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The Concept of Potential Competition – Note by South Africa

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More documents related to this discussion can be found at https://www.oecd.org/daf/competition/the-concept-of-potential-competition.htm

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1. Background

1. Global antitrust enforcement in digital markets has resulted in renewed interest in the assessment of potential competition in merger control. The primary focus of this interest is the pattern of acquisitions of start-ups by the global tech giants, and the concern that these giants are entrenching their position by acquiring future competitors.

2. For instance, the European Commission's Report on Competition Policy in the Digital Era dedicates an entire chapter to the acquisition of start-ups with a rapidly growing user base by global tech giants[1]. The UK Furman Report highlights that the five largest tech firms made over 400 acquisitions globally in the previous ten years, singling out the Facebook-Instagram merger as illustrative of buying up a future rival[2]. The recent US House of Representatives Report on the Investigation of Competition in Digital Markets identifies internal communication amongst Facebook executives that indicates Facebook acquired competitive threats to shore up its dominance and had specifically identified Instagram as a future competitive threat[3]. The recommendations stemming from these reports focus on a heightened merger control focus on such acquisitions and a lowering of notification thresholds to enable such scrutiny.

3. However, far away from the centre of global digital market innovation, a different type of potential competition issue in merger control has arisen in the emerging digital market space of developing countries. As illustrated by the recent South African prohibition of the acquisition of WeBuyCars by Naspers, Europe's largest tech listing under the name Prosus, that concern is one of global companies buying the entrenched leading digital market firms rather than entering and competing themselves. Instead of the incumbent buying the potential entrant, it is the potential entrant buying the incumbent but with the same loss of potential competition.

4. Despite this inversion in roles, the relevant antitrust test is essentially the same, namely that absent the transaction (i.e. if the transaction was unavailable to the acquirer for whatever reason) would the acquirer have likely entered the target firm's market in competition to them and improved the state of competition in that market. However, on top of the potential competition consideration, these types of mergers also raise the prospect that the merger erects additional entry barriers when the complementary assets of the global firm are added to the existing first-mover advantages of digital incumbent. Interestingly, these types of additional factors are precisely those being raised in the context of the Google-Fitbit merger[4].

[1] European Commission (2019) Competition Policy in the Digital Era, chapter 6

[2] Furman et al (March 2019) Unlocking Digital Competition: Report of the Digital Competition Expert Panel, pg 10-11

[3] US House of Representatives (October 2020) Investigation of Competition in Digital Markets; Majority Staff Report and Recommendations pg 12-13

[4] Bourreau et al (September 2020) Google/Fitbit will monetise health data and harm consumers, CEPR Policy Insight 107

2. The emerging digital economy of developing countries

5. Outside of the globally dominated search, social media, smartphone operating systems and app stores, there is a vast array of digital markets emerging as traditional industries look to uncover the benefits from moving aspects of their trading online. It is precisely in these multitude of markets where there is greater scope for localisation of the platform and opportunities for domestic entrepeneurs. This is particularly where global firms need to make country-specific investments in infrastructure, localisation or even just brand marketing to bring the consumers side on board. Whilst some tech companies such as Uber and Netflix have been quick to roll out in other markets realising that their business model may be replicated by local entrepreneurs, this is not necessarily the case with many other innovative tech firms which may lack the investor interest to fund losses whilst such expansion takes place or have little interest in markets that may lag in terms of online access.

6. Delayed entry by global tech firms in certain markets provides scope for local entrepreneurs to copy the business models and make the required localised investments. The first mover advantage may result in a rapidly expanding user base and the benefit of self-reinforcing network effects, enabling a strong market position. In the South African context this is visible across several different types of digital markets.

