Class 20 slides

13. Staples/Office Depot

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STAPLES
The Office Superstore

Office DEPOT®
OfficeMax®
Taking care of business

The Background

The deal

- Staples to acquire Office Depot for $6.3 billion
  - Announced February 4, 2015
    - Take 2: Parties attempted to merge in 1997. The FTC challenged the deal and obtained a Section 13(b) preliminary injunction. The parties subsequently abandoned the deal.
  - Total transaction value: $6.3 billion in cash and stock
    - Office Depot valued at $11.00 per share
      - $7.25 in cash
      - $3.75 in Staples stock (0.2188 shares)
    - 44% premium over the February 2 Office Depot closing price
    - 65% premium over 90-day Office Depot average closing price
  - Office Depot shareholders will hold approximately 16% of the combined company
  - Combined company pro forma sales: $39 billion

The parties

- Staples
  - Largest supplier of office supplies
  - Opened first office products superstore in 1986
  - Operates in three business segments:
    1. North American retail stores and online sales (48.0% of revenues)
       - 1,515 stores in the United States and 331 stores in Canada North American commercial sales (B2B contract sales) (34.8%)
    2. North American Commercial (34.2%)
       - Focusing on B2B sales
    3. International operations (17.2%)
       - Consists of businesses in 23 countries in Europe, Australia, South America and Asia
  - 2014 revenues: $22.5 billion

The parties

- Office Depot
  - Second largest supplier of office supplies
  - Opened first store in 1986
  - Acquired OfficeMax (third largest office supply superstore) on November 5, 2013
    - Announced February 2013
    - FTC closed investigation without enforcement action on November 1, 2013
  - Operates in three business segments:
    1. North America retail (41% of revenues)
       - 1,912 office supply stores, including 823 OfficeMax stores
    2. North American business solutions (B2B contract sales) (31.8%)
    3. International (27.1%)
  - 2014 revenues: $16.1 billion

The deal

- Purchase agreement
  - Drop dead date: November 4, 2015 (9 months)
    - Automatic extension if antitrust conditions not satisfied to February 4, 2016 (one year after signing)
    - Not long enough: Decision was issued on May 10, 2016
  - Divestiture obligation:
    - Office Depot stores with 2014 revenues up to $1.25 billion in the United States
      - 7.8% of Office Depot sales
  - Antitrust reverse termination fee: $250 million (4% of transaction value)

Deal rationale

- Office superstores being severely challenged by new competitors
  - New competitors since the original 1997 enjoined transaction
    - Mass merchants such as Walmart, Target and Tesco
    - Warehouse clubs such as Costco
    - Computer and electronics retail stores such as Best Buy
    - Specialty technology stores such as Apple
    - Copy and print businesses such as FedEx Office
    - Online retailers such as Amazon.com and other discount retailers
  - Concomitant sales declines

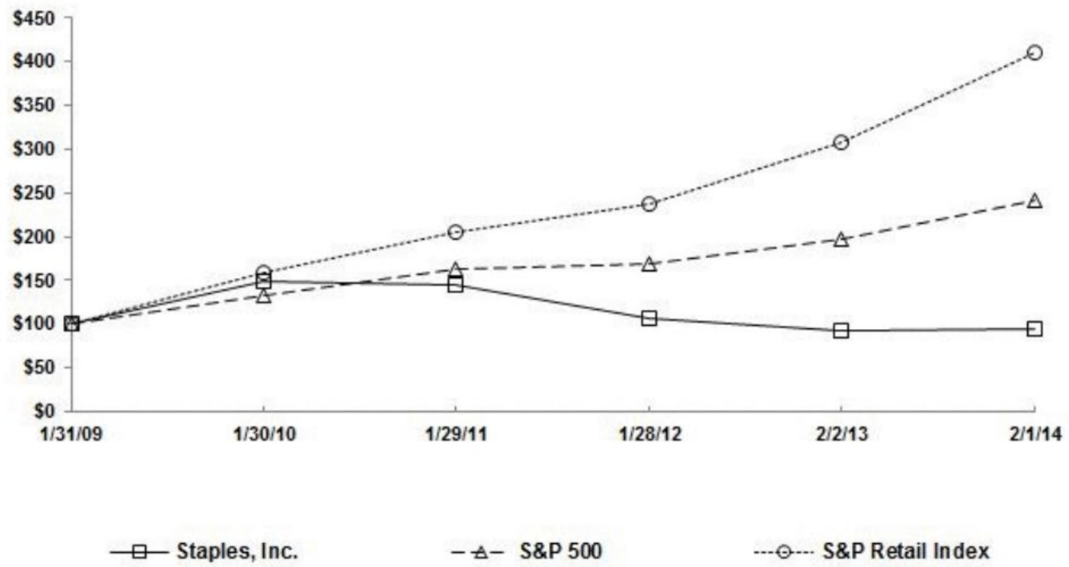
Sales Year-over-Year

	2011	2012	2013
Staples	-3.0%	-1.2%	-5.2%
Office Depot	-2%	-8%	-5%

  - Staples' response
    - Recently announced that it would be closing up to 225 stores
    - Reduced the size of its store prototype from 24,000 square feet to 12,000 square feet

Deal rationale

- Staples stock performance —Return on $100 investment on 1/31/2009



TOTAL RETURN TO STOCKHOLDERS

	31-Jan-09	30-Jan-10	29-Jan-11	28-Jan-12	2-Feb-13	1-Feb-14
Staples, Inc.	$ 100.00	$ 149.49	$ 144.63	$ 106.48	$ 92.95	$ 93.51
S&P 500 Index	$ 100.00	$ 133.14	$ 162.67	$ 169.54	$ 197.98	$ 240.58
S&P Retail Index	$ 100.00	$ 158.09	$ 205.24	$ 238.26	$ 307.32	$ 410.04

Deal rationale

Compelling Strategic and Financial Rationale

- Combined company better positioned to provide more value to customers and compete against a large and diverse set of competitors
- Strategic combination expected to deliver at least $1 billion of synergies by third full fiscal year post-closing
- Operational efficiencies and cost savings used to dramatically accelerate Staples' strategic reinvention
- Provides ability to optimize retail footprint, minimize redundancy, and reduce costs
- Accretive to EPS in first year post-closing after excluding one-time integration and restructuring costs and purchase accounting adjustments

STAPLES

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Deal rationale

Creating a $39 Billion Distributor of Products and Services

		Staples		Office Depot / OfficeMax		Post-acquisition Staples
LTM Revenue $B [1]	North America	$18.8	North America	$12.7	North America	$31.5
	International	$3.9	International	$3.5	International	$7.4
	Total	**$22.7**	**Total**	**$16.2**	**Total**	**$38.9**
Distribution Facilities [2]	North America	69	North America	91	North America	160
	International	47	International	36	International	83
	Total	**116**	**Total**	**127**	**Total**	**243**
Store Count [3]	North America	1,721	North America	1,851	North America	3,572
	International	303	International	145	International	448
	Total	**2,024**	**Total**	**1,996**	**Total**	**4,020**

