

by Andrew B. Graiser and Thomas E. Scotti

Over the past several years, many lenders have recognized the potential benefits of servicing the retail segment. In response, some have even formed specialty divisions to focus on lending to retailers. Notwithstanding multiple formats, product assortments and pricing strategies, there are enough similarities among retail operations that a lender can apply its experience from one deal to the next, gaining synergies in underwriting, portfolio management and collateral monitoring.

Recently, however, even experienced retail lenders have inquired about the unique aspects of lending to supermarkets. The reason is two-fold. First, supermarkets have historically had above-average credit quality and did not require secured senior-credit facilities, so servicing this sector represents new territory for many lenders. Second, supermarkets *are* different from other retail operations and, as such, must be approached under a new set of assumptions. This article will explore some reasons behind the recent reduction in the sector's credit quality, highlight some of the unique dynamics of the collateral found in the supermarket industry – specifically real estate, intellectual property, inventory and furniture, fixtures and equipment; and touch upon some of the unique legal issues surrounding secured lending to the sector.

Students of the discount-department store segment over the past 20 years will recognize many of the challenges facing today's supermarkets. At one time, regional players dominated the discount-department store space. Ames, Zayres, Bradlees, Caldor, Hills, Venture, Richway, Gold Circle, Shopko and a number of other regional chains were profitable in their respective markets, while both Target and Wal-Mart were considered little more than regional players. Only K-Mart dominated as a true national chain. However, increased competition from the spread of Wal-Mart and Target into new overlapping markets, as well as weakened capital structures caused by either leveraged buyouts or suspect acquisitions, produced a wave of bankruptcies and liquidations. Today, the discount space is dominated by Wal-Mart and Target with only K-Mart and Shopko offering noteworthy competition.

Supermarkets currently face the same pressure. First, Wal-Mart and Target have increasingly incorporated grocery products into their stores. Wal-Mart now has over 1,500 Supercenters across the country—having converted many of their discount stores to this grocery and general merchandise format. Of Target's 1,249 stores, 119 of them are Super Targets, which carry a full grocery assortment.

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Also, Wal-Mart and Target now use multiple-level stores to penetrate metro markets where their standard box would have been too large. As both Target and Wal-Mart grow, they will continue to take market share away from traditional supermarket chains.

At the same time, wholesale clubs, drugstores and dollar stores, which have always competed with parts of the supermarket's product offering, continue to expand their assortments. Walgreen's has increased the size of its new stores to 15,000 square feet and now include 60 linear feet of frozen food. Dollar General's perishable foods program, which includes frozen foods, luncheon meats and dairy, has been expanded to over 2,400 of their locations through the end of last year. By offering a limited assortment at either a value price (typical of the wholesale clubs and dollar stores) or in a convenient shopping venue (drugstores), these formats continue to peck away at the supermarkets' business.

In addition to the sales and margin pressure from other retail formats, supermarkets' costs continue to rise as they face nonunion competition and deal with escalating healthcare expenses. The recent strike in Southern California by union workers at Safeway, Albertsons and Kroger was a result of these chains trying to get their payroll and benefits costs under control. While successful in ending the strike in their favor, the companies went through four months of picketing and business disruption in what was one of the longest strikes in U.S. history.

Lower sales and margins and rising expenses have made supermarkets, in general, less creditworthy on a purely cash-flow basis. In facing these challenges, many are pursuing secured lending facilities where they will have more flexibility to execute their strategic and operational objectives. As with all asset-based loans, lenders need to understand the dynamics and values of the underlying collateral in order to properly structure the facility – and get their money back in a worst-case scenario.

The greatest collateral value in a supermarket chain is most often found in the real estate, typically in the form of undermarket leases. While owned real estate is common in many borrowing structures with asset-based lenders, lease values are typically valuable only in the context of Chapter 11 proceedings. In some instances, however, lenders can make under-market leases part of their borrowing formulas outside of bankruptcy.

Most conventional retail leases have antiassignment clauses. Such clauses state that a retailer holding a lease with sufficient term and an undermarket rent cannot extract the value of it by selling (assigning) it to a third party.

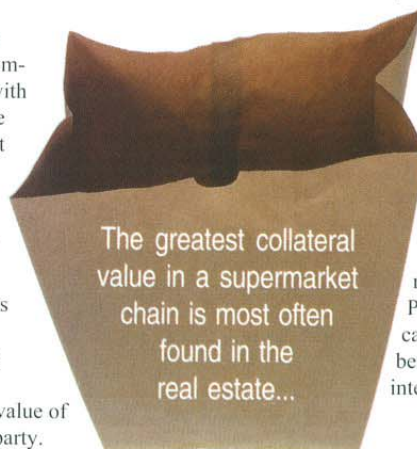
However, under a Chapter 11 scenario, the debtor has the ability to assign contracts and leases, superceding many of the antiassignment clauses in those contracts. In cases where there are long-term leases and rents materially below-market, retailers have assigned those leases to others and extracted value to the estate. DIP (debtor-in-possession) lenders have provided additional liquidity to bankrupt retailers by safely advancing against these values.

However, unlike the bulk of retail leases, many of the older supermarket leases have clauses, which make these leases freely assignable. To the extent the supermarket lease has value, the lender can safely lend against it outside of bankruptcy as long as the transaction is properly documented. Lenders should consult with counsel on any legal matters relating to this issue.

