Completed acquisition by Kerry Foods Limited of the frozen ready meals business of Headland Foods Limited

ME/4893/11

The OFT's decision on reference under section 22(1) given on 12 July 2011. Full text of decision published 3 August 2011.

Please note that the square brackets indicate figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.

PARTIES

1. **Kerry Foods Limited** is part of the Kerry Group plc, a company registered in Ireland that manufactures foods and food ingredients and had sales of around €5 billion in 2010. Kerry Foods Limited is part of the division of Kerry Group plc that manufactures chilled and frozen ready meals (this division is referred to in this decision as '**Kerry**').[1]

2. **Headland Foods Limited** (**Headland**) manufactured frozen ready meals (**FRMs**) under supermarkets' own labels and third party brands. Headland's turnover in the UK was around £67 million in 2010.

TRANSACTION

3. On 14 January 2011 Kerry acquired Headland's FRM business (**the Transaction**), comprising of the freehold to and equipment in Headland's factory in Grimsby, the equipment in Headland's factory in Flint (but not the Flint property itself), stock, the benefit of Headland's contracts, the information and IT systems relating to the business and any claims against third parties relating to the business. The business's employees also transferred to Kerry.

[1] Kerry's frozen ready meals unit is also referred to in the industry as Rye Valley Foods.

JURISDICTION

4. As a result of the Transaction Kerry and Headland's FRM business ceased to be distinct. These enterprises overlap in the supply of FRMs, with a combined share of supply exceeding 25 per cent (see paragraph 75 below). The share of supply test in section 23 of the Enterprise Act 2002 (**the Act**) is therefore met. Therefore, the OFT believes that it is or may be the case that the Transaction has resulted in the creation of a relevant merger situation.

5. The Transaction was completed on 14 January 2011. It was not publicised by Kerry or Headland and, as far as the OFT can ascertain, the Transaction was first mentioned in the press on 28 January 2011.[2] The OFT launched an own-initiative merger investigation on 10 February 2011. Following extensions under sections 25(1) and (2) of the Act, the statutory deadline is 25 July 2011. The administrative deadline is 12 July 2011.

RATIONALE

6. Kerry submitted that it expected the Transaction to result in substantial synergies between Headland's FRM factory in Grimsby and its own FRM factory in Carrickmacross (Ireland). Furthermore, Kerry submitted that the parties' FRM activities had been subjected to spiralling costs of raw materials and significant retailer buyer power in recent years, which led to a decline in the financial performance of their respective businesses. Kerry also suggested that [ ].

7. An internal Kerry document provides the following 'strategic rationale' for the Transaction:

   - 'FRM has declined which has created excess capacity.'
   - '... Kerry Foods and Headland each have about 25 per cent market share and are continually played off each other by all retailers, driving prices down.'
   - 'Closing one of Headland's sites and investing in some more efficient processes at the other would give, with CMX [Kerry's factory at Carrickmacross], a highly efficient operation.'

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[2] See at www.foodmanufacture.co.uk/Manufacturing/Kerry-deal-makes-no-difference-to-consultation-at-Headland-Foods-Flint-factory.

- 'Combining these businesses would facilitate acceptable margins returning to the category.'[3]

COUNTERFACTUAL

8. Kerry submitted that Headland was a failing firm and that therefore the appropriate counterfactual to assess the Transaction is not the state of competition before the Transaction but Headland's inevitable exit from the market shortly after the date of the Transaction. Kerry further submitted that, even if Headland had not exited the market, its financial position meant that the competitive constraint it would have exerted on Kerry would have been minimal, that is, Headland was at the least a 'flailing firm'. Below the OFT considers both possible counterfactuals in turn.

Exiting firm

9. In forming a view on an 'exiting firm' scenario, the OFT will consider:

   a) whether the firm would inevitably have exited the market, in particular whether the firm was unable to meet its financial obligations in the near future and to restructure itself successfully

   b) whether there would have been a substantially less anti-competitive alternative purchaser for the firm or its assets and

   c) what would have happened to the firm's sales in the event of its exit.[4]

10. The OFT notes that where the merger raises concerns relative to the pre-merger situation, the OFT is slow to clear a transaction based on the 'inevitability' of exit of the target business and will only do so when it has sufficient compelling evidence.[5]

Headland's losses

11. Kerry submitted that Headland was heavily loss-making, having consistently made losses, including very substantial operating losses, since 2006, despite increasing its turnover during this period, as set out in Table 1 below. Kerry considers that this was caused by a combination of factors,

[3] Internal Kerry document headed 'Frozen Ready Meals. Headland Foods Limited', dated August 2010 (Annex 3(1) of the response to OFT questions of 12 April 2011), page 2.
[4] *Merger Assessment Guidelines*, paragraphs 4.3.8-18.
[5] See for example *Long Clawson Dairy Limited/Millway*, OFT decision of 8 October 2008, paragraph 87.

including a dramatic escalation in raw material prices, the general decline in the FRM sector, the substantial buyer power Headland faced and the rate at which it was losing business, in particular from major customers. Kerry noted that Headland made a small operating profit in the 15 months to March 2010 but that this was due to several exceptional factors rather than an upturn in Headland's underlying performance, including [ ].

Table 1: Headland's financial performance 2006 to December 2010 (£'000)

	2006	2007	2008	2009/ 2010*	2010**
Sales	58,815	63,928	74,510	88,908	[ ]
Operating profit (before impairments)	**-1,426**	**-197**	**-825**	**74**	**-[ ]**
Impairments/ amortisation	628	9,411	-	5,510	-
Interest expense (gross)	2,395	2,362	2,504	2,844	[ ]
Profit after interest	**-3,250**	**-11,251**	**-2,593**	**-9,945**	**-[ ]**

* 15 months ended 27 March 2010.

** 9 months to December 2010 (management accounts).

12. Having reviewed Headland's financial accounts for 2006, 2007, 2008 and 2009/10 (that is, the 15 months ended 27 March 2010), the OFT accepts that Headland's financial performance was poor. It has been loss-making since 2006, although the OFT notes that the large scale of Headland's bottom line losses in 2007 and 2009/10 appears to be driven by adjustments to Headland's balance sheet (impairment of goodwill in 2007 and impairment of fixed assets in 2009/10). Headland made a small operating profit in 2009/10, but this was not sufficient to cover its interest costs. For the period since March 2010, although the OFT has not been provided with audited accounts, management accounts information show that Headland returned to making operating losses after March 2010 and suffered significant losses (after interest) of £[ ] million for the nine months to December 2010. These losses tend to support Kerry's submission that the small operating profit in the 15 months to 2010 was an anomaly rather than the start of a return to profitability.

Headland's trading performance in 2010

13. Kerry submitted that during 2010 Headland's losses were accelerating. It noted that Headland lost substantial sales during 2010, in particular a loss

to Kerry of its entire [ ] contract with revenue of around £[ ] million and a loss of a significant part of its [ ] contract with revenue of around £[ ] million. According to a statement by [a then Headland employee], this contract loss occurred when Headland started to press its customers for price increases to cover considerable raw material cost increases in early 2010.[6] It further noted that Headland was unable to win any significant new business that was commercially sustainable. For example, Kerry estimated that Headland would have incurred an operating loss of nine per cent on a new [ ] contract (revenue £[ ] million), 13 per cent on two new [ ] contracts (revenue £[ ] million) and 30 per cent on a new [ ] contract (revenue £[ ] million).

14. The OFT accepts that Headland's management accounts for the nine months to December 2010 show that Headland's financial position was deteriorating during this time. However, the OFT notes that the combined revenues of Headland's new contracts in 2010 were significantly higher than the combined revenues of its lost contracts, while it is not clear that the losses Headland would have incurred on its new contracts would have been as commercially unsustainable as Kerry submitted. Headland's largest shareholder, Chamonix Private Equity (**Chamonix**) told the OFT that Headland had bid for the [ ] contract at a very low margin, but that this contract would have allowed it to recover at least some of its overhead.[7] Further, the OFT has treated Kerry's predicted size of the contract losses with caution, as they are partly based on Kerry's own costs (certainly for the [ ] contract) and do not take into account any cost savings from Headland's planned closure of its Flint factory (see paragraph 30 below).

15. Finally, the OFT notes that Headland's management accounts from March to December 2010 do not show a significant drop in turnover (turnover fluctuated between £[ ] million in March and £[ ] million in December).[8] While this may be partly explained by a delayed implementation of Headland's contract losses (for example, turnover from [ ] sales is significantly reduced only in December and [ ]'s turnover did not reduce at all in 2010), the turnover figures also do not yet appear to take (all of)

[6] Statement by [ ], headed 'Headland Foods – Review of business 2008 to 2010', dated 15 June 2011, page 1.
[7] [ ]
[8] Headland's net sales from March 2010 were: March £[ ] million, April £[ ] million, May £[ ] million, June £[ ] million, July £[ ] million, August £[ ] million, September £[ ] million, October £[ ] million, November £[ ] million and December £[ ] million.

