COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 24/LM/May03

In the large merger between:

The Clicks Organisation (Pty) Ltd

and

Purchase Milton and Associates (Pty) Ltd; Milton & Associates (Pty) Limited; J&G Purchase (Pty) Limited and Leon Katz (Pty) Limited

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Reasons for Decision

APPROVAL

On 4 August 2003 the Competition Tribunal issued a Merger Clearance Certificate in terms of Section 16(2)(a) of the Act approving the merger between, on the one hand, the Clicks Organisation (Pty) Ltd and, on the other, **Purchase Milton and Associates (Pty) Ltd,** Milton & Associates (Pty) Limited**,** J&G Purchase (Pty) Limited and Leon Katz (Pty) Limited. The reasons for the approval of the merger appear below.

The Parties

1. **The acquiring firm is the Clicks Organisation (Pty) Ltd ("TCO"), a subsidiary of New Clicks Limited, a listed company that controls the entire Clicks Group. The Group comprises various operations in South Africa and Australia. Locally, the Group consists of Clicks, Diskom, Musica, Compact Disc Wherehouse, The Body Shop and New United Pharmaceutical Distributors.**

2. The Clicks Group owns 248 stores and 13 franchises. Clicks also has a 56% interest in the Link Investment Trust ("LIT"). It is the franchisor of the Link and LinkMax branded stores. Both brands operate as retail pharmacy outlets.

3. The target firms are:

   i. Purchase Milton & Associates (Pty) Limited ("PM&A");
   ii. Milton & Associates (Pty) Limited ("M&A");
   iii. J&G Purchase (Pty) Limited ("J&GP");
   iv. Leon Katz (Pty) Limited ("LK")

4. PM&A is controlled directly by Trevor John Milton who holds 90% of its issued share capital. He also holds 100% of the share capital of Milton & Associates (Pty) Ltd and 100% of the share capital of LK.

5. J&GP is directly jointly controlled by Graham Erlank Purchase and John Ingles Purchase, each holding 50% of the issued share capital.

6. The target firms control three categories of stores – those bearing the Linkmax and Link brands and a number of non-branded stores. The latter refers to stores that bear the trading description Hyperpharm, Guardian, Pharmarama, Remedys, Medirama and Galleria Link stores. There are 50 Link branded PMA stores, 27 Linkmax stores and 3 non-branded PMA stores, therefore a total of 80 PMA stores. The total number of Link franchisees, that is, including both PMA Link branded stores as well as other independents, is in the region of about 320.

The Merger Transaction

7. One agreement is being concluded for each target firm. TCO will acquire all the shares in the target firms and therefore acquire control over all the

businesses operated by the four firms.

Rationale for the Transaction

8. This transaction is consistent with TCO's long-term strategy and business model to enter the pharmaceutical market. It represents the first foray by a corporate into the retail pharmaceutical market, coinciding with legislation designed to make prescription drugs more affordable and available on a wider scale to impoverished communities.[1]

9. Up until now, only pharmacists were legally entitled to own pharmacies. The change in legislation heralds a new era where corporate entities will be allowed to own pharmacies, subject to the proviso that the pharmacy is supervised or managed by a registered pharmacist.

10. South African pharmacy outlets have, up until the present era, resembled the typical "mom and pop" type format. Licensed pharmacies trade in scheduled and other pharmaceutical products. They also trade in a traditional range of 'front shop' products, similar to those available at a Clicks outlet. However, to date, legislation has denied a retail chain like Clicks' the opportunity to trade in the backshop activities that have been the licensed monopoly of registered retail pharmacies. Already 35 years ago TCO anticipated that regulatory changes would essentially do away with this traditional model and it accordingly devised a long-term strategy along the lines of the US drug store format. TCO's long-term vision anticipated a new model that would represent a more business-oriented, corporatised approach to pharmaceutical retailing.

