Local Market Mergers

General note

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This client guide addresses ten key questions regarding the competition review of a local market merger.

1. What is a local market merger?

Local market mergers exist where the natural catchment area of a business is the immediate vicinity where the business is located. Many such mergers are retail businesses, namely, the sale of goods or services by shops to end customers. Examples are cinemas, pharmacies, petrol stations and betting shops. There are also local market mergers where the customers are businesses. An example of such B2B mergers is the production and sale of cement to builders. Some mergers, typically where large groups or chains of local businesses exist, will require both a local market analysis and a broader (for example, national) analysis because some elements of the business are active at the broader level. Thus, a chain of DIY shops engages with customers at the local level, hence the local market analysis, but the business buys its products from suppliers that are active nationally. On this latter upstream market, the business competes with other DIY groups to buy products from producers and both the buyer and seller are active on a national market.

2. What is the geographic market?

In merger analysis, to consider whether a transaction may be expected to result in a substantial lessening of competition, it is first necessary to define the product market and the geographic market. The former relates to the goods and/or services sold by the purchaser and the target businesses. The latter is the physical area where buyers engage with the purchaser and the target businesses. The geographic market may be as broad as being global (for example, crude oil) or as narrow as being one or two miles or less (for example, pharmacies).

3. How important is it to get the correct market definition?

The degree of analysis required will depend upon the result of the preliminary analysis identifying the extent, if any, to which the geographic catchment area for each of the purchaser and the target businesses are close or overlap. If it is self-evident that there is clearly no geographic overlap between the two businesses, then further analysis is unlikely to be required. For example, both parties to a transaction are independent supermarkets, each with three stores. The purchaser's stores are in a town (for example, Southampton in South-East England) and the target's stores are in a different town that is far removed (for example, Leeds which is 237 miles away in the area between the middle and North of England). No person who would naturally shop at the stores in Leeds would consider going to a store in Southampton. Expressed in economic terms, the costs associated with shopping at a store, which are the cost of travel and presumed nominal cost of travel time, would be high for a Southampton-based customer shopping at one of the target's stores in Leeds, and high also compared to the amount of money typically spent at a supermarket on a single shopping trip. Therefore, being economically rational, a customer of the purchaser's stores would not consider that the target stores are competing for its weekly shop. In contrast, if a target business is per our example in the centre of Southampton while the purchaser has three outlets in Portsmouth (about 20 miles or 30 minutes by car) further analysis would likely be required, while if the purchaser instead has three outlets on the outskirts of Southampton, then a detailed analysis would be critical to determine whether any substantive issues arose.

4. How is a local market analysis undertaken?

The way a business engages with its customers and where those customers are based should be considered with an open mind to ensure all material aspects of the business are included in the analysis. However, there are some common methods of analysis used to determine the geographic market. These analytical tools address the questions: (i) where are the customers of the purchaser business based, (ii) what are the travel times from the customers to the purchaser business, (iii) how do the above results relate to the results of those questions for the target business, and (iv) how do the combined results relate to the results of those same questions asked of any competitors in the vicinity of the purchaser and/or target businesses? To address these questions different tools may be used. Which tools to use is often determined by the availability of customer information. The tools commonly used fall into two groups (i) isochrone or distance to customer analysis, and (ii) customer location data analysis.

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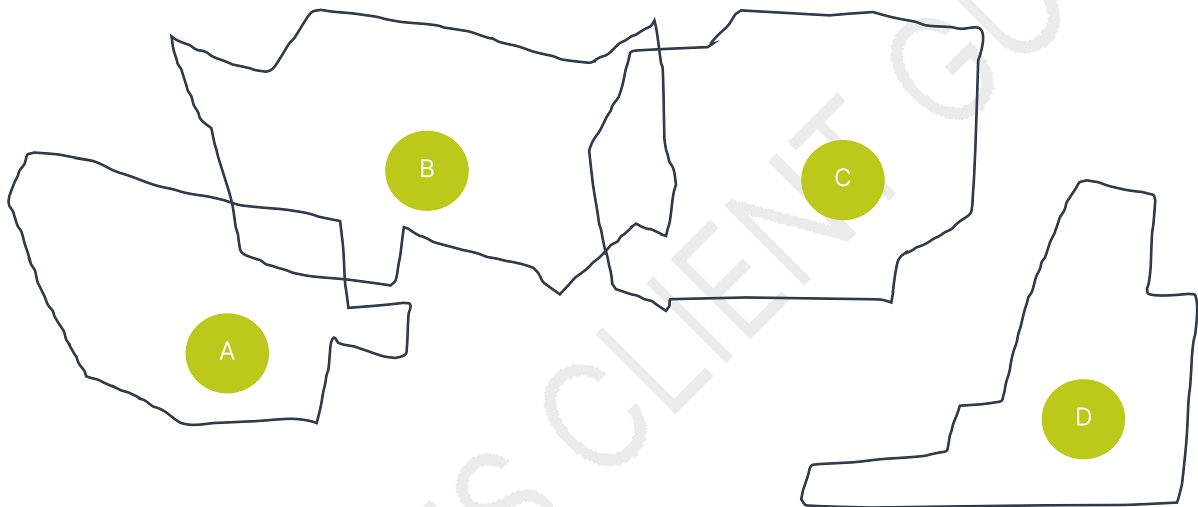
5. What is an isochrone analysis?

