

Assessing Antitrust Risk in Retail Mergers

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A Practice Note discussing the analytical tools to use when assessing the antitrust risk of a planned merger or other consolidation between two brick and mortar retailers. This Note explains the types of evidence used to evaluate retail mergers, including consumer substitution patterns, pricing policies, and loyalty-card information. Adapted from an article that originally appeared in Retail Leader.

The playbook for evaluating competitive concerns from a potential consolidation of two brick and mortar retailers has evolved. Today, reliance on simple market shares for risk assessment can leave the wrong impression about how the Federal Trade Commission (FTC) or Department of Justice (DOJ) reviews a merger of two retailers. This can be especially true for brick and mortar retailers that are looking to forge a path forward through the growth in e-commerce, high-profile bankruptcies, or a sense of being over-stored.

Pre-transaction antitrust risk assessment should align with the modern analytical tools that the antitrust agencies use when reviewing a merger between two brick and mortar retailers. Using a ruler when a precision tool kit is required can lead to unfortunate surprises. Reliance on simple tools may also dissuade potential partners from pursuing a transaction that may appear problematic on first blush, but in fact is unlikely to raise competitive concerns.

The tools described here play a key role in assessing internally the competitive issues that may arise during the antitrust merger review process and that affect the ultimate outcome of that review. Antitrust risks to a proposed merger include the potential for:

- A long and costly antitrust investigation, including compliance with a Second Request.
- Divestitures to resolve competitive concerns raised by the agency.
- The agency seeking to block the transaction entirely.

CONSUMER SUBSTITUTION PATTERNS

Consumer substitution patterns—not market shares—are central to assessing the antitrust risk of a potential consolidation between two brick and mortar retailers. In an investigation, the FTC (the US antitrust agency that primarily handles retail mergers) tries to figure out whether the consolidation is likely to “substantially lessen competition.” A key aspect of answering that question is to determine how closely the two retailers compete with one another. Closeness of competition is evaluated along a variety of dimensions, including geographic proximity and similarities in pricing, promotion, and product assortment. The closer that two retailers are along these dimensions, the more likely it is that the FTC will conclude that consumers view them as close substitutes.

Before/after analysis is a standard practice at the antitrust agencies for assessing customer substitution patterns and whether the proposed transaction is likely to give rise to competitive concerns. Given the depth and breadth of data that retailers track, as well as retailers’ familiarity with A/B style “before” and “after” testing, assessing customer substitution patterns using the modern analytical tools used by the FTC in a merger review is straightforward for most retailers.

One of the most common types of before/after analysis used by the FTC is to compare the parties’ store-level sales before and after a competitor store opens nearby. In undertaking this type of analysis, the agency is attempting to develop evidence to answer questions related to consumer substitution patterns, such as:

- How big a hit to sales does the store suffer when a competitor store opens nearby?
- Is the hit to sales from entry bigger for some categories of products than others?
- Is the hit to sales bigger when one specific competitor (for example, one of the parties to the proposed transaction) enters compared to other competitors?
- Is the effect of the competitor store’s entry temporary or is the hit to sales sustained well beyond the grand-opening?

If the hits to sales from entry by a variety of competitors are all similar, then it is generally more likely the agency will conclude that consumers do not view the parties to the proposed transaction as

particularly unique or especially close substitutes in the marketplace. The same is true if the hit to sales from the entry is small. If the decrease in sales is only temporary, then the agency may conclude that consumers tried out the new store when it first opened, but did not find the new store to be a good substitute and quickly reverted to their original shopping destination.

While this type of information may seem more daunting than simple market shares, retailers often consider before/after event analyses in the ordinary course of business. Many of these internal analyses also compare before/after outcomes to a control group, such as comparable stores that did not experience entry or exit. With A/B style experiments widely used by retailers, these types of entry and exit analyses are relatively common to find in-house as part of ordinary-course analyses of consumer shopping behavior.

