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YE OLDE SUPERMARKET

Stuck in the shrinking middle

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There are new combatants entering the already crowded food retailing market every day, and conventional supermarkets of yore keep taking it on the chin. Can the traditional supermarkets of our youths ever again be what they once were to shoppers? It's not going to be easy.

Executive Summary:

Conventional supermarket chains are mostly losing the battle for customers' wallets and loyalties, with market share eaten away by huge players on the lower end such as Costco Wholesale, Wal-Mart, and others and by smaller but opportunistic niche players on the higher end such as Trader Joe's and Whole Foods. Driving this tectonic shift in the food retailing landscape is a profound change in the way Americans shop: what they buy and how and where they buy it. In order to prevail, conventional supermarket chains will have to revamp their old game plan and reconnect with customers who are leaving for other food venues. The alternative is more of the same: meager sales growth, dwindling profits, and a rash of store closures and bankruptcies.

The hottest U.S. initial public offering (IPO) so far this year isn't a high tech or biotech company or a social media player; it's a supermarket chain. In fact, Sprouts Farmers Market, a relatively small chain of 165 stores in the southwest, has been the most successful IPO since LinkedIn debuted in 2011. After raising nearly $350 million in an IPO offering, shares of Sprouts more than doubled on its first day of trading. It currently boasts a market value of $6 billion, rivaling the $7 billion market cap of Safeway, the nation's second largest supermarket chain with more than 1,600 stores.

How can investors ascribe similar valuations to such disparately sized chains?

The answer lies in the dramatically different way Americans shop today, the proliferation of choice offered them and the persistent inability of the conventional supermarket to reinvigorate itself in ways that will keep it relevant to today's demanding shoppers.

Certainly, the market believes that the heyday of the conventional supermarket is over if players don't adapt to today's harsh business realities. (In September 2013, Safeway adopted a poison pill plan to fend off an activist hedge fund that has acquired a 6.2 percent stake in the company and is arguing that Safeway should exit underperforming markets.) In the food retailing business, aggregate revenue growth is almost entirely dependent on population growth, new household formation and food price inflation, and all three of these variables have been running low for nearly a decade. Personal income growth remains weak as well.

In this low-growth environment, it takes something novel to make an impact, and Sprouts' auspicious debut was hardly a one-off. In April 2013, Fairway Group also went public. Its value has soared more than 50 percent since then, and its $1 billion market cap is impressive for a New York City-based chain of just 12 supermarkets. Last year, Natural Grocers by Vitamin Cottage, a chain of 65 health food stores, had its IPO, and its valuation has doubled since then to more than $900 million.

All three chains, and others like them, have huge growth ambitions as they attempt to capitalize on Americans' increasing appetite for fresher and healthier food at prices they can stomach. At these very rich valuations, the market obviously believes that these companies will be successful and that success inevitably will come at the expense of conventional supermarkets.

