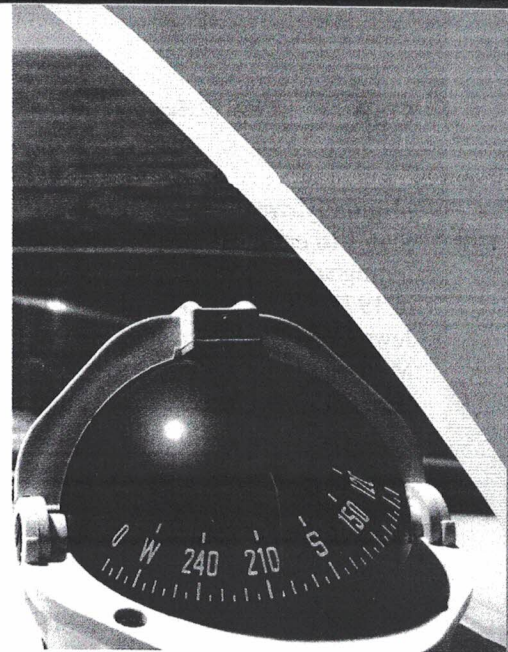


CASE 12

STAPLES IN 2015



INTRODUCTION

It was 1985, and 36-year-old retailer Tom Stemberg was being interviewed by the CEO of the Dutch-based warehouse club, Makro, for the top job at Makro's nascent U.S. operation. Stemberg didn't think Makro's concept would work in the United States, but he was struck by one thing as he toured Makro's first U.S. store in Langhorne, Pennsylvania: office supplies were flying off the shelves. "It was obvious that this merchandise was moving very fast," he later recalled, "That aisle (where the office supplies were located) was just devastated."¹ Stemberg began to wonder whether a supermarket selling just office supplies could do to the office supplies business what Toys R Us had done to the fragmented toy retailing industry—consolidate it, and create enormous economic value in the process.

Within a year, Stemberg had founded Staples, the first office supplies supermarket. Thirty years later, Staples was the leading retailer in the office supplies business, with 1,679 stores in the United States and Canada, and another 284 internationally in 23 countries. Although the company had performed well for most of its history, the 2008–2014 period proved to be extremely challenging. Demand fell in the face of a sharp economic pullback following the 2008–2009 global financial crisis. The period was characterized by intense price competition between Staples and its rivals, which depressed profitability. To com-

pound matters, retailers such as Walmart, Costco, and Amazon.com had expanded their office supplies offerings and were becoming increasingly tough competitors for Staples. In 2007, before the crisis hit, Staples' return on invested capital stood at 19.16%, but it declined to 9.11% by 2014. Staples revenues peaked in 2013 at \$25 billion. By 2014, they had fallen to \$22.5 billion as Staples closed poorly performing stores. Net income dropped from \$974 million to \$135 million over the same period.

Faced with an increasingly tough competitive environment, in early 2015 Staples announced that it had reached a deal to merge with its largest rival, Office Depot. Federal regulators had disallowed a similar proposed merger in 1997, but Staples and Office Depot believed that this time the merger would be approved given the significant change in market dynamics since then.²

THE FOUNDING OF STAPLES

Tom Stemberg

By 1985, despite his young age, Tom Stemberg had assembled an impressive resume in retailing. He had been born in Los Angeles but spent much of his teens in Austria, where his parents were

THE FOUNDING OF STAPLES

Hot on the heels of his trip to Makro, Stenberg started to think about his idea. The first thing was to get a handle on the nature of the market. Stenberg started by asking people if they knew how much they spent on office supplies. In his words:

There was this lawyer I knew in Hartford, which is where I lived then. If ever there was a cheap bastard in this world, he was a cheap bastard. And I said, "Gee, how much do you spend on office supplies?" He said, "Oh I don't know, I guess about a couple of hundred bucks a person, 40 people in the office, I bet you we spend ten grand." I said, "Do me a favor will you? You've got good records. Go through your records and tell me exactly how much you spend." He calls me up the next day. "Son of a bitch, I spend \$1,000 apiece! But I'm getting a discount, I'm paying 10% of list." I said, "Toys R Us is paying 60% of list." He says, "Are you kidding me? You mean I could save like half? I could save like twelve grand?" In his mind, this is the payment on his new Jaguar.⁸

Stenberg began to think that this idea had potential. He reasoned that people want to save money—and in this case the savings might be substantial—but they didn't even know they were paying too much. Small businesses in particular, he thought, might be a viable target market. While working on the idea, the printer ribbon on his printer ran out. It was a weekend. He drove to the local office supply store in Hartford, which was closed. He went to another, but that was also closed. He ended up going to BJ's Wholesale Club, a deep-discount warehouse club. BJ's was open, and they sold office supplies at low prices, but the selection was limited and they didn't carry the type of ribbon Stenberg wanted. Stenberg immediately saw the opportunity.

Around the same time, Stenberg went to see another mentor of his, Walter Salmon, who taught retailing at Harvard Business School. Over lunch they discussed the supermarket business and Stenberg's quest. Salmon asked Stenberg if he had thought of applying his retailing skills to a product category that was growing faster

than the grocery business, and was not well served by modern retailers. Stenberg replied that he had been thinking about office supplies. Salmon responded, "Gee, this is a really big idea."