In an FTC merger review, the impact on sales from a competitor's entry are translated into consumer substitution patterns, which are referred to as diversions or diversion ratios. The amount and value of that diversion provides a numerical measure used by the FTC to assess how closely the parties to the proposed transaction compete. The agency views "high" diversion ratios as indicating that those two retail chains are close competitive alternatives for consumers. Consequently, antitrust risk typically increases if the FTC, using its own analytical framework, is likely to find high diversion ratios between the parties to the proposed transaction. For further discussion of diversion ratios, see Practice Note, Economic Tools for Evaluating Competitive Harm in Horizontal Mergers ([0-536-4207](#)).

Other types of evidence can also be valuable. For example, loyalty-card information can be useful, especially for assessing how far consumers travel to make purchases and whether the merging retailers (and other competitors) are drawing customers from the same geographic area.

Evidence about the extent of customers' cross-shopping across multiple retailers is also useful, but must be interpreted with care. While cross-shopping often reflects consumers' ability and willingness to substitute purchases of the same goods across different retailers, cross-shopping may reflect that consumers satisfy different needs at different retailers or using different channels of sale.

For example, the FTC has taken the view that conventional supermarkets are a limited constraint on grocery stores, such as Whole Foods because cross-shopping reflects consumers purchasing different products at each type of grocery store (for example, buying canned goods at Safeway but fresh products at Whole Foods), not consumer substitution patterns (for example, switching seafood purchases between Safeway and Whole Foods).

ONLINE COMPETITION

Online sales continue to grow significantly as a percentage of overall retail sales. Few brick and mortar retailers have escaped at least some competitive pressure from e-commerce retailers. The constraint from online retailers, however, is not the same in every retail setting. Nearly everyone buys online these days, but not everyone considers buying everything online all the time or even most of the time for certain types of retail purchases.

Determining how much credit the antitrust agency is likely to give online retail competition is critical. In some retail settings, the FTC

has credited online competition as a constraint on brick and mortar retailers, such as:

- The retail sale of office supplies (see What's Market, Office Depot, Inc. and OfficeMax, Inc. (Nov. 1, 2013) (decision to close)).
- Children's toys (see Press Release, FTC Approves Toys 'R Us Petition to Reopen and Modify 1998 Final Commission Order (April 15, 2014)).

But in other retail settings, the FTC has not viewed online retailers as a significant constraint on brick and mortar retailers, despite the growth of online sales overall and in these retail segments. Examples include:

- The sale of tailored men's suits (see What's Market, The Men's Wearhouse, Inc. and Jos. A. Bank Clothiers, Inc. (May 30, 2014) (decision to close)).
- Supermarkets (see What's Market, In the Matter of Cerberus Institutional Partners V, L.P., AB Acquisition LLC, and Safeway Inc. (Jan. 27, 2015) (consent decree) and In the Matter of Koninklijke Ahold N.V. and Delhaize Group NV/SA (July 22, 2016) (consent decree)).

Information readily available on retail dashboards and data from loyalty-card use can help assess how likely it is that online competition will be given full credit. Retailers can also ask themselves:

- At the point of sale, how often are prices matched when a customer holds up their smartphone showing the same product at a lower price?
- If local brick and mortar stores are price checked and mystery shopped, are online retailer websites similarly price checked and mystery shopped?
- What percentage of sales are made online, and are brick and mortar sales declining in relation to online sales?
- Did a new online entrant significantly affect brick and mortar retail sales?

PRICING STRATEGIES

Understanding the business rationale for the choice of pricing strategy is a central issue in the antitrust agency's competitive assessment of a proposed transaction.

ZONE-LEVEL OR STORE-LEVEL PRICING

While zone-level or store-level pricing may be driven by differences in costs to serve, the FTC typically considers prices, pricing policies, and price zones that vary locally based on the presence or absence of key competitors to be a major factor in their antitrust analysis. A price zone allowing for higher prices when a competitor (or type of competitor) is absent or lower prices when the competitor is present is likely to affect how the agency defines the relevant set of competitors and is almost always a critical factor in the agency's ultimate assessment of the merger's competitive effects.

NATIONAL AND OMNI-CHANNEL PRICING STRATEGIES

National and omni-channel pricing, in which prices and promotions do not vary across stores, e-commerce, and hardcopy mailings, such as catalogs, may mean there are different competitive constraints compared to localized pricing strategies. Parties to a proposed transaction often point to their national-pricing policies to explain why the transaction will not change pricing in any local area where the parties both have stores. But the reason for the choice matters.

