The dream deal

The grab for our Woolworths supermarkets by Aussie-based Foodland gets the big thumbs-up from investors across the ditch. But the $690 million “dream deal” has been dogged by costly court battles and, as Fiona Rotherham discovers, is still far from successful.
Progressive's Ted van Asriel enjoying the fruits of his victory after gaining a 45% market share.
IT'S STRANGE HOW life can turn full circle. When grocery man Ted van Arkel started out in the trade, he worked for Woolworths New Zealand. Back then, he says, "We used to look at Progressive and think, 'Gee, if only we could be that good.' Tom Ah Chee had built a wonderful brand."

He's talking about Tom Ah Chee and partner Norm Kent, founders of Progressive, which opened its first Foodstuffs supermarket in Auckland in 1958 and became one of the major forces competing against other newcomers such as 3Guys and Countdown.

Now, several decades later, a perky-looking van Arkel is head of the newly merged Progressive and Woolworths. He should be perky. The new entity, ultimately owned by Progressive's owner, Perth-based Foodland, has taken a year of wrangling and more than $3 million in legal costs to date to come to fruition. The result is an impressive outfit with a combined 45% market share and revenues of close to $4 billion.

Where there were three big grocery chains, now there are two; the rival being owner/operator cooperative Foodstuffs New Zealand, with a dominant 55% share of the country's annual $9.2 billion supermarket sales. Foodstuffs opposed the merger, turning it into one of the most hard-fought takeovers in recent corporate history, with legal battles going all the way to the Privy Council (see "Timeline"). But as Foodstuffs chief executive Tony Carter says, "This is not over."

Although the deal has been settled, the feisty Carter is still pushing for a judicial review on the grounds the Overseas Investment Commission (OIC) didn't look sufficiently at the impact on competition. The review was due in court as Unlimited hit the newstands. If the OIC decision is overturned, Foodland may have to sell its Woolworths shares and undo the Progressive-Woolies integration to date — the management teams, joint promotions and IT systems. This would then trigger an appeal by Foodland and the costly legal stoush would continue.

Good for the lawyers. And competitors.

Just why Foodstuffs has fought so hard is best summed up by its opponent. For van Arkel, it's a merger made in heaven. "An opportunity likes this comes along once in a lifetime in anyone's industry. If you believe it is right, then you go for it, stick to your knitting and work very hard to ensure you achieve the desired result."

What's so right about it? For one thing, Foodland needed it to happen. Caught in that awful neither-big-nor-small zone, Progressive had only 22% of the market (plus the 4–5% held by independently owned Supervalue and FreshChoice, which its wholesale division supplies). Progressive was in danger of being pushed out if Woolworths' former owner, Dairy Farm, had sold it to a big international competitor.

"If Foodland didn't [buy Woolworths] they were going to be subject to more competition from someone else and be left with a very awkward position in the market, with nowhere to go but, probably, out," says David Spry, retail analyst for FW Holst in Melbourne.

The combined companies solve the market share problem and, at the same time, create new opportunities — such as a potential $50 million saving in synergies, increased brand awareness (as either the Woolworths or the Foodtown brand will be rationalised) and increased transtasman buying power. Foodland is planning to boost spending on new stores to gain more market share.

There's another aspect that makes the deal so sweet for Foodland, relating to corporate plays back in Perth. Since buying the Woolworths chain, Foodland's share price rocketed to a high of $A20. It has since fallen to under $A18 due to investor concerns about the legal question, but it's still double what it was 18 months ago and narrows the gap between Foodland's valuation and its market price. Investors like the deal, as do retail analysts, boosting the company's valuation by $3 to the $A20–$A22 range. The deal, half funded by debt and half by equity, doesn't hurt the balance sheet too much, either. Foodland reckons debt gearing of around 50% can be dropped back to its preferred 45% upper limit within just one year because of the increased cash flow.

So much for lower prices.

Suddenly, Foodland has gone from a small player (it had only 5% of the Aussie grocery market) with a discounted share price, to a substantial transtasman retailer. In fact, the only transtasman grocery retailer. That makes it an attractive takeover target. Nobody owns more than 8.5% of Foodland, so it would be easy for an aggressive buyer to establish a cornerstone holding. But working against that, it is a tightly held stock and recent price gains mean any suitor would have to pay up now.

