OFFICE OF FAIR TRADING

Anticipated acquisition by General Mills UK Limited of Saxby Bros Limited

The OFT's decision on reference under section 33(1) given on 27 November 2006. Full text of decision published 6 December 2006.

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

PARTIES

1. **General Mills UK Limited** (General Mills) manufactures and markets consumer food products, including the Jus-Rol frozen ingredient pastry range. Its UK turnover in the year ending 30 April 2005 was £136.5 million.

2. **Saxby Bros Limited** (Saxbys) is a wholly-owned subsidiary of Saxby Bros Holdings Limited, whose principal activity is that of a holding company. Following a re-structuring of its business in February 2005, Saxbys now concentrates solely on the manufacture and marketing of chilled ingredient pastry and un-baked goods to the retail sector. Its UK turnover in the year ending 1 April 2006 was £11.7 million.

TRANSACTION

3. General Mills is proposing to acquire the entire issued share capital of Saxbys for a consideration of approximately £[ ] million. The parties notified the transaction to the OFT on 29 September 2006. The administrative timetable expires on 28 November 2006.

JURISDICTION

4. As a result of this transaction General Mills and Saxbys will cease to be distinct. The parties overlap in the supply of ingredient pastry in the UK and post-merger would achieve a share of supply of 70 to 80 per cent. As a result, the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

FRAME OF REFERENCE

5. The parties primarily overlap in the supply of ingredient pastry to the retail, foodservice and bakery/manufacturing sectors.

6. The merger also gives rise to some smaller overlaps in the supply of (i) unbaked goods that include ingredient pastry; and (ii) baking mixes. In both areas no concerns were raised by third parties. When considered in a number of different frames of reference, the parties' shares of supply are relatively low (below 15 per cent with an increment of about one per cent) and there appear to be a number of other competitors present. As a result, no competition concerns are considered to arise in these segments and they will not be considered further.

Product market

7. The supply of ingredient pastry can be segmented as frozen (sold by General Mills as own label and under its 'Jus-Rol' brand) or chilled (sold by Saxbys as own label pastry and Saxby branded). Frozen pastry can be kept for up to two years and reaches room temperature in three hours, whereas chilled ingredient pastry has a maximum shelf-life of 21- 28 days and can be used within the hour.

8. The parties submitted that supply of ingredient pastry could also be segmented into three distinct categories based on customer requirements and hence the type of product supplied: retail (e.g. supermarkets, retailers and convenience stores); foodservice, and bakery and manufacturing.[1] Third party responses tended to support the proposition that customers in these segments had different requirements. General Mills currently sells frozen ingredient pastry to both retail and foodservice sectors, while Saxbys currently only supplies chilled ingredient pastry to the retail sector. Both parties supply ingredient pastry to the bakery and manufacturing sector.

Demand side substitution

9. The parties submitted that there are separate markets for the manufacture of chilled and frozen ingredient pastry, as each product meets different needs on the part of the consumer in terms of storage and preparation time, both of which are longer for frozen pastry.

10. In support of their arguments, the parties submitted an analysis of price and sales data over time for two of the UK's major supermarkets. The parties claimed that graphical analysis of this data indicated little evidence of price changes in one product impacting on volumes sold of the other, although this analysis also showed price correlation between chilled and frozen pastry, which may be indicative of competition between the two types of pastry.

11. The parties also used econometric techniques to estimate the impact of price changes on the sales of both products (that is, estimating own and cross-price elasticities). While the estimated own-price elasticities were all negative (an increase in the price of the two products led to a fall in the quantity demanded) the results for the cross-price elasticities were more inconclusive. Some cross price elasticities were negative – so that an increase in the price of one good led to a *fall* in the demand for the other – indicating that the products are not substitutes. However, there were also some (statistically significant) positive cross-price elasticities, particularly

[1] The parties define 'retail' as sales made through retail channels to supermarkets, other large multiples and smaller retailers/convenience stores; 'foodservice' as sales made to customers who use the products to make finished products for sale to end consumers (predominantly caterers), and 'bakery and manufacturing' as sales made to bakeries and food manufacturers for use in the manufacture of finished products such as meat pies and tarts.

from frozen to chilled pastry, which suggests that an increase in the price of frozen pastry would be expected to lead to some customer switching to chilled pastry.