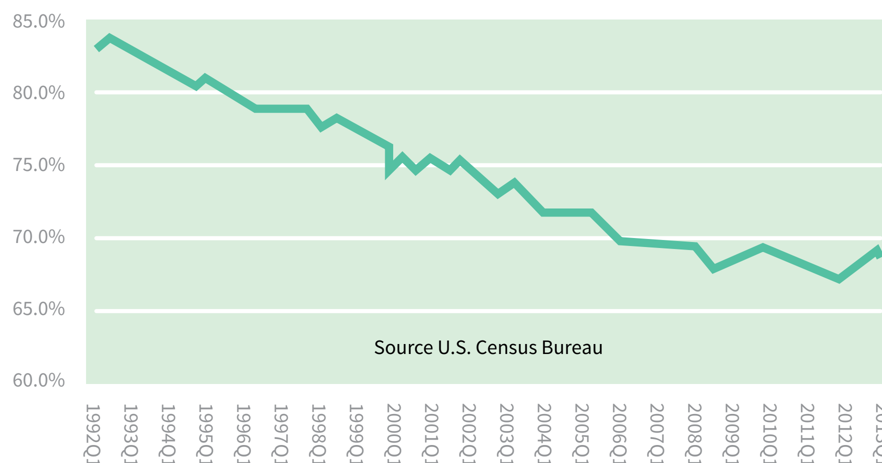
Stuck in the Shrinking Middle

Until two decades ago, American consumers did nearly all their food shopping at traditional supermarkets that all looked pretty much the same and carried similar offerings of consumables. It typically was a dull, one-stop shopping trip endured weekly, and most people in a given neighborhood shopped at the same supermarket or two, regardless of income level. This model has changed dramatically over the last 25 years. Food shopping today has become specialized and fragmented, catering to most every taste, whim and wallet, focusing either on the shopping experience or price. Conventional supermarket chains — for many reasons — have had great difficulty adapting and fending off savvy upstarts.

Conventional supermarkets frequently are locked into long-term leases (often 10 to 20 years) that make it difficult to relocate stores or modify their footprint without incurring onerous costs. Moreover, many well-established chains have underinvested in information technology (IT) for years and have retained functional but obsolete legacy systems long past their useful lives, and the companies can retrieve and utilize only limited point-of-sale information about their customers and products. This has put these companies at a competitive disadvantage to newer players that have made sizable technology investments. Even with a somewhat better understanding of customers and their shopping habits, conventional supermarket growth is constrained further by a long-standing strategy of trying to be all things to all people. As a result, traditional supermarkets typically are stuck in the middle between the low-end, big-box retailers and the higher-end niche players, with market share gnawed away at both ends.

Today, the largest food retailer in America isn't a supermarket at all. More than half of Wal-Mart's U.S. sales at its 3,100 supercenters consist of grocery items. Progressive Grocer estimates Wal-Mart sold nearly $120 billion of grocery goods in 2012 — excluding Sam's Club stores, which sold another $30 billion — giving Wal-Mart close to a 20 percent market share of all food purchased for at-home consumption in America just two decades after it began rolling out its large supercenter store format. That market share has come largely at the expense of conventional supermarkets. In fact, Wal-Mart sells more groceries each year than the two largest national supermarket chains combined. Wal-Mart strictly is a no-frills experience, but countless households rely heavily on Wal-Mart's everyday low price (EDLP) strategy to save a few bucks each week.

And Wal-Mart is not the only general merchandiser eating the conventional supermarket's lunch with a low-price strategy. BJ's Wholesale Club, Costco and Sam's Club, and the large-store format at Target, also continue to siphon off sales from traditional supermarkets.



Moreover, other retailers have begun increasing their offerings of food items, particularly chain drugstores and the ubiquitous dollar stores, many of which have moved beyond shelf-stable food items by installing refrigeration units. More than 25,000 dollar stores dot the American suburban and exurban landscape, providing convenience for those not willing to drive miles to a supermarket for a handful of food-related items.

The increasing availability of food products and other consumables at stores other than supermarkets continues to change the way American households shop. Most visibly, food shopping no longer is a one-stop weekly excursion. It has evolved into a primary trip every week or two (perhaps to a supercenter for staples) supplemented by several smaller fill-in trips to stores other than conventional supermarkets. Two-car households, and the proximity of stores that carry basic food items, mitigate the hassle of these fill-in trips.

All these developments have caused a growing proportion of food sales to leave the traditional supermarket channel. This channel leak has been the industry's dominant storyline for the last two decades (see exhibit above). Of the $830 billion that Americans spent on food last year, $565 billion or approximately 68 percent, occurred at supermarkets. That's about 15 percentage points lower than it was two decades earlier. This represents a huge loss of market share for the supermarket sector.

Shoppers Seeking Fresh and Natural

A more recent threat to conventional supermarkets has been the growing popularity of alternative or specialty supermarkets such as The Fresh Market, Trader Joe's, and Whole Foods Market, which have capitalized on the increasing health consciousness of many American households with their heavy emphasis on fresh products. In these higher-end supermarkets, perishables often account for up to two-thirds of store sales, while shelf-stable offerings are more limited compared with conventional supermarkets.

