

MERGERS & ACQUISITIONS

Who's Next?

By Len Lewis



A wooden cutting board with a hole at the end, resting on a dark grey surface. Two red tomatoes are placed on the board. The board shows signs of use with scratches and a hole at the handle end.

The year 2017 is not likely to be record-setting for merger and acquisition activity in the grocery industry now that mega-mergers like Ahold/Delhaize, Walgreens/Rite Aid and Albertsons/Safeway are complete.

But after five years of consistent – albeit slow – economic recovery, relatively low interest rates and strong availability of capital, the stage is set for another round of consolidations with action centering around robust regional chains and independents who will continue to suffer the most from the e-commerce juggernaut, alternative formats like Aldi and the entry of Lidl, and the need to create niche stores in order to remain competitive.

Looking at the entire M&A ecosystem, surveys by Citizens Commercial Bank found that 53 percent of sellers are involved in or open to making a deal in 2017, up from 34 percent last year.

Additionally, 25 percent of organizations are confident that their company will be acquired this year. This rush to buy is basically due to increased pressure to show revenue growth after several years of not being able to do it organically.

The percentage of potential buyers and sellers was lower prior to the presidential election since little change in the business environment was expected no matter which party came to power.

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However, the potential of lower capital gains and estate taxes under the new administration, as well as hints of a less restrictive regulatory environment, have led to a post-election rise in equity markets in anticipation of accelerated economic growth – an indication that company valuations have yet to peak, the report said.

Moody's Investors Service believes that because of pent-up demand, continuation of historically low interest rates and growing piles of cash will spark a good year.

According to a recent Moody's survey the vast majority of corporate and private equity respondents projecting that 2017 will mark a rebound in M&A activity.

"Every regional chain that does not have a distinct format and operates conventional stores could be a candidate for a business combination in the next five years," according to David Schoeder, a principal in The Food Partners, Washington-based

behind this acquisition was to build up and complement Walmart's existing online efforts and position the company for faster e-commerce growth by expanding its customer reach, according to officials.

This was underscored by Walmart's purchase in January of online footwear retailer ShoeBuy for about \$70 million, which could further bolster Jet.com's business and relieve some of the pressure being put on Walmart and other retailers by Amazon.

On another front, but just as impactful to retailers, is continued consolidation in the manufacturing sector.

"The major CPG companies have seen a material erosion in the value of their brands as private label penetration increased," Schoeder said. "Driven by Walmart, manufacturers had fundamentally changed attitudes, behaviors, practices of the traditional grocery sector to reduce costs, and maintain their return on invested capital and market share in the U.S.

Schoeder believes 2016 was a year of transformation for merger activity in the grocery business. More stores traded hands because of large deals like Ahold/Delhaize, Walgreen's purchase of Rite Aid and Supervalu's sale of its discount Save-A-Lot brand.

"There's not a lot more that can be done at the top," he said. "So the next round of consolidation will affect the regional chains. Chains like HEB or Wegmans that have a well-defined identity will continue building on their own rather than growing through mergers or acquisitions."

But there is a new class of "super independents" emerging that are on the prowl for good buys.

"As a rule they have in excess of \$500 million in revenue, a quality management team and sufficient cash flow to reinvest in existing stores and fund rapid growth," said Schoeder.

"Not only have they been able to take retail locations discarded by major chains and niche them for specific markets, but they have also been the buyer of choice for smaller independents that have elected to sell their stores over the last 15 years," he said. "That's why super independents are commonly referred to as Pac-Man because they continue to make acquisitions in adjacent markets to expand their marketing territory."

We are also seeing a shortfall in next-generation ownership, indicating that more individual stores and chains may be up for grabs as owners, some of whom may be nearing retirement, take advantage of a strong market to exit the business, Schoeder said.

"A lot of people now in their 60s who got into the business as store managers for companies like Safeway or National Tea are reaching retirement age," he said. "Other than a few alternative formats that have sprung up, how many people are getting into the business to build a company? I only know one guy and he's not happy!"

A number of factors were responsible for driving merger activity last year, said Schoeder.

"The primary reason was the need to achieve economies of scale by eliminating one set of back offices to remain competitive," he said. "Some chains are focused on operational



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investment bankers. He deems it unlikely that retailers will look outside grocery retailing for acquisitions.

"There are private companies that have multiple investments, but I don't view this as a core strategy," he said. "If your company has capital constraints, you want to focus on growing your core business to avoid top line erosion and increased operating expenses."

There have been a couple of notable exceptions – both from Walmart.

