

Observations on the Impact of Mergers on Independent Retailers

by

Donald W. Dill
Senior Vice President
Information Services & Planning
Certified Grocers of California, Ltd.
Los Angeles, CA 90040

First I would like to clarify a point made by Bill. He said that when I was asked to replace Carol I said I would be happy to do so. In fact, I approached this assignment with some fear and trepidation. It is a very sensitive area and I hope my remarks reflect this sensitivity.

I am honored to replace Carol. I would have liked very much to have heard her. She is an independent operator who can speak first-hand of the realities of mergers and acquisitions as they have affected her. Her title was to have been "Merger Impacts on an Independent Grocer." My title would be "Observations on the Impact of Mergers on Independent Retailers." Carol had some time to prepare her remarks; my preparation time has been limited to about 24 hours. I hope my remarks do not appear too disjointed.

Merger activities have occurred in the manufacturing, wholesaling and retail segments of the business. My primary emphasis will be on the retail segment with only a small comment on the wholesalers.

By way of background, Certified Grocers is a retailer-owned cooperative with approximately 650 members, serving 4500 stores. In 1984, sales are in the range of \$1.9 billion. We have nine divisions and seven subsidiaries. In the twelve-month period between May, 1984 and May, 1985, we will lose approximately

\$300,000,000 in sales. Approximately half of this is because of mergers and acquisitions and the other half is because of retailers opening their own warehouses.

There has been a significant change in market share over the last 25 years. While I did not bring with me the exact data, the numbers I will quote are approximate in their order of magnitude. Twenty-five years ago the top four chains had an estimated 30 percent share of market. With the completion of the Smith's Food King acquisition by Lucky's, the top four chains' share of market should exceed 60 percent. While Certified management is not happy about this situation, we are pragmatic about it in that we do not expect the current administration to take action to slow down mergers. We are also positive about our own future.

A number of writers have their own laws, Murphy and Parkinson among them. I have two laws that I would like to quote. One of them says, "For every complex problem there is a simple answer, and it is wrong." I say this in conjunction with the discussion that preceded the coffee break. The impact of mergers and acquisitions and the reasons for mergers and acquisitions are very complex problems. They cannot be dealt with by simple solutions. The second law is from Mad Magazine, "You don't need faith to move mountains when you've got the technology." I'll try to

bring these two statements into perspective in regard to mergers' impact on independent retailers.

First, let me review some of the things previous speakers have discussed in light of the subject of mergers' impact on independents and add the impact on chains of mergers. Or, in the complex business of food retailing, what is the relative impact of mergers on a number of issues or characteristics?

Several of our speakers, starting with Bill Boehm, discussed the concept of consumer-driven decision making. The concept of demographics also dealt with the same thing. In my mind, independents have an advantage by being close to the consumer. They have an autocratic capability which allows them to respond much quicker than chains. However, as a general rule they are not as sophisticated as the chains in reading the marketplace, but they do have great "gut" instincts.

Chains, on the other hand, have a high level of sensing devices to measure the marketplace. Because of their structure, they typically are cumbersome and bureaucratic in their execution of decisions.

A summary in terms of merger and acquisition impact would show some positives in each group. I'd rate it as a draw or slight edge to the independent who has good wholesaler support.

Some of our speakers talked about change and ability to change. I would put that in the same light as the previous discussion.

Many of our speakers talked about the need for experimentation, particularly as it relates to new formats. Independents have little opportunity or resources to experiment. They must depend on the wholesaler. Chains, on the other hand, can do it if they wish to. They have greater ability to experiment and thus have a better predictor of success for the future.

Experimentation's impact definitely gives the advantage to the chains. Not because of mergers and acquisitions but because chains have greater resources. The exception might be where the chain gains knowledge by acquisition rather than by internal development.

Many of our speakers talked about the concept of critical mass or the concepts of economies of scale and similar thoughts. The goal for both chains and independents is to maximize asset utilization. Chains typically have a higher per store average. Why? I'm not really sure, but their greater media clout would certainly be an influence. In their distribution centers they have a greater ability to control their destiny and to operate at peak capacity as they manage the expansion of their distribution centers in tandem with the development of their stores. There is a trend on the part of some retailers to discontinue their distribution centers and move to wholesalers.

The adaptability and flexibility of independent retailers allows them to succeed in many chain discards. Independent retailers, by and large, depend on their wholesalers to get maximum utilization of the distribution center. The independent, therefore, has very little flexibility other than to shift wholesalers.