Over the last decade, the growing preference for natural foods has gone from a fad to a lifestyle, and it has become a big business for niche retailers — but not nearly so for conventional supermarkets that have to buy in bulk (and often ship fresh merchandise many hundreds of miles) to get the discounts they depend upon to keep prices low while maintaining their already thin operating margins.

Natural Foods Merchandiser (NFM) reports that sales of natural products (defined as minimally processed and largely free of preservatives and chemicals) plus dietary supplements reached $99 billion last year, a 10 percent increase from 2011. Sales of organic foods, a subsector of natural foods that meets additional quality standards and

must be certified, were about $26 billion of this total in 2012, according to NFM. For the year, about 40 percent of natural products sales occurred at conventional retail stores, with another 41 percent taking place at specialty natural products stores and the remainder occurring via a non-store channel. The Nutrition Business Journal estimates that U.S. sales of natural and organic foods will increase at a 10 percent compounded annual rate through 2020.

Small independent chains collectively compete for a large market share of natural products, and many companies intend to expand rapidly. Natural Grocers by Vitamin Cottage believes it has the potential to grow to an 1,100 store chain from its current 65. It already has signed leases for 120 additional stores. Whole Foods, too, says it can be a 1,000 store chain in time (from nearly 350 currently) while The Fresh Market sees an ultimate footprint of 500 stores. Sprouts Farmers Market stated in its S-1 registration statement that it has the capability to open 1,200 stores nationally under its current format. Fairway Group estimates that it has the potential to add 90 stores in the northeast region and more than 300 nationally. Add these all up over a multiyear period, and that's a lot of new stores scheduled to come on line. The growing presence and market share gains of these small independent chains, for the most part, will be at the expense of the conventional supermarket.

What these specialty supermarkets have been demonstrating consistently is that many shoppers — even middle-income consumers — are willing to pay a bit more for healthy and fresh foods and premium products. Whole Foods always had great appeal with affluent shoppers, but what kicked it into higher gear was its introduction of many value brands and products at more affordable price points, which won over a cadre of additional shoppers during the recent recession — a consumer segment the company has retained to this day.

These specialty supermarkets are smaller chains than the larger regionals and nationals, with store counts

Private Equity Goes Where Others Fear to Tread

One group of investors that hasn't been scared off by the myriad challenges facing conventional supermarkets is private equity.

By purchasing most of SUPERVALU's retail banners in January 2013, Cerberus Capital Management reunited more than 1,000 stores that operate with the Albertson's banner under a single owner. Cerberus also acquired from SUPERVALU several hundred stores that operate under other well-known regional banners and quickly has become owner of one of the nation's largest food retailers. Goldman Sachs estimates the stores sold to Cerberus by SUPERVALU accounted for approximately $24 billion in sales last year and nearly $1.3 billion of EBITDA. Cerberus' strategy is clear: to acquire vast assets cheaply, exploit scale advantages, particularly in the purchasing function, and implement operational improvements that will boost margins. The firm already has succeeded in the former goal. Goldman Sachs estimates Cerberus paid a little under four times EBITDA for the businesses it acquired, including the assumption of pension obligations. The value of owned real estate is a backstop for many of these stores.

Now the real challenge begins. One of the first operating changes implemented by Albertsons' new management since the acquisition closed is to end loyalty card programs at many of its banners, including Albertson's, Shaw's, and Star Markets, and implement an every-day-low-price (EDLP) strategy, which it may be positioned to deploy with the scale it has now achieved. However, loyalty card programs are standard in most large supermarket chains, and switching to an EDLP strategy goes against conventional wisdom in the sector.

Cerberus was also rumored to be on the final list of suitors for Harris Teeter Supermarkets, a 200-plus store upscale chain in the southeast with $4.5 billion in sales that ultimately went to Kroger for $2.5 billion, making it the largest non-distressed M&A deal in the food retailing space in a few years. Incidentally, Harris Teeter's valuation by Kroger, at just seven times EBITDA for a highly regarded and consistently profitable chain, reflects the relatively low valuations for conventional operators.

