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Barriers to entry for black industrialists - the case of Soweto Gold's entry into beer

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Introduction

21 years after the advent of democracy, arguably the most notable commentary on South Africa's economy is how little the structure of ownership has changed. The post-apartheid government has introduced many policies to try to shift the economy onto a different growth path, with limited success. There continues to be a strong path dependency where markets are structured and shaped by previous investment decisions, state interventions and entrenched interests.

With the industrial policy focus now on re-industrialisation and the recent launch of the DTI's "Black Industrialists" programme, it is pertinent to re-visit the debate about how to achieve broader participation in the economy. The NDP and other policy documents refer to the need to reduce barriers to entry but little information is

available about the hurdles facing black entrepreneurs.

A recent CCRED case study reviewed the experience of an entrant in the beer industry to understand the challenges faced by an emerging player with the required knowledge and capabilities in a sector with dominant incumbent firm.¹ This brief draws together the main findings and considers the implications. It uses the case study to reflect on the efforts of policy makers, regulators, and the competition authorities to "*provide all South Africans equal opportunity to participate fairly in the national economy*", as set out in the Competition Act.

Soweto Gold is the first venture into commercial-scale malt beer brewing by a black South African business, following the failed venture in 1994 by Vivo, a brand produced by National Sorghum Breweries. Soweto Gold represents one category of

¹ This research was funded by National Treasury. It is reported in CCRED working paper 2015/11, www.competition.org.za

the firms that the National Liquor Act had in mind when the bill was drafted to encourage increased participation from historically disadvantaged individuals. The firm was started by a black entrepreneur who now holds a 51% stake in the business. However, Soweto Gold and all but one of the entrants in the beer market since the 1990s operate as craft brewers (a niche segment) and the mainstream beer continues to be highly concentrated.

Evolution of the beer industry

The South African beer industry is an apt example of a concentrated market. This has as much to do with the history and past regulation of the industry as with the economics of brewing. Beer brewing is about scale economies in production, distribution and marketing. In fact, scale in advertising is such an important factor in the economics of brewing that it has led to consolidation in many markets. In South Africa the industry structure was arrived at more deliberately by agreement between liquor industry players. It was agreed that SAB would take control of beer brewing and RK investments (Rembrandt and KWV) would take control of wine and spirits. Past regulation was also in place to prohibit Africans from producing and obtaining liquor.

A review of the liquor industry by the first post-apartheid government acknowledged the industry structure and racial bias in ownership and recommended vertical separation to facilitate opportunities for entry and transformation. However, the National Liquor Act did not in the end

ensure vertical separation in contrast with the vertical separation of the beer value chain in other jurisdictions, such as in the USA, which facilitated the growth of entrants.

Instead, in South Africa SAB headed-off recommendations for vertical separation and offered to establish various BEE programmes, including the appointed distributor programme. In a subsequent competition case relating to the position of appointed distributors vis-à-vis

independent distributors (where the arrangements were found not to contravene the Competition Act) the evidence during the proceedings illustrated the strategic barriers created by incumbent firms. For example, SAB documents noted that the appointed distribution system design *“provides a barrier to entry for competitors”*.² Entrants have to struggle to duplicate SAB’s distribution network or find alternative less efficient distribution channels. SAB is able to reap all the scale advantages for itself.

Craft beer is capturing tastes and allowing for entry below minimum efficient scale, however, it makes up a small proportion of the market. There are 89 craft beer brewers in South Africa, which together hold less than 1% of the total beer market.

Soweto Gold’s experience

Soweto Gold was started in 2013 by an experienced master brewer who had worked at both SAB and Brandhouse. It supplies various craft beers and Soweto Gold premium lager, its flagship brand,

² Competition Tribunal South Africa Judgement. (2004). “Competition Commission vs SAB”, case no. 134/CR/Dec07

which could compete with SAB and Brandhouse.

Soweto Gold initially struggled to find funding but was eventually part-funded by the IDC, through the Agro-processing Competitiveness Fund (a fund created as part of the settlement between the Commission and Pioneer Foods).

In 2013, the beer was toll manufactured and canned by Nottingham Road Brewery. Ubuntu Kraal Brewery, in Soweto, was built in 2014. At the time that the paper was concluded, Ubuntu Kraal did not have bottling capability and was sold only in kegs in bars and restaurants. Though Soweto Gold has grown over the years it is still operating below capacity.

Barriers to entry

The study identified the two main challenges that Soweto Gold faced as an entrant:

- access to outlets; and
- routes to market.