- In eCommerce where warehousing and delivery infrastructure is required on top of brand & search advertising, local firms emerged and ultimately consolidated into a single dominant provider, namely Takealot owned by Naspers. The market strategies of Takealot mimic those of Amazon in many respects, looking to rapidly expand fuelled by initial losses and to open up a Marketplace for third party suppliers. Whilst Amazon has entered South Africa in cloud computing and data centres, to date it has not established an eCommerce presence.
- In online classifieds, several of the leading online sites have their roots in the traditional magazine and newspaper advertising. For instance, in motor vehicles Autotrader was the leading car sales magazine that leveraged its brand to transition to the leading online classifieds site.
- In fintech, the established local financial institutions have leveraged their customer base and customer data to ensure a strategy of partnership with local start-ups rather than being disrupted by them. However, there have been some disruptive initiatives from other local financial institutions in adjacent markets exploiting the banksurance model, as insurers launch banking products to their clients and vice versa.
- In online travel & accommodation, the lack of targeted marketing to South African consumers by global firms (such as Booking.com and Expedia) has meant they did not take off to the same extent. This has provided a gap for local start up Travelstart to take a leading position through heavy investment in local marketing and tie-ups with domestic airlines and accommodation.
- In contrast, in e-hailing and short-term accommodation, Uber (along with Bolt) and Airbnb have invested early and heavily to secure a strong leadership in the South African market. Whilst there have been several copycat local start-ups, they lacked the funding to support the early expansion phase and were at a disadvantage relative to the global firms once they achieved critical mass.
- In food delivery there is a mixture of global and local participation due to the two leading players leveraging off their dominant position in related markets. UberEats

has leveraged off its e-hailing position and local brand recognition whilst Mr Delivery has leveraged off the eCommerce delivery infrastructure of Takealot.

7. In the context of the South African market, these local digital leaders have considerable first-mover advantages and have reached the point of critical mass to allow the take-off of the platforms. These advantages include an existing local customer base and strong local brand recognition built through ongoing brand and search advertising required to attract the other side of the market; vast amounts of local customer and supplier data to calibrate the technology offering appropriately; an established revenue stream and profitability to fund ongoing brand advertising and platform development; and existing domestic scale to provide the self-reinforcing network effects (incl. economics of density).

8. However, in all these types of digital markets there are established firms in other jurisdictions that are multiple times the size of the South African counterparts with superior technology and financial resources. These firms have their own advantages in competing with the local leaders. Specifically, having developed and grown to scale in other markets, these global counterparts have ready-built technological platforms and business models which can be leveraged to reduce the costs of entry into new markets. Having got to scale in other markets, these firms also may have a cash positive business which can fund new country expansion or find investor support to do so.

9. Importantly, the advantages of these global counterparts makes them strong potential entrants into developing country markets despite the lateness of entry and the strength of locally dominant platforms. This is certainly the case relative to local start-ups which still need to build those technological platforms and develop a cash positive business in the face of an existing local leader. The locally dominant platform may be comfortable in facing off local threats, but less so in facing off against a global firm with more resources and its own advantages. For both the global firm and the local dominant firm, the war of attrition based on head-to-head competition may be a far less desirable and uncertain outcome than teaming up. This is precisely the context which played out in the prohibited acquisition of WeBuyCars by Naspers in the market for car buying services, or guaranteed purchase used car marketplaces.

3. The Naspers-WeBuyCars Transaction

10. WeBuyCars operates a specialist car buying service. Car buying services emerged to address failings in the market for private used car sales. Consumers that were not trading in their vehicle for another, faced unattractive sale options such as the inconvenience and uncertainty of a private sale or driving to a multitude of used car dealers that often gave low-ball offers. For the typical car dealerships set up to sell cars, sourcing private stock is largely passive (e.g. through trade-ins, walk-ins) resulting in insufficient stock to sell. Sourcing adequate stock in the local area is inefficient and offers limited variety.

11. Car buying services aim to solve this market failing for both sides, offering private sellers an efficient and convenient means to dispose of used vehicles for competitive prices, and in so doing establishing a continuous supply of stock to dealers for resale. They achieve this through the same aggregation model that has become familiar in online platform markets, namely:

- They make considerable investments in brand and search marketing campaigns to raise awareness amongst consumers and direct them to the car buying service in large numbers;

- They make use of purchasing and sales data across a vast range of vehicles to more accurately price used cars through data analytics, enabling them to immediately provide estimated purchase prices to prospective sellers at levels which ensure resale to dealers at a profit;
- This is backed up with some physical infrastructure to conclude the transaction, including inspection services and systems for immediate title transfer and payment. These also include auctions and car warehouses to off-load the vehicles to dealerships. Inspection reports enable more transparency and certainty in bidding, especially for online auctions;
- The generation of network and scale effects, insofar as more private sellers brings in more dealerships given the greater volume & variety of vehicles on offer. This increased ability to find matches to dealers in turn means the service is able to purchase a broader range of vehicles from consumers, increasing its attractiveness to them and at the same time increasing marketing spend efficiency per purchase. The larger geographic presence also permits a more liquid marketplace than the localized used car dealers, permitting location arbitrage to find better prices for vehicle resale and hence purchase too.

