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BARRIERS TO ENTRY FOR BLACK INDUSTRIALISTS - THE CASE OF SOWETO GOLD'S ENTRY INTO BEER

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Abstract

The South African economy is characterised by concentrated industries, which pose particular challenges for the increased participation agenda. One such industry is the beer industry, where the competition authorities have failed to address market power and the structure of the industry continues to be shaped by past state interventions and entrenched interests. The case study uses the experience of Soweto Gold, a recent entrant, to illustrate the barriers to entry and expansion in the beer industry. The study highlights the new opportunities created by the niche craft beer segment of the industry and the interaction between the mainstream and craft brewing. The lessons that have emerged, are the difficulties that entrants face in getting product to market when the supply chain vertically integrated. The study also highlights some broader lessons for government support programmes, by illustrating the challenges where capabilities exist and finance has been provided.

JEL classification

L1, L2, L5, L66

[1] This draws on a research project paper co-authored by Fatsani Banda, Cornelia Matumba and Pamela Mondliwa.

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1 Introduction

One of the challenges facing the current government is achieving sustainable broad-based economic growth required for inclusive development. This requires the policy maker to balance the interests of incumbents and entrants. Reviews of South Africa's performance thus far have shown that the regime continues to favour incumbent firms. To change the growth path it is necessary to understand the specific experiences of firms and particularly entrants across the South African economy in order to understand the policy tools that can be used to facilitate entry. For this reason, the National Treasury has allocated funding to the Centre for Competition, Regulation and Economic Development to conduct a programme of research focused on barriers to entry and inclusive growth. This involves detailed firm-level case studies and sector studies to understand the reality of competitive interaction and the process of building productive capabilities, in concrete terms with the intention of formulating policy recommendations to assist in facilitating greater levels of entry and competition to drive growth This study is a component of the project and will review the experience of Soweto Gold as an entrant in the South African craft beer industry and the barriers to expansion into the premium beer market.

A review of the South African liquor industry conducted by the first post-apartheid government in 1997 found that the industry was characterised by a few companies with high levels of concentration and vertical integration. A new policy was drafted which outlined the government's plans to restructure the industry by unbundling assets to create opportunities for the economic empowerment of the historically disadvantaged individuals.[2] To this end, licensing was introduced and firms were barred from holding licences to operate in more than one level of the value chain. The licencing regulation was challenged on constitutional grounds and later redrafted to exclude retail licencing which is now under the control of provincial government and around that time the prohibition of holding more than one licence was also dropped.[3] This had very material implications, as we discuss.

Since 1997, there has been a formalisation of the beer industry with increased participation in certain levels of the value chain such as retail and to a certain degree distribution. However, the manufacturing level remains concentrated. The beer industry is still characterised by a virtual monopoly today as it was in 1997. SABMiller is the dominant player and its position in the industry is due in part to the large economies of scale in production, marketing and distribution. Literature has shown that where there are economies of scale, imperfect information and strategic behaviour by incumbent firms, entry can be deterred, leading to a lessening of efficiency and overall welfare (see discussion in Banda *et al*, 2015a). The case study explores how economies of scale and the behaviour of incumbent firms can increase barriers to entry by providing concrete illustrations of how entry/expansion has been restricted as a result of these factors. This is done by reflecting on Soweto Gold's experience as an entrant in the craft beer industry. The entry strategy of microbrewers has been to produce on a small scale and target premium local consumers. Soweto Gold, a more recent entrant, targets the middle class market which may be the stepping stone to the premium market.

The case study presents an opportunity to explore questions of increased participation in the South African economy and the extent to which policy is designed to achieve transformation. At the same time due to the nature of the beer industry, it allows for an illustration of the way that barriers to entry can influence the structure of a market. Beer brewing is interesting because it is representative of a traditional consumer goods industry in that firm success depends on marketing and efficient production. Entrants into the beer industry have to overcome challenges of achieving an efficient production, packaging and distribution infrastructure, ensuring reach into retail outlets and consumer awareness. In addition there is

[2] Government Gazette number 18135, 11 July 1997

[3] See the Competition Tribunal Decision in the matter of the Commission vs SAB and others, case number: 134/CR/Dec07 for further details.

a threat of a reaction by the incumbent beer producer. These are challenges that are characteristic of many fast moving consumer goods industries.

The research was conducted by means of desktop research, analysis of available data and primary data. The primary data was collated from interviews with representatives of Soweto Gold, SA Craft Beer, craft breweries, customers (retail outlets), Industrial Development Corporation (IDC) and the Department of Trade and Industry (DTI).

Section 2 gives a background to Soweto Gold and the beer industry in South Africa to contextualise the ease of entry and expansion. Section 3 assess barriers to entry and expansion in micro and macro brewing. First we assess the ease of difficulty with which Soweto Gold was able to enter the micro-brewing segment of the market and identify the challenges that may arise in expanding into macro-brewing. Each of these analyses focus on the critical success factors such as distribution, marketing, route to market and scale in the context of macro-brewing. In section 4, we conclude.

2 Background to Soweto Gold and the beer industry in South Africa

2.1 Background to Soweto Gold

Soweto Gold entered the South African beer market as a micro-brewery supplying various craft beers and a premium lager in 2013. The beer was initially brewed by Nottingham Road Brewery in KZN under license. Contract brewing is common in craft beer when breweries first enter. For example, Darling Brew beer was also produced at the Boston Brewery under licence when they entered the market. Soweto Gold is a brand produced by Madmead Brewing (Pty) Ltd a company started by a local entrepreneur, Ndumiso Madlala, a master brewer who had worked at SAB and Brandhouse. Ndumiso Madlala has established Madmead Brewing in partnership with Josef Schmid, an experienced marketing executive. Madmead Brewing was initially funded by its founding partners and investors to the value of R6.5 million. MadMead Brewing also received funding from the IDC to the value of R3.5 million. The company was registered in 2012 and commenced sales in 2013. In 2014, Soweto Gold opened the doors to its Orlando West brewery, Ubuntu Kraal in Soweto, with a production capacity of 2 million litres a year.[4] Soweto Gold has grown its volumes substantially since entry in 2013, when it was producing 2000 litres a week, to current production levels at 25 000 litres a week. The brewery is still only operating at 63% of total production capacity. The brewery currently employs 12 people on permanent contract and is committed to using contractors and suppliers from Soweto as far as possible. Ubuntu Kraal Brewery is the first brewery to be located in a township.

Soweto Gold has a portfolio of five brands including: Soweto Gold - Superior Lager, its flagship brand; Soweto Gold Lady; Liquid Gold Speciality Beer; Soweto Gold Apple Ale; and, Soweto Weiss Gold. Though the brewery has marketed itself as a craft brewery its flagship brand is a premium lager which should theoretically compete with SAB and Brandhouse premium lager brands. However, even this observation is dependent on one’s understanding of a craft beer. While some define a craft brewery as a brewery producing smaller volumes where there is constant human interaction during the production process, this definition has been conflated with that of a microbrewery. Though craft breweries are usually microbreweries it is not necessary for a microbrewery to produce craft beer. Soweto Gold happens to produce both craft beer and premium lager.

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

[4] http://www.sowetogold.co.za/#!our_story/c18bc

Breweries. MadMead Brewing Co. is a majority black-owned brewery venture. The entry into the beer market is what the DTI policy document had in mind when drafting the national Liquor Act of 2003. Have the market conditions, policies and regulations created a conducive environment for entrants like Soweto Gold to enter and grow in the beer industry?

2.2 Overview of the beer industry

The study is primarily concerned with the supply of beer as it gives an account of the experience of Soweto Gold, as a recent entrant as a micro-brewery producing various craft beers and a premium lager and the barriers to expansion into the mass market. However, as the success of fast moving consumer goods like beer is dependent on efficient production and accessing consumers it is important to understand the supply chain as well as the downstream distribution and marketing activities. The beer brewing industry in South Africa is made up of two main strategic groups, macro-brewers and micro/craft brewer. The macro brewers in South Africa are SAB and Brandhouse whose primary products consist of premium and mass market beers. The second strategic group is classified as micro- brewers and includes a variety of companies with small market shares. The macro and micro differentiation is based on scale of production, however micro and craft brewers overlap as a micro-brewers are unable to compete with macro-brewers in mainstream beer. The words craft and micro will be used interchangeably in the report going forward. Craft beer is considered as premium or super-premium by the market, has a higher retail price, and tends to have unique characteristics. Mainstream beer and craft beer differ in terms of quality and cost. While craft beer is typically only produced from malted barley to give it a stronger taste, mass market beer is produced from a combination of malt and maize to make the beer lighter and the flavour less intense. A craft brewery will use more malt than mass market beer which is mixed with maize, a cheaper grain than barley. Though mainstream brewers typically uses a pale ale for most of their beer, craft brewers also use imported speciality malts to achieve different notes in their beers. The differences in the combination of ingredients used mean that the cost of raw materials is higher for craft brewery than they are for mass market beer.

Economies of scale in beer brewing mean that costs do not increase proportionately to the rate that volume increases. For example, the cost of brewing a 500 litre batch does not differ significantly to that of brewing a 1000 litre batch (Heyns, 2015). Similarly, the cost of inputs, from the price of bottles and ingredients are also lower the higher the volumes purchased from suppliers. As such, the cost of producing a macro-brewed beer is significantly below the cost of beer brewed in a micro-brewery. In South Africa this cost is estimated at approximately R4 per 340ml unit inclusive of all costs, while a micro-brewer’s production costs are estimated between R12 to R16 (Heyns, 2015). So in essence, a mainstream brewery can sell to the consumer at a third of the price of a micro-brewery and potentially make more margin. These differences suggest that the dynamics in the two methods of brewing may be different. So are mass market beers and craft beer in the same market?