1. *LTM Revenue as of 11/1/2014 and 9/27/2014 for Staples and Office Depot, respectively, Office Depot revenue pro forma for merger with OfficeMax and excludes revenue generated by the former OfficeMax business in Mexico.*
2. *As of fiscal year ended 2/1/2014 and 12/28/2013 for Staples and Office Depot, respectively, Office Depot data includes cross docks.*
3. *As of 11/1/2014 and 9/27/2014 for Staples and Office Depot, respectively.*

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Deal rationale

Annualized Synergies Building to at Least $1 Billion Over Three Year Integration Period

The acquisition presents a unique and exciting opportunity to reduce costs and improve service in a way that neither company could achieve on its own

Key Synergy Opportunities

Year 1:
- Headcount and G&A Expense Reductions
- Procurement
- Advertising and Marketing
- Retail Network Optimization

Year 2:
- Headcount and G&A Expense Reductions
- Procurement
- Advertising and Marketing
- Retail Network Optimization
- Supply Chain

Year 3:
- Headcount and G&A Expense Reductions
- Supply Chain
- Retail Network Optimization

Cumulative Annualized Synergies: Building to at least $1 billion by 3rd fiscal year post-closing

Cumulative Costs to Achieve Synergies: One-time costs of approximately $1 billion to achieve synergies

Expanded product and service offering drives revenue synergies

Year 1 | Year 2 | Year 3

STAPLES
MAKE MORE HAPPEN

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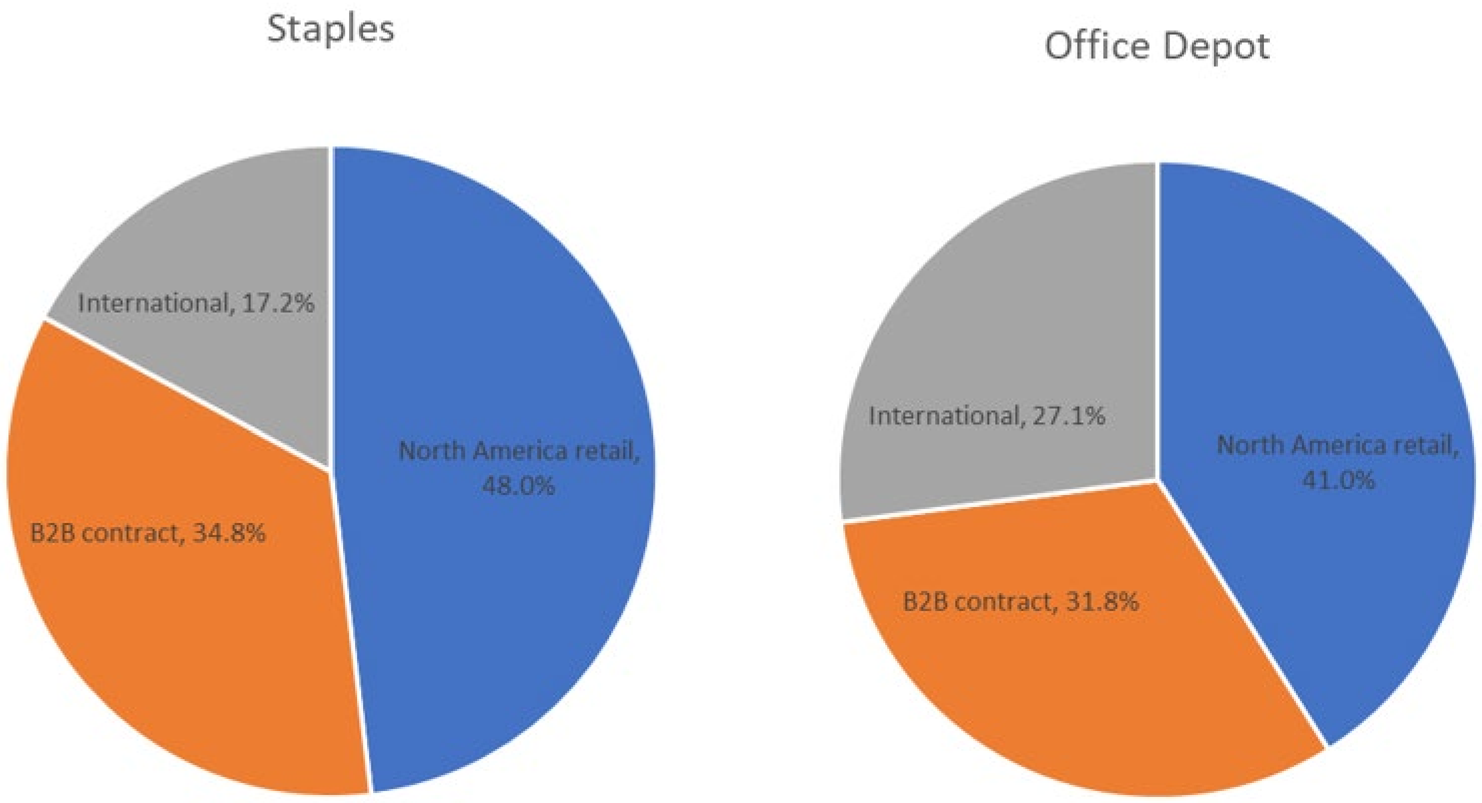
Overlaps


Staples
International, 17.2%
North America retail, 48.0%
B2B contract, 34.8%
Office Depot
International, 27.1%
North America retail, 41.0%
B2B contract, 31.8%

The FTC investigation and litigation

- FTC investigated for almost one year

Date	Event
February 4, 2015	Deal signed
March 30, 2015	Second request issued
August 28, 2015	Staples and Office Depot certify substantial compliance
October 12, 2015	Staples and Office enter into a timing agreement with FTC not to close and the FTC agrees to decide outcome of investigation by December 8, 2015
November 4, 2015	Automatic extension of drop dead date to February 4, 2016
December 7, 2015	FTC challenges transaction by unanimous vote (4-0)

The complaint

- Two counts
  1. Acquisition, if consummated, would violate Clayton Act § 7
  2. Signing of the merger agreement violated FTC Act § 5
- Relevant market
  - Sale and distribution of consumable office supplies to large B2B customers in the United States
    - BUT excluding ink and toner for printers and copiers
  - *Query*: Why no challenge in retail markets?
- Prayer
  - Preliminary injunction pending resolution of the merits in an administrative proceeding

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

FEDERAL TRADE COMMISSION
600 Pennsylvania Avenue, N.W.
Washington, DC 20580

DISTRICT OF COLUMBIA
441 4th Street, N.W., Suite 600 South
Washington, DC 20001

COMMONWEALTH OF PENNSYLVANIA
14th Floor Strawberry Square
Harrisburg, PA 17120

Plaintiffs,

v.

STAPLES, INC.
500 Staples Drive
Framingham, MA 01702

and

OFFICE DEPOT, INC.
6600 North Military Trail
Boca Raton, FL 33496

Defendants.

