MERGER ANTITRUST LAW

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Georgetown University Law Center
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Tuesdays and Thursdays, 3:30-5:30 pm
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GRADED WRITTEN ASSIGNMENT

Instructions

Submit by email by 3:30 pm on Tuesday, November 26
Send to dale.collins@shearman.com
Subject line: Merger Antitrust Law: Graded Homework Assignment

This is an untimed graded homework assignment. You may consult any written source, including without limitation the class notes, cases, outlines (commercial or otherwise), books, treatises, the Internet, Westlaw, and Lexis-Nexis. Of course, you must do your own work and not talk about the problem with any student or any other person until after class on November 26.

Present your analysis in a well-organized, linear, and concise manner. Think about your answers before writing. *Remember Pascal's apology*: "I am sorry that this was such a long letter, but I did not have the time to write you a short one." Clarity of thinking and exposition are much more important than throwing in the kitchen sink. Penalties will be levied for excessive length, verbosity, or lack of organization.

The "facts" in the hypothetical should be complete in the sense that they present what is known at the time the analysis is requested. As in life, some information you would like to have may simply not be available. Analyze the facts as they are presented in the question. If the question cannot be answered without a fact that is missing from the question, you may supply *provided* you explicitly note that you are assuming a particular fact. Before positing a fact, be sure that an answer to the question presented requires the fact. If the question presented, for example, places you at the early stages of a transaction, the fact may simply not be available and the question may require you to spot the need for further investigation rather than posit a fact that could not reasonably have been known at the time.

It should go without saying that, outside of this examination, you should not believe everything (or anything) in the statement of any hypothetical fact situation. I have taken considerable liberties in fashioning the problems and have totally ignored reality whenever it was convenient. The only facts on which you can rely on those that are footnoted.

This homework assignment is final. Do not expect any clarifications or corrections. If you believe there is an error or inconsistency in the exam, please state your assumptions about the issue within your discussion of that issue. You may email me if you wish, but I will either not respond or respond to the class as a whole. *For this reason, and more importantly because we will be continuing to work on cases that may further illuminate concepts that are relevant to the homework assignment, I suggest that you wait until shortly before the due time to submit your answer.*

You should assume that federal subject matter jurisdiction exists and that it is unnecessary to address any jurisdictional questions in your answers. Also, all demand curves are linear in the areas of interest and all marginal costs are constant.

Frozen Dinners Merger

You are an associate in Able & Baker LLP. Along with Daniel Kafee, a partner with whom you work, you have just met with Alice Long, the CEO of Intelligent Ones, a family-owned specialty manufacturer of low-calorie single-serve frozen dinners. The company, which was started by Long's grandfather, has been struggling somewhat in recent years and Long has been thinking about selling it. Although Long did not solicit the offer, ConAgra Brands, one of North America's leading branded food companies, has just approached Long about purchasing Intelligent Ones in an all-cash deal for $135 million.

Long believes that the price is very attractive and would like to pursue the deal. She is aware that the FTC conducts reviews of transactions in the food industry. Although Long acknowledges that she does not know very much about antitrust law and acknowledges that she views ConAgra as one of her most significant competitors, for the reasons she explained at the meeting she does not believe that the FTC should find the deal problematic. As a check on her intuition, however, Long would like Able & Baker to provide her with a preliminary antitrust analysis assessing the antitrust risks in the transaction.

Kafee has asked you to draft a memorandum that he can send to Long with this preliminary substantive analysis. Kafee wants you to address both the current state of the analysis on the facts you have been given by Long as well as to identify the most important pieces of evidence that need to be developed in order to better assess the antitrust risk.

This is what Long told Kafee and you in the meeting:

Intelligent Ones is a mid-sized firm that manufactures and sells low-calorie, healthy, single-serve frozen dinners in grocery stores nationwide. It was founded by Long's grandfather 50 years ago.

Intelligent Ones distinguishes its brand as having exceptionally high-quality ingredients and recipes. Intelligent Ones positions itself as a healthy, low-calorie, convenient dinner for an individual. The cost of the ingredients require Intelligent Ones to charge prices to grocery stores that are higher than its direct competitors. Although prices differ a little depending on the particular product, on average Intelligent Ones sells to grocery stores nationwide at $2.29 per unit with a percentage gross margin of 30%. Last year, Intelligent Ones had revenues of $50 million, variable costs of $35 million, and recurring fixed costs (including advertising and debt service) of $10 million, for total profits of $5 million. Assuming a 20x price-earning ratio, Intelligent Ones would be valued at $100 million. ConAgra has offered $135 million, representing a 35% premium over going concern value. Table 1 provides a summary.