Scoping Out the Opportunity

Stenberg ended up hiring a former teaching assistant of Salmon's for \$20,000 to do some basic market research on the industry and validate the market. As he tells the story:

I never forget the night I went to her house and we went through the slide deck. I always want to jump ahead. And she puts her hand on my hand and says, "Wait, we will walk through it." She's teasing us! Finally she said it was a \$45-billion market growing at 15% per year. And it turns out she was lying. That was actually at the manufacturer level. It was actually more than \$100 billion already if you looked at retail. She confirmed that the pricing umbrellas were as big as we thought they were, and that small businesses victimized the way we had said they were. I was pretty damn excited during the long drive home.⁹

The market growth was being driven by favorable demographic trends. The United States economy was recovering from the recessions of the late 1970s and early 1980s, and underlying economic growth was strong. A wave of new technology was finding its way into American businesses, including personal computers, printers, faxes, and small copiers, and this was driving demand for office supplies, including basic equipment and consumables like paper, printer ink, diskettes, and toner.

The wave of downsizing that had swept corporate America in the early 1980s had a beneficial side effect—unemployed people were starting their own businesses. The rate of new-business formation was the highest in years. There were 11 million small businesses in the country—Stenberg's proposed target market—the vast majority of which had less than 20 employees. This sector was the engine of job growth in the economy: Between 1980 and 1986, small enterprises had been responsible for a net increase of 10.5 million jobs. Many of these new jobs were in the service sector, which was a major consumer of office supplies. Each new white-collar job meant another \$1,000 a year in office supplies.

Stenberg's research started to uncover an industry that was highly fragmented at the retail level, but had

some huge participants. Upstream in the value chain were the manufacturers. This was a very diverse collection of companies including paper manufacturers such as Boise Cascade, office furniture makers, manufacturers of pencils and pens, the Bic Corporation, 3M (which supplied Post-it Notes and much more besides), office equipment companies like Xerox and Canon (manufacturers of copiers and consumables), and manufacturers of PCs, printers, and faxes such as Apple, Compaq, and Hewlett Packard.

Then there were the wholesalers, some of which were very large, such as United Stationers and McKesson. The wholesalers bought in bulk and sold to business clients and smaller retail establishments, either directly or through a network of dealers. The dealers often visited businesses to collect orders and arrange for delivery. The dealers themselves ranged in scale from small, one-person enterprises to large firms that sold through central warehouses. Some dealers also had a retail presence, while others did not. Manufacturers and wholesalers would also sell directly to large business through catalogs or a direct-sales presence.

The retailers fell into two main categories. There were the local office supply retailers, generally small business themselves, and there were the general merchandise discounters, such as BJ's Wholesale and Wal-Mart. The smaller retailers had an intrinsically high cost structure. They were full-service retailers who purchased in small lots, and delivered in trucks or sold out of the store. The general merchandise discounters purchased from wholesalers or direct from manufacturers, and their prices were much lower, but they did not carry a wide range of product.

On the consumer side, most large businesses had dedicated personnel for purchasing office supplies. They either bought from dealers, who purchased directly from manufacturers or through wholesalers, or bought direct from the manufacturer themselves. Large firms were able to negotiate on price and received discounts that could be as large as 80% of the list price on some items. Businesses of fewer than 100 people did not generally have someone dedicated to managing office supplies, and they tended to rely primarily on dealers. For these companies, product availability, not price, was viewed as key. In even smaller firms, the convenience of being able to get office supplies seemed to matter more than anything else.

Consistent with his initial insight, Stemberg found that the big dealers ignored smaller firms. To verify

this he called Boise Cascade, which operated as both a dealer and a manufacturer, to see what service they might offer. First he called on behalf of Ivy Satellite Network, a small company that Stemberg owned that broadcast events of Ivy League schools to alumni around the world. Boise wouldn't even bother to send a catalog to this company. Then he called Boise back, this time representing the 100-person office of a friend of his who was a food broker. This time Boise was happy to send a representative to the food broker. The representative offered the broker deep discounts. A Bic pen from Boise that cost Ivy \$3.68 cents from the local stationary store was offered for just \$0.85. More generally, Stemberg found that while an office manager in a company with more than 1,000 employees could often obtain discounts averaging 50% from dealers, small businesses with fewer than 20 employees were lucky to get a 10% discount and often had to pay full price.¹⁰

Stemberg also found a study produced by researchers at the Wharton School that seemed to confirm his suspicions:

Essentially they first asked dealers, "What does the customer want?" Ninety percent of the dealers said better service, and 10% said other. Then they asked customers, and 90% of the customers said what they really wanted was lower prices. Ha! The dealers were totally out of touch. They were making 40% to 50%, the wholesalers were making 30%, and the manufacturers were making huge margins. Everybody's rich, fat, and happy, and they're all going: "What's wrong with this?"¹¹

Creating the Company

Stemberg knew from experience that for Staples to succeed it would have to execute well, and do to that it needed experienced management. Stemberg turned to people he knew, managers who, like him, had risen quickly through the ranks at the Jewel Corporation or other Boston-area retailers. From Jewel came Myra Hart, who was to become the Staples group vice president for growth and development; Todd Krasnow, who became vice president for marketing; Paul Korian, Staples's vice president of merchandising, and Henry Nasella, Stemberg's mentor at Star market who subsequently became president of Staples. The CFO was

Bob Leombruno, who had bought Mammoth Mart, a failed retail operation, out of bankruptcy for a group of investors. Stemberg took on the CEO role, while Kahn became chairman. Most of these people started working full time on January 1, 1986. They gave up secure jobs, high salaries, and annual bonuses for reduced compensation and 14-hour days.

According to Stemberg, the pitch to prospective managers was this:

I'm going to give you a big chunk of stock in this thing. This is your chance. We're all going to work our tails off. We're going to work crazy hours. But here you'll be part of a retailing revolution. If you own 2% of the company and it gets to be worth \$100 million, you're going to make \$2 million.¹²

In the end, each member of the top management team got a 2.5% stake in the company.