To establish whether two products pose a competitive constraint on each other economists use market definition to identify the products that are substitutes from the perspective of customers. A market definition encompasses a demand-side substitutability analysis to establish the extent to which customers could switch between two products in response to changes in relative prices, quality or other features and a supply-side substitutability analysis to establish whether suppliers of alternative products could switch their existing production facilities to make alternative products in response to a change in relative prices, demand or other market conditions.

The mechanism of competition in mass market beer is production efficiency and marketing. Craft beer brewers cannot compete with mass market brewers on either of these factors due to economies of scale. Micro-brewers regard the mechanism of competition in craft beer to be quality of product and marketing. Though both mass market and craft beer compete on marketing the marketing activities undertaken are different. While mass market brewers make use of mainstream media and sponsorships as its primary forms of marketing, craft beer brewers use viral marketing and beer festivals as the primary forms of marketing.

The discussion above shows that craft beer and mass market beer producers operate under different conditions and these different dynamics justify separate consideration.

Table 1: Macro vs Micro brewing

	Macro-brewing	**Micro-brewing**
No of players	2 (8 breweries)	89
Production capacity (total)	3.5 billion litres/a	15 million litres/a
Mechanism of competition	Efficient production, Marketing	Quality of beer, Marketing
Investment cost of greenfield plant	R3.5 billion (300 million l/yr)	R4 million (0.5 million l/yr)
Product	Mass-market and premium beer	Premium and super premium beer

Source: Compile by Authors

SABMiller produces all the top-selling beer brands in South Africa. These are, in order of market share, Carling Black Label, Castle, Hansa, Castle Milk Stout and Castle Lite. SABMiller's main rival, Brandhouse, began as a local joint venture between Namibian Breweries, Heineken and Diageo, in July 2004. The Brandhouse brands are Heineken, Amstel, Windhoek, Guinness, Kilkenny and Tafel Lager. Though Brandhouse has grown market its share since it has taken over its production and marketing of the Amstel brand, it still makes up less than 10% of the malt beer market. Together SAB and Brandhouse make up 99% of the total beer market.

There is great diversity among the craft brewers in South Africa. The craft brewers range in size from those that produce a few thousand litres a year targeting production for beer festivals to those that produce for the draught and bottled/canned products markets which tend to have larger capacity. The bigger breweries include the Cape Brewing Company (3 million l/a), Mitchell's (2.5 million l/a), Darling Brew, Jack Black, Boston (1.6 million l/a) and Soweto Gold (2 million l/a). In South Africa a micro-brewery by definition has a maximum capacity of 5 million litres per annum.[5]There has been a significant increase in the number of microbrewers in South Africa, however, they still account for a very small share of the market, less than 1% in South Africa (Swaminathan, 2014).

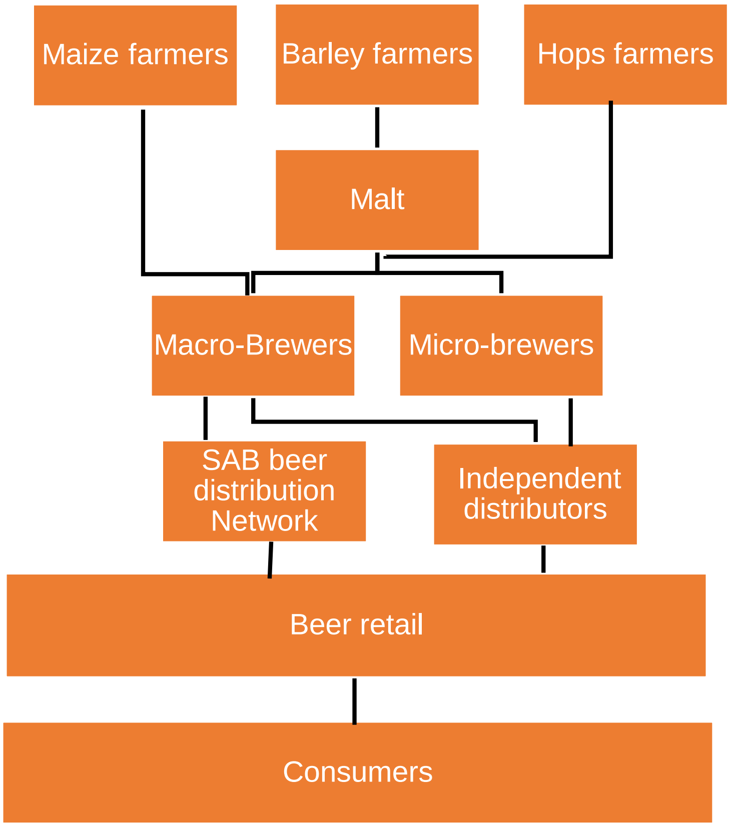
Craft beer in South Africa is typically priced at between R35-R40 for a draught. Packaged beer for off-premise consumption typically retails between R20 and R40 per bottle/can. An assessment of the cost of sales show that packaging is the biggest component of costs (Figure 5).

The main inputs in beer production are barley, hops, yeast and maize for most beer produced in South Africa. The barley is converted into malt which is processed together with the hops,

[5] Craft beer South Africa

maize and yeast by a brewer to produce the beer. The final product is then distributed to the various retailers which then sell the product to the consumer. The value chain is depicted in figure 1.

Figure 1: Beer Value Chain



Source: Authors illustration

Barley, maize and hops are the fundamental ingredients in the production of beer. Most of the malting barley produced in South Africa is procured by SAB Maltings, a subsidiary of SAB Miller. SAB Maltings also supports 150 emerging farmers in their production of barley, through the Taung Barley Farmers initiative. Malting barley is predominantly produced in the northern and southern Cape areas of South Africa by approximately 800 – 900 farmers (Truen et al, 2011).

Hops farming in South Africa is situated in the Southern Cape. Some of the farms are owned and managed by SAB and the remainder are owned by private producers who have long term contracts with SAB.[6] This contract system regulates the industry, protecting growers from over-production.[7] The farmers together produce approximately 850 tons of hops, 85% of which is procured by SAB and the remainder is exported to SAB-Miller breweries in the rest of Southern Africa (Truen et al, 2011). The volumes procured for local use are consumed by SAB and sold to third parties.

Other than maize which is more widely available, the main ingredients in the production of beer in South Africa are tied to the incumbent firm, SAB. Brandhouse, SAB's main competitor,

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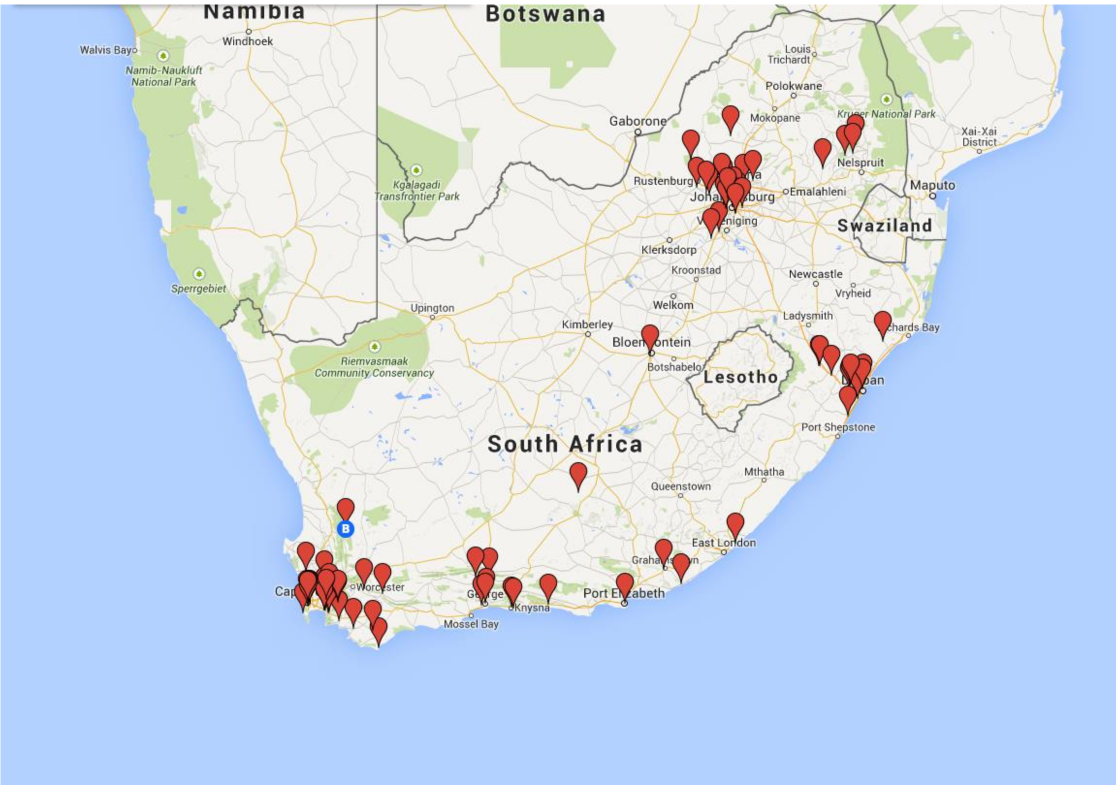
[6] Erusmus, farmers weekly http://www.farmersweekly.co.za/article.aspx?id=38537&h=SAB-Hop-Farms-puts-the-bitter-into-beer
[7] Erusmus, farmers weekly http://www.farmersweekly.co.za/article.aspx?id=38537&h=SAB-Hop-Farms-puts-the-bitter-into-beer

has constructed a maltery but there is no information on whether it makes surplus product and to what extent the surplus would be made available to third parties.

Beer brewing in South Africa is undertaken by SAB, Brandhouse, United National Breweries and a number of micro-breweries. The study excluded sorghum beer which is produced by United National Breweries. There are 101 breweries in South Africa, located mainly in the coastal parts of the country and Gauteng (Figure 2).