12. WeBuyCars was the first car buying service business in South Africa, growing slowly at first until it reached critical mass when the network effects took hold and it secured outside investment. After that it grew extremely rapidly to the current 6000 vehicle purchases per month through its national coverage. Whilst some local start-ups have entered this space, the rapid scaling of WeBuyCars and the self-reinforcing benefits of the network effects presents barriers to expansion for its rivals. For instance, WeBuyCars can outspend on advertising, be more efficient on the advertising spend, has more data for pricing accuracy, and offers consumers and dealers the benefits of the larger network. As a result, the largest rival is less than 10% of its size, with most others under 2% of its size.

13. Naspers has invested heavily in online classifieds, both horizontal and vertical, across developing markets globally and in South Africa where it has its origins. In 2018 Naspers identified the emerging car buying services as being complementary to its classifieds business, adding value to private sellers on its classifieds platform whilst also providing lead generation and pricing/location data to assist in scaling a car buying service quickly. Naspers subsequently made a minority investment in the Frontier Car Group (FCG), a German-based start-up mimicking the Auto1 model but focused on developing countries where Naspers held classifieds assets.

14. As part of that acquisition, FCG secured the rights to partner Naspers in several countries, including South Africa. Publicly the FCG CEO indicated that this was due to South Africa being the largest used car market on the continent, and the ability to leverage off Nasper's classified assets, namely the general classifieds OLX and the largest auto vertical, AutoTrader[5]. After concluding the deal, the CEO proceeded to announce through the press that it would launch in the main metro areas with 45 inspection points within six months and aimed to be the largest player within two years[6]. However, FCG failed to launch in South Africa, unlike other countries where it secured partnership rights, and instead the Naspers acquisition of WeBuyCars was announced.

[5] Financial Times 'Naspers invests $89m in emerging markets car auction startup' (accessed at https://www.ft.com/content/3fcad168-5e8c-11e8-9334-2218e7146b04)

[6] Business Insider (1 July 2018) 'Meet the 24-year-old American prodigy set to disrupt SA's used car industry - within the next two years' (accessed at https://www.businessinsider.co.za/24-year-old-sujay-tyle-largest-second-hand-car-dealer-south-africa-naspers-frontier-car-group-2018-6)

15. The acquisition was opposed by the Commission and ultimately prohibited by the Competition Tribunal. Whilst reasons from the Tribunal have not yet been released, the opposition was based primarily on the removal of FCG as a potential entrant in partnership with Naspers, but also the likelihood of raising barriers to expansion of rivals given the complementary assets of Naspers in South Africa. In this respect the case provides some useful insights for merger control in developing country digital markets.

16. First, there is a need to examine the quality and likely effectiveness of entrants in markets where the leader has already scaled and enjoying the benefits of network effects. Specifically, in many digital markets entry of a superficial nature is relatively easy and greater focus needs to be placed on barriers to expansion and the likelihood of entrants becoming effective competitors. Designing an app or website is relatively costless in most cases, but what is far more difficult is creating the network effects that permit that service to take off and become an effective competitor. This is especially the case when a market leader is already scaled. In this case and numerous others, merging parties point to entry activity to argue that barriers are low, but sub-scale start-ups are not constraints unless they have themselves started to scale or have a strong likelihood of scaling due to who they are and the assets they bring. In this case, FCG clearly represented a different type of entrant to the local start-ups. It had a proven technical platform and business model fine-tuned in other markets, it had greater access to capital from venture capitalists to enable it to fund losses whilst it scaled, and it was partnering with Naspers that owned complementary classifieds businesses which could provide its own advantages.

