The Deal

Grocers start to wilt under competitive pressures

Bankruptcies have already been filed and more restructuring is likely as online, pickup services change sector

BY KIRK O'NEIL

You know things are tough in the supermarket industry when even **Wal-Mart Stores Inc.** (WMT) starts shutting down scores of outlets.

The grocery behemoth announced on Jan. 15 that it was closing 269 stores globally, including 154 in the U.S. Of those U.S. stores, 102 will be its smallest format stores, Walmart Express. Walmart said it wants to concentrate on other things, likes its supercenters, e-commerce business and pickup services.

While the closings represent a minute percentage of Walmart's 11,000 retail grocery outlets around the world, it does show that even the largest industry player is retrenching as the sector—always a competitive, low-margin grind—gets only more so.

The battle last year led to the bankruptcies of U.S. chains such as **Fresh & Easy LLC** on Oct. 30, **Haggen Holdings LLC** on Sept. 8 and **Great Atlantic & Pacific Tea Co.** on July 19. But restructuring professionals believe lessons can be learned from these petitioners.

"What has happened is the grocery business historically has been a low-margin business with profits at less than 2% or 3%," said Bill Brandt, president of turnaround management firm **Development Specialists Inc.** (sixth place among restructuring advisers to distressed companies in The Deal's Out-of-Court Restructuring League Tables) "Real estate prices have risen and a lot of real estate is too expensive to manage."

Larger, well-run chains can bolster those tight margins, address strong competition and the bolster bottom line through consolidation, according to Holly Etlin, managing director of turnaround and restructuring firm **AlixPartners LLP** (fourth place among restructuring advisers to distressed companies with three active cases.)

That consolidation can improve chains' purchase power with vendors, reducing overhead costs and creating more volume through distribution. It also puts more pressure on smaller independent chains, which could create distress for them, Etlin said.

But consolidation doesn't always work.

"Haggen tried to grow through consolidation to compete with Wal-Mart and Target, which was not enough," according to Brandt. "Size alone is not sufficient enough to compete. A big group of stores that are not well-run doesn't work."

Some major regional chains are particularly worth watching when it comes to negotiating the rigors of the sector. Restructuring professionals are watching the plight of **Marsh Supermarkets Inc.** in the Indianapolis market and **Mars Super Markets Inc.** in the Baltimore metropolitan area.

Marsh has been struggling since private equity firm **Sun Capital Partners Inc.** purchased the company in 2006 for $325 million, according to supermarket industry consultant David Livingston of **DJL Research** of Waukesha, Wis.

Marsh currently operates 75 stores in Indiana and Ohio. It closed four stores in April and eight in January 2014 due to deficient sales and diminished future growth potential. The company has run into tough competition from chains such as **Kroger Co.** (KO), **Target Corp.** (TGT), Wal-Mart Stores, **Trader Joe's Co.** and **Meijer Inc.**

Livingston said that his research

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9	BMO Capital Markets Corp.	5
	JPMorgan Chase & Co.	5
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shows that Marsh's sales per square foot come in at 30% below market average in Indiana and Ohio. "What happens when a supermarket chain is in a downward spiral is you start closing stores," Livingston said. "When you're doing well, you're not closing stores."

Marsh CEO Thomas O'Boyle Jr. contradicted Livingston's assertion that the chain is struggling.

"Things are going OK," O'Boyle told The Deal, noting that the chain plans to open 13 stores over the next three years. But that strategy may fly in the face of the company's performance in the recent past.

"I'm sure he wants to open 13 stores, but I'd like to see him try it," Livingston said. "You don't open new stores when your sales aren't growing. One thing you don't want to do is to try something that you're not good at. They are not good at opening stores. They need to find out what they are doing wrong and fix it."

He asserted that when a private equity firm, such as Sun Capital, buys a grocery chain, it soon begins a strategy of growing sales and/or cutting expenses.

"Those who are not good at growing sales will cut labor, stores, advertising and expenditures to improve revenues. That's what they have been doing," Livingston said. "If you want to change your model, you probably need to change your owner."

Sun Capital, which took Marsh private when it purchased the chain in 2006, has failed in two attempts to sell the grocery store chain in recent years.

Things could worsen for Marsh, too, when it comes to competition. Cleveland-based supermarket chain **Giant Eagle Inc.** is looking to open stores in the Indianapolis area, which would add serious competition to a market that already includes Kroger, Livingston said.

"Giant Eagle plans to move into the Indianapolis market," Livingston said. "They are not moving into [the city of] Indianapolis because they think Marsh is going to grow sales. They're coming to Indianapolis because they think Marsh will go away."

Meanwhile, in Baltimore, Mars, a family-owned chain of 13 stores, has also struggled with underperforming outlets, as it faces a relentless challenge from Wal-Mart's Neighborhood Market brand and other chains. It closed four underperforming stores in Harford County, Md., between Jan. 25, 2015, and May 1.

Mars CEO Chris D'Anna didn't reply to requests for comment.