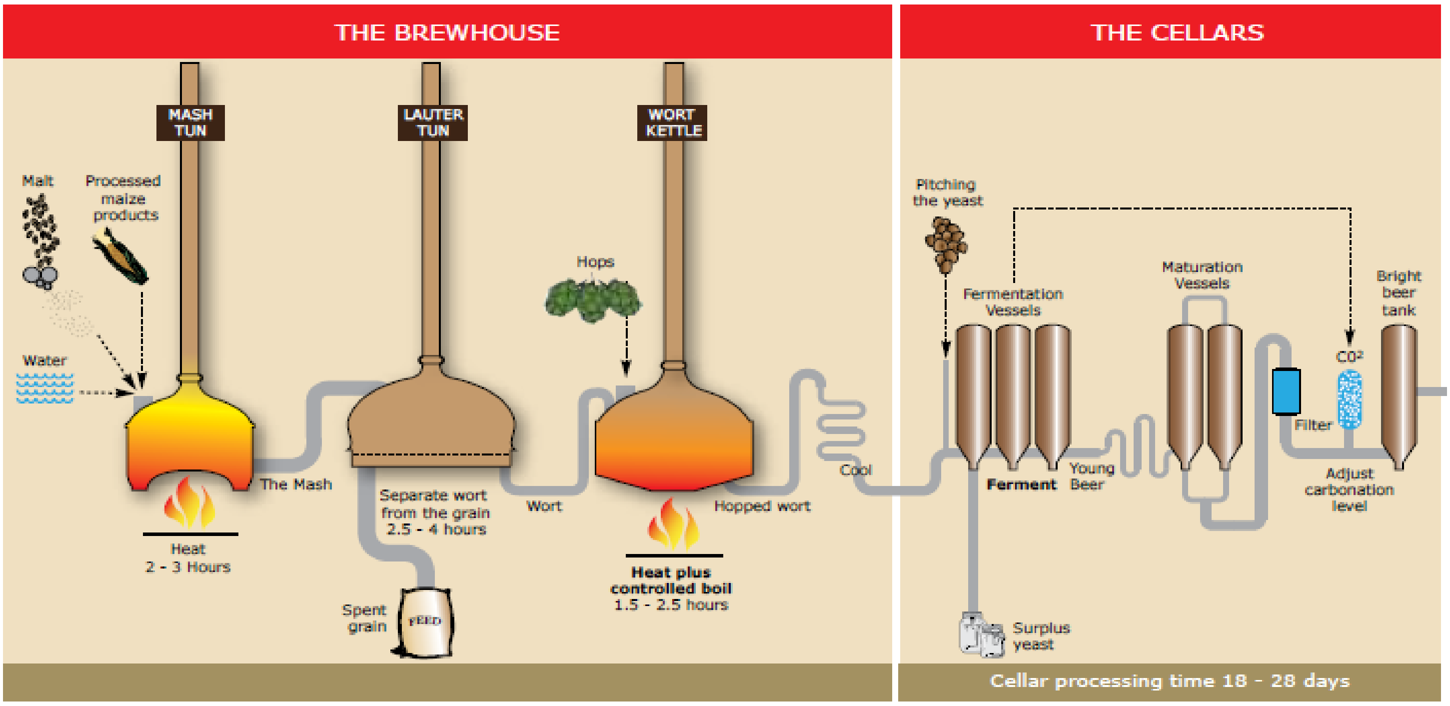
Figure 2: Breweries in South Africa



Source: Meier (2015)

A typical macro-brewery houses six processes that are part of beer manufacturing; i.e. malting, mashing, lautering, wort boiling, fermentation and packaging. Malting prepares the barley for brewing, where the blending of malts contributes to the flavour, body and colour of the beer (SAB, 2014). The malt is then mashed with other ingredients and heated to convert starches into sugars. The mash is then transferred to a lauter tun which filters the liquid (wort) from the grain. The wort is heated again in a wort kettle and the hops is added and then the mixture is cooled and transferred to the fermentation vessels. After fermentation the beer is matured, filtered, carbonated and then packaged into kegs and/or bottles/cans (figure 3).

Figure 3: Brewing Process



Source: Adapted from SAB

Most breweries conduct all the processes in the same plant for efficiencies, however there are breweries that may procure malt from another player and others that outsource packaging. Packaging is an important aspect to the production process as it is not only a source of economies of scale but also determines how the product can be distributed. Between 70 and 80% of the beer consumption in South Africa is of canned/bottled beer.

SAB owns and operates 7 breweries, with a total annual brewing capacity of 3.1 billion litres.[8] The individual breweries vary in size, where the smallest brewery is 150 million litres a year and the largest is 830 million litres a year. Brandhouse has 1 brewery with a production capacity of 400 million litres in Sedibeng.[9]

[8] SAB 2014 Annual report
[9] www.brandhouse.co.za/News.

Figure 4: Beer production capacity in South Africa

	Capacity (million litres)	Share of total beer market
SAB Miller	3100	88.2%
Brandhouse	400	11.4%
Craft-breweries	15*	0.4%
Total	3515	100%

Source: SAB, Brandhouse and Craft Beer South Africa

*estimated from average craft brewery number supplied by Craft Beer South Africa

There are approximately 89 craft breweries in South Africa and together craft beer makes up a small proportion of the total beer market. The average size of a craft brewery is 188 000 litres per annum.[10] The largest craft brewery in South Africa is the Cape Brewing Company with a capacity of 3 million litres a year.[11]

Beer is distributed by various means. It is estimated that 90% of SAB's beer is distributed through its depots and the remaining 10% is distributed by appointed distributers (Truen *et al,* 2014). SAB's relationship with the appointed distributers is governed by exclusive distribution contracts. SAB's distribution is all effectively vertically integrated.

SAB's distribution network is a source of competitive advantage for the company.[12] Brandhouse outsources its core distribution and warehousing functions to Imperial Logistics (part of the listed Imperial group), while also making use of various local distributors and wholesalers to distribute down the retail chain, but is not able to distribute directly to market (Truen et al, 2011). The craft breweries typically use a combination of independent beer and liquor distributers and retail chain distribution networks.

Industry Dynamics

The structure of the beer market has developed as a function of cost and demand conditions and government policy. Increases in economies of scale have meant that particularly in relatively small markets fewer firms can reach minimum efficient scale (Jain, 1995; Sutton, 1991; Ascher, 2012). The main source of changes in minimum efficient scale are ascribed to improvements in the packaging process and the introduction of automated production processes (Sutton, 1991). The economies of scale are also not limited to production. Marketing and distribution are also subject to economies of scale. As a result, entry at minimum efficient scale is expensive and entry below scale means higher per unit costs relative to existing MES breweries. This makes it difficult for below MES entrants to compete directly with breweries able to reap full scale economies. Economies of scale in production, marketing and distribution are so important to the industry that newcomers generally find that the only way to compete is to focus on niche markets.

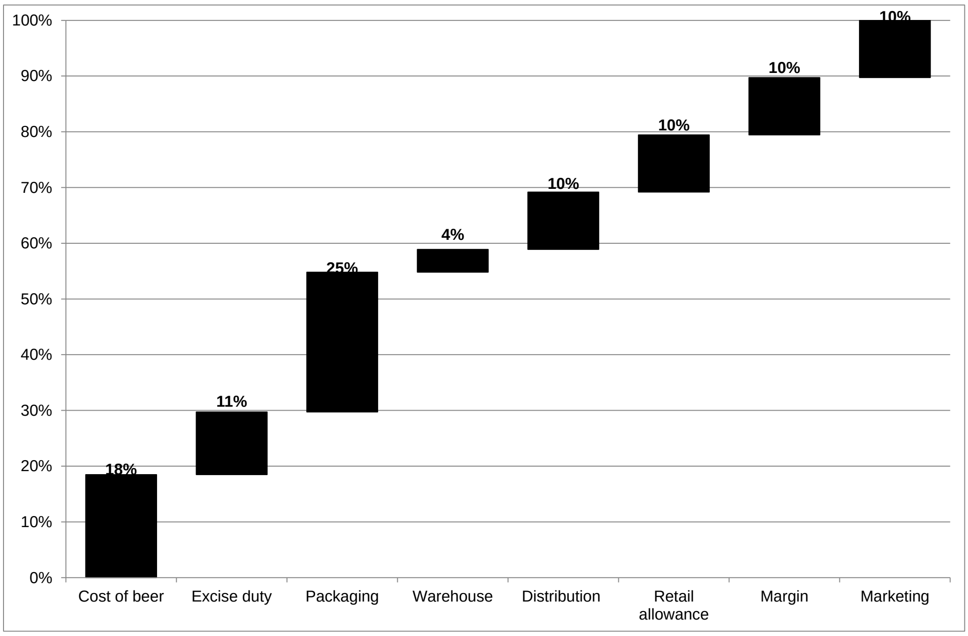
The increases in the size of minimum efficient scale plants has led to consolidation in international beer industries, however, micro-breweries have also grown significantly. Though micro-breweries may be too small to take advantage of scale economies, they can be better positioned to serve the different tastes of niche markets. Microbreweries have grown significantly in South Africa, from 40 in 2008 to approximately 89 in 2014 (Meier, 2014). However, if the international experience is indicative of the potential for micro-brewing then it

[10] Craft Beer South Africa
[11] http://capebrewing.co.za/our-brewery/
[12] Competition Tribunal Decision, Case number 134/CRDec07

is unlikely that they will grow to a point that they can take up a significant portion of the overall beer market. For example, in the USA the first microbrewery was opened in 1965 and by 2011 there were close to 2000 micro-breweries in operation, commanding less than 6% of the total USA beer market (Tremblay *et al,* 2011).

Demand conditions can also have an impact on concentration levels in the beer industry. Larger markets usually induce higher expenditure on things like advertising which adds to sunk costs. High sunk costs raise barriers to entry and likely concentration. The assessment needs to take into account both exogenous costs and endogenous sunk costs which are those affected by the conduct of incumbents (Church and Ware, 2000). An example of endogenous sunk costs are advertising costs. Government policies can also shape the structure of a market through licencing, trade restrictions such as vertical separation and competition policy. Competition laws may impact the structure of a market through its merger rules and success or failure to restrict monopolies from exercising their market power and engaging in anti-competitive conduct such as exclusionary practices.