By now Stemberg had a name for this nascent company, Staples. Reflecting on how it came about years later, he noted:

I'm driving between Hartford and Boston. I'm thinking about names. Pencils? Pens? 8 ½ by 11? Staples? Staples! Staples, the Office Superstore. That was it. The bad thing about the name was that when we started out, we had to explain to everybody what it was. Office Depot basically copied Home Depot and put the "office" in front. It was Home Depot for the office, and it lived off the Home Depot name. Office Club was a Price Club for the office. It lived off the Price Club name. In the early days ours was actually a problem. But those other names aren't a brand. Ours is a brand.¹³

With the management team in place, the next steps were to refine the concept and raise capital. The concept was straightforward; implementing it would not be. The plan was to offer a wide selection of merchandise in a warehouse-type setting with prices deeply discounted from those found at smaller retailers. Because it was to be a supermarket, the idea was to move from a full-service to a self-service format. At the same time, they recognized that staff would need to be trained in office supplies so that they could provide advice when asked.

To make the concept viable, a number of issues had to be dealt with. Where should they locate the

store? How big a population base would be needed to support a store? What kind of selection was required? How many stock keeping units (SKUs) should the store offer? And there was the problem of educating customers: If potential customers currently didn't know that they were paying excessive prices for office supplies, and consistently underestimated how much they spent on the category, what could Staples do to change this?

To keep prices low, Staples would need to cut costs to the bone and be managed very efficiently. They would have to get manufacturers or wholesalers to deliver directly to Staples. How could this be done? Wouldn't wholesalers and manufacturers create channel conflict with dealers and established retailers by delivering straight to Staples? How was this to be resolved? Staples also needed to minimize its inventory, thereby reducing its working capital needs. Management knew that if they could turn inventory over 12 times a year, and delay payment to vendors for 30 days, then vendors would essentially finance Staples's inventory. Pulling that off would require state-of-the-art information systems, and the state of the art at the time in office supplies did not include barcoding on individual items. How was Staples to deal with this?

There was also the potential competition to worry about. Stemberg was sure that once Staples unveiled its concept, others would follow quickly. To preempt competitors, the plan called for rapid rollout of the concept, with sales ramping up from nothing to \$42 million after 3 years. This would require considerable capital. It also required that the concept be easy to replicate, so that once the first store was opened, others could be opened in quick succession. This meant that the systems that were put in place for the first store had to be the right ones, and be able to support rapid expansion. There wasn't much room for error.

As the management team refined the concept, they came to the realization that information systems were key to the entire venture. With the right information systems in place, Staples could track sales and inventory closely at the level of individual items and figure out its gross profit on each item sold, and adjust its merchandising mix accordingly. This would be a departure from existing retailers, the majority of which lacked the ability to calculate profit on each item sold and could only calculate the average gross profit across a range of items. The right information systems could also be used to collect data on customers

at the point of sales, and this would assist greatly in market research and direct marketing to customers.

On the other hand, raising capital proved to be easier than anticipated. Stemberg valued Staples at \$8 million, even though it was still little more than a concept, a management team, and a business plan full of unanswered questions. He went looking for \$4 million, which he would exchange for 50% of the company. The venture capitalists were initially reluctant. They held back, waiting to see who would commit first. They also valued Staples at \$6 million and wanted a 67% stake for the \$4 million in first-round financing. Stemberg balked at that, and instead focused his efforts on one firm that seemed more willing to break away from the pack. The firm was Bain Venture Capital, whose managing general partner, Mitt Romney, later observed that "A lot of retailing startups come by, but a lot of them are a twist on an old theme, or a better presentation . . . Stemberg wasn't proposing just a chain of stores, but an entirely new retailing category. That really captures your attention. It slaps you in the face with the idea that this could be big." (Romney later became governor of Massachusetts).¹⁴

To validate the business concept, Romney's firm surveyed 100 small businesses after being urged to do so by Stemberg. Auditing invoices from these companies for office supplies, Romney discovered what Stemberg already knew—the companies were spending about twice what they estimated. Romney then ran the numbers on his own company and found that his firm would save \$117,000 a year by purchasing supplies at the discount that Stemberg promised. That was enough for Romney, and he committed to investing. Others followed and Staples raised \$4.5 million in its first round of financing, which closed on January 23rd, 1986. This gave the company enough capital to go ahead with the first store. In return for the financing, Staples had to give the VCs a 54% stake in the company. To get the money, however, Staples had to commit to opening its first store on May 1st, 1986, and to meet a plan for rolling out additional stores as quickly as possible.

The First Store

With just 4 months to open their first store, the management team went into overdrive. They would meet every morning at about 7 a.m. in a session that could

run from 30 minutes to 2 hours. Someone would rush out to get sandwiches for lunch, and they would keep working. The workday came to a close at 9:00 or 10:00 p.m. There was no template for what they were doing; they knew they had to put a system in place that would allow them to quickly roll out additional stores.

One of the most difficult tasks fell on the shoulders of Leombruno, the CFO. In addition to setting up an accounting system, he was put in charge of installing the entire information system for Staples. The system had to be able to track customer purchases so that Staples could reorder products. The cash registers, which were to be connected individually to the system, had to be easy to operate so that there would be no congestion at the check-out stands. Stemberg was adamant that the register receipts indicate the list price of each item, as well as a much lower Staples price, and an even lower price for customers who became Staples members. He also wanted the system to collect detailed demographics on each customer.

Leombruno insisted that the system be able to do two things. The first was to calculate the gross profit margin Staples made on each item sold. Most retailers at the time could only calculate the average profit margin across the mix of inventory. Second, Leombruno wanted to make sure that inventory turned over at least 12 times a year, and good information systems were the key. With most vendors requiring payment in 30 days, an inventory turnover of greater than 12 would allow Staples to cut its working capital requirements.