12. Third party views on the extent to which end-consumers regard chilled and frozen ingredient pastry as substitutes were mixed. However, it was generally agreed that chilled and frozen ingredient pastry were not perfect substitutes in the eyes of end-consumers and only a price rise in excess of 5 – 10 per cent might induce some switching. Such switching was thought to be more likely towards chilled pastry, in the event of a price rise to frozen pastry, as frozen pastry was seen by some customers to be an inferior product offering in comparison.

13. We also examined the possibility of demand side substitution by retail, foodservice and bakery/manufacturing customers.

14. In the retail sector, both Saxbys and General Mills supply ingredient pastry to a variety of customers, ranging from national multiples (e.g. supermarkets, large retailers) to more localised smaller retailers and convenience stores. The parties argued that the larger retailers are the only customers who are likely to stock both chilled and frozen ingredient pastry as, with limited fridge space available to them, smaller retailer/convenience stores generally only stock frozen ingredient pastry. This is supported by evidence showing that over [ ] per cent of Saxbys' sales in the retail sector are accounted for by supermarkets.

15. The parties suggested that commercial strategies adopted by national multiples indicate that they do not regard frozen and chilled ingredient pastry as close substitutes. For example, frozen and chilled ingredient pastry are both sold in most stores but in different parts of a store. Some third parties have also suggested that supermarkets use different buyers for frozen and chilled pastry. In general, however, the supermarkets' ability to substitute between the two products will reflect the ability and/or willingness of its customers to switch between the two (discussed above).

16. The foodservice sector is predominantly made up of caterers who buy frozen ingredient pastry products to sell directly to customers. The parties submitted, and customers agreed, that foodservice sector purchasers rarely (if ever) purchase chilled ingredient pastry due to its short shelf life, as

foodservice customers need to be able to store the pastry for a longer period to meet their usage requirements.

17. Ingredient pastry sold to the bakery and manufacturing sector is predominantly in the form of bespoke products which are used as components in the manufacture of a finished product (e.g. a particular pastry lid to fit with a manufacturer's pie that must conform to certain dimensions). Responses from bakery/manufacturing customers supported the view that frozen and chilled ingredient pastries were not substitutable and indicated that they would be unlikely to switch between the two in the event of a 5 – 10 per cent price increase.

Supply side substitution

18. The basic production process used to manufacture both chilled and frozen ingredient pastry is identical. From the manufacturer's point of view, any pastry product is first produced in a chilled form and then, if required, frozen. Therefore, to produce frozen ingredient pastry from chilled the only additional piece of machinery required is freezing equipment, though it is possible to acquire such equipment through purchase (costing approximately £300,000-£500,000), lease it, or sub-contract to a third party.

19. There are some differences between the two products in terms of frequency of production and storage/distribution. Chilled ingredient pastry needs to be manufactured one day prior to distribution in order to maximise the available shelf-life of the product, while frozen ingredient pastry can be put into stock once produced.

20. Third parties considered General Mills and Saxbys to compete on the supply side, suggesting that either would be able to switch between frozen and chilled production fairly easily and quickly. This is supported by the fact that each of the parties has produced the other type of pastry in the past. Furthermore, there are a number of examples where the parties have offered, or been asked to offer, to supply both products or the opposite type of pastry to that which they were currently producing.

Conclusion

21. The evidence on demand side substitutability for end consumers is mixed, but it would appear that there is at least some degree of substitutability between them. In particular, the constraint may be asymmetric, with chilled pastry being a stronger demand constraint on frozen pastry than vice versa. Meanwhile, the ability for first line customers to substitute between frozen and chilled ingredient pastry appears limited due to the different requirements of the customers, shelf life and production processes involved.

22. On the supply side, substitution between frozen and chilled ingredient pastry is not only relatively easy, but there is also evidence of it occurring in the past. This may suggest that it is appropriate to examine the supply of ingredient pastry as a whole, without regard to the different types of customer (retail, foodservice and bakery/manufacturing). However, it still remains the case that the supply options currently available to customers will significantly differ depending on their needs (shelf life, bespoke products, etc). We have therefore taken a cautious view and examined the effects of the merger on each customer segment separately. The potential for supply side switching by suppliers other than the parties will be considered in the context of entry and expansion.