Figure 5: Craft beer cost breakdown



Source: *Compiled from interviews*

Craft brewers have submitted to National Treasury that there should be positive discrimination to in charging excise tax to the benefit of micro-breweries as done in the USA. The argument put forward is that the excise tax will allow the micro-brewery market to grow. There are no other identified examples of countries that apply the positive discrimination for excise duty. EU charged the same tax for all brewers (Bergeron, 2015).

2.3 Review of regulation and industrial policy in the beer industry

Review of regulation in the beer industry

The liquor industry in South Africa is governed by the National Liquor Act 59 of 2003, where the main objectives of the Act are to reduce the socio-economic and other costs of alcohol abuse; to promote the development of a responsible and sustainable liquor industry in a manner that facilitates entry for new participants and diversity of ownership; and to promote an ethos of social responsibility in the industry. The DTI's assessment of the progress of the industry found that the goals laid out in the Act have not yet been achieved. The DTI identifies gaps in the regulations as including inter alia the competition authorities' failure to effectively address market power in the industry; slow progress in the transformation and diversity of ownership of the industry; and the rise in health and social issues relating to liquor (Netshitenzhe and Mabirimisa, 2014).

It may be useful to track the history of liquor regulation in South Africa to understand the importance of achieving the goals of the Act of 2003. A review of the industry conducted by the first post-apartheid government found that the industry was characterised by high levels of concentration and previous policies prohibiting the participation of the black South Africans in the industry had led to informal activity that often did not comply with standards. The DTI was also concerned about the level of vertical integration in the industry and in particular with regards to the potential power it gave incumbent firms to exclude newcomers.[13] The Liquor policy paper proposed vertically separating the industry into three tiers of activity. The tiers were manufacturing, distribution and retail where separate licence would be required for each and firms where prohibited from owning licenses in more than one level.[14] The Liquor bill was challenged and the Constitutional Court found that licencing was an area of exclusive provincial legislature competence and not national government. The Act was re-drafted and the National Liquor Act catered for two classes of licence- manufacturing and distribution, leaving retail licencing at provincial level (Truen et al, 2011; DTI, 2005). Interestingly, the prohibition on holding both classes of licence at the same time was also removed from the Act. Manufacturers are allowed to distribute products as long as the firm has the relevant licences. Similarly, distributors can hold retail licences if they so wish.

In 2015, a policy review to assess the progress to date was undertaken by the DTI, which identified the challenges to fulfilment of the NLA goals. First, the socio-economic impact of liquor, second the slow pace of transformation, third fourth, illegal manufacturing and trading of alcohol and capacity and enforcement constraints on the NLA (DTI, 2015). We focus on the challenge of slow pace to transformation as there are linkages to barriers to entry.

The previous policy objectives were to restructure the liquor industry and give priority to facilitating entry and empowerment of new entrants. The review concluded that the policy framework has not been effective as there have been insufficient structural changes that have taken place in the industry. The discussion document proposes that the slow pace of transformation can be addressed through stricter enforcement of licensing conditions as articulated in the BBBEE Codes of Good Practice. The recommendation is that this will be achieved by empowering the NLA. Though this may bring about change in the form of black ownership in the industry, it will not necessarily bring about structural change. For example, elsewhere in the document it is noted that the extent of vertical integration between production and distribution has also ensured that even the distribution level is fairly concentrated. This is referring to the practice of having BEE programmes such as the driver owned trucks programme. Though this means that there is more black ownership, the structure of the market does not change as the driver owned trucks do not operate independently from the manufacturers own distribution business.

The vertical separation proposal embodied in the initial 1997 policy draft is one such mechanism that would facilitate the structural change in the market.The prohibition of vertical integration in the beer industry would not have been unique to South Africa. For example in the USA, though the prohibition is not implemented to the same extent across the different states firms are generally not allowed to be present in more than one level of the value chain. Reviews of the US beer industry have found that the creation of independent distributors has facilitated the growth of market share by entrants such as Boston Beer Company as the distributors not only move goods from producer to customer but also market products (Ascher, 2012). The relationship with experienced distributors provides entrants access to market knowledge that is otherwise difficult to acquire, narrowing information asymmetries about the

[13] Department Of Trade And Industry Liquor Policy Paper, Government Gazette no 18135 of 1997
[14] Competition Tribunal Decision

market between the incumbent and entrant. In the UK vertical separation was enforced from 1989 by the competition authority which was then Monopolies and Mergers Commission (MMC). The MMC believed that the beer ties, where the brewers owned the pubs meant that the consumer suffered a narrow choice and higher prices. The idea was that vertical separation would improve competition, allowing customers more choice and lower prices. The "Beer Order" was reviewed in 2000 with some amendments and completely revoked in 2003 after it was found that the retailers had amassed bargaining power over the brewers and the regulation was no longer relevant (Spicer *et al*, 2012) The policy change in South Africa thus denied entrants of this advantage and had significant consequences not only for the brewers but also for the transformation agenda of the beer industry. SAB presently chooses to administer much of its distribution activity in house and vertical separation would have created opportunities for distributors/wholesalers. External market participants are unable to duplicate the cost conditions of SAB's internal or appointed distributors and as a result they find it difficult to compete in the formal distribution market for SAB products (Truen *et al*, 2011). Vertical integration can have positive effects of lower production and distribution costs, making beer relatively cheaper than other beverages. In the matter before the competition authorities in South Africa, SAB argued that having a vertically integrated distribution network gives rise to efficiencies.[15] This argument is consistent with economic theory which shows that as firms are able to reduce the number of the intermediary firms that final retail prices will fall and overall consumer surplus increases (Bishop and Walker, 2010). Vertically integrated firms can produce, distribute and sell beer much cheaper than a brewer that outsources certain activities (Ehresmann, 2013).

Other regulations impacting the beer industry can be found in the National Liquor Regulations, 2004, which outlines the procedures for registration of liquor entities and other related matters as required by the Liquor Act of 2003. Unlike the 1989 Liquor Act, which dealt with all liquor-related activities including manufacture, distribution and retail sales of liquor in South Africa, the 2003 National Liquor Act covers mostly manufacturing and distribution aspects. Given the powers vested in the provinces by South Africa's constitution, the responsibility for regulating the liquor industry is mandated to both national and provincial governments, where the provincial governments regulate the retail industry.

The main feature differentiating retailers from distributors, is the ability of retailers to sell to the general public. These provisions are developed to prevent the retailing of liquor from occurring outside of the licensed framework, as they compel distributors and retailers to police their customer base. The pervasiveness of informal retailing arrangements (that is, the shebeen market) suggests that this regulatory safeguard is presently not effective (DTI, 2005). There is also a proposal to ban advertising of alcohol which would potentially make it difficult for entrants to create customer awareness of their brands. The ban is expected to have a disproportionate impact on newcomers as advertising is more important for gaining market than maintaining market share. This is discussed in more detail later in the report.

From recent policy documents it appears that the government is more concerned with addressing the ills of alcohol abuse than the transforming the industry. Though the Liquor Act has transformation as one of its main goals there are insufficient mechanisms identified in the Act to achieve this. Increased participation has only been observed in the retail level of the value chain with limited success in the distribution level.

Review of industrial policy in the beer industry

There is no direct policy instrument that is targeted at growing the beer industry in South Africa however industry participants would be eligible for general incentives afforded by the DTI and development finance offered by the Industrial Development Bank (IDC), National Empowerment Fund (NEF), Development Bank of Southern Africa (DBSA) and other incentive

[1515] Competition Tribunal Decision Case number: 134/CRDec07 programmes offered by government departments and agencies, on the condition that they meet stipulated criteria.

In South Africa a multiplicity of funding institutions have been established, mostly to increase the economic participation of historically disadvantaged groups and to transform the structure of the economy through industrial development and small and medium enterprise growth. The South African context is that previously disadvantaged entrepreneurs struggle to come up with equity. So the design of development finance has to take this into account. Development finance is supposed to serve sectors or populations that are not served by the financial system.

Soweto Gold received funding from the IDC to contribute to the costs of setting up. We discuss the IDC's funding approach versus the needs of firms like Soweto Gold in the sections that follow.

2.4 Review of competition cases in the beer industry

Competition authorities and in particular those in South Africa, where the purpose of the legislation includes addressing excessive concentrations, are concerned about barriers to entry in the economy. Barriers to entry create a conducive environment for dominant firms to abuse their positions or firms to coordinate without threat of competition. We briefly review the competition cases including mergers and acquisitions that have been before the authorities in the beer sector to understand the concerns regarding contestability of the market. We discuss the dismissed inducement case in the barriers to entry section as the issues raised by the case also came up in the course of research.

In 2004, a group of independent beer distributors lodged a complaint with the Competition Commission, alleging that SAB's pricing to the distribution and retail channels was the same as the same making it impossible for the distributors to make positive margins. The Commission investigated the case and referred the case to the Competition Tribunal alleging that SAB and 13 appointed distributers had engaged in market allocation, price fixing, restrictive vertical practice and price discrimination.[16] The Tribunal dismissed the case on all accounts and the Commission appealed to the Competition Appeal Court, which upheld the Tribunal's decision. Relevant to the manufacturing of beer was the restrictive vertical practice allegation. We only discuss the finding under this allegation going further, the market allocation aspect of the case was dismissed on account of the appointed distributers were not sufficiently independent from SAB to constitute competitors.[17] The Tribunal did not consider appointed distributors and SAB's own depots as rivals at the horizontal level.

