THE CAPITOL FORUM

May 9, 2016

Sherwin-Williams/Valspar: FTC Likely to Closely Scrutinize Wholesale Level Competition; Potential Post-Merger Wholesale Price, Slotting Fee, Contract Incentive Effects

Competitive Analysis Update

Head-to-head competition between Sherwin-Williams (SW) and Valspar is relatively limited at the retail level, which is one of the parties' strongest arguments for getting their deal through FTC review. SW focuses on distribution through its company-owned stores, while Valspar paints are sold primarily through Lowe's, as well as the individual dealer channel. Therefore, the parties will contend that head-to-head competition between the two firms' products is less pronounced than aggregate market shares may suggest.

However, this argument does not address another issue that the FTC is sure to closely scrutinize: competition at the distribution level for wholesale customer accounts, including, but not limited to, the process for securing shelf space at big box stores and forming wholesale contracts with individual retail outlets. According to sources familiar with the paint industry, both on the manufacturing and retailer ends of the supply chain, paint companies compete at the wholesale level through a combination of up-front payments paid to retailers i.e., "slotting fees" and other price- and non-price-related extra contract incentives such as credit terms; in-store displays; paint mixing/tinting equipment; advertising dollars; branding fixtures or external signage.

Importantly, both Valspar and SW compete for wholesale contracts by providing retailers some combination of these incentives. A diminution in wholesale competition – either across the board or targeted towards certain wholesale customers, like independent dealers – could lead to reduced contract incentives, higher wholesale prices and ultimately, higher retail prices post merger.

A separated, but related point, involves the argument that SW and Valspar paints, due to their different price points, may not compete closely head to head. However, sources indicate that SW is aggressively promotional in its pricing, and, as a result, sells its products at well below list prices on a regular basis. This pricing strategy allows SW to maintain its premium paint reputation, while effectively pricing competitively with Valspar.

For this article, we spoke to several industry experts including representatives of two regional paint manufacturers, several independent dealers and the purchasing decision-maker of a smaller regional hardware chain.

A Closer Look at Pricing, Distribution Competition

SW's aggressive promotional pricing suggests relatively more substantial head-to-head pricing competition than list prices would indicate. Regarding their paint prices, Valspar and SW will emphasize to the FTC that Sherwin-Williams branded paints are sold at a premium to Valspar's paint products, and therefore contend that price competition between the parties is minimal. For instance, SW's interior paints have a list price of $52 to $80 per gallon on the company's website. On the other hand, Valspar's interior paints on Lowe's website range from $25 per gallon for the lowest-priced product lines up to $45 per gallon for Valspar Reserve. On Ace Hardware's website, the Valspar Aspire product line is priced at $37 per gallon, while Valspar Optimus is priced at $45 per gallon.

However, sources note that the “list prices” on SW’s website are actually quite different from the actual prices that customers end up paying for the company’s paints, in both the retail and contract channels. According to a source that has monitored SW’s paints as a retail competitor (i.e., an independent dealer), and another source that competes with SW at the wholesale level as a regional manufacturer, SW is notorious in the industry for running a stream of constant promotions.

“When you factor in all of these promotions, a lot of times SW’s prices can easily come within a dollar or two of big box prices, including Valspar,” one source said. “First of all, if a customer goes into the store and just gives their e-mail address and phone number, they’ll get 10% off right off the bat. And besides that, SW regularly has 30% off, 40% off promotions, which they advertise constantly,” the source said. “SW always says they’re a premium paint, ‘because look at our prices’ – but they hardly ever sell at that price.”

“What SW does is called ‘anchor pricing,’ and they’ve been doing it for decades – for as long as I’ve been in this industry,” said a second source. “Their paints have an artificially high retail price. And what happens is what I like to call the Starbucks scenario: when they give a discount, everyone runs in and buys their paint, because they think they’re getting this great price for what has been advertised as a really premium product. But in reality, they hardly ever sell it for the listed retail price.”

Of course, other paints are also within a similar price range as Valspar, indicating that SW’s motivation for being aggressively promotional might be in response to those other brands. For instance, Glidden paints at Home Depot or Ace’s private-label brand, Clark + Kensington, are also within the $20 to $40 range. But if FTC staff finds that SW’s pricing strategy is aimed at price competition with Valspar, at least in part, such evidence will provide support for a potential FTC challenge. Furthermore, we note that because SW’s company-owned paint stores sell exclusively SW products, the FTC will be forced to look across retail outlets in its analysis of price competition.