One can measure the distance from a shop to a customer. At its most simple the distance would be measured 'as the crow flies'. Thus, the hypothesis might be that the geographic market for a cinema is five miles as the crow flies. A more sophisticated approach would be to take account of the transport network. Thus, the hypothesis might be that the market is five miles according to the transport network. An even more sophisticated approach would be to take account of the time taken to travel, thus distinguishing between major and minor roads, and the time of day when the journey occurred. Isochrone analysis (from the Greek, 'iso' meaning the same and 'Chronos' meaning time) is a tool measuring the time taken to travel from two points on a map. This tool is used, probably unknowingly, by people when using Google, Waze and similar travel apps to plan their journey. Specialised software exists more appropriate to merger analysis, but the principle is similar. As a result of the analysis a picture is produced identifying the relationship of the parties and other potentially competing businesses in the area. A hypothetical example is shown below.



In this example, for a travel time of 20 minutes, some of A's customers are in the catchment area of B suggesting that A and B compete at least for those customers. B and C also have some customers in common, but A does not appear to compete for the same customers as C. D is an 'island' having no customers that are also potentially customers of A, B or C.

Determining the travel time to use in the isochrone analysis is one of the key elements to ensure the tool is yielding the correct result. As a rule of thumb, the isochrone analysis should capture at least 85% of the customers of the business being analysed. This leads to the question of who are the customers of a business?

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6. Who are the customers of a business?

All local market businesses have a sense of where their customers are approximately based. Absent any actual evidence, the usual method to determine the question is a customer survey. Customer surveys are composed of four types of questions. First, identifying the location of the customer (using precise information such as post-codes, or less precise but still potentially relevant information such as naming a town or suburb). Second, the mode of travel (car, public transport). Third, the choices made by the customer in visiting the identified store, for example, 'why did you come to this pharmacy rather than any other?'. Fourth, the frequency of such visits. There are several challenges to producing a customer survey, of which a material one is to ensure that the survey results will be accepted by the competition authority as providing valid evidence. The UK's competition authority – the Competition & Markets Authority (CMA) – has produced guidance on many aspects of the design, interpretation, and assessment of surveys.

Increasingly businesses do have some, and in some cases detailed information on its customers. The most common source for such information is store loyalty cards. This information can be combined with the purchase information of those customers that have loyalty cards to build a picture of the customer location, frequency of visits and type of purchases made.

Whether the evidence is through a customer survey and/or customer loyalty cards, it will be necessary to determine the extent that this information is representative of a store's customers generally. For example, it seems reasonable that more frequent cinema goers would have a loyalty card compared to those who went only occasionally. If 45% of teenage cinema goers go only once every three months or less, then the data that is collected from those that have cards might not be representative. For example, those with a loyalty card might generally live closer to the cinema being analysed, so relying on just those customers would result in a catchment area that was too small.

7. Who are the competitors?

If it is determined there is competitive interaction between the purchaser and target businesses, the assumption is that there will be some lowering of competition in the market post-transaction. It is important to note that the competition authority will assume that the purchaser and target stores within the same local market were competing pre-transaction and will not compete post-transaction. This is the case even if the two stores remain with their previous brands and on their face appear not to have changed their business following the merger. The next step is to identify the competitors and the degree to which they compete and thus counterbalance or otherwise negate any negative effects on competition caused by the transaction. Expressed simply, a competitor is one whose customers are shared with at least one of the purchaser or target businesses. The more there is customer overlap, the more the businesses are likely competing. It will be important at this stage to compare the competitors and potentially reconsider the product market definition. For example, if the market is cinema exhibition, the question can be asked whether a modern edge-of-town large multiplex cinema is to be treated as equally competitive as an old in-town three-screen cinema from the customers' viewpoint.

