straightforward and has minimal cost implications. Pacific Brands advises that even within a single production shift **[CONFIDENTIAL]** it is able to vary the grade being produced, albeit within a relatively narrow range. Vita is similarly able to vary grades within a single production shift. Moreover, for each separate production shift both Pacific Brands and Vita are able to switch manufacturing to any of their respectively produced grades. Given that Vita's production shift is only **[CONFIDENTIAL]** and Pacific Brands' **[CONFIDENTIAL]**, switching to produce the varying grades across the spectrum is straightforward.
- 11.14 Although for Pacific Brands there are limitations beyond a wide range of grades which can be produced by its continuous foam plant, these specialised grades of PU foam are imported. As these grades are at the outer edge of the spectrum and tend to be relatively low volume and reasonably high cost items, importation (in the case of Pacific Brands, from its Australian parent) provides a viable and cost-effective means of supply.
- 11.15 From a demand side perspective, demand side substitution exists between grades of PU foam, albeit on a more limited scale. In general, PU foam used in bedding is of a lower grade than that used for manufacturing furniture with the average density around 20kg per cubic metre.¹² PU foams used in specialist applications, such as in healthcare mattresses or marine squabs, tend to be either higher grade or specialist grade PU foam. Nonetheless, without drawing any bright line distinctions, in the majority of instances, acquirers have the ability to switch between a small range of grades. For example, in response to the increased price competition imposed by imports, Vita and Pacific Brands have both experienced furniture manufacturers substituting PU foam previously used with lower grades of PU foam.
- 11.16 Accordingly, the parties submit that the relevant product market for PU foam is a differentiated product market comprising all grades of flexible PU foam. While acknowledging that flexible PU foam is differentiated by its grade, and thus application and price, its high supply-side substitutability favours the adoption of a single product market.

Flooring underlay generally

- 11.17 Flooring underlay comes in three distinct forms:
- (a) Waffle Rubber sponge;
 - (b) Slab Latex foam; and
 - (c) PU.
- 11.18 Each form is produced utilising a distinctive methodology outlined below:
- (a) *Waffle Rubber sponge*: Rubber sponge is manufactured from synthetic rubber, limestone powder, process oil and blowing agents. The agents are mixed, then strip-fed onto a roll press. The newly formed sheet is then transferred onto a

¹² Vita advises that its average PU foam density is approximately **[CONFIDENTIAL]** per cubic metre, whereas Pacific Brands is approximately **[CONFIDENTIAL]** per cubic metre, reflecting the size of the Sleepyhead PU foam contract which Pacific Brands has.

chain belt where backing material (polyester, polypropylene and paper) is added. The backing material causes the mix to expand, with the shape controlled by the chain belt. To finish, the rubber is water-cooled, cured and then trimmed and wrapped for storage.

- (b) *Slab Latex foam*: Latex foam and crumb is made from a mixture of synthetic and natural latexes, latex based chemicals, limestone powder, surfactants and thickeners. The product is mixed for 2-3 hours and then stored. The foam is then spread onto the same backing material utilised in the production of rubber sponge, with a blade used to determine thickness. The product is then cured, cut, trimmed and wrapped for storage.
- (c) *PU*: PU underlay is made from waste PU and binder. The PU is ground into crumbs and mixed with the binder. The resulting mix is then put into a block mould and heated, creating a solid block of rebounded PU. From there, the blocks are peeled into sheets, with the material laminated with polythene film on one side. The final product is then cut to length and wrapped in heat sealed polythene.

11.19 PU underlay plays an important part of foam manufacturers' efforts to reduce waste and recycle foam. PU foam is a high grade product with density controlled during production to the extent that any off-cuts are suitable for use in the production of underlay.

11.20 In New Zealand, rubber flooring underlay was historically the more popular form of underlay. However, strong recent growth, due to improvements in PU quality and its lower cost, has seen PU foam underlay emerge as by far the most popular form of underlay in New Zealand. The Parties estimate that today, at least 90 percent of underlay sales in New Zealand are in PU foam underlay.

Flooring underlay

11.21 The Commission has not previously considered markets relevant to flooring underlay. Although the Commission has on two recent occasions considered carpet markets, it did not consider underlay in its decisions. The United Kingdom Competition Commission ("**UKCC**") has, however, considered flooring underlay in a merger context. In *Duralay International Holdings Ltd and Gates Consumer Industrial*¹³ the UKCC considered that although several forms of underlay were used in flooring (some of which are not used in New Zealand), these varying forms of underlay formed differentiated segments within a single market for underlay.

11.22 Vita submits that in accordance with the UKCC conclusion on the product dimension that the relevant product market ought to comprise both PU foam and rubber flooring underlay. While acknowledging that the differing production methods and requirements between PU foam underlay and rubber underlay limits supply-side substitutability, Vita considers that the UKCC's conclusion that "all five products [in the UK] are designed to provide the same functions of comfort, extending the product's [carpet] life, and sound and heat insulation" supports strong demand-side substitutability.

11.23 Applying the Commission's criteria set out in its Merger & Acquisitions Guidelines,¹⁴ in the event that there was a small increase in the price of either rubber or PU foam underlay, relative to the price of the other, then the majority of acquirers would be able to switch to the cheaper alternative.

¹³ A report on the proposed merger, UK Competition Commission, 2001.

¹⁴ Commerce Commission, Mergers & Acquisitions Guidelines, 2004, p. 16.

- 11.24 Vita advises that underlay can be characterised as a "grudge" purchase; Having paid a considerable amount for carpet, consumers are not prepared to pay more than is absolutely necessary for underlay which is not visible beneath the carpet. It is accordingly highly price sensitive. In addition, given the vast majority of the market is comprised of PU foam underlay, it would be contrary to commercial common sense to define separate markets for PU foam and rubber underlay. Vita, accordingly, submits that the appropriate product dimension is a differentiated market for all types of flooring underlay.

Functional Dimension

Polyurethane foam

- 11.25 Both Pacific Brands and Vita manufacture PU foam in New Zealand. In addition, Pacific Brands imports PU foam from Australia and Vita sources a limited quantity of [CONFIDENTIAL]. While both Pacific Brands and Vita supply foam in block or slab form to industrial customers, they also convert it into shapes required by downstream acquirers. As such, the buyer-seller relationship is characterised by the need for market participants to be able to supply a mix of both lower value block or slab foam and higher value converted foam. While, as evidenced by Greenpark's presence in the market, this requirement is not so strong so as to prevent non-vertically integrated conversion firms from competing with vertically integrated market participants, there are economies of scope between the functional levels which justifies them forming a single functional market.
- 11.26 Vita therefore submits that the relevant functional dimension to the market is the manufacture and / or wholesale supply of PU foam.

Flooring underlay

- 11.27 Flooring underlay is both imported and manufactured for supply to the New Zealand market. For example, Pacific Brands exports [CONFIDENTIAL] of scrap PU foam per annum to Australia each year for it to be manufactured by the Pacific Brands Group's underlay manufacturing operations in Australia. Pacific Brands imports approximately [CONFIDENTIAL] rolls of PU foam underlay into New Zealand annually. By contrast, other market participants such as Vita and Sleepyhead manufacture PU foam underlay in New Zealand from scrap PU foam.¹⁵ Vita advises that all rubber underlay is now imported into New Zealand.¹⁶
- 11.28 In terms of underlay, the wholesale distribution aspect of production is important. The Commission observed in *Decision 628: Cavalier Corporation Ltd / Norman Ellison Holdings Ltd* that the carpet retail market in New Zealand is characterised by retail chains of considerable size with a corresponding degree of countervailing power. Accordingly, the ability to supply effectively at a wholesale level is key. Moreover, given the intermediary role of the carpet retailer, there is not the scope for a separate functional market comprised of wholesale supply alone.
- 11.29 As such, Vita submits that the functional dimension to the underlay market is the manufacture and / or importation for wholesale supply of flooring underlay.

¹⁵ Vita manufactures PU underlay from scrap PU foam produced in the conversion of PU foam. It also purchases scrap PU foam from Enviro-foam and imports a considerable volume of compressed scrap foam.

¹⁶ Skellerup and Feltex both previously manufactured rubber underlay in New Zealand, but have since ceased production.

