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Vigor of Imperial Seen as Issue in Reynolds/Lorillard Merger

March 24, 2015 – by Robert W. Welkos – The $24.7 billion merger of Reynolds American Inc. (RAI) and Lorillard, Inc. (LO) would transform America's tobacco industry, resulting in two companies controlling 84 percent of the market. But in interviews with *CT Financial News*, two antitrust attorneys who once held key posts at the Federal Trade Commission have expressed differing opinions on the likelihood of the deal winning FTC approval.

One who thinks the deal will be approved is Chul Pak, a former assistant director of the FTC's Mergers IV Division and now a partner at the New York law firm Wilson, Sonsini, Goodrich & Rosati. "If you eliminate a significant portion of the competitive problem by offering to divest in the overlap area, ergo, there is no competitive problem," Pak told *CT Financial News*.

Under terms of the deal, Lorillard's menthol cigarette Newport, which currently has 13 percent of the retail market, would be combined with Reynolds' key brands Camel, Pall Mall, Natural American Spirit, Grizzly and VUSE. But in a side deal, Imperial Tobacco Group plc (IMT) has agreed to purchase Reynolds' Winston, Kool, Salem, Maverick and blue eCigs brands and other assets for a total of $7.1 billion in cash. Imperial will also acquire Lorillard's manufacturing and R&D facilities in Greensboro, N.C. along with a work force of roughly 2,900.

As a result, Imperial's U.S. market share is projected to increase from 3 percent to 10 -12 percent, becoming the third biggest tobacco products company in the United States. But Imperial has struggled lately and has seen its market share dip over the last three months, giving rise to concerns that the company might not be able to restore the same level of competition as currently exists.

David A. Balto, a Washington, D.C. attorney who served as policy director at the FTC's Bureau of Competition from 1998 to 2001 and who also previously worked at the Justice Department's Antitrust Division, does not think the Reynolds/Lorillard merger is a slam dunk. "Eliminating Lorillard is not going to make life any better for consumers," Balto told *CT Financial News*. "Imperial is a very weak competitor and has a lot of second-rate brands." Balto noted that the tobacco industry has a long history of collusion: "The cigarette industry is the model of an oligopoly," he said.

Critics charge that the merger would create a duopoly. Reynolds is currently No. 2 in the market followed by Lorillard. After the merger, Reynolds-Lorillard would see its combined market share, even with divestitures, jump to 34 percent behind the biggest player, Altria Group Inc. (MO), parent of Philip Morris USA with such brand-name cigarettes as Marlboro, L&M, Parliament, and Virginia Slims.

Pak told *CT Financial News* that Imperial's performance as an indicator of its likely future performance is important for the FTC to analyze. Also important is what other options are available in terms of potential buyers. This will be weighed against the likelihood of harm to consumers and the likelihood of the FTC winning in any antitrust litigation it might bring against the companies. Pak said the FTC is seeking answers to two principle questions: Is the asset package sufficient to restore competition? And, does Imperial have the wherewithal in terms of financing, experience, and incentives to restore competition to pre-merger levels.

"The parties have already agreed to divest Kool and Salem," Pak noted. "The traditional overlap that would be of competitive concern would be in the area of menthol cigarettes. Lorillard already has Newport. ... In any merger, when the parties are talking about a settlement, you identify areas X and Y as being competitive problems and say, we think we can fix problem area Y by divesting assets to a third party and that third party will be able to restore competition to pre-merger levels or close enough to, so that the problem goes away."

The companies have said they expect the deal to close in the first half of the year.

Edward L. Sweda, senior attorney for the Tobacco Products Liability Project at Northeastern University's School of Law, said that antitrust enforcers should be concerned about the impact the merger will have on the overall tobacco products market and also questions whether Imperial can adequately compete with Altria and the combined Reynolds-Lorillard. "Imperial doesn't have much of anything of a history in the United States," Sweda told *CT Financial News*. "At the very least, the open question is whether they could develop into a potential player in the market."

