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The Office Depot/OfficeMax merger and the changing retail landscape

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The US Federal Trade Commission's decision last month to clear a merger between office supply superstore rivals Office Depot and OfficeMax shows just how much the competitive landscape for retail mergers has changed in the 15 years since the FTC blocked a nearly identical deal. Now, a team of lawyers from Simpson Thacher & Bartlett and economists from Charles River Associates who advised on the merger explain what convinced the FTC to let the deal through.

Sixteen years ago, the US Federal Trade Commission won a landmark merger victory by successfully blocking a proposed deal between two retail office supply giants, Office Depot and Staples. In the 1997 FTC v Staples, Inc decision, the district court adopted the FTC's proposed relevant market of the sale of consumable office supplies (pens, paper, file folders, ink and toner cartridges, and so on) through what it called office supply superstores, of which there were three in the US – Staples, Office Depot and OfficeMax.

In limiting the market to office supply superstores only, the court relied in part on econometric evidence showing that Staples and Office Depot had significantly higher prices in areas with only one superstore than in areas where all three rivals competed.

Moreover, the court found that Staples' and Office Depot's prices were not lower in areas where non-office supply competitors, such as Wal-Mart, were present. In light of that evidence, the court agreed with the FTC that there was a reasonable probability that the transaction would harm competition.

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In early 2013 Office Depot and OfficeMax – the second and third-largest office superstores in the US – entered into a proposed merger of equals that would test whether the Staples decision continued to apply today. Although it was plain that a host of new retailers both on- and off-line had begun selling office supplies over the past decade or so, some observers questioned whether the landscape had shifted so dramatically that the FTC would allow the Office Depot/OfficeMax transaction to go forward. Based on a survey of prices for a few office supply products at a handful of office supply superstores and on Amazon, one publication speculated that even today online retailers may not serve as substitutes to brick-and-mortar retailers for consumers of office supplies.

After the initial merger filing, the FTC conducted an expansive second request investigation; collecting documents from numerous employees, analysing reams of sales and pricing data, and conducting depositions of both parties' key executives to understand how the office supply industry operates today.

The evidence presented to the FTC demonstrated that competition in 2013 bears little resemblance to 1997, with mass merchants (Wal-Mart, Target), club stores (Costco, Sam's Club), and even drug stores (Walgreens) expanding their office supply product offerings. As these non-superstore retailers have increasingly moved into the office supply space, office supply superstore retailers have downsized stores and increased sales of different items, such as janitorial products.

As the commission noted in its statement on the merger, "fewer consumers today shop [at office supply superstores] as a destination. Instead, consumers place a greater premium on convenience, preferring in many cases to purchase supplies at retailers that also offer other products that office supply customers purchase."

But perhaps the most dramatic shift in the competitive landscape has been the growth of office supply sales online by Amazon and countless other websites that did not exist in 1997. Documents and testimony showed that the online channel for office supplies has taken significant market share from in-store purchases, which has caused brick-and-mortar retailers to evolve and devise new ways to compete against Amazon and other online competitors.

Although the FTC staff was presented with strong evidence of the growth of online and mass merchandiser retailers in the office supply space, the parties still needed to persuade staff that their retail pricing was in turn affected by non-office supply superstore competition—unlike in 1997 when the court found that office supply superstore pricing was only affected by other office supply superstore competition.

To do so, the parties' antitrust counsel worked closely with company executives to develop a compelling presentation that first explained the parties' complex pricing strategies and then demonstrated that competition from both office supply superstores and other retailers affected the parties' pricing.

Such evidence from the parties' documents and testimony was bolstered by econometric analysis. Econometric analysis played a key role in the FTC's decision and was important not only for addressing the spectre of econometric results the FTC relied on in Staples, but also to provide concrete, empirical proof that the changing retail landscape for office supplies has affected the parties' pricing incentives.

As noted in its closing statement, the commission relied on extensive econometric analysis in conducting its review, including using econometric "event studies" analysing the effect of office supply superstore store closings on the prices charged by remaining office supply superstores in local areas.

Event studies, an econometric tool recently applied to merger analysis by the FTC in FTC v Whole Foods, allowed the agency to assess the extent to which the companies directly constrain each other on price, and whether pricing is instead constrained by other competition, including online retailers and other brick-and-mortar retailers such as Target and Wal-Mart.

In econometric event studies presented to FTC staff, the companies used regression analysis of prices before and after store closings to show that neither Office Depot nor OfficeMax raised prices after one another's store closings. The regression analysis compared how prices changed when a nearby rival office supply superstore closed, with stores that had similar prices but were not affected by a rival's shuttering. The analysis focused on "banner" store closings – closings where the only OfficeMax in the vicinity of an Office Depot closed, or vice versa – and looked at both situations in which Staples had stores in the area and in places where Staples was not present.

The results of the analysis showed that prices did not increase in stores after closing, relative to prices in control stores, and this was true whether Staples had a store in the area or not and irrespective of how near the closing store had been to the remaining store. These results strongly supported the conclusion that Office Depot's and OfficeMax's pricing is not uniquely constrained by competition with one another, and is constrained by broader competition with other retailers including online shops and other brick-and-mortar retailers.

The event studies together with other econometric analyses led the commission to conclude that, "the econometrics, none of which assumed or depended on any particular definition of a relevant product or geographic market, indicate that the merger is unlikely to lead to anti-competitive price increases."

The outcome of the FTC's investigation in this matter demonstrates the critical role played by econometric analysis aligned with documents and testimony, and may identify a roadmap for the analysis of the potential for competitive price effects in other retail mergers. While the internet appears to have changed the competitive landscape in many retail environments, it will be key in any merger review not only to show persuasively that there is vigorous competition from online and other retailers through ordinary course documents and compelling testimony by company executives, but also to develop empirical econometric evidence demonstrating the effects of such a broader competitive landscape.

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