Analysts are predicting Woolworths Australia, as one of the two major players in the Australian market, may be keen. It isn't saying, but it was a bidder for Woolworths New Zealand and analysts say it could well afford to simply shift its attention to the bigger combined entity. More speculative, and more fun, is the idea that Woolworths Australia may be a bidder for Woolworths New Zealand and analysts say it could well afford to simply shift its attention to the bigger combined entity. More speculative, and more fun, is the idea that Woolworths Australia may be the vehicle for US retailer Wal-Mart to enter Australasia, as Australian Coles Myer could be a vehicle for UK-based Tescos.

The speculation doesn't end there: there's also talk about The Warehouse entering the fresh food business. It's all fancy talk, though, and much of it assumes Progressive's takeover will work — quite an assumption. There is still plenty that could go wrong, especially if Carter and friends have their way.

Key challenges

Tony Carter strides rather than walks. A no-nonsense man, he'd just come back from a weekend watching the All Blacks do the Aussies in freezing climes in Christchurch when we interviewed him. In charge of the biggest of the three Foodstuffs cooperatives, Auckland-based Carter doesn't back away from a fight. After the Privy Council decision went Foodland's way in April, Carter rang van Arkel to say, "We're going to be a very tough competitor out there in the marketplace." Van Arkel's laconic response: "That's fine, we'll keep our boxing gloves on."

The legal costs, which Carter won't reveal, have been spent protecting Foodstuffs' dominant patch. The takeover, Carter says, is not in the best interests of New Zealand consumers, as less competition equals higher prices and less choice. Nor, he admits, is it in the best interests of Foodstuffs. His company has been the clear winner in the battle for supermarket sales in the past five years, growing turnover by $1.7 billion and adding an extra 7% market share. Now it has a rival with almost equal market share.

The legal shenanigans are just the start for van Arkel. Just as

Make or break

Success for the $690 million Woolies purchase hinges on six key issues:

Deal-makers
- The merger gives Foodland transtasman buying clout
- Economies of scale with an extra $1.6 billion in sales
- Makes Foodland more attractive as a takeover target

Deal-breakers
- Judicial review may force Foodland to divest Woolworths shares
- Integration may not go as well as hoped
- Some suppliers resist demands for better trading terms

Too many small suppliers can't tell you what it costs them to move categories of product from point A to point B — that's the difficulty

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The sparring partners

Foodland Associated
The listed Australian company, FAL, is the only Australasian grocery operation to operate on both sides of the Tasman. It has wholesale and retail supermarket operations in Western Australia, Queensland and New South Wales. In New Zealand it owns the Progressive grocery chain and the Farmers department store chain. Progressive's brands include:
Foodtown (30 stores)
Countdown (32)
3Guys (5)
Woolworths (62)
Big Fresh (9)
Price Chopper (14)
Its wholesale operations are:
The Supply Chain and Red Arrow tobacco and confectionery distributor.
It supplies the independent owner/operator groups:
FreshChoice (8 stores)
SuperValue (31)
Private labels:
Signature and Basics

Foodstuffs
The Foodstuffs organisation is New Zealand's fourth-largest business and the largest grocery distributor. It is run by owner/operators under three separate, regionally-based cooperatives — Foodstuffs (Auckland), Foodstuffs (Wellington) and Foodstuffs (South Island). The three cooperatives jointly own Foodstuffs (NZ) Ltd, which acts as the federation body and owns the brands.
Foodstuffs' brands include:
New World (125 stores)
Pak 'N Save (34)
Four Square (312)
Write Price (8)
And cash 'n' carry operations:
James Gilmour & Co in Auckland
Toops Wholesalers in Wellington
Trent's Wholesalers in the South Island
Private labels:
Pam's and Budget
important is achieving the anticipated synergy benefits of $50 million in three years. At 1.4% of costs, that’s a conservative expectation, says UBS Warburg senior retail analyst Keira Grant. But it’s what everyone’s expecting, if not more. To make these savings, Progressive must attack the supply end of its business.

For example, it is determined to increase the amount of packaged goods coming through its central distribution centre from 70% to 90%. Securing new trading terms from local suppliers is crucial.

In its first Commerce Commission application, Foodland chief executive Trevor Coates said huge savings in the supply chain are a major benefit from the takeover. Progressive has long argued that Foodstuffs has used the buying power generated by its 55% market share to force suppliers to deliver direct to some of its stores (mainly Pak’N’Save) for the same price as delivery to a central distribution centre. This cut Foodstuffs’ logistics costs, Progressive claims, while passing on a higher cost of distribution to the rest of the industry.