Civil Action No. 15-cv-02115

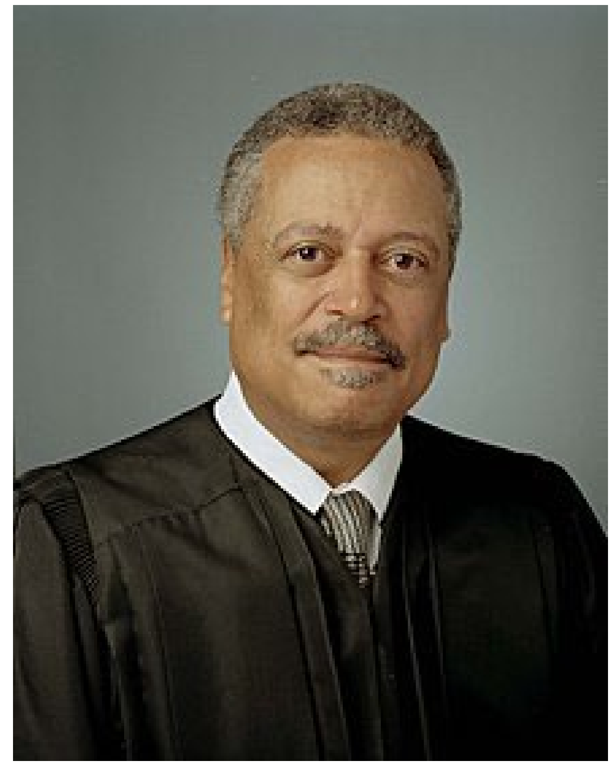
PUBLIC VERSION

COMPLAINT FOR TEMPORARY RESTRAINING ORDER
AND PRELIMINARY INJUNCTION PURSUANT TO
SECTION 13(b) OF THE FEDERAL TRADE COMMISSION ACT

Plaintiffs, the Federal Trade Commission ("FTC" or "Commission"), by its designated attorneys, and the District of Columbia and the Commonwealth of Pennsylvania, acting by and through their respective Office of Attorney General (collectively, "Plaintiff States"), petition this Court for a temporary restraining order and preliminary injunction enjoining Staples, Inc. ("Staples") from consummating its proposed merger (the "Merger") with Office Depot, Inc.

The District Court

- Tried in the District Court of the District of Columbia
  - Judge Emmet G. Sullivan
    - Appointed by President Clinton
    - Assumed office: June 16, 1994
    - First merger antitrust case



The Section 13(b) proceedings

- Timing developments

Date	Event
December 7, 2015	Section 13(b) complaint filled
December 21, 2015	Staples proposes divesting $1.25 billion in commercial contracts — FTC rejected with no counteroffer
February 2, 2016	Parties extend drop-dead date to May 16, 2016
February 10, 2016	EU approval (with conditions) — Divestiture of Office Depot's European contract business — Divestiture of all of Office Depot's operations in Sweden
February 16, 2016	Staples agrees to sell $550 million in large corporate contracts business to Essendent for $22.5 million — Conditioned on closing of Staples/Office Depot merger
March 21, 2016	Evidentiary hearing commences — 4 months after filing of the complaint

The Section 13(b) proceedings

- Discovery
  - 15 million pages of documents produced
  - >70 depositions taken
  - Five expert reports
- The trial
  - March 21, 2016, to April 5, 2016
  - 10 live witnesses
  - 4000 exhibits admitted
  - At the conclusion of the plaintiffs' case, the *defendants rested their case without presenting any fact or expert witnesses*
  - NB: Defendants represented to Court that they would *terminate their transaction* if the Court entered a preliminary injunction

PI entered: May 10, 2016
Deal terminated: May 10, 2016

The expert witnesses

- FTC expert: Carl Shapiro
  - Professor of Professor of Business Strategy, UC Berkeley
  - Former chief economist, Antitrust Division (twice)
  - One of two principal drafters of the 2010 Merger Guidelines
  - Former Member, Council of Economic Advisers
  - Very experienced trial expert witness
  - A favorite of the DOJ and FTC

- Merging parties: None
  - Rested their case without calling witnesses
    - Had an expert witness but elected not to call any witnesses

Organization of opinion

- Relevant markets
  - The relevant geographic market
    - Stipulated to be the United States
  - The relevant product market
    - Consumable office supplies sold to B2B customers BUT excluding ink and toner
      - Legal principles considered when defining a relevant market
      - Application of legal principles to plaintiffs' market definition
      - Defendants' arguments in opposition to plaintiffs' alleged market
      - Conclusions regarding the relevant market
- Application of *PNB* presumption
  - Analysis of the plaintiffs' arguments relating to the probable effects on competition based on market share calculations
  - Defendants' arguments in opposition to plaintiffs' market share calculations
  - Conclusions regarding plaintiffs' market share
- Additional evidence of competitive harm
  - Plaintiffs' evidence of additional harm
- Defendants' further response to plaintiffs' prima facie case
  - Downward pricing pressure defenses
- Weighing the equities

The District Court Opinion
1. The Prima Facie Case
A. Relevant Geographic Market

Relevant geographic market

- Stipulated: The United States

The District Court Opinion

1. The Prima Facie Case

B. Relevant Product Market

Relevant product market: The parties' positions

- FTC alleged market
  - Sale and distribution of consumable office supplies to large B2B customers in the United States (excluding ink and toner)
    - **Cluster market** with a carveout
    - Also a **targeted customer market**
      - B2B customers (definition): spend $500K or more annually on office supplies (appx. 1200 companies)
      - The "large B2B" customers limitation essentially limits market participants to office supply superstores and a few other retailers (e.g., Amazon)
- The parties
  - Sale and distribution of all consumable office supplies by all firms
    - Cluster market without a carveout
    - No target customers

The Court: Accepts FTC's definition

- Notes that ***cluster markets*** and ***targeted customer markets*** are recognized by the courts and Merger Guidelines
- Three *Brown Shoe* factors support:
  1. Public recognition as a separate market (based on parties' business documents)
  2. Exhibits distinct prices and high sensitivity to price changes
     - Bid for vendors using RFPs for 3-5 yr. contracts (with upfront lump-sum rebates)
       - NB: Contracts not exclusive
     - Customer's "play" Staples and Office Depot off against each other
     - Pay about ½ compared to average retail customer
     - Bids are %-off list prices for core products
     - Customers will switch vendors for small percentage differences
  3. Consists of distinct customers with distinct requirements
     - Require bids by RFP
     - Require sophisticated IT capabilities
     - Personalized, high-quality customer service
     - Nationwide delivery to dispersed geographic locations
     - Expedited delivery services (next day and "desktop" delivery – direct to user within organization)
     - Internal business units organized to focus on B2B business

The Court: Accepts FTC's definition

- Hypothetical monopolist test satisfied
  - Parties agree on test and its applicability
  - *Evidence*: Shapiro expert testimony on hypothetical monopolist test
    - Court provides few details
    - An exhibit used in Shapiro's testimony shows he used a recapture analysis:

Hypothetical Monopolist Test ("HMT")
Depends on a Threshold Recapture Rate

- Using 5% price increase, HMT is satisfied if:

$$\textit{Recapture Rate} > \frac{10\%}{\textit{Profit Margin} + 10\%}$$

- Profit Margin estimates range = [redacted]% to [redacted]%
- Leads to Threshold Recapture Rate = [redacted]% to [redacted]%

