



Food Industry Closes Ranks

M&A activity among food distributors gives bold players much needed clout in today's competitive marketplace.

By Benjamin Gordon

For most of the 124 years since the invention of the supermarket, the food distribution landscape was dominated by independent regional retailers. Accounting for 40% of the total grocery sales, these independents relied, in turn, on an army of independent distributors to keep their shelves stocked. Large national chains provided healthy competition, taking 25% of the total, and everyone thrived.

But there has been a changing of the guard. According to Progressive Grocer's 74th Annual Report of the Grocery Industry, independent supermarkets only managed to garner 8.7% of sales in 2006 – a 77% decline. Almost as important is the fact that only 24% of the 34,052 supermarkets in the U.S. with over \$2 million in annual sales are still independent.

The Big Get Bigger

The same trend toward consolidation that struck general merchandise retailers over the past 25 years has come to the grocery industry. The Food and Beverage industry is currently the most active merger & acquisitions (M&A) sector of the already hot Consumer Products market. With a 392% increase in transactions since Q1 2003, the majority of the activity has been among manufacturers and retailers, drastically changing the playing field for mid-market food wholesalers.

However, though the number of transactions has significantly increased, the total value of those transactions has risen only modestly, suggesting that companies looking to acquire are now looking deeper into the middle market for targets. For those mid-level distributors feeling the pressure and looking for options, this is good news. Responding to pressures from shrinking retail outlets and the explosion of new products entering the market will require added muscle if wholesalers are to maintain their place on the field.

Some wholesalers have already begun looking for some extra help to compete on the new terrain. In the past three months alone, deals have been finalized between Apollo and Smart & Final, and Countryside Foods and I&K Distributors. On top of that, SUPERVALU has consolidated its logistics operations in the East, merging three distribution centers into one facility in Lancaster, Pennsylvania.

Others have looked to capitalize on new niche markets. The acquisition of Wild Oats by Whole Foods, both of whom serve the organic and natural food markets, creates a giant in the growing market for natural and organic products. Alternately, British grocery retailer Tesco opted to enter the U.S. market with their "Fresh & Easy Neighborhood Market" concept, based on smaller, more localized neighborhood stores.

More than ever, mid-market distributors have to find a way to meet the wave of change facing them while there are options available.

Consumers Change the Landscape

"The Customer is Always Right." It's one of the favorite mantras of service industries everywhere. But nowhere is this felt as strongly as in food retailing. Major changes in consumer characteristics have had retailers and distributors struggling to adapt for some time. Thanks to innovations in data collection, the industry knows more about those changing characteristics than ever before and has created new inventory management techniques to take advantage of them.

Until recently, retailers made decisions about what products they would carry based on the deals wholesalers were able to make with suppliers. This often resulted in piles of overstock in warehouses if products did not sell, and shortages of other products for which the demand was unexpectedly high.

With techniques like category management, modern grocery retailers now fine tune their inventories on a daily basis. By evaluating sales of entire categories of products, such as soft drinks or cereal, instead of individual products, category managers view their product assortment strategically, measuring overall success rather than the success of individual products, which may come at the expense of other items in the same category. This can lead them to remove or replace under-performing products much faster than they might have done previously.

The high turnover on the shelves creates significant challenges to the rest of the supply chain. Where there were once roughly 11,000 stock keeping units (SKUs) to keep track of, modern distributors can have as many as 75,000 items to track and transport, with new products arriving almost as quickly as suppliers can create them. Technological innovations have helped distributors keep up, but the impact on distribution of having to add so many new products to the system, as well as store and track them, has been challenging, to say the least.

It has also diminished a wholesaler's strength when negotiating with its suppliers. With so much of the business being done by self-distributing retailers, many manufacturers have become happily accustomed to dealing with fewer players. Without the benefit of being able to buy their historically large quantities, wholesalers are struggling to find new footing from which they can elicit the best deals from manufacturers and other suppliers.

To continue to have a role in this environment, wholesalers must find new ways to add value to the supply chain. "[Wholesalers] need to become more efficient to achieve the turns they need, while still maintaining huge product assortments," said Karin Bursa, vice president at Logility Inc., a maker of supply chain management software, in a recent interview.

In this environment, efficient, accurate and timely order delivery has become a fundamental necessity. Since accomplishing that requires the cooperation of an extensive network of trading partners, working together with others is almost a necessity. New technologies like radio-frequency ID tags are speeding up inventory tracking throughout the length of the supply chain, while providing opportunities to reinvent traditionally labor-intensive operations in the warehouse.

An effort to anticipate the needs of the other players in the supply chain is also in the distributor's best interest. In the same way manufacturers and retailers both plan their inventories by forecasting demand, so can wholesalers. This is a radical departure from the typical distributor's system of using order histories and setting replenishment points, but by using the same tools as both supplier and customer, distributors can prove their value and carve out a more secure place in the process.

Increasing Competition for a Decreasing Audience

Conventional wisdom holds that consolidation in an industry reduces competition and provides added leverage for the new, larger organizations. However, in food retailing, the reverse seems to be true. As major retailers have combined, competition seems to have grown even more fierce.

