Europe Economics

The Tesco-Booker merger: should we be concerned?

A preliminary look at the potential theories of harm created by the Tesco/Booker merger following the opening of the first phase of the investigation by the Competition and Markets Authority.

Context

Tesco is the largest food and grocery retailer in the UK, while Booker is the largest wholesaler. On January 2017 Tesco announced its £3.7 billion takeover of Booker with the intention to create "the UK's leading food business".[1]

The merger was initially welcomed by investors and market participants: both Tesco and Booker's shares jumped in value following the announcement. However, since then a number of important shareholders in Tesco have prompted doubts over the expected benefits of the acquisition. Schroder Investment Management and Artisan Partners, among Tesco's four largest investors with stakes of 4.49 per cent and 4.48 per cent respectively, just two months after the announcement stated that they are against the transaction.

Yesterday, on 30th May 2017, the Competition and Markets Authority opened the first phase of the investigation, scheduled to last until the end of July. After this first phase, if the CMA believes that the merger may result in a substantial lessening of competition (SLC), the merger will be referred for an in-depth investigation. This second phase can last up to 24 weeks.

Overview of the industry

The UK grocery industry is characterised by many different suppliers operating at different levels of the supply chain.

According to the OFT (2008), there are hundreds of grocery wholesalers in the UK, yet the two largest grocery wholesalers, Palmer & Harvey McLane and Booker, account for around half of grocery wholesaling revenues. Within this market we can distinguish between cash and carry and delivery wholesalers. Both cash and carry and delivery wholesalers typically supply retailers, caterers or other traders.[2]

Booker is active in both cash and carry and delivery and has also developed its own symbol group to which it delivers supplies. Booker's main competitors in the UK grocery wholesale market have been identified by the CMA within the context of the Booker-Makro merger.[3] The CMA analysis shows that Booker in 2013 was the largest cash-and-carry operator ahead of Bestway, Costco and Makro. When including delivered operators, Booker was the second behind Palmer and Harvey.

Wholesalers usually supply medium-small retailers. Large retailers might instead deal directly with the producers. The OFT (2008) identifies several categories of retailers in this market:

- Large grocery retailers – retailers that cover all or most of the UK (e.g. Asda, Sainsbury's and Tesco);
- Regional grocery retailers – retailers that operate only in a particular part of the UK.
- Symbol group retailers – retailers that operate stores under a common symbol independently and under a franchise agreement, or directly under the ownership of the symbol group or affiliated wholesalers (e.g. Spar, Premier and Londis).
- Convenience store operators – retailers operating stores selling all kinds of groceries in a usually space smaller than 280 sq metres.
- Limited Assortment Discounters (LADs) – retailers that have a limited range of products at a very competitive price (e.g. Aldi, Lidl).

1 http://www.telegraph.co.uk/business/2017/01/27/tesco-buy-wholesaler-booker-37bn-deal-create-uks-leading-food/.

2 Case ME/6588/16, "Anticipated acquisition by Co-operative Foodstores Limited of 15 Budgens grocery stores from Booker Retail Partners (GB) Limited"

3 Competition Commission (2013), "A report on the completed acquisition by Booker Group PLC of Makro Holding Limited".

- Frozen food retailers – retailers specialised in frozen food (e.g. Iceland and Farmfoods).
- Specialist grocery retailers – retailers that are specialised in a given category of product, including butchers, bakeries, and health food stores.

Tesco and Booker are both active in the retail of grocery products. Tesco operates in this market using four different signs: Extra, Superstore, Metro and Express. The company also owns and operates One Stop which is a chain of small convenience stores.

Booker is active in the retail of grocery via its symbol group's stores, these include Premier, Family Shopper, Budgens and Londis stores. According to the CMA (2016), Booker operates 3,082 convenience stores under the Premier brand, 1,458 convenience stores under the Londis brand, and approximately 149 convenience and mid-sized stores under the Budgens brand. The large majority of these stores are independently owned but receive services from Booker including wholesaling, marketing and store development. A small number (26) of the Budgens stores are fully owned and operated by Booker.[4]

The CMA, within the context of the Booker / Co-operative Foodstores merger, identified Booker's competitors based on size and retail proposition (e.g. large supermarkets were not considered as exercising a relevant competitive constraint on convenience stores). The shops competing with Booker's convenience stores and brands included: Asda, Sainsbury's, Tesco, CK Supermarkets and Waitrose. The competing Symbol groups included: Nisa-Todays, Best-One, Costcutter and Select & Save.

Potential harm

There are three main potential theories of harm in relation to this case:

- loss of competition in the downstream market;
- foreclosure in the downstream market; and/or
- excessive buyer power (foreclosure in the upstream market).