Tight margins and fast expansion have put supermarket chains on the road to ruin, but competition really has to be heeded, too.

Haggen on Sept. 8 and Fresh & Easy on Oct. 30 filed their Chapter 11 petitions in the U. S. Bankruptcy Court for the District of Delaware in Wilmington, both with plans to sell off their store assets. For Fresh & Easy, it was a repeat filing, given the chain had entered ankruptcy for the first time on Sept. 30, 2013, also in Wilmington, to allow it to complete a $130 million sale to Ron Burkle's **Yucaipa Cos.**

"These cases are sort of different but also sort of all the same," said Fresh & Easy's debtor counsel for its recent filing, Ilana Volkov of **Cole Schotz PC**. "The bankruptcies were all caused by a competitive industry."

Volkov asserted that Fresh & Easy and Haggen may have suffered from "growing pains," too. Fresh & Easy expanded to about 200 stores in just six years, making no profits. It also had signed most its above-market store leases at the height of the real estate market in 2006, which affected its ability to generate profits.

"Fresh & Easy got too big too fast at a time when people were mindful of how much money they were spending," she said.

Haggen, which operated 164 stores in Arizona, California, Nevada, Oregon and Washington fell into financial distress after completing an acquisition of 146 Albertson's stores. Albertson's had been required by the Federal Trade Commission to divest 168 stores pursuant to its Safeway Inc. merger.

Haggen, which had only 18 stores in Washington and Oregon before the Albert-

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son's acquisition, rebranded and transitioned the 146 additional stores to the Haggen brand between Feb. 14 and June 23, according to a declaration by CFO Blake Barnett.

Haggen debtor counsel Frank Merola of **Stroock & Stroock & Levin LLP** didn't return calls.

"They had to open quickly," said Volkov of Haggen's situation. "They had a limited amount of time to open the stores and couldn't do it."

Too much real estate and lease issues also played a role in A&P's Chapter 11. The debtor's failure to eliminate legacy leases of nonperforming stores during its first bankruptcy filing in 2010 because of provisions in a labor agreement added to the debtor's financial problems, Volkov said.

A&P debtor counsel Ray C. Schrock of **Weil, Gotshal & Manges LLP** didn't return calls.

Online grocery sales may eventually play a role in eliminating some real estate expenses of supermarket chains. Online grocery transactions are starting to get traction with consumers, which could both reduce chains' real estate costs and strengthen another competitive threat, according to Rick Pedone of **Nixon Peabody LLP**.

"We're seeing more and more direct home delivery from online grocery sales," he said. "Once you eliminate the supermarket real estate expense, you will open up more online competition. Supermarkets don't need to be in a certain location as in the 1970s and 1980s. The online grocery delivery business will expand in the future. That's where the trend is going in the next 10 years. Eventually, someone will get the model down."

Indeed, Wal-Mart isn't the only one looking to improve its grocery sales via e-commerce and pickup services. Several online grocery delivery companies have already launched their models on a regional basis that could increase competition, according to Bradford Sandler of **Pachulski Stang Ziehl & Jones LLP**, who represented the official committees of unsecured creditors for the Haggen and A&P Chapter 11 cases.

"We're seeing a trend toward online grocery services such as Instacart, AmazonFresh, Fresh Direct and Peapod," Sandler said. "The technology shift is making it easier for consumers to buy groceries."

A survey conducted by television and radio ratings firm **Nielsen Co.** in April on the Future of Grocery found that 25% of respondents say they currently order groceries online. Another 55% of respondents say they are willing to try online grocery shopping in the future.

San Francisco-based Instacart is an online grocery shopping platform that serves 18 metro areas across the U.S. Skokie, Ill.-based Peapod Inc., owned by **Ahold USA**, serves parts of 11 states in the Midwest and East Coast. AmazonFresh is **Amazon.com Inc.**'s (AMZN) grocery shopping site that charges a membership fee of $299 per year. Fresh Direct is a Long Island City, N.Y.-based online grocery delivery company serving New Jersey, New York, Pennsylvania and Vermont.

Some online grocery companies provide a full service of fresh produce and staples, while others focus on staples, such as canned goods, dry goods and paper products.

Sandler said larger supermarket chains are already adjusting to the shift in technology to make grocery shopping easier for their customers. Some are developing their own technology to serve customers, he said.

Sandler said many supermarket chains are emphasizing customer service with a variety of measures. Chains are trying to make their customers' shopping experience more enjoyable by offering local produce and organic produce.

Some are even opening taverns inside their stores that offer craft beers and specialty foods. **Wegmans Food Markets Inc.** of Rochester, N.Y., has opened The Pub in their stores. **Weis Markets Inc.** has launched in-store beer cafes in the Pennsylvania stores.

"Supermarkets and grocers will need to adopt a high-tech focus," Sandler said. "Anytime there's a shift in trends or change in technology and a company doesn't adapt to the changes or changes too late, they will need restructuring work." ■

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