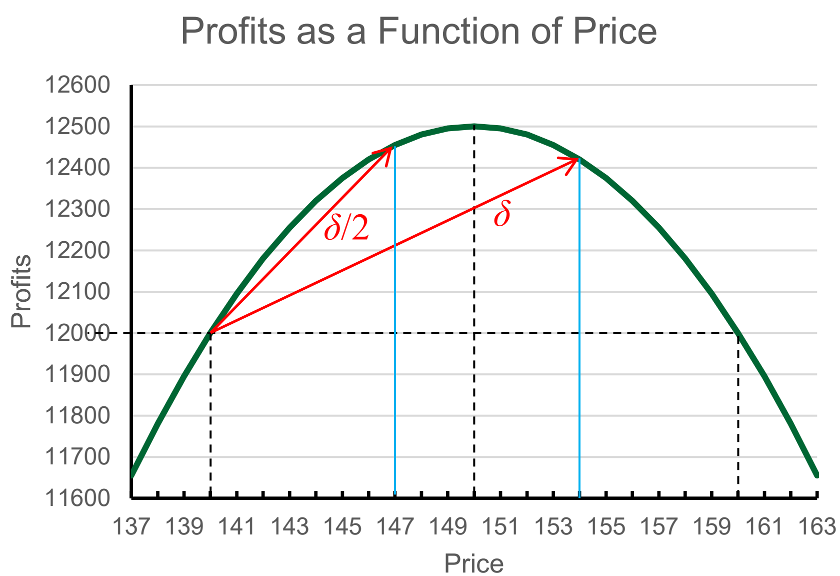
Query: What kind of test is this? Is it the right test?

Query: If the SSNIP was 5%, why did Shapiro use 10% in calculating the critical recapture rate?

Redacted in public version of exhibit

The Court: Accepts FTC's definition

- Hypothetical monopolist test satisfied
  - Shapiro testimony: Used the *profit-maximization version* of the HMT
    - Illustration—Not Shapiro's analysis
      - As shown by the diagram below, the equal profit-prices are at the prevailing price of 140 and at 160
      - For linear demand, the profit-maximizing price is one-half the distance between the equal profit prices—here, 150
      - So, for a SSNIP of 5% under a profit-maximizing HMT, use 10% in the critical loss or critical recapture formulas: Profitability under 2×SSNIP → Satisfies profit-maximization HMT



Propositions:

1. If a SSNIP δ is profitable, then the profit-maximizing percentage price increase is at least $\delta/2$
2. If a SSNIP δ is not profitable, then the profit-maximizing percentage price increase is less than $\delta/2$

NB: This technique works only with linear demand curves

The Court:

- Accepts FTC’s definition
  - Proposed market encompasses all methods of procuring office supplies by large companies
    - Types of suppliers included in proposed market:
      - Primary vendors
      - Off-contract purchases
      - Online
      - Retail
    - Evidence
      - Customers
      - Documents (?)
      - Competitors
  - Note
    - Court relies on both the Shapiro and customer testimony for the proposition that companies can get lower prices because of the competition between Staples and Office Depot → a hypothetical monopolist could raise prices
    - WDC: This amounts to using an anticompetitive effect to prove market definition

The Court: Rejects defendants' attack

- *Argument 1*: Gerrymandered cluster market
  - Parties' position:
    1. No principled reason to exclude BOSS—Just made for litigation
       - Plaintiffs admit that excluded products are included in primary vendor contracts "the overwhelming majority of the time"
    2. Definition inconsistent with the one used by the FTC in assessing the 1997 proposed merger
    3. FTC made the decision on exclusions prior to Shapiro's independent determination

    NB: But defendants did not invoke *Brown Shoe* factors or hypothetical monopolist test to justify inclusion
  - Court: Rejects argument
    - Defendants' arguments fail to address the key question: "[A]re the items subject to the same competitive conditions?"

The Court: Rejects defendants' attack

- *Argument 1*: Gerrymandered cluster market
  - Court: Rejects argument (con't)
    1. Ink, toner , and BOSS subject to different competitive dynamics given competition from Managed Print Services vendors (e.g., Xerox, H-P, Lexmark, Ricoh)—
       - Recall, contracts not exclusive, so customers can purchase from other vendors
       - The number of companies providing ink and toner ("Managed Print Services" or "MPS") to large customers is greater than the number providing other consumable office suppliers
       - Customers view MPS vendors as viable contracting suppliers of ink and toner, but view only Staples and Office Depot as viable contracting suppliers for other consumable office supplies
       - Customers frequently disaggregate purchases of ink and toner from purchases of other consumable office supplies
       - Parties' market shares in ink and toner were lower than they are in the alleged relevant market, showing the lack of "analytical similarity" with the FTC's alleged relevant product market
       - *WDC*: Missed the most important thing: Products can be and are separately priced to respond to product-by-product competitive conditions that are different from other products in the cluster market
    2. Competitive conditions have "dramatically" changed since 1997
       - MPS vendors did not exist at the time
       - Case focused on retail consumers and not contract channels for large B2B customers
    3. Irrelevant that the FTC decided on exclusions prior to Shapiro making an independent determination
       - "Voluminous" empirical evidence supports the exclusions

The Court: Rejects defendants' attack

- *Argument 1*: Gerrymandered cluster market
  - A point not made in the opinion (but should have been): Staples breaks out ink, toner and BOSS in its SEC reporting, indicating that it views them as separate business lines:

	Fiscal Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
Core office supplies	27.5%	28.1%	29.4%
Ink and toner	20.2%	19.7%	19.5%
Business technology	15.2%	16.6%	18.0%
Paper	9.0%	9.0%	9.0%
Facilities and breakroom	8.7%	7.4%	6.5%
Computers and mobility	6.9%	6.9%	6.8%
Services	6.9%	6.7%	5.7%
Office furniture	5.6%	5.6%	5.1%
	100.0%	100.0%	100.0%

  - The FTC's relevant product market appears to encompass:
    - Core office supplies (27.5%)
    - Paper (9.0%)