Geographic Dimension

Polyurethane foam

- 11.30 In *Recticel / Greiner* (supra), the European Commission ("**EC**") concluded that the market for PU foam was "not of a national but rather of a regional dimension, comprising several national markets, if not the entire Community." However, the EC reached this conclusion on the basis of the overlapping radii of production plants of key foam producers across Europe. Significantly, the EC noted that relatively important transport costs and the need to guarantee just-in-time delivery limited the radius to which PU foam products could be sold to about 500 km from the relevant factory. While Vita agrees with the points noted by the EC it is of the view that this finding cannot be transplanted wholly to New Zealand. In the almost 11 years since the EC reached its decision in *Recticel / Greiner* technological changes, together with New Zealand's unique characteristics, justify a departure from the EC's findings on geographic market definition.
- 11.31 In the ACCC's Public Competition Assessment of Pacific Brands' proposed acquisition of Joyce, the ACCC appears not to have conclusively decided whether the geographic dimension of the relevant market was state-wide or national in scope. Vita submits, however, that the context in which its proposed acquisition of the Assets falls to be assessed is materially different to that before the ACCC for consideration, having regard in particular to the exponential import growth experienced in New Zealand in respect of upholstered furniture, and more recently in inner sprung bedding.
- 11.32 Considerable advances have been made in the transport of PU foams in recent years, namely via advances in compression technology. Particularly for higher density PU foams, compression technology has allowed for the more efficient transportation of PU foam. The importation of PU foam from Australia and previous supply to the New Zealand market by Joyce Foam from Australia indicates the market is at least national in scope. This is further supported by the fact that Pacific Brands imports a significant volume of PU foam into New Zealand from its Australian manufacturing operations.
- 11.33 **[CONFIDENTIAL]**.
- 11.34 As set out above, in the past Joyce Foam ("**Joyce**") has supplied PU foam to A H Beard in New Zealand. Vita understands that Joyce supplied foam to A H Beard in New Zealand in the early 2000s. Joyce also tendered in 2007 for the supply of PU foam to A H Beard, but was ultimately beaten by Vita lowering its initially quoted price. This indicates that transport of PU foam across some distance is viable.
- 11.35 Accordingly, Vita considers that the relevant geographic market is national in scope. For the purposes of assessing the competitive effects of the proposed acquisition, Vita considers a national geographic market to be the most appropriate market in which to assess competitive effects.

Flooring underlay

- 11.36 In *Duralay* (supra) the UKCC found the relevant geographic dimension of the underlay market to be national in scope, noting that all large manufacturers of flooring underlay supplied on national basis. Vita submits that a national geographic market is also appropriate for the New Zealand flooring underlay market. Both it and Pacific Brands supply flooring underlay on a national basis with little or no variation in pricing. For example, **[CONFIDENTIAL]**.

- 11.37 Vita further contends that the viability of imported flooring underlay as evidenced by Pacific Brands and other competitors such as Jacobsen Creative Surfaces ("**Jacobsen**") supports a broader geographic market definition. Indeed, while recognising that for the purposes of the Commerce Act 1986, the geographic market is that of a national market, in reality the market is more of a global market with flooring underlay imported across the world from a variety of sources.

Market Definition summary

- 11.38 Based on the above analysis, Vita considers that the relevant markets affected by the acquisition of the Assets are as follows:
- (a) the manufacture and / or wholesale supply of polyurethane foam in New Zealand ("**PU Foam Market**"); and
 - (b) the manufacture and / or importation for wholesale supply of flooring underlay in New Zealand ("**Underlay Market**").

12. CURRENT COMPETITORS

- 12.1 There are a number of participants competing with Vita and Pacific Brands in the PU Foam Market and the Underlay Market:

- (a) **Enviro-foam:** Enviro-foam is an established manufacturer of PU foams with sites in Auckland and Christchurch. Enviro-foam is also present in Australia. Enviro-foam also converts PU foam using computerised technology.

Enviro-foam competes with Vita and Pacific Brands in the manufacture and wholesale supply of a wide range of flexible PU foam in New Zealand.

- (b) **Greenpark Products Ltd ("**Greenpark**"):** Greenpark sources bulk flexible PU foam from Vita and Pacific Brands and by way of importation of specialty PU foams (some of which it supplies to Vita). Greenpark's expertise is in the conversion of PU foam (and other foams) into shapes required by industrial customers.

In addition, Greenpark supplies a number of finished PU foam consumer products direct to retail. Greenpark competes with Vita and Pacific Brands principally through its conversion operations.

- (c) **Sleepyhead:** Although not presently active in the manufacture of PU foam, Vita understands Sleepyhead has a mothballed foam plant located in Otahuhu, Auckland. **[CONFIDENTIAL]**¹⁷ Sleepyhead has until mid 2006 manufactured PU foam from its Otahuhu site for its bedding operations and continues to manufacture PU foam underlay at this facility.
- (d) **Other:** There are a number of smaller, and often specialist, foam converters who supply converted PU foam suitable for use in bedding and / or furniture. Further details of these participants are set out in paragraph 16.1.
- (e) **Imports:** Although limited in number at present, overseas PU producers such as Joyce Foam have supplied PU foam into New Zealand from time to time.

¹⁷ **[CONFIDENTIAL]**

As evidenced by Joyce's 2007 quote to A H Beard, it can still be considered an existing competitor for the purposes of competition analysis.

13. DIFFERENTIATED PRODUCT MARKETS

Extent of Product Differentiation

Differentiation on the basis of marketing

- 13.1 There is generally very little brand differentiation in both the PU Foam Market and the Underlay Market. Brand loyalty, particularly in the PU Foam Market is limited, as a reasonable number of the main acquirers use multiple sources of supply. For example, **[CONFIDENTIAL]**. In addition, Vita advises that a significant number of its customers who are involved in the upholstery industry acquire PU foam from a combination of suppliers, with many seeking supply from two or three PU foam suppliers.
- 13.2 Key factors for customers are price, service, and product performance. Due to tight trading conditions in downstream markets such as the bedding and furniture manufacturing markets, customers are generally very price sensitive (more information on this point is set out below). Equally important for customers is the level of service offered. Customers require reliable and efficient supply of PU foam. While an important driver in competing for business, in Vita's view, service is simply a matter of having the right personnel and effective systems in place. To a lesser extent, quality is also important to customers and Vita considers that there are slight variations in quality amongst competitors in the PU Foam Market. **[CONFIDENTIAL]**.
- 13.3 Aside from differentiation in the form of its composition, there is little or no differentiation in the Underlay Market. Vita advises that in excess of 80 percent of the PU foam it supplies is covered by the following specification:
- (a) Density of between 85kg and 110kg per roll; and
 - (b) Thickness of underlay between 8mm and 11mm.
- 13.4 Vita's PU foam and flooring underlay have been sold in New Zealand for 31 and 28 years respectively, with its brand and its products well known to users. As the PU Foam Market is mature, Vita supplies a largely static (although declining) customer base, and consequently does not specifically market or advertise its brand in New Zealand. Nonetheless, Vita does promote its products and expertise by providing literature and technical information for the New Zealand market.
- 13.5 Pacific Brands has similarly been active in the PU Foam Market and Underlay Market for at least 25 years and while, **[CONFIDENTIAL]** opportunities to tender for supply come up reasonably frequently in the market, both markets supply to relatively static, albeit declining, customers.

Packaging format and customer base

- 13.6 Common to all PU foam outputs, differentiation in the PU Foam and Underlay Markets is relatively minimal. This is borne out by the fact that, as noted above, it is viable, particularly for large users of PU foam products, to seek supply from more than one distributor or supplier producer. All sales of underlay or PU foam (whether bulk or converted) by Pacific Brands, are made on a business to business basis. Customers tend to purchase varying quantities but purchases are made on a relatively frequent basis due to the bulky nature of PU foam products.

- 13.7 Product differentiation can arise in circumstances where customers have ongoing relationships with particular PU foam suppliers and through that relationship are able to develop new applications for the products in conjunction with the supplier. Vita and Pacific Brands consider large, sophisticated bedding customers to be innovative in the use of PU foam and have worked with these customers to provide more innovative PU foam solutions for use in the manufacture of bedding
- 13.8 More specifically, in New Zealand, Vita has relationships for supply of PU foam with customers including, but not limited to:
- (a) [CONFIDENTIAL];
 - (b) [CONFIDENTIAL];
 - (c) [CONFIDENTIAL]
 - (d) [CONFIDENTIAL]; and
 - (e) [CONFIDENTIAL].

- 13.9 However, Vita's relationship with these customers is not dependent upon any one aspect which differentiates the PU foam supplied by Vita to these parties from that which could be supplied by any other market participant. Underlay is a highly homogenous product. Scope for technical innovation or differentiation is minimal.

Supply-Side Substitution within PU foam grades

- 13.10 As noted above, PU foam suppliers produce different grades within the PU Foam Market. For example, PU foam used for bedding is usually of a density of approximately [CONFIDENTIAL] per cubic metre. Furniture by comparison uses a wider range of grades, [CONFIDENTIAL]
- 13.11 However, most PU foam suppliers produce or import a similar range of PU foams, which facilitates switching between suppliers for customers. Overall though, Vita considers that the extent of the range of PU foams supplied is dictated by demand from acquirers. For example, if a new seating grade is produced or imported by one competitor and proves popular, Vita is of the view that this further grade could (and would) be easily replicated by other competitors. Supply-side substitutability is therefore wide and easily achieved as key characteristics of PU foam (density and hardness) are easily measured in the finished product.
- 13.12 The investment required for a current supplier to switch grades, including the cost of physically changing the plant setting or configuration to make the alternative product, is at best negligible. Whilst there is a wide variance in grades, with each altering the hardness and density of the resulting PU foam, switching between any of these grades can be easily done between different production shifts. Moreover, Vita advises that it is capable of producing a much wider range of grades if there is sufficient demand to justify a production run. The only costs involved are chemical costs, and the inevitable wastage which occurs at the start and end of each production shift.
- 13.13 Pacific Brands and Vita are both able to switch between a narrow range of grades of PU foam during a single production shift. This further lowers the costs and time of switching between grades of PU foam and indicates that supply-side substitutability is viable across almost all grades of PU foam, which are required for different end-use applications.