Geographic market

23. Each of the parties manufactures its ingredient pastry products at sites in the UK and distributes those products throughout the UK and Republic of Ireland. Third party responses indicated that, although most customers were supplied on a national basis, a national presence was not necessary and customers provided evidence that regional suppliers were used to supplement supply where it was deemed appropriate and/or where regional preferences existed for certain brands or products. There is currently no cross-border activity into the UK in the supply of ingredient pastry, and it therefore appears appropriate, following a conservative approach, to consider the relevant geographic scope to be national. The potential for imports from continental producers will instead be considered in the context of entry and expansion.

HORIZONTAL ISSUES

Shares of supply

24. In the supply of ingredient pastry to the bakery and manufacturing segment the parties will have a combined share of about [15-20] per cent (increment [0-5] per cent) in the UK. There are a number of other larger manufacturers present in this segment, including PINIT (about [35-45] per cent) and Pukka Pies (about [25-35] per cent). Customers in this segment indicated that they consider there to be suitable alternative potential suppliers if the merged entity attempted to raise prices following the merger. Given these factors, the merger is not considered to give rise to any competition concerns in the bakery and manufacturing segment.

25. In the foodservice segment, the merger will not give rise to an increment to the merged entity's share of supply as Saxby's is not active in this segment. However, General Mills is considerably larger than competitors like PINIT, Pukka Pies, William Sword Ltd (Swords), Bells Bakers Ltd (Bells), Vandermortelle and Harvester. As a result some customers suggested that they 'play off' the merging parties against one another when negotiating supply contracts, with one raising concerns that there may be a cost increase as a result of the merger. Therefore, whilst the parties are not currently competing directly in the foodservice segment, third party evidence tends to suggest that Saxbys does exert some competitive constraint on General Mills as a potential supplier. However, there would also appear to be a number of other suppliers present in the segment who could, by virtue of their ability to expand, also represent a similar competitive threat.

26. In the retail segment, the parties will have a combined share of supply of ingredient pastry in excess of 80 per cent (increment about [25-35] per cent) if frozen and chilled products are considered together but no increment if considered separately. In either case, a number of smaller competitors from the food service segment are present, such as Bells and Swords.

27. Retail customers were mixed in their views regarding the impact of the merger. While some considered that they still have sufficient alternative supply options available to them post-merger, others expressed some

concerns at the loss of their ability to play the parties off against one another when negotiating contracts.

Competition between the parties

28. As noted above, direct competition between the parties is limited. Instead, the parties would appear to exert a degree of competitive constraint on one another in the form of a potential competitor for each others' customers.

29. Of the customers who responded, the majority considered that the parties were each other's closest competitors. Both General Mills and Saxby already have established relationships, on a national basis, with the major retailers. In addition, both General Mills and Saxbys have supplied chilled and frozen ingredient pastry respectively in the past. General Mills maintains the means for supply of chilled pastry and distribution is through third-party hauliers, so this does not a present a significant barrier to providing chilled pastry to retail customers. Although, Saxbys no longer has the necessary equipment to produce frozen pastry, this can be acquired relatively cheaply through purchase, leasing or sub-contracting such activity to a third party if necessary.

30. The ability of General Mills to potentially compete in the supply of chilled ingredient pastry is further evidenced by its attempts to bid (albeit unsuccessfully) for supplying all the major supermarkets in the last five years. Evidence from third parties indicates that they have previously 'played off' the two parties against one another when negotiating new supply arrangements. This evidence would seem to suggest that the parties provide a competitive constraint on each other in terms of prices offered to retailers, even if frozen and chilled products are considered separately.

31. In so far as brand may be of importance, the parties clearly have established brand strength in the UK. Third parties considered that the parties could easily carry this brand strength between chilled and frozen segments.

32. Overall, there is evidence to suggest that customers – and supermarkets in particular – consider that the parties impose competitive pressure on one another, even if this was primarily by way of threat of entry into each other's sub-segments. While the extent of this constraint is difficult to determine, it is nonetheless of importance given the parties' strong

positions in the frozen and chilled ingredient pastry sub-segments. We have therefore considered whether entry and expansion by new or existing competitors and/or exertion of buyer power by customers will be sufficient to offset any potential substantial lessening of competition which may arise as a result of the merger.