Heinz/Beech-Nut: in the classic “shelf space” case, FTC appellate court victory established the importance of wholesale competition. That said, the parties’ arguments around price point discrepancies and the lack of head-to-head retail competition do not address a second potential arena of competitive interaction, wholesale competition. A similar issue ultimately derailed the proposed 2000 merger between Heinz and Beech-Nut, where, after an FTC loss in district court, the appellate court reversed, in a decision that heavily emphasized the importance of “shelf space” competition.

In 2000, the jarred baby food industry was dominated by three firms: Gerber, Heinz and Beech-Nut. Gerber, the market leader, held a 65% share of the jarred baby food market, and could be found in over 90% of American supermarkets. Would-be acquirer Heinz was the number two player in the baby food industry, with a 17.4% market share and shelf space in approximately 40% of all supermarkets. The target, Beech-Nut, was in third place, with a 15.4% market share. Beech-Nut brand baby foods could be found in approximately 45% of all supermarkets.

Despite this high level of market concentration, the parties argued that their merger would not lessen competition substantially, as their respective products did not really compete at the retail level. Because Heinz and Beech-Nut products were rarely found together on the shelf, the parties argued, competition between the parties was trivial. Heinz’s and Beech-Nut’s baby foods were not considered substitutes by consumers, according to the parties, primarily because Heinz was positioned as a value brand, whereas Beech-Nut was marketed as a premium brand. Furthermore, the parties pointed to the fact that Heinz and Beech-Nut products were rarely carried by the same retail outlets.

One of the FTC's key findings was that Heinz and Beech-Nut often made lump-sum payments known as "slotting fees" or "pay-to-stay arrangements" to grocery stores in order to obtain shelf space. Gerber, on the other hand, due to its strong name recognition and brand loyalty, did not make such payments.

As a result, the FTC concluded that the merger would eliminate an important form of competition between the two parties: competition to be the second brand of jarred baby food on supermarket shelves. Importantly, the FTC found that Heinz and Beech-Nut were the only two competitors for the second position on the shelf. The FTC sought an injunction based on a theory of harm to competition at the wholesale level.

The district court ultimately denied the FTC's motion for preliminary injunction, agreeing with the parties' argument about limited pre-merger competition. On appeal, however, the appellate court found several flaws in Heinz/Beech-Nut's argument that the harm to competition was sure to be limited just because retail competition was minimal. The judge's reasoning for disagreeing with the lower court's decision is instructive here, as SW and Valspar are likely to make a similar argument to the one made in *Heinz* – that competitive interaction between the parties is limited due to minimal point-of-sale competitive interaction.

Wholesale competition – SW/Valspar's negotiations with retailers – is seen as setting the stage for downstream competition. In *Heinz*, the parties attempted to minimize the importance of wholesale competition, suggesting a distinction between fixed payments (or "fixed trade spending") such as slotting fees and "variable trade spending" such as marketing, displays and promotions. Fixed fees – like the slotting fees paid by Heinz and Beech-Nut – did not reduce retail price, the parties argued, and were therefore irrelevant to consumer welfare.

In rejecting the parties' argument, the appellate court noted that "no court has ever held that a reduction in competition for wholesale purchasers is not relevant unless the plaintiff can prove impact at the consumer level." In other words, wholesale competition is just as important a form of competition as competition at retail. Moreover, said the appellate court, it was not the FTC's burden to prove that wholesale competition ultimately benefits consumers – through lower retail prices or otherwise. Rather, the judge noted that the antitrust laws assume retailers faced with wholesale cost increases will pass those costs onto its customers in the form of higher retail prices.

The FTC's view that "price wars, bidding wars, and promotion wars invariably benefit consumers" (as seen in a reply memo from the *Heinz* case) is instructive to the SW/Valspar merger. "To reach consumers, manufacturers must first compete to be accepted by retailers," said the Commission. "It is that competition that, in part, sets the stage for downstream competition for consumer sales. Manufacturers affect retail pricing only through wholesale pricing, consumer promotions, and other marketing strategies."

The merger will eliminate wholesale price competition between Valspar and SW for independent dealer contracts. We spoke to the executive of a well-established regional manufacturer about competition for wholesale accounts in the paint industry. According to this source, smaller paint companies send out a continuous stream of salespeople to gain wholesale accounts. "Our company tries to get the lower-profile outlets – so mainly independents or dealers who've joined Ace or True Value," he told us. "The bigger guys, like SW or Valspar, will go after the higher profile outlets, obviously – the Home Depots and Lowe's of the world."

