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PROGRAM SUMMARY

Strategic Planning and Management in Retailing Program Makes 44th Run in North America

In May 2006, the open enrollment version of the Strategic Planning and Management in Retailing Program ran for the 44th time. The program was conducted in Williamsburg, Virginia, at the Mason School of Business of the College of William and Mary. In addition, in late May, the program was offered for the 21st time in Australia at the Cape Schanck Resort outside of Melbourne, and sponsored by the Australian Centre for Retail Studies (ACRS) of Monash University. ACRS also sponsored the 12th offering of the program in Singapore in June 2006. Currently, this program is offered twice in North America (at Babson and at William and Mary), and once in Australia and in Singapore (both sponsored by Monash University in Australia).

The programs were kicked off with "The Eight Ways to Win in Retailing," and, with slight differences from program to program, featured cases on Wal-Mart in 2005, Tesco, Best Buy and Best Buy in 2005, Home Depot, Zara, Kohl's, and Meijer. In addition, the faculty delivered lectures and exercises on financial and productivity analysis, strategic thinking and planning, category scorecards, and supply chain management that included a simulation.

On Wednesday afternoon at the Williamsburg program, the group participated in a store tour with visits to a new Wal-Mart Supercenter, Target Greatlands, Costco, Lowe's, World Market, Ukrop's, Best Buy, Circuit City, PetSmart, Toys "R" Us, T.J.Maxx, and others. In addition, they were given a guided tour of Colonial Williamsburg, followed by dinner at the King's Arms Tavern in the restored colonial area.

Australia program participants enjoyed the Cape's spectacular coastal environment and views of Southern Ocean and Port Phillip Bay. The Cape Schanck Resort is ideally located between the traditional resort areas and the burgeoning wine, food, and golf district of the Mornington Peninsula. In Singapore, participants were housed at the Rasa Sentosa Shangri-La, set on a stretch of white, sandy Siloso Beach overlooking the South China Sea.

Program participants represented 15 different countries and included companies in the drug, food, apparel, footwear, home improvement, consumer electronics, furniture, and consulting sectors. The class was composed of senior executives from buying and merchandising, marketing, store operations, strategic planning, human resources, logistics, finance and control, and business development. Channel management executives represented several manufacturers. Professors Larry Ring and John Strong were the primary program faculty members.

The next Strategic Planning and Management in Retailing Program will be offered September 9-15, 2006, at Babson. For more information or to apply, contact Sally Aubin at saubin@babson.edu or at 781-239-4411, or visit www.babson.edu/bee/retailing_newsletter.

Supermarket Mergers and Acquisitions: Lessons to Be Learned

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This article reviews the experience of the most recent wave of supermarket mergers, which began in earnest in the late 1990s, and whose fallout is still being felt today—most recently in the sale and break-up of Albertson's. We review five major transactions, examine the results, and draw lessons from their outcomes (and outlook).

Mergers and acquisitions have always played a role in food retailing. During the 1920s, multistore grocery chains, such as A&P and Kroger, expanded rapidly both by growing organically and by acquiring others. Beginning in the 1930s, the rise of self-service, multi-department supermarkets led the chains to sell their smaller stores to local grocers.

Supermarket mergers have been subject to close government scrutiny, given their localized markets and the fact that most regions have had one or two dominant players. As a result, most mergers in the 1970s and 1980s involved absorption of weaker companies by larger regional chains, or "in-fill" deals where gaps in regional market coverage were addressed through acquisitions of smaller grocers.

Another wave of supermarket restructuring took place in the mid-1980s, mainly in the context of leveraged buyouts of publicly held grocery retailers. These deals typically involved extreme levels of borrowing and reliance on operating cash flows to service this debt. The investor groups who were involved in taking these companies private sought to divest less profitable parts of the business, thereby creating smaller retailers with higher profitability. Although, much of this profit went to service the debt and to provide cash returns to their investors, rather than being reinvested in the business. The leveraged buyout of Safeway in 1986 began a series of other grocery buyouts, including 7-11, Pathmark, and Grand Union. In 1988, this wave reached

a high point with the attempted leveraged buyout of Kroger by private investor groups. Kroger resisted, but was forced to undertake its own major leveraged recapitalization—in effect, doing a leveraged buyout of itself.

