Cendant Corporation
and
RAC Holdings Limited

A report on the merger situation

MONOPOLIES AND MERGERS COMMISSION

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Presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty
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[1]These members formed the Group which was responsible for this report under the chairmanship of Mr P G Corbett.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests.

The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.

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Part I

Summary and Conclusions

1 Summary

1.1. We were asked to investigate the proposed acquisition of RAC Motoring Services Limited (RACMS), the former motoring services arm of the Royal Automobile Club (the Club), by Cendant Corporation (Cendant), a US company (see Appendix 1.1 for our terms of reference).

1.2. RACMS's principal business is the provision of insured breakdown services for light vehicles. Its forecast revenue for 1998 is around £300 million and its breakdown services operation covers some 5.5 million vehicles. Most of its breakdown call-outs are dealt with by a directly employed, liveried patrol force and the remainder by a network of independent garage contractors.

1.3. Cendant was formed in 1997 by a merger between two quoted US companies, HFS Inc (HFS) and CUC International Inc (CUC). In that year it had sales of some $4.2 billion (£2.5 billion) (as restated following the accounting adjustments referred to in paragraph 1.11). Its operations derived from HFS consist primarily of managing a portfolio of consumer brands in the hotel, travel and property industries, the businesses themselves being largely operated by franchisees. The former CUC business is known as alliance marketing and chiefly involves the marketing of portfolios of products and services to the members of different programmes. Soon after the merger between HFS and CUC, Cendant acquired the UK company National Parking Corporation Limited, which owns National Car Parks Limited and Green Flag Group Limited (Green Flag), a breakdown organization.

1.4. In April 1998 the RAC group put RACMS up for sale. After an auction which attracted a good deal of interest, Cendant emerged as the preferred buyer and on 21 May it was announced that Cendant had agreed to acquire RACMS for £450 million. In order to effect the sale in a tax-efficient way the RAC group reorganized itself. It set up a new holding company for RACMS, RAC Holdings Limited (RAC Holdings), the shares in which were distributed to the 12,000 full members of the Club. In August 1998 the members of RAC Holdings voted to approve a scheme of arrangement providing for the share capital of the company to be sold to Cendant. The scheme of arrangement is subject to satisfactory clearance by the competition authorities.

1.5. We consider that the supply of insured breakdown services for light vehicles in the UK is a single economic market. There are, however, significant differences between the various sales channels:

(a) direct retail, where breakdown organizations sell directly to individuals: these sales have been falling as a proportion of the whole market but still represent over 70 per cent of total sales revenue;

(b) intermediary schemes, where an intermediary body buys breakdown services wholesale from a breakdown organization and sells them to its customers or members on an unbundled basis;

(c) so-called mandatory schemes, where a financial institution buys breakdown services wholesale and sells them to its customers bundled with motor insurance;

(d) motor manufacturer schemes, where a motor car manufacturer buys breakdown services wholesale and sells them to its customers bundled with the sale of a new or (less commonly) used car; and

(e) fleet sales, where a fleet operator buys breakdown services wholesale for the benefit of the users of its vehicles, whether externally insured or self-insured.

We see the first two of these channels, where the motorist chooses which product to acquire, as forming a distinct segment of the market, which we refer to as the discretionary segment. Of the non-discretionary channels we see motor manufacturer schemes and fleet sales as forming a single segment, with mandatory schemes as a separate small segment. The divisions are not always clear-cut, however; in particular, mandatory schemes have some features in common with intermediary schemes.

1.6. Estimates of market shares in 1998, measured by sales revenue, show that the Automobile Association (AA) is by far the biggest supplier with 48 per cent of total sales. RACMS is the second biggest with 29 per cent and Green Flag the third biggest with 12 per cent. None of the other suppliers has more than 3.5 per cent. Shares of the discretionary segment as a whole are similar but in direct retail alone the AA's share is even higher, 59 per cent, with RACMS on 29 per cent and Green Flag on 6 per cent. The AA, like RACMS, has its own patrol force but most other suppliers, including Green Flag, use only independent contractors to deal with call-outs.

1.7. The parties submitted that, in the direct retail channel, Green Flag was not an effective competitor to the two long-established, patrol-based operators. The merger would benefit competition by creating a stronger second force to compete with the AA. Cendant would preserve consumer choice by maintaining both the RAC and Green Flag brands. Moreover the market was dynamic: recent and prospective entrants were well placed to provide competition, and direct retail customers could switch to intermediaries to take advantage of their buyer power.

1.8. In our view Green Flag is an important competitive force in the discretionary segment and its loss as an independent third force would significantly weaken competition. Moreover RACMS has great strengths and we expect that, managed in a commercial manner, it will be able to compete successfully with the AA whether the merger goes ahead or not. Some of the other suppliers are potentially effective competitors in their chosen areas but in view of the history of the industry we do not expect that they would be able quickly to attain a position comparable with that achieved by Green Flag. The market is highly concentrated and the merger would make it more so. The merged group would in our view be able to dominate the intermediary sales channel. We expect that, in the longer term, the relationship between the AA and the merged group would become duopolistic and that their shared interest in maintaining a high-priced market would prevail.

1.9. We believe the merger would have effects in the mandatory segment broadly similar to those in the intermediary channel.

1.10. Motor car manufacturers, however, are in a strong position as buyers and there is an effective third force in the shape of Mondial Assistance (UK) Limited. We believe that fleet buyers would be able to seek out alternative sources of supply if necessary. We therefore have no major concerns about the merger's impact in this segment.

1.11. Shortly after Cendant was formed it discovered that there had been fraudulent accounting in former CUC businesses which had substantially overstated CUC's profits.

Cendant appointed independent investigators to look into the matter. It subsequently agreed with the US Securities and Exchange Commission that new accounts should be prepared covering 1995 to 1997 and these were filed at the end of September 1998. We have carefully considered the ramifications of these events. Whilst doubts remain as to the consequences of outstanding lawsuits, in our view these doubts are not such as to justify a conclusion that Cendant would be an unsuitable acquirer of RACMS.

1.12. We consider that the overall effect of the merger would be on balance to weaken competition and that this would have adverse consequences in the medium to long term. There is the prospect of some efficiency gains but the benefits are unlikely to be passed on to consumers. In any event they are, in our view, outweighed by the harm which the merger would cause to competition. We conclude that the merger would be against the public interest in that, in the supply of insured breakdown services for light vehicles, prices would be higher, service quality lower and innovation reduced compared with the situation which would otherwise exist. These adverse effects would apply in the discretionary and mandatory segments of the market, which together account for 85 per cent of total revenue from the supply of insured breakdown services.

1.13. We do not believe that there are any behavioural undertakings which could remedy the loss of the dynamic benefits of competition: the only adequate remedy is for RACMS and Green Flag to be kept in separate ownership. [

Details omitted. See note on page iv.

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1.14. We therefore recommend that before acquiring RACMS, Cendant should undertake to divest Green Flag, in a manner and to a party approved by the Director General of Fair Trading, such divestment to take place within six months of the undertaking being given. If Cendant is not prepared to give such an undertaking, the merger should be prohibited.