Headland's new contracts into account (for example, turnover from [ ] sales is significantly increased only in December).

Scenarios for exit

16. The fact that a firm is loss-making is not in itself sufficient to show that the firm would inevitably have exited the market in the near future. A firm's financial failure is often characterised by two possible scenarios. Firstly, the firm's main creditors may decide to close the business or, secondly, a cash flow crisis occurs that cannot be financed.

17. In this case, Headland's accounts show that all of its long-term debt was held by its shareholders rather than by a bank or a major trade creditor.[9] Kerry noted that, in addition, there were debentures in favour of Credit Agricole and HSBC and a charge over Headland's Grimsby property in favour of HSBC. Headland's shareholders supported its continued existence despite the fact that it had been making losses since 2006[10] and its net value was substantially negative from 2007 (see Table 2 below). The OFT has considered below to what extent Headland's deteriorating position in 2010 may have resulted in a change of position of Headland's shareholders in this respect (see from paragraph 22 below).

Table 2: Headland's capital and reserves 2006 to March 2010 (£'000)

	2006	2007	2008	2009/10*
Called up share capital	2,719	2,719	2,719	2,719
Profit and loss reserve	-1,382	-12,633	-15,226	-25,171
Total shareholders funds	1,337	-9,914	-12,507	-22,452

*15 months ended 27 March 2010.

18. To assess the likelihood of an imminent cash flow crisis, the OFT has considered Headland's liquidity ratios. They are set out at Table 3 below. This table shows a sudden increase in current liabilities in 2009/10 and hence a significant worsening of liquidity ratios for this period. This is caused by a reclassification of shareholder loans as being payable within one year rather than after one year due to the sale of Headland's business

[9] Note 13 to Headland's financial statements for the 15 months ended 27 March 2010 shows that long-term debt consisted of shareholder loan notes, preference shares and junior debt. According to Kerry's response to an OFT question, this junior debt consisted of loan notes held by shareholders in Headland.

[10] The OFT notes that in assessing the value of Headland's business for its shareholders, it is most appropriate to consider Headland's losses before interest since (almost) all of the interest paid by Headland was to service the loans granted by its shareholders.

in January 2011 (which is when the accounts for 2009/10 were prepared).[11] The OFT has therefore also recalculated Headland's current liabilities for 2009/10 by stripping out shareholder loans. This is indicated in the last column of Table 3 below.

Table 3: Headland's liquidity ratios 2006 to March 2010

	2006	**2007**	**2008**	**2009/10***	**2009/10*** (adjusted)
Current assets (£'000)	15,507	16,682	17,412	15,299	15,299
Current liabilities (£'000)	11,992	12,567	14,175	50,869	12,319
Current ratio	**1.3**	**1.3**	**1.2**	**0.3**	**1.2**
Current assets less inventory (£'000)	9,815	9,677	9,729	9,055	9,055
Quick ratio	**0.8**	**0.8**	**0.7**	**0.2**	**0.7**

*15 months ended 27 March 2010.

19. The ratios set out in Table 3 show that Headland was technically solvent in the period it was making losses (2006 to 2008), and only became insolvent in 2009/10 due to the need to pay back the shareholder loans. However, as set out below (see from paragraph 22), the OFT has concluded that, absent the Transaction, the shareholders were unlikely to have called in their debt, at least in the short term. It is therefore more appropriate to adjust Headland's current liabilities to reflect the change in treatment of the shareholder loans in its 2009/10 accounts. After this adjustment, Headland's liquidity ratios remain substantially unchanged during the entire period to March 2010, suggesting that these ratios are not at an unsustainable level. Also, the ratios are at a higher level than would normally be expected from a firm suffering a severe liquidity shortage.

20. The OFT has not been provided with full information on Headland's assets and liabilities after March 2010, but its management accounts show that in the nine months to December 2010 its cash position deteriorated, with its closing cash balance reducing from £[ ] million to £[ ] million. Kerry submitted that Headland faced a substantial cash flow disadvantage because in 2010 it had to pay several suppliers in advance, which was not

[11] Note 11 to Headland's financial statements for the 15 months ended 27 March 2010.

a common situation in the FRM industry, while Headland's customers typically demanded 60 days credit.

21. However, Headland's closing cash balance in December 2010 does not in itself show an imminent liquidity problem. Headland could still purchase from the majority of its suppliers without paying in advance. The OFT does not have sufficient evidence on Headland's projected cash flows and its access to credit to conclude that Headland's exit from the market was imminent on the basis of a cash flow crisis.

Headland's restructuring plan: closure of Flint factory

22. Internal Headland documents[12] and information provided to the OFT by Headland's largest shareholder, Chamonix, show that before and during 2010, shareholders and management had been considering various options for returning Headland to profitability, including restructuring, new business opportunities and expanding abroad. They concluded that new business opportunities could not restore Headland to a sustainable level of profitability.[13] Headland's largest shareholder informed the OFT that it believed that the best long-term opportunity to arrest Headland's margin decline was to improve production efficiencies through increased volumes by combining Headland's business with Kerry, through a merger or joint venture. However, as a short-term solution and in parallel with merger talks with Kerry, Headland decided to consolidate its business by closing its factory in Flint and moving its production to its other factory in Grimsby.

23. At the time of the Transaction, Headland had started this restructuring process. On 15 November 2010, when Headland's discussions with Kerry were far advanced, Headland began a 90-day consultation process with the

[12] Minutes of a meeting of the Works Committee at Headland's Flint factory on 1 September 2010 (provided to the OFT by Kerry on 25 March 2011) show that 'Mike [Russell, Headland's CEO] has been asked by the shareholders to consider all options and moving to a single site [that is, Grimsby] is just one of the options. Mike stated that ... [w]e are looking at new business such as [ ]' (point 12). Also, a presentation headed 'Headland Foods. European Frozen Ready Meal Markets-Stage 1', dated June 2010, considers the attractiveness of Headland's entry into various European countries (provided to the OFT on 14 April 2011 in response to OFT question 7(c) of 6 April 2011).
[13] Announcement of Flint factory closure to employees by Mike Russell, 15 November 2010 (annexed to Kerry's letter to the OFT of 11 March 2011), and information provided to the OFT by Chamonix.

Flint employees with a view to redundancy plans from mid-February 2011.[14]

24. Kerry submitted that Headland's plans for this restructuring were poorly considered and unrealistic. It stated that the plans (i) had scarcely gone beyond the first step of the redundancies consultation process, (ii) had not adequately dealt with any of the numerous technical and logistical issues, and (iii) grossly underestimated the costs of the restructuring. Kerry further submitted that it is hard to see how, given Headland's financial predicament, it could have raised the necessary capital for the restructuring.

25. As an example of the gaps in Headland's plans, Kerry referred to the fact that [ ]. Kerry also provided some examples of what it considered to be poor planning for the move of specific equipment from Flint to Grimsby. Kerry further submitted an internal finding by Kerry, based on its due diligence assessment of Headland's business, that 'their Flint to Grimsby Transfer Plans are not well advanced and Exit is their only real option.'[15]

26. Set against this, the OFT notes that the restructuring process had been under active consideration since at least October/November 2009, as shown by internal Headland documents,[16] which suggests that Headland gave substantial thought to the feasibility of restructuring. The OFT also notes that Headland was still in the process of planning its restructuring when it showed its plans to Kerry's employees. It is not unlikely that in the absence of the Transaction Headland would have produced restructuring plans that were more carefully considered and more advanced.

27. Further, the evidence regarding the expected costs of the restructuring is mixed. Kerry submitted that Headland expected these costs to amount to around £[ ] million, but that Kerry's own estimate was that the actual costs

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[14] Annex 15 to the submission of 4 April 2011, page 27 (page headed 'Future Plans – Single Site').

[15] Internal Kerry document headed 'Project Trinity' by Mark Boyle, dated 8 December 2010, page 6 (Annex 16 to the submission of 4 April 2011).

[16] Minutes of an internal Headland meeting of 8 January 2010 (headed 'Project Forest meeting'); document headed 'Closure costs update' with reference to 'End 2008 estimate', 'Oct 09 update and 'Nov 09 Downsize update'; and draft plans for the alterations at the Grimsby site required for the restructuring dated 27 January and 2 February 2010 (all annexed to Kerry submission to the OFT of 25 March 2011). Closure of the Flint factory is also one of the options outlined to Headland's shareholders in a presentation of January 2009 produced by a financial advisory firm, alongside sale of the business to Kerry or others (presentation prepared by Spayne Lindsay and Co LLP, headed 'Strategic Options. Project Fjord', dated January 2009, provided by Kerry to the OFT on 2 June 2011).

would be closer to around £[ ] million, which was the cost estimated in a presentation to Headland in January 2009.[17] In a statement provided by Kerry to the OFT, [a then Headland employee] also states that the restructuring would have cost £[ ] million.[18] However, a contemporaneous internal Kerry document[19] shows that in September 2010 Headland expected a cost of £[ ] million.[20] Hence, it is not clear whether Headland had indeed, as Kerry submitted, underestimated the costs of the restructuring.