By the early 1990s, much effort was spent on reducing debt levels and on internal performance improvement. At the same time, two other trends emerged to shape the economic context of the supermarket industry. The first was the development and rapid expansion of Wal-Mart, especially its supercenter format, which now has approximately 110 million square feet of food combined with 260 million square feet of discount department store market. Wal-Mart not only put pressure on margins through pricing, but also focused attention on the cost structure of many established grocers—in particular, the consequences of strong union contracts and generous health and pension benefits.

Another factor in supermarket industry dynamics was a series of acquisitions of U.S. grocers by international companies. The highest profile acquisitions were by Royal Ahold of the Netherlands, which purchased Stop & Shop in New England, Giant Food in the Middle Atlantic region, and Tops in Western New York, among others. These acquisitions, along with concerns about Wal-Mart, led to renewed emphasis on acquisitions as a means to build scale and to provide growth.

The supermarket merger and acquisition wave that resulted was unprecedented. Prior periods involved mostly local or regional retailers, whereas the mid-1990s wave involved acquisitions of multiple companies, creating companies with national reach, albeit usually under different brands. Many of these deals focused on anticipated cost reductions and efficiency gains, to help compete with mass merchandiser and warehouse club rivals. Another factor was the rising capital expenditure requirements of building new stores versus purchasing existing operations or brands (many of which had achieved good sales volume). The net effect was that acquisitions made during the mid-to-late 1990s were, for the most part, buyouts of stronger regional players at unprecedented valuations and acquisition premia. Between 1997 and 1999, there were 19 major acquisitions, involving 3,500 store locations and more than \$67 billion in sales.

Supermarket Mergers: Five Recent Examples

Albertsons Acquisition of American Stores

Albertsons was a Boise, Idaho-based chain with substantial operations in the west and in Florida. Prior to acquisitions, it had \$9 billion in sales, approximately 1,100 supermarkets, and a reputation as a strong mid-market operator. Albertsons acquired American Stores for \$11.7 billion in 1998. American Stores included Jewel (Chicago), Acme (Northeast), and Lucky's (California). Each was one of the leading chains in its region in terms of market share, but profitability and operations were weaker. For example, Albertsons 1997 supermarket sales were 20 percent less, but profits were about 50 percent greater than American Stores supermarket divisions. At the time of the deal, American operated a variety of formats, including 283 combo, 524 supermarkets, and 773 stand-alone drug stores. The combined company had sales of \$28.9 billion, with 1,690 supermarkets and about 1,000 other stores. Subsequently, Albertsons bought Shaw's and Star Markets (total 200 stores) of New England in 2004, for the very high price of \$2.5 billion.

Post-acquisition, the Jewel and Acme brands were retained (as were Shaw's and Star Market), while Lucky's was converted to Albertsons. Lucky's was seen as the weakest of the chains; it also was the only one of the three American Stores brands that had significant market overlap with Albertsons.

Historically, American Stores had been among the most decentralized of major chains, but just prior to acquisition had undertaken a centralized buying system and common IT platforms across its regional brands. In particular, American Stores drug chains (Sav-On and Osco) had a reputation for good IT and pharmacy systems. However, Albertsons replaced the newly installed American Stores IT system with its own centralized system. This created management and staff discontent at Lucky's and spurred a significant decline in sales. Also, Albertsons decided that the freestanding drug store IT systems couldn't be used in supermarket pharmacies, and so replaced American Stores' in-store pharmacy systems with their own systems.

Major disruptions due to system incompatibility resulted, while only very small purchasing, merchandising, and

logistics synergies were achieved. Also, this result led to uncertainty across the other acquired chains, as Acme, Jewel, Shaw's, and Star Market staff began to wonder, "Are we next?"

These IT problems led to other issues of centralized control versus autonomy for operating divisions, and the entire company struggled to bring overall performance up to that of best units (Jewel-Osco, the drug stores, and Shaw's).

COMPETITORS REACTED QUICKLY AND STRONGLY TO ALBERTSONS' PROBLEMS—PARTICULARLY VALUE PLAYERS IN EACH MARKET.