11. In pursuing this strategy, TCO entered into loose associations with the target firms, which in recent years acquired several well-known pharmacy outlets. TCO has provided them with loans to this end. With the coming into effect of the new legislation, TCO's strategy is now ripe for realisation. The only remaining obstacle is whether TCO will be issued retail pharmacy licences by the Department of Health.

The Relevant Market

Product Market

12. The Commission identified two types of product sold by a typical

1 Section 22A of the Pharmacy Act provides for more accessible ownership of pharmacies and for the Minister to prescribe who may own a pharmacy and the conditions of such ownership. This intention was reinforced in GNR 553, GG 24770 published on 25 April 2003.

pharmacy. On the one hand it dispenses pharmaceutical products (**dispensary products**) and, on the other, it sells more general consumer products (**front shop products**).

Front Shop Products

13. The parties classify their products under three categories: health products, lifestyle products and beauty products. The CC defined the market more narrowly, according to 14 categories of consumer goods in which both the acquiring and target firms have competing products. These products are referred to as “front shop” products.

- Hair care market
- Body care market
- Feminine hygiene market
- Skincare market
- Foot care market
- Baby care market
- Men’s toiletries market
- Vitamins market
- Bath products market
- Eye care market
- First aid market
- Make-up market
- Diet formulae market
- Perfume market

14. For reasons emphasized in other similar mergers, we are not concerned with competition in this market[2]. In respect of the lifestyle, beauty and health markets, a proliferation of competitors sell the same or similar products, including the large and smaller grocery retail chains and independent health shops. For instance, significant competitors of New Clicks in the retail of lifestyle, beauty and health products include Pick ‘n Pay, Shoprite Checkers, Superspar, numerous pharmacies and health stores, Woolworths, Stuttafords, Edgars, Truworths, Foschini, @ Home, Mr Price Home, Game and Makro.

Retail Pharmaceutical (Dispensary) products

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2 See **the large merger between <u>Clicks Pharmaceutical Wholesale (Pty) Ltd and New United Pharmaceutical Distributors (Pty) Ltd</u> 69/LM/Dec02**

15. The Commission did not initially evaluate the dispensary product market at all, since until Clicks receive their license to dispense pharmaceutical products or dispense scheduled drugs, there is no product overlap with the retail pharmaceutical business of the target firms. However, the Tribunal requested both the parties and Commission to provide additional information and to make further submissions in respect of the likely evolution of this market from both a regulatory and competition perspective.

Geographic Market

16. The geographic market was deemed by the Commission to be local since both acquiring and target firms set prices according to conditions in the local market. It proceeded to evaluate the number of pharmacies owned by the target firm in various magisterial districts around the country. [The conclusion was that both parties to the merger compete in the major towns and cities around SA and there are large numbers of competitors in these markets].

17. The parties argued that there are no national retail pharmaceutical chains as such. This is due to historical legislation prohibiting non-pharmacists from owning pharmacies. Accordingly no corporate model of ownership has to date emerged in the retail pharmaceutical market. Despite the phenomena of franchising and buying groups, pricing of pharmaceutical products is not centrally managed on a national level, but is determined instead as a competitive response to conditions in each local market by the professional pharmacist who owns each of the stores. These pharmacists seek to retain control over the local operations even when part of a larger franchise or buying group.

18. Trevor Milton alluded to two distinct modes of competition in the areas of chronic and acute medication. Purchasers of chronic medicines, these being regular purchasers of the same drug over a lengthy period, are more easily serviced by big national mail order suppliers like Direct Medicines and Chronic Medicines than are the consumers of acute medication. On the other hand considerations of convenience and effective therapy dictate that acute medication will be purchased at the local pharmacy – these drugs must be available on request and, unlike the case of chronic medicines, demand cannot be accurately predicted in advance. While this explanation would suggest that there will be some competitive threat to TCO around at least chronic medication, further investigation is required to enable us to make a clear finding.

19. If the market is segmented between consumption of chronic and acute medicines, then the relevant geographic market could either be defined as local (acute medication) or national (chronic medication), although we probably require additional information in this regard. However we need not define this conclusively in light of the findings elaborated below.

