E.CA COMPACT

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Vertical effects when assessing passive minority shareholdings

While the discussion among economists on passive minority shareholdings focusses on horizontal unilateral as well as coordinated effects of such acquisitions, in some cases the main concerns of market participants are of a vertical nature. When analysing such vertical effects one needs to account for the fact that the acquirer does not gain control over the strategic decisions of the target precluding certain foreclosure strategies. This allows a more focussed review of competitive effects.

The majority shareholder of Knorr-Bremse AG, a supplier to manufacturers of rail vehicles, planned to increase its minority share in Vossloh AG, also a supplier to manufacturers of rail vehicles as well as a rail vehicle manufacturer itself. As the proposed transaction was considered a passive minority shareholding, not conferring any control over the target, the transaction was not notified with the European authority.[1] It was instead notified in Germany and Austria where minority shareholdings of 25% and above as well as transactions that give the acquirer a competitively significant influence require notification.[2]

Generally, the discussion of passive minority shareholdings among economists focusses on horizontal unilateral or coordinated effects.[3] Vertical and conglomerate effects are seldom discussed. In Austria, competitors of Knorr-Bremse and Vossloh were, however, mainly concerned about vertical and conglomerate effects of the proposed transaction.

The investigation in Austria therefore covered those effects in particular. This Compact explains some issues in relation to vertical effects that should be taken into account when assessing passive minority shareholdings.

Feasibility and incentive to foreclose

In a merger case where the acquiring company gains full control over the target company, it can be assumed that the acquiring firm will be able to steer the target. Feedback effects from the target to the acquirer and vice versa are therefore taken into consideration. In comparison, when acquiring passive minority shareholdings the acquirer does not gain control. It is therefore not able to steer the strategic decisions of the target.

For horizontal unilateral effects, this implies that the expected price increase after acquisition is less pronounced than in the case of a full merger. In a vertical context, the lack of control implies that competition concerns can usually be limited to either input or customer foreclosure, depending on the position of the acquiring company in the vertical chain. This simplifies the investigation compared to a full merger.

[1] European merger control applies to transactions that convey a lasting change of control where control is the possibility of determining strategic commercial decisions, see Consolidated Jurisdictional Notice under Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings (2008/C 95/01) (http://ec.europa.eu/competition/mergers/legislation/draft_jn.html).

[2] E.CA Economics was appointed as the economic expert by the Austrian Cartel Court for the assessment of horizontal, vertical and conglomerate effects of the planned capital market share increase. The preliminary analysis did not identify significant concerns and the investigation was closed.

[3] See e.g. OFT research report (2010) on "Minority interests in competitors" prepared by DotEcon Ltd (http://www.oft.gov.uk/OFTwork/publications/publication-categories/reports/Economic-research/oft1218).

Feasibility of foreclosure strategies

	Input foreclosure	Customer foreclosure
Upstream acquirer	+	-
Downstream acquirer	-	+

Source: E.CA Economics.

The feasibility of foreclosure strategies is limited due to the following reasons.

Input foreclosure concerns arise if, after acquisition, the upstream firm may raise input prices or restrict input supply for competing downstream firms thereby increasing their costs. Consider a case where a downstream firm acquires a passive minority shareholding in an upstream firm. Due to the lack of control the downstream firm cannot "order" the upstream firm to increase costs for certain clients. The one-way nature of the equity stake means that the upstream firm has no incentive to do so. Thus, harming competitors (to the detriment of consumers) in this manner is only feasible if the acquirer is the upstream, and not the downstream, company.

Customer foreclosure concerns arise when the downstream company is an important customer who decides to procure its inputs (mainly) from the associated upstream company and thereby forecloses other upstream rivals from a sufficient customer base. Due to the same logic as discussed above, this behaviour is only feasible if the acquirer of the passive minority shareholding is the downstream firm. Customer foreclosure is thus unlikely with an upstream acquirer.

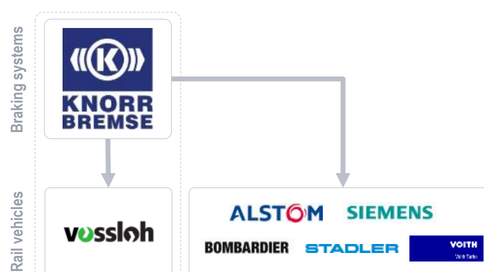
In comparison to a full vertical merger, where usually both input and customer foreclosure is assessed, when acquiring a passive minority shareholding it should generally be sufficient to assess only one of the two foreclosure forms. Furthermore, when accessing the incentive of the acquirer to foreclose, one has to take into consideration that the passive minority shareholder bears all of the costs of a foreclosing strategy but will only reap a minority share of the additional profits. This reduces its incentive to foreclose in comparison to a full vertical merger. In this context it is also important to analyse the likelihood with which the increased profits will result in higher pay-outs of dividends or reach the acquirer otherwise.

Assessment of input foreclosure

In the Austrian case, the acquiring company Knorr-Bremse is an input provider for the target Vossloh. Following the logic explained above, we found that customer foreclosure was unlikely and we focussed on input foreclosure.

Knorr-Bremse had a large market share in a vital input market (braking systems). Thus, in theory it would be feasible for the upstream company to restrict access to this input for rival downstream firms and thereby raise their costs.

Vertical structure of the planned transaction



Source: E.CA Economics.

However, the likelihood of anticompetitive effects was found to be small:

- **Affected costs**: The percentage of total costs affected by the braking systems was minor. Thus, increasing the input price would not significantly harm the competitive position of rivals.
- **Retaliation**: Although Vossloh had sufficient market share in one downstream segment, attempts to foreclose in this segment could have resulted in retaliation in other, economically more important segments.
- **Minority share of profits**: Although Knorr-Bremse would bear 100% of the cost of foreclosure, it would have gained at most 30% of the profits downstream.

Conclusion

As passive minority shareholdings do not grant control over the target company, it should normally be sufficient to assess either input or customer foreclosure. Furthermore, the incentive to foreclose is reduced in comparison to a full vertical merger as the acquirer only gains part of the additional profits.

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