If the current location is considered surplus real estate due to the fact that it is out-positioned in the market by other supermarkets, it may be *valueless*, notwithstanding what one would consider sufficient term and low-rent structure for a nongrocery store user. Any lease analysis of a supermarket location requires an understanding of the local competition, any new competitors coming into that market and the current financial performance of that location. If the location is currently underperforming and its prospects are not good, it may not be marketable to another supermarket chain at any price. Given the costs for conversion, some leases may even have a negative value. However, the enterprise value of a supermarket location can often be twice the value of the real estate.

There are many other issues unique to supermarket locations that make their valuation more complicated than a typical retail box. First, refitting a supermarket for an alternative use can be expensive, often in excess of \$500,000. Alternately, the cost of splitting a store into smaller units can run in excess of \$1 million, making any nonsupermarket use more expensive. In addition, many existing surplus locations are between 25,000-40,000 square feet and run very deep (200 to 250 feet deep) which adds to the complexity of the property. Such square footage is considered "tweener space" for many supermarket and nonsupermarket users alike.

Another unique feature of supermarket collateral is the value of pharmacy prescription files or "scripts". Many supermarkets have pharmacies in their stores and there is likely significant value in this intellectual property. Many recent script sales (e.g., Drug Emporium, Phar-Mor, etc.) have generated significant cash when auctioning these files for the benefit of the estate. Buyers of the files are interested in building market share and



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increasing foot traffic in their stores by acquiring and retaining those pharmacy customers. The hope is that those customers will not only fill their prescription needs, but also buy other merchandise at the acquiring entity's store.

Historically, both drugstores and supermarkets have bid aggressively for these assets both in and outside of bankruptcy. In a disposition scenario, the pharmacy inventory is invariably packaged with the prescription files for that location and auctioned on a store-by-store basis. The proximity of competitors and the competitors' willingness to bid in an auction environment are the key drivers of value for this intangible asset.

Many lenders are surprised at the often low valuation of supermarket inventory. Values can range from the mid-50s to the high 60s as a percentage of cost inventory. There are two primary variables which drive this result. The first is the relatively low markup and margins of supermarket goods. Because of the highly competitive nature of the



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segment, as well as the high turnover of the product, margins found in supermarkets are much lower than in other retail segments, typically ranging from the low- to mid-20s as a percentage of sales. So even though the recovery on the retail price of the goods tends to be very high, the recovery as a percentage of cost is low due to the high cost factor of the merchandise. The second factor that lowers the recovery value of inventory is the high expenses needed to run a supermarket disposition. A going-out-of-business (GOB) sale in a supermarket is extremely labor-intensive with many of the employees at high-wage rates due to union membership. In addition, utility costs of operating the physical stores are high, primarily due to running the refrigeration units. All these factors drive the liquidation value of the inventory to the lower end of the scale.

There can also be hidden value in supermarket furniture, fixtures and equipment (FF&E). For example, the equipment found in the deli, bakery and meat departments (slicers, mixers, ovens, etc.) can command significant value depending on make, model and vintage. In addition, the refrigeration units, particularly the more current "door front" units, are very desirable, although removal costs can be significant. A full-service supermarket with late model equipment can command a recovery on the FF&E in excess of \$300,000. To the extent the FF&E can be sold in place for use by another supermarket, a higher recovery can be achieved.

Given the difference in the collateral composition between supermarkets and conventional retailers, it behooves lenders to seek out competent appraisers and disposition professionals who understand the dynamics of the grocery sector. It is also important for lenders to realize that, while each piece of collateral, from real estate and scripts to inventory and fixtures, has an inherent independent liquidation value, they are often packaged together and sold off at the store level in a Chapter 11 scenario.



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Finally, any discussion of lending to supermarkets on a secured basis would be incomplete without mention of the unique legal issues that lenders should explore with their counsel before structuring any loan. Specifically, the lender should understand the rights of certain vendors. Typically, vendors to conventional retailers do not retain any rights to their product once it is sold. Their receivable, in the context of a Chapter 11 scenario, is classified as an unsecured prepetition claim. However, in an attempt to protect farmers and other producers, the United States government has enacted certain federal laws to provide financial protection to select vendors. Part of the Perishable Agricultural Commodities Act (PACA), for example, provides for certain suppliers to maintain a trust claim on the product sold and retain that claim until they are paid in full. In a deteriorating situation a lender will want to understand how significant that claim could be and manage the credit accordingly. Any lender considering a secured facility to a supermarket should explore these and all legal issues with counsel.

The competitive landscape is changing rapidly in the supermarket sector. Many chains are trying to combat this by expanding into new formats and by operating outside their traditional trading areas. For example, Albertsons completed its purchase of Shaw's Supermarkets in New England this past spring in an attempt to grow outside of its traditional footprint. Albertsons has also recently announced a new price-impact supermarket concept under the Super Saver banner which will have a limited assortment, high-quality products, low prices, and minimal services. The company expects this new format to expand rapidly through a series of acquisitions and new store openings.

These and other initiatives in the marketplace are examples of the rapid change occurring in the supermarket sector. In general, change has always provided opportunities for secured lenders. The successful ones will be those who can understand the risks and manage them effectively. ▲