NON CONFIDENTIAL

Presentation

Case study

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MARKET IN A NUTSHELL

manufacturer	OS	Other specifics	Market shares									
			volume					value				
			2015	2016	Y2Y	2017	Y2Y	2015	2016	Y2Y	2017	Y2Y
A	Z	Incumbent, general purpose	48%	43%	-5%	35%	-8%	40%	37%	-3%	28%	-9%
B	own	High end, multimedia	5%	11%	6%	14%	3%	9%	17%	8%	23%	6%
C	own (tbc)	Business	12%	14%	2%	16%	2%	15%	17%	2%	19%	2%
D	own? Z?	Low cost entrant, plans to complete its mid/high end offer	12%	17%	5%	23%	6%	12%	16%	4%	21%	5%
others	Z (?)	5 players	23%	15%	-8%	12%	-3%	24%	13%	-11%	9%	-4%

The two parties have high market shares in volume and value but this covers the effect of tectonic forces:

- The fringe is disappearing
- A is on the road to perdition
- B has created a high end segment
- C is growing steadily
- D is hitting the market hard and moving up the quality ladder

Counterfactual

WHAT IS THE RELEVANT COUNTERFACTUAL?

- The usual counterfactual in merger control is normally « business as usual » but this industry is clearly not in a steady equilibrium
  - The incumbent is in free fall: it lost 9% in a year, i.e. 25% of its market share
  - The same is happening to the fringe
  - Conversely, B and D are up full speed, having increased by a third between 2016 and 2017

- A is not failing, but it is not doing great either: this should have an influence in one way or another

- This issues of the burden of proof, legal standard and standard of proof are textbook PhD/JD/LLM thesis topics
  - The definition of the counterfactual clearly falls on antitrust authorities in antitrust (Mastercard) and there is no reason it should be different in merger proceedings
  - Once this is said, the legal standard can be quite lax and the standard of proof quite low (Mastercard again)
  - However, if failing firm defenses are seldom accepted, this is generally because facts don't match

- In practice, we all know that the parties will come with the arguments

SCENARIOS FOR A

- Scenario A (the one Nikodem presented):
  - A is a strong and stable player
  - It had a temporary downturn but it will recover and go back to ancient glory
  - I understand why this is appealing to antitrust agencies, but this is not credible
  - Trust the Frenchman (and not the brexiters): ancient glory never comes back, reality strikes dreamers back
- Scenario B:
  - A is taken in the downwards snowball effect of bad technological choices, bad design, poor customer experience and reviews
  - It is going down to never come back
  - By five years, it stops producing smartphones and becomes a patent troll
  - Don’t believe me? Ever heard of Nokia and Motorola?
  - You believe me? Then why is B buying A?
- Merger control is not about beliefs, but about facts, and the facts are unlikely to depict a clear scenario A or B
  - We will look at internal documents and business reviews
  - We will look into parties’ pipelines and financials

SCENARIOS FOR B

- The issue for B is less dramatic as it has succeeded from scratch an impressive lateral entry into the smartphone business

- It is however also possibly facing challenges:
  - B has managed a successful entry based on third party key elements and engineering
  - It does not own any connectivity or computing technology. It is not very cost efficient and had issues supplying large quantities of phones globally
  - It has a very high end offer, but D is coming from the low to mid range. It will have a more complete offer and is much more efficient

- This is where the merger takes its sense:
  - A lacks vision and has missed the last big turn (including by underestimating the computing needs of modern smartphones).
  - On its own, it is going down but it still has superb engineering, patents and ability to design its own chips
  - It is also a supply chain champion
  - B taking over A will make a much stronger champion to resist D's full speed arrival

- Again, this is not a question of belief, so can we find the following in B's internal documents that:
  - B is really scared of D (and really does not see A as a threat)?
  - B is really facing engineering and supply chain issues and is at the end of the first scaling cycle?
  - B really has a project for A's engineering and production specialist (and much less for A's design…)?

SCENARIOS FOR D

- D is currently disrupting the market from the low cost segment
- It is doing so based on its internal engineering capacity and very low cost base
- It is dominant on its own very large domestic market, it is extremely profitable and generates very large cash flow
- Internal demand for higher end smartphones is growing, as shows the increased market share of B in this market
- D plans to expand its offering to mid-range this year and to high end in the next two years
- How will D deal with the challenges ahead?
  - What OS is D using? Will it switch to Z to get more apps?
  - Does it have the technical capacity and design ability to compete with B on high end products? By when?
  - Will it be able to offer an equivalent customer experience with respect to apps? Is there any merger specificity to this?