36.5% of Staple's overall business

So a cluster market does not have to contain the bulk of a firm's business

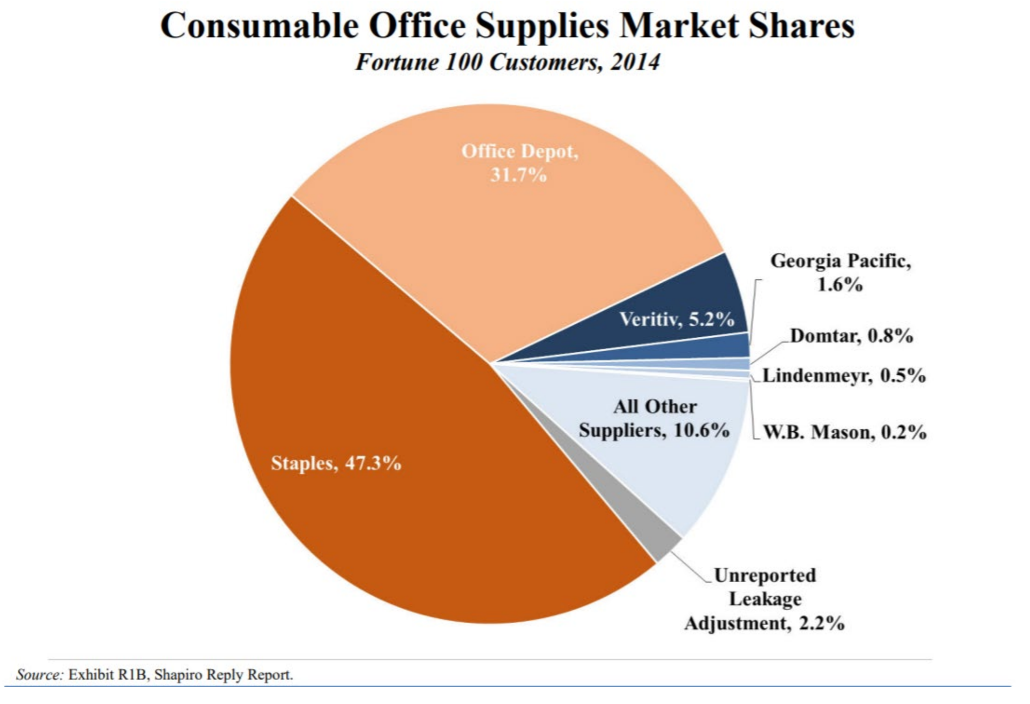
The Court: Rejects defendants' attack

- *Argument 2*: Improper to limit the market to large B2B customers
  - Parties' position
    - Plaintiffs' attempt to protect "mega companies" is misplaced, because the merger "indisputably will benefit all retail customers, and more than 99 percent of business customers"
  - Court: Rejects argument
    - Antitrust laws exist to protect customers, including relatively small targeted groups
      - Recognized by Merger Guidelines
      - Part of the judicial "submarket" concept
    - Here—
      - "Large" customers can be identified by suppliers
      - Can be differentially priced
      - No meaningful opportunities for arbitrage (i.e., markets are separable)
    - "Significantly, Defendants themselves used the proposed merger to pressure B-to-B customers to lock in prices based on the expectation that they would lose negotiating leverage if the merger were approved."
      - *QUERY*: Why did the Court think this was significant?
      - *QUERY*: What was really going on here?

The District Court Opinion
1. The Prima Facie Case
C. The *PNB* Presumption

PNB presumption triggered

- Data
  - Carl Shapiro used data obtained from a survey of Fortune 100 companies—81 responded with sufficient data:
    - Their overall spend on consumable office supplies
    - The amount spent on consumable office supplies from Staples
    - The amount spent on consumable office supplies from Office Depot



PNB presumption triggered

- Plaintiffs' market shares and HHIs
  - From opinion:

	Share	HHI
Staples	47.3%	2237
Office Depot	31.6%	999
Others (6)	21.1%	74
TOTAL	100.0%	3310
Combined	78.9%	3310
Delta		2989
Post		6299

WDC: I arbitrarily chose the number of equally sized "other" suppliers—this is not in the opinion. Note that the HHIs are not especially sensitive to the number of "other" firms

- Court:
  - Triggers *PNB* presumption and establishes a prima facie case of anticompetitive effect
    - NB: Court used only Merger Guidelines thresholds to reach this result
  - "Put another way, Staples and Office Depot currently operate in the relevant market as a 'duopoly with a competitive fringe'"

PNB presumption triggered

- Defendants' attack
  1. Challenged whether sample was representative of buyers in the relevant product market
     - 1200 companies in relevant market
     - Only 81 companies responded with sufficient data
  2. Did not adequately account for "leakage"(unreported discretionary "purchases" by employees)
     - Shapiro survey asked for leakage data
     - 26 reported
     - 12 indicated that leakage was de minimis
     - Fact witnesses testified that leakage was insignificant
     - Shapiro assumed 1%
- Court: Rejects attacks as speculative
  - *WDC*: Big problem for defendants
    - Failed to offer alternative data or analysis that would reach a materially different result

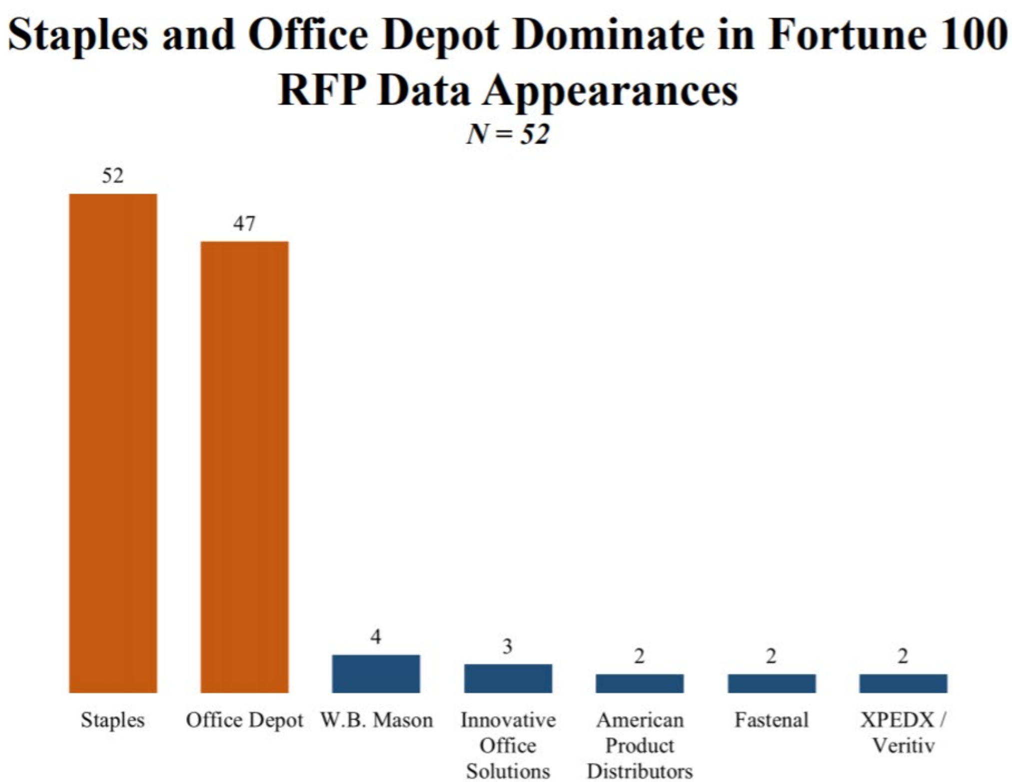
The District Court Opinion
1. The Prima Facie Case
D. Additional Evidence of Anticompetitive Effect

Additional evidence: Unilateral effects

1. Bidding data showed that Staples and Office Depot engaged in significant head-to-head competition
   - 81% of Staples' bid losses were to Office Depot
   - 79% of Office Depot's bid losses were to Staples
   - Often "played off" against each other by customers

Additional evidence: Unilateral effects

1. Bidding data showed that Staples and Office Depot engaged in significant head-to-head competition
   - From Shapiro exhibit:



Note: Based on most recent event at each Fortune 100 customer, 2012-2015. In total, 45 suppliers are mentioned.
Source: Exhibit R7A, Shapiro Reply Report.

