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Behaviour Remedies to Address Concerns Deriving from Horizontal Overlaps – Illinois Tool Works/MTS Systems

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On 18 November 2021, the China competition authority State Administration for Market Regulation (“SAMR”) released the decision that the acquisition of Illinois Tool Works Inc. (“ITW“) over MTS Systems Corporation (“MTS“) is conditionally approved (the “Decision”) [1]. It is the third merger case cleared with remedies by the SAMR in 2021. But what is eye-catching is not just due to the fact that it is a high-profile merger in the industrial manufacturing industry, but that the SAMR’s adoption of a portfolio of pure behaviour remedies to address the concerns primarily out of the parties’ horizontal overlap in this transaction.

Case background and the SAMR’s Decision

ITW – a global manufacturer of industrial products and equipment – and Amphenol Corporation (“Amphenol”) – a global provider of high-technology interconnect, antenna and sensor solutions – entered into an agreement in January 2021, under which ITW planned to acquire MTS’ Test & Simulation Business (ITW and MTS jointly referred as the “Parties“) (“Transaction” or “Case“), following Amphenol’s acquisition of MTS in early 2021. [2]

The SAMR was notified on 11 March and had this case filed on 21 April. After an around 211-day-long review period, the SAMR cleared the Case with conditions on 18 November. The SAMR defined four relevant product markets in this Case: (i) Ground vehicle durability test equipment; (ii) Static material testing equipment; (iii) Electric mechanical material testing equipment; and (iv) High-end electro-hydraulic servo material testing equipment (“High-end ESMT Equipment”). According to the Decision, the SAMR identified that the relevant High-end ESMT Equipment market, to which the geographic market is defined as China, would give rise to severe competition concern deriving from the horizontal overlaps between the Parties.

According to the Decision, in 2020, the market shares of MTS and ITW in the Chinese market for the High-end ESMT Equipment market were 40%-45% and 25%-30%, respectively, with a combined market share of 65%-70%. The Transaction would cause an increase of the HHI index from 2,286 to 4,946, generating an incremental of 2,660, thereby greatly enhancing the market concentration. The SAMR also deemed that the Transaction would eliminate the head-to-head competition between the Parties that competed at the same latitude and frequently appeared in the same bidding process pre-Transaction in China and would significantly weaken the bargaining

power of downstream customers.

As a result, the Case was approved by the SAMR with four conditions of behaviour-remedy nature, namely: (i) Continue to fulfil existing contracts with Chinese customers involving relevant products/services; (ii) Continue to maintain service quality for Chinese clients not inferior to the pre-Transaction situation; (iii) Ensure the prices of relevant products/services not exceeding the average price under comparable conditions of the pre-Transaction situation; and (iv) Ensure of no delay of supply, no unreasonable trade conditions, no degradation of products quality or technological level and no reduction of service level in other aspects, unless with justifications.

It is observable that in this Case, albeit SAMR identified concerns mainly out of horizontal overlap between the Parties, but the decision for behaviour remedies which is not in line with a customary preference over structural remedies (e.g. divestiture, hold-separate of business) to address such kind of concerns.

Preference of structural remedies for concerns from horizontal overlap

Competition authorities display an overt preference over structural remedies, particularly for concerns arising from the horizontal overlap. Such preference can be attributed to the fact that *”Structural remedies are clean and certain, effective, and avoid ongoing government entanglement in the market”*[3, page 13], contrary to the implementation of behaviour remedies that aim to restrain the parties’ future behaviour requiring the competition authorities’ continuous monitoring for a given period of time [4, page 11].

The past Chinese conditionally-approved cases provide a clue of the China competition authority’s preference over structural remedies for addressing concerns from horizontal overlap. Looking through these 52 conditionally approved cases, it can be observed that almost all of mergers giving rise to concerns from horizontal overlap were remedied by structural remedies (including divestiture and hold-separate of business reliefs), with a very few of exceptions (discussed below) [5, 6].