Continuing issues with Albertsons adopting a "we bought you" approach rather than adopting best practices, led to the board bringing in Larry Johnston from GE as CEO, expressly to straighten out merger integration. Johnston had consolidated GE's European Medical Systems businesses into a single unit. At Albertsons, he cut costs, pulled out of some markets, and closed stores. He also ordered major cuts in capital investment in stores, especially in renovations and upgrades.

Albertsons added to its problems with the purchase of nonunion Bristol Farms (an 11 store, high-end California chain) in 2004 for \$137 million. This small deal was problematic because Albertsons had just faced a 4 1/2-month strike in California in 2004 at former Lucky's stores over union wages and benefits.

Competitors reacted quickly and strongly to Albertsons' problems—particularly value players in each market. Albertsons responded that competitors should be held accountable for the "creation of irrational pricing environments," as indicated by the following letter in reply to a shareholder in 2000:

Dear Albertsons:

A year ago I bought stock in your company. Now my investment has lost half its value. What gives?

Dear Shareholder:

We mishandled the conversion of Lucky stores into

Albertsons supermarkets, failed to keep a lid on expenses in general and were forced to match competitors' low prices. The first problem is over, we'll fix the second and we'll ride out the third. Here's a coupon for a free gallon of Lady Lee milk—enjoy!

Overall, Albertsons' acquisition of American Stores was an attempt to build mass to compete with Wal-Mart, as well as to "keep up" with other supermarkets mergers. What was missing was an overall strategy: no clear-cut idea of what its tactically and geographically diverse divisions stand for in the marketplace and how they interact with each other. In addition, the high prices paid led Albertsons to try to impose cuts and consolidation to achieve financial targets, while store and customer experience was worsening.

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After six years of integration efforts, Albertsons was put up for auction in fall 2005. The entire company was sold for \$17.4 billion in December 2005, structured as \$11.1 billion in cash and the assumption of \$6.3 billion in debt. In total, the acquisitions had cost \$14.4 billion, and Albertsons had been valued at close to \$10 billion prior to the deals.

Kroger's Acquisition of Fred Meyer

In 1999, Midwest-based Kroger was the largest supermarket operator in the United States, with about 1,400 stores and \$30 billion in sales. The company operated on a regional structure with centralized operations. Kroger has always followed a high/low strategy with higher than average prices. It had become the most significant private label supermarket in the country, with three tiers of corporate brand and about 60 percent of own brand being produced in-house.

Fred Meyer was a northwest U.S.-based grocer that evolved into a multi-department store, with 45-50 per-

cent nonfood offer. The stores held everything from electronics to home goods to apparel. A typical Fred Meyer store was 150,000 square feet, with 225,000 SKUs, and an average investment of U.S. \$24.5 million per store. In addition, the company had sizable convenience and jewelry divisions, and had previously acquired supermarkets in California and the west.

Kroger acquired Fred Meyer for U.S. \$13 billion in 1999, representing a 30 percent premium. The combined entity had 2,200 supermarkets, 800 convenience stores, and 400 jewelry shops. The companies reportedly expected \$380 million one-off synergy, then \$225 million annually in cost savings, mostly from manufacturing, distribution, and administration. In particular, it was believed that Kroger private label could help Fred Meyer, while Fred Meyer's nonfood expertise were expected to improve Kroger's super centers.

However, only about one-half of the synergies were realized. Fred Meyer's nonfood offer proved only of limited value in the standard 50,000 square foot supermarket format. The most significant benefit came from the introduction of Kroger private label products into Fred Meyer stores.

More recently, the development of "Marketplace Stores" has provided the combination of Fred Meyer nonfood with Kroger food, bringing sharper assortments and distribution savings. Reports of revenue growth from this new format have been promising, but it has taken much longer than anticipated for the two companies to learn to work together.

Safeway's Acquisitions of Dominick's, Randalls, and Genuardi's

In 1998, Safeway was the second largest grocer in United States, with 1,378 stores and sales of \$26.5 billion. By the 1990s, the company had worked through the restructuring of its leveraged buyout and was again seeking growth opportunities. Safeway had a long history of making smaller acquisitions, which were uniformly converted to Safeway formats, systems, and operations.