- 13.14 There are no relevant barriers to switching (eg patents) and the know-how for producing a broad range of PU foams is readily available (production processes for different grades of PU foam are in any event essentially the same, and utilise the same equipment). Thus, there is virtually unlimited supply-side substitution among grades of PU foam **[CONFIDENTIAL]**.
- 13.15 The effect of this is that, due to customers' down-stream demand, product differentiation may at any one given point in time differ among suppliers. However, due to the high level of supply-side substitutability, product lines can readily and seamlessly be tailored to the specification of different and/or new suppliers' requirements.
- 13.16 Overall, in common with all markets characterised by commodity-like products and relatively little brand differentiation, competition is based mainly on price. Quality is a relevant consideration insofar as producers must be able to meet consistently their customers' specifications, but tends not to drive the customer's choice because most producers are capable of doing so.

14. VERTICAL INTEGRATION

- 14.1 The proposed Transaction is likely to result in a degree of additional vertical integration, for the combined entity. Through the acquisition of Pacific Brand's Sleepmaker business (which comprises part of the Assets), Vita will be a vertically integrated PU foam producer and inner sprung bed manufacturer. This vertical integration will, however, complement and make more efficient Vita's existing vertically integrated furniture manufacturing business.

15. PREVIOUS ACQUISITIONS AND COMMISSION NOTIFICATIONS

- 15.1 There have been no previous acquisitions involving Vita or Pacific Brands (or any interconnected body corporate or predecessor thereof) as an applicant or target notified to the Commission in the last three years.
- 15.2 Vita has not undertaken any other acquisition of assets of a business or shares in any markets material to the Commission's present investigation in the past three years.

PART III: CONSTRAINTS ON MARKET POWER BY EXISTING COMPETITION
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16. EXISTING COMPETITORS IN MARKET*Polyurethane Foam Market*

16.1 Suppliers of flexible PU foam in the PU Foam Market, in addition to Vita and Pacific Brands, include:

- (a) **Enviro-foam:** Enviro-foam has an approximate **[CONFIDENTIAL]** percent market share of the PU Foam market. Enviro-foam produces foam for the bedding and upholstery industries. It also manufactures specific products including cushions, squabs, Tetron wrap, soft fill cushions, foam chip, and 'Nimbus' polyester cushion fill. Enviro-foam manufactures a wide range of PU foam grades, from Visco (a high end foam) down to low-end, low density foams. Enviro-foam currently supplies PU foam to both bedding¹⁸ and furniture manufacturers.

Enviro-foam is ultimately majority owned by interests in Australia. It operates in the North Island through Auckland Foam Company Limited, which is wholly owned by Mainland Foams Limited. Enviro-foam is present in the South Island through Mainland Foams operating out of Christchurch. Enviro-foam also operates in Australia.

Vita estimates that through its Auckland Foam and Mainland Foam operations, Enviro-foam has approximately **[CONFIDENTIAL]** tonnes of PU foam capacity annually.¹⁹

Further information on Enviro-foam can be found at www.envirofoam.co.nz

- (b) **Greenpark Products Ltd:** Greenpark has a **[CONFIDENTIAL]** percent share of the PU Foam Market in New Zealand. Greenpark is a privately owned New Zealand company, established in 1949 and based in Auckland and Christchurch.

[CONFIDENTIAL] Greenpark which it then converts using a fully computerized, state of the art foam cutting machinery to precision cut foam. Greenpark supplies furniture manufacturers with converted foam and also supplies direct to the retail sector. Greenpark supplies converted PU foam under its Maxfoam brand. Greenpark has a strong presence in the supply of converted PU foam to the upholstery industry and Vita estimates that it would be likely to supply in excess of 25 percent of the upholstery industry in the North Island with PU foam.

As well as operating its foam conversion plant, the company has expanded by importing and distributing fabrics, particularly wholesaling curtain and upholstery material to the retail industry. Greenpark also imports some Ester foams.

Further information can be found at www.greensite.co.nz

¹⁸ Vita understands that Enviro-foam supplies Brownies, a New Zealand bed manufacturer, with PU foam.

¹⁹ Estimate based on Enviro-foam operating one shift per day. Capacity could be further increased by Enviro-foam operating a second shift, or even further by the addition of a night shift.

- (c) **Para Rubber:** The Para Rubber brand is owned by Skellerup Industries Limited. Para Rubber ("Para") has nine stores throughout New Zealand. Para provides a variety of foam products, including uncovered squabs, mattresses and bed underlays as well as untrimmed foam sheets, closed cell foam and general foam cuttings. Para Rubber has instore cutters which allow it to convert PU foam into finished products.

Further information can be found at www.pararubber.co.nz

- (d) **Foam Alone:** Foam Alone is the foam division of DAA Holdings Limited. Located at the Highbrook Technology Estate in Manukau, Auckland, Foam Alone specialises in the conversion of flexible foam products. These flexible foams are supplied by a number of manufacturers and are then supplied unconverted or converted into end use products. Foam Alone offers foam insulation, foam sealants, diecuts and stock foam for marine, construction or manufacturing use.

Further information can be found at www.foamalone.co.nz

- (e) **Sleepyhead:** Up until approximately mid-2006, Sleepyhead manufactured PU foam as part of its vertically integrated bed manufacturing operations located in Otahuhu, Auckland. In addition to supplying itself with timber for bedding frames, Sleepyhead manufactured most of its PU foam requirements. Sleepyhead's batch PU foam plant has been mothballed since mid-2006, although it continues to manufacture PU foam underlay.

Vita understands that Sleepyhead could at any time, with minimal delay or cost, resume production of PU foam, and this competitive threat provides very real constraint as against Vita and Pacific Brands. **[CONFIDENTIAL]**

- (f) **W Wiggins:** W Wiggins Limited is involved in the wider outdoor fabrics industry. It provides products for the marine, awnings and shades, apparel, soft signage and equestrian markets. W Wiggins Limited primarily uses and converts PU foam for upholstery in the manufacture or recovery of furniture.

Further information can be found at <http://www.wwiggins.co.nz/wiggins/Architectural.html>

- (g) **Reid & Twiname:** Reid & Twiname Limited is an importer and distributor of a wide variety of fabrics and trims. It provides outdoor fabrics, motor trimming and automotive body building accessories. Reid & Twiname Limited also sells equestrian supplies, security seals and marine and automotive textiles. It converts foam for use as marine and automotive trims and accessories. It is located in Auckland but also has a branch in Christchurch and a distributor in Wellington.

Further information can be found at <http://www.retwine.co.nz/index.htm>

- (h) **Foam Distributors:** Foam Distributors Limited is located in Wellington and specialises in the distribution of high quality PU foam. Foam Distributors Limited stocks PU foam sheets and converts them to order, often in complex shapes. The foams are primarily used in the manufacture of products such as seating, car upholstery, furniture, squabs and mattresses.

Further information can be found at <http://www.foam.co.nz/>

- (i) **Highland Distributors:** Highland Distributors are based in Dunedin. Highland Distributors make marine and automotive upholstery, carpets, trims as well as a wide variety of textile products such as floor-mats.

16.2 Market share information for the PU Foam Market is set out below. Table 1 represents market shares of PU foam for just importers and manufacturers of PU foam, whereas Table 2 represents market shares in a market including PU foam converters.

Table 1

Polyurethane Foam manufacturers / importers

Supplier	Volume of sales (tonnes)	Share %	Capacity (tonnes)	Share % by capacity
Vita	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Pacific Brands	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
<i>Combined:</i>	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Enviro-foam	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Total	[CONFIDENTIAL]	100	[CONFIDENTIAL]	100

Source: Parties estimates

[CONFIDENTIAL] Moreover, although the table does not reflect capacity which Joyce brings to the market either as a near entrant or present market participant, regard should be had to the capacity and output which Joyce is placed to bring to the market.

Table 2
PU Foam Market shares

Supplier	Volume of sales (tonnes)	Share %
Vita	[CONFIDENTIAL]	[CONFIDENTIAL]
Pacific Brands	[CONFIDENTIAL]	[CONFIDENTIAL]
<i>Combined:</i>	[CONFIDENTIAL]	[CONFIDENTIAL]
Enviro-foam	[CONFIDENTIAL]	[CONFIDENTIAL]
Greenpark	[CONFIDENTIAL]	[CONFIDENTIAL]
Others ²⁰	[CONFIDENTIAL]	[CONFIDENTIAL]
Total	[CONFIDENTIAL]	100

Source: Parties estimates

- 16.3 Although aggregation in the PU Foam Market is outside the Commission's safe harbours, the combined entity will be constrained post acquisition in particular by Enviro-foam, but also by Greenpark, the threat of re-entry by Sleepyhead, the threat of imports (for example, from Joyce), and by imports of furniture and bedding (discussed later).

