

CHAPTER 8

Conclusions

The merger situation

8.1. Under the terms of reference we are required to investigate and report whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation in which section 64(1)(b) of the Fair Trading Act 1973 will be satisfied.

8.2. Section 64(1)(b) is satisfied as it is evident from the published accounts of Initial that its assets exceed £30 million.

8.3. By virtue of section 64(8) a merger situation qualifying for investigation exists if two or more enterprises have ceased to be distinct enterprises in the circumstances described in section 64(1). Under section 75(2) we are required to proceed in relation to a prospective merger as we could proceed if it had taken place immediately before the reference.

8.4. On 6 July 1984 BET made a revised offer to acquire the whole of the issued share capital of Initial which it did not already own. The offer lapsed when a reference was made to the Commission but BET indicated to us that it remained interested in the acquisition. Arrangements for the merger are therefore in contemplation.

8.5. BET already owns 42.4 per cent of Initial's ordinary shares. Section 65(1)(a) provides that any two enterprises shall be regarded as ceasing to be distinct if they are brought under common ownership or common control. Section 65(4) provides that for the purposes of section 65(1)(a) a person or group of persons may be treated as bringing an enterprise under his or their control if, being already able to control or materially to influence the policy of the enterprise, that person or group of persons acquires a controlling interest in the enterprise. It follows, even assuming BET is already able to control or materially to influence the policy of Initial by virtue of its ownership of some 42 per cent of Initial's ordinary shares, that BET's acquisition of a controlling interest in Initial may be treated as a merger situation.

8.6. We conclude that a merger situation qualifying for investigation will be created if the arrangements in contemplation for the acquisition of the remainder of the issued share capital of Initial by BET are carried into effect.

The public interest

The relationship between BET and Initial

8.7. The merger situation referred to us is one in which, unusually, the acquiring company, BET, already own a large percentage (42.4) of the ordinary shares of the company to be acquired, Initial. BET has indeed held over 20 per cent of Initial's ordinary shares since 1954 and nearly

40 per cent since 1973. It is not part of our remit to assess the effects on the public interest of this large existing holding. It is only the effects on the public interest of the merger situation actually referred to us, ie the effects of proceeding from whatever degree of influence BET actually or potentially has over Initial by virtue of its existing shareholding to a full controlling interest, that we are required by our terms of reference and by the statute to assess.

8.8. In the course of the Sunlight/Initial/Johnson inquiry BET argued that there was no scope for it to co-ordinate its interests in Initial and Advance, and indeed, any such attempt would have been totally contrary to its whole management philosophy. The Commission did not accept in their report in 1983 that there was no scope for co-ordination by BET of the activities of Initial and Advance. On the contrary they took the view that its holding (at that time) of 41 per cent gave BET the power to co-ordinate the activities of Initial and Advance not only in a formal way through Board decisions but also through informal contacts between directors of the two companies. Furthermore BET undoubtedly had the power as a shareholder in Initial positively or negatively to influence strategic decisions and, while it might be contrary to its philosophy to do so, it could in the future influence the general directions in which Initial and Advance should develop. Nevertheless the report noted that in their trading activities Initial and Advance appeared then to be as much in competition with each other as each was with other companies in the industry (paragraphs 9.10 and 9.11 of the 1983 report).

8.9. In the current inquiry both companies told us that up to the present there had been no change in the relationship between Advance and Initial as described in paragraphs 7.17 and 7.18 of the 1983 report. BET, however, indicated that its present relationship with Initial was not consistent with its new strategy to concentrate on the development and expansion of a limited number of business sectors with good potential for growth. It had plans for considerable rationalisation of the activities of Initial and Advance (paragraph 8.11).

8.10. BET also explained its current arrangements for controlling subsidiary companies. The Boards of BET's principal subsidiaries typically included two or three BET executives, one of whom would be the chairman. Its executives sought to ensure that BET's objectives were reflected in the annual plans of subsidiaries. There were detailed monthly financial reporting procedures for subsidiaries within the BET group. In addition to these more formal processes, there was a significant degree of contact between BET's head office and local operating subsidiaries, particularly between the chairman and chief executive of each subsidiary. BET's executives would take particular interest in the activities of a subsidiary which was in difficulties or in a phase of rapid expansion or change.