28. Neither contemporaneous evidence nor statements made to the OFT indicate that the restructuring, while carrying significant risks, was clearly not a feasible alternative to a sale of Headland's business to Kerry. On 8 September 2010 Flor Healy, CEO of Kerry Foods, emailed Diarmaid Kilduff, Kerry's Director of Meal Solutions, and others to report on the 'key points made by Malcolm Little (Chairman of Headland) at our meeting today'. Mr Healy wrote:

> 'They have from the Headland Managemnet [sic] Team seen a very workable business plan based on a one site strategy. It would cost £[ ]m to implement but would yield savings of £[ ]m pa. He agreed that there were some significant execution risks associated with this strategy and that the competitive nature of the business suggested that they wouldn't hold on to all of the money saved. ... They intend to proceed and announce the closure of Flint before the end of September. ... Chamonix, Electra and Montague [Headland's shareholders] all support the new business plan and adequate funding is in place to execute it.'[21]

29. The OFT acknowledges that Headland's Chairman may, at least to some extent, have made these points to Kerry's CEO in order to achieve a higher

[17] Presentation prepared by Spayne Lindsay and Co LLP, headed 'Strategic Options. Project Fjord', dated January 2009, provided by Kerry to the OFT on 2 June 2011, slide 28.
[18] Statement by [ ], headed 'Headland Foods – Review of business 2008 to 2010', dated 15 June 2011, page 2.
[19] Email from Flor Healy, CEO of Kerry Foods, to Diarmaid Kilduff, Kerry's Director of Meal Solutions, and others, dated 8 September 2010 (Exhibit DK1 to the witness statement of Diarmaid Kilduff, dated 20 June 2011, page 1).
[20] Headland's largest shareholder, Chamonix, informed the OFT that it believed the expected cost to amount to around £[ ] million. The OFT has placed only limited weight on this statement, since it was based on recollection only, but the OFT notes that this amount sits between the other expected cost figures the OFT has obtained.
[21] See footnote 19.

sale price for Headland.[22] However, statements by [a then Headland employee] and its largest shareholder, Chamonix, also indicate that the restructuring could have improved Headland's position for at least some time, indicating that exit was not imminent. In particular, [the then Headland employee] stated that the restructuring was a realistic alternative option to the sale to Kerry with an expected return to modest profitability of £[ ] million per year, provided that the significant risks did not materialise.[23] Headland's largest shareholder, Chamonix, informed the OFT that the restructuring afforded it an opportunity to break even. [The then Headland employee] expressed doubt about whether Headland's shareholders would have fully supported and implemented the restructuring, in particular if any significant risk materialised, but Chamonix informed the OFT that Headland had determined that it could pay the restructuring costs by using its cash reserves and increasing its debt burden.

30. Contemporaneous documents also indicate that the closure of Headland's Flint factory could have resulted in significant cost savings and may have improved Headland's profitability.[24] The OFT also notes that Kerry informed the OFT that the Flint factory was old and out of date, while the Grimsby factory was much more modern. This is also indicated by internal Kerry due diligence documents.[25] This supports the expectation of a more efficient operation of Headland's business at its Grimsby factory.

31. Both [the then Headland employee] and Chamonix also referred to the significant limitations of the restructuring in improving Headland's position. In particular, [the then Headland employee] stated that the restructuring carried significant downside risks of tight cash flow, cost overruns and further raw material cost increases and contract losses. Similarly, Chamonix stated that it did not believe that the restructuring was a

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[22] This is suggested by the first point that Kerry's CEO reported from his conversation with Headland's Chairman: 'They were dissapointed [sic] with our offer letter, it wasn't £[ ]m and the tone of the letter suggested to them that we believed they had nowhere else to go.'
[23] See footnote 18, page 2.
[24] Presentation by Headland to Kerry, dated 19 November 2010 (Annex 15 to the submission of 4 April 2011), page 27 (page headed 'Future Plans – Single Site'). Also, presentation prepared by Spayne Lindsay and Co LLP, dated January 2009 (footnote 17), slide 28. Kerry has suggested that this presentation states that a sale was the only realistic option for Headland, but the presentation, while recognising risks associated with all options, does not in fact appear to express a preference for a sale (options 2 and 3) over a Flint closure (option 1).
[25] Documents headed 'Project Trinity. Functional Area: Operations' (page 2) and 'Project Trinity. Functional Area: Quality & Technical' (page 2), both dated 8 December 2010 (Annex 3(5) and 3(8) of the response to OFT questions of 12 April 2011).

solution in the long term, since Headland's resulting cash position would have become very tight and the return to profitability would have been only temporary given in particular the raw material cost increases and buyer power in the market. Chamonix stated that if it had not been able to sell Headland's business to Kerry, it may have tried to combine with another FRM manufacturer or change its business to focus on niche lines for customers such as airlines and food service customers. Chamonix did not indicate that in the short term it would have ended its support for Headland or that Headland would have exited the market if the Kerry sale had not taken place. Its 'Plan B' for the sale of Kerry, in at least the short term, was Headland's restructuring.

32. On balance, the evidence obtained by the OFT therefore suggests that, although the planned restructuring carried risks and Headland may not have continued in its pre-Transaction form in the long term, the restructuring also gave a prospect of a return to profitability for Headland, at least in the short term. As set out in detail above, the evidence regarding the likely success or failure of Headland's restructuring plans is mixed. However, the OFT requires compelling evidence in order to adopt an alternative counterfactual to the prevailing conditions of competition in assessing a transaction. In this case, the evidence also supports that there was at least a realistic prospect that the Headland business would have been restructured and this would have led to profitability in, at least, the short term. Information from Headland's main shareholder indicates that it considered the restructuring, rather than Headland's imminent exit, as the alternative to the Transaction in at least the short term. The OFT is therefore not persuaded that exit of Headland was inevitable and/or imminent.

Kerry's purchase of Headland's business

33. Kerry paid a purchase price of £[ ] million for Headland's FRM business. The OFT has considered whether Kerry's acquisition of Headland's business as a going concern at this purchase price, rather than at a potentially much lower price from administration, suggests that Headland was not, in fact, inevitably exiting for reasons of financial failure.

34. Kerry submitted that the purchase price included £[ ] million for stock, with a provision that Headland would reimburse Kerry if the actual value of the

stock was less than this amount. Kerry submitted that the remaining purchase price of £[ ] million was justified by:

a) the expectation of synergies of around £[ ] million annually in operating its own FRM factory and Headland's Grimsby factory[26]

b) [ ] and

c) if Kerry had waited with its purchase until Headland went under, it expected Headland's restructuring plans to end in a 'car crash' situation, in which it would have had to make additional costs of rationalisation compared to a controlled acquisition and would have run the risk of harming relationships with key customers that would have turned to Kerry to replace Headland's supplies.[27]

35. Kerry also submitted that, although Headland's shareholders refused to reduce the purchase price, it was able to negotiate an improved deal with these shareholders that reduced the cost of the acquisition for Kerry after Headland's situation had become even clearer to Kerry in its due diligence investigation.[28]

36. The OFT considers that, in view of Kerry's submissions, Kerry's purchase of Headland's business for a purchase price of £[ ] million does not, in itself, suggest that at the time of the Transaction Kerry itself expected Headland to continue as a going concern.

Conclusion on 'exiting firm' counterfactual

37. Based on the evidence set out above, at the time of the Transaction Headland had been loss-making for a considerable period of time and its financial position had been deteriorating. However, Headland continued to trade and although in 2010 it had lost important contracts, it was also winning new contracts that would have earned revenue exceeding the revenue of the lost contracts. These new contracts may have been on loss-making terms, but they allowed Headland to recover some of its fixed costs and there is insufficient evidence that the losses on these contracts would have been so significant that Headland could not, at least in the

[26] Internal Kerry document headed 'Project Trinity' by Mark Boyle, dated 8 December 2010, page 2 (Annex 16 to the submission of 4 April 2011).
[27] Witness statement of Diarmaid Kilduff, Kerry's Director of Meal Solutions, dated 20 June 2011, paragraphs 13 to 19.
[28] Id.

short term, have borne them. There is also insufficient evidence that Headland faced severe or imminent liquidity problems.

38. Given that Headland's long-term debt was held by its shareholders, the decision to close Headland was mainly in the hands of its shareholders. The evidence shows that the shareholders did not believe Headland could have continued in its pre-Transaction form in the long term. However, the evidence also indicates that, although the restructuring carried significant risks, Headland's restructuring plans in the form of a closure of one of its two factories gave, at least in the short term, a realistic prospect of a return to profitability for Headland and that Headland's main shareholder considered the restructuring, rather than Headland's imminent exit, as the alternative to the Transaction.

