SUPERMARKETS AT A CROSSROADS

Two avenues to growth: Upscale and discount

BY BRANNON BOSWELL AND STEVE MCLINDEN

To truly comprehend where the traditional supermarket stands on its 75th anniversary, visit Bristol Farms and Super Saver, two very different concepts owned by the No. 2 U.S. supermarket chain, Boise, Idaho-based Albertsons. A trip to the Beverly West Bristol Farms store in Los Angeles can easily become a half-day event, but not because of long lines or slow service. Even the most purposeful of shoppers will tend to get sidetracked here by the store’s eclectic array of merchandise and services.

Inside, Bristol Farms offers a floral boutique that sells orchids flown in from Singapore. And in addition to a dizzying variety of fresh and packaged foods, shoppers who shun the do-it-yourself approach to gourmet entertaining can order freshly prepared take-home cuisine, including coq au vin ($9.49 a pound) and seafood Florentine ($9.99 a pound). Profit margins are so high here that it doesn’t matter if some of the merchandise moves a bit slowly.

Meanwhile, about 1,800 miles away, in Baton Rouge, La., the Super Saver store on Airline Highway presents a very different side of the supermarket business. Customers who shop here are tackling a task quickly and cheaply. Super Saver has few frills to slow them down. The store only carries about 18,000 different items, compared with the 40,000 in a typical supermarket. Prices here are 10 to 20 percent cheaper than the average supermarket.

Most of the goods in Super Saver’s bakery and deli sections are prepackaged, and little is offered in those departments by way of service. Shoppers even bag their own groceries, and excess merchandise is stacked on top of shelves, warehouse-style. By trimming every last nickel, the store is generating enough traffic and volume to offset the products’ razor-thin profit margins.

These two retailers have little in common other than the fact they both sell food. But now they are siblings. Albertsons created Extreme, an autonomous subsidiary that will operate the Super Saver store portfolio, in April of last year. Then, last summer, Albertsons bought the 11-store Bristol Farms.

It is all part of the company’s strategy to trifurcate its business in key markets into “high, middle and low” concepts, with Bristol Farms, Albertsons and Super Saver stores, respectively, as the flagship banners.

“The three banners will each have a small percentage of national brands in common,” said CFO Felicia Thornton at a Banc of America investor conference in March. The bulk of the merchandise will be unique to each concept, though, she said.

Adapt, or suck air

This is a model that more supermarkets should emulate, experts say, because the middle is an increasingly tough place to be in the food business. “Everybody is running to ethnic service or healthy-food formats or other specialties, and there’s just no middle anymore,” said Doug Wiele, a principal of...
El Dorado Hills, Calif.-based Foothill Partners, which owns and develops grocery-anchored centers. "Conventional grocers are either going to change or they're going to be sucking air."

For decades, "everybody has to eat" has been the maxim behind the appetite for and the value of U.S. grocery-anchored shopping centers as investments. But tectonic shifts lie ahead for the food retail sector, say real estate investors. Today's supermarkets are finding that consumers, though still eating, to be sure, are getting their groceries from a variety of sources, including discount boxes and fresh markets.

With the economic middle offering fewer and fewer growth opportunities, national names are using separate store concepts for commodity goods that sell at high volume (à la Wal-Mart) and premium-quality, high-margin goods that sell at high prices (à la Bristol Farms).

"These businesses can't maintain the status quo," said William Gerrity, president of San Diego-based GMS Realty, which owns about 6.5 million square feet of grocery-anchored centers. "Clearly, they have a place in the market, but they have to shift."

Observers predict that a shakeout like the one among cinema chains in the late 1990s will hit the grocery sector within 10 years as nationals slough off unprofitable stores, wriggle out of operating covenants and get focused.

For now, landlords are watching carefully as supermarkets strive to just get relevant. Whether they succeed or not could change the DNA of the neighborhood shopping center.

**Food for thought**

Albertsons and rivals Kroger Co. and Safeway are the last of the huge national supermarket chains. When the dust from a decade-long consolidation frenzy settled, around 1997, these three were the last ones standing, having gobbled up about $60 billion worth of smaller competitors over the years. With strong national supply chains, brands and locations, they were poised to compete with Wal-Mart.

Or were they? In their haste to swallow up competitors and please Wall Street, major supermarkets lost sight of their core business, says Willard R. Bishop Jr., president of Barrington, Ill.-based Willard Bishop Consulting.

Now "the supermarket's customers are being intercepted," said Bishop, "and those companies have to take a hard look to determine if those traditional customer sources are going to be there for them in the future."

The prognosis is not promising. Traditional supermarkets have seen their share of the $850 billion-plus U.S. food market fall from 60 percent to 40 percent since 1994. In the meantime, alternative, discount-oriented retailers have expanded their market share from only 24 percent in 1999 to 35 percent today. The discount segment alone could grow to as much as 45 percent of the market by 2010, according to research by CIBC World Markets. Dollar stores are not far behind. Dollar General is even testing a 16,000-square-foot concept that is one-third food.

