Anticipated acquisition by Tesco PLC of Booker Group plc

Summary of final report

1. The Competition and Markets Authority (CMA) has found that the anticipated acquisition by Tesco PLC (Tesco) of Booker Group plc (Booker) (the Merger) may not be expected to result in a substantial lessening of competition (SLC) within any market or markets for goods or services in the United Kingdom (UK).

Background

2. On 12 July 2017 the CMA referred the Merger for further investigation following a phase 1 review.[1] Our investigation and report has been led by a group of CMA panel members (the Inquiry Group) who must decide:

   (a) whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation; and

   (b) if so, whether the creation of that situation may be expected to result in an SLC within any market or markets in the UK for goods or services.

3. We were required to come to, and report on, our final decision by 26 December 2017.

The Parties

4. Tesco is the UK's largest grocery retailer (it also supplies general merchandise, clothing, petrol, mobile phone and banking services). It owns approximately 3,500 supermarkets and convenience stores including some operating under the One Stop brand. Separately, Tesco owns the One Stop franchise which has approximately 160 stores which Tesco does not own.[2] In

[1] In exercise of its duty under section 33(1) of the Enterprise Act 2002.
[2] The One Stop franchise model is one where Tesco owns the brand and provides wholesale services to the franchisees who are independent from Tesco. Franchisees agree to a large degree of central control by Tesco [✂] and to source a large proportion of their products from Tesco.

2016/17 Tesco generated £55.9 billion of revenue worldwide, with £42.5 billion coming from the UK.

5. Booker is the UK's largest grocery wholesaler. It provides grocery wholesale services to retailers and caterers whether as delivered services or cash and carry. It is also the owner of the symbol group brands Londis, Budgens, Premier and Family Shopper. Symbol groups are collections of stores which are affiliated with a wholesale symbol group provider (the symbol group wholesaler), usually operating under a common brand or 'fascia'. The retailer is independent from the wholesaler, but generally commits to minimum purchase requirements (and other conditions which vary by wholesaler and symbol group brand), in return for use of the symbol brand and other benefits such as improved promotions. Booker has around 5,500 retail stores under its symbol group brands. In addition, Booker owns and operates a very small number of Budgens stores. In 2017 Booker generated £5.3 billion of revenue worldwide, almost all of which was generated in the UK.

6. In this report we refer to Tesco and Booker collectively as the Parties.

Jurisdiction

7. We have found that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation within the meaning of the Enterprise Act 2002 (the Act) and therefore we have jurisdiction to review it.

Rationale

8. The Parties stated that the rationale for the Merger is to benefit from the growth opportunities arising from the combination of two complementary businesses, in particular, in the fast growing 'out of home' food segment. Consumer preferences have been changing in two ways in particular: (i) there is a trend for convenience shopping (where consumers buy fewer items per shop but shop more frequently) and (ii) rapid growth in eating out (which includes restaurants and also pre-prepared sandwiches and salads for lunch offered by retailers). The out of home segment is forecast to grow faster in the short term compared to 'in home' consumption of groceries. The Parties plan to grow their presence in the out of home segment by, for example, supplying restaurants with a broader range of products and by selling pre-prepared food in retail stores. To help them achieve these synergies the Parties submitted that:

   (a) Booker has expertise and knowledge in the catering and food service business to serve the out of home channel; and

(b) Tesco has expertise in supply chain management (sourcing and distribution) and product development, with particular strength in fresh, chilled and own label categories, and well developed digital capabilities (customer insights and online ordering/delivery).

Market definition

9. We have assessed whether the Merger is likely to result in an SLC anywhere in the supply chain. In doing so, we have adopted the following frameworks for our analysis of the potential competitive effects of the Merger.

10. For our analysis of retail competition, we have differentiated by store size and distance within the categories of 'one-stop stores',[3] 'mid-size stores' and convenience stores. We have treated:

    (a) mid-size stores (280–1,400 sqm) as competitively constrained by other mid-size stores within a 5-minute drive-time in urban areas and within a 10-minute drive-time in rural areas, and by one-stop stores within a 10-minute drive-time in urban areas and within a 15-minute drive-time in rural areas; and

    (b) convenience stores (under 280 sqm) as being competitively constrained by other convenience stores, mid-size stores and one-stop stores within 1 mile.

