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Reversals of Fortune in the Tea Industry

Part XXXIX: Mergers and Acquisitions

The Xerox 914 Office Copier
Released in 1959

Priced at $29,500, the original commercial office copier was a hard sell. However, leasing the copier for $95 per month (with maintenance, supplies, and up to 2,000 monthly copies included) was a huge success. Copies beyond the monthly allowance of 2,000 were priced at 5 cents each. Soon, over 2,000 copies were being made each day! This was a hundred times the average number of copies produced by the earlier "wet" process copiers.

What do office supplies and specialty teas have in common? Beyond the fact that most office supplies, like pencils, paper, and other daily-use items, are considered consumables, there are few direct comparisons. Unless, of course, you consider the high level of M&A (merger and acquisition) activity in the office supply industry and that of the so-called specialty tea and coffee industries.

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Reversals of Fortune in the Tea Industry, Part XXXIX

Mergers and acquisitions are fraught with pitfalls. According to a study conducted by one of the "big four" auditing firms, *KPMG International,* 83% of mergers fail to add shareholder value. There are several reasons for the high failure rate of M&A activity, but the one factor most often overlooked is customer impact.

In an article entitled *Why Mergers Kill Customer Value*, Christine Crandell states:

> Having been involved in a lot of M&A transactions, I find the "customer" is rarely the centerpiece of integration work. In fact, while customers are the most valued asset in a transaction, they are treated like their loyalty can be bought and sold. In fact, the disruption and chaos from a merge often drives customers away and is the primary reason acquisitions do not measure up to their projected financial benefits.
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> For all the M&A due diligence done very little effort is expended to understand the expectations of customers. An equal paltry amount is spent on understanding how customers will respond to the news or to minimizing the disruption to their experience. Deals are made under the mistaken assumption that customers will remain loyal even as the brand they love will change.

The likelihood of a consumer suffering the negative impact of a merger or acquisition seems to be increasing with time. M&A activity reached record levels in 2015 and, according to *KPMG International*, 2016 is off to a strong start. It would be cynical to assume all of these M&A transactions will be customer-hostile and one must assume that none are intentionally so.

Industries that have the highest level of M&A activity can be divided into two categories, those that have rapidly growing markets (expansion) with untapped opportunities, and those that have shrinking markets (contraction or oversaturation).

In the first category, those companies that have excess capital or good credit can make strategic acquisitions that are expected to capture a larger portion of the expanding market. In the second category, stronger companies are able to acquire the assets and customer base of struggling competitors, who see a buy-out even at a low price as an attractive alternative to bankruptcy. As illustration, we will examine markets that are currently in transition, the office supply market and the specialty tea and coffee markets.

The office supply business is an interesting study because it is clearly in the second category today, but just a few decades ago it was squarely in the first. The transition from expanding market to contracting market was gradual but strident.

The expansive period for office supplies was spawned during the 1980s, during which increasingly affordable copiers and printers chewed up reams of paper that had to be stapled, punched, clipped, mailed, faxed and/or filed. Much of it was highlighted, revised, signed, and stamped, after which dozens of copies might be circulated. Ultimately, much of it ended up being shredded.

All of this attracted forward-thinking entrepreneurs and venture capitalists who embraced the superstore (a.k.a. "big box") retail model. *Office Depot* was founded in March 1986, followed by *Staples* two months later. *OfficeMax* joined the club in 1988 and the race to capture market share was on.

Before the first office supply superstore was built, however, a number of mail order office supply houses were expanding nationwide. *Quill Corporation* was an offshoot of a small Chicago shop, founded by Jack Miller in 1956, with an initial loan of $2,000 from his father-in-law. Jack's shop was in a small room near his father's poultry business, which was the inspiration for the *Quill* name.

Jack's brother, Harvey, joined the company in 1957. By shifting focus from phone sales and cold calls to direct mail marketing, sales reached $3.5 million dollars by 1974. That year a third Miller brother, Arnold, joined the team. Arnold, who was working in California as a CPA, started in the Miller family business as secretary.

By the time *Office Depot, Staples,* and *OfficeMax* were founded, annual sales at *Quill Corporation* reached a respectable $180 million, but competition from the big box stores would soon begin to erode margins as price wars ensued.

Copier paper was in the front lines of the battle. *Quill* was successfully selling their own brand of copier paper at $37.50 per case, but the big box stores decided to use copier paper as a loss leader. Copier paper at $20.00 per case would get a customer into the store, where they would buy other high-margin supplies and see cheap, but highly profitable, office furniture.

The Miller brothers countered by entering the retail office furniture business. They acquired *Aaron's Office Furniture Warehouse*, a chain of five stores operating in the Chicago area. They renamed the stores *Quill's Office Furniture* and began to expand from the original five locations.

Quill.com was launched in 1996 and, within two years, annual sales of *Quill Corporation* reached $600 million. By now, however, the Miller brothers were thinking about retirement, but no member of the next generation of the Miller family seemed interested in battling it out with the competition.

In 1998, with what seemed to be a spontaneous decision, the Miller brothers accepted a buy-out offer from *Staples* in an all-stock acquisition valued at $685 million. Total sales the previous year were roughly $600 million.

