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Start-ups, killer acquisitions and merger control – Note by Germany

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More documents related to this discussion can be found at
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1. This contribution addresses the subject of newly introduced notification thresholds as a means to ensure that so-called “killer acquisitions” do not fly under the radar of merger control. It provides a short introduction to the topic and the need for revised criteria regarding merger notification requirements (1), followed by an outline of the notification thresholds applicable under German jurisdiction (2). The focus lies on the various elements of the definition of the transaction value threshold (3) and its practicability (4). The submission closes by drawing some general conclusions (5).

1. Introduction

2. The latest debates on effective merger control focus on acquisitions of start-ups or nascent firms by rivals. This article does not intend to contribute to the different theories of harm this topic entails; it is the logical precondition for any meaningful competitive assessment of a merger’s actual effects on the market structure that potentially harmful acquisitions do not escape the prism of merger control in the first place. Preventing enforcers from being strategically kept out of the picture when it comes to addressing the phenomenon of killer acquisitions and other critical acquisitions of start-ups or nascent firms is a matter of cross-jurisdictional relevance.

3. Potential competitive pressure is a crucial element of undistorted markets and a priority for enforcers. Introducing a novel threshold which is not based solely on the turnover generated by the companies involved but primarily on the transaction value is therefore an important element of the revised merger control framework in Germany. It was designed to expand the scope of merger review to include transactions which involve market-relevant companies of the digital economy that do not generate a particularly high turnover at the time of the transaction but should nevertheless come under scrutiny because of the target’s competitive potential on the relevant markets. Merger control is essentially linked to the premise that a merger project is subject to notification and enforcers can swiftly clear deals that raise no particular concerns. The new provisions introduced in Germany complement the existing merger control system, particularly with regard to markets driven by technology and innovation, with the aim of preventing any possible market foreclosure effects and barriers to market entry and protecting the potential for innovation.¹

4. As a result of these new provisions, mergers involving target companies or assets which (as yet) generate little or no turnover but are purchased at a high price can now be examined under competition law. Market-leading companies are able to acquire emerging competitors or their assets and integrate them into their own business by purchasing them in the early stage of their development and fully integrating, changing or discontinuing the acquired company’s original activities. From a competition policy perspective, such acquisitions may require a preventive merger investigation, especially with regard to protecting the potential for innovation and competition in technology markets.²

¹ Bundeskartellamt, Press Release of 9 July 2018; the Bundeskartellamt’s publications are available at: www.bundeskartellamt.de.

² Ibid. para. 4.

5. Hence, the transaction value approach seeks to ensure that it is not possible for large companies to use mergers in order to enlarge their portfolio, to create or increase barriers to entry or simply to buy emerging competitive products or innovative efforts from new entrants or rivals without the assessment of anticompetitive effects under German merger control.

2. The road to the amended German merger control framework

6. The reform package of the 9th amendment of German competition law provided *inter alia* some additional criteria for the assessment of market power and a new transaction-value-based merger control threshold, which was also introduced in a similar manner in Austria. As a result, a transaction is subject to German merger control not only if the traditional turnover thresholds are met, but also if in the last completed financial year

- the combined aggregate worldwide turnover of all the undertakings concerned was more than 500 million euros,
- the domestic turnover of one undertaking concerned was more than 25 million euros,
- neither the target undertaking nor any other undertaking concerned achieved a domestic turnover of more than 5 million euros,
- but the consideration for the acquisition exceeds 400 million euros and
- the target company has substantial operations in Germany.