39. Therefore, the OFT considers that, given the high evidentiary standard that the OFT must use in 'exiting firm' cases, there is not sufficiently compelling evidence that at the time of the Transaction Headland would have inevitably and imminently exited the market. This means that consideration a) for the 'exiting firm' counterfactual (see paragraph 9 above) is not met. There was therefore no need for the OFT to consider considerations b) and c).

40. That said, although the OFT did not consider these in detail, it is far from clear that there is sufficient evidence to demonstrate, to the relevant standard, that Kerry was the least anticompetitive possible buyer for Headland, as would have been required under limb b) of the 'exiting firm' counterfactual.

'Flailing firm'

41. Kerry has submitted that, even if Headland had not exited the market, its extremely precarious financial position in late 2010 meant that its ability to compete with Kerry as a supplier of FRMs was weakened to such a degree that it would have imposed only a minimal, if any, competitive constraint on Kerry. Kerry has submitted that this is demonstrated in particular by Headland's loss of important contracts during 2010 and its failure to win any significant new business that was commercially sustainable (see further at paragraph 13 above).

42. However, as set out in more detail above (paragraphs 14 and 15), the combined sales value of Headland's new contracts is significantly higher

than the combined sales value of its lost contracts, while it is not clear that the losses Headland would have incurred on its new contracts would have been as commercially unsustainable as Kerry has submitted. There is also no evidence that any third parties considered that Headland had lost or was losing its position as a credible supplier of FRMs.

43. Therefore, the OFT does not consider that there is sufficiently compelling evidence to demonstrate that, absent the Transaction, Headland's ability to compete with Kerry would have significantly weakened.

Conclusion on the counterfactual

44. The OFT generally adopts the pre-merger conditions of competition as the counterfactual against which to assess the impact of the merger, but will assess the merger against an alternative counterfactual where, based on the evidence available to it, it considers that there is not a realistic prospect of the pre-merger conditions continuing.[29] In this case, as set out above, the OFT did not receive sufficiently compelling evidence to demonstrate that, at the time of the Transaction, Headland would have inevitably or imminently exited the market or would have become a significantly weaker competitor. Therefore, the OFT considers that the pre-merger conditions of competition form the appropriate counterfactual for its competitive assessment of the Transaction.

MARKET DEFINITION

45. Kerry and Headland overlapped in the production of FRMs. Both Kerry and Headland produced FRMs for large grocery retailers and for brand owners under their customers' label. Kerry also produces FRMs under brands that it owns itself or licenses from [ ].[30] Kerry also produces chilled ready meals (**CRMs**).

Product market

46. When selecting a candidate market, the OFT will include at least the substitute products (narrowly defined) of the merging parties.[31] Put differently, the starting point for market definition is the narrowest

[29] *Merger Assessment Guidelines*, paragraph 4.3.5.
[30] Kerry licences the [ ] and [ ] brands from their brand owner [ ]. See here: [ ].
[31] *Merger Assessment Guidelines* (CC2 and OFT1254, September 2010), paragraph 5.2.11.

plausible market in which the parties' products overlap. In this case, this is the manufacture and supply of FRMs.

47. The OFT did not receive evidence to suggest that different types of FRMs (for example, regarding value segments and different cuisines) may constitute separate markets on the basis of either demand-side or supply-side factors, with the possible exception of FRMs that are manufactured to the specifications of large grocery retailers and brand owners. This possible distinction is discussed further from paragraph 64 below.

Competitive constraint from CRMs

48. Kerry submitted that it saw the evidence as being consistent with the existence of a single relevant product market comprising both CRMs and FRMs, and that regardless of formal market definition, CRMs exert a significant competitive constraint on FRMs. In particular, Kerry submitted that CRMs and FRMs are very similar as regards their composition, manufacture, marketing, regulatory controls, as well as exhibiting overlaps in the customer base, both at the wholesale and retail level. Kerry also noted that internally it views CRMs and FRMs as one market, as illustrated by the fact that they are combined in one division.

Demand-side factors

49. Kerry provided the following demand-side arguments in favour of a combined FRM and CRM product market:

    a) The major wholesale purchasers of FRMs and CRMs are generally the same entities, that is, large grocery multiples.

    b) FRMs and CRMs provide the same utility to consumers, that is, a fast and convenient meal that only requires re-heating. There is significant overlap in CRM and FRM consumers: around 68 per cent of ready meal consumers buy both CRMs and FRMs and around 90 per cent of FRM consumers also buy CRMs.[32] Kerry also noted that consumers can freeze and store CRMs just as with FRMs. Furthermore, Kerry noted that the packaging and appearance of the meals is often similar.

    c) Given the substantial increase in sales of CRMs in recent years and the contemporaneous decline in sales of FRMs, CRMs appear to be taking

[32] The OFT notes that an internal Kerry document headed 'Frozen Ready Meals shoppers basket analysis' (undated) found that in 2008/09 82 per cent of FRM buyers also buy CRMs (Annex 6 of the response to OFT questions of 12 April 2011).

market share from FRMs (amounting to 2.2 per cent of FRM volumes in 2010).

d) In many cases, FRMs and CRMs within the same value category impose a stronger competitive constraint on each other than do FRMs within different value categories. There is a continuum of prices for both products, albeit with FRMs concentrated at the lower (price) end of the range and CRMs at the higher end. However, there is also overlap between FRMs and CRMs in relation to prices, in particular at the lower (priced) end of the continuum. Kerry provided some examples of specific value FRMs and CRMs that were priced at similar levels.

50. However, market research reports provided to the OFT by Kerry suggest that competitive interaction between CRMs and FRMs is limited. A Mintel report states that the peripheral location of FRMs in supermarkets 'makes them unlikely to make it into the choice equation as consumers compare ready meals in-store'.[33] Further, a market research report prepared for Kerry states that consumers see FRMs as the 'poor relative' of CRMs, with purchasing based on price rather than product appeal, and that the roles of CRMs and FRMs 'are too distinct to encourage overlap in terms of choice in-store'.[34] The report also states that consumers perceive FRMs as cheaper than CRMs without recognising 'price laddering' between different value categories,[35] as also noted in Kerry's own internal analysis.[36]

51. The internal marketing documents that Kerry provided to the OFT do not indicate that Kerry actively targets CRM consumers, although one internal document does mention the threat of FRM sales diverting to CRMs if Kerry increased its FRM prices.[37] Kerry submitted that, while it could not provide any other internal documents which corroborated the competitive interaction between FRMs and CRMs, this was a key internal document that shows that Kerry was very aware of this competitive constraint.

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[33] Mintel report *Chilled and Frozen Ready Meals, Market Intelligence*, May 2010 (Annex 9 to the submission of 4 April 2011), page 41.

[34] Shopper centric report *Frozen Ready Meals Research Report*, 4 August 2010 (Annex 2 to the responses to OFT questions of 18 May 2011), pages 9 and 15; similarly page 22.

[35] Id, page 35.

[36] Kerry document *Frozen Ready Meals Category Vision*, undated but produced after October 2010, page 5 ('No clear price ladder').

[37] Internal Kerry document headed 'Project Trinity' by Mark Boyle, dated 8 December 2010 (Annex 16 to the submission of 4 April 2011): 'Key challenge will be ... remaining competitive vs. other Frozen and CRM's' (pages 2-3).

52. Further, while the sales figures for CRMs and FRMs provided by Kerry may suggest some competitive interaction, they are not definitive as they do not disentangle cause and effect. The OFT also notes that, even if Kerry could demonstrate that 2.2 per cent of FRM sales had been directly lost to CRM sales in 2010, this is not a significant enough percentage to firmly put the two in the same relevant market. In any event, FRM sales are expected to increase in 2011.[38]

53. Kerry acknowledged that supermarkets generally have different buyers for FRMs and CRMs, which is not suggestive of a large degree of competitive interaction between these products.

54. The OFT notes that the European Commission concluded in 2005 that, although chilled foods may exercise some competitive constraint on FRMs, this was not sufficient to include them in the same market, given in particular that chilled foods are generally priced at higher levels than FRMs.[39] In 2009 the OFT considered the constraint imposed by chilled pizzas on frozen pizzas, but did not obtain sufficient evidence to conclude that they were part of the same market.[40] Further, in a recent decision the OFT concluded that ambient ready meals (such as canned ready meals) were insufficiently constrained by CRMs and FRMs to put all three in the same market.[41]

55. The views of third parties on the degree of overlap between FRMs and CRMs were mixed. Some respondents confirmed that an increase in the price of FRMs would result in significant switching to CRMs by consumers. However, several third parties stated that any switching would be limited given the significant price differentials between FRMs and CRMs (one third party noted that the average FRM price was £1.31 compared to an average CRM price of £2.18 and another third party stated that FRMs were 'very much a discount market').