11. For our analysis of grocery wholesale competition we have, where appropriate, treated symbol group, cash and carry and delivered grocery wholesale services separately. We have undertaken that analysis on the basis of the following differentiation, treating:

    (a) wholesalers offering delivered services to symbol group and independent retailers as competing within an area in which they derive 80% of their customers, but also taking account of a larger area in which they derive 100% of their customers;

    (b) wholesalers offering cash and carry services as competing within an area in which they derive 80% of their customers, but also taking account of a larger area in which they derive 100% of their customers.

12. For the procurement of groceries from suppliers we have assessed the Merger on the basis of product categories on a national basis.

[3] The report uses 'one-stop stores' to refer to large supermarkets (greater than 1,400 sqm) and 'One Stop stores' to refer to owned or franchised stores under the One Stop brand.

Competitive assessment

13. Tesco is primarily a grocery retailer and Booker is primarily a grocery wholesaler. There is very little direct, head-to-head competition between them. The Merger is therefore primarily vertical in nature. Moreover, Tesco mostly procures products directly from suppliers without using wholesalers. One Stop's expenditure on wholesale services is small relative to the UK total. It is commonly accepted that vertical mergers may lead to efficiencies which may result in benefits to customers; but some can weaken competition and may result in an SLC. Our approach to the competitive assessment reflects this.

14. We have used the following theories of harm to assess whether the Merger may be expected to result in an SLC. We have considered whether:

   (a) any additional buyer power to the merged entity would weaken rival wholesalers or dampen suppliers' incentives to innovate;

   (b) the merged entity would increase its wholesale prices or cut costs (that affect its quality of wholesale service) in local areas where its retailer customers overlap with Tesco's stores, in the expectation that it would be able to offset any resulting loss of wholesale sales through increased retail sales at Tesco's stores, to the advantage of the merged entity as a whole;

   (c) the merged entity would increase its retail prices or cut costs (that affect its quality of retail service) in local areas where Tesco's stores overlap with the merged entity's retailer customers, in the expectation that it would be able to offset any resulting loss of retail sales through increased wholesale sales to its retailer customers, to the advantage of the merged entity as a whole;

   (d) the merged entity would increase retail prices or cut costs that affect its quality of service in local areas where the Parties' owned and operated grocery stores overlap, thereby weakening local retail competition; and

   (e) if Tesco were to stop using third party wholesalers post-Merger this would substantially weaken delivered wholesale competition.

15. In our inquiry we have:

(a) commissioned a survey of 463 independent and symbol group retailers about their supply options and relationships with wholesalers;[4]

(b) received submissions, internal documents and commercial data from the Parties;

(c) received representations including responses to written questionnaires and telephone interviews with third-party wholesalers, suppliers, retailers and trade bodies;

(d) received commercial data from some third party wholesalers about their sales, churn rates of symbol group members, depot locations and catchment areas; and

(e) received commercial data from some suppliers about their terms with the Parties.

16. In addition, we have conducted various quantitative analyses, including an analysis of the effect on Booker's sales to retailers from over 1,600 examples of entry and over 300 examples of exit by competing retailers. We have also examined via a quantitative model, local areas based on over 12,000 stores (for one theory of harm, and around 2,300 for another) in order to assess whether after the Merger the merged entity is likely to have an incentive in any of these areas to increase prices or cut costs that affect quality of service.

17. Although we have taken into account Booker's wholesale activities to caterers in some of our analysis (for example, when we consider issues of efficiencies and buyer power) in other parts of our analysis we have focussed only on the retailing segment where, unlike the catering segment, Tesco is present.

18. In order to make our assessment of whether the Merger is likely to lead to an SLC under any of the theories of harm presented in paragraph 14 above, we have first examined grocery retail and wholesale services to understand the context in which the Parties compete.