What is the impact of mergers and acquisitions with regard to critical mass? On a store-by-store basis, perhaps none. The chains do have a greater opportunity to maximize the effectiveness of their distribution centers through mergers and acquisitions; however, I don't know of any merger that occurred because of the chain's desire to maximize the utilization of its distribution center. As a matter of fact, two of the most recent acquisitions in the Southern California market were by chains whose distribution centers were taxed to the limit prior to the merger.

Media costs are an area where the chains have a significant advantage over the independent. Typically, to get the same coverage a chain can do it much cheaper than an independent. Mergers and acquisitions have a significant impact on this in that a significant portion of the incremental gross profit goes directly to the bottom line because here is no increase in media costs.

Promotional allowances is another area where the chains have an advantage over the independents. Because of their size they have greater leverage. They have greater monitoring and control capabilities which benefit both the retailer and the manufacturer.

The independents, on the other hand, are dependent to a great degree on the wholesaler to develop programs. Manufacturers typically do not regard multiple independents in the same light as a comparable number of stores in a chain.

The current structure of promotional allowances gives a definite advantage to the chains. With mergers and acquisitions where allowances are determined on a per-store basis, this increases the moneys available to chains. Ten years ago a Von's and Ralph's typically would have two pages in the Los Angeles Times. Today, they will have seven or eight pages. A significant portion is paid for by vendors' promotional allowances.

Many of our speakers have talked about the cost of entry. Bill Boehm indicated he did not perceive there being a significant barrier to entry. I disagree with that. The chains are far better able to develop sites, to take risks and wait for sites to develop. They have greater resources for development, including human resources and access to the financial markets. Wherever an independent developer develops a site he is looking for a AAA tenant and in markets today that is a chain store.

Independents depend on their wholesaler. Where the wholesaler has a well established site development program the independents do not suffer much. In areas where such a program does not exist, the independents are definitely at a disadvantage. Independents, in many cases, are dependent on chain cast-offs for their new sites.

Mergers and acquisitions are significantly affected by the cost of entry. Chains are using mergers and acquisitions as an entry mechanism. They find acquiring existing stores as cheaper and faster than developing sites from scratch. This is further affected by the fact that chains are finding alternative uses for their cast-offs by leasing them to non-food retailers and other tenants who can pay higher rents than can food retailers.

Demographics has been a subject of discussion many times in the past two days. Typically, it was spoken of in light of the consumer. But the same demographic characteristics that are affecting the consumer are affecting our employees. The chains with their structured tendencies and thick personnel manuals are not as able to adapt to the employees from the "me" generation as well as the independents with their greater flexibility in structure. While I have no empirical data on this, my "gut" feeling says that the independents are going to be better able to adapt to the value systems of the new employees.

There is one other factor that concerns me as a wholesaler and that is that the "me" generation does not have the same entrepreneurial bent as their parents did. I suspect that in the next five years we will have more difficulty identifying new store owners than we have in the past.

The final characteristic I would like to compare between chains and independents is labor costs, most specifically, union contracts. Virtually

all chains are union members. In some places they have two-tiered contracts where new employees are hired at a lower rate than are experienced employees. Where chains are growing and independents are stagnant, this gives a tremendous advantage to the chains. Many cities have two-tiered contracts; that is, one contract for the chains and another contract for the independents. Forbes Magazine recently had an article on the impact of this particular approach on four cities: Philadelphia, Pittsburgh, Detroit and Cleveland. Where this condition existed, the chains have virtually removed themselves from those markets unless they were able also to get a lower contract. Recently, in Southern California, the industry-wide bargaining unit signed an agreement with the Retail Clerks. In this is a clause called the "favored nations clause." This clause states that if the union signs a contract with a retailer where the contract terms are more favorable than the existing one with the chains, then all employers in the industry-wide bargaining unit would get the more favorable contract. The exceptions are for stores with less than 25 employees or companies with multiple stores and less than 100 employees. This particular clause gives us at Certified great concern.

What is the inner relationship between labor costs and mergers and acquis-

itions? Typically, the independent would be at the advantage where he is able to negotiate a lower contract or become non-union. Where he must abide by the same contract as the chains he is at a definite disadvantage. The other area where the independent is at a disadvantage is in his knowledge of labor law. Whereas chains have staff experts in this area, the independent must depend upon expensive consultants or his wholesaler for this service.

The final subject I would like to cover today is the area of mergers among wholesalers. The trend has been going on for better than ten years where strong wholesalers acquire other wholesalers. They are typically looking for wholesalers with good facilities, a good sales base and a management team that is willing to stay. The acquiring firm usually brings to the merger a host of services which, when provided to independents by the acquired wholesaler, strengthens the independent and gives him greater ability to compete in the marketplace.

These are my random thoughts on mergers and acquisitions and the comparative advantages to chains and independents.

Thank you.