Barriers to entry and expansion

33. With regards to entry of new suppliers or expansion of existing ones, there are a number of potential alternative sources of supply: existing domestic ingredient pastry retail suppliers; suppliers of unbaked finished goods with in-house pastry manufacturing capability; and international suppliers.

34. In relation to each of these existing competitors and potential entrants it is worth noting that distribution and logistics do not appear to present a significant barrier. The parties themselves do not have their own in-house distribution capabilities since volumes are not sufficient to make building such a network a viable option. Instead, third-party hauliers are generally used for transport to retail distribution depots, whilst other large multiples prefer to either collect the products directly from the factory or use nominated sub-contractors.

Expansion by existing competitors

35. As noted earlier, there are a number of smaller competitors present in the ingredient pastry sector who may be capable of expanding supply. For example, Bell's currently has a strong presence selling branded chilled ingredient pastry to both large and small retail customers in Scotland. The OFT also identified another competitor who had previously successfully supplied a large supermarket chain with own label frozen pastry over a number of years.

36. One third party competitor suggested that there were no significant economies of scale in pastry manufacturing and that the parties held no technological advantage in production. Evidence submitted to the OFT also shows that a number of competitors have spare capacity in the sector and several indicated that they would be willing and able to expand production on the offer of sufficiently large volumes (for example, a major supermarket contract).

Entry and expansion by suppliers of unbaked goods

37. The parties estimated that there are at least 28 firms currently producing pastry for use in baked goods, of which 19 already supply the UK retail market, including firms such as Bernard Mathews, Ginsters and Northern Foods, who already have long-established relationships with major retailers. The parties submitted that each of these suppliers (as well as a number of others) would have the necessary resources to enter the sector and begin supplying ingredient pastry. Bell's, Swords and Dorset Pastry are also examples of firms who are present in the ingredient pastry sector in addition to manufacturing baked pies and other finished goods.

38. The parties submitted that there is very little difference between pastry produced for use in baked goods and ingredient pastry. In their opinion, therefore, barriers to entry for existing suppliers of finished products that manufacture their own pastry for inclusion in their products are low – these firms could readily take pastry off the production line early in order to package and sell it as ingredient pastry. It was submitted that entry could be achieved at relatively low cost and within a maximum period of 24 weeks.

39. The parties estimate the additional capital investment required to enter the ingredient pastry market – for an entity already manufacturing ingredient pastry for use in baked goods, which has an existing presence in the retail channel – to be between zero and £200,000, depending on the equipment they already have at their current production facilities. If the firm did not already supply the retail channel, the parties submitted that an additional investment of approximately £10,000 would be required, to be able to receive Electronic Data Interchange (EDI)[2] orders and ensure that they obtain sufficient expertise to deal with retail customers.

Entry and expansion by international suppliers

40. There is evidence of several established European firms who have successfully supplied ingredient pastry to the major UK supermarkets in the past and third parties confirmed that cross-border supply already takes place across continental Europe. The parties submitted that three

[2] An electronic system whereby customers can enter their orders in an agreed form which are then received and processed by the supplier.

continental European based manufacturers of ingredient pastry (Euro-dough/Sara Lee, Nestlé and JOWA) already have a sizeable retail presence in the supply of consumer food products to the UK and hence would be well-placed to take advantage of their existing distribution frameworks and relationships with the major retailers.

41. Although a continental-based supplier considering expansion into the UK market may need to consider the impact of transport costs, the parties submitted that these are unlikely to be significant due to geographical proximity (for example, Euro-dough/Sara Lee and Nestlé both have pastry manufacturing plants sited in Northern France). Third parties confirmed that entry cost where not particularly high – more important were the commercial and marketing costs of establishing a brand.

Brand strength

42. A number of existing suppliers and potential entrants expressed concerns that the costs associated with establishing a brand constituted a barrier to entry. Some third parties estimated that it would cost up to £1-2 million to pay for the necessary branding and advertising to gain a presence in the market. The importance of branding would appear to be limited to the retail segment, with foodservice customers indicating that there was little or no brand loyalty in the segment.