Impact on competition

20. As mentioned, our fundamental concerns with this merger lay in the retail pharmaceutical or dispensary market. These concerns centred on the prospect of large potential competitors such as Pick 'n Pay entering this market.

21. The Commission took the view that because TCO was not already active in the retailing of pharmaceutical products, this transaction presented no competition issues in this market. On this view, TCO was a new entrant in this market. However, what is significant is that TCO was always the *most likely potential entrant into this market. TCO had for a long time set itself up to enter once the regulatory barrier was removed. It's looming presence had, in all likelihood, already acted as a competitive constraint on participants already active in the market - TCO was a large front shop waiting to get into the back shop. TCO has now entered thus eliminating itself as a potential threat. But because it has done so by choosing to enter via acquisition rather than* by rolling out *its* own*, new pharmaceutical branches, its elimination as a potential threat has not been compensated by the injection of additional capacity, by the addition of a new active competitive presence. In summary, then, TCO, because of its particularly strong potential presence should, for the purposes of this merger, properly have been treated as a market participant and effectively presumed to constrain existing rivalry. Accordingly, the theory of potential competition allows us to impute into our analysis the market shares of a firm, that would not otherwise have been considered a competitor because of there being no product overlap.*[3] It would accordingly have been appropriate if the Commission had evaluated this market initially.

22. The case of the Federal Trade Commission v The Proctor and Gamble Company is instructive.[4] Here the US Supreme Court upheld a decision by the Federal Trade Commission ordering a manufacturer of household

3 See Gavil, Kovacic, Baker. Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy, 2002 at page 453.

4 1224 386 U.S. 588, 18 L.Ed. 2d 303 1967

products to divest itself of certain liquid bleach assets. The Court referred in its reasons to the acquisition of Clorox by Proctor eliminating Proctor as a potential competitor:

> *"It is clear that the existence of Proctor at the edge of the industry exerted considerable influence on the market. First, the market behaviour of the liquid bleach industry was influenced by each firm's predictions of the market behaviour of its competitors, actual and potential. Second, the barriers to entry by a firm of Proctor's size and with its advantages were not significant…"*

23. An analysis of the post-merger market, the structure of which will be enormously influenced by a new regulatory environment, would obviously be highly speculative. It is not known how many licenses will be secured by TCO, nor which or how many other new entrants will be licensed to compete with them. We have previously imposed a postponed divestiture remedy precisely because the regulatory environment in which the markets in question operated were, as in this case, in considerable flux.[5] However, such an approach did not prove very effective and is unlikely to provide comfort in this case precisely because it is unclear when there will be certainty in respect of the manner in which the regulations are to be enforced.

24. We assumed for purposes of this merger, that the Link branded stores would post-merger form part of the control group owned by TCO. This would give Clicks ownership of approximately 320 Link outlets[6]. Assuming this scenario, concentration would be quite high, particularly in the urban metropolitan areas. However, because of the uncertainty surrounding the regulatory environment – and in particular the regime governing the issuing of licenses to operate pharmacies – we do not have sufficient information to evaluate the extent to which potential entrants may enter the scheduled drug market.

Barriers to Entry

25. The next step in our analysis, was to proceed to evaluate the barriers to entry into the retail pharmaceutical market, to examine to what extent new entrants would be encouraged to enter the market and thus constrain a

5 Nasionale Pers Limited and Educational Investment Corporation Limited 45/LM/Apr00

6 The parties disputed that Clicks controlled the LIT franchisees, this being rather a loose guild of independently-run franchises. Clicks has merely rendered consulting and merchandising assistance. They asserted that to take Link franchises into account as part of the merged entity would be wrong. However, we nevertheless did proceed to assume the worst-case scenario.

possible exercise of any market power by the merged entity. To this extent, the application of the licensing conditions by the Department of Health becomes highly relevant.

26. It appears that licenses will be awarded on the basis of the "need" for another pharmacy in respect of the particular area for which the application is made.[7] This presumably means that the department will not issue a license if it is deemed that there is already a sufficient presence of pharmacies in that area.