Reasons for a national pricing policy that are benign or affirmatively helpful to a proposed merger include that the national pricing is driven by:

- A desire to provide a singular experience because many consumers purchase across multiple stores and using multiple channels, both instore and online.
- Vigorous competition from omnipresent e-commerce alternatives.
- Vigorous competition from thousands of diverse mom-and-pop retailers across the country.

On the other hand, if the reason for national pricing is that the other party to the transaction has a nationwide or nearly nationwide footprint of stores, making nationwide pricing an efficient way to price against that key competitor, national pricing will not help the parties avoid antitrust scrutiny. In short, during a merger review, expect that the FTC will assess whether the transaction is likely to eliminate a competitive constraint that would lead to higher prices across the board.

EFFICIENCIES AND TRANSACTION-RELATED STORE CLOSURES

The ability to lower costs often motivates a potential combination. That is useful because it is important to be able to articulate a strong procompetitive rationale for the proposed transaction. The focus of the antitrust agency's investigation is not on how the consolidation may benefit the merging parties, but rather "How will the transaction benefit consumers?" A merger premised on lowering costs and passing those savings on to consumers through lower prices is an example of a procompetitive deal rationale that benefits consumers and the FTC is likely to view favorably.

But not all synergies are inevitably procompetitive. While cost synergies are often viewed as procompetitive, synergies that stem from transaction-related store closures can create a red flag. The FTC may view store closures as having no pro-consumer benefit or as reducing consumer choice and may even view closures as an attempt to eliminate "cannibalization" that reflects meaningful pre-merger competition. Therefore, transaction-related store closures to address being over-stored, whether characterized as a revenue synergy or a cost synergy, require careful pre-deal consideration, including whether those stores were likely to have closed even in the absence of the transaction.

TRADITIONAL TOOLS AND EVIDENCE

Traditional tools and pieces of evidence still matter for pre-deal risk assessment. In retail merger investigations, these include:

- Documents discussing competition and efficiencies that are submitted with the merging parties' premerger notification Hart-Scott-Rodino filings.
- Interviews of competitors of the merging parties and other industry participants.
- The merging parties' ordinary-course documents focusing on how the merging parties assess competition, their competitors, and their market shares.

Although the modern economic tools are often more relevant for predicting the agency's ultimate assessment, unhelpful documents

and unfavorable third-party testimony can extend an investigation, result in the agency requiring store divestitures as a condition of approving the merger, and may even appear in a complaint seeking to stop a transaction entirely.

For further discussion of traditional merger analysis, see Practice Note, How Antitrust Agencies Analyze M&A ([3-383-7854](#)).

RECENT FTC INVESTIGATIONS

In recent years, the FTC has reviewed many proposed transactions between well-known retailers, including:

- Office Depot/OfficeMax (see What's Market, Office Depot, Inc. and OfficeMax, Inc. (Nov. 1, 2013) (decision to close)).
- Safeway/Albertsons (see What's Market, In the Matter of Cerberus Institutional Partners V, L.P., AB Acquisition LLC, and Safeway Inc. (Jan. 27, 2015) (consent decree)).
- Dollar Tree/Family Dollar (see What's Market In the Matter of Dollar Tree, Inc. and Family Dollar Stores, Inc. (July 2, 2015) (consent decree)).
- Walgreens/Rite Aid (see What's Market, Walgreens Boots Alliance, Inc. and Rite Aid Corporation (Sept. 19, 2017) (fix it first)).
- 7-Eleven/Sunoco (see What's Market, In the Matter of Seven & i Holdings Co., Ltd., 7-Eleven, Inc., and Sunoco LP (Jan. 18, 2018) (consent decree)).

The FTC's public statements about these transactions confirm that the agency is using more sophisticated data-driven tools during its retail-merger investigations. For example, in Office Depot/Office Max, the FTC closed its investigation after relying on, among other things:

- An econometric study that included an analysis of the impact of store closings on the prices charged by remaining office supply superstores.
- Evidence that the merging parties had lost substantial in-store sales to online competitors.
- The merging parties' pricing policies, which were national for the majority of their products, and specifically factored in a broad set of competitors where products were priced locally.

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