Additional evidence: Unilateral effects

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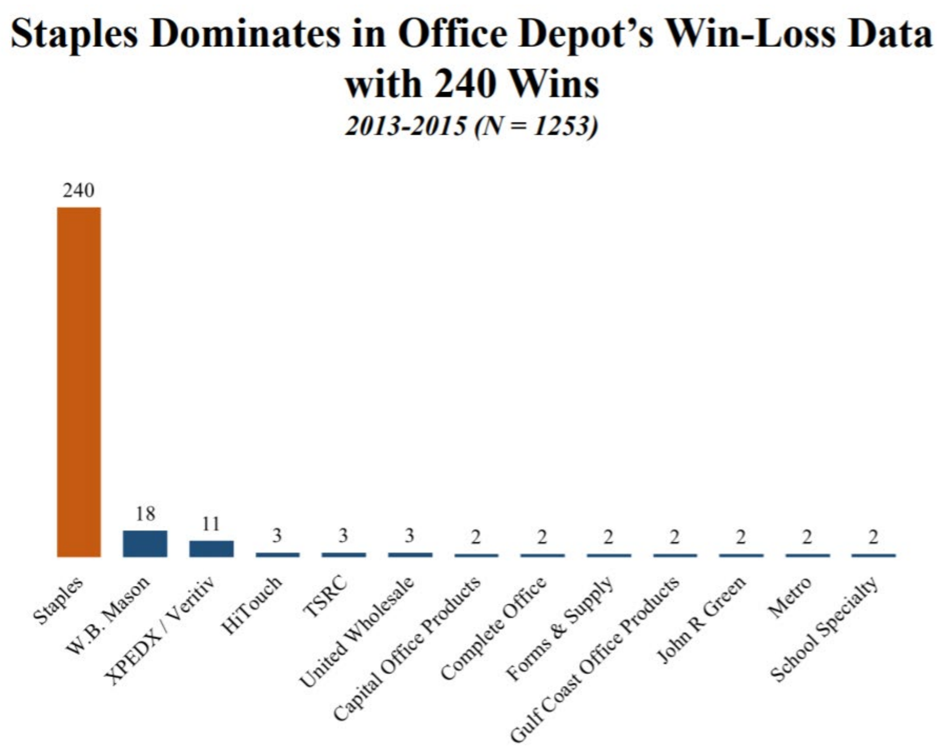
   - From Shapiro exhibit:



Note: Competitors listed have at least 2 wins. In total, 40 competitors are mentioned.
Source: Exhibit 10, Shapiro Report.

Additional evidence: Unilateral effects

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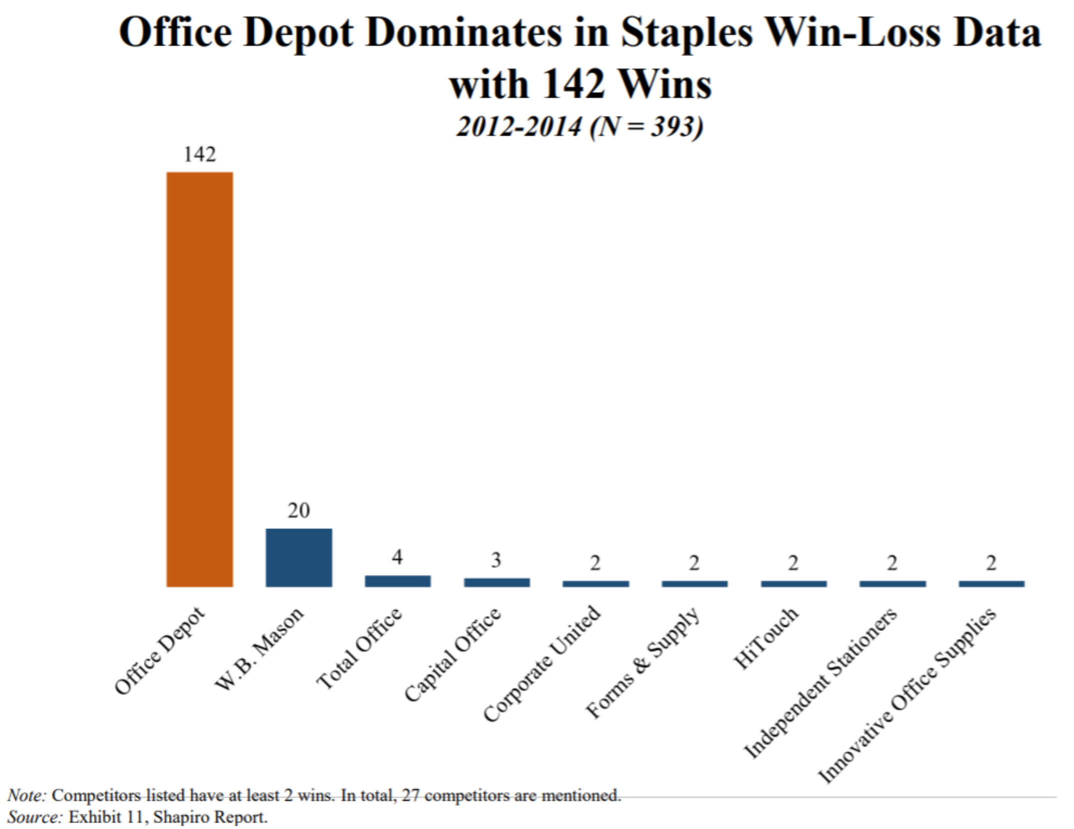
   - From Shapiro exhibit:



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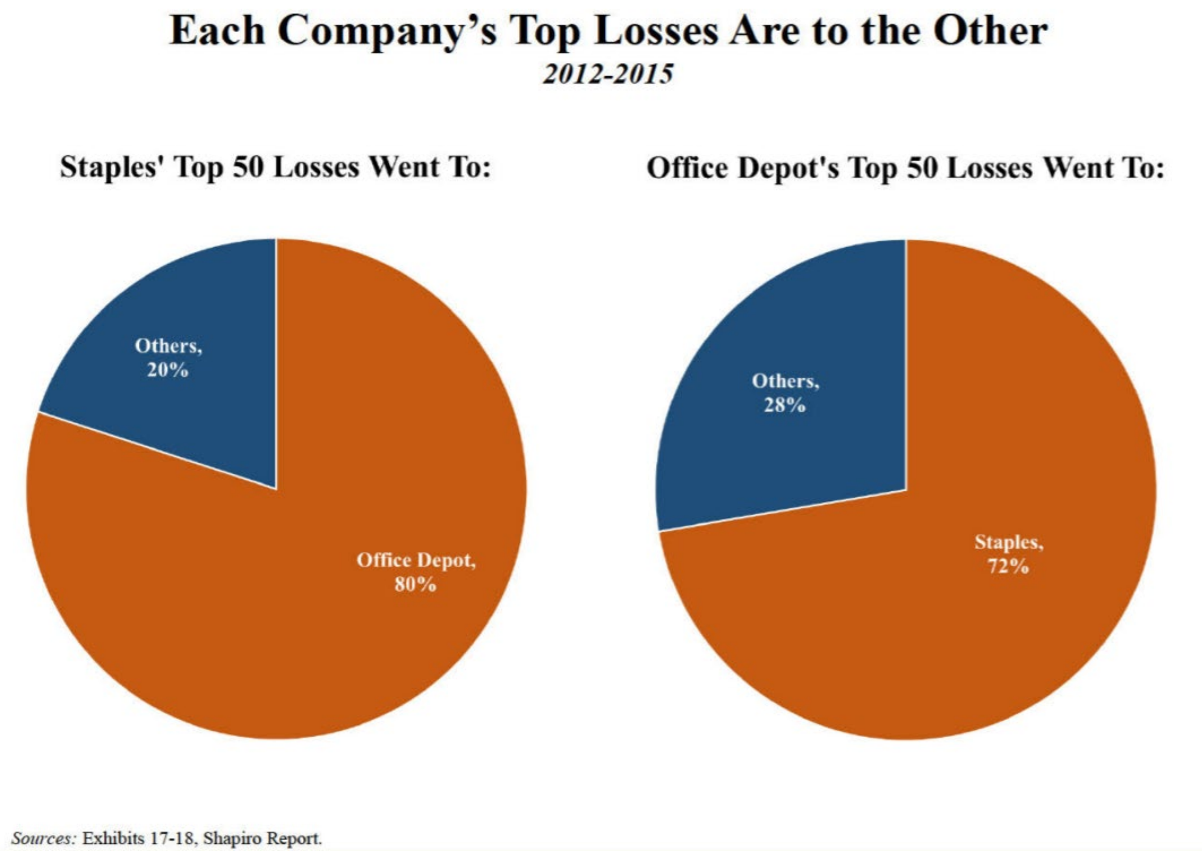