"Many industry analysts feared that consolidation would create less competitive markets and higher food prices," said Ephraim Leibtag, of the USDA's Economic Research Service. "However the opposite trend has taken hold."

A major factor over the past 25 years is that the percentage of food that is eaten at home has steadily decreased. Now in the 21st century, people eat nearly as many meals prepared away from home (e.g., restaurants and take-out establishments) as they do meals they make themselves. The growing numbers of dual-income families, over-extended soccer moms and dads, and young people without the skills or inclination to cook, have driven this trend away from purchases of raw ingredients. All those time-starved consumers have also created a strong demand for convenience.

Competition in food retail used to be easily categorized to regional chains, mid-sized grocers and small independent operators. But now virtually every retail outlet imaginable sells groceries – gas station convenience stores, dollar stores, outlet stores, and pharmacies all now sell groceries in some fashion, not to mention the trend towards "superstores" (stores combining general merchandise as well as groceries) that Wal-Mart introduced to the industry in 1988.

Competition in such a landscape requires both a sizable organization that can take advantage of increased economies of scale and an agile one that can aggressively enter new markets as they open up.

Battling the Goliath from Bentonville

As with every other market that it has touched, Wal-Mart's effect on the food industry has been swift and complete. In the 19 years since the introduction of the first Wal-Mart Supercenter in Washington, Missouri, the company has managed to overtake all of the veterans of grocery business (including the Kroger Cos., founded by supermarket pioneer, Barney Kroger) to become the #1 supermarket chain in America, with 2006 grocery sales of over \$91 billion.

Wal-Mart's presence in the retail food industry has had a domino effect much like that felt in general merchandise over the past 20 years. Distributors are being squeezed from both directions as the remaining retailers reach higher up the supply chain in hopes of increased savings and manufacturers reach down to ensure their places in the market. And as the number of retail outlets has fallen

under intense competition, spurred by Wal-Mart, the customer base for wholesalers has dwindled.

No one knows this better than the former employees of the Fleming Companies. In 2003, Fleming filed for Chapter 11 bankruptcy protection, after its relationship with its largest customer, Kmart Corp, was ended as part of Kmart's own bankruptcy proceedings. While Fleming's troubles were compounded by its own internal problems (in the form of an SEC investigation of its accounting practices and a thorny class-action lawsuit by shareholders), the redistribution of Fleming's \$20 billion of business is still being felt throughout the industry. But there are lessons to be learned from such a large scale failure.

Opportunities from Hard Lessons

With the rise of large national self-distributed chains, there is a resulting opportunity for wholesalers to align themselves more strongly with the remaining independent retailers that still need their services. And the best way to do that is to look at what they already know in a different light.

"Wholesalers must become marketers for the independent retailer", consultant Ron Lunde, president of The Lunde Co., said in a *Food Logistics* article on Fleming's demise. "Not marketers in the sense of running ads and promotions, but being able to take data and turn it into information and actionable insights. They have to create a situation where the independent can thrive."

Wholesale distribution needs to move from a strictly logistical operation, which offers no advantage over the self-distributed chains, to one that can offer competitive information to its customers, thus keeping them in the game.

As Lunde explained, Wal-Mart is essentially a "homogeneous store," meaning that they assume all their customers are alike and supply them all with essentially the same products. This creates a golden opportunity for wholesalers to remain relevant by providing their customers with the tools to understand their communities and provide them the unique product assortment that their customers will be drawn to.

It appears that wholesalers have taken Lunde's advice already. In the UK in 2006, *Grocer Magazine* awarded its Gold Award to Bestway Cash & Carry for "consistently providing customers with initiatives that improved their bottom lines" and there's every indication that U.S. wholesalers have seen the light as well, as SUPERVALU's nearly \$44 billion 2007 sales figure shows.

Leveling the Playing Field

Fortunately, the climate for new partnerships looks better than it ever has. While net profits still hold in the 1%-1.5% range, the industry's ROE is up in the most recent fiscal year more than 3%, according to the FMI's Annual Financial Review. And where a mid-market distributor might have been valued at 4-5 times earnings before interest, taxes, depreciation and amortization (EBITDA) in 1997, that same company can be worth as much as 7 times EBITDA today, with some companies achieving huge premiums, like Foodland Associates' selling price of \$1.1 billion (or 15.8 times EBITDA) in 2005. Indeed, companies that have solid growth trajectories and compelling stories could well command premium prices like never before.

Closing the ranks will be essential to long term success. In finding new partners, mid-level companies will find the size to achieve the economies of scale so necessary to survive in the low-margin, high-volume grocery industry. They may also find increased access to capital, which will allow them to adopt new technologies that keep them in step with consumers and provide critical value-added services to their customers.

But this window of opportunity may not last. Consolidation at the upper levels of the industry, notably SUPERVALU's \$9.7 billion acquisition of Albertson in 2006, is raising the stakes considerably. And the attractive numbers the industry is recording may well attract out-of-the-box buyers who wouldn't have been looking previously.

Those mid-market distributors who intend to remain on the field have a perfect opportunity to position themselves for the new economic landscape. Now more than ever, he who hesitates is lost.