To be sure, the prolific expansion plans of Wal-Mart alone (a planned 55 million square feet this year) dwarf the collective plans of the national supermarkets. But the Supercenter machine is not the food retailing be-all, end-all it may seem to be — not just yet. According to an ACNielsen survey, the typical U.S. shopper makes about 70 trips a year to a grocery store, 26 to a supercenter such as Wal-Mart, 15 to a drugstore, 13 to a dollar store and 11 to a warehouse club.

"As a regional chain, we're alarmed to see Wal-Mart moving quickly into our markets," said Shelly Sponholz, senior vice president of asset management and development at Pittsburgh-based Giant Eagle, which operates 200 grocery stores in the Northeast.

During a year-end conference call, Kroger CEO David Dillon said Wal-Mart clobbered his company in...
three markets: Augusta, Ga., Riverside, Calif., and San Diego. The reason, he said, was Kroger’s failure to follow Wal-Mart’s openings of two Supercenters a piece in each of those markets with stores of its own.

All is not lost for chain supermarkets, though. Collectively, they remain the country’s food basket. Even in Northern California, where national grocers are battling discounters and well-capitalized specialty independents, there are very few dark grocery-anchor sites, says Wiele, adding that good real estate will always attract good food stores.

He is not the only one who thinks so.

“A lot of people have overreacted to Wal-Mart, which is understandable,” said Mary Lou Fiala, president and COO of Regency Centers Corp., one of the largest U.S. owners of grocery-anchored centers. “They do appeal to a certain type of customer. But there’s also a certain type of customer who wants to go to a neighborhood shopping center. Consumers of any age just want to know they’re getting good value, whether that’s the lowest price at a discounter or the best possible product elsewhere.”

**Be like the niche players**

At the other end of the spectrum, upscale niche players are on the advance. The likes of HEB, Trader Joe’s, Wegmans and Whole Foods have turned grocery-getting into a social event.

In fact, the mainstream 60,000-square-foot supermarket format may well be on the way out, says David J. Livingston, managing partner of Pewaukee,Wis.-based retail consulting firm DJL Research. He also says he is not sure the managers of the chains believe that, though. “MBAs and accountants with no grocery experience usually run these large public companies, and their first priority is stockholders and stock prices,” he said. “But it’s hard to run a grocery business if you’re not a grocer yourself.” Further, he said, “if you look at the landscape now and what segment has grown, it is 25,000 to 30,000 square feet — Trader Joe’s or Gelson’s in California, which tells you some consumers are willing to take less choice in exchange for higher quality and specialty items.”

Save-A-Lot stores offer shoppers prices that are almost as low as Wal-Mart’s.

The trick for supermarkets will be to re-evaluate each site and then determine which type of store is most appropriate to the trade demographics, sources say. "Supermarkets need to better understand consumer wants and needs in specific trade areas," said Kevin Holland, director of Texas acquisitions at Equity One, one of the largest owners of grocery-anchored shopping centers in the U.S. "But that’s tough to accomplish when you have several layers of bureaucracy to work through."

Indeed, the supermarket industry suffers as much from a lack of vision as from competitive pressures, Holland says. "There was a publicly owned grocer who recently built in a Florida neighborhood that was 99 percent Jewish," he said. "They put in one aisle of kosher products and thought they were thinking in Northern California, where national grocers are battling discounters and well-capitalized specialty independents, there are very few dark grocery-anchor sites, says Wiele, adding that good real estate will always attract good food stores.

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None of this is lost on the supermarkets. Several others besides Albertsons are testing hybrid concepts, adding new merchandise and rejiggering store layouts.

Kroger’s 105,000-square-foot test store in Anderson Township just east of its Cincinnati home office features a Nature’s Market whole-foods section, expanded frozen and dairy offerings, an enhanced international department, plus jewelry and many other non-grocery items. Kroger’s new Fresh Fare stores, which are as small as 25,000 square feet, feature more organic and prepared foods.

Get a lifestyle
And Safeway’s Lifestyle concept, which the chain expanded zealously last year, features larger delis, more organic foods and ready-to-eat meals, warmer color schemes and upscale wines. The chain now has more than 150 such lifestyle locales and says it plans to convert an additional 300 of its 1,800 existing stores to this format by year-end. Lifestyle stores are currently earning a 23 percent return on investment, higher than any traditional Safeway remodel, CEO Steve Burd said during a year-end-earnings call.

Just last month Burd announced a $100 million marketing campaign for the company’s Safeway, Pavilion and Vons banners that is to be the largest in its 80-year history. The campaign, including national TV spots, will promote these stores as a stylish alternative to discounters, Burd says.

Food Lion, meanwhile, is growing a lifestyle format of its own. Its pilot Bloom concept (story, ‘Echo boomers’ next big demographic for grocers), which includes personal scanners, information kiosks and such convenience goods as milk, bread and other everyday items up front, is being tested at five stores in Charlotte, N.C.

