OFFICE OF FAIR TRADING

Completed acquisition by Meggitt plc of the design and manufacturing business of Dunlop Standard Aerospace Group Limited from funds managed and advised by Doughty Hanson & Co.

The OFT's decision on reference under section 22(1) given on 7 December 2004

Please note square brackets indicate exact figure replaced by a range at the request of the parties for reasons of commercial confidentiality.

PARTIES

1. **Meggitt plc (Meggitt)** designs and manufactures systems and components for the aerospace, defence and electronics sectors. **The Design and Manufacturing Business of Dunlop Standard Aerospace Group Limited (the D&M Business)** designs and manufactures aviation components and supplies related aftermarket services and spare parts for the global civil and defence aerospace industry. The D&M Business was previously owned by funds managed and advised by Doughty Hanson & Co. The UK turnover generated by the D&M Business in 2003 was [less than £70 million].

TRANSACTION

2. Meggitt's acquisition of the D&M Business was completed on 24 August 2004. The statutory deadline for consideration of this transaction is therefore 24 December 2004. The OFT received a complete informal submission on 11 October and the administrative deadline is therefore 7 December 2004.

JURISDICTION

3. As a result of this transaction Meggitt and the D&M Business have ceased to be distinct. The parties overlap in relation to the supply of:

- fire seals (in relation to which the parties achieved a combined UK share of supply of approximately [40 to 60] per cent in 2003); and

- moulded airframe, door and window seals (in relation to which the parties achieved a combined UK share of supply of approximately [less than 40] per cent in 2003).

The share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met as a consequence of the parties' combined share of supply of these goods. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

RELEVANT MARKET

Product market

4. The aerospace sector is characterised by a small number of large multinational lead manufacturers (such as BAE Systems, Airbus and Rolls Royce) which produce final products such as complete aircraft or aero engines. These lead manufacturers are then supplied by a larger number of prime contractors (such as Smith Industries and GKN) supplying a specific range of components or specific sections of the finished product. An example of this is the production of the area around the engine which is called a nacelle. A prime contractor will contract to produce this part of the airframe and then sub-contract where necessary the production of specific components to specialist suppliers. These prime contractors either supply particular components themselves or utilise a large number of small aerospace component suppliers making a range of components. Some of these component manufacturers supply high technology leading edge designs or products. Others manufacture more generic components such as rubber seals or seat covers. These relationships are illustrated in Figure 1 below.

5. The market for the final product (complete aircraft or complete engines) is dominated by a small number of very large multinational manufacturers. For example, civil aircraft production is dominated by Boeing and Airbus, while engine production is dominated by Rolls Royce, General Electric and Pratt & Whitney. Despite the high degree of concentration among the manufacturers of the final product, the complete aircraft sector and the aero engine sector are generally considered to be competitive with a constant need for lead manufacturers to put downward pressure on costs.

6. The recent trend among lead manufacturers has been away from supplier relationships on a regional basis to one of worldwide supply from a reduced number of prime contractors. This trend has driven consolidation in the components sector as suppliers try to achieve sufficient scale to embed their business in the worldwide supply chain for lead manufacturers.

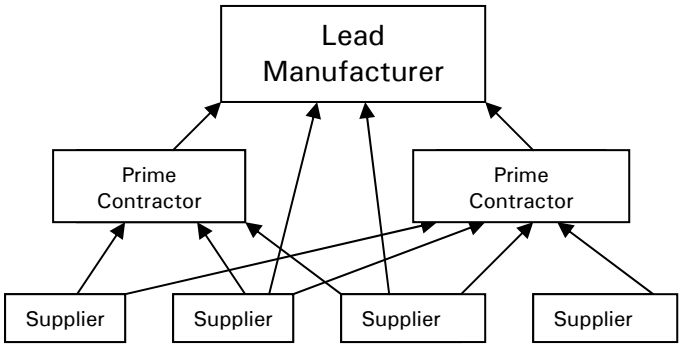

Figure 1

7. It might be possible to define a broad product market for aerospace components: many of the players in this market manufacture a wide range of parts for a small number of prime or lead manufacturers. However, within this broad product set there are a number of specialist products which could be defined as narrow product markets. In the *EADS* case, the European Commission argued that it was possible that 'each type of component could be regarded as a separate market due to the very high degree of specialisation on both the supply and demand side'.[1] It is arguable that in a broad sense this is the correct approach and therefore it is necessary to analyse each of the two sectors in which the parties overlap as separate markets in the horizontal assessment below. However, the bespoke nature of some aerospace components means that in effect there is competition for the market rather than within the market for such components.