43. Most supermarkets tend to only stock one type of chilled and frozen ingredient pastry – either branded or own label, suggesting that inter-brand competition is minimal.[3] One competitor suggested that supermarkets were reluctant to accept other brands outside of Jus-Rol and Saxbys, as these were the leading brands and therefore a 'safe' choice. However, the parties submitted that brand loyalty in ingredient pastry is extremely low and have provided evidence that brand recognition is quite low amongst end consumers. Third party evidence from both customers and competitors suggests that neither Jus-Rol nor Saxbys is a 'must have' brand, nor is ingredient pastry a 'must have' product.[4]

[3] Possibly with the exception of some supermarkets in Scotland who stock Bell's (a Scottish brand) alongside another branded or own label ingredient pastry.
[4] Jus-Rol brand research indicates that only 52 per cent of grocery shoppers claim to have purchased ready-made pastry in the past year.

44. The parties submitted that there are a number of potential suppliers with an established brand, such as Nestlé and Sara Lee, who would be able to use this brand strength to enter and begin supplying ingredient pastry. The parties suggested that a further possibility would be for a third party to manufacture ingredient pastry and market this product under an alternative established brand through obtaining a licence from the brand owner.

45. Another possible route to expansion or entry for a supplier without an established brand may be to manufacture own label ingredient pastry for the supermarkets. Evidence suggests that when retail customers develop an own label product, they stop stocking the branded equivalent. This indicates that retail customers view own label supply as a viable alternative to branded products. The parties argued that there is little difference in price between branded and own label pastry. Third party responses generally supported this, indicating that own label products are typically priced around five per cent below branded products.

46. A comparison of data on retail margins between own label and branded ingredient pastry indicates that these are broadly comparable. This demonstrates that own label ingredient pastry is not just a potential threat against the merged entity in the event of a price increase, but also a credible one.

47. There are a number of examples of the supermarkets developing and selling own label ingredient pastry. Sainsburys currently sells own label chilled ingredient pastry, while Asda, Somerfield and Safeway have all sold own label ingredient pastry in the past. This further supports the view that supermarkets consider own label to be a viable alternative to branded ingredient pastry and are willing to pursue this strategy.

48. Four out of the five supermarkets we spoke to during the investigation also considered that sponsoring entry would be a potentially viable option following a price increase. Long term contracts could be used to help establish a new entrant or expand an existing player to supply either an own label or a branded product. Evidence provided by third parties indicated that sponsored entry and expansion had occurred in the past for the supply of own label ingredient pastry.

Conclusion

49. Based on the evidence available to the OFT, we consider that the costs of entry and expansion into the ingredient pastry sector (particularly own label) are relatively low. Nor does the need for a distribution network represent a barrier, as even the parties have forgone an established in-house network in preference to using third party distributors. There also appears to be sufficient spare capacity in the sector amongst existing suppliers. Manufacturers of unbaked finished goods that include pastry and international suppliers, both appear capable of achieving successful entry, particularly where they have an established brand. Switching to own label ingredient pastry also represents a real and credible constraint on the parties and alleviates the need for expenditure of branding and advertising by the supplier. Given these factors, we consider that the prospect of new entry or expansion by existing suppliers in the sector, particularly into own label, would exert a significant constraint on the parties post-merger.

Buyer power

50. Beyond the buyer power that retailers may have by virtue of their threat of sponsoring entry, the parties argue that the customers affected by the merger have substantial buyer power in any case.

51. Supply arrangements between ingredient pastry manufacturers and retailers are characterised by a lack of formality. Sales are generally made on an 'order-by-order' basis and tend to be negotiated orally. As a consequence of these arrangements, the parties argue that there is no contractual barrier to retailers de-listing products or switching suppliers.

52. Supermarkets and large food retailers are the only customers that purchase significant quantities of both chilled and frozen ingredient pastry. Sales data provided by the parties show that both General Mills ([ ] per cent) and Saxbys ([ ] per cent) rely on these categories of customer for a substantial proportion of their retail sales.

