On special this week: Supermarkets
Canadian Business; Toronto; Dec 24, 1998-Jan 8, 1999; Patricia D'Souza; Sean Silcoff;

Duns: 20-030-0473 Duns: 20-413-7475
Volume: 71
Issue: 21
Start Page: 32-40
ISSN: 00083100
Subject Terms: Grocery stores
Consolidation
Competition
Industrywide conditions
Grocery stores
Consolidation
Competition
Industrywide conditions

Classification Codes: 8390: Retail stores, includes groceries
2330: Acquisitions & mergers
9172: Canada

Geographic Names: Canada
Companies: IGA Inc
Sobeys Stores Ltd Duns: 20-030-0473
Loblaw Cos Ltd Duns: 20-413-7475
IGA Inc
Sobeys Inc
Loblaw Cos Ltd

Abstract:
Despite razor-thin margins and daunting odds, the grocery business has never been more popular. Indeed, the hottest selling item in North America these days is whole grocery chains. In one of the most daring corporate deals of the year, the Sobeys family announced in November that it had locked up control of the Oshawa Group Ltd., owner of the IGA and Price Chopper chains, and the second-largest grocer in Canada. The Sobeys' offer had barely hit the press in late October when Loblaw Cos. Ltd., the country's largest grocer, struck back with a $1.6 billion takeover bid for Provigo Inc., the largest grocery chain in Quebec. The feeding frenzy among grocers is the direct result of the industry's slender margins. The mathematics of the grocery business argue strongly for consolidation. The implications of this consolidation drive are massive: shoppers can expect to be greeted over the next couple of years with cleaner and brighter stores as the conquering companies pour hundreds of millions of dollars into their newly acquired locations.

Full Text:
Copyright CB Media Ltd Dec 24, 1998-Jan 8, 1999

Grocery chains are feasting on a new delicacy—each other. But as Sobeys and Loblaw bulk up with new acquisitions,

an even bigger competitor is ready to challenge them both.

Survival in the grocery industry means giving customers what they want, and customers at Sun Valley Fine Foods, a family-run store in Toronto, want pasta. To make sure they get the kind of pasta they desire, Spiro Aravantinos, the store’s general manager, stocks more than 80 different kinds, from fresh pasta delivered daily to couscous imported from the Middle East.

Then things get complicated. Conventional grocery theory says that you put all the pasta together on one shelf so people know where it is. But Aravantinos knows that’s not the way people shop. That’s why when you walk into Sun Valley, you’ll see an inviting salad bar in the center of the store, filled with pasta salads. You’ll find fresh pasta in a refrigerated case near the produce section and dried pasta in bags in the aisles—which is also where you’ll find a range of pasta sauces. “You don’t want to just throw it on the shelf,” Aravantinos says. “You have to give it more of a distinctive feature so your customer will notice it.”

Grocers live or die by paying attention to such minuscule details. In the penny-pinching struggle to win over fickle food shoppers, a superstar grocer is one who succeeds in extracting a 3% profit on sales—or a mere 5C on the average bag of pasta. A grocer’s razor-thin margins often run between 1% and 2%, and leave little room for a bad decision. A store’s profits for an entire week might hinge on whether it advertised the lowest price on beef in that Wednesday’s newspaper flyer.

You would think that competitors would want out of such a cut-throat business. Yet despite the daunting odds, the grocery business has never been more popular. Indeed, the hottest-selling item in North America these days is whole grocery chains. In one of the most daring corporate deals of the year, the Sobeys family of Stellarton, NS, announced in November that it had locked up control of the Oshawa
Group Ltd., owner of the IGA and Price Chopper chains, and the second largest grocer in Canada. With that bold move, the Sobeys tripled the size of their empire. Overnight their family-owned regional firm vaulted into position as a national retailing force with combined sales of about $10 billion a year.

The Sobeys' offer had barely hit the press in late October when Loblaw Cos. Ltd., the country's largest grocer, struck back with a $1.6-billion takeover bid for Provigo Inc., the largest grocery chain in Quebec. The acquisition will boost Loblaw's annual revenue past the $16-billion mark. The giant food merchant is already slavering for more.