8.11. BET said that the proposed change in its relationship with Initial as a result of its bid for complete control would not much affect some aspects of competition between Advance and Initial. Separate brands and existing differences in their services would be retained and the companies would in these respects continue to compete as before. It acknowledged

that if and when Initial became a subsidiary there was bound to be some breaking down of the separateness of Advance and Initial in the market place; they would be able, for example, to see each other's customer lists. Tendering for NHS contracts would be co-ordinated. Similarly there would be a combined national accounts group and some integration of distribution to rural customers. BET also indicated that it had in mind to integrate the processing of rented workwear, cabinet towels and dust mats etc into larger, more efficient units and there would be some integration of bulk distribution. It would expect to achieve considerable economies of administration.

8.12. BET argued that its present 42 per cent shareholding in Initial would not in itself enable it fully to integrate some of the activities of Advance and Initial in the ways it had indicated because there were two different bodies of shareholders involved.

8.13. Initial told us that, looking at the prospective merger from the point of view of managers rather than directors, they would expect the management of Advance and Initial to end up working together much more closely and there would be cross-fertilisation at all levels without the difficulties and constraints that presently existed. The expectation would be that direction would be given in areas of uncertainty by BET on advice and in the light of papers submitted by management.

8.14. There was also evidence from competitors on the changes they would expect if BET acquired a full controlling interest in Initial as well as Advance. Sketchley took the view that effective competition between the two companies would cease or at least be substantially diminished. BET would be free of the constraints imposed by a majority outside shareholding in Initial, and in pursuance of its normal duties to the company and its shareholders, the Board of BET would be bound to ensure as far as possible that the policies of Advance and of Initial did not come into conflict and so damage each other. Another major textile rental company¹ commented that one factor which helped to maintain competition between Initial and Advance at present was that arrangements involving mutual restrictions between them would require registration under the Restrictive Trade Practices Act 1976. It also considered that BET's ability to manage the affairs of Initial in the best interests of BET was limited by the need to take into account the interests of the other shareholders in Initial.

8.15. Thus we have evidence that BET would intend to retain the individual brands and distribution services of Initial and Advance where these are commercially advantageous. On the other hand they would exert a greater degree of central direction than at present and aim to rationalise some aspects of processing and distribution in ways that would be likely to reduce effective competition between them. As in the previous report, however, we take the view that BET's existing shareholding already gives it considerable potential scope for co-ordinating the activities of Advance and Initial. In looking in detail at the effects on competition of the greater degree of rationalisation which is now proposed, we bear in mind the important consideration that the existing situation is a different starting

¹ This is the same company as that referred to in paragraphs 8.23, 8.26, 8.30 and 8.38.

point from one where two wholly independent businesses are combined. We shall return to this consideration; meanwhile we look in particular at the likely effects on competition in the markets where there is a significant overlap between the two companies' activities.

Competition and market shares

(a) Workwear rental

8.16. The workwear rental market was worth around £128 million in 1983. Initial was the leading supplier with a market share of some 23 per cent, followed by Sketchley and Pritchard with around 17 and 12 per cent respectively. Advance, Johnson and Sunlight each had about 5 per cent. Smarts had around 1 per cent and other companies the remaining 31 per cent or so of the market.

8.17. BET told us that in its view the substantial market shares of Sketchley and Pritchard showed they were fully capable of competing effectively with Initial and Advance and that this opinion was reinforced by the ease of entry into the market, particularly at the lighter end where Advance's sales were concentrated. Advance's market share had been relatively static for several years and it had a much less optimistic view of the market than Johnson had taken at the time of the 1983 report.

8.18. Initial considered there was an undeveloped market for workwear which would provide ample room not only for Initial and Advance but also for their many competitors to expand. Initial had 4 or 5 per cent in the lighter end of the market and some 19 per cent in the heavy industrial end. It felt that most of the smaller companies were in the lighter end where expansion was likely and where a local firm operating on a fairly small scale was capable of giving a good workwear service.

8.19. We found general agreement among the larger workwear companies that the lighter end of the market would grow in the short term and that possibly the decline in the heavy industrial sector had ended. Initial was convinced that given somewhat better prospects in the economy, the latter sector would also grow significantly.

8.20. In terms simply of market shares, bringing together Initial (now some 23 per cent) and Advance (still about 5 per cent) creates *prima facie* a powerful position in the workwear market. In terms of competition, however, the effects are muted. At the heavy end of the market where Initial's share is matched by Sketchley's (and Advance is hardly involved) we share Sketchley's view that aggregation of the shares of Advance and Initial would have little or no effect. Only about one-third of the 28 per cent combined share of Initial and Advance would be at the lighter end where there are vigorous competitors and where many local operators can, we agree, offer good service.

