Class 17 slides

Unit 11: Sysco/US Foods

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Good things come from Sysco

US. FOODS™
KEEPING KITCHENS COOKING.™

Five new concepts

1. *Cluster markets* in product market definition
2. *Targeted customer markets* in product market definition
3. Use of *overlapping draw areas* to define geographic markets
4. *Auction* theory of unilateral effects
5. "Litigating the fix"

The Background

The deal

- Sysco Corporation to acquire US Foods
  - Announced December 8, 2013
  - $3 billion of Sysco common stock (13% of combined company)
  - +$500 million of cash
  - Assumption of $4.7 billion of USF debt
  - Total transaction value: $8.2 billion
  - Agreement expires September 8, 2015 (21 months)

The parties

- Sysco
  - Publicly traded "broadline" distributor
  - Sales = $44 billion in food distribution sales 2013
  - #1 with about 17% of total food distribution sales nationally
  - 72 distribution facilities nationwide

- US Foods
  - Privately owned broadline distributor (Clayton, Dubilier & Rice and KKR)
  - Sales = $22 billion in food distribution sales in 2013
  - #2 with about 8.6% of total food distribution sales nationally
  - 61 distribution facilities nationwide

Deal rationale

1. Creates a company with $65 billion in sales
   - Sysco (#1 w/17%) + USF (#2 w/8.6%) = Combined (#1 w/25.6% of total food distribution sales nationally)
     - Number 3: Performance Group (2.4%)
   - Would employ over 14,000 sales reps
     - No other company employs more than 1600
   - Would operate over 13,000 trucks
     - No other company operates more than 1600 trucks
2. Immediately accretive to earnings
3. Annual recurring synergies > $600 million (after 3-4 years)
   - Eliminate duplicative overhead
   - More leverage to lower costs of goods (COGS)
   - Optimize distribution facilities and logistics
   - Integrate sales force
   - Bigger platform for enhanced innovation and development of exclusive products

Industry background

- Food service distribution
  - Total industry sales nationwide = $231 billion (2015)
  - Supply a broad range of fresh, frozen, canned and dry food and non-food products to away-from-home food service operations
  - Customers include—
    - Independently owned single location restaurants, regional and national chain restaurants (majority of sales)
    - Hotels, motels, and resorts
    - Hospitals
    - Schools
    - Government and military facilities
    - Retail locations

Industry background

- Types of food distributors: Product range/channel
  1. Broadline
     - “One-stop” shop—carry everything
  2. Specialized
     - Meat
     - Seafood
     - Produce
     - Baked goods
  3. Systems distributors
     - “Customized” distributors for fast food, casual chain restaurants (e.g., Burger King, Wendy’s, Applebees)
     - Small number of SKUs
     - Often proprietary to chain
     - Very small sales forces
  4. Cash-and-carry and club stores
     - E.g., Restaurant Depot, Costco, Sam’s Club
     - Do not deliver
     - No sales force dedicated to individual customers
     - Typical customer: independent restaurant

Industry background

- Types of food distributors: Geographical distribution footprint
  - National
  - Regional
  - Local

Industry background

- Largest food distributors in the United States

Distributor	Distribution Footprint	Distribution Centers
Sysco	Nationwide	72
US Foods	Nationwide	61
Performance Food Group	Eastern/Southern U.S.	24
Gordon Food Service	Midwest, Florida, TX	10
Reinhart Foodservice	East, Mideast	24
Ben E. Keith Co.	Texas and bordering states	7
Food Services of Am.	Northwest	10
Shamrock Foods	Southwest, Southern Calif.	4
Local distributors	Local	1-5 each

Industry background

- Distribution centers
  - Key for broadline distribution

- 28-foot clear-height ceilings
- “Super-flat” insulated floor systems to meet strict temperature control standards
- Zoned to accommodate the storage of both perishable and dry goods

Distribution centers

- US Food distribution centers in 2017
  - Only three more centers than in 2013

The FTC investigation and litigation

- FTC investigated for one year
  - Second request issued on February 18, 2014 (a little over two months after signing)
  - Investigation ended February 20, 2015
- Fix-it-first solution:
  - On February 16, 2015, Sysco signed a deal to sell 11 of 61 USF distribution centers to #3 Performance Food Group
    - Announced Feb. 16, 2015
    - Conditioned on closing main deal
  - The centers to be divested largely located in the western U.S.
    - PFG had only one center in the West
    - PFG had 24 centers in East/South
  - Accounted for $4.5 billion in sales
    - About 20% of USF premerger sales
    - Would give PFG a total of $10.5 billion in sales
    - Compare to $60.5 billion for the combined firm post-divestiture
- FTC rejected the fix and brought suit
  - Joined by 11 states seeking relief under Clayton Act § 16 in their sovereign capacity
  - Parties “litigated the fix”

FTC complaint

- Plaintiffs:
  - Federal Trade Commission
  - 10 states plus the District of Columbia
- *Filed*: February 20, 2015
  - 14 months after signing
- *Claim*: Acquisition, if consummated, would violate Section 7 in—
  1. Nationwide foodservice distribution to "national" customers
     - Combined first and second largest broadline foodservice distributions
     - Results in a combined share of 59%-71% share and HHI deltas of 1500-1966 (depending on metric)
     - Auction unilateral effects
  2. 32 local markets
     - With combined shares as high as 90.3% and deltas as high as 4123
     - Auction unilateral effects
- Prayer:
  - Preliminary injunction blocking the deal pending a final adjudication of the merits
  - *Query*: Should the states also have sought a permanent injunction?

The District Court

- Tried in the District Court of the District of Columbia
  - Judge Amit P. Mehta
    - Appointed by President Obama
    - Assumed office: December 19, 2014
    - Assigned case: February 20, 2015

  - Case was tried with the understanding that the parties would terminate their merger agreement if the PI was entered

Testifying experts

- FTC: Dr. Mark A. Israel
  - Senior Managing Director, Compass-Lexecon
  - Ph.D in Economics, Stanford University (2001)
  - Extensive testifying experience in antitrust cases (especially merger antitrust cases)

- Parties: Dr. Jerry Hausman
  - Professor of Economics, MIT
  - D.Phil, Oxford (1972)
  - Leading academic econometrician
  - Extensive testifying experience in antitrust cases (including merger antitrust cases)

The District Court

- Entered the preliminary injunction blocking the deal
  - Relevant markets
    - Nationwide broadline foodservice distribution to national customers
    - Local broadline foodservice distribution to local customers
  - Anticompetitive effects (upward pricing pressure)
    - *PNB* presumption
    - Unilateral effects in the national broadline customer market
    - Unilateral effects in local broadline markets
  - Defenses insufficient to put the prima facie case into dispute
    - The PFG “fix”
    - Dealing regionally by national customers
    - Entry/expansion
    - Efficiencies
  - Equities favored the entry of a preliminary injunction

PI entered: June 23, 2015
Deal terminated: June 29, 2015

Parties abandon the merger

- Costs to Sysco
  - $300 million breakup fee to US Foods
  - $25 million breakup fee to divestiture buyer Performance Food Group
  - $265 million to redeem financing
  - $258 million on integration planning and advisers
  - $100 million in historical financing costs, and
  - $53 million in computer systems integration

Total cost to Sysco: $1 billion