Underlay Market

- 16.4 Suppliers of flooring underlay, in addition to Vita and Pacific Brands, include:

- (a) **Sleepyhead:** Sleepyhead manufactures PU foam underlay using the scrap PU foam produced from its conversion of bulk foam at its manufacturing plant (a Sunkist Rebond Underlay Plant). Due to a shortfall in scrap foam, Sleepyhead also imports compressed scrap foam for the manufacture of PU foam underlay.

Vita and Pacific Brands consider there to be little variation in the density and thickness of the PU foam underlay produced by Sleepyhead compared with that which they produce or import.

- (b) **Jacobsen Creative Surfaces ("Jacobsen"):** Jacobsen imports a wide range of floor coverings and underlay, including Rebond PU foam. Jacobsen is the exclusive distributor of Bridgestone natural rubber underlay in New Zealand.

Further information can be found at www.jacobsens.co.nz

- (c) **RLA Polymers Pty Ltd ("RLA"):** RLA is a New Zealand based subsidiary of RLA Australia, which is based in Melbourne, which is in turn owned by British Vita Plc (not interconnected with Vita).

²⁰ Others include Para Rubber, Foam Alone, W Wiggins, Reid Twiname, Foam Distributors and Highland Distributors.

RLA specialises in the supply of double stick commercial latex 'slab' rubber underlay. In addition, it manufactures or imports a number of other flooring applications and adhesives.

Further information can be found at www.rlapolymers.co.nz

- (d) **James Halstead Flooring NZ Limited ("Halstead"):** Halstead is a wholly owned subsidiary of Polyflor Limited, an offshore flooring specialist in flooring solutions.

Halstead acquires rubber and foam flooring underlay on a wholesale basis in New Zealand which it sells for both residential and commercial application. Vita understands that at present Halstead takes supply of all of its PU foam underlay requirements from Sleepyhead's underlay manufacturing operations.

Further information can be found at www.halstead.co.nz

- (e) **Gilt Edge Industries:** Gilt Edge Industries Limited ("**Gilt Edge**") has seven stores throughout New Zealand including a large manufacturing and bulk store facility in Christchurch. Gilt Edge offers a comprehensive range of flooring product, including floor levellers, carpet gripper, underlay, flooring trims and even tools. Gilt edge takes supply of its foam requirements from Sleepyhead's manufacturing operations.

Further information can be found at www.giltedge.co.nz

- (f) **MJ Sturgess:** MJ Sturgess is an Australian manufacturer of flooring underlay based in Mansfield, Queensland. Pacific Brands advises that it is currently present in New Zealand on a small scale through arrangements with local distributors. Pacific Brands understands, however, that MJ Sturgess has recently been in discussions with parties regarding increasing the scale of its presence in the underlay market in New Zealand.

Table 3
Underlay Market shares²¹

Supplier	Volume of sales rolls (1,000)	Share % by volume	Value of sales (\$)	Share % by value%
Vita	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Pacific Brands	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
<i>Combined:</i>	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Sleepyhead	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Jacobsens	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
RLA	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Total	[CONFIDENTIAL]	100	[CONFIDENTIAL]	100

Source: Parties' estimates

16.5 As Table 3 shows, the Parties' combined supply to the market is [CONFIDENTIAL] percent by volume. Although outside the Commission's safe harbours, Vita considers that Sleepyhead and other suppliers of underlay, coupled with the ease and prevalence of imports in the market, will continue to constrain the combined entity post-acquisition.

16.6 Vita does not consider that the proposed acquisition would give rise to a substantial lessening of competition in the Underlay market, due to strong existing competition (comprised of a number of imported sources), and the very real prospect of cost effective and timely expansion by those and other fringe competitors in the New Zealand market.

17. CONDITIONS TO EXPANSION BY EXISTING COMPETITORS

17.1 As identified in paragraph 10.2 (and evidenced in Table 1), the PU foam industry is characterised by substantial overcapacity. As such, there exists the potential for existing competitors to readily increase their current output to the New Zealand market.

17.2 In particular, Enviro-foam, which has its own PU foam batch plants, is running at considerably less than capacity at around [CONFIDENTIAL] percent of potential capacity. The parties estimate that for Enviro-foam to produce an amount of PU foam approximately equivalent to that which Vita produces, it would only need to run its batch plant for eight hours a day. Barriers involved in expanding production to include another shift, or even 24 hour operations are relatively low, requiring only increased chemicals and labour, possibly some increased storage and relevant regulatory approvals (principally an air discharge consent).

²¹ Note: Halstead and Gilt Edge have not been included in Table 2 as this would in effect 'double count' the underlay manufactured by Sleepyhead. Nonetheless, it is important to consider them as separate market participants as either could easily also source underlay from overseas and compete in the market in this way.

- 17.3 Other conditions relating to expansion are similarly low. Expansion by existing PU foam manufacturers such as Enviro-foam will require a hot-block cooling area large enough to handle increased capacity. Hot-block cooling areas are, in reality, little more than an open-sided barn, and can easily and cheaply be extended or erected.
- 17.4 In addition, extra staffing required can be readily employed. Employees required in the manufacture of PU foam tend for the most part to be unskilled and an expanded operation would not be likely to require further technical or managerial staff. As discussed in further detail in paragraph 22.11, although PU foam plants require air discharge consents to operate, an expansion of an existing production site would not ordinarily require new or further consents.
- 17.5 Given that the manufacture of PU foam favours higher volume production to achieve economies of scale, rather than increasing costs, expansion by an existing competitor would enable it to access lower marginal costs. This would, in turn, make an expanded competitor an even greater competitive threat to the combined entity. Moreover, as identified above, product differentiation is minimal and qualification of alternative sources is relatively easy. Accordingly, acquirers in the New Zealand market can, and do, easily switch between different suppliers.
- 17.6 Vita contends that expansion by existing or fringe competitors who either already import or could commence the importation of PU foam products is also viable, and thus acts as a competitive constraint in the market both now and post-acquisition. Specifically, expansion by existing or fringe import customers is feasible because:
- (a) as illustrated by Pacific Brand's importation of both slab PU foam and underlay, and Joyce's previous supply of PU foam into New Zealand (set out in more detail in paragraph 11.32 and in **[CONFIDENTIAL]** both underlay and PU foam are freight effective, and an increase in volume shipped to New Zealand would likely either be equally cost efficient, or result in even greater economies of scale for importers. This is particularly true for suppliers importing to the New Zealand markets from Australia, or elsewhere in the Asia-Pacific region;
 - (b) existing competitors already have existing distribution arrangements in place in respect of New Zealand markets;
 - (c) existing competitors already have established relationships with New Zealand customers (for example Joyce has an historic relationship with A H Beard by way of its previous supply, which led to its 2007 tender);
 - (d) tariffs on imports are low, at 7 percent for both PU foam and underlay, a reduction from their previous level of 9.5 percent. Tariffs on imported PU foam and underlay are set to decrease to just 5 percent in July 2008 making imports even more cost effective (and imports from Australia, where historically most imports have come from, do not attract any duty under CER); and
 - (e) Vita and Pacific Brands understand that Australian PU foam producers face overcapacity issues similar to those in New Zealand. Accordingly, expansion by existing competitors by importation is not likely to be hampered by capacity constraints. Indeed, this overcapacity provides further incentive for near entrants such as Joyce to supply PU foam to the New Zealand market, either through New Zealand based distributors, or in its own right. In terms of pricing, given the importance of economies of scale, any further supply opportunities to supply at pricing above marginal cost (having regard to the greater economies of scale in Australia) would incentivise an Australian manufacturer such as Joyce to enter the New Zealand market.

- 17.7 Accordingly, if following the proposed acquisition, the combined entity were to attempt to increase the price of either PU foam or underlay, existing and new entrants would be able to expand or enter the New Zealand market quickly in response to such an attempt to raise prices. The identity of those near-entrants and their ability to expand is described further in section 24 below.

18. CONCLUSIONS ON CONSTRAINT BY EXISTING COMPETITION ON EXERCISE OF UNILATERAL MARKET POWER

- 18.1 Vita and Pacific Brands are currently constrained in both the PU Foam Market and the Underlay Market, and the combined entity will remain so after the proposed acquisition. Key factors which currently constrain Vita and Pacific Brands, namely the threat of expansion by way of local manufacture or importation and issues of overcapacity, will remain post acquisition:

- (a) **Overcapacity in New Zealand and overseas:** As highlighted above, the PU foams industry faces overcapacity issues in New Zealand. Conditions in Australia are not dissimilar. As the production of PU foam is reliant upon high volumes, manufacturers in New Zealand, and near entrants in markets such as Australia will naturally be looking for any opportunities to secure supply and thus decrease their level of underutilisation of capital. Indeed, given the trading conditions in the New Zealand PU foams industry, and the consequent low margins (or losses) being earned, the threat of losing volume to a competitor or near entrant will act as a very real competitive constraint on the combined entity.
- (b) **Ease of entry and expansion:** As evidenced above, both the PU Foam Market and the Underlay Market have low barriers to entry and expansion, and there exists strong existing international competitors. These neighbouring markets act as a constraint on the pricing of PU foam and underlay.
- (c) **Ease of imports:** Imports currently feature to a limited extent in the PU Foam Market and are especially prevalent in the Underlay Market. Given recent advances in PU foam compression technology, and the growing cost-effectiveness of sea-freight, imports will remain a viable constraint in both markets.