Likewise, the EU explicitly expresses that *”Divestiture commitments are the best way to eliminate competition concerns resulting from horizontal overlaps“* [7, para 17]. With regard to the practice in the EU, 63% of the European Commission’s remedied merger cases were equipped with pure divestiture remedies in 2020 (with a rate of 66% in 2019) [8, page 2]. In the US, the *2020 Merger Remedies Manual* specifies that *“Structural remedies are strongly preferred in horizontal and vertical merger cases”*, [9, page 13] and *“Tailored conduct relief may be useful in certain circumstances to facilitate effective structural relief”*[10, page 14].

It is well witnessed from the above that structural remedies have been deemed as preferable and appropriate to address concerns resulting from horizontal overlaps in the merger case.

Why were behaviour remedies opted for addressing horizontal overlap-generated concerns in ITW/MTS?

(1) No appropriate buyer?

The success of a structural or divestiture relief largely relies upon the buyer that needs to have the competence to run the to-be-divested business effectively, competitively, and viably. According to the Decision, in the China High-end ESMT Equipment market, MTS and ITW's market shares were 40-45% and 25-30%, respectively, pre-Transaction, with a combined market share of 65-75%, way ahead of their competitors. In addition, the Parties' prominent market position in the China High-end ESMT Equipment market is also indicated in the SAMR's rationale used to define the relevant geographic market as China. Given that Parties' host equipment equipped with complete accessory functions, the Parties' longstanding strong position in the China market and the China market's features of having limited size and needing high cost to build a sales service team, there is nearly no foreign competitors that can exert effective competition constraints over them. In light of the above, we can infer that, in the China High-end ESMT Equipment market, no domestic or foreign competent competitors can match the Parties, and therefore, at least in this market, it may be a tough task to identify a feasible buyer.

However, scouting the past cases that were imposed with a divestiture remedy by the China competition authority, where the concerned undertakings to the transactions similarly had left their competitors far behind and the barrier to enter the relevant Chinese market was also recognised as high (e.g., *Danfoss/Eaton* (2021), *Abbott/Laboratories* (2016), *Baxter/Gambro* (2013)), a divestiture remedy was not cast away. Furthermore, even if a proper buyer could not be identified for the High-end ESMT equipment business/assets of the Parties, there is a particular structural remedy – hold-separate of business to require the parties to the transaction independently run their business for a certain period of time – that is frequently favoured by the China competition authority to address concerns from horizontal overlaps, as in *II-VI/Finisar* (2019), *Cargotec/TTS Gruppen* (2019), *ASE Group/Siliconware Precision* (2017). As such, it is not convincible that not being able to identify an appropriate buyer could amount to resulting in the SAMR switching its propensity from structural remedies to behaviour remedies to address concerns out of horizontal overlaps.

(2) No viable ways to divest assets in China?

If not be viable to divest relevant business and/or assets of the Parties in China, it may not be appropriate to determine the structural remedies for the Case and therefore impel the SAMR to opt for behaviour remedies. A conjecture is that the relevant business or assets of the Parties' High-end ESMT Equipment may not physically exist in China, or are not appropriate to divest.

The previous practice of the China Ministry of Commerce ("MOFCOM", the former China antitrust authority) in *Bayer/Monsanto* (2018) may provide some reference as regard this. [11] One of the competition concerns lay in the horizontal overlap between the parties' businesses in digital agriculture, as to which the MOFCOM was concerned that the merger would adversely affect competition in the novel digital agriculture market. In order to address such concern, the MOFCOM obliged the parties with a behaviour remedy: To give all of the Chinese agricultural software application developers access to interoperate and use their digital agriculture platform under fair, reasonable and non-discriminatory terms within five years *after* the parties' digital agriculture products enter the Chinese market. The behaviour remedy in *Bayer/Monstanto* implies that at the time point of the merger, the parties' digital agriculture products had yet entered the

Chinese market. This fact rendered a divestiture remedy not practical but a behaviour remedy that would constrain the parties' future conduct when they would their digital agriculture products in China more suitable. Likewise, if there are no assets/facilities of the High-end ESMT Equipment of the Parties in China, in particular when the High-end ESMT Equipment's geographic market is defined as China, a divestiture remedy may not fit for the Case.