With independent dealers, said our source, such wholesale contracts almost always include a purchasing commitment for the initial purchase, where the wholesale price is one of the most intensely negotiated terms. As far as independent dealers are concerned, the playing field is at least arguably level between the larger nationwide manufacturers and smaller regional competitors – except of course that the larger companies should, at least in theory, have the benefit of scale economies to offer lower wholesale prices.

In the independent channel, the initial deal between manufacturer and retailer will almost always be sweetened with some additional perks. For example, the manufacturer may extend credit terms, advertising dollars or discounted or free equipment. Valspar competes vigorously for independent dealer accounts, primarily through its paint supply relationship with Ace Hardware. To a lesser extent, SW also has a presence at independents through its Dutch Boy and Pratt & Lambert brands.

Another source noted, given ongoing industry consolidation, the price negotiations have become more difficult on the dealer end as there are less and less potential brands for dealers to carry. "At one point 30 or 40 years ago, there were several hundred regional paint brands to pick and choose from, which gave us some leverage during price negotiations," said the source. "If you didn't like the terms being offered, you could walk away. Now, there are fewer and fewer paint companies every year, and probably less than ten that can supply a fairly complete product lineup. So there's not much we can do if we're unhappy with the price."

According to this source, the SW/Valspar merger will only exacerbate this issue for independents who will end up negotiating with a company that controls several of the remaining brands available to independent dealers. "And this will be just as true for those who already carry Valspar, since they're going to find themselves negotiating with a whole new entity," said the source.

The independent dealer situation may make the merger's anticompetitive effects especially pronounced in rural areas – for example, a small town with few retail outlets as it is. We spoke to one industry source from a small town with a population of approximately 40,000, who explained that he had seen the number of brands available to consumers in his town significantly whittled down over the years. "At one point, there was a Columbia Paints store, a SW store, plus one independent selling Benjamin Moore and one selling PPG," he told us. "Once SW acquired Columbia Paints in 2007, those two stores were combined. Next, one independent dropped BM for Valspar, and recently, the second independent started carrying Valspar products as well, instead of PPG. So, given that folks can basically get either SW or Valspar in our town, I'm interested to see how the merger plays out here," he added.

The merger could also put an end to Valspar's up-front payments to retailers. In addition to competing on wholesale prices, Valspar gives "contract incentives," in the form of up-front payments, to certain customers with whom it has long-term contracts. According to a March 2015 regulatory filing, "in connection with obtaining these contracts, [Valspar] is obligated to make various types of up-front payments for which [the company expects] to receive a benefit in excess of the cost over the term of the contract. These up-front payments primarily relate to contract incentives (including launch incentives, slotting fees and customer origination payments)."

In its 2015 10-K, Valspar stated it has "not typically entered into long-term contracts" with its major customers for minimum purchase requirements, alluding to its situation with Lowe's. This could suggest that contract incentives are used in the independent retail channel, and perhaps in connection with Valspar's agreement with Ace. Whether these contract incentives are currently provided to independent dealers, big box stores or customers in between, their potential loss may draw FTC scrutiny.

If, given relatively diminished competition for shelf space, the post-merger company were to eliminate or slowly phase out Valspar's up-front payments, retailers would essentially be faced with an increase in the wholesale cost of paint. As the appellate court in *Heinz* explained, the antitrust laws assume that such wholesale cost increases will be passed on to retail customers. In addition, Valspar notes it makes up-front payments for equipment and fixtures required to prepare paint for the end customer. The merger could make Valspar less likely to provide these extras as well, which would raise retailers' costs of carrying Valspar's paints.

While SW does not pay slotting fees, given that it sells the bulk of its paint in company-owned stores, SW still provides other contract incentives, in addition to the retail promotions mentioned above. For instance, an independent dealer who carries Pratt & Lambert paints (one of SW's dealer-oriented brands) said, "When I made the initial purchase agreement with Pratt & Lambert, I was provided an automated tinting machine for my use. In addition, they paid for my external signage."

The loss of a major competitor for big box business could, in itself, transform the competitive dynamics of the industry. According to a source, price negotiations regularly occur for the big box channel, just as they do for the independent channel. "Even with the long-standing relationships that are already formed, like Valspar at Lowe's or Behr at Home Depot, the two sides will have negotiations regularly – say, on a six-month or yearly basis – to talk price, product mix, in-store displays, etc.," said the source.

Perhaps more importantly, looking at the industry as a whole, the competition for shelf space at the big box stores is really only between four companies at this point – a fact not likely to be lost on FTC staff. Of course, given the purchasing power that Lowe's and Home Depot enjoy, the big box stores have substantially greater leverage than the independent dealers to push back on manufacturers, should they be faced with wholesale price increases or less favorable terms post merger. Losing a big box contract is just as much of a blow to the manufacturer as it is to the retailer – a point illustrated by the recent situation at Lowe's. Valspar lost Lowe's shelf space to SW, and thereby took a significant hit to its earnings; meanwhile, Lowe's paint sales performed even better with SW's HGTV product line.