Other private equity sponsors with an appetite for food retailers include Lone Star Funds, which owns the BI-LO chain and more recently acquired the chronically underperforming Winn-Dixie in December 2011 for a little more than four times EBITDA. Last May, BI-LO announced a $270 million acquisition agreement to purchase the Sweetbay and Harveys chains from Delhaize America, consisting of some 165 stores and $1.8 billion in sales. All Lone Star supermarkets operate in the southeast, and the company, undoubtedly, is counting on cost synergies and scale advantages to create value in what, arguably, is a very saturated part of the country for food retailing. The Yucaipa Companies also have been active in food retailing, acquiring The Great Atlantic & Pacific Tea Company in late 2011 by helping finance its exit from Chapter 11 along with other private investors. The venerable New York metro area chain, operating under the A&P, The Food Emporium, Pathmark and Waldbaum's banners, remains highly challenged in a crowded market that now must contend with the expansion of Fairway and Trader Joe's chains in the region. And, recently, Yucaipa agreed to purchase most of the Fresh & Easy Neighborhood Market stores from Tesco and will try making a go of it in the southwest, an area slowly recovering from the worst excesses of the housing bubble.

ranging from a couple of dozen to a few hundred. Specialty shops typically have very loyal customers, and the stores are more productive and profitable than conventional supermarkets. Specialty supermarkets have made fresh and natural foods more affordable to the masses and have wide brand name recognition as these stores enter new markets. And specialty supermarkets have a mandate to grow. Collectively, they, too, are a force to be reckoned with in food retailing. Their primary challenge will be to maintain superior operating performance, mostly local sourcing and a great customer experience as they expand into untested markets and regions.

The Harsh Realities

Conventional supermarket chains did not sit by idly as these rising competitors encroached on traditional stores' turf. Many have upped their game in ways that have made them far more attractive shopping venues than they were 20 years ago. For starters, they have migrated to a larger store prototype. Supermarkets today in non-urban locales typically encompass 40,000 to 45,000 square feet compared with 25,000 to 30,000 square feet or so back in the 1980s. The Food Marketing Institute (FMI) notes that supermarkets today are nearly one-third larger than they were 20 years ago. Aisles are wider, lighting is brighter, offerings are more abundant and service has improved. Prepared meals (i.e., home meal replacement) are increasingly appetizing and affordable, while perishable offerings are greatly varied vs. a decade or two ago. Catering services now are available in many large supermarkets.

Food shoppers generally are price sensitive, and large supermarket chains have used loyalty card programs to try to hold onto shoppers when it's not possible to compete directly with the EDLP practices of the largest general merchandise chains. Unfortunately, rather than even the playing field, all these changes only may have served to slow the exodus of food sales from conventional supermarkets. On a brighter note, the declining market share for supermarkets appears to have leveled in recent years after nearly two decades of steady erosion.

The FMI states that there are about 37,000 supermarkets across the country — defined as a grocery store or supercenter with more than $2 million in annual food-related sales. The two largest national supermarket chains,

Kroger and Safeway, account for about $100 billion of food-related sales, or less than 20 percent of the supermarket sector's total domestic sales. Regional and super-regional chains with sales of $10 billion to $25 billion such as Stop & Shop, Albertson's, Publix and Food Lion, round out the Top 10, with a sizable drop-off after that. The FMI reports that the Top 10 account for 13,000 store locations, or 35 percent of all supermarkets, while the Top 50 account for 54 percent.

The supermarket sector is somewhat unique in retailing in that the largest national and regional chains have been unable to use their scale and ubiquity to thwart upstarts with niche appeal and other unconventional formats. Many upstarts today actually have been around for a couple of decades or more; such stores tend to be family-owned businesses in specific regions whose demonstrated success and popularity have encouraged them to open additional stores or enter other regions. Trader Joe's and Wegmans are two examples of local chains that have expanded selectively over the years with considerable success and fanfare.