56. On balance, the OFT does not consider there is compelling evidence to broaden the FRM product market to include CRMs on the basis of demand-side factors. While there is some evidence that at the wholesale level,

[38] Mintel report *Chilled and Frozen Ready Meals, Market Intelligence* (footnote 33), page 42.
[39] Case COMP/M.3658 *Orkla/Chips*, decision of 3 March 2005, paragraph 12.
[40] *Dr Oetker (UK) Limited/Schwan's Consumer Brands UK Limited*, decision of 5 May 2009, paragraphs 11-18.
[41] *Princes Limited/canning business of Premier Foods Group Limited*, decision of 22 June 2011, paragraph 123.

where competition between the parties takes place, CRMs may impose some competitive constraint on FRMs, in particular due to an indirect constraint at the consumer level, there is insufficient evidence that this constraint is sufficient to warrant including both CRMs and FRMs in the same relevant market based on demand-side factors.

Supply-side factors

57. When defining the relevant product market, the OFT generally refers to demand-side substitution alone, but there are specific circumstances under which it may aggregate several narrow markets into one broader market on the basis of the responses of suppliers, specifically in markets where:

    a) production assets can be used by firms to supply a range of products which are not demand-side substitutes, and the firms must have the ability and incentive to quickly shift capacity between these products depending on demand and

    b) the same firms compete to supply these different products and the conditions of competition between the firms are the same for each product.[42]

58. From a supply-side perspective, Kerry submitted that manufacturers of CRMs can switch to producing FRMs rapidly and at low cost. Kerry estimated that the capital costs for a CRM manufacturer to begin supplying five per cent (18.6 million units per year) of total current FRM output would involve [ ]. Kerry noted that, alternatively, a CRM manufacturer could purchase one of the existing FRM facilities that have become available in recent years.

59. As regards consideration a) in paragraph 57 above, the evidence before the OFT is mixed. Third parties' estimates of the cost and time scale of a possible switch by a CRM manufacturer to producing FRMs were generally (somewhat) greater than Kerry's estimates.[43] Furthermore, several third parties stated that a switch to FRM production may be uneconomical, given the low price of FRMs compared to CRMs, particularly in light of the necessary investment costs necessary for the switch. None of the CRM manufacturers contacted by the OFT expressed a current interest to switch

[42] *Merger Assessment Guidelines* (CC2 and OFT1254, September 2010), paragraph 5.2.17.
[43] For example, one respondent estimated that in order to convert CRM manufacturing capacity to the manufacture of FRMs, producing circa five per cent of annual FRM volumes, would require conversion of five CRM lines, at a cost of £3m-£5m and would take six months.

to producing FRMs. An additional obstacle to a quick switch between FRMs and CRMs may be that, as Kerry noted, the logistics of supplying and delivering FRMs to supermarkets are different from supplying CRMs.[44]

60. That said, the parties told the OFT that a supplier that predominantly manufactures CRMs had begun producing own-label FRMs for [ ]. Further, Kerry submitted that the production costs for FRMs in earlier stages of the production process (before the ready meal is frozen) may be lower. The OFT notes that this may suggest that FRM manufacturers could switch to CRMs but does not necessarily indicate that the converse is likely.

61. As regards condition b) in paragraph 57 above, the OFT notes that, notwithstanding the fact that Kerry manufactures and supplies both FRMs and CRMs, and that several CRM manufacturers supply small FRM volumes to their CRM retail customers, there are substantial differences between the identities of CRM and FRM manufacturers. Furthermore, the OFT considers that the competitive conditions between the products vary significantly, particularly with respect to pricing and their locations in supermarkets.

62. Therefore, the OFT does not consider that there is compelling evidence that specific circumstances exist under which it would be appropriate to markets for FRMs and CRMs into one broader product market.

Conclusion regarding CRMs

63. On balance, the OFT does not consider there is compelling evidence to broaden the FRM product market to include CRMs on either demand-side or supply-side factors. The OFT has, however, considered the possibility of entry by CRM manufacturers in its competitive assessment below (see from paragraph 115).

OL, CP and OB FRM manufacturers

64. Both Kerry and third parties distinguished between the manufacture and supply of own-label (**OL**), contract-packed (**CP**) and own-brand (**OB**) FRMs. OL FRMs are manufactured and packed to the specifications of large grocery retailers and CP FRMs to the specifications of brand owners. OB FRMs are manufactured by the brand owner itself or (as, for example, in

[44] For example Kerry noted that retailers required CRM deliveries seven days a week.

the case of Kerry) by the licensee of a brand. As set out at Table 4 below, Kerry is active in all three categories. It produces OB FRMs under the [ ] and [ ] brands, which are licensed by Kerry from [ ], and under its own Mr Brains brand. Headland produced only OL and CP FRMs.

Table 4: OL, CP and OB FRM production by the parties

Type of FRM	Kerry	Headland
OL	[ ]%	[ ]%
CP	[ ]%	[ ]%
OB	[ ]%	-
Total	[ ]%[45]	[ ]%[46]

Source: Kerry.

65. Kerry submitted that the distinction between OL, CP and OB FRMs is not relevant for the competitive assessment, as the products and suppliers are broadly the same for each category. Kerry noted that the only main UK FRM manufacturer that does not produce OL or CP FRMs is Heinz, and that it is not aware of any reason why Heinz would not also produce OL or CP FRMs. Kerry further submitted that supermarkets can and do switch between OL and OB FRMs in response to proposed price increases, as shown by disparate and changing patterns of OL and OB shares in the sales of different supermarkets.[47] Kerry noted that supermarkets have no reason to resist purchasing OB FRMs when they are not satisfied with an OL offering, because [ ] ([ ][48]). Furthermore, supermarkets can influence the products supplied by OB FRM suppliers to achieve their desired in-store range of products.

66. Third-party information received by the OFT supports Kerry's submission that supermarkets switch between OL and OB FRMs, at least in the short term. In particular, Co-op told the OFT that it has switched all of its OL FRM purchases away from Kerry since the Transaction (see further from paragraph 107 below) and is replacing its OL FRMs with branded FRMs. However, Co-op informed the OFT that this is only until it has been able to identify alternative OL suppliers.

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[45] The remaining [ ] per cent of Kerry's FRM production was to customers outside the UK.
[46] The remaining [ ] per cent of Headland's FRM production was for in-flight catering.
[47] According to Kerry, the share of FRM sales accounted for by OB FRMs changed between 2006 and 2011 from [ ] to [ ] per cent for Asda, from [ ] to [ ] per cent for Iceland and from [ ] to [ ] per cent for Morrisons, while for Tesco and Sainsbury's the share remained relatively stable around [ ] per cent.
[48] The OFT noted that [ ].

67. Further, the differences in firms producing OL and CP FRMs and firms producing OB FRMs were greater than Kerry suggested. In particular (and in addition to Heinz), Youngs, which is the fourth largest FRM manufacturer (see Table 5 below), has devoted 95 per cent of its production to OB manufacturing. Therefore the parties' two main competitors produce exclusively or mainly OB FRMs. Further, some of the parties' smaller competitors, such as SFC and Kershaws, also produce only OB FRMs.

68. Third-party comments on switching at the wholesale level, suggested that it is not clear that OB FRM manufacturers formed an alternative to suppliers of OL and CP FRM. In particular, these expressed doubt as to whether these manufacturers would be interested in producing OL FRMs, particularly in situations where a large supplier of OB FRMs would produce OL FRMs which could compete with their OB offering for end-consumer spend. Furthermore, several third parties told the OFT that other OB manufacturers may not be capable of replicating the parties' OL range.

69. Third-party comments on switching at the consumer level were mixed, notwithstanding the evident similarity between FRMS and CRMs. Some grocery retailers believed consumer switching from OL to branded FRMs (that is, OB and CP FRMs) would be limited given the retail price difference between these products. This may form an indirect constraint in competition at the wholesale level, where the parties operate, because manufacturers of OL FRMs may be constrained in increasing the wholesale price for these products if this could result in consumer switching to branded FRMs following pass-through by the retailers of the OL FRM price increase to consumers.

70. Given that the evidence about the inclusion of OB FRM production in the relevant product market was mixed, on a cautious basis the OFT has considered the effects of the merger in both an overall FRM market and a separate market for third-party manufactured FRMs (consisting of OL and CP FRM manufacturers). The OFT notes, however, that the constraint imposed on the merged firm by OB manufacturers is taken into account in either case, because in a separate market for OL and CP FRMs there is the prospect of entry by OB FRM manufacturers.[49]

[49] *Merger Assessment Guidelines*, paragraph 5.2.2.

Geographic market

71. Kerry submitted that currently imports into the UK amount to around [30-40] per cent by value from the Republic of Ireland (FRMs manufactured by Kerry and Heinz) and around [0-10] per cent by value from elsewhere. On this basis, Kerry submitted that the market is at least as wide as the UK and that it faces increasing competition from continental Europe and elsewhere.

72. Third parties generally considered the market to be the UK. Several third parties stated that they had considered imports from continental Europe, or would consider these in the event of a price rise, but they identified various difficulties with such imports (including exchange rate issues, transportation costs and differing taste profiles). As set out in detail at paragraph 113 below, Kerry disagreed that these difficulties existed. Neither Kerry nor third parties identified any suppliers in the Republic of Ireland apart from Kerry and Heinz.