In August, the company acquired Jet.com for \$3 billion in cash and shares. The idea

"Continued consolidation of CPG companies is anticipated primarily to create synergies by eliminating duplication of sales forces and consolidation of food processing facilities," he added.

However, retail industry observers are quick to point out that grocery is only one part of a larger global M&A ecosystem which is also the result of five years of stable growth and the accumulation of massive cash reserves, giving corporate executives the confidence and the means to pursue acquisitions.

efficiency in order to make the numbers and give investors an adequate return.

On the other end of the spectrum, independents are focused on differentiation by store and customer intimacy in order to get an adequate rate of return.

“I think Albertsons and Safeway are among those that have learned that you have to drive the business on a regional basis and create niche stores,” Schoeder said. “Clearly, you can’t take every grocery store in the U.S. and make it look like a Safeway. From that standpoint they are doing things right.”

Schoeder, along with other industry observers, believes that the Ahold/Delhaize merger was something of a high-water mark.

“This was a particularly good deal that involved minimum divestitures,” he said. “And with the exception of some Atlantic states, they now go from Florida to Canada.”

Looking ahead, 2017 promises to be active for the entire merger and acquisition community.

in the next 10 years depending on where you operate,” Schoeder said. “So in 10 years with inflation, operating expenses will go up and the top line will go down 10 percent. The world is becoming more competitively priced.”

Since the industry has pretty much automated everything it can, he expects that e-commerce will drive more consolidation because of the top line impact as well as margin compression.

“Increased operating expenses are fine as long as everyone in the industry is facing the same thing,” he said. “But the 10,000-pound gorilla called e-commerce eliminates the need to put products on shelves or run them through cash registers. The question is whether consumers are so time starved they don’t care about delivery costs and are willing to pay for the convenience.”

But you need population density in order to make an e-commerce solution successful.

“However, companies are taking a more disciplined approach to it. In the past acquisitions were driven by synergies and people wanting to increase their geographic footprint,” Schoeder said. “Today, companies are more focused on sustaining sales and enhancing the store.”

Consequently, whether companies are in the market for turnaround situations is questionable.

“If they’re public yes, if private no,” he said. “The jury is still out on whether Kroger’s acquisition of Roundy’s was a good thing or not. The Pick ‘n Save stores in Wisconsin were a turnaround situation. Kroger was enamored with Mariano’s, which are lovely stores, but the question is whether they can they make them profitable enough. They are putting their systems and marketing approach in place. I don’t think we’ll know the outcome for at least 12 to 24 months.”



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But won’t involve the same volume of stores in the grocery industry,” he said. “In 2015 the average deal peaked at 71 stores and a total of 4,164 stores traded hands. We’ll probably average 40 transactions per year for the next five years.”

Schoeder doesn’t believe the political climate will have much effect.

“A lot of people in the industry felt their world was coming to an end due to increased regulations, specifically from the Department of Labor,” he said. “But there’s not much on the regulatory front.”

While inflation will be a major factor in accelerated consolidations in 2017 and beyond, the continued rise of online retailing is an overriding issue.

“One of the things that drove 2016 was the acknowledgement that e-commerce will take five to 15 percent of grocery store sales

Unless robotics is used to solve the picking problem it’s hard to employ people full time at a distribution center.

“Every grocer in the country has spent a ton of money trying to figure out e-commerce. You have to have it to compete but most have not been successful. Over the next 12 to 24 months it is the e-commerce business that will set the tone for acquisition and merger activity for the next five years,” he added.

This will be the same for chains and independents with between one and 25 stores, according to Schoeder.

“Some of this activity will be below the radar since there’s a lot of one and two store deals being done that never rise to the level of being published,” he said.

Despite all the optimism in the marketplace, the criteria for a good acquisition have not fundamentally changed.

Meanwhile, the jury is still out on whether the growth of alternative formats – specifically the entry of Lidl and continued expansion of Aldi – will have a significant impact on industry consolidation.

“My concern is that Lidl could do a lot of damage to markets before they prove or disprove their model works. My understanding is they’re not picking ‘A’ sites and poor site selection was one of Fresh & Easy’s problems,” Schoeder said. “For the most part they’re putting stores in urban markets primarily dominated by chains. That strategy is not going to drive merger activity.”

Schoeder added that health and wellness trend is also going to drive consolidation.

“Aldi got the memo,” he said. “But those operating conventional groceries without that twist are becoming less relevant at an accelerated pace. They’re prime candidates for consolidation.” ■