Conventional supermarket chains that were slow to react or were ineffective in doing so generally have met a harsh fate regardless of their size. Winn-Dixie, a one-time 1,000 store, $10 billion regional chain, was unable to compete in Florida with Publix and an encroaching Wal-Mart. Winn-Dixie failed in 2005 and closed nearly half of its stores. It continued to flounder for several years after emergence from bankruptcy until the company was acquired in 2011 by BI-LO, itself a reorganized chain.

Penn Traffic, a northeast regional chain that was one of the first to transition to a large store format back in the late 1980s, filed for bankruptcy three times within a decade and eventually was liquidated. Similarly, the Grand Union chain pulled off a trifecta of Chapter 11 filings. Other notable supermarket chains that have filed for bankruptcy in recent years include Bashas', BI-LO, and The Great Atlantic & Pacific Tea Company (A&P). These chains had been in business for many decades only to meet their fate since 2000.

More recently, Fresh & Easy Neighborhood Market, a hybrid grocery store chain with nearly 200 locations in the southwest that was developed and operated by British food retailing giant Tesco, was on the selling block after a six-year struggle in a recession-plagued region. It is believed that Tesco has lost

more than $1.5 billion on this failed venture. SUPERVALU, a long-standing industry leader in food distribution, bought Albertson's in 2006 for $16 billion but was unable to make it competitive or profitable enough. SUPERVALU decided to sell Albertson's — along with Acme, Jewel-Osco and Shaw's — earlier this year for little more than face value of the debt obligations, a very costly capitulation for SUPERVALU. And just last month, Belle Foods, a small, 57-store southern chain that previously was owned by food distributor C&S Wholesale Grocers, filed for bankruptcy, citing (among other reasons) new competition entering its markets and financially challenged customers.

The economics of conventional supermarkets — a low-margin, high-volume business—have never been attractive, but, today, they are more challenging than ever. Growth prospects are modest at best. Return on investment (ROI) is mediocre. For many years, market valuation multiples for traditional supermarket chains consistently have been among the lowest in the U.S. retail sector. But specialty supermarkets have a business model that differs in some critical respects from conventional supermarkets; those that emphasize fresh food, particularly produce, enjoy higher gross margins and generate several more inventory turns than conventional stores. Thus, specialty stores are considerably more profitable on an ROI basis. However, most fresh foods in these specialty stores are sourced locally or as close to a store as possible. This presents some unique challenges with respect to fulfillment, and it remains to be seen whether this success can be replicated consistently on a large scale. Whole Foods is showing that it's possible, but at just over 300 stores, it still is relatively small.

Cleanup in Aisle 1: What Conventional Supermarkets Can Do

For starters, conventional supermarket chains have to end the complacency of being an incumbent and acknowledge that certain locales or markets can no longer be justified on an ROI basis. Piggly Wiggly Carolina Company, for example, which operates over 60 stores primarily in South Carolina, is selling some select stores to BI-LO and Harris Teeter in order to focus on its wholesale business and in geographic areas where it has a strong position.

In other words, Piggly Wiggly is attempting to leverage its strengths, get rid of stores in indefensible markets, and define pockets of profitability and competitive advantage. This is a sound strategy for supermarket chains caught in the ever-shrinking middle.

Every conventional chain needs to find a focus that is defensible. It could be a particular geographic area or an effective supply chain capability. It also could be a customer base that can be reached with wares tailored to local appetites such as ethnic offerings if that audience is underserved in a particular area. Of course, this also means making the requisite IT and supply chain investments, optimizing sourcing strategies and investing sufficiently at the store level — initiatives that many struggling conventional chains have been unable or unwilling to embrace.

Conventional supermarkets never will recapture their former glories or market share; there are just too many convenient alternatives for food shoppers these days. But a number of established companies have shown they can be fairly price competitive with large general merchandisers, and most traditional players have improved the customer experience offered, something that continues to matter to shoppers. It remains to be seen, however, whether this will be enough to hold on to what conventional supermarkets still have and enable them to provide a decent return for their owners. ■

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