The main questions that the CAC sought to answer with regards to the restrictive vertical practices case was whether the distribution of SAB products on a competitive basis would foster inter-brand competition. The Commission argued that foreclosure of independent distributers from accessing SAB products, as the substantial proportion of the clear beer market, was likely to deny these firms scale to compete effectively.[18] This in turn would meant that SAB's rivals upstream (manufacturing) would be denied access to cost effective distribution from scale economies. SAB's response to this was that if it could not use the appointed distributor system then it would only use its own distribution. SAB distributes its beers by means of two models, its own distribution arm (90%) and appointed distributers

[16] Tribunal Decision (2011) in Competition Commission v South African Breweries and 13 others. Case number 137/CR/Dec07

[17] SAB has agreements with the appointed distributors, which grant them exclusive territories to distribute its beers and for which they receive a distribution fee. A complaint was lodged in 2004 when Big Daddy, an independent distributor of SAB, alleged that it was not possible for independent distributors/wholesalers to make any profits on distribution because SAB pricing to wholesalers/distribution channel was the same as the retail channel while appointed distributors received more favourable prices.

[18] CAC Decision, case number 129/CA/Apr14

(10%). The CAC found that the evidence that was led did not support the case of significant lessening or prevention of competition which is required to sustain a restrictive vertical restraint case. The CAC emphasized that the Commission's case related to only 10% of the distribution market. Interestingly, the 90/10 split is a SAB construct.

SAB's vertical relationships also came into the spotlight when the competition authorities reviewed Coleus packaging (wholly owned by SAB) acquisition of Rheem Crown Plant in 2003. Rheem is a manufacturer of bottle crown in competition with MCG. The Competition Commission was concerned that the merger would lead to customer foreclosure.[19] The Commission recommended a prohibition of the merger on the ground of a threat of customer foreclosure. However, the Tribunal approved the merger on condition that SAB enforce a previous supply agreement between Coleus and MCG.

The implications of the cases discussed is that there may be challenges in accessing a cost effective distribution system for entrants at the manufacturing level and the incumbent firm may have the power to restrict competition as a result of vertical integration in a market. Though there was no positive finding in the distribution case the evidence traversed during the case revealed the difficulties in setting up a successful independent beer distribution firm in South Africa and consequently the difficulties that entrants in beer manufacturing face in accessing an existing beer distribution network. These difficulties include access to the SAB product, a large proportion of the clear beer and liquor industry in South Africa.

3 Barriers to entry into the South African beer industry

Barriers to entry and expansion can be broadly classified as those that arise due to the intrinsic nature of the products and activities in question (and which can be viewed as exogenous to the decisions of the firms), and those that may result from strategic decisions by the dominant firm. A detailed discussion of the economic theory of barriers to entry and expansion can be found in the Review Papers 1 and 2.[20] The beer industry is generally characterised by high concentration. This means that over and above the structural barriers to entry that arise due to the nature of the business, strategic barriers created by the incumbent firm are more likely to exist. As markets mature the total demand grows at slower rates and firms have to take market share from each other in order to grow. In the USA and European markets, growth of firms has largely been achieved through mergers and acquisitions.

This section assesses the barriers to entry and expansion in beer manufacturing based largely on information obtained in interviews, and publicly available sources. We chronicle Soweto Gold's experience as an entrant and the barriers to entry/expansion that it faces. We note that Soweto Gold entered the beer market as craft beer brewer, however, as beer is a differentiated product it is difficult to draw the boundaries of the relevant market. Craft beer is a niche market and though the players in this market may not be actual competitors to mainstream beer overtime they may pose a potential competitive threat.

In line with this, the analysis of the barriers to entry is twofold. First, we assess the barriers to entry into the craft beer segment by looking at Soweto Gold's entry experience. Second, we consider the barriers to expansion into the beer mass market.

[19] The Commission was also concerned about potential input foreclosure of SAB's competitors Guiness UDV and Distell.
[20] See Banda et, al 2015a and Banda et al 2015b for discussion.

3.1 Barriers to entry in Craft Beer

The success of an investment in the craft beer is dependent on a few key factors namely: availability of quality hops, yeast, barley and/or malt; access to capital to construct the brewery; access to distribution network; and, marketing. A combination of these factors should result in acceptable returns to a potential entrant in the market.

Access to quality ingredients

As discussed above, the main ingredients required for the production of craft beer are malted barley, hops and yeast. Malted barley and hops are produced locally but all the sources are tied to SAB. SAB makes product available to third parties and is currently supplying a few of the craft brewers. Soweto Gold sources some of its malt from SAB. Micro-breweries either source malt from SAB or import the product through agents.

Economists are often concerned that in markets where a player procures input from a vertically integrated competitor, the competitor may have an incentive to anti-competitively raise the rival's costs. This is not a concern in this case as malt represents a small proportion of the total costs of brewing beer such that any attempts to raise the rival's costs would not have a significant impact on the rival. The cost of producing beer including all ingredients is estimated at 18% of total selling price of beer. The malt is also used in small quantities for each batch of beer produced. However, what is of concern is whether or not Soweto Gold is supplied with appropriate quality malt. One of the craft breweries indicated that malt is not always supplied at required quality. If it is indeed the case, this will have a significant impact on the breweries as the malt contributes to the flavour, body, colour and aroma of beer (SAB, 2014). Further enquiry into the quality issue revealed that the poorer quality batches received were isolated incidents. As SAB's main business is in mass market beer it is unlikely that it has an incentive to engage in strategic behaviour to constrain micro-brewers, however, as the main supplier of inputs it certainly has the ability to do so.

We note that Brandhouse has recently constructed a malting facility at its Sedibeng Brewery. No information is available about the capacity of the facility and whether it can also supply third parties.

Cost of entry and access to capital

Capital and financial regimes also contribute to the ease with which a potential entrant can enter a market. A craft brewery can be set up for approximately R4 million for a production capacity of 10 000 litres per week.[21] To make a judgement on whether set up costs raise barriers to entry, the costs must be considered in the context of the industry (Bishop and Walker, 2010). As a super-premium product, craft beer revenues are relatively high such that an investment of R4 million would not raise barriers to entry. Assuming a repayment period of 5 years and an interest rate of 10%, loan repayments for a 10 000 litres a week plant would be R2.12 per litre of capacity.

Though this is not a significant amount of money, banks typically offer only offer loans to businesses that have a track record of at least 2 years. So for an entrepreneur that does not have access to these types of funds it would be difficult to enter into the market without support from a DFI.

The first challenge that was faced by Soweto Gold was access to capital. Ndumiso Madlala struggled to find funding for the MadMead Brewing business proposal. He started meeting with potential funders as early as 2010 without success. Funders were of the view that there was no space in the market for another brewery and SAB, the incumbent firm would compete

[21] Craft Beer South Africa

aggressively with the entrant and could easily drive it out of the market. This stems primarily from the incumbent firm's cost advantages deriving from economies of scale and allegations against it by the Competition Commission. This is the perceived power of SAB even though at the time it was not present in the craft beer market segment. MadMead Brewing was able to secure some funding in Europe which was complemented by the two partners' own investment and funding from the IDC. The funding from the IDC was provided for a combination of working capital, CAPEX, operational cost and start-up losses. Soweto Gold entered the market at a total cost of R10 million. The Gauteng Development Agency was very helpful in linking Soweto Gold to potential public funders even though they did not offer funding themselves.

Industrial Development Corporation (IDC)

The IDC's funding is generated through income from loan and equity investments and exits from mature investments, as well as borrowings from commercial banks, development finance institutions and other lenders (IDC, 2014). Its funding activities focus mainly on the private sector, but it also works closely with different levels of government agencies and sector organisations to coordinate industry development. It further supports government in other areas related to its development objectives, such as research and management of government funds allocated to achieving specific outcomes (IDC, 2013). The priorities of the IDC have had to change overtime in accordance with the changes in policy direction but what remains fundamental to its existence is the notion that it would help improve the industrial capacity of the country, and in so doing play a key role in creating jobs. Currently the IDC's mandate is focused on the economic goals stated in the New Growth Path (NGP) and the Industrial Policy Action Plan (IPAP). Nevertheless the IDC has had to adjust its mandate from year-to year depending on the prevailing economic conditions (IDC, 2010). For example post the financial crisis of 2008 the IDC had dedicated R6.1 billion to "distressed" sectors during these tough economic times (IDC, 2011).

In the case of Soweto Gold, the IDC has been a source of funding for the business venture. Through the IDC's Agro-processing Competitiveness Fund (Agri-Fund), the IDC invested R3.5 million into Soweto Gold. The R3.5 million is a zero-rated loan which Soweto Gold has 7 years to pay off. There are no commitment or cancellation fees attached to the loan since the Agri-Fund is classified as an off balance sheet fund in the IDC's financial books. These funds were made available to Soweto Gold on the basis ,that they would be used in the following three parts of financing a start-up venture: working capital; capital expenditure; and as part of covering the initial sunk costs/ losses incurred from being a new entrant into the market (IDC, 2015b).

The Agro-processing Competitiveness Fund was conceptualised as part of the remedy imposed by the Competition Tribunal on Pioneer Foods for engaging in cartel activity in the bread and flour markets. The main objective of the fund is to promote competition in the agro-processing sector. The fund is relatively flexible when it comes to criteria for approving investments. Initially the IDC funded deserving projects in the agro-processing sector but following instruction from the Economic Development Department, the ministry that oversees both the Competition Commission and the IDC, the remaining funds are reserved only for the bread value chain. The total value of the fund was R250 million where, R225 million was earmarked for loans to the agro-processing industry, R12.5 million was set aside for business support and R12.5 million as a research grant. The loans from this fund bear 0% interest and the fund had achieved reflows of R7.5 million as of March 2015.

Table 2: Summary of Agro-processing Competitiveness Fund

	Direct investment	**No. of Clients**
Fund Size	225 000 000	

Approvals	212 421 470	31
Funds available	12 578 532	
Projects on Track	146 647 720	23
Projects under supervision	61 373 750	7
Projects subject to legal action	4 400 000	1

Source: Competition Commission

Soweto Gold's application was approved for funding on the basis of a strong management team in Ndumiso Madlala as the master brewer and Josef Schmid as the marketing manager; a good business plan with much of the ground work on marketing already done; the fact that it is a majority black owned company entering and promoting competition in a traditionally white industry (craft beer brewing); the fact that Madlala (51 per cent of stake holder) is a historically disadvantaged individual who is a youth; and the potential for the project to create jobs in Soweto.