The regional chains aren’t blinking either. Wegmans, a highly regarded Northeast chain that topped Fortune magazine’s list of the 100 best companies to work for this year, features a French Pastry Shop, a Market Café and daily cooking demos in the 125,000-square-foot prototype it opened early this year in Fairfax, Va.

In Indiana, Marsh Supermarkets has introduced stores with a circular layout that features a central café surrounded by European-style market items. Texas-based HEB (story, HEB in Texas: A benchmark for market domination), which boasts multiple store formats and neighborhood-customized products, rolled out a 161,000-square-foot HEB Plus store in Corpus Christi, Texas, complete with sushi bar, music and entertainment sections, and other retail departments.

To compete on the value end of the business, supermarkets need to do more than merely mimic Wal-Mart by slashing prices at their traditional stores, experts say, though many grocers are attempting just that.

“We’re engaging in a variety of cost-cutting measures,” said Giant Eagle’s Sponholz. “In the past, we passed along cost savings to our shareholders. Now it’s imperative that the savings go to the consumer.”

Kroger competes with more Wal-Mart Supercenters on a store-by-store basis than any other grocery chain, and the retailer is determined to bridge the 15-20 percent price gap between its merchandise and Wal-Mart’s, says Kroger’s director of real estate, Terry Evans. Albertsons has identified a tranche of everyday merchandise items to which it is trying to establish everyday “low” prices. But depending on the market and competitive environment, these prices may differ from one city to another, says Thornton.

Trying to duplicate Wal-Mart’s phenomenal supply-chain economy in a traditional supermarket, however, is unrealistic at this point, observers say. What grocers can do to compete with Wal-Mart is infuse some value, real or perceived, to the traditionally priced merchandise at their regular
supermarkets, says Kathleen Wong, an analyst at CIBC World Markets.

Private-label goods are one tool that supermarkets are using to set themselves apart from the competition. Albertsons says it increased the contribution of its private-label goods to overall sales by 34 basis points in the fourth quarter. Kroger says it has introduced more than 765 new private-label items to its merchandise mix, an increase of 32 percent. Kroger also says blind taste tests show that shoppers prefer its private-label foods to the national brands.

An even more successful strategy, says Wong, is to develop one’s own discount concept, as Albertsons is doing with the Extreme division. To date, Extreme has converted nine unprofitable Albertsons stores into Super Savers. The company says it is thrilled with the sales results and will continue to open Super Saver stores throughout the year, not all of which will be in former Albertsons units.

Speaking of real estate
As much as landlords want their supermarket tenants to succeed, they are also partially responsible for some of the woes, experts say. In many instances, grocers put themselves behind the eight ball years ago by locking into long-term leases that will continue to be nonperforming assets long after they close, while others remain tied to continuous-operations clauses that prevent them from going dark if they need to.

“They’re paying for a lot of unproductive or nonperforming sites in these ways,” said Alan C. Clifton, director of leasing and disposition at Irvine, Calif.-based Passco Real Estate Enterprises, which owns grocery-anchored properties in the Western U.S.

The only way the Big Three will be able to get out of some of these unprofitable stores is to file for bankruptcy, as troubled Southeastern chain Winn-Dixie did in February, say experts. Following the closures of 156 stores last year, the Jacksonville, Fla.-based company's bankruptcy filing may have been less about solvency and more about dumping real estate, some speculate. New Winn-Dixie CEO Peter Lynch, a former Albertsons executive, said future changes could include additional store closings but will incorporate "cost reductions, improving the merchandising and customer service in all locations and generating a sense of excitement in the stores."

Livingston says he thinks 100 conventional supermarket sites will close this year. That will be good news for many landlords, says Gerrity. "Some of these leases are 20 years old in California," he said. "Those leases are at $3 per square foot per year, so there's tremendous upside for the landlord."

Buy your own
Today more grocery retailers insist on owning their own sites, no matter how expensive the property. Kroger, for instance, will own about 80 percent of its new stores, said Evans, at ICSC’s Conference on Open-Air Centers in Phoenix in February. The trend will serve supermarkets in giving them the control over their real estate that they want, sources say.

But like malls and department stores, neighborhood centers are coming to realize that they do not have to depend on grocery anchors to draw traffic. During the recent grocery union strike in California, for example, grocery anchors shut down for extended periods at some of Gerrity’s shopping centers in that state. Despite that, he says, traffic remained steady, and his in-line tenants are apparently enough of a draw on their own. At the same time, more developers are putting up unanchored “convenience centers” in prime locations, and they are finding lenders more willing to back such projects.

Credit tenants such as supermarkets are still the main criteria capital sources look for when approving loans. But if grocery chains' bond ratings slip to junk status, as some predict will happen, landlords will start looking for other kinds of anchors, Gerrity says. "We'll be rethinking the grocery-anchored center," he said. "The collateral for the center is not the grocer. It is the value of the property for retail business."

ICSC will take a critical look at these and other issues in the “Grocery Wars: Shaking the Foundations of our Industry” session on Monday, May 23, at the Spring Convention this month in Las Vegas.