As the wish list for the information systems grew, it soon became apparent that it would not be possible to do everything in the allotted time span. No existing software package did what the management team wanted, so they had to hire consultants to customize existing packages. In the end, several proposed features were dropped. However, at Stemberg's insistence, the three-way price requirements remained. To track sales and inventory levels, Staples assigned a six-digit look-up code for each item. While entering the codes was a slower process than scanning items, most manufacturers in the office supplies business were still not marking their products with barcodes, which meant scanning was not feasible.

Another problem was to get suppliers to ship products to the first Staples store. The company

was asking suppliers to bypass the existing distribution system, and risk alienating longtime customers in the established channel of distribution. To get suppliers on board, Staples used a number of tactics. One was a visionary pitch. The company told suppliers that they were out to revolutionize the retail end of the industry. Staples would be very big, they said, and it was in the best interests of the suppliers to back the start-up. Stenberg's punchline was simple: "I'm going to be very loyal to those who stick their necks out for us. But it's going to cost you a lot more to get in later."¹⁵ Connections also helped to get suppliers to deliver to Staples. One of the venture capitalist backers of Staples, Bessemer Venture Partners, also owned a paper manufacturer, Ampad. Bessemer told Ampad to start selling to Staples, which they did, even though existing distributors complained bitterly about the arrangement.

Finding real estate also presented a problem. As an enterprise with no proven track record, Staples found it difficult to rent decent real estate large enough to stock and display the 5,000 SKUs that it was planning for its first store, and to do so at a decent price. Most landlords wanted sky-high rent from Staples. In the end, the best that Staples could do was a site in Brighton, Massachusetts, that was within sight of a housing project and had failed as a site for several different retailers. The one redeeming feature of the site was that it was smack in the middle of a high concentration of small businesses.

Despite all the problems, Staples opened its first store on May 1, 1996. The opening day was busy, but only because everybody who worked at Staples had invited everybody they knew. On the second day, just 16 people came through the store. On the third day, it was the same number. A few weeks of this, and Staples would have to shut its doors. Desperate, Krasnow decided to bribe customers to get them into the store. The company sent \$25 to each of 35 office managers, inviting them to shop in the store and pass along their reactions. According to Krasnow, "A week later we called them back. They had all taken the money, but none of them had come into the store. I was apoplectic."¹⁶ In the end, nine of them finally came in, and they gave Staples rave reviews. Slowly the momentum started to build and, by August, lines were starting to form at the cash registers at lunchtime.

THE 1990s: GROWTH, COMPETITION, AND CONSOLIDATION

Growth

Staples had set of target of \$4 million in first-year sales from its Brighton store, but within a few months the numbers were tracking up toward a \$6-million annual run rate. The concept was starting to work. The number of customers coming through the door every month was growing, but it was not only customers that were coming. One day Joe Antonini, the CEO of K-Mart, was spotted walking around the Staples store. Around the same time, Stenberg heard from contacts that Staples had been mentioned at a Wal-Mart board meeting. He realized that if other discount retailers were noticing Staples when it had just one store, competition could not be far behind.

Within 5 months of the opening of the first Staples store, a clone had appeared in the Southeast: Office Depot. Needing money fast to fund expansion and lock in Staples territory, Stenberg went back to the venture capitalists. While the initial backers were only willing to value Staples at \$15 million, Stenberg held out for and got a valuation of \$22 million, raising another \$14 million. He pulled off this trick by finding institutional investors who were willing to invest on a valuation of \$22 million. He then went back to the original VCs and told them that the deal was closing fast, which persuaded them to commit.

By May 1987, Staples had three stores open and planned to increase the number to 20 by the end of 1988 (in the event, it opened 22). Sales were running at anywhere from \$300 to \$800 per square foot. In contrast, high volume discount stores were lucky to get \$300 per square foot. By mid-1989, 3 years after its first store opened, Staples had 27 stores open in the Northeast and an annual sales run rate of \$120 million, way above the original 3-year target of \$42 million. The stores now averaged 15,000 square feet and stocked 5,000 items.

Explaining the success, Stenberg noted; "From a value perspective, I think there is no question that we have been a friend to the entrepreneur. If you look at the average small town merchant, we've lowered the costs of his office products—where he was once paying

say \$4,000 to \$5,000 a year, now he's paying \$2,000 or \$3,000. We've made him more efficient."¹⁷

Helping to driving sales growth was the development of a direct marketing pitch. Every time Staples opened a store, it purchased a list of small businesses within 15 minutes driving distance. A group of telemarketers would go to work, calling up the buyer of office supplies at the businesses. The telemarketers would tell them Staples was opening up a store like Toys R Us for office supplies, ask them how much they spent on office supplies every year (often they did not know), cite typical cost savings at small businesses, and sent them a coupon for a free item such as copy paper. Slowly at first the customers would come in, but momentum would build as customers realized the scale of their savings.

Every time a customer redeemed a coupon at a store, they were given a free Staples Card. This "membership" card entitled cardholders to even deeper discounts on select items. The card quickly became the lynchpin of Staples direct marketing effort. From the card application, Staples gathered information about the customer—what type of business they were in, how many employees they had, where they were located, and so on. This information was entered into a customer database, and every time a member used that card, the card number and purchases were logged into the database via the cash register. This gave Staples real-time information about what was being purchased and by whom. This information then allowed Staples to target promotions at certain customer groups—for example, card holders who were not making purchases. The goal was to get existing customers to spend more at Staples, a goal that over time was attained.

Because Staples started to reach so many of its customers through direct marketing (about 80% of its sales were made to cardholders), it was able to spend less on media ads; in some areas, it dropped media advertising altogether, saving on costs. This was an important source of cost savings in the Northeast, where media is expensive.