The first theory of harm relates to the so-called unilateral effects of mergers which arise from the individual incentive that the merged entity has to raise prices post-merger or modify – to the detriment of consumers – any other parameter of competition. These effects typically follow when the merger is between two actual competitors; the closer the competitors the higher the possibility that the merger would have this adverse effect on consumers. The CMA has already identified that Booker and Tesco compete in the market of convenience stores.[5]

This effect has been downplayed by both Tesco and Booker which have generally claimed that the franchisee nature of Bookers' convenience stores would not allow the merged entity to influence prices or any other parameter of competition in Booker convenience stores after the merger.[6] [7] Mr Lewis, CEO of Tesco, commented on possible competition concerns by saying that: "*It's very important that we understand the difference between a retail operation and a wholesale operation. The customers that Booker serves are independent entrepreneurs that own their own business, that have a contract with Booker, and have absolute free opportunity to engage in the marketplace*".[8]

Overall, when scrutinising local competition the CMA would face two key questions. First, whether Booker's convenience stores have a significant degree of independence as to the setting of key competition parameters (e.g. prices).[9] Second, whether convenience stores actually compete with large retailers (e.g. supermarkets). Back in 2002 when Tesco bought One Stop, the merger was cleared as the CMA defined as separate the market of convenience stores and the supermarkets business.[10] However, the CMA might

[4] Case ME/6588/16, "Anticipated acquisition by Co-operative Foodstores Limited of 15 Budgens grocery stores from Booker Retail Partners (GB) Limited".

[5] Case ME/6588/16, "Anticipated acquisition by Co-operative Foodstores Limited of 15 Budgens grocery stores from Booker Retail Partners (GB) Limited"

[6] http://uk.businessinsider.com/tesco-booker-merger-takeover-competition-concerns-cma-2017-1

[7] https://www.theguardian.com/business/2017/jan/27/tesco-booker-shoppers-takeover-londis-budgens.

[8] http://www.telegraph.co.uk/business/2017/01/27/tesco-buy-wholesaler-booker-37bn-deal-create-uks-leading-food/.

[9] It is worth noting that within the context of the Booker/Co-operative Foodstores merger the Parties submitted evidence indicating that Booker may exert a degree of control/influence over the prices and products stocked by all retailers operating under these symbol group brands.

[10] https://www.theguardian.com/business/2017/jan/27/tesco-booker-shoppers-takeover-londis-budgens.

change its mind given that recent evidence shows that customers have a more fluid shopping pattern.[11] [12]

The second theory of harm revolves around the fact that a significant part of Booker's business is built on wholesale activities to a number of businesses in direct competition with Tesco. A clear concern is therefore whether or not the merged entity would choose to foreclose these stores – usually small convenience stores.

The literature on vertical relationships and market foreclosure has examined various mechanisms through which a firm with significant market power manages to weaken competition in other markets. These mechanisms typically include take-it-or-leave-it exclusive-dealing contracts, and price discrimination. The use of its bargaining power to impose vertical restraints on downstream firms enables the firm to exert significant power in both markets.[13]

For such a strategy to be credible it must first be established that the merged entity has sufficient market power in the wholesale market to be able to behave in such a way, and if it does whether it has an incentive to do so. With a market share of around 20 per cent in the grocery wholesale market [14] [15] even if one could rationalise a decision to foreclose the market for convenience stores [16] (potentially hard to do if competition with larger retailers is also considered relevant, as this strategy would not remove that form of competitive constraint), it is unlikely that the merged entity would have sufficient market power to be able to force out the non-Booker convenience stores.

The situation for Booker's convenience stores may be somewhat different, however. The extent to which this strategy would represent a real concern for Booker convenience stores would depend on the contractual arrangements in place with Booker, principally the scope that they have to source their products from other wholesalers, as well as the merged entity's ability to price discriminate against the Booker convenience stores specifically.

The third theory of harm regards instead the increase in buyer power that the merger might generate. Farmers Union of Wales Policy Officer Charlotte Priddy has expressed concern over the merger, stating: "*There are already well recognised concerns regarding the balance of power along the supply chain being loaded in favour of major retailers, so any moves which increase such imbalances are a great worry*".[17]

As described before, a firm with significant market power might manage to weaken competition in other markets by imposing unfavourable contractual terms and conditions. The increased power that the merged entity may enjoy on the buying side could create greater imbalance between the manufacturers and the merged entity, potentially resulting in manufacturers suffering for example from a further squeeze on their margins.

Conclusions

Given the scale of, and interest in, this merger, the CMA has an important task on its hands to disentangle these issues to identify whether the proposal deserves to be cleared at Phase 1. It may mean that a Phase 2 referral is necessary to allow the case to be considered in sufficient detail and these issues to be unpicked. We wait with interest for the CMA's decision in July.

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11 http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/11590348/The-battle-is-only-just-beginning-for-Britains-big-four-supermarkets.html.

12 https://www.acs.org.uk/press-releases/tesco-and-booker-announce-merger/.

13 Chemla, G. (2003), "Downstream Competition, Foreclosure, and Vertical Integration".

14 Market share of Booker is computed using IGD Retail (2017) value of the estimated 2016 value of UK wholesale grocery market (which includes cash and carry, delivery wholesale, and delivered foodservices) and Booker's 2016 turnover.

15 To note this relates only to the Booker market share with respect to wholesalers. It is worth noting, however, that during the Booker/Makro merger Booker used survey evidence (commissioned by Booker) to show that half of customers (a.n. of Booker) would use supermarkets as alternative suppliers to cash and carry outlets. If this is the case, while the market share of the merged entity may be higher by taking into account the role of Tesco in supplying convenience stores, including the supermarkets in the market definition would also dilute the market share of the merged entity.

16 This would require analysis of the profits Tesco might divert to its own stores by foreclosing Booker's clients.

17 http://fuw.org.uk/tesco-booker-merger-a-concern-for-food-producers-fuw-says/.

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