MOFCOM Lifts Many, But Not All, Hold Separate Requirements Previously Imposed as Conditions to Clearance of Hard Disk Drive Deals

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Over three years ago, MOFCOM conditioned its clearance of two hard disk drive transactions on unprecedented hold separate remedies which precluded realization of many of the synergies and cost savings that the transactions were designed to achieve. MOFCOM now removes some of these restrictions, allowing the parties belatedly to capture some of those efficiencies.

Summary

This week, China's Ministry of Commerce (MOFCOM) lifted some of the worldwide hold separate conditions on Western Digital's 2012 acquisition of Hitachi's hard disk drive ("HDD") business and Seagate's 2011 acquisition of Samsung's HDD business, citing a changed competitive landscape and acknowledging that merger integration would facilitate synergies and reduce costs. MOFCOM allowed the companies to integrate production and research & development for their acquired businesses. But MOFCOM left in place (for two more years) significant hold separate requirements applicable to the sales forces of Western Digital and Hitachi GST.

Western Digital/Hitachi GST

In March 2012, MOFCOM **conditionally approved** data storage drive manufacturer Western Digital's acquisition of Hitachi GST (now "HGST"), then a subsidiary of Hitachi. The agency concluded that the transaction would remove a key competitor in an already concentrated global market for hard disk drives. In contrast to U.S. and EU authorities who imposed a more traditional structural remedy (divestiture of 3.5-inch HDDs), MOFCOM imposed a broad hold separate behavioral remedy. MOFCOM required that HGST's hard drive disk business be operated as an independent competitor on a worldwide basis. Under the supervision of a monitor, Western Digital was required to:

- ensure that HGST products are independently manufactured, priced, and marketed;
- refrain from exercising its shareholder rights in HGST in an "anticompetitive" manner;
- maintain independence between the two entities' research and development groups; and
- establish firewalls to prevent the transmission of competitively sensitive information between the two entities.

MOFCOM's ruling provided that Western Digital could apply in March of 2014 for relief from these conditions to clearance and Western Digital filed its application for relief at that time.[1] Western Digital

[1] MOFCOM did not immediately take up Western Digital's application because it was investigating the company's compliance with the hold separate remedy. MOFCOM found two violations (warranting a fine of $47,400 each): (1) Western Digital reorganized the (*cont.*)

claimed that relief from these hold separate requirements would allow it to save $100 million in operating expenses per quarter and that it was unable to respond to changing market conditions because of these requirements.[2]

Eighteen months after this application was filed, MOFCOM responded. The agency concluded that changed competitive conditions had reduced the need to maintain all of the previously imposed hold separate conditions:

- Solid-state drives have become a stronger competitive constraint on traditional hard disk drives, and the trend would likely continue.
  - Data showed that solid-state drive prices had dropped and output had increased, and third-party analysis indicated that lower gross product margins for hard disk drives were attributable to the increasing constraint of solid-state drives.
  - Customers like Apple, Lenovo, Dell, and Hewlett-Packard had boosted their use of solid-state drives.
  - Major solid-state drive makers had increased their R&D efforts for more high-performance, high-capacity hard disk drives for corporate customers.
  - Industry projections predict that solid-state drives will grow faster than expected.
- Capacity utilization in the traditional hard disk drive industry has fallen (to approximately 80%) since 2012 and will likely fall further (particularly amid substitution by solid-state drives). This reduced the risk that competitors could unilaterally or collectively restrict competition.

MOFCOM acknowledged that the hold separate conditions inhibited Western Digital/HGST as a competitive force: "The remedies have led to the inability of Western Digital and HGST to provide a full range of products, as well as increased costs and weakened R&D arising from separation of production and R&D activities, therefore stopping them from fully engaging in competition and hindering their clients' product procurement."[3]

Despite these findings, MOFCOM concluded that certain hold separate conditions must remain in place. The agency noted that Western Digital/HGST remained a strong competitor, with 47% of sales in traditional hard disk drives (50% of hard disk drives for certain applications). And the agency stated that the competitive constraint of solid-state drives was not strong enough to offset the potential anti-competitive impact on customers' bargaining power in the bidding and pricing process if full integration were permitted.

Accordingly, MOFCOM decided the companies' sales teams and product brands must be kept separate for two more years. Specifically:

- Each company's sales force must sell that company's products under the original and any future brands, and approach customers, conduct bidding, set prices, and make other decisions (including hiring and firing) independently.