The incumbent firms offer fridges on loan to taverns and some bars and other incentives in exchange for exclusive use. There are also exclusivity provisions for draft beer (which especially inhibit smaller breweries who do not have bottling facilities). The incentives (discounts, merchandise) are provided to bars in exchange for the display and bar space. Smaller entrants cannot match this offering and therefore are unable to access certain outlets. This was part of the Commission's inducement case referred to the Competition Tribunal however it was thrown out on legal grounds as the referral was broader than the initial complaint. Access to outlets is an important factor as exemplified by various competition complaints internationally regarding

conduct by dominant firms that limits access by entrants.

SAB-Millar itself as the smaller rival laid a similar complaint in Mexico, where there was a resolution in its favour. Similar cases were settled by Coca Cola Beverages in Singapore and Chile, where it was agreed to amend supply agreements to allow rival drinks to be stocked in its fridges. Soweto Gold has faced ongoing obstacles in marketing its beers to taverns in Soweto due to arrangements between the taverns and the incumbent liquor producers.

In terms of routes to market, Soweto Gold initially struggled with distribution of the product as well as marketing. The macro brewers are vertically integrated through to distribution. Alternative distribution channels were used which work for the craft business but will pose a challenge once they enter the mainstream market.

Broad lessons

In South Africa, entrants will typically be up against well-entrenched incumbents. Successful entry requires being able to bring together a number of things including production capabilities, finance, branding, marketing and distribution. Without strong, even affirmative, competition enforcement these markets will not be effectively opened up to entrants.

The case of Soweto Gold illustrates the challenges where the capabilities exist and even where the finance has been made available. Under the requirements of the standard development funds of the IDC, Soweto Gold would not have been financed, however, it was able to access the concessionary finance from the Agro-processing Competitiveness Fund (Agri-Fund). Finance for rivals or 'challengers'

needs to be provided on a basis which allows for the time to establish the business and build a brand and market presence.

Often incumbents are vertically integrated, further raising entry barriers, and providing opportunities for strategic behaviour. These incumbents have substantial lobbying ability, including to influence regulations in their favour. If South Africa is to achieve increased participation then policy and regulation needs to balance the interests of incumbents and entrants.

For example, it is imperative for competition policy in developing economies like South Africa with skewed economic power to play a dual role of uplifting disadvantaged agents as well as setting rules for free and fair competition. The abuse of dominance provisions and their interpretation by the courts have given little if any consideration to the former.

The study has illustrated that transformation has been very limited. Transformation of production and supply raise fundamental questions about the extent to which regulations and policies should proactively support entrants. In this regard, study identified three regulatory gaps:

- the competition authorities' failure to address market power;
- the failure for the National Liquor Act to ensure vertical separation and access by smaller producers to distribution and retail; and,
- slow progress in transformation and diversity of ownership with regards to the objectives of the NLA.

The Liquor Act was recently amended to address the lack of progress with regard to transformation, amongst other changes. The proposed enforcement of the BBBEE

codes, requiring licencees to comply with the codes, is however unlikely to change the structure of the market as it primarily relates to ownership of existing firms and not opening up opportunities to small rivals.

Policy Recommendations

First, the provisions regarding anti-competitive conduct in the Competition Act should be amended to give effect to the objectives of the Act, which encompass both economic efficiency and equitable opportunities, understood in the context of the history of South Africa. This can be achieved by replacing separate the specification of conduct with a broad framing of exclusionary conduct, following EU and most jurisdictions. This recognises that firms are likely to pursue multiple exclusionary strategies that may evolve over time.

Key factors to be taken into account in competition assessments could be specified (as they already are for merger evaluation) as part of structured rule of reason, to include the following:

- Considering how the dominant incumbent firm acquired its position;
- Enhance the inquisitorial powers of Tribunal in remedies and in directing hearings. This reduces the burden of poorly resourced complainants in an adversarial process that favours firms with deep pockets.
- Consider removing the “substantial lessening or prevention of competition” standard in sections 5 and 9 of the Act. Other jurisdictions simply require that the conduct “prevents, distorts, or restricts competition”.

Second, the National Liquor Authority must recognise the importance of access to the

retail network for the success of liquor entrants and should include vertical separation in the amendments to the National Liquor Act. Vertical separation will give entrants access to other levels of the value chain and thus reducing the burden of entering at multiple levels. It has been successful in supporting entry in countries like the United States of America.