IDC has submitted that it has to balance its financial sustainability as a self-funded parastatal and risky lending. The IDC does not have the capacity to cover 100% of the costs of start-up ventures.[22] Because of this, start-up enterprises are usually requested to bring in 50% of the equity to fund their business while the IDC would aim to cover the other 50%. It was noted that obtaining this initial 50% equity has been difficult for start-up businesses since smaller businesses engage in smaller transactions and the breadth of the business may not be as broad as it could be (IDC, 2015b).

In the beer industry the IDC is currently supporting three firms including Madmead Brewing (Pty) Ltd. These investments are managed in the Agro-Industries business unit. Interestingly beer investments do not fall under the focus areas of the business unit which include; competitive import replacement; land utilisation and sector innovation (IDC, 2015a).

The IDC also provides non-financial support to companies that it funds. The client still remains responsible for the business plan but the IDC may, based on knowledge of industries make suggestions in terms of the things that are required for success in a particular industry. This however, does not mean that the IDC will assist with market research for an enterprise. Other means of non-financial support include a suite of service providers that can assist clients.

The Soweto Gold brewery was also constructed without a bottling/canning and malting capacity. Micro-breweries typically do not have a malting facility but most of the more successful micro-breweries also have bottling or canning facilities. As bottled/canned product give the breweries access to off-premise consumption market segment, this has limited the Soweto Gold's reach to on-premises demand, which only accounts for approximately 20% of the market. Micro-breweries either have a manual, automated or a semi-automated bottling process. The bigger breweries all have automated packaging processes. However, some have semi-automated packaging facilities. As shown earlier, packaging costs make up the biggest proportion of the beer sales price, so it would be advantageous to have a fully automated packaging facility to reduce the packaging costs per unit. Soweto Gold entered the market without a packaging facility for bottles/cans due to insufficient funds and this meant that it could not supply the off-premises segment of the market.

Other costs associated with entry include compliance with regulations such as registration and licencing. The total cost of setting up a micro-brewery from a compliance perspective is

[22]Interview with the IDC on the 7th of April 2015 at the IDC, Johannesburg.

between R20 000 and R30 000.[23] A beer brewer is required to register as a manufacturer with the DTI in terms of National Liquor Act no 59 of 2003. A manufacturing license is granted to a liquor manufacturer who produces more than 100 million litres of malt beer per annum or 50 million litres of sorghum beer per annum. The costs of acquiring and renewing beer manufacturing licences appear to be reasonable and are charged in proportion the production volumes of the firm in question (table 3).

Table 3: Licence fees for beer manufacturing for different volumes of beer

Annual Turnover	< 5 mil	5-15 mil	15-250 mil	250-1000 mil	>1000 mil
Application	R 500	R 1 000	R 7 500	R 10 000	R 25 000
Initial Registration	R 2 000	R 4 000	R 5 000	R 7 500	R 15 000
Notice to review	R 500	R 1 000	R 7 500	R 10 000	R 25 000
Annual Renewal of registration	R 2 000	R 4 000	R 5 000	R 7 500	R 15 000
Variation to initial registration	R 1 500	R 3 000	R 5 000	R 7 500	R 15 000

Source: The DTI (2010), National Liquor Authority Registration procedures and fees

Interviewed firms confirmed that the process of acquiring national licenses is accessible and licences are granted within reasonable time frames. Though one of the firms interviewed indicated that it took time 2 years to get all the clearances to build a brewery. Interviewees also noted that there is a misalignment between the requirements of the national and provincial liquor regulation. This makes compliance onerous for breweries that distribute in their products in more than one province. The cost of registration and acquiring licences is not exorbitant and would not pose a barrier to entry.

The costs of entry into the craft beer market in and of itself is not significant. The cost to set up the plant and all regulatory compliance comes to approximately R4 million for an above average sized micro-brewery at a capacity of 500 000 litres per annum.[24] However, due to the circumstances of most South Africans access to these monies may be a challenge as was the case for Soweto Gold. The IDC was able to fund part of the total cost of production. An alternative approach would be to have the product toll manufactured for the first two years to establish a track record for a bank loan. However, given that there are other costs associated with making sales including marketing a brand, toll manufacturing alone may not be able to realise positive profits in the first year or two of production.

Access to distribution and customers

Lack of access to an extensive distribution network can pose a barrier to entry in the South African beer industry. The micro-brewers have taken an innovative approach to distribution by making agreements with the various retail chain stores to distribute their beers through their distribution networks. The retail chain stores that are currently distributing beer on behalf of micro-brewers are Pick n Pay, Shoprite Checkers and Spar all of which have national presence. This however only serves part of beer demand and excludes 70% of beer sales volumes in South Africa in taverns and shebeens. While SAB is able to deliver to the tavern and/or shebeen, the owner would have to go to a retail stockist to go collect product of the micro-brewers using retail chain store distributers. Access to an existing distribution network played an important role in the growth of micro-brewers in USA and the challenges in

[23] Interview with Brian Stewart of Craft Beer Association.
[24] A micro-brewery according to the NLA's definition has a capacity below 5 million litres per annum.

accessing in South Africa means makes it more difficult for firms to successfully enter the market.

Soweto Gold beer is currently distributed to 35 restaurants and bars in Gauteng and Western Cape. The draught beer is delivered in kegs. It costs approximately R20 000 to install a keg in a restaurant and bar and breweries compete for space on the counter.[25] It is important for the beer to be available at eye level so that even customers that are not aware of the product can see. The cost of installing the kegs at restaurants also gives established breweries with financial backing an advantage over smaller players with limited funding.

Beer distribution to restaurants and bars only represents about 20% of the total distribution for macro beer while for micro beer draught represents about 80% of sales.[26] The rest is distributed to retailers such as bottle stores, shebeens and taverns. A brewer would require an additional investment of between 1 and 1.5 million rands to package, brand and distribute to retailers.[27]

The micro-brewers are using the retails chains for their distribution. Soweto Gold entered into a co-marketing and distribution agreement with Shoprite Checkers Liquors, a national chain store. The distribution agreement is relevant for the bottled/canned beer, which Soweto Gold is no longer producing. Micro-breweries all over the country have agreements with retail chain stores to distribute their beer but unfortunately this still excludes the shebeen and tavern market. Some micro-breweries use their own truck and independent distributers e.g. WineZani, James Agent, Icehouse liquor.

Marketing

Craft beer like other beer products requires investment in marketing to create awareness about a brand. As craft beer is a normal good, as incomes increase the demand will also increase and marketing is important in capturing new sales. The market for craft beer is highly differentiated with over 400 craft beers that are available in South Africa. As such, every brewer has to use marketing to highlight the characteristics of their particular beer. As most craft brewers do not have large marketing budgets, the commonly used marketing strategies include viral marketing, beer festivals and promotions materials produced in partnerships with retailers.

Soweto Gold's primary marketing medium is viral marketing on social media and internet. This method of marketing is not as expensive as advertising in mainstream media. Though craft brewers have to invest funds and human resources into marketing it is not a barrier to entry into micro-brewing. Recall from Figure 5 above that marketing costs represent 10% of the total cost of a craft beer, whereas for SABMiller and Brandhouse the figure is approximately 1% and 4%, respectively. Soweto's Gold's expenditure on marketing is more or less in line with the market average.

The implications of the incumbent firm's business model

Firms' decisions to enter or expand in a given market are based primarily on an evaluation of the costs of entry/expansion versus the likely benefits of entry/expansion. The main factors that influence this decision are the level of sunk costs and the expected profitability of entry (Bishop and Walker, 2010). Where there is a large incumbent firm with absolute cost advantages, entry is deterred as potential entrants will have higher costs than the incumbent. Incumbent firm(s) can take decisions that determine costs for the industry, marketing costs are a good.

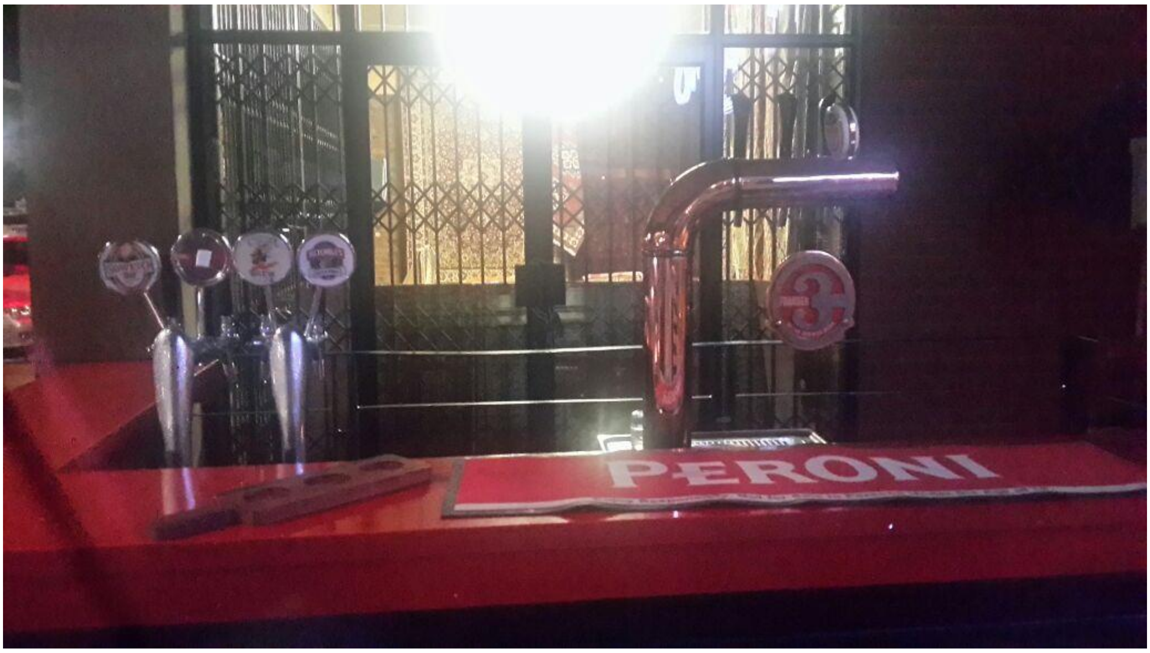
[25] Interviews with craft beer brewers
[26] Interview with Mitchells
[27] Interview with the craft beer association

Craft brewers in South Africa emphasize that they are not in competition with SAB as they supply niche markets. However, all beers compete for space on the counter in bars. Even though Soweto Gold has also proclaimed that it is not in competition with SAB it will compete with it for this space. As the incumbent firm, SAB can raise the cost of setting up draught beer on tap at bars. The cost of installing a keg for draught beer at bars is estimated at R20 000 and this cost is incurred by all brewers that wish to be available on tap at bars.[28] However, interviewed micro-breweries have submitted that SAB offers additional incentives to bars to position SAB kegs at the most visible place at the bars. This means that other breweries including the micro-breweries have to incur similar costs to ensure that their product is positioned at customer's eye level, otherwise most of the space would go to SAB beers. This is only one of the ways that that the incumbent can increase the costs of doing business.