7. The novel threshold was discussed due to certain gaps perceived in the established notification regime with regard to the platform economy. In 2015, Facebook acquired the WhatsApp messenger service. At the time of the takeover, WhatsApp had only 55 employees and revenues of 10 million euros.³ Still, the company managed to reach millions of consumers by providing its services for free. The immense competitive potential and significance were reflected in the purchase price of approx. 19 billion US dollars for the takeover by Facebook. The case was originally subject neither to German nor to EU merger control and was only investigated after the case was referred to the European Commission by other Member States. Ultimately, the EU Commission cleared the deal and came to the conclusion that it would not hamper competition in the dynamic and growing market and that the companies involved were no close competitors.⁴

8. As the revised merger control framework has only been in force for a relatively short time, the Bundeskartellamt's experience in this respect is still limited. The practical experiences gained will soon be included in a statutory evaluation of the transaction value threshold, which is required by law and which will take place in 2020.⁵ This contribution already points to some lessons learned since the introduction of the threshold.

³ Bundeskartellamt, Interview of President Mundt by *Welt am Sonntag* of 12 July 2015.

⁴ European Commission, Press Release of 3 October 2014.

⁵ Bundeskartellamt, Activity Report 2017/2018 (in German only), p. 23.

3. The elements of the transaction value threshold

9. Given the new threshold, mergers are now also subject to merger control in Germany if, in addition to the merger fulfilling some specific requirements for turnover thresholds, the value of a consideration exceeds 400 million euros and the company or a part of the company that is to be acquired shows significant domestic activity in Germany. Against this background, the interpretation of (i) the value of the consideration and (ii) the extent of domestic operations is of particular interest.

3.1. Value

10. The value of the consideration comprises all assets and other monetary benefits that the seller receives from the buyer in connection with the merger in question. In this respect, the term “asset” is interpreted in a broad sense as applied in German commercial law. It covers all cash payments and the transfer of voting rights, securities, tangible assets and intangible assets. This also includes considerations that are contingent on certain conditions, such as those specified in earn-out clauses, or other additional payments to the seller agreed in connection with the merger that are conditional on the achievement of certain turnover or profit targets at a specific point in the future (e.g. licence fees). Payments for non-competition by the seller are also to be included unless they are already completely covered by other elements of the consideration.⁶

11. Generally speaking, a distinction must be drawn between the company value calculated on the basis of business methods and the purchase price and consideration value for a company. This is due to the fact that surcharges or premiums that exceed the determined value of the company are often paid for its acquisition. Consequently, they form part of the consideration value. The value of the consideration is therefore often higher than the value of a company calculated on the basis of a stand-alone valuation because the calculation of the consideration value is often critically influenced by the buyer’s subjective assessment of how the company to be acquired will develop after it has been integrated in the buyer’s company or corporate group.⁷

12. The value of the consideration relates only to the proposed merger project in question. The value assessment does not cover any company shares already held or exchanged, for example. Instead, a case-by-case assessment has to be carried out to determine whether individual acquisitions that are closely connected in material terms and in terms of timing should be regarded as parts of a single merger, in which case the considerations of the individual transactions should also be included in the calculation of that merger’s consideration value.⁸

13. The threshold provided for in Section 35(1a) German Competition Act does not affect the practical application of the turnover-based criteria. No special rules apply to the turnover calculation of the turnover-based elements included in the new provisions.⁹

⁶ Bundeskartellamt/BWB, Guidance on Transaction Value Thresholds for Mandatory Pre-merger Notification, para. 11.

⁷ Ibid. para. 12.

⁸ Ibid. para. 13.

⁹ Ibid. para. 7.

3.2. Substantial domestic operations

14. This criterion is meant to exclude cases essentially relating to the takeover of a company exclusively operating abroad from the scope of the provision governing the threshold. If a company that exclusively or primarily operates on the domestic market is taken over, it is usually safe to assume that a substantial level of domestic activity is shown to exist. This criterion is generally measured on the basis of the target company's market-related activities and not on the basis of its domestic turnover.¹⁰

15. Different criteria to measure activities may be applied to different sectors and activities. A definitive list of possible criteria cannot be provided. The measurement should be carried out based on industry standards that cannot be easily manipulated. In the digital sector, enforcers may refer to user numbers ("monthly active users", "daily active users") or the frequency of access to a website ("unique visitors") as examples of possible indicators.¹¹ The relevant criteria are context and case-specific and the particular choice should be guided by the aim to accurately determine that the relevant activity is connected to the domestic market and to ensure that it is geared towards the market.