Who else is on the menu? Just about everyone. Officials at both Quebec's Metro-Richelieu Inc. and BC-based Overwaitea Foods Ltd. are dropping huge hints that their operations may soon be snapped up by their bigger competitors, while California-based Safeway Inc. — already a major player in western Canada — says it's sniffing around for a few good stores. Meanwhile, every company from New Jersey's Great Atlantic and Pacific Tea Co. (A&P) to France's Carrefour SA is rumored to be kicking the tires on grocery carts across the country.

The feeding frenzy among grocers is the direct result of the industry's slender margins. Sure, a grocery store may make only a penny or two for every dollar of groceries it sells. But consider what a tiny improvement in efficiency means to the bottom line: if you can raise your profit margin from a penny per dollar to a penny and a half, you've boosted your earnings by 50%. The mathematics of the grocery business argue strongly for consolidation. If grocers can spread their costs over more stores, they can squeeze out tiny economies of scale that in total add up to millions of dollars in extra profit.

The implications of this consolidation drive are massive: shoppers can expect to be greeted over the next couple of years with cleaner and brighter stores as the conquering companies pour hundreds of millions of dollars into their newly acquired locations. Prices are expected to drop as the new grocery giants fight each other and join forces against super discount warehouse clubs like Costco Cos. Inc., which sells billions of dollars in groceries each year.

Yet while consumers may benefit from bare-knuckles competition, some people are going to be hurt. If Loblaw does gain entry into Quebec, its muscular presence will almost certainly wreak havoc among the province's independent grocers, who are unused to vigorous competition. Across the country, both Loblaw and the newly expanded Sobeys' chain are likely to flex their unprecedented buying power to extract millions of dollars in concession from manufacturers. Any supplier whose products aren't No. 1 or No. 2 in a category could find their offerings squeezed off shelves altogether. "It certainly means that it's going to be tougher for smaller companies that don't have national name brands," says George Fleischmann, president and CEO of the Food and Consumer Products Manufacturers of Canada. "Any company — whether it's Canadian or multinational — that doesn't have a large share could be in trouble."

The new mega-grocers may feel the pinch of competition themselves. Loblaw, for instance, may find that it's far tougher to make headway against the hard-driving Sobeys clan than the lacklustre former management of the Oshawa Group. Yet the Sobeys, for their part, still have to prove they're ready for the national stage. With their bold play for Oshawa, the East Coast family has left at least some observers wondering whether they've filled their cart too high. Is Sobeys Canada Inc. saddling itself with too much debt to pay for the acquisition? Can a small, tightly controlled, regionally focused operator turn around a sprawling, loosely controlled, problem-plagued giant like Oshawa? The future shape of the Canadian grocery industry will hinge on whether the Sobeys can make their huge acquisition pay off.

Blink your eyes while driving down the highway to Stellarton, NS, and it's easy to miss the tiny town of

5,200 people. Nestled in the haunting, remote northern highlands of mainland Nova Scotia, Stellarton is best known as the next-door neighbor of Westray, the doomed coal mine where 26 miners lost their lives in an underground explosion six years ago. But it is also here that Canadian business legend Frank Hoyse Sobey began building his Maritime dynasty back in 1924, when the young man convinced his father, a butcher, to add vegetables, dairy products and tinned goods to his shop. By the time of his death in 1985, Frank Sobey had made his family's name a synonym for food store throughout the Atlantic provinces. Through Empire Co. Ltd., a family-controlled public holding company, the Sobey's dominate the region's grocery and convenience store business, control most of its major shopping malls and screen more movies at their 100 cinemas than any other exhibitor east of Quebec City.

But the Sobey's magic has deserted them when they have attempted to expand westward. The family first opened stores in Quebec in the '60s, but they have encountered only modest success in that province and in neighboring Ontario. Their attempt to buy the Ottawa-based Loeb supermarket chain in 1977 failed. Almost three years ago the company sold its minority share in Provigo, with little more to show for its efforts than years of stormy relations with Provigo's board of directors.