(b) Cabinet towel rental

8.21. Initial had around 38 per cent of a cabinet towel rental market worth some £62 million in 1983 and Advance about 25 per cent giving them an aggregate share of the order of 63 per cent. Both BET and Initial argued that cabinet towels should be seen as part of the wider hand-drying or washroom services market in which their aggregate share was on our estimate

between 31 and 34 per cent. BET said that cabinet towels, hand towels, paper towels and warm air dryers were all substitutable one for the other although each had benefits and disadvantages. It believed that its view that the hand-drying sector was the relevant market definition was supported by a market research exercise carried out on its behalf by an independent company in November 1984. BET pointed to the way in which warm air dryers had increased their market share at the expense of cabinet towels over the period 1979 to 1983 and to the steep decline of cabinet towels in the hand-drying market in the USA since 1960. In addition to competition from paper towels and warm air dryers both regional and national competition had been growing as a result of acquisitions in the cabinet towel sector itself.

8.22. Initial told us that the cabinet towel market had declined significantly since 1981. It indicated that some adjustment had been inevitable because cabinet towels had been over-sold in an unusually high penetration in the United Kingdom market. Initial also drew our attention to differences in the services provided by Advance and itself; Initial's towels were personalised, as the company's title implied, and the two companies used different types of cabinets and had different billing systems. Whereas Advance served several large institutional customers, Initial's market was largely among smaller customers where strong competition was coming from small local laundries as well as their larger rivals.

8.23. The evidence we received from competitors contained varied views about the nature of the market. Sketchley told us that it saw cabinet towels as part of a rental package which included workwear and dust mats, and perhaps some other textile rental items, rather than as part of a hand-drying market. It also discounted the importance of brand competition between Advance and Initial as a factor affecting consumer choice. A major textile rental company said there was a core of customers who for reasons of convenience preferred cabinet towels; it believed that the extent to which other means of hand-drying were serious competitors was limited. Spring Grove and Johnson, however, accepted that cabinet towels were in competition with warm air dryers and paper towels but, like the major company referred to above, stressed the difficulty of obtaining a sufficient market share to obtain economies of scale and secure an acceptable return on heavy investment in stocks.

8.24. The 1983 report recognised that paper towels and warm air dryers were to some extent alternatives to cabinet towels but concluded that they were not acceptable substitutes in all cases and in assessing the effects on competition concluded that it was reasonable to regard cabinet towel rental as a separate category (paragraph 9.29 of the 1983 report). The judgment involved in identifying separate sub-markets is always difficult and is open to review in changing circumstances. In this instance we note some evidence that in the last two years disposable paper towels and warm air dryers have continued to improve their shares of the wider hand-drying market, largely at the expense of cabinet towels. The aggregate shares of Advance and Initial would amount to a strong position even in this wider market. But we believe that the existence of competition from paper towels and warm air dryers would at least limit the effect of any attempt to exploit the combined companies' dominance in cabinet towel rental.

(c) Dust mat rental

8.25. We have been given estimates of the size of this growing market which range from £17 million to £30 million. Its size is of some importance because it has a marked effect on the calculation of the combined share of Initial and Advance. On the above figures their share could range from one-third to nearly two-thirds. Our own best estimate is that the market was worth around £20 million in 1983, with Initial taking about 39 and Advance some 13 per cent, giving a combined total of around 52 per cent. Advance and Initial would together have over six times the market share of Pritchard, their nearest rival. The top six companies would have some 76 per cent of the market.

8.26. BET argued that rented dust mats were largely an optional product; a variety of mats was available which firms could purchase and maintain themselves. Initial said that dust mat rental services were provided not only by the national operators but also by a substantial number of small local companies. It pointed out that the dust mat was a relatively new product. Initial had gained a large market share by leadership but it would not expect this to last much longer in a growing market where entry was not difficult. In contrast a major textile rental company told us of a company that had been trying to get into the market for six years but had been unable to build up an economical workload. Sketchley believed that it was easier to enter this market if it were being added to other textile rental services; it was not something which many small companies would undertake.

8.27. The 1983 report did not reach any separate conclusion on the effects of the proposed mergers on competition in the dust mat rental market. In this inquiry we have found no consensus even on its approximate size. Initial is, however, still the clear leader and despite losing some ground six companies retained about three-quarters of the market in 1983.