CONCLUSION

- There is large uncertainty on the path that the industry will take in the short to mid term

- This should shed positive light on the deal if:
  - internal documents and business review confirms that A is not going to fully recover to its previous levels
  - B is indeed facing a scaling up issue and would benefit from A's assets
  - D is coming fast to the mid and high end segments

- Conversely, this should shed a negative light on the deal if:
  - A has a credible plan to come back on the high end segment
  - B faces no particular hurdle to scale up and complement its offer with less exclusive smartphones
  - D will unlikely succeed to take a strong foot at the high end segment in the near future

- But to study all this, there are probably a few other things we need to understand about the market

Closeness of Competition

WHAT IS THE BUSINESS SEGMENT?

- One player, C, is mostly active on the « phones used for business » and is increasing steadily
  – What does that mean? Are there different phones? Are there different customers?

- The investigation looked into « market shares » for business customers (in value), for 2017
  – Scenario 1: business segment is 30%, C sells only to this segment, B and D negligible
  – Scenario 2: business segment is 40%, C sells only to this segment, B and D negligible
  – Scenario 3: business segment is 30%, C does not only sell there, but D has gotten the business price sensitive customers

	Overall	Scenario 1		Scenario 2		Scenario 3	
		Business	Non-Business	Business	Non-Business	Business	Non-Business
A	28%	27%	29%	43%	18%	20%	31%
B	23%	5%	31%	5%	35%	5%	31%
C	19%	63%	0%	48%	0%	50%	6%
D	21%	0%	30%	0%	35%	20%	21%
others	9%	5%	11%	5%	12%	5%	11%

- It is quite easy to see that there will always be a problem with “non-business” customers

- But is there such a thing as a business customer and is this even the most relevant distinction?
  – Is there more difference between a business customer and a non-business than between a high and low end?

A MORE GENERAL LOOK AT CUSTOMER BEHAVIOUR

- We have been described very large differences between segments and very large shifts in market shares
  - Is the market actually growing?
  - Who is eating who (both the fringe and A)?

- Clearly, there are also very large differences in customer preferences and market players have differentiated offers
  - Market shares misrepresent the constraints parties impose on each other
  - The merger will have smaller (resp. larger) effect if the parties are distant (resp. close) competitors

- It seems crucial in this context to have a very close look directly at customer level data
  - It would seem useful not only to have "static" customer level data but also diversion ration
  - Ideally, one would have a survey on customer choices and determinants and long series of product characteristics and quantities
  - The durable good dimension is also key here: to what extent are producers competing against old versions of themselves?

- What do we measure (and how do we link it to economic theory)?
  - If we measure diversion ratios, where does the switch come from: price or other dimensions?
  - What drives prices? Quality? Entry? Optimal pricing of firms selling durable goods?
  - Use economic theory to guide the assessment (e.g. hedonic prices)
  - Use a whole range methods based on adequate modelling: UPP, calibration, estimation

Vertical foreclosure

WHAT ABOUT Z?

Is B going to stop using Z for A's phones?

- Pro: cost efficient, attract demand (?)
- Cons: differentiation

- It is not clear that B has the incentives to stop using Z and if it does it is probably not in a classical scenario of customer foreclosure
  - But this we should find in internal docs
  - A classical critical loss analysis likely misses the point: need to have a bespoke analysis

- This does not mean that one should not be concerned by accidental foreclosure

- Who cares about Z?
  - Is D using Z? if yes, no issue
  - If no, could D start using Z?
  - If not, it shows that an entrant does not need Z. Stop dreaming, the constraint is not going to come from one of these traditional fringe smartphone companies: B entered from the side and to the top and D from the bottom
  - Then, maintaining Z alive is pretty useless to consumers

WHAT ABOUT STREAMING?

- When asked to self assess, I flagged the issue of access to B's streaming services
- B has allegedly made its success at least partly on integration with this services and other apps
- D will need access to the latest apps, possibly to B's streaming
- Will B provide access?
- If not, how much of it is merger specific?
  - The situation is not a textbook vertical foreclosure issue
  - B is already vertically integrated
  - Integration could change its incentives to stop providing to third parties but allegedly less than if it was not already vertically integrated: it could already do it now
  - Would he be prevented to make discriminatory offers to A and D before or after the merger?
  - What prevents ex-post regulatory intervention?
- There might be few grounds for ex-ante intervention, but the proper remedy is pretty obvious

Other issues

COMPASS LEXECON

WHAT ABOUT THE DYNAMIC EFFECTS?

- We have heard the concern that the merger could reduce innovation in the market

- How are these effects different from static effects?
  - Are these effects not normally derived from the prospects of static ones in the future?
  - If yes, are they not of second order? Why should we bother at all about these (except to extent remedies)?
  - If not, are there conditions in which there would be strong dynamic effects and small potential static effects in the future?
  - Are there situations where static effect are balanced by efficiencies and dynamic ones not?
  - Are there situations where dynamic effects are pro-competitive?
  - If yes, are they large and when? Who should look at it?

- What about the durable good element?

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Thank you!

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