27. We should be clear at the outset of this discussion that we have no quibble with the need to impose conditions via a licensing regime on the distribution of pharmaceutical products. Safety considerations would, on their own, necessitate regulatory oversight of pharmaceutical distribution. We are, however, extremely concerned at the inclusion of what are effectively competition considerations – such as the 'need' for additional pharmacies – into the licensing criteria precisely because this is likely to raise entry barriers into the market for those new entrants seeking to compete with the likes of an incumbent such as TCO. In short, while we accept that entry should be denied those who are unable to demonstrate the capacity to adhere to safety standards, beyond these technical considerations, the level of entry and exit should be dictated by the play of market forces. Hence, for example, a would-be licensee wishing to establish a new pharmacy in Sandton should not be denied entry on the grounds that the market is fully served as indicated by some or other measure such as the number of pharmacies per capita. A would-be new entrant presumably believes that it possesses a competitive formula that would enable it to compete business away from other pharmacies in the license area or even to draw customers from beyond the license area. This formula may involve drawing additional customer into the store by discounting its front shop products, or, regulation permitting, its pharmaceutical products or it may offer more frequent deliveries of longer opening hours. Why should a license be denied an entrepreneur because of an administrative determination of the level of 'need' in the license area? In any market characterized by ease of entry, it is competition that will determine how many pharmacies are 'needed' in a particular area, and it is competition that will determine which those are to be, which will flourish and which will be forced to exit the market.

28. In summary we are concerned that by determining the number of

7 Regulation 7 published under Government Notice No. R553 of 25 April 2003 (Gazette 24770) provides the criteria for the determination of a need for the pharmacy in respect of an area that must be satisfied in order to obtain the license.

pharmacies in a particular area on the basis of a competition criterion such as 'need', the licensing conditions will effectively operate to protect "first-mover" incumbents such as TCO from the threat of new entrants. Neither the parties nor the Commission, after discussions with the Department of Health, were able to allay these concerns.

29. The theory of contestable markets postulates that if entry is difficult, less weight should be placed on potential entry as a constraining factor.[8] With 'need' and hence new entry determined by administrative fiat rather than by the market assessment by would-be new entrants, the threat of potential competitors to constrain the behaviour of the incumbent firm could quite easily be diminished.

30. The parties argued that single exit pricing would act to constrain price increases. This refers to a regulation that would enable the Minister of Health to determine a single peremptory price at which medicines will be sold by suppliers to pharmacists. In other words, the manufacturers' list price shall be the applicable prices of pharmaceutical products to the final end-consumer. In short, trading in pharmaceutical products, that is, 'trading' in the sense of charging a margin on the product purchased from the manufacturer of wholesaler, will be prohibited. Pharmacists will earn their keep by levying a specified dispensing fee.

31. It appears that little is known about how this pricing regime will operate in practice. It is not clear whether a price will be specified in respect of all scheduled products or whether this will be applied to only selected products. Nor is it clear whether the price regulations will specify a maximum price, thus permitting competition at levels below the specified maximum. We have no knowledge of how the dispensing fee is to be determined or whether pharmacies will be entitled to compete on the basis of the dispensing fee. These are issues to be determined, or so it appears, by the recently appointed pricing committee. However, even assuming the best possible environment for competition in a price regulated environment, (namely, that the regulations only specify a maximum price and that pharmacies will be free to compete with each other in the area of dispensing fees), any potential room for competition left in the system will be massively compromised if the licensing regime further restricts entry on the basis of non-technical, competition-relevant criteria like 'need'.