The *Quill* story is quite similar to that of *Viking Office Products*, an outgrowth of a small Los Angeles office supply store founded in 1960. The *Viking* name was officially adopted in 1969, and within ten years the company was competing nationwide with *Quill* and would soon take its concept overseas. International sales eventually reached approximately $1 billion, eclipsing domestic sales of $600 million.

Viking was acquired by *Office Depot* in 1998 (the same year that *Staples* acquired *Quill*) with a one-for-one stock swap, a deal that valued *Viking* at around $2.6 billion, substantially more than their annual worldwide sales. Unfortunately, this acquisition took place just as offices were beginning to go digital.

Scanning, email, and disk storage soon eliminated the need for much of the paper, filing systems, binders, and other traditional office products. What was once a lucrative expanding market was rapidly eroding.

Besides facing a shrinking market, *Office Depot* had to tackle an integration process that may have been more difficult than expected. Some loyal *Viking* customers, who were used to the "old" *Viking*, experienced some "changes" that encouraged them to try other sources, and by then there were plenty of alternatives. Why the *Viking* name was eventually abandoned in the U.S. is not clear, but it still operates overseas under the name *Viking Direct*.

Office Depot and *OfficeMax* merged in 2013, and at the present time, *Staples* has offered to purchase the *Office Depot/OfficeMax* operation, an acquisition that may not receive FTC approval.

Just how bad the office supply business can get in the coming years is unclear. In a *Business Insider* article entitled *Nothing Can Stop The Implosion Of Office Supply Chain Stores,* Kim Bhasin seems to feel the worst is yet to come.

We now make a sudden turn to the specialty tea and coffee markets, which have been enjoying rapid growth for decades. With a little imagination, we can draw some interesting analogies between the office supply business and that of the specialty tea and coffee markets.

The coffee and tea industries, which some take to be a single industry, have been more or less heavily involved with M&A activity for decades. For brevity, the writer will first focus on the small number of acquisitions that have transpired since *Upton Tea Imports* was founded in 1989 and for which the writer has first-hand knowledge.

Tea may have played second cousin to coffee in the initial decade of this movement, but it has recently attracted many in the coffee industry as an important opportunity for growth. The first acquisition that directly affected *Upton Tea Imports* occurred in 1994, when *Starbucks* bought George Howell's popular 24-store chain, known as *The Coffee Connection*.

Having lived in Berkeley in the late 60s and early 70s, Howell learned first-hand about the west coast coffee revolution, often credited to Alfred Peet. When he and his wife moved to Boston, Howell "was appalled" at the abominable quality of the coffee he found throughout the east coast. In 1975, George Howell and his wife opened their first store in Harvard Square. It was George's wife, Laurie, who came up with the clever name.

The Coffee Connection grew at a steady pace, with a new store opening roughly every two years. The opening of the twelfth store must have been an exciting experience, but it appears to have caused a reflective pause as well. Here was the quandary. Twelve stores were difficult to manage and still maintain the passion for quality that distinguished the Harvard Square store. On the other hand, twelve stores might not be enough to stave off the anticipated invasion of *Starbucks*!

Howard Schultz acquired *Starbucks* in 1987 and promptly opened a store in Chicago. It was their first store beyond the Pacific Northwest and was considered a test case for national expansion. After some initial setbacks, the Chicago experiment was deemed successful and, by 1993, it was assumed that *Starbucks* would soon open on the east coast.

Believing that accelerated growth was the best defense, Howell took on venture capital and, within a year, *The Coffee Connection* doubled in size to 24 stores. Rapid growth may have been what the venture capital firm dictated, but Howell soon realized that he had other priorities. Competing with *Starbucks* by growing a nationwide coffee empire was not what interested George Howell.

Within a year the entire operation was sold to *Starbucks* for $23 million. While the stores remained under the sign of *The Coffee Connection* for some time, almost immediately some changes were made that perplexed more than a few customers, particularly the tea drinkers.

Besides enjoying a worldwide reputation as a coffee expert, Howell has a passion for tea, and that passion showed in the selections of loose tea he offered at *The Coffee Connection*. The variety was good, especially for the time and, although tea sales amounted to a small fraction of coffee sales, Howell moved enough to keep his stock fresh.

Starbucks had a different tea concept. Their brand was *Tazo,* the Portland-based tea brand that they would soon acquire from founder, Steve Smith. It was also the brand that immediately replaced the line of loose teas that *The Coffee Connection* had been selling for years.

Many tea drinkers love variety, but those who regularly drink a specific tea do not take lightly to the loss of that tea. The *Tazo* tea may have been good. Perhaps it was better than just "good," but it was not the tea the customers wanted.

The heated banter between barista and the forsaken tea customer prompted a coordinated effort on the part of all 24 stores to address the problem. Within days the phones at *Upton Tea Imports* started ringing much more frequently than usual. We were getting a large number of first-time orders from former tea customers of *The Coffee Connection*.

We soon learned that employees of *The Coffee Connection*, now employed by *Starbucks*, had been told to give their unhappy tea customers the phone number of *Upton Tea Imports*. Business at *Upton Tea Imports* grew 20% overnight! There were, however, some glitches that had to be untangled over the coming months.

Our series on *Reversals of Fortune in the Tea Industry* will continue in the next issue of the *Upton Tea Quarterly*.