(*cont.*)

corporate form of Hitachi's U.S. hard disk drive business to be Western Digital's wholly-owned subsidiary in March 2012; and (2) Western Digital dissolved HGST's development division and transferred some employees to work for Western Digital in January 2013.

[2] Western Digital Corp., FQ3 2015 Earnings Call Transcript, S&P Capital IQ (Apr. 28, 2015).

[3] Regulatory Authority Press Release (Translated)) Confirmed, "Western Digital/HGST: MOFCOM partially removes hold-separate remedies (full translation)," PaRR (Oct. 19, 2015), at **http://app.parr-global.com/intelligence/view/1316454?src_alert_id=63113**.

- The two sales forces must each have a vice president reporting to a single senior sales vice president, who will set separate sales targets for each sales force. The two sales forces may not use shared facilities, and cannot cooperate in marketing and project development.
- The sales forces are allowed to each sell the combined firm's full range of storage products, including desktops, laptops, and corporate-level solutions.
- Western Digital may not qualitatively change its previous business model or force directly or indirectly its customers to purchase hard disk drives exclusively from Western Digital.
- Western Digital must continue its current pace of investing in product innovation.

Seagate/Samsung HDD

On the same date as its Western Digital/HGST ruling, MOFCOM agreed to lift all hold separate conditions imposed on Seagate Technology's $1.4 billion acquisition of Samsung's HDD business in 2011.

As in its later Western Digital merger clearance, MOFCOM had required that Seagate operate Samsung HDD as an "independent competitor" on a worldwide basis, with independent pricing, sales activities, production, and R&D. MOFCOM additionally required that Seagate expand Samsung HDD's capacity and then maintain productivity levels, including setting "reasonable" output targets based on market forces of supply and demand (with such targets reportable on a monthly basis to a monitor). Seagate was allowed to apply for relief from these conditions one year after implementation.

In ruling upon Seagate's application to be relieved of these conditions, MOFCOM again noted that (1) solid-state drives had become a stronger competitive constraint on traditional hard disk drives; and (2) the overcapacity problem was worsening for the traditional hard disk drive firms.

MOFCOM concluded that Seagate and Samsung HDD had relatively small areas of product overlap. The agency stated that Samsung HDD mainly sold hard disk drives for laptop or portable application, which faced greater substitution from solid-state drives, and its profitability and competitiveness were relatively low. The combined firm's share of traditional hard disk drives is 6.5% (the smallest among industry players), and its share for portable applications is 26% (close to other competitors).

Presumably based on these findings, MOFCOM decided to completely remove the hold separate requirements of its initial order, including the prohibitions on integrating sales forces which it left in place in its contemporaneous Western Digital/HGST ruling. The agency also lifted the requirement for Seagate to maintain production capacity, set "reasonable" production targets based on market supply and demand, and report such targets to a monitor monthly.

But MOFCOM additionally noted that Seagate is a key HDD player, holding an approximately 30% share across all hard disk drive segments and 40% of hard disk drives for certain applications. Perhaps for this reason, MOFCOM left in place other conditions prohibiting Seagate from materially changing its business model, requiring customers to purchase hard disk drives exclusively from the company, or limiting supply of an input to rivals. MOFCOM also required Seagate to maintain recent levels of investment in innovation. MOFCOM put a two-year time limit on these conditions, which initially had no deadline.

Key Takeaways

- MOFCOM's decision several years ago to impose broad hold separate remedies in the HDD cases, in addition to the narrow structural relief favored by the U.S. and EU, has been criticized as unnecessarily harmful to the achievement of procompetitive benefits of mergers which involve costs savings and other efficiencies.
- With these two recent decisions, MOFCOM has shown a willingness to reconsider whether such remedies are still necessary several years after the transactions have been consummated.

Nevertheless, at least in the Western Digital/HGST ruling, the agency remains unwilling at this time to remove some conditions which would yield significant synergies and cost savings.

- Although the antitrust head of the agency has indicated a willingness to reconsider whether hold separate remedies are practicable after MOFCOM gains more experience with them, it remains unclear whether it will impose hold separate conditions in future transactions. In many deals, the valuation of an acquisition target depends upon the achievement of cost savings and synergies. Hold separate conditions may postpone or block these costs savings and synergies. Accordingly, this is an area which should be watched closely going forward.

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