Table 1
Intelligent Ones

Revenues	$50,000,000
Variable costs	$35,000,000
Fixed costs	$10,000,000
Earnings	$5,000,000
Going concern value (20x)	$100,000,000
Purchase price	$135,000,000
Premium	35%

Market research by Intelligent Ones shows that customers are attracted both by the products' healthy, low-calorie attributes as well as by the convenience and economy of simply heating a single package to make a full meal.

Intelligent Ones' most direct competitors are Nestlé's Lean Cuisine and ConAgra's Healthy Choice. Like Intelligent Ones, these products are low-calorie, single-serve frozen dinners. Aside from a few small brands, there are no other brands in this space. Other low-calorie, single-serve frozen dinners are a little cheaper than Intelligent Ones at wholesale and retail because they do not use as high a quality of ingredients and, at least in the case of Nestlé and ConAgra, have lower procurement costs even for the identical ingredients. Long also believes that, given the customer's desire for convenience and economy, Intelligent Ones strongly competes with non-low-calorie frozen dinners, which contain more calories and higher levels of sodium and are considerably cheaper than low calorie frozen dinners. Table 2 summarizes Long's estimates of the prices and costs of single-serve frozen dinners:

Table 2
Single Serve Frozen Food Prices, Costs, and Margins

Parameter	Intelligent Ones	Other LC SS	Non-LC SS
Price to the grocery[1]	$2.29	$1.86	$1.71
Marginal cost (mc)	$1.60	$1.30	$1.20
%margin (%m)	30%	30%	30%
$margin (m)	$0.69	$0.56	$0.51

All LC SS: All low calorie single serve products
All SS: All single serve products
Non-LC SS: All non-low calorie single serve products

Long provided estimates of sales revenues and market shares of the various firms in the frozen dinner space, which are attached as an appendix as well as an Excel spreadsheet.

When questioned about why ConAgra would like to buy Intelligent Ones, Long said that there were two obvious reasons.

[1] Groceries typically sell their products at a markup of 12%, of that the average retail price of Intelligent Ones, for example, is $2.56 (= $2.29 times 1.12).

First, there are significant cost savings resulting from the acquisition. ConAgra has sufficient excess capacity in its production, distribution, marketing, and back office systems to accommodate Intelligent Ones, with plenty of room left for growth, which will permit ConAgra to shut down Intelligent Ones' duplicative operations and eliminate about $6 million per year in annual recurring fixed costs. Moreover, because ConAgra already has a massive nationwide advertising program, it almost surely can increase the overall advertising of Intelligent Ones (perhaps by cutting back on some other products with lower margins) while saving some of the $4 million in advertising Intelligent Ones is currently spending. Finally, given its scale, ConAgra has been able to achieve significant savings in procurement of ingredients. Long does not know the numbers for sure, but she suspects that ConAgra can reduce the marginal cost of Intelligent Ones' from the current level of $1.60 to $1.50 or even $1.40 without reducing the quality of the product.

Second, the acquisition of Intelligent Ones will assist ConAgra in the contest with Nestlé for grocery store shelf space. One reason that Intelligent Ones has been struggling in recent years is that Nestlé and ConAgra, by far the largest two firms in all types of single serve frozen dinners (low calorie and non-low calorie), have been increasing the number of different products they offer and using their size and bargaining power with grocery stores to increase their share of shelf space in the grocery store frozen food cabinets. This has made it increasingly difficult for smaller manufacturers such as Intelligent ones to maintain their market share, much less grow. In some instances, grocery stores have stopped carrying the smaller brands altogether. To counteract this, Intelligent Ones has significantly increased its spending on comparative advertising to demonstrate the quality of its products in the hopes that customers will pressure their stores to keep Intelligent Ones in the store and provide space for existing and new Intelligent Ones product offerings.

Long believes that ConAgra's interest in Intelligent Ones is motivated in part by ConAgra's product diversity/growth strategy. Intelligent Ones offers a recognized higher-quality product than ConAgra's Healthy Choice line. ConAgra has told Long that, once it acquires Intelligent Ones, ConAgra plans on accelerating the introduction of new Intelligent Ones products and increasing advertising to attract additional customers to the product line. ConAgra told Long that it is not concerned about cannibalizing Healthy Choice customers by increasing the demand for Intelligent Ones. ConAgra believes (correctly) that, given that customers switch unit-for-unit and that Intelligent Ones has a higher gross margin than Healthy Choice, a switch by some of ConAgra's customers from Healthy Choice to Intelligent Ones will only increase ConAgra's profits.