A problem that continued the bedevil Staples as it expanded was a shortage of good real estate locations that could be rented at a reasonable price, particularly in the Northeast. Finding a good site in the early days required flexibility; at various times Staples converted anything and everything from restaurants to massage parlors into Staples stores. As the company grew, its real estate strategy started took on a defensive aspect, with Staples bidding for prime sites in order to preempt competitors.

The high cost of real estate in the Northeast led Staples to establish its first distribution center in 1987 (it now has some 65 "delivery fulfillment centers" and larger "distribution centers" in North America). This decision was hotly debated within the company and opposed by some investors who thought that the capital should be used to build more stores, but Stenberg prevailed. The distribution center was located off an interstate highway in an area of rural Connecticut where land was cheap. The facility cost \$6 million to build, and tied up a total of \$10 million in working capital, almost \$0.29 out of every dollar that the company had raised to that point. But Stenberg saw this as a necessary step. The inventory storage capacity at the distribution center enabled the company to operate with smaller stores than many of its rivals, but still offer the same variety of goods. By 1989, the average Staples store was 35% smaller than the Office Depot outlets that were then opening up all over the Southeast, saving on real estate costs. The distribution center also helped save labor costs, because wages are lower in rural areas. Equally important, inventory storage at the distribution centers allowed the stores to remain fully stocked. A Stenberg noted: "In competition with the clones, it will come down to who has the lowest costs and the best in-stock position."¹⁸

The expansion strategy at Staples was very methodical. Stores were clustered together in a region, even to the extent that they cannibalized each other on the margin, so that Staples could become the dominant supplier in that market. The early focus was on major metropolitan areas such as Boston, New York, Philadelphia, and Los Angeles. Although high real estate and labor costs in these areas were a disadvantage, strong demand from local businesses helped compensate, as did the distribution centers. In 1990, Staples open its second distribution center, in California, to support expansion there.

The expansion at Staples was fueled by the proceeds from a 1989 IPO, which raised \$61.7 million of capital—enough for Staples to accelerate its store openings. By mid-1991, Staples's store count passed 100.

Competition

A rash of imitators to Staples soon appeared on the market. The first of these, Office Depot, focused on the Southeast. By the end of 1988, Office Depot had 26 stores, Office Club had opened 15, Biz Mart had

Office Depot acquired Office Club, giving the primary rival of Staples more than twice the number of stores. For its part, Staples acquired HQ Office Supplies Warehouse in 1991 and, in 1992, it purchased another smaller chain, Workplace.²⁴

These trends continued and, by the mid-1990s, it became apparent that three players were rising to dominance in the industry: Office Depot, Staples, and Office Max. By mid-1996, Office Depot led the industry with 539 stores, followed by Staples with 517, and Office Max with around 500 stores. In terms of revenues, Office Depot had a clear lead with \$5.3 billion in 1996, Staples was second with \$3.07 billion, and Office Max third with \$2.6 billion. Staples remained concentrated in the Northeast and California, with numerous stores in dense urban areas. Office Depot's stores were concentrated in the South, and the company continued to stay clear of congested cities. Office Max was still strongest in the Midwest.²⁵

The consolidation phase peaked in September 1996, when Staples announced an agreement to purchase its larger rival, Office Depot, for \$3.36 billion. The executives of the two companies had apparently been talking about merger possibilities for years, while continuing to pursue their own independent growth strategies. If the merger went through, Tom Stemberg would step into the CEO role. The two companies sold the merger to the investment community of the basis of cost savings. The combined firm would have almost 1,100 stores and revenues of \$8.5 billion. The combination, Stemberg argued, would attain terrific economies of scale that would allow it to significantly lower costs, saving an estimated \$4.9 billion over 5 years, including \$2.2 billion in product cost savings.

In a move to preempt a possible investigation by the Federal Trade Commission (FTC), the companies claimed that, because their stores focused on different territories, the combination would not reduce competition. They also noted that Staples still faced intense competition not only from Office Max, but also from the likes of Wal-Mart, Circuit City, and mail-order outlets. Indeed, Stemberg claimed that the combined company would still only account for 5% of the total sales of office supplies in the nation.²⁶

The FTC didn't buy the arguments, quickly started an investigation, and, in May 1997, sought an injunction to block the deal. The FTC claimed that the deal would stifle competition and raise prices for office supplies, especially in those markets where

the two firms competed head to head. To buttress its case, the FTC released a report of pricing data showing that nondurable office supplies such as paper were 10 to 15% higher in markets where Staples faced no direct rivals. Staples claimed that the FTC's pricing surveys were done selectively and were biased.

In July 1997, a federal judge granted the FTC's request for an injunction to halt the merger. Staples realized that it was in a losing fight, and pulled its bid for Office Depot. But the failure had a silver lining—not anticipating much interference from the FTC, Office Depot had put most of its expansion plans on hold, opening just two stores in 8 months. In comparison, Staples opened 43, allowing the company to close the gap between itself and its larger rival.

STAPLES'S EVOLVING STRATEGY

Moving into Small Towns

Stemberg has described Staples's initial strategy to deal with the high costs of doing business in the Northeast as follows: "Establish superstores that were smaller than most, save on rent and operating costs, cluster them in densely populated areas to justify paying for expensive advertisements, and stock the stores from a distribution center."²⁷ The drawback with this strategy was that Staples ignored many potentially lucrative markets in smaller towns. While Office Depot was barnstorming into towns with populations of just 75,000, Staples could not see how they made it pay. Surely towns of that size were just too small to support an office supplies superstore?