Additional evidence: Unilateral effects

2. B2B customers see the merging parties as each other's most significant, if not only, competitor
   - From Shapiro exhibit:

Customers Recognize Staples and Office Depot as Closest Competitors

- [redacted] (June, 2015): "Only two B2B providers, Staples and Office Depot, are left in the Office Supplies space since the merger of Office Depot and OfficeMax."

- [redacted] (April, 2014): "Only two providers can support [redacted] requirements, Staples and Office Depot"

- [redacted] (November, 2013): "The Big Three are soon to become the Big Two, and will make up 75% of total market share"

Sources: *See* Shapiro Rpt. at 26 (citing PX07008, PX07001, PX07010).

Additional evidence: Unilateral effects

3. Party ordinary course of business documents show that each merging company views the other as its most significant competitor
   - From Shapiro exhibit:

Staples and Office Depot Recognize They Are Closest Competitors

- Staples (November, 2013): "There are only two real choices for customers. US or Them."
- Office Depot (March, 2014): "only 2 primary players in the Enterprise space."
- Office Depot (February, 2015): "I am sure you have heard the news today regarding the Staples acquisition…. I thought it was odd after the Max/Depot merger that global and large national organizations had basically only two options for office supplies. If this deal is approved that will dwindle to one.

  For companies wanting savings, new terms, or additional incentives now is the time to ink those details in a long term contract. [sic] with Depot."

Sources: *See* Shapiro Rpt. at 24-25, 40 (citing PX04082, PX05250, PX07175).

Additional evidence: Unilateral effects

- Observations
  - Interestingly, the court did not refer by name to "unilateral effects"
  - Rather, without going into the details provided in the 2010 Merger Guidelines, the Court simply cited the first sentence of Guideline 6 (entitled "Unilateral Effects"):

> The elimination of competition between two firms that results from their merger may alone constitute a substantial lessening of competition.[1]

  - After discussing the competitive closeness of the merging firms revealed by the win-loss evidence, customer testimony, and regular course of business documents of the parties, the Court simply concluded:

> This additional evidence strengthens Plaintiffs' claim that harm will result in the form of loss of competition if Staples is permitted to acquire Office Depot.[2]

  - WDC: Although the Court's approach is qualitative, I agree that the evidence is compelling. Given the strength of this evidence, a more quantitative approach was not required

[1] FTC v. Staples, Inc., 190 F. Supp. 3d 100, 131 (D.D.C. 2016). [2] *Id.* at 133

Aside: *GUPPI*/2 Merger simulation

- Formula:

$$GUPPI_1 = D_{12} m_2 \frac{p_2}{p_1}$$

- Data
  - One-SSNIP diversion ratios
    - $D_{S \to OD}$: 81%
    - $D_{OD \to S}$: 79%

    From win-loss data
  - Percentage gross margin
    - Assume Staples and Office Depot have the same percentage gross margin of 25%
  - Prices
    - Assume Staples and Office Depot have roughly the same prices

Rule: Assuming that the merged firm's residual demand curve is linear in product 1, the unilateral percentage price increase from unilateral effects is $GUPPI_1/2$

Remember: the $GUPPI_1$ is the breakeven percentage price increase for the merged firm given the diversion ratios, the percentage gross margin, and the prices

- Application
  - Firm 1: Staples

$$GUPPI_1 = (0.81)(0.25)(1) = 0.2025 = 20.25\%$$

    - Implies a GUPPI/2 = 10.125% unilateral price increase in Staples' prices
  - Firm 1: Office Depot

$$GUPPI_1 = (0.79)(0.25)(1) = 0.2025 = 19.75\%$$

    - Implies a GUPPI/2 = 9.875% unilateral price increase in Office Depot's prices

The District Court Opinion
2. Defendants’ Rebuttal Arguments

Two rebuttal arguments

Defendants' sole argument in response to Plaintiffs' *prima facie* case is that the merger will not have anti-competitive effects because [1] Amazon Business, as well as [2] the existing patchwork of local and regional office supply companies, will expand and provide large B-to-B customers with competitive alternatives to the merged entity.[1]

- *Remember*:
  - Staples and Office Depot did not call any witnesses
  - Evidence closed after the plaintiffs presented their case-in-chief
- Queries:
  - How did the defendants get support for these arguments into evidence?
  - What was Staples' strategy here?

[1] FTC v. Staples, Inc., 190 F. Supp. 3d 100, 133 (D.D.C. 2016).

Amazon Business

- Defendants' position:
  - Amazon Business, a newly emerging company in the B2B space, would replace any lost competition
    - Started in 2015
  - *WDC*: This is an expansion defense
- Court: Rejected—Fails sufficiency and timeliness requirements
  - Court: Although Amazon Business has some impressive strengths, it—
    1. Lacks of RFP experience
    2. Has no commitment to guaranteed pricing
    3. Lacks ability to control third-party price and delivery [half of AB's sales are through 3Ps]
    4. Has no ability to provide customer-specific pricing
    5. Lacks customer service agents dedicated to the B2B space
    6. Has no desktop delivery
    7. Has no proven ability to provide detailed utilization and invoice reports
    8. Lacks product variety and breadth
  - Also, has a low market share projected for 2020, so are unlikely to provide significant additional competition in the four years following a Staples/Office Depot merger
  - Failure to satisfy the burden of production in *Baker Hughes* Step 2

Amazon Business

- WDC: The court could have gone further
  - Assume that Amazon is a committed expander
  - Consider the HHIs if Amazon had already expanded and taken 30% or even 50% of the business of each of Staples and Office Depot:

	Before Amazon		After Amazon (30%)		After Amazon (50%)	
	Share	HHI	Share	HHI	Share	HHI
Staples	47.3%	2237	33.1%	1096	23.7%	559
Office Depot	31.6%	999	22.1%	489	15.8%	250
Amazon	0.0%	0	30.0%	900	50.0%	2500
Others (6)	21.1%	74	14.8%	36	10.6%	19
TOTAL	100.0%	3310	100.0%	2522	100.0%	3328
Combined	78.9%	3310	55.2%	2522	39.5%	3328
Delta		2989		1465		747
Post		6299		3987		4075