19. In grocery retailing we have found that the main factors in local competition, in addition to price, are store size, distance from other stores and the fascia of the store. We have taken these factors into account in our analysis. Regarding fascia we have found that a large number of retailers compete against Tesco including supermarket multiples, symbol group retailers, and Aldi Stores Limited (Aldi) and Lidl UK GmbH (Lidl). The strength of

[4] The survey report is published on the Tesco/Booker merger inquiry case page.

competition in grocery retail varies from area to area and we have taken account of that variation in our analysis.

20. In grocery wholesale, we have found that retailers generally have a range of wholesaler alternatives to choose from regardless of whether they are symbol group retailers or use delivered grocery wholesale services or cash and carry services. The strength of competition in wholesale services varies from area to area and we have taken account of that variation in our analysis. During our inquiry Palmer & Harvey McLane Limited (P&H), and most of its subsidiaries, entered administration. We have considered what this has meant for our inquiry and for competition at the wholesale level. We have found that for each of the customer groups previously served by P&H – major multiple retailers, symbol group retailers, multi-site retailers, and other retailers including independent retailers – as well as for tobacco suppliers, sufficient options and competitive constraints will remain after the Merger.

Efficiencies and buyer power

21. We have investigated whether the Merger may be expected to result in an SLC in delivered and cash and carry grocery wholesaling as a result of the merged entity receiving more favourable terms from some suppliers or increased buyer power.

22. Some third parties raised concerns that merger-specific procurement efficiencies may lessen competition in grocery wholesale services. Specifically, third parties argued that the merged entity might pay less for its products for wholesale than others in the marketplace. This might be because of the merged entity's ability to achieve the more favourable of the supply terms currently received by either Party separately (harmonisation), or because of the merged entity's greater bargaining power. Some who expressed concern told us that supply terms to rival wholesalers may actually worsen because they would have lower sales volumes (in the event that some of their customers would have switched to the merged entity) or because suppliers would seek to recoup some of the lost profit on sales to the merged entity through raising prices to the suppliers' other customers. In any event, if the merged entity did achieve more favourable supply terms, it would receive a competitive boost in delivered and cash and carry grocery wholesaling.

23. The third parties said that, in the above scenario, eventually competition in delivered and cash and carry grocery wholesaling would be substantially lessened. Further, retailer customers, catering customers and end consumers would suffer detriment as a result of weaker competition.

24. The above concerns rely on the merged entity receiving more favourable supply terms compared to those that Booker or Tesco currently enjoy and that these will be passed on to customers so that customers of rival wholesalers would then switch to the merged entity. They therefore require us to consider the benefits to customers which could be realised in the short term and the less certain long-term impact on competition.

25. In order for this theory of harm to result in an SLC, a number of cumulative conditions would need to be met. These are that:

(a) the merged entity will be able to negotiate better supply terms from its suppliers;

(b) the resulting lower prices will be passed on to customers (ie retailers or caterers) which in turn will allow the merged entity to attract additional business away from its wholesale competitors;

(c) the competitive pressure on the merged entity from competing wholesalers will be substantially weakened as a result of rival wholesalers losing customers to the merged entity to such a degree that they either exit the market or they remain but the cost of serving their remaining customers increases (eg because suppliers increase prices to those wholesalers); and

(d) the merged entity will have the ability to increase prices or worsen its terms in the longer term as a result of substantially lessened competition in delivered and/or cash and carry wholesaling with the prospect of entry or expansion of the remaining competitors not being sufficient to prevent those price increases.

26. We have found that the merged entity would likely benefit from better terms from some suppliers with regard to some products through a degree of harmonisation of supply terms, where one of the Parties currently receives better terms than the other. The evidence indicates that this may apply to a relatively small proportion of Booker's current total grocery procurement. However, we have not found it necessary to conclude on the magnitude of any procurement efficiencies. In any event, to the extent that the merged entity receives more favourable terms, it is likely that a proportion of these better terms would be passed on to customers, making the merged entity a more effective competitor. Apart from where one of the Parties currently receives better terms than the other, we do not consider that the merged entity would receive substantially better supply terms on any products as a result of strengthened buyer power across its retail and wholesale businesses as a whole. The overall increment to Tesco's share of procurement as a result

of the Merger is generally low. In tobacco, where we have found that the Parties have a sizeable combined share and there is a significant increment from the Merger, suppliers are likely to have a significant degree of bargaining power.