8. Is competition in the market sufficiently strong?

Having identified who are the competitors and the extent they are competing; it is necessary to determine whether the transaction may be expected to result in a substantial lessening of competition. A facet to this determination is whether, post-transaction, customers would still have sufficient choice. At its basic level this can be approached by determining how many competitors there will be post-transaction in the local market. Thus, if there were six pharmacies in a town and post-transaction two merge, then will the remaining four pharmacies and the merged purchaser/target pharmacies (so five in all) provide enough choice for customers. The answer to this question will depend in part on the product market definition. Does the result change if the transaction results not in five but four competitors, and what if there are three? As a reference, competition authorities are likely to investigate for potential serious issues if there are three or fewer competitors because of a transaction.

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9. What can be done to resolve any issues?

If the transaction has already completed, divestment will almost certainly be the remedy required to resolve the finding that a substantial lessening of competition is expected because of the transaction. If the transaction has not completed, then the purchaser will need to resolve the issue before completing the transaction. This leads to two key issues. Is it the purchaser or buyer site that should be divested, and to whom can the site(s) be divested? Where each party has several stores, it may be that a mix of target and purchaser stores would remedy the issue. However, competition authorities may resist, arguing that the divestment stores should come either from the purchaser or the target. The purchaser's business plan for the merged businesses and other elements will be relevant to the point. For example, if the purchaser plans to have all the target stores rebrand and to sell the divestment stores with the right to trade using the target brand name, then the competition authority may press the parties to have all the divestment stores be target stores. This might result in 'crown jewel' stores of the target being divested.

Because the nature and scale of divestments can have a material effect on the economics of the transaction, the determination of which stores are likely to need to be divested should be determined with a reasonably high degree of certainty prior to the transaction fundamentals being settled. A related point as regards transaction value net of divestments is to consider ahead of time the likely purchaser or purchasers of the divestment sites. It should be noted that the competition authority must approve of the purchaser. Typically, therefore, the divestment purchaser is already active on the product market (for example, it already owns several pharmacies) but not in the geographic area (market) of the divestment site. As the sale to the divestment purchaser must not itself create a competition concern, the choice of divestment purchaser might be limited, for example, in an already concentrated market.

10. What complications can arise?

For transactions that have not completed, where divestments of local businesses are required it should be noted that in legal terms the divestment seller might be the target business. Protocols and procedures will need to be put in place between the parties and their advisors to ensure maximum sale value within a relatively short period of time, while maintaining the competitive independence of the purchaser to the stores to be divested. The need for this 'clean team' vigilance is underlined by the competition authority invariably requiring the parties to engage a third-party sale trustee and probably a third-party monitoring trustee to have oversight of the divestment transaction and process.

In practice a combination of isochrone analysis and customer location analysis likely will not produce a clear single result. Instead, there will be different layers of results (e.g., one for a 20 minutes isochrone analysis and another for a 15 minutes isochrone analysis). Each layer might produce a different result in terms of number and location of divestment stores, with the consequence that identifying with clarity the scale of divestments and their economic impact on the transaction value is typically within an estimate range. Pre-notification discussions with the competition authority may be able to reduce this range.

Transactions involving many local markets, for example, the merger of two supermarket chains, can lead to very many local market overlaps. The volume of work involved means a competition authority cannot meet its usual timetable to undertake the work. This often results in assumptions being made by the authorities. For example, any local market where the number of competitors reduces to four or fewer is assumed to raise substantive concerns unless the contrary is proven. Parties can seek to 'cut a deal' with a competition authority by agreeing to divest all sites that fall within this negative assumption. This creates significant efficiency for the authority and the parties, although it does create a potential missed opportunity for the parties to try to retain some sites by arguing that the assumption does not apply in certain cases.

Given the scale of work involved for the parties and the competition authority, transactions involving local markets typically take more time and resources to complete than other transactions. These factors should be built-in to the parties' timetable and expectations.

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