  - These are all in ranges in which the *PNB* presumption has been triggered and courts have found Section 7 violations
    - Not surprising, since even with Amazon as a major player, the transaction is a 3-to-2 merger with a fringe

WB Mason and other competitors

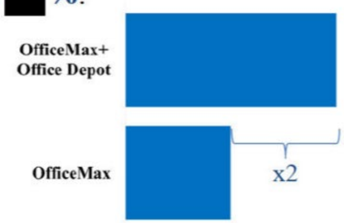
- Defendants' position:
  - *WB Mason* and other competitors would grow to replace any competition lost as a result of the merger
  - This is a type of entry/expansion defense
- Court: Rejected
  1. WB Mason is a regional supplier that targets 13 NE states and DC
     - $1.4 billion in revenues
  2. Distant #3, with less than 1% market share
     - No customers in the Fortune 100
     - Nine customers in the Fortune 1000
  3. Does not have resources to serve nationwide customers
  4. Does not bid for large RFPs outside of "Masonville" [DC] (where it is located)
  5. CEO testified that WB Mason does not have the desire or ability to compete with the merged company outside of Masonville

WB Mason and other competitors

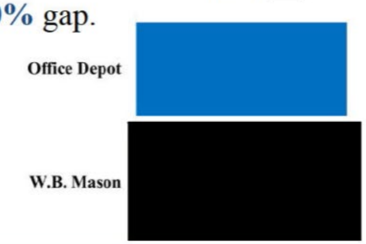
- Court: Rejected
  6. *Purchasing economies of scale*: Costs are higher than Staples and Office Depot, since WB Mason and other competitors must purchase through wholesalers rather than manufacturers
     - From Shapiro exhibit:

Estimate of a COGS Gap
Between W.B. Mason and Office Depot

- Based on estimates from OfficeMax-Office Depot merger, doubling in scale lowers COGS by [redacted]%.



- W.B. Mason would need to double roughly [redacted] times to match Office Depot's scale – implying a **6.0%** gap.



Query for the mathematically inclined (or the just curious): Can we recover Shapiro's numbers?

Working backwards on this:
OD = $16.1 million
WBM = $1.4 million

Solving for the number of doubling times:

$(1.4)^{2^x} = 16.1$
$x = 3.046$ (which is close to 3)

So WBM would have to double 3 times to eliminate the 6% gap with Office Depot

Solving for the doubling percentage y:

$(1 - y)^3 = 1 - 0.06 = 0.94$
$y = 0.0204$

This implies that doubling in scale lowers COGS by about 2%

Note: This type of progression is known as **exponential decay**. Why should this characterize the COGS percentage reduction?

WB Mason and other competitors

- Court: Rejected
  6. *Purchasing economies of scale*: Costs are higher than Staples and Office Depot, since WB Mason and other competitors must purchase through wholesalers rather than manufacturers
     - From Shapiro exhibit:

Other Market Participants Have Higher COGS

- **W.B. Mason**: "I believe that no other vendor can consistently compete effectively with Staples or Office Depot on the cost of goods. They purchase far more volume from manufacturers than any other vendor. From my experience as a buyer of office supplies from manufacturers, I know Staples' and Office Depot's unmatched scale leads to unmatched buying power. WBM, as the third-largest office supplies vendor in the country, has some ability to obtain discounts from manufacturers, but not as much as Staples and Office Depot, so our cost of goods is higher."

- [redacted]: "In terms of overall purchase volume, it is generally true that the more a customer buys [redacted] the better the overall pricing and program incentive. As a result, Office Depot and Staples typically receive better combined pricing and program incentives based on their mix of purchases (less commodity/higher value mix) than do smaller independent dealers. Further, independent dealers often require additional services [redacted] (e.g., catalog support, marketing programs, digital platform support, etc.), which must be covered in the overall transactional pricing and incentive programs that they receive."

- [redacted]: "Based on my experience working for [redacted] for over a decade, I am familiar with the difference in COGS that large companies like Staples and Office Depot can negotiate with manufacturers compared to [redacted]. Although it varies based on the commodity and manufacturer, I estimate that Staples and Office Depot are able to obtain a net cost differential (including back-end rebates) of about 5% to 25% lower [redacted]."

WB Mason and other competitors

- Court: Rejected
  7. WB Mason would not commit to expand nationally even if Staples and Office Depot financed the expansion through a “cash divestiture”

WB Mason and other competitors

- Court: Rejected
  7. Other firms would not expand even in the event of a SSNIP
     - From Shapiro's exhibit:

Competitor Views on Expansion

- [redacted]: "[redacted] has no specific plans to expand into any new markets."
- [redacted]: "Even if Staples merged with Office Depot and the combined firm raised prices significantly (by 10%, for example), we would not alter our expansion plans. We currently do not have any excess physical capacity."
- [redacted]: "[redacted] has no material plans to pursue large national or multiregional customers, like Fortune 1000 companies. [redacted] does not have the resources to expand our geographic footprint or invest in the services necessary to compete for these large customers, and I do not see [redacted] making these investments within the foreseeable future."
- [redacted]: "[redacted] focuses on customers smaller than [the Fortune 1000], mostly within our primary operating region."
- [redacted]: "[redacted] has] no foreseeable plans to materially expand our business to pursue large national or multiregional accounts, such as Fortune 500 companies."
- [redacted]: "[redacted] would find it prohibitively expensive to make the investments necessary to compete for large business customers the way Staples and Office Depot do today."
- [redacted]: "[redacted] lack of a national sales and distribution network has impeded our ability to win national accounts. . . . More often than not, we choose not to bid on national accounts, because…it is an exercise in futility."

WB Mason and other competitors

- Court: Rejected
  - *Conclusion*: No evidence that supports defendants' contention that a collection of regional or local office supply companies could meet the needs of B2B customers
    - Failure to satisfy the burden of production in *Baker Hughes* Step 2

The District Court Opinion
3. Determining the Net Anticompetitive Effect

Determining the net anticompetitive effect

- Unnecessary to proceed to Step 3 of *Baker Hughes* since the defendants failed to produce sufficient evidence to put the prima facie case in dispute
  - Merging parties to satisfy their burden of production on the only two defenses they advanced

It is common in judicial decisions for courts to reach for "corner solutions"—finding a failure of proof in Step 1 or in Step 2 in order to avoid balancing in Step 3

- *Query*: If you had to balance, how would you do it?
  - Consider two situations:
    1. Everyone is affected the same way
       - *Example*: The merger creates upward pricing pressure through the elimination of rivalry, but it also produces downward pricing pressure form marginal cost efficiencies. Balancing on which pressure is dominant, everyone's price will either go up or go down
    2. Different customers are affected differently—some are harmed and some benefit
       - *Example*: Prices go up for everyone, but some customers value the product improvements the merger enables, while other customers do not value it

The District Court Opinion
4. Balancing the Equities

The equities

- FTC: Equities in favor or entering preliminary injunction
  - Public interest in effectively enforcing antitrust laws
  - Public interest in ensuring that the FTC can order effective relief if it succeeds at the merits trial

The canonical public equities

- Merging parties: Equities in favor of denying the preliminary injunction
  - None addressed in the opinion

PI entered: May 10, 2016
Deal terminated: May 10, 2016