If the merger is approved, Sweda added, "then (Altria) and the Reynolds-Lorillard combination will be huge. The vast majority of cigarette brands will involve one of those two companies." Thus, he added, it would be a "huge undertaking" for Imperial to even attempt to chip away at the overall market.

Sweda also relates that with tobacco, there is the substantial issue of the public's health to factor into any equation. Sweda said Lorillard's history of promoting smoking to kids and of denying the health hazards of cigarettes over the years is "about as reprehensible as Reynolds." "In terms of tobacco, consumers are hurt more by the product itself," Sweda said.

Joseph Harrington, a professor of business economics and public policy at the University of Pennsylvania's Wharton School, asked rhetorically why not leave Lorillard where it is today — at No. 3 in the market — and see if it comes up with a new product that will increase its market share? Perhaps, he said, Lorillard could develop a new non-menthol cigarette that would impact the overall market in the same way that the old Liggett & Myers tobacco company did with generic cigarettes. "The elimination of an independent firm from the market means one less source of innovation," he stressed. "Even though Lorillard is a small player in the non-menthol cigarette market, who is to say that they will not introduce an innovative product that would compete?"

"Liggett & Myers had a pretty small part of the overall market, but ended up making a big impact on the overall market," Harrington recalled. "At the time, Philip Morris wasn't going to introduce low-priced cigarettes to draw away from Marlboro cigarettes. (Liggett & Myers) created this whole generic category."

Harrington believes that antitrust enforcers have been "too lenient" in approving some other recent mergers that have come before the agency for approval. He cited one example as the Justice Department's 2013 blessing of the American Airlines/US Airways merger. At the time, critics expressed concern that the merger of these two big air carriers would result in higher ticket fares. "They didn't argue there would be any reduction in costs, but there would be an increase in flight frequency and so forth," Harrington said.

Balto, meanwhile, pointed out that the U.S. airlines industry is not as "tight of an oligopoly" as the tobacco industry, which he characterized as really knowing "how to do the dance of collusion."

In a speech last year in San Francisco, Deborah L. Feinstein, director of the FTC's Bureau of Competition, said that "In markets, the past is not always prologue," and cited as an example her agency's decision not to block the Office Depot/OfficeMax transaction 17 years after it had obtained an injunction to block the Staples/Office Depot combination. "The commission found significant changes in the competitive environment, including a greater reliance by customers on mass merchants rather than office supply superstores and continued growth of on-line competitors," she explained.

Feinstein went on to say that in analyzing a merger between two long-standing competitors, the FTC typically begins with examining the historical facts, what market shares have been in past years, and whether companies have marketed or bid against each other before and what factors influenced the prices they set. But the FTC, she added, also looks at other "dimensions of competition such as quality, service or innovation." "Once we determine that a firm is in the market, we must assess the competitive impact it is having or is likely to have on competition," Feinstein said. "In contrast to committed entrants, some firms must expend more effort, either in terms of time or sunk costs, to begin making sales in the relevant market. The competitive significance of such firms will depend on how far along they are in the variety of concrete steps needed to begin actual sales and the likelihood such entry will occur."

Erik Bloomquist, an analyst at Berenberg Bank, believes that the FTC will view Imperial as a more substantial competitor than the now controversial Franchise Services of North America who were approved to purchase the divested assets from the Hertz/Dollar Thrifty combination. "The U.S. component of IMT even post transaction combined with IMT's existing U.S. business is only likely to account for around 20 percent of the Group operating profit," Bloomquist explained in an email to *CT Financial News*. "Although carrying a fair amount of debt, IMT managed to reduce its debt materially in F2014, freeing up funds for brand investment across the Group and is also confident in its ability to reinvest all of its cost savings from combining the two U.S. businesses into the acquired brands," he continued.

Bloomquist believes Imperial's transaction will be a "highly visible test case of its ability to focus and revitalize brands generally, and also as an effort to enhance its leverage to the stable, predictable and profitable U.S. market". While acknowledging that Imperial has not been particularly successful in the U.S. to date, Bloomquist contends that post acquisition, with a sales force that has broader coverage and with a management team that is experienced in the U.S. market, the company stands a better chance of succeeding than its initial U.S. efforts.