Further, low tariffs, coupled with the superior scale and lower labour costs of offshore manufacture, mean that imported flexible PU foam and underlay can feasibly be imported at a level competitive with locally manufactured flexible PU foam and underlay.

- (d) **Countervailing power of acquirers:** Given that there is minimal product differentiation, buyers can switch between suppliers and/or distributors with ease and at minimal or no cost. Moreover, Vita considers that the bulk of the New Zealand PU Foam market is comprised of a number of large and sophisticated end users, such as large bedding and furniture manufacturers. Due to the sheer volume of each of these large accounts, acquirers possess considerable countervailing power against suppliers and distributors. Consequently, any attempt by the combined entity to exercise market power will result in acquirers resisting the exercise of market power by seeking supply from the combined entity's competitors or via a self-supply.

In particular, the combined entity will be constrained from increasing its prices to acquirers who are active in the manufacture of furniture. Over the past 3 to

4 years, margins in the furniture industry have come under intense pressure for two reasons. First, since the entry of Harvey Norman and other 'big box' furniture retailers such as Big Save, retail margins have been reduced drastically. While margins overall have fallen, retailers have enjoyed relative margin stability at the expense of furniture manufacturers. Five years ago, typical margins on furniture accounts were approximately [CONFIDENTIAL] percent. Today they sit typically at between [CONFIDENTIAL] and [CONFIDENTIAL] percent. Secondly, imports of upholstered furniture have increased substantially over the past three to four years. In 2006, a total of 412,655²² upholstered seats or lounge suites were imported into New Zealand, at a value of \$100,387,430.²³

The effect of these two changes has been that the viability of upholstered furniture manufacturing in New Zealand has become increasingly marginal. In order to continue to be a viable source of upholstered furniture for large retailers, which manufacturers depend on to generate volume, New Zealand manufacturers have to be priced competitively with imported furniture. As cheaper imports have increasingly appeared more financially attractive, a number of retailers have switched to retailing imported furniture, which is more profitable for them. Large retailers taking supply of imported furniture include:

- (i) Farmers;
- (ii) Smith City;
- (iii) Harvey Norman;
- (iv) Furniture City; and
- (v) Big Save.

The marginal viability of domestically manufactured furniture has manifested in the closure or transition to import supply by furniture manufacturers.²⁴
[CONFIDENTIAL]

[CONFIDENTIAL] but it also evidences the sensitivity of downstream acquirers to any price increases in PU foam. In effect, as is presently the case, any attempt by the combined entity to raise prices to furniture manufacturers will likely be met with a decision to move manufacture offshore or by the closure of that business, either way resulting in a loss of volume for the combined entity.

19. MARKET CHARACTERISTICS FACILITATING OR IMPEDING COORDINATION

19.1 The risk of coordinated effects post-acquisition is low. Both the PU Foam Market and the Underlay market are characterised by a number of features which condition against prospects for coordinated effects. These features in respect of each of the respective markets are as follows:

19.2 In respect of the PU Foam Market:

- (a) Low barriers to entry and expansion;

²² Source: Department of Statistics.

²³ CIF cost.

²⁴ [CONFIDENTIAL]

- (b) Innovation and research initiatives;
- (c) The asymmetry of market shares and of costs; and
- (d) The countervailing power of acquirers.

19.3 In respect of the Underlay Market:

- (a) Low barriers to entry and expansion;
- (b) The high proportion of the market which is comprised of imports;
- (c) The asymmetry of market shares arising out of the unconcentrated nature of the market; and
- (d) The unconcentrated nature of the market.

19.4 The acquisition does not affect any of these factors and therefore cannot be said to facilitate coordination.

20. NO EVIDENCE OF PRICE CO-ORDINATION, PRICE MATCHING OR PRICE FOLLOWING

20.1 Neither Vita nor Pacific Brands is aware of any past or current co-ordination of its activities with any other competitors in supply to the New Zealand market.

21. NO RISK OF CO-ORDINATED BEHAVIOUR

21.1 In summary, Vita currently competes vigorously in the PU Foam Market and the Underlay market. The proposed acquisition will not impact on this intense competition. In particular the low barriers to entry and expansion in all markets and the asymmetric nature of the market shares indicate that the exercise of coordinated market power is unlikely to cause concern post-acquisition.

PART IV: CONSTRAINTS ON MARKET POWER BY POTENTIAL COMPETITION

22. CONDITIONS OF ENTRY

22.1 Conditions of entry to commence supply in either of the PU Foam Market or the Underlay Market differ. Due to the ease of importation for underlay (evidenced by the prevalence of imports in the Underlay Market), conditions of entry to commence supply in the New Zealand Market are low and a number of potential entrants exist. Conditions of entry in the PU Foam Market are more complex. Nonetheless, Vita considers that entry into the market is viable at a relatively low cost and within a relatively short period of time.

*Polyurethane Foam Market***Manufacturing capabilities**

22.2 In order to manufacture PU foam, potential entrants will need to procure a PU foam production plant. As noted previously, PU foam plants come in two distinct forms; batch production plants or continuous production plants. Vita and Pacific Brands both operate continuous foam production plants. However, Vita is of the view that a potential entrant could enter the market by setting up either a batch production plant or a continuous production plant.

22.3 Although batch foam plants produce foam at a slower rate than a continuous production plant, a batch foam production plant would in many ways be better suited to the capacity requirements of the PU Foam Market. For example, Vita understands that the quantity which it produces at its own Maxfoam continuous foam production plant in [CONFIDENTIAL] is produced by Enviro-foam in around 8 hours. Furthermore, in Vita's opinion, the variable costs of operating a batch foam production plant on this basis would be similar to a party such as Vita operating its continuous foam plant. In addition, as is evidenced by Pacific Brands' importation of high density foams from Australia, the heightened value and more durable properties of these types of PU foams mean that importation is also possible, particularly at the upper end of the spectrum.

22.4 A comparison of the estimated costs and production outputs between a batch foam production plant and a continuous foam production plant is set out below.

Comparative Analysis: Box and Continuous Foam Plants

	Box Foam Plant	Continuous Foam Plant
Key Difference:	Continuous Foam has reasonably high fixed costs but its bulk/core density differential is advantageous if output is sufficient.	
Benefits:	<ul style="list-style-type: none"> Needs significantly less production and warehousing space Can easily vary the size of production runs and manufacture wide range of product Small production runs economical Low cost of entry with reasonable level of capacity available 	<ul style="list-style-type: none"> Product consistency is better, cell structure more consistent Consistent density throughout the foam High capacity capabilities
Negatives:	<ul style="list-style-type: none"> Product can be difficult to replicate from one run to the next Product consistency can be an issue for very specialist customers Potential for differential in density of the product 	<ul style="list-style-type: none"> Needs high technical knowledge High setup costs Needs long production per grade to be competitive Needs high volumes to justify existence Cannot vary sizes easily Cost of failure run high
Output:	Box Foam Plant	Vita Plant
Fixed Costs per cu/m	\$(CONFIDENTIAL)	\$(CONFIDENTIAL)
Variable Costs per cu/m	\$(CONFIDENTIAL)	\$(CONFIDENTIAL)
Chemical Cost per kg	\$(CONFIDENTIAL)	\$(CONFIDENTIAL)
Chemical Cost per slab	\$(CONFIDENTIAL)	\$(CONFIDENTIAL)
Chemical Cost per cu/m	\$(CONFIDENTIAL)	\$(CONFIDENTIAL)

22.5 A "turn key" batch foam production plant can be purchased for as low as approximately NZ\$(CONFIDENTIAL) For example, Sunkist Chemical Machinery Limited ("**Sunkist**"), a Taiwanese company with a strong reputation in the manufacture of machinery required for the production of flexible PU foam manufacturing, can supply installed turn-key batch foam plants for little more than NZ\$(CONFIDENTIAL) Although at this price, the plant would be a low-tech, entry level plant, Vita understands that 'turn key' high-tech, high-end batch foam plants can be purchased from more reputable suppliers such as Cannon Viking for less than \$(CONFIDENTIAL)

- 22.6 In addition to Sunkist, other international manufacturers of single block foam machines include:
- (a) Cannon Viking;
 - (b) Hennecke; and
 - (c) Beamech.
- 22.7 A diagram illustrating the nature, dimensions, and footprint of a batch foam plant is set out at Appendix B.
- 22.8 Beyond the purchase of a batch foam plant, there are few other requirements in terms of establishing a manufacturing site. The footprint of these plants machinery is relatively small. Vita estimates that in terms of site space, a site of approximately 750m² would be sufficient to commence PU foam production using a batch foam plant. This space would be taken up by production (200m²), curing (250 m²) and storage/office (300m²). The only other equipment required is chemical storage tanks, and piping and pumps from storage tanks to the foam plant. These requirements are relatively low tech and low in cost proportionate to the cost of the initial plant.
- 22.9 Consequently, Vita is of the view that a quality batch foam production plant could be set up for comfortably less than NZ\$[CONFIDENTIAL]. Given that this type of foam plant would be capable of producing approximately [CONFIDENTIAL] of PU foam annually, the start-up costs of such a plant are insignificant in comparison with the capacity of the operation.
- 22.10 Although PU foam is relatively flammable immediately after production, its volatile nature does not create any material barriers to entry. All that is required to accommodate PU foam immediately after production is a "hot block room" where the slabs of PU foam are left to cool for approximately 24 hours. As stated earlier, these "hot block rooms" are in effect little more than open-ended barns and in the case of a batch foam production plant are unlikely to take up a large amount of space.