In 1998, Safeway paid \$1.8 billion for Dominick's in Chicago, followed by similar acquisitions of Randalls in Houston and Genuardi's in Philadelphia. Dominick's was one of two largest grocers in the Chicago metro area

with nearly \$3 billion in 1998 sales from 112 stores. The company was known for its product variety and fresh offerings, as well as its historically amiable relationship with the unions.

Safeway tried to adapt its prior acquisition model to the acquisition of these stronger regional chains. Brand identities were retained, but procurement was centralized. Perhaps most importantly, Safeway took a very aggressive stance with the unions over contract issues. The unions resisted in Chicago, and Dominick's CEO quit as a result. In response, Safeway replaced the rest of the management team and reverted to its old model. Safeway tried to recover costs quickly by cutting staff and by replacing familiar local brands with Safeway house labels. Consumers rebelled against these changes, and revenues declined. A similar pattern and similar results occurred with Randalls and Genuardi's. Safeway tried (unsuccessfully) to sell Dominick's in 2003, and was forced to write off the value of Dominick's to \$315 million, a decline of more than \$1.5 billion.

Food Lion's Acquisition of Hannaford Brothers

Food Lion was a Southeast-based regional player known for everyday low prices, basic stores, and strengths in marketing, real estate development, and cost containment. It was believed to have the lowest per store breakeven among major grocers, following a low-cost, lower-margin, higher-volume strategy. Majority owned by Delhaize Group of Belgium, it had sales \$10.2 billion and 1,258 stores in 1998.

Food Lion bought Hannaford Brothers for U.S. \$3.3 billion cash and stock in 1999 (again a significant premium). Hannaford Brothers was a northeast U.S.-based wholesaler that had become a retail grocer. It was perceived that the company had particular expertise in general merchandising, in-store services, and category management. Sales were \$3.3 billion with 152 stores.

The combined entity had 1,400 supermarkets and sales of \$13.5 billion. The combination was expected to achieve \$40 million in one-off synergy, and then \$75 million annually in cost savings. The main costs savings were anticipated from synergies in private label assortments, and sharing best practices in shrink reduction, procurement, administration, and IT.

In addition, Food Lion created a new holding company, Delhaize America. Food Lion, Hannaford, and Kash n' Karry became subsidiaries and were operated quite separately. The holding company was set up to make it easier to bring additional chains into the group. The basic approach was to keep the brands and substantial autonomy with operations and management, thus positioning the company as a multiregional, multibrand player. By 2003, only limited synergies had been achieved, and the different brands had varied performance. Hannaford continued to perform well, while Food Lion and Kash n' Karry faced increasing pressure from Wal-Mart and other low-price and low-cost operators.

Wal-Mart's Acquisition of ASDA

ASDA was the second largest grocer in Britain, with a 17 percent market share. ASDA had 259 stores and 19 ASDA Depots, mostly in northern England and Scotland. The company had a reputation as cheaper than Tesco or Sainsbury, and had copied Wal-Mart's EDLP & Rollback campaigns after a 1994 visit to Wal-Mart by managing director Archie Norman.

THE COMPANY'S APPROACH HAS BEEN TO DIFFERENTIATE BETWEEN GOOD PERFORMERS (IN WHICH WAL-MART IS BUYING BUSINESSES) AND POOR PERFORMERS (IN WHICH WAL-MART IS BUYING REAL ESTATE AND MARKET ACCESS).

Looking to grow internationally, Wal-Mart acquired ASDA in 1999 for \$10.8 billion. Unlike its acquisitions in Canada, Mexico, and Germany, Wal-Mart retained the ASDA name and management. This approach was in line with the fact that Wal-Mart did not have a uniform acquisition philosophy. The company's approach has been to differentiate between good performers (in which Wal-Mart is buying businesses) and poor performers (in which Wal-Mart is buying real estate and market access).

Post-acquisition, ASDA began a super center format, which has not proven as successful as hoped (due to slowing sales growth). Recent initiatives have included efforts to develop the ASDA Fresh small format (25,000 square feet), and a major effort to introduce Wal-Mart's

“Smart Price” line of 400 products at the value price point. Synergies have been significant, with ASDA’s nonfood lines up from 7,000 to 12,000, of which 8,000 are jointly sourced with Wal-Mart. Sales growth in non-food was up 25 percent from the pre-acquisition period.