17. Second, there is an incentive for both the global potential entrant and the locally dominant firm in platform markets to conclude a deal rather than go head-to-head, with a feasible deal space created by the threat of entry. For the locally dominant firm, whilst it may dwarf its rivals and hold numerous advantages over them, the threat of a well-resourced global tech company entering the market provides a completely different challenge. Under the entry counterfactual it is likely that the local firm will see reduced profitability and growth even if it eventually holds onto its lead. The lower business value of the counterfactual of no deal means that shareholders are willing to discount current firm value for a deal. This deal discount simultaneously makes an acquisition more attractive to the global giant relative to greenfields entry, which may hold more risk and lower short-term profitability over a discounted acquisition given the presence of a scaled rival. In this case, the shareholder was willing to conclude a deal with Naspers at a price which valued the company 33% lower than it achieved with another buyer once the deal was prohibited.

18. Third, it is common for the acquirer to reason that the acquisition provides the basis for establishing a presence more quickly than the alternative, and to attest that the business has subsequently declined to go the greenfields entry route in any event. This case was no exception. However, in markets where competition is limited and the target is a material player in that market, ease of entry should not be a valid basis for ignoring the competitive benefits that greenfields entry may bring from a large entrant. Furthermore, it is easy and convenient to disown an entry strategy when faced with merger prohibition, and hence that assessment should be a probabilistic one based on the documentary evidence and not the sworn testimony of acquiring firm management.

19. Fourth, it has also become commonplace for the acquirer to raise the threat of Google or Facebook to argue that the acquisition is not anti-competitive, as these giants will no doubt enter, and to play the national champion card that they need the domestic strength to face any prospect of competing with such global giants. Again, this case was no exception as the acquirer invoked Facebook's move into classifieds as the real threat it was trying to meet. However, just because Google and Facebook are perceived to be such all-powerful tech giants does not mean that vague and unsubstantiated claims of entry and

constraint should be accepted without proper investigation. These firms are not active in all tech markets nor do they offer all their services in every country, and their presence in some areas is less successful than others. No evidence was ultimately led to demonstrate that Facebook Marketplace was substantial in South Africa or that it was making substantial inroads in the auto category.

20. Fifth, even if the view on entry is not conclusive, the inquiry should not end there and consideration needs to be given to how any complementary assets of the global firm may further entrench the local market leader and raise barriers to the entry / expansion of rivals. In this case, the small size of the local rivals and the sheer size of Naspers meant that the classic "kill zone" effect was likely to play out as investors pull back funding to start-ups given the reduced odds of successful recoupment. The financial resources also would permit a more rapid scaling effort to build greater deterrent network effects. In addition, the complementary Naspers leadership in private auto online classifieds and dealership advertising platforms would foreclose rivals to leads from these platforms through self-preferencing in both the purchase and sales channels. The other businesses also generated substantial unique data, extending the advantage in pricing algorithms and enabling more targeted advertising on both the sale and purchasing sides.

21. The Naspers-WeBuyCars case illustrates that in addition to the start-up acquisition concerns in digital markets, developing countries at least also need to be alive to instances of acquisition in lieu of entry which may equally rob consumers of more robust digital market competition. However, as discussed next, this lesson also holds for a broader set of local market too which raises the issue of whether the potential entry doctrine needs some revisiting in a developing market context to promote efforts at reducing concentration levels.

4. A broader perspective of 'acquisition in lieu of entry' in developing markets

22. The economic characteristics of digital markets tend to amplify many of the competitive outcomes of different business strategies. As a result, these markets have attracted moves for more robust enforcement action by competition authorities, including tests which err more on the side of competition and seek to place more onus on the dominant firm. However, many of the features of these markets and strategies pursued also resonate with other market contexts even if the outcomes may be less dramatic than single firm global dominance. Maybe none more so than the loss of potential competition from large rivals in adjacent markets seeking to expand and doing so through acquisition of a leader rather than entry.

23. The South African economy is unduly concentrated, with most markets dominated by five or fewer firms. Whilst South Africa's position is exacerbated by our history, many developing country markets also face undue market concentration due in part to small market sizes. Furthermore, the conduct of large firms alongside other developing market features (such as more constrained access to finance) collectively conspire to constrain entrants from expanding sufficiently to challenge the incumbents. For instance, recent research by the Competition Commission shows that there is very limited movement of firms between size categories across the economy, with the market shares of the largest firms being relatively durable across most sectors.