Internationally, the mainstream breweries are also entering the craft beer market with others having operated in the market for some years. SABMiller (Britain) acquired Meantime Brewing Company in 2015, a leading craft beer brewery. Similarly, in the United States AB InBev acquired Goose Island, craft beer brand in 2011 and Elysian Brewing in 2015. MillerCoors (SABMiller's US joint venture with Molson Coors) has Blue Moon craft beer on its portfolio of beers. [29]

In South Africa, SAB launched the No. 3 Fransen Street, a craft beer to compete in the speciality beer category with Soweto Gold and other microbreweries in 2014. On promoting the new speciality beer SAB offered bars a sales service package (incentives), a premium draught tap, branded glassware, branded merchandise, management of aged stock and draught machine services.[30] It is standard practice in the industry to supply the draught tap, but the additional services offered by SAB in this instance may incentivise bars to favour the No 3 Fransen brand. To compete, other breweries would also have to offer similar packages to bars at a cost. This cost is sunk as firms cannot recoup if they are to exit.

Figure 6: Bar space at a restaurant in Johannesburg



[28] Interview with Josef Schmid, Managing director of Soweto Gold
[29] Other acquisitions of craft beer breweries by mainstream breweries include; Bend, Ore.'s Ten Barrel Brewing Co by A-B InBev's (ABI), Blue Point Brewing by Behemoth.
[30] SAB promotional material given to bars.

Source: Picture taken by authors

Another example of how SAB has been able to increase the cost of doing business is through offering retailers fridges and requiring that only SAB beer is stocked in the SAB branded fridges. This is most effective in the shebeen/tavern segment of the market where the retailers are often small and cannot afford to purchase own fridges. Soweto Gold, at the time it was producing cans of beer, attempted to sell to shebeen and taverns in Soweto but was unsuccessful. The shebeen and taverns indicated that they did not have space in their refrigerators for Soweto Gold beer. The responses of the shebeens and taverns is consistent with the Commission's allegations that SAB was incentivising shebeen and taverns not to deal with competitors. At the time of referring the distribution case, the Commission also alleged that SAB had engaged in conduct that induced retail outlets not to deal with its competitors in the markets for manufacturing and distribution of beer. The Tribunal dismissed the case relating to the effects on upstream rivals, finding it did not have jurisdiction due to differences between complaint and Commission referral. In the press statement announcing the decision, the Tribunal noted that the outcome was regrettable but that it was bound by the decisions of superior courts.[31] One of the reactions to the decision was that "technical decisions" may be hindering the investigatory role of the competition authorities to the advantage of well-resourced businesses (Bleby, 2011). The merits of this part of the case were never heard.

The Commission alleged that SAB induces retailers not to deal with other brewers and other distributors using a number of mechanisms. First, SAB supplies refrigerators on loan to retailers and requires that only SAB beer is stocked in them. The Commission further alleges that this has the effect of tying up the tavern and shebeen markets which account for 70% of volume sales in South Africa. The taverns and shebeens have no countervailing power against SAB as they lack the capital to purchase the fridges themselves and SAB is a must have brand particularly in this market segment. Also, even if the SAB's upstream competitors could offer fridges to these taverns and shebeens the space in these outlets is limited. Second, the taverns and shebeens were required to purchase their beer from SAB and not independent distributors. Third, SAB also offered other incentives including display (where SAB advertising had to be placed in the most prominent position in the tavern/shebeen), volume incentives, payments for promotion of SAB products and promotional material. The Commission argued that these incentives were for loyalty rather than efficiency reasons.

Interestingly, SAB Miller filed a similar complaint with the Federal Competition Commission (FCC) of Mexico in 2010 alleging that the country's duopoly Modelo and FEMSA were offering payments, loans and refrigerators to restaurants and retailers in exchange for agreeing not to serve/stock other brands (Ascher, 2012). SAB Miller argued that the conduct of the incumbent firms reinforced anti-competitive practices against entrants. The FCC and the respondents reached a settlement agreement in 2013, whereby FEMSA and Modelo were required to limit the exclusive arrangements to 25% of total sales in the market and incorporate new conditions to existing exclusivity contracts to avoid monopolist practices. The directive was expected to make the restaurant and mom and pop stores more accessible competitors.

This has the effect of increasing the costs of doing business as the shebeens that would allow/have sufficient space for another fridge, would require that microbrewers to give them similar offering. However, often the shebeens have limited space and cannot take another refrigerator, in which case the conduct may result in other brewers being excluded from the biggest segment of beer consumption. Brandhouse and Distell also offer bars and restaurants free branded refrigerators with some terms and conditions. SAB and Brandhouse require that their fridges be used exclusively for their own brands but, Distell will allow for other brands to be stocked as long as the Distell brands such as Savanna are packed at eye level. The sales

[31] http://www.comptrib.co.za/publications/press-releases/the-competition-commission-and-sab-07-april-2011/

representatives ‘police’ the fridges to make sure that the terms and conditions are adhered to. Where they are not the other products are removed.

The conduct goes beyond restrictions on usage of the refrigerators for other brands to also restricting advertising of other brands in the taverns. While on field investigations, Tseou (2009:93-94) observed an SAB representative visiting a tavern in Soweto and inspecting the premises for non-SAB posters and replacing them with SAB posters.[32]

Whether SAB is guilty of the inducement case would depend on a number of factors such as the efficiencies that arise from the arrangements with the retail outlets and the effect of the conduct on competition. That SAB Miller has also lodged a similar complaint in Mexico may be an indication that the exclusive arrangements between beer manufacturers and retail outlets contribute to barriers to entry by limiting access to a significant group of customers. The Competition Commission has not initiated a new case against the incumbent.

On a visit to a pub in Soweto, we noted that most of the signage in that particular pub is of SAB brands, the walls are painted with branding for Castle Lite, Flying Fish and Miller. The bar top was built by SAB and has Castle Lite branding all around the bar. The awning screens are also branded with Castle Lite. Signage of other brands was also visible but to a lesser extent. There was a small Amstel (Brandhouse) poster and the stage is branded with Jack Daniels logos. The pub also had two both Klipdrift branded televisions.

The bigger players also offer more flexible payment terms and allow you to send stock back which is sometimes required after events or promotions.

Entry barriers in micro-brewing are not prohibitive, since there is access to the ingredients, cost of investment is not high, marketing, and sunk costs of starting a micro-brewery are relatively low. However, even though craft beer is not a direct competitor for mass market beer, the strategic behaviour of macro-brewers regarding routes to market may create barriers for micro-brewers. Also, in the South African context access to capital, even for relatively smaller amounts can be a challenge.

3.2 Barriers to expansion into the mass-market

Production

For large-scale brewers, the cost of building new plants or acquiring existing plants appears to be expensive and given that there are also production and distribution economies of scale and entrants would effectively have to enter in multiple levels of the value chain to be able to compete head on with the incumbent firm. It has been argued that the construction of a new minimum efficient scale brewery involves large sunk costs (Johnson, 2003). If Soweto Gold were to expand into the mass market segment then a minimum efficient scale plant would have to be constructed. In 2009 Brandhouse built a 300 million litre brewery for R3.5 billion. This is equivalent to R11.67 to install a litre of capacity.

Distribution

The beer business is as much about getting the product to the customer as it is about producing the product. For an entrant to have national reach it has to have access to a national distribution network. For the economics of a beer distribution business or division to work there should be sufficient demand for the product such that every truck load is filled to capacity to reduce the distribution costs per unit. As discussed earlier, the South African beer distribution level of the value chain is dominated by SAB which distributes its product exclusively and SAB appointed distributers that also only carry SAB product. There are also independent

[32] The researcher worked at three different shebeens in Soweto (in the suburbs of Dlamini, Silvertown and Dobsonville) for ten to fourteen days each as part of her research (Tsoeu 2009,).

distributers that can carry all brands but this category of distributers is struggling as SAB brands are the most popular brands in South Africa making it very difficult to fill a truckload with the remaining brands.

SAB’s distribution network has been identified as a source of competitive advantage for the incumbent firm. Brandhouse, its closest competitor, has not been able to duplicate SAB’s distribution network and instead outsources its core distribution and warehousing functions to Imperial (Truen et al, 2011). Brandhouse also uses various local distributors and wholesalers to distribute down the retail chain.