3.3. Caseload

16. So far, the Bundeskartellamt's practical experience with the newly introduced threshold is still rather limited. In the second half of 2017 and throughout 2018, mergers were notified for the first time on the basis of the transaction value threshold. As expected by the legislator, the new regulation did not lead to a large number of additional notifications. In 2017, 8 mergers were notified and in 2018, 10 mergers were notified with regard to the transaction value threshold. In 7 of these cases, the notification was withdrawn after it had become apparent that the notification provision did not apply to the specific notified merger project. In the remaining 11 cases (3 in 2017 and 8 in 2018), the mergers were cleared in the first phase proceeding, although in some cases the question as to the obligation to notify the merger was not finally clarified.¹²

17. To the extent that informal consultations or the assessment of notifications revealed that there was no obligation for the parties to notify the merger under the transaction value threshold, this was in the vast majority of cases due to the fact that the target company was not found to carry out significant domestic activities.¹³

4. Practicability of the transaction value threshold

18. Adequate notification requirements play a distinctive role in dealing with killer acquisitions from a competition law perspective. Proper thresholds are the prerequisite for competition authorities to review transactions in order to prevent market activities that are in conflict with competition law principles according to common understanding. Repressive means may help to sanction abusive conduct but cannot guarantee that disadvantages can be undone. Severe economic disadvantages may have already occurred and be irreversible.

¹⁰ Ibid. para. 64, 65.

¹¹ Ibid. para. 66, 67.

¹² Bundeskartellamt, Activity Report 2017/2018 (only German), p. VII.

¹³ Ibid. para. 25.

19. In respect of the German transaction value threshold, the provision aims to cover cases in which the target's current turnover and the purchase price for the target differ to a disproportionate extent. The high purchase price in such takeovers is often an indication that the target has innovative business ideas and shows great competitive market potential.¹⁴

20. In practice, it turned out that a large part of the cases the Bundeskartellamt dealt with on the basis of the transaction value threshold concerned the pharmaceutical and the IT industries. In these sectors, innovation is crucial and there is great potential for future gains. Consequently, one could assume that such industries are prone to the phenomenon of killer acquisitions. Nevertheless, in the limited period during which it has been possible to gain experiences with the transaction value threshold under German competition law, the Bundeskartellamt has not encountered a case notified under the new provision that was assessed and classified as a killer acquisition.

4.1. Decisional practice

21. At the end of 2019, the Bundeskartellamt cleared the planned acquisition of Honey Science Corp. (Honey) by Pay-Pal Inc. (PayPal) as it was not expected to significantly impede effective competition. The merger had to be notified since it exceeded the transaction value threshold set out in Section 35(1a) German Competition Act. The parties involved did not reach the regular turnover thresholds. In particular, the target company's sales numbers in Germany were very low in the relevant fiscal year 2018. However, since the value of the consideration provided in return for the merger amounted to approx. 3.6 billion euros, thus exceeding the amount of 400 million euros, and Honey had already taken up considerable activities in Germany, the threshold applied.¹⁵

22. The assessment of whether the company's activity in Germany was substantial had to focus primarily on the number of users located in Germany because with regard to online trading and the associated advertising measures this is the location where the service is actually rendered. In this respect, it is irrelevant that users in Germany use the promotional codes free of charge. Including such services in the assessment is in fact the rationale behind the transaction threshold. In September 2019, the target company already had a relatively large number of users in Germany despite the fact that it was only establishing its business in Germany and its sales figures in Germany had been low in the preceding financial year.¹⁶

23. Therefore, the activity was not only a marginal one. In this respect, it had to be taken into account that the transaction threshold is intended to cover those cases previously excluded from merger control as the target company has not (yet) achieved noteworthy sales figures while nevertheless showing great economic and competitive potential. Since this potential is not reflected in the low sales figures, examining the sales figures in such cases thus fails to provide an adequate benchmark. In non-English-speaking markets such as Germany, Honey is still establishing its business. At the time of the decision, the company had not developed a German-language browser extension and had not introduced a number of functions in Germany. Consequently, the company had not been very active in encouraging its business in Germany. Especially the fact that Honey was nevertheless able to convince a relatively large number of Germany-based users of its service and to

¹⁴ Bundeskartellamt/BWB, Guidance on Transaction Value Thresholds for Mandatory Pre-merger Notification, para. 3.

