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Staples/Essendant: Vertical Office Products Tie-Up Faces Dealer Complaints; Ongoing FTC Questions

Deal Update

FTC staff attorneys investigating Staples' $996 million deal to acquire office products wholesaler Essendant (ESND) have conducted wide-ranging interviews with office supply vendors opposed to the merger in recent weeks, sources familiar with the matter said.

The Staples offer, which Essendant formally accepted on September 14, has attracted meaningful customer opposition, six independent office products dealers said, adding that some dealers had reached out directly to the FTC to voice concerns about the proposed tie-up.

The dealers, including three interviewed by the FTC in recent weeks, said they fear Staples could use its control of Essendant to raise their prices, discontinue partnerships, and misuse confidential business information.

"This isn't a merger of equals," one independent dealer said. "This is, in our opinion, a play for our largest competitor to basically cut us off at the knees and effectively take us out of business."

But Staples CEO Sandy Douglas told *The Capitol Forum* that dealers' fears are unfounded. "That's 100 percent the opposite of what we plan to do," Douglas said. "Our intention is to do everything to promote their [dealers'] interest, and to do anything else would be self-defeating."

Despite some vendor opposition, the path to a full-stop FTC challenge to the vertical tie-up is not straightforward. Importantly, Essendant competes with another national wholesaler, S.P. Richards, to which dealers may switch—or threaten to switch—if Staples increases Essendant's prices or degrades its service. S.P. Richards' strength and viability has been a key aspect of FTC questioning during dealer interviews, sources said.

FTC staff attorneys have also focused on an Essendant program that supports independent dealers in competing for enterprise accounts, as well as confidential business information concerns flowing from the deal, sources said. The interviews have been heavily-staffed, with a half dozen or more FTC attorneys and economists on some calls, sources said.

The FTC and Essendant declined to comment.

Vertical tie-up. Framingham, Massachusetts-based Staples is the nation's largest office supply retailer, servicing individual and business customers through its web of brick and mortar stores and delivery operations.

Essendant, a wholesaler headquartered in Deerfield, Illinois, sells core office supplies, furniture, janitorial and sanitation supplies, and other office products to independent dealers and resellers. Independent dealers, in turn, compete with larger rivals Staples and Office Depot to sell office products to end customers, including small and medium-sized businesses.

Although independent dealers can source certain products from non-wholesaler options, including direct from manufacturer, dealers describe a wholesaler relationship as crucial to their ability to compete effectively. Essendant and S.P. Richards, a subsidiary of General Parts Company, are the only two national office product wholesalers.

Given that many of its competitors rely on Essendant for wholesale services, Staples could use its control over Essendant to harm independent dealers' ability to compete, executives representing independent dealers said.

"They don't have to make many changes," the first executive said, adding that Staples could increase product prices or freight costs, or slow down delivery on the margins. "Subtle changes to the rest of the service offerings would still have dramatic impacts," the executive said.

S.P. Richards. But simply because Staples could use Essendant to harm independent dealers doesn't mean that it would have the incentive to actually do so.

At the outset, for Staples to acquire Essendant only to drive away its customers would be self-defeating, said Douglas. "Whether we earn the customer's business as Staples or the dealers working with and supported by Essendant wins the business, the theory of this in our own self-interest is that we would win either way," the Staples CEO said.

But even if Staples were to increase Essendant's pricing, dealers could respond by diverting purchases to S.P. Richards. In fact, almost all independent dealers retain contractual relationships with both wholesalers, through which dealers select a primary, or "first-call" wholesaler for most of their supply before using their "second-call" wholesaler to supplement any outstanding needs.

This close head-to-head competition between the two wholesalers led to significant dealer opposition to S.P. Richards' earlier, April 12 agreement to acquire Essendant. In breaking that agreement in favor of the Staples proposal, Essendant Chairman Charles Crovitz cited factors including "the extended regulatory process and risks associated with the S.P. Richards transaction."

The same closeness of competition dynamic that created antitrust risk around the wholesalers' proposed merger could lessen concerns about the Staples/Essendant tie-up. Given existing relationships with S.P. Richards, Essendant first-call dealer switching—or threatened switching—could be sufficient to prevent Essendant from increasing prices or degrading service.

Northeast, Midwest weakness. However, this leverage only exists if diverting purchases to S.P. Richards represents a realistic alternative for most dealers. In fact, S.P. Richards' strength and viability as a competitive option has been a key area of FTC inquiry in recent customer interviews, sources said.

Although the two wholesalers offer broadly similar services, five of the executives described S.P. Richards as suffering from regional capacity deficiencies that could restrict its ability to serve as a competitive first-call option for some dealers, especially independents with footprints in the Northeast.

"There's no question there is a capacity problem," the second executive said of S.P. Richards. "They don't have capacity in New England, and they don't have capacity in New York," he said.

"Every time I looked into possibly switching away from Essendant, [S.P. Richards] simply didn't have the infrastructure or the breadth of product or the services that Essendant did," the third executive said. "Their facility in Middletown, New York is so small and undermanned, it's not a fair comparison to make."

Two dealers identified a similar issue in the Midwest. "In our region, they're very weak. Their warehouse is small," said one Midwest dealer. "If they make the proper investments into their warehouses, into their distribution, into their inventory, they could be a viable alternative. But at this point I would say that they are not."

S.P. Richards' weakness in the Northeast could prove especially important for the nation's third-largest office products retailer, W.B. Mason, a first-call Essendant dealer concentrated in the Northeast that accounts for 11 percent of the wholesaler's revenue.