It turned out they were not. The mistake Staples made was to assume that a store would serve customers within a 10- to 15-minute drive. But in smaller cities customers would drive much further to get good prices. The revelation did not hit home until Staples opened its first store in Portland, Maine. With a population of 200,000, the town was smaller than most areas focused on by Staples, but within a few months the store was doing very well. To test the hypothesis, in 1992 and 1993, Staples opened stores in a number of smaller towns. The results were surprising. Many of the stores generated higher sales per square foot

established 10, and Office Max about 12. More than a dozen other office supplies superstores had sprung up. Venture capitalist looking to repeat the success of Staples financed some of these businesses. Others were financed by established retailers, or even started by them. For example, Ben Franklin started Office Station in 1987, but shut it down in 1989 as it failed to gain traction.

Initially, most of the competitors focused in unique regions—Office Depot on the Southeast, Office Club on California, Office Max on the Midwest, BizMart on the Southwest—but as the number of entrants increased, head-to-head competition became more frequent. Stemberg's belief had always been that competition was inevitable, and that the winners in the competitive race would not necessarily be those that grew the fastest, but those that executed best. This philosophy underpinned Stemberg's insistence that the company grow by focusing on key urban areas and achieving a critical mass of stores served by a central distribution system.

Not everyone agreed with this recipe for success. Office Depot did the opposite: The company grew as fast as possible, entering towns quickly to preempt competitors. Office Depot lacked centralized distribution systems, but made up for that by locating in less-expensive areas than Staples, persuading suppliers to ship directly to stores and keeping more backup inventory on the premises. Although this meant larger stores, the lower rental costs in Office Depot's markets offset this.

It soon became apparent that the rash of entrants included a number of companies that simply could not execute. Very quickly a handful of competitors emerged in the forefront of the industry: Staples, Office Depot, Office Max, and Office Club. As the market leaders grew, they increasingly came into contact with each other. The result was price wars. These first broke out in California. Staples entered the market in 1990, and initially focused on pricing not against Office Club, but against Price Club. Although Price Club was a warehouse store selling food and general merchandise, it had the largest share of the office supplies market in California. Staples positioned itself as having the same low prices as Price Club, but a wider selection of office supplies and no membership fee.

Todd Krasnow, the executive VP of marketing at Staples, describes what happened next: "What we failed to realize was that Price Club was very worried about Office Club and was pricing against Office

Club. So when we went and matched Price Club, we were matching Office Club. And Office Club was saying: 'We are not going to let anybody have the same prices as us.'"¹⁹ Office Club lowered its prices, causing Price Club to lower prices, and Staples followed. Not willing to be beat, Office Club cut prices again, and so continued the downward spiral. The price war drove profit margins down by as much as 8%.

As Krasnow noted, "We realized that by engaging in this price war, we were focusing on our competitors, not our customers. Our customers weren't paying attention to this spat. So we raised our prices a little. You feel like you're just doing absolutely the wrong thing, because your whole position is: We have the lowest price."²⁰ Be that as it may, Office Club and Price club followed suit, and prices started to rise again. Ultimately, the three companies carved out different price niches, each unwilling to be undercut on about 20 or so top-selling items, but in general they were not the same items.

What happened in California occurred elsewhere. When Office Max entered the Boston market in 1992, a price war broke out. There was an unanticipated effect this time, though—the price cuts apparently broadened the market by making buying from Staples attractive to customers with between 25 and 100 employees, who previously bought directly from mail-order and retail stationers.²¹

Price wars such as those that started to break out in California and Boston started to moderate. "We finally realized that it's not in any company's self-interest to have a price war because you can get lots of market share without having a price war. And having a price war among low-priced competitors doesn't get you more market share. It doesn't serve any purpose."²² Other factors that may have contributed toward more rational pricing behavior in the market were the strong economy of the 1990s and industry consolidation.

Industry Consolidation

At its peak in 1991, there were 25 chains in the office supply industry.²³ Industry consolidation started when some of the clones began to fall by the wayside, filing for bankruptcy. U.S. Office Supply, itself the result of a merger between two office supplies chains, filed for bankruptcy in 1991, as did Office Stop. Consolidation was also hastened by acquisitions. In 1991,

than those located in large cities. Sales were helped by the fact that in many of these small towns the only competitors were small “mom and pop” stationers, and that many small towns also lacked supermarket electronic retailers, such as Circuit City, selling low-priced office equipment, allowing Staples to pick up a much larger share of that business. Moreover, the lower rent, labor costs, advertising costs, and shrinkage made these stores significantly more profitable.

From that point on, Staples moved into small towns and suburban locations, where the same economics apply. Stenberg has described not moving into small towns earlier as “one of the dumbest mistakes I made.” In 1994, some 10% of Staples stores were in small towns; by 1998, that figure had risen to 28%, and some of the most profitable stores in Staples network were located in small towns.²⁸

Selling Direct

Established as a retailer, Staples initially turned its back on customer requests for delivery and mail- or telephone-order service. The reason for doing this was simple: Staples saw itself as a low-cost retailer, and a delivery service would probably raise costs. However, Staples’s competitors started to offer mail-order and delivery service, and customers continued to ask for the service; so, in 1988, Staples began to experiment with this, albeit halfheartedly. Store managers were not enthusiastic about supporting a delivery service that they believed decreased store sales, and Staples discouraged delivery by tacking a 5% delivery charge onto the order price. Moreover, the company questioned whether it could generate the volume of business to cover the costs of a delivery service and make a decent return on capital.

This all changed when a study undertaken for Staples by a management-consulting firm found that the customers who purchased via a catalog and required delivery were not always the same ones who brought directly from the store. While there was a lot of cross-shopping, the mail-order customers tended to be bigger and somewhat more interested in service, whereas those buying from the store were often buying for home offices. Staples also could not help but notice that its major rivals were offering a delivery service, and that business seemed to be thriving.