Environmental

- 22.11 In order to operate a foam production plant, air discharge consents are required. While obtaining the required discharge consents involves the typical regulatory process and consultation with the relevant regional council, Vita does not consider that the requirement for discharge consents constitutes a barrier to entry. In terms of timing, resource management experts advise that the process for obtaining a typical air discharge consent takes between 6 and 12 months and that the total cost of the process, including solicitors' and other professionals' fees, could be expected to be as low as NZ\$25,000, with a total cost of NZ\$50,000 at the high end of the scale.
- 22.12 In addition to discharge consents, in the event that entry required building of a green-foot site the usual building consents would be required.

Distribution

- 22.13 Distribution of foam is straight-forward. PU foam is transported from source by truck. Vita has contracted owner-drivers in Auckland who drive exclusively for Vita and owns a B-Train trailer unit with which it transports PU foam between its Auckland and Upper Hutt sites. As such, distributional requirements do not constitute a barrier to entry.

Other conditions

- 22.14 As PU foam is a relatively homogenous product, there are no barriers to entry in respect of branding. It is common for acquirers to split supply between various suppliers at present and Vita sees no reason for this practice not to continue post-acquisition.
- 22.15 Furthermore, while the outputs of batch foam production plants may differ slightly from that produced by continuous production foam plants, the fact that Sleepyhead, a reputable and established bedding manufacturer, used PU foam sourced from its own batch foam plant for a number of years evidences that the quality of output produced by batch foam production plants is more than sufficient to supply to bedding manufacturers, the largest source of demand in the PU Foam Market.
- 22.16 In summary, barriers to entry or expansion in the PU Foam Market are not so great so as to deter entry taking place in a timely and effective manner.

Underlay Market

- 22.17 Entry into the Underlay Market would potentially occur either by way of importation or by local manufacture. Vita considers that given the excess capacity in the market de novo entry into manufacturing in New Zealand is less likely. However, it would be economical and indeed logical for an entrant in the PU Foam Market to commence in the production of PU foam underlay. Using scrap PU foam arising out of the production of bulk PU foam, all that is required to convert the scrap foam into underlay is for the scrap PU to be mixed with binder, and then for the mix to be allowed to 'set' in a heated mould. The manufacture of PU foam underlay plays a vital role for any PU foam manufacturer in the minimisation of waste which occurs during the manufacture of PU foam and it is therefore highly likely that any entry in the PU Foam Market would also be replicated in the Underlay Market.
- 22.18 Conditions to expansion in the Underlay Market are very low. The only material constraint on expansion to existing underlay manufacture is sourcing sufficient supplies of scrap PU foam. Parties such as Sleepyhead currently import scrap PU foam from sources which include China, Japan, Europe, and beyond. As such, expansion would simply require increased importation of scrap PU foam. Moreover, in the event that Sleepyhead were to recommence PU foam manufacture, this would provide it with an increased supply of scrap PU foam paving the way for its expansion in the Underlay Market.
- 22.19 Importation of underlay faces few barriers to entry. As underlay is a relatively high value product (compared with PU foam), importation is cost effective as is evidenced by the considerable number of imports currently in the New Zealand market. For example, freight costs from Pacific Brands' operations in Australia comprise only **[CONFIDENTIAL]** of the CIF price of underlay. As finished underlay is an inert product, transportation is safe and straightforward and compression technology means that underlay can be efficiently freighted by container. Pacific Brands advises that it is able to efficiently compress underlay in rolls for transportation without any material damage or loss upon arrival in New Zealand.

- 22.20 Tariffs on imported underlay do not constitute a material barrier to entry. Under New Zealand's Closer Economic Relations trade agreement with Australia, imports from Australia will not attract any duty, and as part of New Zealand's liberalisation of trade, tariffs on underlay have steadily been decreased. In 1999, tariffs on flooring underlay were decreased from 9.5 percent to the current level of 7.5 percent. As part of New Zealand's tariff reduction programme, tariffs on flooring underlay will further decrease to just 5 percent in July 2008. In addition, several countries also enjoy the benefit of preferential tariffs for imports into New Zealand rendering duty payable on imports an even lower barrier to entry.²⁵

Distribution

- 22.21 In respect of either local manufacture or importation of underlay, a warehouse facility is required for the storage of foam underlay. Given that the majority of acquirers of underlay are carpet retailers or commercial flooring acquirers, it is common place for the manufacturer or importer to hold the stock of the underlay (during which time it is 'let out' - the process returning it to its usual state following compression) and provide just-in-time delivery as required. Beyond warehousing requirements, distribution of underlay is relatively straightforward. It is easily transported by truck. The only distribution constraint is the logistical challenge of servicing minor centres. [CONFIDENTIAL]
- 22.22 In summary, there are no relevant impediments or material obstacles to entry or expansion in the underlay market.

23. POTENTIAL NEW ENTRANTS

Polyurethane Foam Market

- 23.1 As stated above in paragraph 16.1(c), the most immediate threat from potential new entry arises from Sleepyhead with its mothballed foam production plant [CONFIDENTIAL]. Similarly, in Vita's view, other significant threats of potential entry come from bedding manufacturers who in the event of the combined entity seeking to exercise market power would be incentivised to commence self-supply of PU foam, and from overseas importers who could enter the New Zealand market if presented with appropriate economic incentives. In further detail, these potential entrants include:

- (a) **Sleepyhead:** Sleepyhead has a batch foam production plant located in Otahuhu, Auckland. Up until 2006, Sleepyhead was producing its own PU foam requirements from this batch foam production plant. Vita understands that this production plant has simply been mothballed since Sleepyhead commenced taking supply from Vita, in the first instance, and since last year, Pacific Brands.

While at present, [CONFIDENTIAL] if faced with the imposition of a *SSNIP* by the combined entity Sleepyhead could easily switch to supply itself with PU foam from its moth-balled plant. Vita considers that if post-acquisition it sought to increase its prices to Sleepyhead in the order of [CONFIDENTIAL] percent, it would be very cost effective for Sleepyhead to commence self-supply.

In addition, as Sleepyhead has continued its production of underlay, but has to import scrap PU foam from China as it does not produce enough scrap, recommencing supply of PU foam from its own batch production plant would also provide it with a greater source of scrap foam from which to produce

²⁵ Preferential tariffs are available to a number of least developed countries and countries in the Middle East.

underlay. As Sleepyhead has experience in the production of PU foam and has successfully managed to self-supply in the past, it would face few, if any, barriers to entry to recommence self-supply of PU foam. In addition, in order to gain scale, Vita considers it likely that in the event Sleepyhead recommenced supply, it would also supply to other acquirers of PU foam, particularly in the bedding industry.

In recent discussions with European foam production plant manufacturers, Vita has learned that Sleepyhead has recently been in contact with European manufacturers enquiring about sourcing a PU foam plant. **[CONFIDENTIAL]**. This highlights the fact that in addition to commencing resupply with its moth-balled plant, Sleepyhead, in common with any other PU foam acquirer, is easily able to acquire a new PU foam production plant at a relatively low cost.