In addition, Wal-Mart attempted to learn from ASDA as well. Some of ASDA’s approaches to management recruitment and development were adopted, and Wal-Mart tried to learn more about ASDA’s seemingly friendlier, interactive work environment. Overall, ASDA believed they were contributing to improving the performance of their parent company as well.

Major Lessons to Be Learned

1. Match Your Approach to the Type of Acquisition

There appear to be two basic approaches to supermarket acquisitions. The first, full centralized integration is likely to spur culture clashes, and is most likely to work when acquirer is much larger, and the acquisition has limited systems and weaker performance.

A second approach is decentralized divisional structure and autonomy. The challenge here is that acquired companies are more likely to be well run, so high acquisition premiums make it harder to achieve financial returns. In contrast, this “hands-off” model is very risky if acquired supermarkets are underperforming, because they may tend to drag down the combined company. In these cases, the challenge is to improve operational efficiency (the triangle), while preserving the customer and team member environment (the pentagon).

2. Understand Alignment and Differences

When assessing a prospective deal, it is very useful to compare pentagons to see where each company “wins” and “loses,” across place, product, people, communication, and value. Next, compare triangles: what systems are used? What is the supply chain management story in each company? How decentralized or centralized is each company? How extensive and similar are supplier relationships? The more similar each is, the better the fit will be, and the easier to work together—assuming that the decentralized acquisition model is followed.

3. Systems and Synergies

Most deals focus on cost savings from procurement, distribution, and administration. However, head-office administration’s savings generally have been overestimated. Triangle savings are hard to achieve in practice, given systems incompatibility and mismatches of companies (for example, in the degree of decentralization). It is very difficult to do “best-of-breed” selection across chains, because of linkages across operations. Centralized/decentralized combinations are proving the hardest deals to make work.

4. Customers

Typically, synergies are realized only if sales are maintained or grown. It is very important to monitor customer and associate satisfaction. The recent mergers have experienced very significant same-store sales decreases when these satisfaction measures have worsened post-merger.

Customer perceptions are hardest to manage. Many customers believe prices rose post-acquisition. Moreover, service levels and front-line employee morale has been very important to how customers “see” the acquisition. In addition, mergers have worked best when new store investment and new products (not replacements) are introduced. Customers are very loyal to grocers, so acquirers need to introduce something that customers see as “better,” either in terms of store investment, private label, or service. In addition, many acquisitions have hurt the parent’s stores. In other words, don’t neglect your own customers and staff.

5. Company Associates

Communication is critical especially with store managers at both companies; giving the “we are one company” message is important, but not enough. The acquiring company should quickly explain why the acquisition was done and what expectations and opportunities are perceived. These ideas should be tied to clear metrics and goals (market share, sales growth, new product introductions, etc.).

6. Financial Perspective

Acquisitions are financial transactions. Make sure you “work backwards,” and understand what performance needs to be achieved at the store level, not just in aggregate.

A short-term investor focus doesn't work; synergies are hard to achieve, and it has been common to turn to staff cuts, expense reductions, and price increases to increase returns. However, successful deals have been those that have achieved improved performance through a combination of cost savings, enhanced productivity, AND revenue growth.

7. Culture

For any retail organization, particularly those with different divisions and formats, the people that work there need a guiding philosophy that is consistently implemented. The challenge for senior management is to provide one, or all, of the parts of the company will quickly lose ground to competitors.

8. Know Why

Those grocers contemplating retail mergers and acquisitions should try to answer the question, "What Did You Buy?"

1. A high-performing asset/business?
2. Real estate?
3. Market access?
4. Well-known brand?
5. Management talent?
6. Reduced competitive intensity?
7. Building a castle with moat?
8. Bulk—is bigger better?
9. Me too? (Everybody else is doing it ...)
10. Synergies in operations? In administration?

The answer might be any of the above, but the answers are important guides to how you should approach the process of integrating the combined companies. Maybe, the answer should be determined before the acquisition is made in the first place.

2006–2007 PROGRAM DATES	
<ul style="list-style-type: none"> — Babson, September 9–15, 2006 — William and Mary, April 28–May 4, 2007 — Monash, May 20–25, 2007 — Singapore, June 10–15, 2007 	
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