¹⁵ Bundeskartellamt, B6-86/19, Decision of 17 December 2019, Case Summary of 31 March 2020, p. 1.

¹⁶ Ibid. p. 2.

acquire considerable funds from venture capital funding in several rounds of financing between 2014 and 2018 showed the company's considerable economic and competitive potential.

24. Especially internet-based business models such as those implemented by Honey are usually characterised by a high degree of scalability and can often be rolled out very quickly in additional markets at reasonable cost. This applies particularly to the internet services provided by Honey; its transaction platform offers services free of charge (to users) on the one side and services for a charge (to retailers or affiliate networks) on the other side. It could be assumed that both sides are significantly affected by indirect network effects since the retailers benefit from a large number of users and the users also benefit from a large number of available promotional codes and participating retailers. During the first year of operations in Germany, Honey was already able to considerably increase the number of active users. It could be expected that the quicker both market sides of the service grow, the better Honey would be able to finance its service in the long term. Therefore, transaction platforms are often monetised on a larger scale only years after entering a market. During the first years following the market entry, the figures of such services usually do not reflect the competitive potential.¹⁷

25. Lastly, when evaluating the exact number of users to draw conclusions as to whether the company's activity in Germany is substantial, it had to be taken into account that the target company is active on a rather young market which is still developing and growing fast. Honey's users who had already signed up in Germany were likely to constitute a significant part of the still young market. In this case, the considerable number of partnerships with German retailers was also a reason to assume that the company's activity in Germany was substantial.

26. At the same time, due to the existence of a broad range of competitive constraints on the relevant markets and the lack of horizontal overlaps, the transaction could be cleared without an in-depth investigation.¹⁸ Despite PayPal's relatively strong market position in the market for internet payment methods, the merger was not expected to significantly impede effective competition. The main reason for this was that a number of fast growing payment service providers have emerged, such as Klarna, WireCard or Adyen. In addition, with Apple Pay and Google Pay having been launched in the recent past, two companies with significant resources and a very large user base had entered the market; it could be expected that they would be able to reach a position in which they can trigger strong network effects. Therefore, there was no reason to expect any vertical or conglomerate effects arising from this market, such as market foreclosure or bundling practices, or the transfer of market power to third markets.

5. Conclusions

27. From a competition policy perspective, killer acquisitions require preventive merger investigation above all in order to protect the potential for innovation and competition as a key factor for economic growth. Adequate merger notification requirements are therefore essential for authorities to meet new concerns.

28. Irrespective of the statutory evaluation of the German transaction value threshold to be carried out in 2020, it can already be seen that the number of additional notifications

¹⁷ Ibid. p. 3.

¹⁸ Ibid. p. 4.

resulting from the new provision is only in the single-digit range, which is why the legislator's assumption in this regard has proven to be correct.¹⁹

29. A transaction value threshold introduces the obligation to notify acquisitions with regard to which the turnover generated by the target does not reflect the case's importance for competition. This enables enforcers to examine cases that may turn out to be killer acquisitions or otherwise detrimental to competition, especially in innovative industries. However, the Bundeskartellamt has so far not had to deal with a critical case notified due to the transaction value threshold.

30. A transaction value threshold does not replace a thorough competitive assessment or solid theory of harm; but it can ensure that the focus of merger control is extended to include takeovers of low turnover unicorn firms in their infancy.

¹⁹ Bundeskartellamt, Activity Report 2017/2018 (only German), p. VII.