"I think the general feeling among S.P. first call dealers is, there is no way S.P. could handle a sudden increase in volume of dealers leaving Essendant en masse," the fourth executive said, "Especially [not] a dealer the size of W.B. Mason."

To be sure, independent dealer defection to S.P. Richards in response to a Staples move to increase prices or cut back on service would presumably be gradual, rather than sudden, potentially allowing S.P. Richards time to strengthen its infrastructure to take on new customers. In fact, S.P. Richards has already assured dealers that it is looking into reinvestments into facilities to service additional first-call dealers post merger, sources said.

But at least some dealers expressed skepticism that S.P. Richards will be able to position itself as a strong near-term option for all independents in the Northeast and Midwest. “You can’t build distribution centers overnight. They just don’t have the infrastructure. I’m guessing it would take them years, and by then it wouldn’t matter,” the first executive said.

Partnerships and Essendant’s Vertical Markets Group. In addition to concerns about S.P. Richards’ viability, independent vendors also fear that the merger would weaken Essendant programs that sharpen their ability to compete with larger rivals such as Staples.

One such program is Essendant’s Vertical Markets Group, which works with dealers to offer contracts tailored for large business customers by examining a client’s price lists and usage reports and developing plans through which the dealer can service the client at a discounted rate. Effectively, the program enables independent dealers and Essendant to jointly compete for larger customers who might otherwise source from Staples or Office Depot.

The program has emerged as a focus of the FTC’s review, sources said, with one source describing agency staff attorneys as “very interested” in the issue.

“Something like the Vertical Markets Group we need,” the third executive said, adding that the program enables his business to compete for both regional and national accounts. “We don’t see how Staples could continue to offer that type of service. It’s geared specifically to compete against them.”

But Douglas told *The Capitol Forum* that Staples will not alter the program post merger. Although conceding that there are times when an Essendant/independent dealer partnership would compete for business on which Staples is also bidding, the Staples CEO described the frequency of those situations as “very small.”

In fact, as the FTC argued during its litigation effort to block the 2015 Staples/Office Depot tie-up, independents partnering with Essendant play a very limited role in national enterprise account competition. Instead, independents are strongest in small and medium businesses—the exact segment in which Staples is a less significant factor.

And to the extent independents partnering with Essendant have little impact on its enterprise business, Staples will have no real incentive to discontinue the Vertical Markets Group post merger. “We fully intend for Essendant to continue to operate and support the dealers through that program and I’m sure through many others,” Douglas said.

Nonetheless, some dealers express skepticism that Staples would continue a program targeted at undercutting itself on price. “There’s just no way they’re going to allow the vertical markets team to give me pricing that would give me the ability to beat them,” the fifth executive said.

The merger’s potential impact on the program is especially concerning, the executive said, given that S.P. Richards’ national accounts program is generally weaker than Essendant’s, and focuses on government contracts. “As far as enterprise accounts, bigger customers, they’re very poor.”

The executive added that his business could switch to S.P. Richards but would likely forfeit its national accounts in doing so, citing the wholesaler’s patchy national presence and de-centralized processes that vary from branch to branch.

Confidential information concerns. In addition to the Vertical Markets Group, dealers also said that Essendant provides extensive marketing and e-commerce capabilities programs, including help on optimizing web sites and search engine technology.

“Essendant is at the heart, is the heart of independent dealers’ ecommerce systems,” the first executive said. “99.9 percent of our content on our website comes from them,” the second executive said, adding “Essendant has a lot of control on what our customers see in search.”

Essendant also collects dealers’ competitively sensitive information through more traditional means—namely, dealer orders that include pricing, quantity, and the end customer’s name and address.

As a result, Essendant has amassed significant data on independent dealers and their customers. In fact, dealers’ most frequently-cited concern arising from the merger is Staples’ access to this competitively sensitive information, through which the company could disadvantage rivals or target their end customers. “It’d be a happy hunting ground for my customer database,” the fourth executive said.

Firewall remedy. In an effort to pre-emptively address these concerns, Staples has independently committed to prevent post-merger information sharing between its retail and wholesale units. “Essendant and their customer information will operate 100 percent independently from Staples in their commercial operations. And that will be done through a strictly established firewall—no information will be exchanged between the two businesses of that kind, and there will be no exceptions to it,” said Douglas, the Staples CEO.

Staples may also argue that a strong firewall aligns with its commercial incentives, given that dealers could simply decamp to S.P. Richards in response to any data misuse. “It self-defeats what we're trying to do—to help the dealers be more competitive, and Essendant to be more successful at serving them—to have anything to diminish the trust between the businesses," Douglas added.

If the FTC does conclude that Staples would gain an incentive to use Essendant's confidential business information to harm competition, the commission would typically seek to impose a firewall remedy as a condition of antitrust clearance.

Such conduct remedies, however, have become increasingly disfavored at both U.S. antitrust agencies. Although DOJ antitrust division chief Makan Delrahim has taken the most strident stance against such fixes, FTC Chairman Joe Simons has broadly endorsed Delrahim's approach. "We're pretty close actually on our views on behavioral remedies," Simons said in June.

Two executives said a firewall would address their concerns regarding Staples' post-merger access to Essendant's data.

However, other dealers said that a firewall would be insufficient. "We don't feel that a firewall will satisfy that risk," the third executive said. "You're not going to get dealers to think that that's an agreeable pattern," said the fourth dealer. "It sounds kind of comical to me, in today's world of data breach."