- (b) **Sealy:** Sealy has approximately **[CONFIDENTIAL]** percent of the New Zealand bedding market. As such, it is a significant acquirer of PU foam and would be incentivised in the event that the combined entity sought to exercise a manifestation of market power to install its own batch foam production plant.
- (c) **A H Beard:** Although the smallest of the four large bed manufacturers in New Zealand, A H Beard nonetheless remains a large PU foam account, currently split between Pacific Brands and Vita. It, too, would arguably be incentivised to commence self-supply of PU foam (or take supply of PU foam via Enviro-foam) in the event that the combined entity sought to impose a manifestation of market power upon it. In addition, as a trans-Tasman manufacturer, A H Beard could divert production of beds to either New Zealand or Australia, or as is evidenced by Joyce's past supply to A H Beard, A H Beard could seek PU foam supply from Joyce (see paragraph (e) below).
- (d) **Greenpark:** As a foam conversion company, it would be a logical fit with Greenpark's existing business for it to commence self-supply. As it is reliant upon Pacific Brands and Vita for supply of bulk foam, although post-acquisition it would be left with the option of seeking supply from Enviro-foam, Greenpark could also install its own PU foam batch production plant and commence self-supply. Given Greenpark's existing business operations, it would also likely supply to other acquirers of PU foam. Vita is of the view that Greenpark would be well placed to expand in the event that it elected to self-supply PU foam, particularly by increasing its role as an alternative source of PU foam for furniture manufacturers who are averse to taking supply from Vita due to it being vertically integrated in furniture manufacture.
- (e) **Joyce Foam:** Joyce Foam ("**Joyce**") is a large Australian PU foam manufacturer. Owned by giant Indian PU foam company, Sheela Foam, Joyce manufactures a large range of polyester and PU foams for the automotive, industrial and nappy industries. Joyce supplies domestic acquirers of PU foam and also exports PU foam. As stated above, Joyce has supplied PU foam to A H Beard in New Zealand as recently as 2004, and also tendered for part of A H Beard's PU foam account in 2007. Accordingly, Joyce could re-enter the New Zealand PU Foam Market given the right economic incentives.

Underlay Market

23.2 In addition to the wide number of imported underlay products currently supplied into the New Zealand market, there remain a number of potential entrants who would be well placed to commence supply of underlay to the New Zealand market in a timely fashion with minimal barriers to entry. These potential entrants include:

- (a) **Chinese producers:** In recent years, the amount of underlay produced in China has increased considerably. In addition, the quality of the underlay produced in China has kept abreast with increases in capacity. Vita understands that there is presently further capacity in China opening the way for Chinese suppliers to successfully enter the New Zealand market for the importation and wholesale distribution of underlay in a timely and effective manner. In particular, potential entrants from China include:
 - (i) **Shanghai Baji:** A Chinese manufacturer of Rebond underlay.
 - (ii) **Kangton Industry Inc:** Based in Shanghai, Kangton manufactures foam underlay. It currently exports to a number of markets in the Middle East, Asia and Europe.
 - (iii) **Shine Holdings Corporation Limited:** Based in Hangzhou Economic Development Zone in Shanghai, Shine Holdings Corporation Limited ("**Shine**") manufactures sponge carpet underlay. According to its website, Shine exports at present to India, Russia, Europe and the United States.
 - (iv) **Agents:** A number of import agents, such as Szalmuk Capital and Citex, have approached Vita with offers of underlay supply from Chinese manufacturers of underlay.

24. CONCLUSION ON POTENTIAL ENTRY

24.1 In summary:

- (a) In respect of the PU Foam Market, there remain several parties who could enter the markets in a timely and effective manner. Such is the combined entity's need to retain volume that the threat of potential entry by these entities operates as a significant constraint.
- (b) In respect of the Underlay market, entry could easily be undertaken by share producers or local de novo manufacturers. However, Vita considers that entry by import is the most likely form of potential entry.

PART V: OTHER POTENTIAL CONSTRAINTS

25. CONSTRAINTS ON MARKET POWER BY THE CONDUCT OF ACQUIRERS

- 25.1 The largest acquirers of PU foam in the PU Foam Market are bedding and furniture manufacturers. Although furniture manufacturers have decreased, both in number and in scale of late, they remain large acquirers of bulk and converted PU foam. In addition, despite recent inroads by imports into the bedding industry, bedding manufacturers essentially comprise a number of the largest single acquirers of PU foam. For quite separate reasons, both sets of acquirers act as a constraint upon both Pacific Brands and Vita at present and will continue to do so as against the combined entity in the future.
- 25.2 In the PU Foam Market, competition in the downstream furniture manufacturing market acts as a very real constraint upon the pricing of Pacific Brands and Vita. Any attempts by the combined entity to impose a *SSNIP* would see the loss of these accounts either by way of the local manufacturer electing to manufacture offshore or by the closure of the furniture manufacturer in question. To date, as imports have become more and more prevalent in the furniture industry, local furniture manufacturers have decreased the grades of PU foam used in production and cut back on the quantity of foam used in the manufacturing processes in attempts to cut costs and remain competitive with imports.
- 25.3 Import competition is evidenced by the continuing increase in the number of imported lounge suites. For the period 2003 to 2007, the number of lounge suites imported into New Zealand increased from 42,432 in 2003 to 98,688 in 2007. While there has been a sharp increase in the quantity of imported lounge suites, the CIF average price of lounge suites decreased from \$760.04 in 2003 to \$491.53 in 2007, indicating imports have become cheaper and more competitive over the past three years.²⁶ Similar patterns have characterised imports of single pieces of upholstered furniture. Figure 1 below sets out more comprehensive data on furniture imports into New Zealand.

	COMPLETE SUITES					PIECES					Total \$	Total Qty
	CIF \$NZ	QTY	(%)	Avg Price (\$)	(%)	CIF \$NZ (\$)	QTY	(%)	Avg Price (\$)	(%)		
2003	32,249,907	42,432		760.04		36,427,841	217,312		167.63		68,677,748	259744
2004	37,357,549	54,534	28.52	685.03	-9.87	49,772,746	288,324	32.68	172.63	2.98	87,130,295	342858
2005	40,257,756	65,456	20.03	615.04	-10.22	51,902,726	349,018	21.05	148.71	-13.85	92,160,482	414474
2006	41,156,249	70,699	8.01	582.13	-5.35	59,231,181	341,986	-2.01	173.20	16.47	100,387,430	412685
2007	48,508,542	98,688	39.59	491.53	-15.56	57,683,975	369,556	8.06	156.09	-9.88	106,192,517	468244

- 25.4 In short, the combined entity will not realistically be able to impose any price increase upon furniture manufacturers. As the PU Foam Market will continue to be driven by volume, the loss of furniture accounts, [CONFIDENTIAL] will provide a very real constraint upon the combined entity.

²⁶ Source: Department of Statistics.

- 25.5 In respect of bedding, the main acquirers of bedding (Sleepyhead, Sealy and A H Beard) all represent sufficiently large accounts that the threat of the loss of one, or even part of one of these accounts, either to self-supply or an existing competitor such as Enviro-foam is sufficient to deter the combined entity from seeking to increase prices to such account by as much as a *SSNIP*. The market shares of bedding manufacturers in the bedding market are as follows:

(a)	Sleepyhead	[CONFIDENTIAL]	[CONFIDENTIAL]
(b)	Sleepmaker	[CONFIDENTIAL]	[CONFIDENTIAL]
(c)	Sealy	[CONFIDENTIAL]	[CONFIDENTIAL]
(d)	AH Beard	[CONFIDENTIAL]	[CONFIDENTIAL]
(e)	Imports	[CONFIDENTIAL]	[CONFIDENTIAL]
(f)	Other ²⁷	[CONFIDENTIAL]	[CONFIDENTIAL]
	TOTAL	[CONFIDENTIAL]	100%

Source: Vita Estimate

Such is the size of these bedding accounts that the loss of one would have a material impact upon the profitability of the combined entity. [CONFIDENTIAL], the loss of a contract which was priced at above marginal cost would have detrimental impact upon the marginal costs of the combined entity's remaining output. By having less volume to spread its fixed costs over, any drop in capacity will negatively impact upon the competitiveness of the combined entity in the supply of PU foam to other acquirers. As noted above, in the case of furniture manufacturers, such increased costs are unable to be passed on to acquirers, with the effect that the combined entity would have to absorb these increased marginal costs.

- 25.6 As the combined entity will be a vertically integrated business, a drop in the volume of production of PU foam will not only impact on the prices which the combined entity supplies to its industrial customers, but will also impact upon the competitiveness of the combined entity's consumer products. By increasing the cost of the PU foam the combined entity will supply internally to its consumer products, these products will suffer increased costs of production. In the case of Vita's furniture manufacturing operations, this will place increased pressure on the viability of its furniture manufacturing operations in what, as has been described above, is a highly competitive market. As Vita exports a number of innovative sofa-beds, an increase in its marginal costs of production will increase the cost of its exports, rendering them less competitive in export markets. Vita submits that these constraints will remain post acquisition.²⁸

²⁷ Other bedding manufacturers include Bedmakers Group which Vita estimates to have sale of approximately \$[CONFIDENTIAL] million annually, and Brownies, with annual sales of approximately \$[CONFIDENTIAL]m.

²⁸ For example, the increase in chemical costs which has seen the cost of PDI increase by 125% over the past three years has not been reflected in price increases to PU foam acquirers, reflecting the constraints already in place upon PU foam producers in the Polyurethane Foam Market.

25.7 In addition, as evidenced by the table above, imported inner sprung mattresses now comprise approximately 7 percent of the New Zealand bedding market. The growth in imports has been substantial. Imports of inner sprung beds increased from 13,756 units in 2003 to 45,467 in 2007.²⁹ This import growth acts as a constraint on the combined entity in a similar way to imports of furniture. As well as losing supply due to imports, in the event that the combined entity sought to increase price, bedding manufacturers now have the alternative of shifting production offshore resulting in the loss of those accounts. In the past 12 months, Sleepyhead has stated publicly that it has considered taking its production offshore.