When questioned more about this in the meeting, Long estimated that if Intelligent Ones would increase its price by 5%, it would lose 16.6% of its customers. Long believes that 50% of the lost customers would divert to Lean Cuisine or Healthy Choice, 40% to other (non-low calorie) single-serve frozen dinners, and 10% to a large variety of other products.

As an aside, Long mentioned that the situation in low calorie single-serve frozen dinners is not symmetrical. If the price of Lean Cuisine, Healthy Choice, or any of the other low calorie single-serve frozen dinner products was increased by 5%, it would lose a similar 16.6% of its customers. However, we would not see any diversion to Intelligent Ones because its price would still be too high for these customers. Instead, 90% of the diversion would be to the other low calorie single-serve frozen dinners whose price was not increased and 10% to other products.

If the price of all low calorie, single-serve frozen dinners was increased by 5%, Long estimates that again 16.6% of the customers would switch to another product. But in this situation Long believes that 50% of the lost customers would divert to (non-low calorie) single-serve frozen dinners because of the convenience and 50% to a large variety of other products (including other low-calorie alternatives).

If the price of all single-serve frozen dinners (low calorie and non-low calorie) was increased by 5%, Long estimates that now only 10% of the customers would switch to another product, all diverted outside of single-serve frozen dinners. The low percentage of switching results from the fact that purchasers of non-low calorie frozen dinners, which constitute the bulk of the all single-serve frozen dinner market (73%), are motivated almost exclusively by the convenience of single-serve packages and therefore would be reluctant to switch outside to other products.

Table 3
Diversions and Percentage Actual Loss for a 5% SSNIP

	Intelligent Ones		**All LC SS**		**ALL SS**	
Total %loss		16.6%		16.6%		10.0%
for 5% SSNIP	Diversion	%Actual loss	Diversion	%Actual loss	Diversion	%Actual loss
Low calorie SS	50%	8.3%	0%	0.0%	0%	0.0%
Non-LC SS	40%	6.6%	50%	8.3%	0%	0.0%
Other	10%	1.7%	50%	8.3%	100%	10.0%
	100%	16.6%	100.0%	16.6%	100%	10.0%

All LC SS: All low calorie single serve products
All SS: All single serve products

The final factor motivating Long to sell is that Bellisio Foods is openly considering entering into low calorie single serve frozen dinners. Bellisio is the third largest single serve frozen dinner producer after Nestlé and ConAgra. Its product line is established in grocery stores and it would be a natural and relatively inexpensive extension of its respected Michelina's and Patio brands to add a low calorie single serve frozen dinner product line. In addition to the brand name reputation, Bellisio has the production and distribution facilities and know-how to enter without any significant suck cost expenditure the production and distribution of a low calorie single serve frozen dinner product line. It also has a national advertising program in place that could easily accommodate the new product line. Finally, Bellisio today is three times the size of Intelligent Ones and if Bellisio extended its product line it would pose another significant threat of pushing Intelligent Ones of the grocery store shelves.

Appendix

Revenues and Revenue Shares
(see also the accompanying Excel spreadsheet)

Table 4
Low-Calorie Single-Serve Frozen Dinners

	Sales	Share
Nestlé (Lean Cuisine)	142.45	54.8%
ConAgra Foods (Healthy Choice)	57.41	22.1%
Intelligent Ones	50.00	19.2%
Others/Private label (6)	10.22	3.9%
	260.08	100.0%

Table 5
All Single-Serve Frozen Dinners

	Sales	Share
Nestlé USA (Stouffer's, Lean Cuisine)	307.33	31.0%
ConAgra Foods (Banquet Dinners, Marie Callender's, Healthy Choice, Kid Cuisine, Patio)	235.26	23.7%
Bellisio Foods (Michelina's, Patio)	150.33	15.2%
Amy's Kitchen	66.55	6.7%
Heinz North America	56.31	5.7%
Pinnacle Foods Group	50.69	5.1%
Intelligent Ones	50.00	5.0%
Others/Private label (10)	75.00	7.6%
	991.47	100.0%