On the other hand, big box stores are – at least in some sense – even more limited in their supply options than the independent dealers, given that there is a much smaller competitive universe of nationwide suppliers, particularly those with the manufacturing capacity to stock the paint departments of thousands of Lowe's or Home Depot branches. Big box stores might possibly be able to sponsor entry of a lesser known paint brand or company; the "sponsored" paint brand would undoubtedly benefit from the widespread distribution and customer exposure that only a big box could provide. Still, manufacturing capacity would likely remain an obstacle.

In 2010, when Walmart's paint business was up in the air, five companies were around to compete for that contract: SW (with its Dutch Boy brand), Akzo Nobel (with the Glidden brand), plus Masco, PPG and Valspar. SW was considered a front runner for the deal, especially given that its Dutch Boy paints were already on Walmart's shelves. Ultimately, however, it was Akzo that secured the exclusive agreement with Walmart, and its Glidden brand replaced Dutch Boy in 3,500 Walmart stores.

The Walmart deal shifted the power players significantly, demonstrating the importance of securing a contract with the big box retailers. Although SW was able to hold onto its position at the top, Akzo was boosted up to second place in the U.S. paint market, taking over Masco's former position. Before the Walmart deal, Akzo had been tied for third place with Valspar and PPG, behind Masco.

The Walmart/Akzo agreement also contained a manufacturing component, under which Akzo took over production of Walmart's private label paints, the ColorPlace brand. Valspar's recently formed "strategic paint supply relationship" with Ace Hardware also involved Valspar taking over production of Ace's private label, Clark + Kensington – an interesting parallel that hints at the importance of manufacturing capacity in securing these high-profile contracts.

In 2013, Akzo left the U.S. paint market entirely, selling its North American architectural coatings business (including the Glidden brand) to PPG. This move left the four major players we see today: SW, Valspar, PPG and Masco. After the SW/Valspar merger, there will be only three companies left who could reasonably compete for the big box contracts. "If this merger goes through, the only thing left is for PPG or SW to acquire Behr [from Masco]," one source predicted. "With the way things are going, I certainly wouldn't be surprised."

Issue Snapshot

Outlook: Market Consensus is Too Bullish	
Reasons for Challenge/Collapse	**Reasons for Merger Clearance**
Most Compelling Narrative Sherwin-Williams and Valspar are two of the only five nationwide, full-line paint manufacturers left in the U.S. due to a history of heavy consolidation in the paint industry, and two of the only four major nationwide distributors. In particular, Sherwin-Williams' recent entry into Lowe's may highlight close competition between the parties at the wholesale level and could lead to close FTC scrutiny of the parties' overlap in the U.S. paint market.	**Most Compelling Narrative** The parties' direct competitive interaction has traditionally been relatively minimal at the retail level, as Valspar has its strongest presence at Lowe's, and Sherwin-Williams' products are mostly sold at company-owned Sherwin-Williams paint stores. Sherwin-Williams therefore places more of a focus on contractors and other professional painters, who prefer to shop at specialty paint stores, while Valspar is a leading product for DIY customers, who tend to buy their paint through big-box hardware retailers like Lowe's.
Competitive Analysis - SW, Valspar, PPG Industries and Masco own the vast majority of brands available to U.S. paint customers through all major retail channels, including big-box, independent and company-owned paint stores. - SW and Valspar engage in head-to-head competition at Lowe's, both at the wholesale and retail levels; as a direct result of SW's entry at Lowe's, Valspar saw a	**Competitive Analysis** - If the FTC determines that Valspar products are rarely substituted for SW products, and/or vice versa, the merger could potentially be cleared without divestiture, as the agency would conclude the merger's potential for anticompetitive harm is minimal. - While Valspar and SW are certainly two of the top players, other strong competitors exist like PPG Industries and Benjamin Moore, as well as smaller,

significant decline in sales in its Consumer Paints segment. - SW and Valspar compete for wholesale customer accounts through slotting fees and other contract incentives, such as favorable wholesale prices, credit terms, advertising dollars and in-store displays; SW is likely to significantly reduce at least some of these contract incentives post merger.	regional paint companies (who sometimes enjoy particularly strong customer loyalty) like Dunn-Edwards and Kelly-Moore.

Timeline

- Parties filed HSR on April 8.
- Parties expect deal to close by Q1 2017.