27. Based on the overall evidence that we have received, we have found that Booker's share of grocery wholesale on any relevant measure is at a level at which we would not normally expect any firm to be in a position to substantially lessen competition across the whole marketplace. These shares indicate the very large scale of customer switching to the merged entity that would need to occur before an SLC could be contemplated. We have also found that competition in grocery wholesale services is generally strong which the merged entity would need to overcome in order to increase its relatively low share of grocery wholesaling.

28. Recent changes in the industry indicate that some rival wholesalers might be able to offer prices competitive to the merged entity. Wm Morrison Supermarkets plc (Morrisons) has recently announced that it will supply Safeway products and national brands to some retailers. Separately, the Co-operative Group Limited (the Co-op) has recently announced a bid for Nisa Retail Limited (Nisa) (which is subject to CMA approval). Another possible response could be for wholesalers to strengthen competition on non-price aspects such as service quality differentiation. These might include quality of range, service offering to symbol group retailers and delivery logistics.

29. This analysis would be sufficient to conclude that the Merger may not be expected to result in an SLC. Even so, we have further examined the evidence on entry and expansion by rivals to investigate whether the merged entity would be able to harm competition in the longer term. Even in the hypothetical scenario that the merged entity were to increase its prices in the longer term (and there is no evidence to suggest this would be the case), we have found that rival wholesalers would be able to expand to compete for customers and defeat such a price increase.

30. Finally, we note that it would generally be against the principles of merger control to find that a merger gives rise to a likely SLC just because it made one or both parties more efficient and a stronger competitor.

31. Therefore, we have concluded that the Merger may not be expected to result in an SLC because of achieving better supply terms.

Vertical effects: wholesale to retail

32. A firm might look to increase its profits by increasing its prices or by reducing its cost base in a way that reduces the quality of the service it offers to customers. What might prevent a firm from doing this without a merger is that some customers would not tolerate the higher prices or reduced quality of service, and would look to purchase their products elsewhere. While the firm would earn additional profits on the sales to customers that stay with it, it would lose sales (and profits) from customers that switched away. The threat of customers switching away disciplines the firm from raising prices or cutting costs that would reduce the quality of its offer.

33. A merger might change a firm's incentives, however. If enough customers who would switch away from one merging party would switch to the other merging party, then what was not profitable before the merger could become profitable after it. This is because the second merging party, in recapturing some of the switching sales, is able to offset some of the losses to the first, to the benefit of the enlarged group.

34. Tesco and Booker do not generally compete at the same level of the supply chain. Therefore, they will not be able to recapture sales directly between one another. However, some of the retail stores which Booker supplies will compete in their local area with Tesco's owned stores, and others will compete in their local area with Tesco's One Stop franchised stores.

35. If the merged entity were to increase its wholesale prices, or cut costs that affected its quality of wholesale service, it might earn higher profits on each sale it made. On the other hand, it might lose retailer customers to other wholesalers. If these higher prices or lower quality of service at the wholesale level were reflected in a worsened shopping experience, the merged entity might also face reduced demand from retailer customers it retained, as shoppers at their stores switched to shop at other convenience stores instead. In local areas where these stores compete with Tesco, Tesco might gain some of these switching shoppers.

36. Post-Merger, the strategy might therefore be profitable for the merged entity overall if the profit gained by the locally competing Tesco store at the retail level (from additional shoppers it won) and from the merged entity's wholesaling activities (from larger margins on sales it retained), is greater than the profit which it lost (from customers that switched away, and lower sales to customers it retained). If this is the case, the merged entity might have the incentive to increase its wholesale prices or cut costs that affect its quality of wholesale service (ie pursue a foreclosure strategy) in those local areas.