53. This dependence on major supermarkets is replicated in sales of other (non-ingredient pastry) products, particularly for General Mills, for whom sales of ingredient pastry represents a small proportion (less than [ ] per cent) of its overall sales of consumer food products to supermarkets/other large retailers. As a consequence, the parties claim any attempt by the merged

entity to raise prices will be severely compromised by the prospect that the major supermarkets could retaliate by threatening to stop purchases of other products forming part of the merged entity's portfolio. The parties provided a number of examples where the supermarkets had exerted their buyer power in one product segment to reduce price in another. [ ]. Several supermarkets supported the view that they could exert some bargaining power in this manner.

54. The parties argued that prices to retailers have been falling over time and provided us with supporting data that shows a steady decline in invoice prices for a variety of ingredient pastry products over the last five years across all major supermarkets. The parties have provided further evidence, which shows that supermarkets have successfully sought price reductions for such products in their negotiation of supply agreements. This would seem to indicate a significant degree of buyer power, either through a credible threat of leverage across a range of suppliers' products or switching suppliers.

55. Overall, the evidence suggests that the supermarkets and other larger retailers possess a significant degree of buyer power. Though the merger removes the most direct constraint that the supermarkets have for each of the merging parties, given the ease of switching suppliers, together with the possibility of exerting power through portfolio effects and sponsoring entry, it is considered that sufficient buyer power will remain post-merger, which when combined with low barriers to expansion and entry will exert an effective constraint on the parties and offset any loss of competition which may arise as a result of the merger.

VERTICAL ISSUES

56. The merger does not give rise to any vertical issues.

THIRD PARTY VIEWS

57. The majority of third parties we contacted did not raise concerns about the merger. Some third parties were concerned that the merged entity's combined brand strength post-merger may raise barriers to entry/expansion and give the merged entity the power to push through customer price increases, particularly in the retail segment. However, the majority of retail customers we spoke to consider that they still have sufficient alternative

supply options open to them, including the possibility of sponsoring entry or purchasing from overseas manufacturers. Some foodservice customers also felt that there may be cost increases as a result of the merger. The concerns raised by third parties have been dealt with in greater detail above.

ASSESSMENT

58. The parties overlap primarily in the supply of frozen and chilled ingredient pastry to the retail, foodservice and bakery/manufacturing sectors.[5] General Mills currently manufactures frozen ingredient pastry, while Saxbys currently manufactures chilled ingredient pastry. However, the parties have supplied both frozen and chilled ingredient pastry in the past. While supply side substitution between frozen and chilled ingredient pastry is relatively easy, demand side substitution is limited. Therefore, from the customers' perspective, any competition between the parties at present is limited to that of potential entry into each others sub-segment.

59. The parties have significant combined shares of supply in both the retail and foodservice segments (though no increment in foodservice). In both instances there are a number of other (albeit significantly smaller) competitors present. While several of the supermarkets considered they had sufficient alternatives available to them, a number of other third parties (both customers and competitors) expressed concerns about the merger, and the loss of the constraint imposed by the parties on one another.

60. However, barriers to entry and expansion are not considered to be significant. Existing suppliers confirmed that they hold spare capacity and there are a number of international suppliers and manufacturers of unbaked goods who would be able to supply ingredient pastry into the UK. To the extent that branding constitutes a barrier to entry in the retail segment, switching to own label ingredient pastry supply is considered to be a credible strategy and negates the need for establishing a brand. In addition, a number of potential entrants, including potential international entrants already have established brands. In the foodservice segment, third parties indicated that branding is of limited importance. The majority of

[5] Other smaller overlaps were noted but we did not consider that these gave rise to competition concerns and they were not considered further.

supermarkets also indicated that they would consider sponsoring entry in the event of a price increase.

61. The supermarkets account for a significant proportion of each of the party's sales in the retail sector. There is evidence that the supermarkets have successfully negotiated lower prices in the past and have also leveraged their buyer power across the parties' portfolio of products (for example, by threatening to de-list a product line). In most instances, there are no formal contracts and switching suppliers is considered relatively easy.

62. Low barriers to entry and expansion, combined with the presence of strong buyer power are considered to exert a significant constraint on the parties post-merger sufficient to offset any loss of competition arising from the merger.

63. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

64. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.