8.28. The market, although growing, is not large. Initial and Advance together would have a substantial share but it appears to be declining. Thus while Advance and Initial together have little more than maintained the value of their sales between 1981 and 1983, three major textile maintenance companies significantly increased their sales and their shares of the market. It is not clear therefore that bringing together Advance and Initial would significantly impair the progress of others in the dust mat rental market.

The textile rental market

8.29. The 1983 report looked at competition in the textile maintenance market as a whole. This market consisted of the cabinet towel, workwear and dust mat rental categories, already discussed; and also included linen, industrial wiping cloth and ancillary rental, domestic and contract laundry, and dry cleaning, in all of which there is either an insignificant or no overlap between Initial and Advance. In the narrower market combining workwear, cabinet towel and dust mat rental, as shown in Table 8.1, we estimate that Advance and Initial would have a share of about 41 per cent.

TABLE 8.1 Turnover in the workwear, cabinet towel and dust mat rental markets, 1983

	£m	%
Initial	60.6	29
Advance	24.6	12
Combined	85.2	41
Other companies	124.8	59
Total	210.0	100

Source: MMC study.

8.30. Sketchley put it to us that it was appropriate to look at the workwear, cabinet towel and dust mat rental markets in aggregate because there were substantial economies of operating the three sectors together. Thus the cost of collection and delivery of garments or other goods was crucial to the economics of the business; full lorry or van loads needed to be organised for collection/delivery within a limited geographical area if the business was to be profitable. The main potential for growth was in the provision of rental services to smaller businesses which individually or collectively required all three services. Sketchley believed that in consequence the merged companies would become increasingly dominant in these combined rental markets. For new entrants provision of these services to small businesses in the face of a dominant low cost competitor would be highly unattractive. A major textile rental company also emphasised the importance of the relationship between the different sectors of the textile rental market and pointed to the difficulty of building up a competitive customer distribution system in the face of large market shares.

8.31. On the other hand Spring Grove thought that in the short run there would be market opportunities for competitors of Advance and Initial after the proposed merger as BET sought to integrate the two companies. In the longer run the success of the combined group would depend on the quality of its management. Pritchard held that the textile rental market was competitive. In its experience the smaller local undertaking was as likely to win a contract from a national major as the converse; competition would not be reduced by BET's ownership of Initial and Advance.

8.32. BET saw no economy in local distribution arising from the merger apart from the possibility of small savings on maintenance. Initial said that local distribution would not be a major area of economy but it would look at integrating delivery in the more remote areas of the country. Initial Services Division mostly ran deliveries with a variety of services on the same van. It would also be possible to carry different brands on the same vehicle; this had already been done very successfully within Initial.

8.33. To sum up, some three-quarters of the combined workwear, cabinet towel and dust mat rental markets are in the hands of seven suppliers. The acquisition of Initial by BET would crystallise an already high degree of concentration and augment the market share of the leading supplier whose strong position in the market would in our view be enhanced by its ability

to distribute the three products together. These considerations are *prima facie* detrimental to competition. We consider this detriment in relation to the evidence we had of the effects of the merger on efficiency and employment in the industry.

Employment

8.34. BET told us that its proposals for rationalising the activities of Advance and Initial would entail some loss of employment, particularly in administrative functions; it estimated that approximately 120 jobs would be lost over a period of three years. The acquisition of Initial also offered the possibility of substantially increasing the capacity utilisation of Advance and Initial by facilitating the process of freeing capacity for NHS work and improving their workers' security of employment. It could in addition help to stem the decline in cabinet towels in favour of paper towels and warm air dryers, thus saving jobs because the cabinet towel industry was relatively labour-intensive (paragraph 8.36). If the hopes of further NHS work did not materialise, BET believed that there would be a reduction in capacity with or without the merger and that the level of reduction would be unaffected by the merger. In the longer term, Initial considered that the benefits arising from the merger in terms of prices, quality of goods and services and efficiency would be translated into growth in the various market sectors with a consequent increase in employment.