32. Restrictions on entry of additional pharmacies into the lucrative middle and

8 Bishop and Walker, The Economics of EC Competition Law p 42

high income urban markets, seems, in substantial part, to be predicated on the desire to encourage would-be entrants into the pharmaceutical trade to locate in 'underserviced' low income areas, in particular the rural areas. We do not understand this. Clearly, a would-be entrant into a high income area is attracted there by the relatively high returns that are expected. Denying entry to the areas of lucrative return will not, in and of itself, direct investment to the rural areas if the returns to be gleaned there are deemed inadequate by potential investors. This will shift once the differential between the returns earned from investment in the urban area and those available from investment in the rural areas is narrowed. The only sustainable mechanism for reducing returns in the urban areas – thus increasing the relative attractiveness of alternative sites – is to encourage new entry into these high margin areas. However, by restricting entry into the urban areas through, inter alia, the application of a 'needs' based criteria, the supra competitive returns to investment in the urban areas and the superior attractiveness of these already privileged investment locations is reproduced.

33. It was suggested in submissions made to the Tribunal, that a quid pro quo system might be adopted. Such a system would effectively grant TCO pharmacy licenses in urban areas in exchange for the licensees investing in the establishment of pharmacies in the rural areas. While we do not necessarily take issue with the subsidization of investment in the rural areas, this is a particularly non-transparent form of subsidy – the subsidized party is effectively given the opportunity to extract a monopoly rent from urban consumers who are the actual source of the subsidy. As we elaborate below, the truly attractive feature of this transaction is the entry of large retail chains into the pharmaceutical retail trade. They are efficient, they have significant purchasing power and considerable experience in the exercise of it, and they have a wide footprint extending across the country. They therefore uniquely possess the capacity to penetrate areas that other, less well-resourced, investors would steer clear of. By intensifying, through, inter alia, liberal entry conditions, the competitive temperature in the most attractive locations, the chains will turn increasingly to investment in those areas currently deemed less attractive. Conversely, by inhibiting new entry into the urban areas, the incumbents in those areas, including efficient and well-resourced corporates like TCO, may rationally opt to garner the supra-competitive returns available in their protected markets.

34. What is, in the end, obvious is that TCO will have a first-mover advantage in this market. Although we are certainly not inclined to penalise firms for adopting long-term pro-competitive strategies, this advantage, together

with a regulatory system that inhibits new entry, may well underpin the rise of an anti-competitive structure in the retail pharmaceutical trade.

35. We have painted the worst possible application of the licensing regime, although the specific inclusion of the 'needs' criteria into the licensing criteria leads us to fear that this 'worst case' may in fact accurately describe the unfolding reality. There is, however, no certainty, no necessity, that the licensing authority will interpret its mandate in this fashion. Clearly it is possible to take a liberal view on entry just as it is possible to leave significant areas of price determination to the market even in the context of a single exit pricing regime. In order to ensure competition in the post-merger pharmaceutical products market we would urge, above all, that the regulator does not inhibit easy entry into all geographical markets.

36. Certainly TCO's entry into this market does potentially portend major pro-competitive gains. It is likely to inject innovation and efficiency into a market hitherto characterized by a staid "mom and pop" type format. The evidence suggests that pharmacies are coming under persistent pressure from manufacturers as far as their margins are concerned. Accordingly the corporate clout of the Clicks group could well serve to check this market power on the part of manufacturers. As already noted, the scale and footprint of a group like TCO is a likely basis for investment in the rural areas, provided only that they are placed under competitive pressure in the more attractive areas.

37. Furthermore, other competitive issues do suggest that the pharmacies will not have an unfettered discretion to behave anti-competitively - powerful medical aid providers are incentivising patients to go where the price is most competitive, certainly in the case of chronic medication.

38. Accordingly, given that the potentially negative aspects of this transaction are largely governed by the uncertain state of play over regulatory issues and that there are likely to be significant pro-competitive aspects to this merger, we find that on balance, there is unlikely to be a substantial lessening of competition in the retail market for pharmaceutical products. We do, however, take this opportunity to urge the Commission to engage with the Department of Health and to utilize its advocacy powers to ensure that those responsible for regulating this sector are appraised of basic competition principles that favour, above all, ease of entry to the market.

The merger is therefore approved unconditionally. However we must caution that this is a market that requires careful monitoring.

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D. Lewis

9 September 2003
Date

Concurring: N. Manoim, F.Fourie

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