37. We have considered in our analysis whether the Merger is likely to result in an SLC through such a vertical effect nationally. At the national level, Booker accounts for around 10-20% of grocery wholesale services overall and 18% to the retail channel, while Tesco accounts for around 28% of grocery retailing. We have found that it is not likely that the Parties could carry out a national foreclosure strategy at these levels of supply. For example, if the merged entity were to increase its wholesale prices and/or cut wholesale costs that affect its quality of service nationally, its customers (whether retailers or caterers) would be likely to switch to the other wholesalers who make up around 80% of UK wholesale supply to retailers. Likewise, in the large majority of local retail areas, Booker-supplied retailers are likely to face sufficient competition from third-party retailers to make the necessary recoupment through Tesco unlikely.[5]

38. We have assessed whether the Merger may be expected to result in an SLC through this vertical effect locally. For there to be an incentive for the merged entity to increase wholesale prices and/or cut wholesale costs that affect its quality of service to its symbol group and independent retailer customers, the strategy would need to be profitable to the merged entity overall. There are several factors that affect whether this is likely to be the case. These are:

    (a) the degree of competition between Tesco stores and Booker-supplied retailers at a local level (ie the conditions of local retail competition). This will determine the extent to which end-customers may switch from Booker-supplied retailers to Tesco stores, rather than to other retailers' stores;

    (b) the degree of competition at the wholesale level. This will determine the extent to which retailers may switch away purchases from the merged entity and use alternative wholesalers instead if the merged entity deteriorates its offering;

    (c) the profits that the merged entity stands to gain from any consumers who switch to the locally competing Tesco store, compared to the profits that the merged entity stands to lose on lost wholesale sales (net of the higher profits it earns on higher-profit wholesale sales it retains). This will depend on the margins earned on each sale – since Tesco generally earns a much higher margin on its retail sales than Booker earns on its wholesale sales, it is plausible that forgoing a smaller (wholesale) margin in favour of

[5] Since our provisional findings P&H has gone into administration and therefore we note that Booker's share of grocery wholesale services overall and grocery wholesale to retailers is likely to be higher than the 10-20% and 18% respectively that we quoted in our provisional findings report. Taking into account of P&H going into administration, even on a cautious basis we estimate that Booker's revised share will remain below 30% on either measure.

a higher (retail) margin could be profitable to the merged entity overall; and

(d) the extent to which a worsening of the wholesale offer (particularly in the form of a wholesale price rise) is likely to feed through to a similar worsening at the retail level (particularly in the form of a retail price rise). The larger the change in retail prices, the more likely that sales will divert at the retail level which may be recaptured by a locally competing Tesco store, and the greater the incentive for the merged entity to increase wholesale prices (for any given level of wholesale losses that would result).

39. We have examined the Parties' incentive to carry out a strategy of increasing the merged entity's wholesale prices, or cutting costs that affect its quality of wholesale service, in relation to over 12,000 stores supplied by Booker that face competition in their local area from at least one store owned or supplied by Tesco.

40. We have found that the merged entity would not have any material incentive to worsen wholesale price or service. This is because, overall, we found that competition in wholesale services was generally strong, meaning that, in most areas, many retailers would switch purchases to other wholesalers rather than suffer (or pass on to shoppers) a worsened service – defeating the merged entity's ability to carry out this strategy. Further, in many areas, the presence of other nearby retail competitors would mean that Tesco would not be able to recapture sufficient sales to make the strategy profitable, as competing retailers would capture some of the switching sales.

41. We have found that there may be, at most, some limited incentives in relation to a very small number of local areas. However, any incentives that might arise at the wholesale level would be reduced by, for example, retailers purchasing only a fraction of their products from the merged entity and the rest from other wholesalers, and by retailers not passing the full wholesale price rise through to shoppers at the retail level. Further, pursuing a targeted strategy in these areas would require coordination across the merged entity's retail and wholesale arms. We consider that the costs of implementing such a strategy would be disproportionately high relative to the very small number of areas involved. In addition, we found that wholesale competition was sufficiently strong in all of these local areas.

42. We have therefore found that the Merger may not be expected to result in an SLC with respect to this theory of harm.

Vertical effects: retail to wholesale

43. We have investigated whether the Merger could make it profitable (in a way that was not profitable prior to the Merger) for the merged entity to implement a strategy of increasing retail prices or cutting costs that affect its quality of retail service, due to the possibility of recapturing sales at Booker-supplied retail stores that overlap with Tesco stores.