Demand side substitution

8. Due to the very specific purposes for which the products in question are designed the scope for demand side substitution is limited.

[1] Case No Comp/M.1745 – EADS, at paragraph 24.

Supply side substitution

9. The potential for supply side substitution will depend on the nature of the specific component. For generic components such as airframe seals it is likely that there are several manufacturers which can enter the market to produce the components, if requested. For more complex components it is likely that supply side substitution is more limited, especially during the life of an existing product. Where relevant supply side substitution is discussed in more detail below under the horizontal assessment.

Geographic market

10. The relevant geographic market for each component will vary according to the particular supply conditions for that component. In the *EADS* case[2] the European Commission agreed with the parties' views that the relevant market was worldwide. All third parties who expressed a view agreed that the relevant markets for the particular components produced by both parties to this merger were worldwide, even where the sourcing of those components has traditionally been from UK or European suppliers.

11. Whilst the geographic market for aerospace components is in general worldwide there might be specific issues in relation to a specific component which mean that a narrower geographic market definition would be appropriate. In particular, for the production of fire seals there is a need for the seals to be tested for safety. This might suggest that UK customers would prefer a supplier with facilities that are easily accessible. However, JPR Hutchinson is a major player in the UK although it manufactures in France and Meggitt has undertaken some testing of its fire seals with testing facilities located in [Western Europe]. Moreover, third parties who expressed a view all thought that the market for fire seals was worldwide in scope.

12. For the purposes of this decision the relevant geographic market is therefore considered to be worldwide.

HORIZONTAL ISSUES

Fire Seals

13. Fire seals are seals used to protect key parts of an aeroplane, such as the engine or the fuel tanks, from fire damage. Fire seals sold by Meggitt and the D&M Business include bleed valves for sealing between the engine and

[2] Ibid., at paragraph 26.

bypass and seals which protect various fire zones on the aeroplane, such as core fairing seals, bifurcation panel seals and bifurcation seals used in the nacelle. Fire seals are usually designed to withstand high temperatures for sufficient time for a plane to lower its altitude. Fire seals are usually bespoke products specific to the particular engine or aircraft being produced. Hence aircraft or engine manufactures specify the design requirements for a particular fire seal and then invite suppliers to tender for the work based on a detailed specification.

14. The parties estimate that the overall volume of sales in the UK in 2003 was £4.2 million. The D&M Business' UK turnover for fire seals in 2003 was approximately [less than £1.7 million], giving a share of approximately [less than 40] per cent of sales of fire seals in the UK; Meggitt's UK turnover for fire seals was [£400,000 – £1.3 million], giving a share of sales of fire seals of approximately [10 to 30] per cent. The parties therefore have a combined UK share of approximately [40-60] per cent in the supply of fire seals.

15. Estimates of Meggitt's and the D&M Business' worldwide market shares vary but all third parties who expressed a view put the combined share at below 25 per cent.

16. Despite the high UK share of sales of fire seals it does not seem that increased concentration among manufacturers located in the UK could lead to sustained price rises. There are several reasons for this.

17. Firstly, as discussed above, the relevant geographic market for the supply of fire seals is likely to be worldwide. All third party customers who expressed a view on this point agreed that the market was likely to be worldwide and that faced with a price rise they would consider sourcing from overseas. Both Meggitt and the D&M Business export fire seals and JPR Hutchinson of France is active in the UK market.

18. Secondly, considerable buyer power exists in the market for aerospace components in general and fire seals in particular. Customers specify the design and properties of fire seals for each new aircraft or engine. The small number of buyers and larger number of suppliers means that in general the buyers have considerable negotiating power up to the award of the contract.

Barriers to entry for the production of fire seals

19. There are two main potential barriers to entry to a new supplier of fire seals: the need for access to test facilities and the requirement for adequate liability insurance.

20. To meet stringent safety standards fire seals have to satisfy a variety of quality criteria and test procedures in the manufacturing process. Manufacturers must demonstrate compliance with standards laid down by the International Organisation for Standardisation through a test facility accredited by the Civil Aviation Authority. The main suppliers such as the D&M Business and JPR Hutchinson have their own test facilities. The lack of access to a test facility is potentially a significant barrier to entry in this market, but independent test facilities are available in both the UK and Europe. In fact both Meggitt and the D&M Business used independent test facilities until 2000 and 1998 respectively. This would suggest that the need for access to test facilities is not a significant barrier to entry.