The family realized about two years ago that it would have to take more drastic action if it wanted to steer its way through the oncoming wave of consolidation. "It became clear to us that we either had to take part in the consolidation process, continue our organic growth by opening new stores or become a consolidatee," says 41-year-old Paul Sobey, a grandson of Frank Sobey, who stepped into the CEO's role at Empire earlier this year.

The company set its sights on a big target: the Oshawa Group, the flabby, underachieving giant of the Canadian grocery industry. Despite being the second-largest grocer in the country, Oshawa has suffered from a long-term deficiency in muscle, definition and ambition. It has overseen a clutch of regional grocery chains, but, until recently, it has made little effort to combine those disparate fiefdoms into a unified empire.

As the Sobey's looked over the Oshawa Group in late 1997, they saw a firm badly in need of a guiding hand. The company's overhead costs were running far higher than its competitors', many of its stores desperately needed renovation, and it was losing market share and money in the rich but fiercely competitive Ontario market. The Wolfe family, which owned only a small portion of the company's equity but 100% of its voting control, seemed reluctant to make hard choices.

"Decisions didn't get made," says one analyst. "It was more like, 'Let's have a meeting to decide when we meet again.' If you never go up to bat, you never strike out but you never hit a home run. I guess they didn't want to strike out."

Behind all the problems, though, the Oshawa Group was a tempting renovation project. The sprawling chain had the lowest EBITDA (earnings before interest, tax, depreciation and amortization) in the industry. If new management could merely bring Oshawa's abysmal 0.9% profit margin up to the industry average of 1.6%, it could add $43 million in profit. If management could transform Oshawa into an above-average performer, the upside was even higher.

The Sobey's timing was perfect. Oshawa had just begun a long overdue effort to streamline operations when chief operating officer Jonathan Wolfe abruptly quit this past summer after he was passed over for the CEO job. His resignation turned into a bitter public spat and revealed the depth of dissension within the firm. For years, the Wolfe family had resisted any attempt to break their strangle hold on the company's voting shares. Now the Sobey's figured they might be more receptive to a takeover bid.
The East Coast clan dispatched their financial advisers to tell the Wolfe's lawyer they wanted to do a family-to-family deal. The Wolfe's played hard to get, turning down one proposal to negotiate, then rejecting an offer of $70 for each of their 685,000 voting shares. But when the Sobeys jacked up their offer by an astonishing $46 a share, the Wolfe's yielded and tendered their shares to the rich takeover bid.

At tremendous cost, the Sobeys have succeeded in forging a new retailing giant. They are now forming a new company, Sobeys Canada Inc., to take control of the Oshawa assets as well as Sobeys' own grocery division. The firm plans to raise $380 million in a public offering. The Sobeys will be left with 62% ownership of the new company, a stake that gives the family a free hand to do what it wants with the merged operation.

Much of the responsibility for making the merger work will fall to Doug Stewart, who runs the existing Sobeys grocery chain. He will be CEO of the new company, and he is already salivating at the prospect of cutting fat from the combined operations. A former regional president at Oshawa, he is intimately familiar with both his old and new employer, and he estimates he can save $70 million a year by trimming duplication and waste. "Our goal is to be the most profitable grocer in Canada," says his boss Paul Sobey. "That will benefit all our constituents—our employees, our shareholders and our customers."

Yet for all the brave talk, the Sobeys are taking on a bushel of problems. They must continue to restructure Oshawa and overhaul its antiquated distribution system. They must also deal with a fragmented and sometimes chaotic network of regional chains, including IGA, Price Chopper, Knechtel, Tradition Market Fresh Foods and Omni. "We're going to take the best vehicles [including the Sobeys banner] and continually grow each element of those businesses going forward," says Sobey. "We're going to grow all of them. That's the objective here." Among other potential headaches, Sobeys Canada inherits a huge network of 587 independent franchisees from Oshawa where are only 116 such stores in the Sobeys chain. Even a task as seemingly straightforward as combining the two companies' private-label programs will require tactful negotiations between the old and new members of the organization.