44. In theory, and all other circumstances being equal, the incentives arising under this theory of harm will be lower than those discussed in the above 'vertical effects: wholesale to retail' theory of harm. This is because the profit which the merged entity stands to gain at the wholesale level from sales recaptured at its retailer customers' stores are reduced in two ways. Firstly, the margins which Booker currently earns on wholesale sales are lower than the margins which Tesco currently earns on retail sales. Secondly, Booker does not supply all of its retailer customers' wholesale requirements. Any increased demand that Booker's retailer customers face due to shoppers switching to their stores after the Merger will therefore be spread between the wholesalers that they purchase from, only one of which may be Booker.

45. For there to be an incentive for the merged entity to increase its retail prices or cut costs that affect its quality of service (notwithstanding that this may result in some lost sales), the strategy must be profitable to it overall. There are several factors that affect whether this will be the case:

   (a) First, the degree of competition between Tesco stores and Booker-supplied retailers at a local level (ie the conditions of local retail competition). This will determine the extent to which end-customers may switch from Tesco stores to Booker-supplied stores, rather than to other retailers' stores.

   (b) Second, the profits that the merged entity stands to gain from any additional wholesale sales that result from end-customers switching to Booker-supplied stores, compared to the profits that it stands to lose on lost retail sales at Tesco stores as shoppers switch away (net of the higher profits it earns on the more profitable retail sales it retains).

46. As Booker's current wholesale margin is smaller in value compared to Tesco's prices, the value of recaptured sales is small in relative terms (ie from Tesco's point of view). This means that for the strategy to be profitable to the merged entity overall, the rate of diversion in any local area must be significantly higher under this theory of harm compared to the 'vertical effects: wholesale to retail' theory of harm.

47. We have taken into account the share of a retailer's total wholesale supply that Booker provides. If this is a small proportion, then the value of the sales the merged entity stands to win will also likely be small, and therefore the 'gain' of the strategy reduced.

48. We have examined the local areas in which over 2,300 Tesco-owned stores face competition from at least one Booker-supplied store.

49. We have found that the merged entity would not be likely to have any material incentive to worsen retail price or service. This is because, if the merged entity were to raise its retail prices, it would incur losses through: other non-Booker-supplied retailers recapturing sales, Booker-supplied retailers not purchasing all their stock from the merged entity, and Booker's current wholesale margins being lower than Tesco's retail margins.

50. We have found that there may be, at most, some limited incentives in relation to a very small number of areas, and pursuing these would require coordination across the merged entity's retail and wholesale arms. Moreover, the recaptured revenue would come via customers of the merged entity's wholesale business whose continued purchases from the merged entity are far from guaranteed. The costs and risks of implementing such a strategy would be disproportionately high relative to the very small number of areas involved.

51. We have therefore found that the Merger may not be expected to result in an SLC with respect to this theory of harm.

Horizontal effects

52. Booker owns and operates a small number of convenience and mid-sized stores, some of which are located near Tesco stores. In the CMA's phase 1 decision it identified two local areas in which a realistic prospect of an SLC arose. We have examined those two areas.

53. In the first area, within a mile of the Booker store there is a Co-op, Aldi and Lidl. The overlapping Tesco store is also within a mile but further away than the rival stores. On the basis of existing local competition we have concluded that competition concerns are not likely to arise in this local area.

54. In the second area, there are two nearby Tesco stores, both located slightly over a mile (and both under 6 minutes' drive-time) away from the Booker store. However, J Sainsbury's plc (Sainsbury's) and Asda Stores Limited (Asda) are present in the local area, and Aldi and Marks and Spencer plc (Marks and Spencer) Simply Food are both only slightly more than 5 minutes'

drive-time away. On the basis of existing local competition we have concluded that competition concerns are not likely to arise in this local area.

55. We have therefore found that the Merger may not be expected to result in an SLC with respect to horizontal effects.

Conclusion

56. We therefore have concluded that the Merger may not be expected to result in an SLC within any market or markets for goods or services in the UK.