21. As for all aerospace components, a producer of fire seals would require sufficient liability insurance. However, no third parties identified obtaining such insurance as a particular problem and it does not seem to represent a significant barrier to entry.

Moulded airframe, door and window seals

22. Moulded airframe, door and window seals are either produced to a standard generic design or created on a bespoke basis, depending on the requirements of the customer. Typically such seals act as gap fillers in the aircraft structure. For example, seals are used to fill round windows and doors or to retain fluid. In addition a large number of seals are used to fill gaps on wings to get maximum lift on take off. A range of different materials are used to make different seals but most seals are made out of silicone rubber or terylene glass.

23. The parties estimated that the overall volume of sales of moulded airframe seals in the UK in 2003 was £6 million. Meggitt's sales of seals in 2003 amounted to [£600,000-£1.8 million], giving it a share of sales of approximately [10-30] per cent. D&M had UK sales in 2003 of [less than £1.2 million], giving it a share of approximately [less than 20] per cent. On the basis of these figures the parties would have a combined share of UK sales of approximately [less than 40] per cent.

24. The D&M Business has traditionally specialised in producing standard seals which can be cut to length. It retains the tooling capability to undertake this cutting process. Meggitt operates in a slightly different niche whereby it provides bespoke seals as part of its role as a solution provider. The tools for cutting the seals are retained by the customer.

25. Whilst the parties overlap in the supply of moulded airframe door and window seals the market for these seals has a large number of UK and overseas suppliers. Third parties who expressed a view all thought that the market for moulded airframe, door and window seals was worldwide. UK competitors include Wide Range Elastomers, FPT Technologies limited, MG Silicones, and Northern Rubber. Overseas suppliers include Chase Walton, Esterline Technologies, Trelleborgs and JPR Hutchinson. Typically aerospace manufacturers purchase seals via a tendering process, from a wide range of suppliers.

26. Third parties agreed with the parties' assessment that the production of aerospace seals did not require specialist skills or technology which were beyond the range of large number of potential suppliers active either in the production of other aerospace components or in the production of other goods requiring similar technology. None of the third parties surveyed believed that the seals provided by the parties had any unique features which could not be replicated elsewhere. Third parties also believed that if faced with any price increase there were no significant barriers to switching to other suppliers

Barriers to entry for the production of moulded airframe, door and window seals

27. The main barrier to entry for a new entrant not already engaged in the manufacturer of aerospace components would be the need for sufficient liability insurance. However, third parties did not think it would be unduly difficult to obtain such cover. Evidence of market entry was cited by several third parties, such as the recent entry into the UK market (within the last three years) by Specialised Polymers and Wide Range Elastomers.

Buyer power

28. A feature of the aerospace components sector is that, due to switching costs, such as design drawings and testing of the components, prime contractors or lead manufacturers will be less inclined to switch to alternative suppliers for those components which are not a significant cost in the total cost for the finished product. Theoretically this would mean that suppliers of aerospace components could opportunistically raise prices

once they had entered into a supply arrangement with a prime contractor or lead manufacturer. In practice however, a customer who faces opportunistic cost increases on a product range from a supplier will consider sourcing from alternative suppliers for any new projects. Therefore the ability of the component supplier to generate additional short term profits from a particular customer could be at the expense of a long term decline in future sales from that customer. The loss of reputation will only fail to be a concern to a supplier exiting the market.

29. Third parties took the view that the concentrated nature of the market for final products and the wide range of suppliers of aerospace components meant that there was a significant degree of buyer power in this sector.

VERTICAL ISSUES

30. The transaction does not give rise to any vertical issues.

THIRD PARTY VIEWS

31. There were no third party concerns about the merger from either customers or competitors.

ASSESSMENT

32. There is only limited overlap between the parties' activities. The parties have a high combined share of the UK sales of fire seals. However, the global nature of the supply chain, the presence of strong competitors, significant buyer power, and low barriers to entry all suggest that the merger would not lead to a significant lessening of competition in this sector.

33. There were no third party concerns over the merger.

34. Consequently, the OFT does not believe 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.

DECISION

35. This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.