8.35. In our view a degree of rationalisation of the activities of Advance and Initial would be likely to result from the proposed merger and it would entail a loss of jobs. The extent to which the loss would be compensated or perhaps more than compensated in the longer term by growth, of the markets is impossible to measure but, given the market power of Initial and Advance together and the prospects for expansion of the workwear and dust mat rental markets, we do not believe that Initial's optimistic view of the outlook for employment in the enlarged group is simply speculative. We are more doubtful about the combined companies' prospects of gaining substantial further NHS work but we consider that the net effect of the merger on employment would be likely to be small.

Efficiency

8.36. BET expected that annual savings of around £2.7 million would be achieved after three years as a result of rationalisation of the administration and operations of Advance and Initial. The largest potential savings would be in administration, processing, data processing and rural distribution. BET foresaw that in the longer term plant could be dedicated to specific product lines which would bring considerable further cost savings. This could, for example, help to retard the decline in the cabinet towel market. It also believed that the merger would enable it to compete in a more effective and sustained way than had been possible hitherto for the textile maintenance work of the NHS. The integration of the processing units of Initial and Advance would facilitate the freeing of their spare laundry capacity for NHS work. Current profit margins on this work besides the difficulty of long-term planning would not justify investment. This view of investment was likely to change only as mutual confidence was established between

the private sector and the NHS on the basis of greater experience of laundry contracts, but the combined business base of Advance and Initial would spread the risks associated with investing in large NHS contracts.

8.37. Initial took a more optimistic view than BET of the potential cost savings it would expect from the merger and considered that future prospects for growth in the textile maintenance industry would be enhanced by a more widespread use of dedicated processing units. The industry had to move to a new level of efficiency if it was to attract new trade and open up new markets. This entailed a restructuring of the industry to achieve the increased volumes which were a prerequisite for substantial new investment in higher volume dedicated plants. Meanwhile the merger would allow Initial and Advance to integrate their processing capacity and release laundry plants in the most appropriate geographical location to compete for NHS contracts. This should result in substantial savings of public funds. In the longer run it was hoped that more use would be made of the private sector to provide and manage the linen requirements of the NHS but that stage was a long way off.

8.38. Sketchley and another major textile rental company had no doubt that substantial cost savings would accrue from the merger, making the merged group a more formidable competitor. Spring Grove was less sure that the merger would be successful (paragraph 8.31). Johnson, Sketchley and the major company referred to above were sceptical about the private sector's prospects of obtaining substantial profitable NHS laundry contracts in the present round of tendering.

8.39. We accept on the evidence that the merger before us would be likely to result in a material reduction in costs and thus improve the efficiency with which resources are used in the industry. While it is difficult at this early stage to assess the potential of the enlarged group in competing for laundry contracts in the NHS and possibly proceeding to a broader participation in linen management, the merger should strengthen rather than weaken the companies' ability to offer effective services.

Conclusion

8.40. We have analysed effects on competition varying in degree in the three segments of the textile rental market where there is a significant overlap between the activities of Initial and Advance: workwear, cabinet towels and dust mats (paragraphs 8.20, 8.24 and 8.28), and seen a *prima facie* detriment to competition in the three segments combined (paragraph 8.33). We believe that any short-term detriment to employment would be slight and that in the longer term there is some prospect that the level of employment in the enlarged group would increase (paragraph 8.35). We also see some benefit to the public interest in terms of saving of costs and, while not fully accepting the arguments advanced by the two companies, we believe that their ability to offer services to the NHS should be enhanced (paragraph 8.39).

8.41. If we were looking at the putting together of wholly independent companies, given the substantial market shares involved, we do not think these benefits would outweigh the detriment to competition in the three

market segments combined. We must, however, now return to the consideration with which we started our discussion of the public interest. We are here dealing with an unusual merger situation where we have to assess the effects of BET's proceeding from the degree of influence it already actually or potentially has by virtue of its 42 per cent holding in Initial to a position of full control. As recorded in paragraph 8.15, we take the view that BET's present shareholding gives it considerable potential scope for co-ordinating the activities of Advance and Initial. In these circumstances we feel bound to recognise that to a significant though unquantifiable extent the effects on competition referred to above may well be inherent in the existing situation and therefore not properly attributable to the further stage of acquisition of a controlling interest. This being so, we believe that it would be unsound to determine that the merger now before us may be expected to operate against the public interest.

8.42. We conclude that the arrangements in contemplation by BET for acquisition of Initial may be expected not to operate against the public interest.

ALAN NEALE (*Chairman*)

P H DEAN

G D GWILT

RONALD SWAYNE

C A UNWIN

N E D BURTON (*Secretary*)

16 January 1985