Then there are the labor questions. The Maritime company has always detested unions, and it has gone to spectacular lengths to fight unionization drives in its Quebec and Ontario stores. One such drive, in Baie-Comeau, Que., lasted four years and cost the organizer, the Quebec Federation du commerce, more than $1 million in legal fees before it won certification. There were only 11 unionized stores and warehouses in the previous Sobeys empire, but, with the Oshawa purchase, the Sobeys have added at least 150 unionized union shops to the mix. Investors have to wonder whether Sobeys management will be engulfed in labor problems. "They don't know how to manage a union store," says Jean Lortie, president of the Federation du commerce, which represents 28,000 unionized workers in Quebec. "They are very panicked by that."

Plus, the merged grocery chain won't have extra money to throw around. Sobeys Canada starts life as a publicly traded company saddled with $1 billion in debt, much of it accumulated to pay for the Oshawa takeover.

The biggest question of all is how Sobeys will fare against Loblaw, the 900-pound gorilla of Canadian grocery retailing. Outside of its Maritime stronghold, Sobeys will be the No. 3 competitor or worse in just about every market. And Loblaw, despite its No. billing, shows no signs of taking it easy. The company runs the tightest, most efficient food distribution system in the country, and its sales have grown by a compounded rate of 6.5% a year since 1990, more than double the industry average. The Provigo takeover, should it succeed, will make Loblaw even bigger and more commanding. David Schroeder, an analyst with Dominion Bond Rating Service, says the Sobeys "are going to be in a weakened position and a worsened competitive position in the future. They've got a lot of challenges."

Loblaw is taking the battle to Sobeys' home turf. Earlier this fall, it struck a deal with Oshawa's management to buy the company's troubled 140-store Atlantic division much to the chagrin of the Sobeys, who found out about the deal only after making their offer to the Wolses. The purchase boosts Loblaw's market share in the Maritimes to 38%, just shy of Sobeys' 43%. "While the region isn't a big profit producer for Loblaw, it is for Sobeys," says Perry Caicco, a retailing analyst with investment firm First Marathon Securities Ltd. in Toronto. "[In the highly unlikely event that] Sobeys ever gets Loblaw mad by staging a price war in Toronto, Loblaw could drop the price of milk in the Maritimes to pennies and make the Sobeys bleed. They've got the market share to do it."

Are the Sobeys making a big mistake? The truth is, they have little choice. As Paul Sobey notes, the rapidly consolidating world of the grocery business means that mid-sized chains have to either bulk up or exit the industry. In fact, in the not too distant future, both the newly enlarged Sobeys and the already huge Loblaw are likely to find themselves up against an even bigger competitor. Wal-Mart Stores Inc., the Arkansas-based Gargantua, is expected to introduce full grocery departments to its Canadian stores as it has done with resounding success in the US. When Wal-Mart does start selling pasta and vegetables, its economies of scale will dwarf anything that Canadian chains can offer.

In this battle of the food giants, size will be a given. What isn't so clear is who will be the most adept at reading shoppers' minds. Sobeys will have to hope that its rembleness and attention to detail can make it the equal of its bigger competitors.

If the chain is looking for direction, it should talk to Spiro Arvanitinos. The manager of Sun Valley Foods in Toronto is nonchalant about the arrival of the Sobeys, whose presence will be felt at the IGA store just one block east of his 7,000-sq.-ft. location on Danforth Avenue. He's not worried about the new kids on the block. "I've managed to cram everything in here you can get in bigger stores," he says. "I cater to the people who don't want to shop in the big stores. They'd rather have more personal service from a family-run business." Ultimately the battle for the food dollar won't be run by comparing revenue figures or balance sheets. It will come down to who runs the best pasta counter.

Reproduced with permission of the copyright owner. Further reproduction or distribution is prohibited without permission.