73. In previous decisions, competition authorities have generally identified national markets for consumer food products.[50] This is determined by, for example, different customer preferences between countries rather than where these products are physically produced. In this case, the OFT considers that there is currently insufficient evidence to conclude that the market is wider than the UK. However, it has considered the constraint imposed by suppliers outside of the UK and the Republic of Ireland in its competitive assessment below (see from paragraph 111).

Conclusion

74. For the reasons set out above, the OFT has considered the competitive impact of the Transaction by reference to the market for the manufacturing and supply of all FRMs to UK customers and the market for the manufacturing and supply of all third-party manufactured FRMs (that is,, OL and CP FRMs) to UK customers.

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[50] For example, European Commission decision of 3 March 2005 on Case COMP/M.3658 *Orkla/Chips*; Competition Commission's report of 24 March 2006 on *HJ Heinz Company/HP Foods Group*; and OFT decision of 5 February 2007 on *Premier Foods plc/RHM plc*.

UNILATERAL EFFECTS

Market shares

75. Kerry submitted that it faces considerable competition from several large FRM manufacturers. Table 5 below shows the shares of the merged parties and their main competitors in the supply of FRMs in the UK in 2010, both in value and volume terms.

Table 5: Shares of UK FRM supplies in 2010

Supplier	Units (m)	Share (per cent)	Value (£m)	Share (per cent)
Kerry	[ ]	[20-30]	[ ]	[20-30]
Headland	[ ]	[20-30]	[ ]	[15-25]
Combined	**[ ]**	**[45-55]**	**[ ]**	**[40-50]**
Heinz	[ ]	[5-15]	[ ]	[5-15]
Youngs	[ ]	[5-15]	[ ]	[5-15]
Authentic Foods	[ ]	[0-10]	[ ]	[0-10]
Loxton Foods	[ ]	[0-10]	[ ]	[0-10]
Brown Brothers/ Food Pro	[ ]	[0-10]	[ ]	[0-10]
SFC	[ ]	[0-10]	[ ]	[0-10]
Kershaws	[ ]	[0-10]	[ ]	[0-10]
Others[51]	[ ]	[10-20]	[ ]	[15-25]
Total	**372**	**100**	**479**	**100**

Source: Kerry estimates based on Nielsen figures.

76. This table shows that the merged parties account for around [40-50] per cent of the UK FRM supplies in 2010 by value, with an increment of around [15-25] per cent arising from the merger. Their combined share by volume is around [45-55] per cent, with an increment of around [20-30] per cent. This difference in shares by value and volume confirms third-party comments that the parties are both active primarily at the lower-price end of the market (see further at paragraph 88 below). The parties' competitors are all significantly smaller, with the next largest supplier, Heinz, supplying around [five-15] per cent (by volume and value) and the third largest

[51] FRM manufacturers with volume and value shares below [0-10] per cent, including Crops, Tryton Foods, Stratmore Foods, CP Thailand, Linda McCartney, Vion, Laila's Fine Foods, Ferndale Foods, Fresh Park, Schwan, CPF, Daloon, King Asia, Summit Coldwater Seafood, Danby's and Robert's. Longbenton is also included as this regards 2010 figures, but it went into administration on 11 March 2011.

supplier, Youngs, supplying around [five-15] per cent by volume and [five-15] per cent by value.

77. The parties' combined market share in all FRMs is high enough to give the OFT cause for concern over unilateral effects,[52] in particular as Heinz and Youngs may impose a smaller constraint on the parties than their shares suggest, given the nature of the FRMs they produce (see further at paragraph 89 below).

78. Table 6 below shows the 2010 shares of the parties in the supply of OL and CP FRMs, calculated by value. The OFT does not have the equivalent shares by volume, but these shares are likely to be higher than the parties' value shares given their position in the market (see paragraph 76 above).

Table 6: Shares of UK OL and CP FRM supplies in 2010

Company	Value (£m)	Share (per cent)
Kerry	[ ]	[25-35]
Headland	[ ]	[30-40]
Combined	**[ ]**	**[55-65]**
Authentic Foods	[ ]	[5-15]
Loxton Foods	[ ]	[0-10
Brown Brothers/Food Pro	[ ]	[0-10]
Youngs	[ ]	[0-10]
Others	[ ]	[15-25]
Total	**303**	**100**

Source: Kerry estimates based on Nielsen figures.

79. From Table 6, the merged parties' share is even more pronounced when considering a separate market for the supply of OL and CP FRMs. Pre-merger, the parties were the largest suppliers by far at a combined share of around [55-65] per cent (increment around [25-35] per cent), with the next largest supplier, Authentic Foods, holding a relatively small share of circa [five-15] per cent.

80. The parties' high combined share is confirmed by share estimates provided by three of the parties' customers, with estimates of the parties' combined share ranging between 60 and 70 per cent.

[52] *Merger Assessment Guidelines*, paragraph 5.3.5.

81. The parties' combined market share in OL and CP FRMs is high enough to give the OFT cause for concern over unilateral effects.

Closeness of competition

82. Internal documents provided to the OFT by Kerry provide evidence that Kerry and Headland were close competitors. One internal document which discusses the proposed transaction and its strategic rationale suggests that the parties are continually played off against each other by all retailers, which has in the past served to drive prices down.[53] Another document states that 'Headland is the main competitor to Kerry Foods ... in the UK & IRL frozen ready meal market'.[54]

83. All third parties that were asked about closeness of competition between Kerry and Headland indicated that they were close or extremely close competitors, because they were the only suppliers of FRMs in the UK that could supply a broad range in large volumes at the value end of the market.

84. Third parties also reported that Kerry and Headland frequently bid against each other. Kerry provided the OFT with its own and Headland's bidding history across the OL and CP segments between 2008 and 2011. This does not provide a complete history of bidding in the FRM market, as it does not include details of tenders where neither party participated, nor does it reveal how many other competitors bid.

85. However, third parties told the OFT that Kerry and Headland were 'typically' invited to tender. Therefore, the OFT considers that it is representative of bidding for OL and CP FRM tenders on the whole, particularly as the parties tended to submit bids for larger tenders. The data on tenders corroborates what third parties told the OFT and is consistent with the parties' high combined market share, inasmuch as it reveals that—of tenders where Kerry and/or Headland bid—they bid against each other about half the time.

[53] Internal Kerry document, dated August 2010 (see footnote 3), page 2.
[54] Internal Kerry document headed 'Purchasing – Project Trinity. Pre-Acquisition Management Process Due Diligence Report', dated 16 December 2010 (Annex 3(6) of the response to OFT questions of 12 April 2011), page 3.

Table 7: FRM bidding history, 2008-2011

Participated	Number of tenders in which either or both parties participated						Weighted by volume*
	2008	2009	2010	2011	Total	Total (per cent)	Total (per cent)
Both	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**47.4**	**53.0**
Headland	[ ]	[ ]	[ ]	[ ]	[ ]	10.5	9.2
Kerry	[ ]	[ ]	[ ]	[ ]	[ ]	42.1	37.8
Total	[ ]	[ ]	[ ]	[ ]	[ ]	100	100

*Weighted volumes are the number of tenders, weighted by the size of the contract.

Competition from alternative suppliers

86. Almost all customers stated that the number of alternative suppliers was limited, in particular for large volumes, for a wide range of products and for value FRMs, such that the Transaction had significantly reduced their options. Several customers expressed concern about the lack of capability of alternative suppliers to replace the merged party's supplies of value meals.

87. Kerry submitted that the bidding history referred to above shows that in nearly half of all contracts it provided data for, from 2006 to 2010, customers switched supplier, which suggests that switching costs are low. Customer comments regarding switching costs were mixed, but none of the customers stated that switching costs were high. However, as also noted by customers, switching costs are not relevant if there is no-one to switch to.

88. The OFT notes that these customer concerns about the lack of alternative suppliers appear to be justified based on the large size of the merged firm's production compared to competitors' size, as set out at Table 5 and Table 6 above. Also, Table 8 below shows that Kerry and Headland were two of the lowest priced suppliers. The competitive constraint imposed by competitors that price at similar levels (at an implied RSP of £1.25 or below) is limited, in particular for OL and CP production: Heinz and SFC produce only own-brand FRMs, Youngs produces mainly own-brand FRMs

and has traditionally focused on fish-based products,[55] and the other low-priced competitors are all very small or have subsequently exited the market (Longbenton).

Table 8: Implied pricing of UK FRM manufacturers in 2010

Company	Units (m)	Value (£m)	Implied average retail price (£)
Kerry	[ ]	[ ]	1.16
Headland	[ ]	[ ]	1.12
Combined	**[ ]**	**[ ]**	**1.14**
Heinz	[ ]	[ ]	1.25
Youngs	[ ]	[ ]	1.15
Authentic Foods	[ ]	[ ]	1.85
Loxton Foods	[ ]	[ ]	2.76
Brown Brothers/ Food Pro	[ ]	[ ]	1.65
SFC	[ ]	[ ]	1.21
Kershaws	[ ]	[ ]	1.38
Crops	[ ]	[ ]	1.25
Tryton	[ ]	[ ]	1.21
Longbenton	[ ]	[ ]	1.11
Stratmore	[ ]	[ ]	1.09

Source: Kerry.