Underlay Market

25.8 Acquirers of underlay tend to be carpet stores and commercial flooring businesses. As noted by the Commission in *Decision 628; Cavalier Corporation Limited / Norman Ellison Holdings Limited*, retailers of carpet are increasingly comprised of large retail chains with large amounts of buying power. As these large retail chains tend to take supply of underlay from one source, they have significant countervailing power when seeking pricing from underlay manufacturers or importers. In common with PU foam, underlay derives significant economies of scale from volume and underlay suppliers, and particularly manufacturers, are therefore incentivised to maintain sales of underlay at as high a volume as possible. The threat of losing a sizeable account with a flooring chain, such as Carpet Court or Carpet One, is sufficient to act as a constraint upon the combined entity post-acquisition.

25.9 Vita notes that tenders in both the PU Foam market and Underlay market are rare. However, in securing its accounts for supply of underlay to Carpet Court, Vita had to take part in a highly competitive tender process. Vita was successful in winning that tender through providing highly competitive pricing as it was very keen to ensure that it did not lose that volume of underlay sales. As such, Vita submits that both now and post-acquisition, the combined entity will be constrained by the power of acquirers of underlay.

26. CONSTRAINTS ON MARKET POWER BY THE CONDUCT OF SUPPLIERS

26.1 The chemicals used in the manufacture of PU foams are priced as world commodities on a world market. In particular, two chemicals comprise by far the largest variable cost in the manufacture of PU foam: Polyol and TDI. Both these chemicals are priced by the world market. The combined entity will not enjoy pricing that is materially more favourable than those of its competitors or that which either of Pacific Brands or Vita currently enjoys. Accordingly, there is no scope for the combined entity to attempt to exercise market power in respect of chemical suppliers.

26.2 The parties do not consider that any additional relevant constraints are imposed by suppliers in the PU Foam Market or the Underlay Market.

²⁹ Source: Department of Statistics

This Notice is given by Vita New Zealand Limited

The company hereby confirms that:

- (a) all information specified by the Commission has been supplied;
- (b) all information known to the applicant which is relevant to the consideration of this application/notice has been supplied; and
- (c) all information supplied is correct as at the date of this application/notice.

The company undertakes to advise the Commission immediately of any material change in circumstances relating to the application/notice.

Dated 7 March 2008

Signed by Vita New Zealand Limited

Robert Brouwer
Chief Executive Officer

I am a director/officer of the company and am duly authorised to make this application/notice.

DEFINITIONS AND GLOSSARY

"Application" means the clearance application sought in respect of the acquisition by Vita New Zealand Limited of all the foam, flooring and Sleepmaker bedding assets of Pacific Brands Holdings (NZ) Limited, which trades as Dunlop Foams & Flooring and Sleepmaker respectively.

"Assets" means those assets required for the carrying on of foam, flooring and bedding businesses in New Zealand as identified in the Sale and Purchase Agreement, more specifically:

- (a) the manufacture of PU foam (using a Verti Tower process at East Tamaki in Auckland) and the importation of specialty polyurethane and other foams, and the conversion of those foams in factories in Auckland and Christchurch; and
- (b) the supply of bonded polyurethane carpet cushion to the flooring industry at wholesale pricing, manufactured in Australia and shipped to New Zealand for resale; and
- (c) the manufacture, distribution and marketing of mattresses and bed bases, including the importing and/or manufacturing of a range of inner sprung, latex, foam and other mattress technologies from factories in Auckland and Christchurch.

"CIF" means the cost price, including insurance and freight, of imported goods.

"Polyol" means alcohols containing multiple hydroxyl groups. Specifically in relation to polymer chemistry, polyols are compounds with multiple hydroxyl functional groups available for organic reactions. The main use of polymeric polyols is as reactants to make other polymers (e.g. they can be reacted with isocyanates to make polyurethanes, and this consumes most polyether polyols).

"PU" means a polyurethane, which is any polymer consisting of a chain of organic units joined by urethane links. Polyurethane polymers are formed by reacting a monomer containing at least two isocyanate functional groups with another monomer containing at least two alcohol groups in the presence of a catalyst.

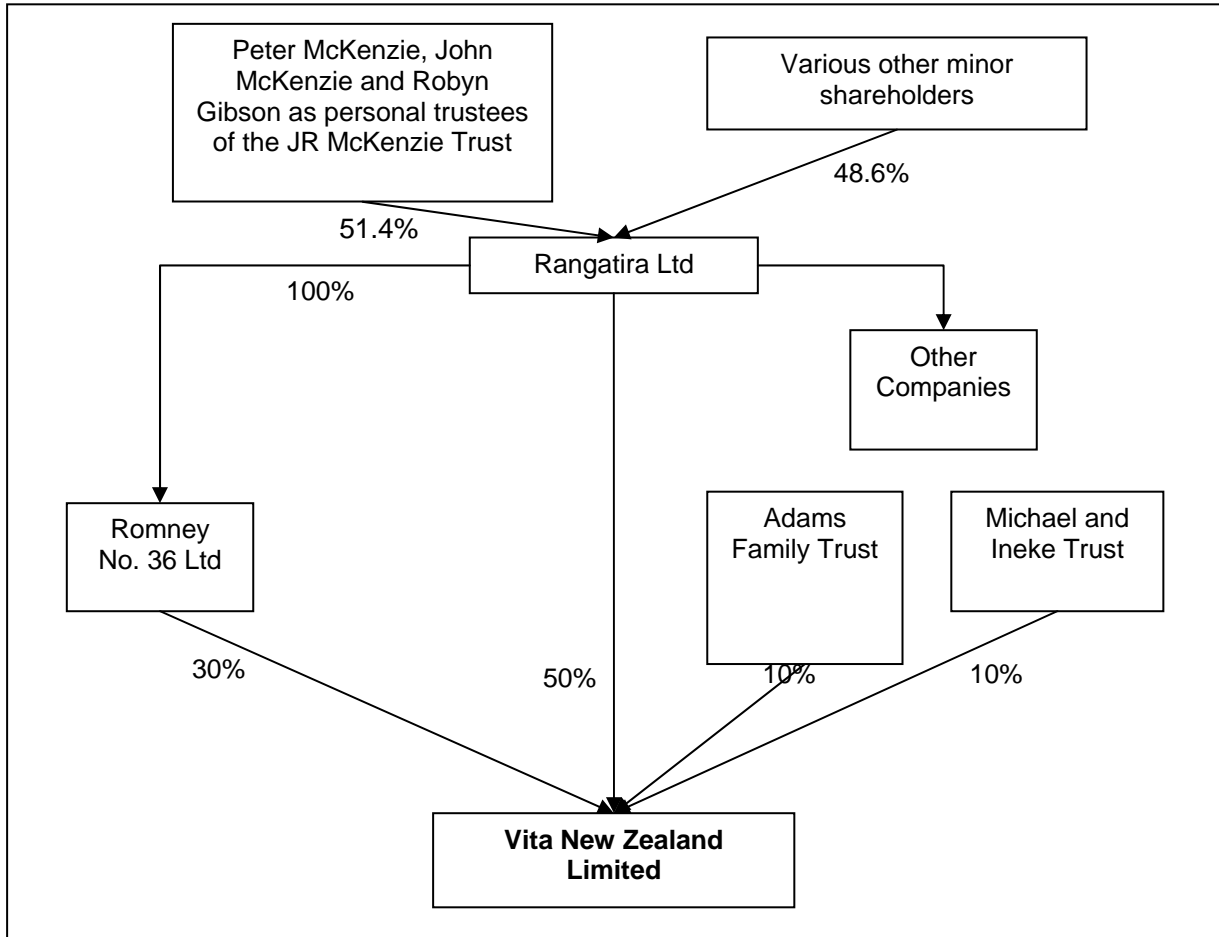
"Sale and Purchase Agreement" means the sale and purchase agreement between Pacific Brands Holdings (NZ) Limited (vendor), Pacific Brands Limited (vendor's covenantor"), and Vita New Zealand Limited (purchaser) for the assets and undertaking of the Businesses.

"SSNIP" means a small but significant and non-transitory increase in price above the competitive level. This is a test used by the NZCC to ascertain whether a merged entity will be sufficiently unconstrained so as to be able to impose a manifestation of market power without any competitive backlash or other competitive restraint.

"TDI" means toluene diisocyanate which is an aromatic diisocyanate produced for reaction with polyols to form polyurethanes. It is the main chemical ingredient in polyurethane foam.

"Verti" means a vents process, which is a form of continuous foam production plant that produces slabs of PU foam by pushing the relevant mix of chemicals up a 'verti tower' during which the chemical reaction process occurs.

APPENDIX A
VITA CORPORATE STRUCTURE



APPENDIX B

BATCH FOAM PRODUCTION PLANT