In 1991, Staples set up an independent business unit within the company to handle the mail- and

telephone-order and delivery service, known as Contract and Commercial. The core of this business unit was Staples Direct (now called Staples Business Delivery). The man put in charge of this business, Ronald Sargent, would replace Stenberg as CEO of Staples in 2003.

One issue that had to be dealt with was the potential conflict between Staples Direct and the stores. The stores didn’t want to push business the way of Staples Direct because they would not get credit for the sale. As Sargent commented later, “We were like the bad guys inside Staples, because the feeling was that if customers got products delivered they wouldn’t shop inside our stores.”²⁹ To align incentives, Staples changed the compensation systems so that (a) the store would get credit if a delivery order was placed through the store, and (b) the annual bonus of store employees would be partly based on how well they met goals for generating delivery sales.

As Staples Direct started to grow, the company also discovered that the delivery infrastructure they put in place could be used to serve clients in addition to the company’s established, small-business customers, which typically had less than 50 employees. Increasingly, medium-sized businesses (with 50 to 100 employees), and larger businesses (with more than 100 employees) started to utilize Staples Direct. To support this new business, Staples started to grow by acquisition, purchasing a number of regional stationary companies with established customers and delivery systems. Typically, Staples kept the owners of these businesses on as Staples employees, often because they had long-established relationships with key accounts in large organizations such as Xerox, Ford, and Pepsi Cola. Staples, however, established a consistent product line, brand image, and computer and accounting systems across all of its acquisitions.

Between 1991 and 1996, Staples Direct grew from a \$30-million business to almost \$1 billion. As sales volume ramped up, Staples gained greater efficiencies out of its distribution network, which helped to drive down the costs of doing business through this channel. Staples used a network of regional distribution centers to hold an inventory of some 15,000 SKUs for delivery, compared to 8,000 SKUs in a typical store. In 1998, a web-based element was added to Staples Direct, Staples.com. Through the web or catalog, Staples customers could access some 130,000 SKUs,

many of which were shipped directly from manufacturers with Staples acting as an intermediary and consolidator.

To continue building the direct business, in 1988, Staples acquired Quill Corporation for \$685 million in Staples stock. Established in 1956, Quill is a direct-mail catalog business with a targeted approach to servicing the business products needs of around a million small- and medium-sized businesses in the United States. Quill differentiated itself through excellent customer service. Staples decided to let Quill keep its own organization, setting it up as a separate division within the Contract and Commercial business unit, but integrated Quill's purchasing with that of the rest of the organization to gain economies of the input side. Quill now operates under two brands—Staples National Advantage, which focuses upon large multiregional businesses, and Staples Business Advantage, which focuses upon large- and medium-sized regional companies, and has the flexibility to handle smaller accounts (although these are mostly handled via Staples Direct). In justifying the acquisition of Quill, Stemberg noted that the direct business amounted to a \$60-billion industry annually, but it was highly fragmented, with the top eight players accounting for less than 20% of the market.³⁰

By 2014, the combined North American delivery business had grown to represent 40% of total sales, with some two-thirds of the *Fortune* 100 being counted as customers of Staples delivery business.³¹

Going International

Staples first foray into international markets occurred in the early 1990s. A Canadian retailer, Jack Bingleman, who wanted to start a Staples-type chain north of the border, approached the company. Bingleman also approached Office Depot and Office Max, but had a preference for Staples because of the close geographic proximity. Board members at Staples initially opposed expansion into Canada, arguing that scarce resources should be dedicated toward growth in the much larger U.S. market, but Stemberg liked Bingleman's vision and pushed the idea. Ultimately, in 1991, Staples agreed to invest \$2 million in Bingleman's start-up for a 16% equity stake.

Known as Business Depot, the Canadian venture expanded rapidly, modeling itself on Staples. Between 1991 and 1994, the number of Canadian Business Depot stores expanded to 30 stores, and the

enterprise turned profitable in 1993. In 1994, Staples announced an agreement to purchase Business Depot outright for \$32 million.³² By 2014, there were 315 stores in Canada.

The Canadian venture was soon followed by investments in Europe. Staples entered the U.K. market in 1992, partnering with Kingfisher PLC, a large retailer that operated home improvement and consumer electronics stores, among other things. The Canadian venture had taught Staples that a local partner was extremely valuable. As one Staples executive noted later:

You absolutely cannot do it yourself. There are too many cultural impediments for you to know where the booby traps lie. In a retail start-up, the most important task is to generate locations. There's no way a U.S. national can go into any country and generate the real estate it needs. That person will be chasing his tail for a long time.³³

On the heels of entry into the United Kingdom, Staples purchased MAXI-Papier, a German company that was attempting to copy what Staples had done in the United States. This was followed by entry into the Netherlands and Portugal. In late 2002, Staples purchased the mail-order business of a French company, Guilbert, for nearly \$800 million, which boosted delivery sales in Europe from \$50 million a year to \$450 million a year almost overnight.³⁴ In 2008, Staples purchased Corporate Express NV, a Dutch office supplies company with a substantial direct-delivery business in Europe. By 2014, Staples had stores in 23 countries outside of North America, including 112 stores in the United Kingdom, 59 in Germany, 41 in the Netherlands, and 34 in Portugal. At this point, around 20% of total sales were generated by the international operations, with half of that total coming from direct delivery and the remainder from retail sales.

Changing the Shopping Experience

By the 2000s, Staples started to realize that its stores looked very similar to those of its two main competitors, Office Depot and Office Max. As the number of markets where all three companies competed grew, head-to-head competition increased. Management started to look for ways to differentiate their stores from those of competitors. A new store design,

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known as “Dover,” emerged. The core of “Dover” was a customer-centric philosophy known as “Easy.” Rolled out across the company in 2005, “Easy” is all about making the shopping experience for customers as easy as possible—through store design and layout, through a merchandising strategy that aims to ensure that items are never out of stock, and through superior in-store customer service. The idea is to complete transactions as expeditiously as possible.