89. Kerry submitted that other manufacturers of FRMs can, like itself, also achieve large volumes and the resulting scale efficiencies by concentrating on specific types of FRMs. For example, it noted that French manufacturer Stefano Toselli [ ] is one of Europe's largest pasta FRM suppliers. Kerry further submitted that it is not aware of any reason why other FRM manufacturers, including Heinz, would refuse to produce (more) OL and/or CP FRMs and therefore any supermarket or brand owner would regard all major FRM manufacturers as potential alternative suppliers.

90. However, as noted at paragraph 68 above, this is not borne out by third-party comments. None of the parties' customers named Heinz or Youngs as viable alternative suppliers to the parties, nor did the OFT receive any evidence that alternative OL and CP FRM manufacturers—individually or

[55] Mintel report *Chilled and Frozen Ready Meals, Market Intelligence*, May 2010 (Annex 9 to the submission of 4 April 2011), page 48. This is supported by third-party views.

even taken together—could supply the range and scale of FRMs that Kerry does. Furthermore, as discussed in paragraph 86 above, several of these competitors either do not supply OL and CP FRMs (Heinz) or focus on specific meal ranges (Youngs mainly produces OB fish FRMs).

91. In particular, even if all FRM manufacturers were considered to be alternative suppliers, the merged firm's combined share is around [40-50] to [45-55] per cent (by value and volume respectively), while the firm's competitors are significantly smaller (the largest firm, Heinz, has a much smaller share at around [five-15] per cent of the wider market including OB sales) and may not therefore be able to replace the merged firm as a major supplier at the same prices, volumes and product ranges.

92. On balance, then, the evidence available to the OFT does not indicate that competition from alternative suppliers is sufficient to replace the competition between Kerry and Headland removed by the merger.

Spare capacity

93. Kerry submitted that competition in the market is fierce because many, if not all, of its competitors have substantial spare capacity and are able to expand output significantly at short notice, particularly for a major purchaser with guaranteed volumes such as a large grocery retailer. Kerry estimated that four of its largest competitors – [ ] – have around [ ] million units of spare capacity. This is close to the merged firm's own production in 2010 of [ ] million units. Kerry also submitted that its competitors could expand their production by purchasing additional factory space and assets, such as the Longbenton factory. Kerry also pointed to the shrinking size of the market (although the OFT notes that a Mintel report forecasts a small growth of the market, see paragraph 52 above).

94. Third-party comments indicated that spare capacity was substantially less than estimated by Kerry [ ]. Since [ ], the effective spare capacity figure (likely to be below [ ] million units), while significant, is nevertheless very substantially lower than the merged firm’s own production. Moreover, the evidence available to the OFT indicates that [ ] also have little effective spare capacity.

95. Consistent with this, third parties were generally of the view that the parties were the only large scale operators who could provide the

necessary scale and capacity, such that efficiencies and as a result lower prices were achieved.

96. Indeed, the limited spare capacity in the market is illustrated by [ ].[56]

97. Therefore, the OFT considers that the existing spare capacity is unlikely to exert a significant competitive constraint on the merged entity.

Post-merger price increases

98. Several customers informed the OFT that immediately following the Transaction, Kerry proceeded to push through significant price increases, in some cases demanding cost prices that were significantly higher than those asked for before the Transaction. Some customers also stated that this was already filtering through in higher retail prices of FRMs for consumers.

99. This is consistent with the intention expressed in Kerry's internal documents to seek significant price increases after the Transaction. For example, a document that was described by Kerry as a key document regarding the Transaction, states: 'The success of the acquisition depends on the major challenges of delivering significant Price Increases on all Customers across the combined Business of on average [ ] per cent as well as the realisation of £[ ]m of synergies.'[57]

100. Kerry accepted that after the Transaction, in January/February 2011, it sought price increases over and above what it had previously sought (on average, [ ] per cent compared to [ ] per cent[58]), and over and above the prices that Headland had agreed with customers when it had tendered for contracts at very low prices in 2010 (see further at paragraph 13 above). Diarmaid Kilduff, Kerry's Director of Meal Solutions, stated that these price increases were necessary 'first, to keep pace with raw material price increases; second, to return prices to a sustainable level going forward.'[59] Mr Kilduff stated that Kerry's strategy of price increases has met with only partial success, because [ ] and because the vast majority ([ ] per cent) of

[56] Kerry informed the OFT shortly before the date of this decision that [ ], reinforcing this point.
[57] Document headed 'Project Trinity' by Mark Boyle, dated 8 December 2010 (Annex 16 to the submission of 4 April 2011), page 2. Also, internal Kerry document headed 'Frozen Ready Meals. Headland Foods Limited', dated August 2010 (Annex 3(1) of the response to OFT questions of 12 April 2011), page 2.
[58] Witness statement of Diarmaid Kilduff, dated 20 June 2011, paragraphs 21 and 23.
[59] Id, paragraph 26.

the increases [ ] has been overtaken by the increase in raw material costs.[60]

101. Kerry submitted detailed estimates of its raw material costs in mid 2010 and mid 2011, which show significant cost increases. Kerry further submitted that it had based the price increases sought from customers of [ ] per cent prior to the Transaction and [ ] per cent after the Transaction (instead of rather than in addition to the previous [ ] per cent increase) on equivalent increases in raw material costs.

102. However, Kerry did not submit evidence for this increase in raw material costs between the period before the Transaction and the period after the Transaction. Also, even if it had provided this evidence, the change in price increases sought from some customers were in fact greater than the change in cost increases. For example, after the Transaction Kerry sought, and obtained, a price increase of [ ] per cent from [a customer], where information from [this customer] indicates that before the Transaction it had sought a price increase of [ ] per cent.[61] Further, shortly before the Transaction Kerry and Headland had both tendered for a contract with [ ]. After the Transaction, Kerry increased its contract price by [ ] per cent compared to the price it had tendered before the Transaction (rather than the [ ] per cent that is the difference in raw material cost increases). The OFT notes that Kerry's customers were only partly successful in refusing to accept price increases, or even had to accept these price increases in full (for example [ ]).

103. The OFT therefore concludes that the evidence suggests that the significant price increases Kerry had obtained after the Transaction, which led to at least a short-term improvement in its margins, may be, at least in part, due to the reduction in competition resulting from the Transaction. This is notwithstanding Mr Kilduff's statement that the price increases have now been, mostly but not completely, overtaken by increases in raw material costs or by the notion that, before the Transaction, prices were not at a sustainable level given the substantial losses suffered by both Headland and Kerry's FRM business. The OFT's remit is to protect competition rather than individual competitors. It is possible that if the Transaction had not taken place, prices may still have increased in view of

[60] Id, paragraphs 27 to 41.

[61] The OFT notes that [this customer] was not among the customers referred to by Mr Kilduff in his witness statement (paragraphs 29 to 39), where he discussed the negotiations between Kerry and five specific customers about price increases.

the losses suffered by the two main suppliers, but it appears likely that this increase would have been smaller and/or slower than the increases made possible by the Transaction.

104. Mr Kilduff also stated that since the Transaction, some of Kerry's customers have removed substantial portions of their business and have threatened to remove further business. [ ].[62] The OFT has considered this loss of contracts and buyer power below.

Buyer power and contracts lost post-merger

105. Kerry submitted that it faces significant buyer power, as the purchasers of its FRMs are a small number of large grocery retailers and major brand owners that can switch to other suppliers, de-list Kerry's products at short notice or can sponsor new entry or expansion by other manufacturers. It referred to Iceland's sponsoring of expansion by Authentic since 2005 as an example. Kerry also referred in this respect to the fact that the vast majority of its products are sold under its customers' labels and that it can therefore not rely on consumer brand loyalty, as well as to the fact that it has no long-term contracts in place.

106. However, while the merged firm's customers generally acknowledged that, at least before the Transaction, they had some buyer power and that contracts were informal and/or short-term, several customers stated that the Transaction had significantly affected their negotiating strength due to the lack of sufficient alternative suppliers capable of producing the product range and volume of the merged firm at the value end of the market. Most customers also stated that their ability to sponsor entry or take production in-house was limited due to the costs and time involved.

107. Kerry submitted that such customer concerns are shown to be without foundation, because it has already lost a substantial volume of business since the Transaction [ ]. Kerry noted that, as far as it is aware, the lost business has gone not only to one of its UK competitors ([ ]) but also to a competitor from elsewhere in the EU ([ ]).