MTS, as identified by the SAMR the first ranked competitor in the China High-end ESMT Equipment market, runs its industrial test & simulation business through its subsidiary MTS Industrial System (China) Co., Ltd. and affiliates (jointly as "MTS China Subsidiaries") in China. According to the registered business scope on China National Enterprise Credit Information Publicity System, for the industrial test business, MTS China Subsidiaries focus on relevant assembly, sales and sales services, [e.g., 12, 13] seemingly more like a sales point. We may speculate that if MTS did not operate major manufacturing sites for its High-end ESMT Equipment in China, it may be less feasible for the SAMR to adopt a divestiture remedy against it.

ITW operates its industrial test business in China through its subsidiary ITW Test & Measurement (Shanghai) Co., Ltd., which engages in R&D, manufacturing, and sales. Nevertheless, the relevant product High-end ESMT Equipment does not appear to constitute its top featured product in China and, a prominent market position of the ITW's High-end ESMT Equipment as stated in the SAMR's Decision could not be substantiated via public source. Presumably, a moderate business may be less appealing to constitute a divestiture portfolio either in eyes of the authority or of the buyer.

(3) Pressure from stakeholders?

It is observable that in China's merger control, the SAMR's focus is always placed in the China market, and on some occasions, the pressure from stakeholders such as downstream industries could prompt the SAMR to pursue a more stringent review approach. As in *Infineon/Cypress* (2020, China), the transaction was only subject to remedies for the clearance in China but unconditionally approved in other major jurisdictions (e.g. the US and EU), and in *Qualcomm/NXP* (2018), the transaction was abandoned by the parties after failing to secure the Chinese merger control approval though then it had been conditionally approved by the European Commission. One of the perceivable explanations for the dichotic outcome of such cases in China and other jurisdictions could come down to the opposition from downstream industries and other stakeholders.

In this case, the SAMR pointed out the high barrier to entry to the China High-end ESMT Equipment market and the dependence of the downstream customers on the High-end ESMT Equipment hindering them to switch to the low-end product. What's more, the behaviour remedies imposed in this Case show a propensity to ensure a stable supply to the downstream customers. It is thus very likely that the voices from the downstream industries have played an important part in the remedial outcome. It is also worth noting that, this Transaction has not been remedied in other jurisdictions. Under such circumstances, if the case needs to be remedied in China, the behaviour remedy is observed more likely to opt.

The ITW/MTS (2021) could be counted as the first case in China which, according to the Decision, gives rise to concerns merely from the horizontal overlaps between the Parties but is ultimately

subject to pure behaviour remedies determined by the China competition authority. Albeit it is not able to draw a one hundred percent-certain conclusion of the rationale of the SAMR in doing, with the above analysis, this article is of the hope to shed light on the behind consideration of the SAMR to adopt pure behaviour remedies to address concerns out of horizontal overlaps under the China merger control scheme.

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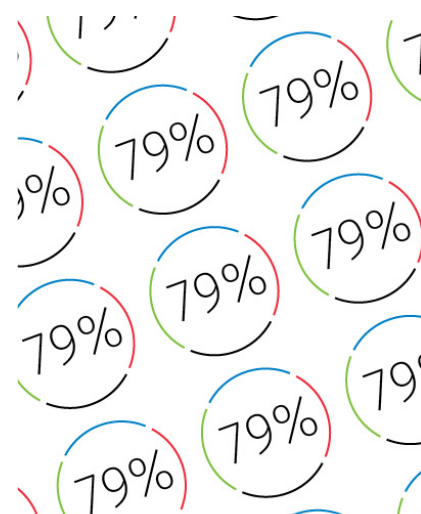
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