To execute “Easy,” Staples had to redesign its store layout, invest in upgrading the knowledge level of its sales associates, and improve its supply-chain management processes.³⁵ Staples started a big push to improve the efficiency of its supply-chain management process in 2003, and that is still ongoing today. Elements of this push include better use of information systems to link Staples with its suppliers, and extensive use of “cross-docking” techniques at distribution centers, so that merchandise spends less time in distribution centers. As a consequence of this strategy, Staples has increased inventory turnover, reduced inventory holdings, and improved the in-stock experience for its customers.

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In February 2002, Tom Stemberg announced that he was stepping down as CEO and passing the baton to Ron Sargent. Stemberg would remain on as chairman. Upon taking over as CEO, Sargent put the brakes on store expansion, declaring that Staples would open no more than 75 new stores a year, down from over 130 in 2000. He used the slowdown to refocus attention upon internal operating efficiencies. The product line within stores was rationalized, with Staples cutting back on stocking low-margin items such as PCs. He also set up a task force to look for ways to remove every excess cent out of the cost structure. As a result, operating margins at Staples stores came in at 5.9% of sales in 2002—the best in the industry, and up from 4.5% in 2000.

By 2003, Sargent was refocusing on attaining profitable growth for the company. Although by this point Staples or one of its competitors operated in all major markets in North America, the company’s management decided that Staples was in a strong enough position to go head to head with major competitors.

In 2005, Staples pushed into Chicago, a market previously served by Office Depot and Office Max, opening 25 stores. The Chicago experience proved to be a pivotal one for Staples. In the words of COO, Mike Miles, “What we found in Chicago was we can come into a two-player market and make it a three-player market successfully. There was a little trepidation about that because the model in the first 10 to 15 years was that office superstores were interchangeable.”³⁶

Outside of the retail market, Sargent turned his attention to the direct-delivery business, where he had made his name. He points out that, although the number of independent office supplies dealers is down to 6,000 from 15,000 a decade ago, the delivery market is still highly fragmented and very large. Sargent believes that direct delivery from warehouses can be as big a business as Staples’s office supplies stores. He also sees huge potential for growth in Europe, which is the second-largest office supplies market in the world and still years behind the United States in terms of consolidation.

At the same time, Staples continues to face strategic challenges. Additional expansion by Staples in North America is bringing it into direct competition with Office Depot and Office Max. Staples also faces continued competition from Sam’s Club and Costco, both of which are focusing on small businesses and continue to sell office supplies. In addition, FedEx Kinko’s, which has a nationwide network of 1,000 copying and printing stores, is now offering more office supplies in a new store layout.

The 2008–2009 global financial crisis triggered a deep economic recession in the United States and elsewhere. The U.S. office supplies industry was hit by price discounting which, resulting in much slower top-line growth for Staples and a decline in net profit. Sargent responded by cutting back on expansion plans and reducing capital spending going forward. Staples, however, continued to be the strongest of the big three office supplies retailers.

While the economy started to recover from the recession in 2010, Staples and its peers did not. The recession seemed to usher in a permanent change in buyer behavior. As Ron Sargent noted in 2014, “Our customers are using less office supplies, shopping less often in our stores and more often online, and the focus on value has made the marketplace even more competitive.”³⁷ Amazon, Wal-Mart, and Costco had all expanded their office supplies offerings since the

mid-2000s, and online sales from all three were cutting into demand for product from physical stores. Staples, too, saw its online sales grow even as sales from its physical stores stagnated or declined. By 2015, over half of all of Staples sales in North America were online.

Staples responded to this trend by announcing in March 2014 that it would close up to 225 of its North American stores by the end of 2015 as part of a corporate goal to reduce its annual operating costs by \$500 million. At the same time, the company would continue to expand its online offerings. In 2013 and 2014, it increased the number of products sold on its website, Staples.com, from 100,000 to 500,000. Ron Sargent expected this number to reach 1.5 million by the end of 2015. Most products will be shipped directly from the manufacturer to the customer, with Staples acting as an intermediary, much as Amazon does.³⁸

With their sales also falling, Office Depot and Office Max completed a \$1.2-billion merger in late 2013. The two companies cited the growth of Internet sales as a prime reason for the merger. The FTC, which had opposed the proposed merger between Staples and Office Depot in 1997, blessed this merger, noting that the deal “was unlikely to substantially lessen competition.”³⁹ The merger was expected to reduce the costs of the combined entity by \$400 to \$600 million per year, primarily by closing duplicate stores.

In late 2014, the hedge fund Starboard Value announced that it had taken a position in both Staples and Office Depot. Jeffrey Smith, the CEO of Starboard Value, has emerged as a powerful activist investor over the last few years, taking large positions in companies and then urging them to change their strategy. Smith urged Staples and Office Depot to merge, stating that if they did not, he would mount a proxy battle to get board seats in both companies and push a merger through. As it turned out, neither company needed much encouragement. In February 2015, the two companies announced a \$6.3-billion merger agreement. If the deal goes through, it will create a company with \$34 billion in revenues and 4,400 stores worldwide. Both Staples and Office Depot argue that the proposed merger is necessary to compete in a world where bigger store chains and online competitors have reduced prices and provided new competition. Reflecting on these developments, Sargent noted; “I think Amazon just

launched a business-to-business office products initiative, so I’m sure they are knocking on the door.”⁴⁰ It remains to be seen whether the FTC will agree.

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