24. However, a further feature of the South African market, as with numerous other developing countries, is that many leading national firms tend to pursue a conglomerate strategy by expanding into adjacent markets either in lieu of, or in addition to, regional or international expansion of the core business. This has long been considered a rational

strategy in a developing market context where favoured access to scarce finance and skills along with the importance of brand in building consumer trust make it more successful than conglomeration in more developed economies[7]. Such a strategy identifies adjacent markets where the firm can leverage off existing assets such as existing complementary products, distribution channels, captive customers or skill sets. And of course, more recently, leveraging off data.

25. In this manner, such firms are no different to the global tech firms of today which have similarly sought to leverage their existing assets to expand into new adjacent markets. For instance, Uber used its business model, delivery partners and brand to successfully enter takeaway food delivery. Facebook continually finds new ways to monetise the attention of its installed base of social media users, including launching new services to this base. Amazon is accused of using its Marketplace platform to enter in competition with suppliers and Apple / Android do the same in the app space.

26. Where such entry does not involve foreclosing rivals or acquiring them, that expansion can bring positive competition benefits due to the fact that a larger firm in an adjacent market with existing assets to leverage may be better equipped to more rapidly expand and provide a competitive constraint. The broad area of financial services illustrates such outcomes in the South African context. The banking sector has long been dominated by four firms with life insurance the same, only different firms. Health and short-term insurance are also concentrated but once more by different firms. In recent years we have seen the strong emergence of the banksurance model where certain banks have moved to leverage customer relations and financial health data to cross-sell insurance products. First National Bank is probably the best known proponent of this model. Similarly, the largest health insurer, Discovery Health, has leveraged its customer base, health data insights and behavioural business model toolkit to build a meaningful position in life insurance, vehicle insurance and now banking.

27. However, the benefits of such expansion may be lost where the strategy is one of acquisition of a leading firm in the adjacent market rather than organic growth or the acquisition of a smaller market player which is assisted to grow. Such acquisitions raise the same types of issues as highlighted in the Naspers-WeBuyCars case, namely aside from the removal of stronger entrant, the potential to reinforce an existing leadership position and raise expansion barriers through endowing the incumbent with more complementary assets.

28. Furthermore, the existing potential competition test in merger control may face challenges in preventing such an outcome in many cases. For instance, the acquirer may opt for an acquisition as a preferred strategy from the outset because it is easier and enables building a presence more quickly, but is likely to enter organically were such an option unavailable to them. Alternatively, the acquirer may state that the Board has subsequently declined to pursue the greenfield entry option with Courts then inclined to take such statements as determinative at that point in time. The focus of the potential competition test on existing plans to enter and a short-term perspective on likelihood of entry would both mitigate against a prohibition in such circumstances.

29. In the interests of erring on the side of competition and promoting longer term competitive markets, it may be of interest for competition authorities to look far more sceptically at the acquisition of a leading market player by a large firm in an adjacent market. This may include a longer-term perspective on the prospects of entry that is focused

[7] Ramachandram et al (2013) Why Conglomerates Thrive (Outside the US), Harvard Business Review (December 2013 issue)

on incentives to do so rather than whether there are immediate plans to do so. Naturally, the acquisition of a smaller firm in an adjacent market would not warrant such scepticism unless there were other factors which contributed to making the merger anti-competitive.

5. Concluding remarks

30. Digital markets continue to provide lessons for enforcement, in large part due to the amplified effect of market conduct in these markets and the tendency to quickly tip in favour of market leaders. These markets have also generated more interest by competition authorities in tightening the enforcement rules towards ones which err a little more on the side of competition.

31. The examination of potential competition in merger control is one such area for lessons. However, in digital markets itself there should be increased debate beyond the acquisition of start-ups by tech giants and consider the acquisition of existing market leaders in lieu of organic entry as another area warranting more enforcement action. Stronger enforcement around such acquisitions may be a means to promote organic entry by rivals with the resources and complementary assets to expand and challenge the incumbents. Such an approach is also likely to benefit other concentrated markets in developing countries.