108. The OFT has carefully considered whether this loss of contracts is sufficiently compelling to discount the indications of the parties' market power. Kerry has lost substantial business since the Transaction,

[62] Id, paragraph 41.

representing around [ ] per cent of the predicted combined 2011 turnover of Kerry and Headland.[63] As far as the OFT can ascertain, this consists of [ ]. However, in view of the third-party comments summarised above it is possible that this loss, which the OFT understands will be phased in over the course of a few months, represents the only volumes that customers could relatively easily switch in the face of Kerry's significant post-merger price increases. The OFT considers that retailers' threats of further turnover loss may be a negotiating tactic and does not necessarily mean that these retailers are able to carry out their threat. [ ]. The OFT further notes that [ ], increasing a concern that the potential for further switching is limited (see paragraph 96 above).

109. The OFT also notes that [a retailer], which has switched [ ] purchases away from Kerry, told the OFT that the suppliers it has switched to, had only become viable following the price increases imposed by Kerry, since they charge prices that are significantly above Headland's pre-Transaction prices but below Kerry's current prices. [A retailer] also noted that for some of the merged firm's product lines it had not been able to find any viable alternatives.

110. On balance, the OFT considers that the loss of contracts does not provide sufficient evidence to show that after the Transaction alternative suppliers can impose a sufficient constraint on the merged firm to reject the realistic prospect of a substantial lessening of competition as a result from the Transaction.

Entry by FRM manufacturers outside the UK and Ireland

111. Kerry submitted that it faces increasing levels of competition from abroad, in particular from continental Europe but also from Asia. It estimated that suppliers from outside the UK and Ireland currently supply [0-10] per cent of the UK market by value ([0-10] per cent by volume). It submitted that transportation costs are not a significant obstacle, as illustrated by the fact that both Kerry and Heinz produce all their FRMs for the UK in Ireland.

112. Third-party comments regarding imports were mixed. Several third parties referred to suppliers from continental Europe as alternative suppliers. However, most third parties stated that importing a significant share of

[63] The OFT considers it more appropriate to consider the size of the loss in relation to the combined turnover of Kerry and Headland than only Headland's turnover, since the losses occurred after the merger and involved at least one contract that was originally Kerry's.

FRMs would be difficult, mainly because of exchange rate issues, transportation costs and difficulties in producing the required flavour profiles. In addition, some customers appeared to consider greater imports only as an alternative following the post-merger price increases, which suggests that imports are only economically viable at the higher, post-merger price levels.

113. Kerry submitted in response to these third-party comments that exchange rate issues and transportation costs have not prevented it competing in the UK with FRMs manufactured in the Republic of Ireland.[64] It also provided an example of the detailed specifications for an FRM that are given by grocery retailers and brand owners for the production of products under their label or brand. According to Kerry, this shows that they can require suppliers elsewhere in Europe to produce FRMs using precisely the same ingredients and processes. Kerry also provided an estimate of transport costs from different areas in Europe, including France, Belgium and Germany, which shows that they are on average between 0.5 and 2.6 eurocents per FRM higher than transport costs from its own factory in the Republic of Ireland (close to the border with Northern Ireland). Kerry submitted that these costs are not sufficiently high to impede imports, although it is not clear to the OFT that this difference is not significant given the low margins earned by manufacturers on many FRMs. Finally, Kerry referred to other frozen food products that are imported into the UK from continental Europe in significant quantities, such as frozen pizzas.

114. The evidence on the extent of a constraint from imports from outside the UK and the Republic of Ireland is therefore mixed. While the OFT accepts that the significant imports from the Republic of Ireland, including by Kerry itself, suggest that obstacles to imports are not insurmountable, third parties expressed considerable doubts and imports from countries other than the Republic of Ireland are currently low. The OFT also notes that current imports often relate to specific types of products such as frozen pasta meals rather than the broad range of products offered by Kerry and Headland. Imports may become more attractive at higher post-merger price levels, but the OFT normally only takes the likelihood of greater entry into account at pre-merger price levels.[65] On balance, therefore, the OFT could

[64] The OFT notes, however, that Kerry itself said in January 2010 that its FRM business had been severely impacted by the depreciation of Sterling (article in the Dundalk Democrat of 19 January 2010, see www.dundalkdemocrat.ie/news/local/td_doubts_rye_valley_jobs_claim_1_1980699).

[65] *Merger Assessment Guidelines*, paragraph 5.8.9.

not conclude that the possibility of greater imports imposes a sufficient constraint on the merged firm to reject the possibility of a realistic prospect of a substantial lessening of competition as a result from the Transaction.

Entry by CRM manufacturers

115. Kerry has submitted that it faces a credible threat of market entry by the major UK suppliers of CRMs. It has submitted that CRM manufacturers can switch to production of FRMs rapidly and at low cost (see at paragraph 57 above). It has also noted that the main CRM manufacturers already have strong existing relationships with supermarkets, which means that supermarkets could sponsor their entry into the FRM market.

116. However, as noted above (paragraph 59 above), the evidence on the ability and likelihood of entry by CRM manufacturers is mixed. In particular, although the costs of a switch to FRM production may be limited, such a switch may be uneconomical given the low margins of FRMs compared to CRMs. None of the CRM manufacturers contacted by the OFT expressed a current interest to switch to producing FRMs. Further, although most customers did not entirely exclude the possibility of sponsoring entry, they were generally very reluctant to do so. Therefore, even if barriers to entry by CRM manufacturers are relatively low, it is not clear that they have the incentive to enter.[66] There is therefore insufficient evidence to conclude that the threat of entry by CRM manufacturers forms a significant constraint on the merged firm.

THIRD-PARTY VIEWS

117. Third-party views have been discussed above where relevant. Out of eight of the parties' customers from which the OFT received views, seven expressed concerns about the Transaction, in particular about the resulting strong market position of Kerry and the lack of alternative FRM suppliers. None of the parties' competitors expressed concerns.

ASSESSMENT

118. Kerry submitted that the appropriate counterfactual to assess the Transaction is not the state of competition before the Transaction but Headland's inevitable exit shortly after the Transaction due to its poor

[66] Id.

performance. Headland had been loss-making for a considerable period of time and its financial position had been deteriorating. However, Headland continued to trade and in 2010 it was winning more business than it was losing. These new contracts may have been on loss-making terms, but they allowed Headland to recover some of its fixed costs and there is insufficient evidence that the losses on these contracts would have been so significant that Headland could not, at least in the short term, have borne them. There is also insufficient evidence that Headland faced severe or imminent liquidity problems.

119. Given that Headland's long-term debt was held by its shareholders, the decision to close Headland was mainly in the hands of its shareholders. At the time of the Transaction, Headland had started a restructuring process to close one of its two factories. Although the evidence shows that Headland's shareholders did not believe it could have continued in its pre-Transaction form in the long term, Headland's restructuring plans, albeit with significant risks, gave a prospect of a return to profitability for Headland due to increased efficiencies, at least in the short term, such that imminent closure by its shareholders was not inevitable.

120. Therefore, the OFT considers that there is not sufficiently compelling evidence that at the time of the Transaction Headland would have imminently and inevitably exited the market. The appropriate counterfactual is therefore competition in the market before the Transaction.

121. The OFT has found that the merged firm has a significant combined market share, at around [40-50] per cent in value and around [45-55] per cent in volume, while its competitors have significantly smaller shares (the next largest supplier, Heinz, has a share of only around [five-15] per cent by value and volume). The merged firm's combined share is higher if OL and CP FRMs are considered separately from OB FRMs, at around [55-65] per cent, with the next largest supplier at only around [five-15] per cent.

122. The merged firm faces some constraints in the form of, in particular, alternative suppliers, in particular in the UK but also elsewhere in Europe, as demonstrated by Kerry's loss of contracts since the Transaction. However, the merged parties were close competitors and the merged firm is by far the largest supplier of FRMs to UK customers. Almost all customers have expressed concern about a lack of alternative suppliers, in particular for large volumes and a broad range at the value end of the

market. This applies in particular if manufacturers of OB FRMs are excluded, which the evidence suggests do not provide, at the least, as strong a constraint as OL and CP manufacturers.

123. The OFT also notes that, consistent with its pre-merger plans according to internal documents, after the Transaction Kerry implemented significant price increases, which were generally larger than the price increases it had sought before the Transaction. Kerry has not shown these increases to be fully explained by increases in raw material costs and the evidence strongly suggests that the significant price increases Kerry had obtained after the Transaction may be, at least in part, due to the reduction in competition resulting from the Transaction. Kerry has lost a number of contracts after the Transaction, but the OFT considers that this does not provide sufficient evidence to show that after the Transaction alternative suppliers can impose a sufficient constraint on the merged firm.

124. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom, namely the manufacturing and supply of frozen ready meals.

125. Kerry did not offer any undertakings in lieu of a reference.

DECISION

126. This merger will therefore **be referred** to the Competition Commission under section 22(1) of the Act.

END N0TES

1. With regard to paragraph 3, Kerry clarified that the Chairman, Chief Executive and Company Secretary of Headland's FRM business did not transfer to Kerry.

2. With regard to paragraph 60, the OFT clarifies that the reference to [ ] should be to [ ].