3.2.1 Advertising

The success of an alcoholic beverage is closely related to its brand, as brand recognition is one of the top drivers of sale volumes (Fieldgate et al, 2013; Jain, 1994). The incumbent will also have an advantage in terms of advertising as the higher the sales volumes the lower per unit cost of advertising. The top brewers are usually the top spenders on advertising. To be able to compete effectively with the market leader in beer, an entrant is required to spend as much money as the market leader, in absolute terms (Jain, 1994). This is because acquiring market share is more difficult and expensive than maintaining market share. This also advantages the incumbent as consumers are already aware of the incumbent brands while entrants have to create awareness and lure customers to switch in a market where brand loyalty is rife. Advertising plays its most important role in consumers’ choice of brands (ARA, 2013).

The implication is that advertising is an endogenous cost as the existing firms in the market make choices about the amount of advertising and as a consequence the real or perceived quality of their products without external thresholds (Sutton, 1991). This means it can be used to deter entry, a firm can spend an inefficient amount on advertising to discourage entry. Thus, advertising is a fixed and sunk cost as it does not fluctuate with output nor can it be fully recovered, representing a strategic barrier to entry.

The South African beer market like others in the world epitomises this, the incumbent firms spend millions of rands in advertising in media such as television, radio and print and also sponsor sports events and various promotions. SAB has been increasing spending on advertising over the years even though their brands are well established (SAB, 2014). In the 2014 financial year SAB, reported increased volumes in the sale of lager as a result of successful brand campaigns, pack and brand innovation and effective execution in the trade (SAB, 2014). This highlights the importance of advertising in the domestic market. Brandhouse also advertises on similar mediums as SAB. Since Brandhouse ended its license agreement with SAB and started to supply its brands (mainly Amstel) in the market independently, SAB increased its advertising expenditure (Figure 7).

Figure 7: Advertising expenditure by top 2 beer manufacturers

Source: Extracted from Fieldgate *et al (*2013)

*note: figures represent total advertising expenditure by each company

The scale economies in advertising can be illustrated by the cost of advertising for SAB Miller versus Brandhouse. On average SAB spends 24 cents on advertising for every litre of beer that is sold while Brandhouse spends 4.6 times this amount at R1.13 per litre of beer sold.[33]These are both large scale brewers and the cost of advertising to a micro-brewery would be significantly higher per litre given the low volumes sold. As discussed above, marketing is important in packaged consumer goods and an entrant needs to spend as much as the incumbent firms to be able to compete head on.

Advertising in mainstream media such as television is national and thus cost effective only for national breweries. Advertising played a part in the consolidation in USA. As the MES grew the market share required to reach MES also increased. As a result, the cost minimising industry structure (or number of firms) decreased significantly.

MES is such an important factor to the mainstream beer industry that in the USA when there were more firms than the industry structure could support then the beer wars broke out in the 1960's. Interestingly during the beer wars advertising spending increased significantly as well as the price competition. During the wars the mechanism of competition changed from the art of brewing to marketing and advertising. The high costs of national advertising influenced the consolidation that followed in the market. The Department of Health has proposed a ban on alcohol advertising in South Africa. It is not clear at this point if the ban will be comprehensive covering all forms of advertising or limited to certain mediums. The ban will have a disproportionate impact on newcomers due to the importance of advertising to gain market share. SAB confirms that under advertising bans established firms do better (Crotty, 2013). However, we note that currently the micro-brewers are relying primarily on beer festivals, the internet and social media for consumer awareness so the advertising ban would directly impact microbrewers if there was a comprehensive ban. In any event it will be important to weigh the effects of alcohol advertising on society versus the consequences on the beer industry.

There is no consensus in the literature about whether or not advertising leads to increased consumption of alcohol. The Industry Association for Responsible Alcohol Use (ARA)

[33] Average aadvertising spend per litre calculated based on total advertising expenditure and total sales for each brewer.

commissioned a study that reviewed the relationship between advertising and alcohol consumption, among other things, for submission to parliament.[34] The study reviews empirical studies that have examined the relationship between advertising and alcohol consumption and found mixed results. Of the 47 studies reviewed 49% found a positive relationship between advertising and consumption while 45% found no relationship and 6% were inconclusive (Fieldgate, 2013). This finding is in line with surveys conducted by independent researchers (Anderson and Baumberg, 2006 and Nelson, 2001). However, the methodology of these econometric studies have been questioned and particularly those that use advertising expenditure as a measure for effectiveness of marketing (Anderson and Baumberg, 2006). Advertising expenditure is often limited to mass media and excludes promotions, sponsorship and viral marketing. The studies that separately test the impact of televised alcohol advertising on youth drinking behaviour have shown mixed results, however, the longitudinal studies have found that advertising in mass media influence youth drinking behaviour (de Brujin, 2012). Though the impact of sponsorship and viral marketing I is relatively studied, longitudinal studies of non-media alcohol marketing have shown an impact of alcohol marketing on drinking behaviour (See de Bruijn (2012) for a review of these studies).

Though there is no consensus in the literature about the relationship between alcohol advertising and consumption at the aggregate level, there appears to be a positive relationship when it comes to the youth.

4 Conclusions

Soweto Gold represents one category of 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. Craft beer represents less than 1% of the overall beer market in South Africa so the largest segment of beer is still highly concentrated. The liquor policies have failed to facilitate increased participation in the mass market for beer. Competition law enforcement has also not succeeded in addressing market power in mass market beer. The proposed enforcement of the BBBEE codes is also unlikely to change the structure of the market. If successful, it may influence the ownership.

The case study sought to assess barriers to entry in beer brewing by analysing the actual investments required and routes to market for entrants, focusing on the Soweto Gold experience. There are two strategic groups of breweries in South Africa, namely mass market and craft. As Soweto Gold is a micro-brewery producing craft beer, we first looked at the barriers to entry into this segment of the market. However, we note that beer is a differentiated product market and the closeness of competition between the different brand offerings varies.

The factors that are important for competing in the craft segment include access to quality inputs, access to customers and marketing. We assessed all these factors as well as cost of entry and access to capital. Entry into the craft beer market is relatively easy as the economies of scale in production do not play as important a role as they do in mass market beer. Entry at a capacity below minimum efficient scale is viable as the higher cost is covered by the higher price of craft beer. The cost of investment is also relatively low but given the circumstances of most South Africans access to capital can be a challenge. Capital market imperfects also mean that in concentrated industries, the reputation of the incumbent firm may reduce the expected short term profitability of entrants, making it difficult for entrants to raise funds. Soweto Gold encountered this problem when they initially sought funding to establish the

[34] ARA members are the leading alcoholic beverages manufacturers such as SAB, Brandhouse and various wines and spirits.

business. Soweto Gold was later able to access funding from foreign private investors and the Agro-processing Competitiveness Fund from the IDC.

With regards to access to market we considered distribution, routes to market and dynamics at the retail outlets. Access to a distribution network is important for breweries entering the South African market. Beer has to be distributed to bars and restaurants in kegs and cans/bottles, to liquor stores, and to taverns. Beer distribution in South Africa is typically done by the mass market manufacturers' vertically integrated downstream businesses. Craft beer brewers cannot access these distribution networks and have adopted other distribution channels. The craft brewers have made use of logistics firms, liquor distribution firms, and supermarket chains. Soweto Gold, like many craft brewers have formed agreements with the retail chains to distribute and market their bottled products. The retail chains have extensive distribution networks across the country, however this route only allows for distribution to retail supermarket liquor stores, a small proportion of the total off premises liquor consumption. As Soweto Gold was not canning/bottling at the time that the study was conducted they were not making use of their agreement with a retail chain.

Though craft beer is not usually targeted at taverns, Soweto Gold sought to change this. This has highlighted issues at the retail level. Even though craft beer and mainstream beer are not seen as direct competitors they are competitors in some of the routes to market. For example, all beers compete for space on the bar tops and mainstream beer brewers are in a position provide the bars with incentives. Soweto Gold also struggled to get their beers into taverns as the fridges are provided by the larger brewers on loan for exclusive use of their brands. Though this conduct may not be directly targeted at Soweto Gold and a side effect of competition between mass market brewers, it has implications for access to market for micro-brewers. The incumbent firm has effectively changed the "rules of the game to its advantage and this has impacted the competitive dynamics in the market. Brandhouse also invested in fridges when it entered the market as it is difficult to have presence in the tavern segment of the market without offering this additional service. This is an important issue for entrants as, SABMiller itself has laid a complaint against the incumbent firms in the Mexican market for similar conduct.

Access to quality ingredients is currently not an issue Soweto Gold like many other craft breweries source malt and hops from SAB and import speciality malts. Though SAB does not appear to have an incentive to foreclose the craft brewers by denying access to the inputs. Overtime this situation may change. SAB has also entered into the craft beer market by introducing its own speciality beer. Also, internationally, the craft beer market is becoming more attractive to mainstream brewers as it is the source of the growth in an otherwise mature beer market. SABMiller's and other mass market brewers have started acquiring craft brewers. As SAB is vertically integrated from hops and barley farming to the distribution of beer, there opportunities for strategic behaviour. This may be an issue as Soweto Gold expands or SAB increases presence in the craft beer.

Soweto Gold has successfully entered the craft beer segment of the beer market but still has to work on consumer awareness for their product portfolio. Marketing the Soweto Gold brand is important in achieving this. Marketing is important for consumer goods and beer is no different. The proposed adverting bans will restrict the ability of the firm to marketing their products. Though craft beer is not usually advertised in mass media like television and print media, viral marketing and beer festivals play an important role in creating consumer awareness.

The study also looked the barriers to expansion into the beer mass market. There are high barriers to entry into the mass market segment stemming from the economies of scale in production, distribution and marketing; sunk costs in the form advertising; access to the distribution network and the strategic behaviour by the incumbent firm. The DTI's reversal of its position on the requirement for vertical separation in the industry has meant that entrants have to struggle to duplicate SAB's distribution network or find alternative less efficient distribution channels. The economies of scale in the beer manufacturing level of the industry mean that the market will likely always be a quasi-monopoly with competition from Brandhouse in the premium beer market and the craft breweries operation at the fringe of the market. Brandhouse is able to take on SAB because of links to Heineken and Diageo which are international players with financial backing.

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