Foodland was determined to negotiate new trading terms with suppliers by early August. Coates personally attended two Auckland briefings with 900 suppliers to outline what the company wanted, after it had trawled through Woolworths’ books to compare what it had been paying.

It’s not a good time to be a supplier. The smaller ones, in particular, tried to stall. As Unlimited went to press, Progressive was standing firm — though has agreed to let suppliers negotiate directly with its category buyers. In the midst of such negotiations, it’s hard to find suppliers who will talk openly. One, who didn’t want to be named, says there were huge mistakes in the comparison of terms that Progressive sent: “Foodstuffs may not be getting a better deal at all; it may just be better at keeping its records up to date.”

Progressive’s demands include cheaper deals, preferred supplier status and a blanket 0.5% charge for ullage (but you didn’t know that word, meaning goods damaged while in transit from supplier to supermarket). Another anonymous supplier says the demands were no surprise but Progressive was pushing them through in a “bulldozer fashion”.

After criticism from suppliers, the ullage charge has been cut back to 0.15%, apart from fresh foods, but Progressive will still save money as it won’t need to process credits.

Griffins Foods boss Tony Nowell is less fazed by the new expectations. All that is being asked for is transparency — small suppliers need to get their houses in order. “Too many small suppliers can’t tell you what it costs them to move categories of product from point A to point B — that’s the difficulty.”

As you would expect in a competitive market, Foodstuffs has been agitating behind the scenes, also meeting with suppliers and urging them to hold out on their existing terms.

“Progressive has said for many years that we get better trading terms than they do, but I strenuously deny that. They chose to go to central distribution, so why should suppliers be expected to pay for that?” asks Foodstuffs’ Carter. Direct delivery to stores is more common at Foodstuffs Auckland than elsewhere. Carter is adamant Foodstuffs won’t change its trading terms as a result of any better deals Progressive secures.

“One of the major concerns I have is that the industry will split into two camps. I think that is a pretty unhealthy situation in that if those suppliers then fall out with Progressive, they’ll come flying along here, and we’ll say, ‘No, you’ve been in Progressive’s camp, go away.”’

You can see why suppliers are unhappy with a duopoly.

Integration
Another key risk is how well Foodland handles the integration. It has a history of good management performance in this area, recently integrating 36 Franklins stores in Queensland and New South Wales that it bought off Hong Kong-based retailer Dairy Farm last year.
Progressive’s new management team hopes to rationalise its six brands to three (the same as Foodstuffs) within two years. Countdown and Price Chopper are obvious choices in the discount offerings. The big question is whether Foodtown or Woolworths will be the preferred full-service supermarket brand to compete against Foodstuffs’ New World. Consumer research is being undertaken, but van Arkel suggests Foodtown may be retained in Auckland, where it has stronger brand recall, and Woolworths in the rest of the country.

Progressive is also stuck with the contract Woolworths signed to run supermarkets at Gull’s 26 service stations. Overseas grocery retailers such as Woolworths Australia have moved into convenience stores in a big way but it is understood Woolworths’ deal here has not made money, and van Arkel plans to change the range sold in the format.

It also appears Progressive has decided to stick with Woolworths’ loss-making internet shopping service, reappointing Richard Hamilton as online head. Van Arkel was initially sceptical about online shopping because, apart from Tescos, no one has made any money out of it internationally. “We’re pleasantly surprised with the enhancements Woolworths has been able to make to its software program and the speed of allowing customers into its website, so I think there is a real glimmer of hope.” Is it making money? Van Arkel laughs. “As I said earlier, there is only one retailer making money out of it, but it is getting closer.”

What next?
Assume the merger works, the suppliers are knocked into submission, the brands are successfully relaunched, the systems are integrated and the competition tied down. What happens next? Expect more fun with the ownership and possible new entrants. Players include The Warehouse, which was approached by suppliers early in the piece encouraging an extension into fresh food. There’s some logic in this. The existing retail platform gives it massive advantage. The Warehouse already makes $120 million a year from grocery items and allocates 10% of its total floor space to products such as health and beauty and confectionery. Wal-Mart, on which The Warehouse was modelled, successfully followed this path.

The Warehouse chief executive Greg Muir refutes the speculation as just that. His hands are full dealing with its Australian expansion, he says. Moving into fresh food is something the company considered a couple of years ago, but decided New Zealand was overshopped in that area. Instead, it opted for the Australian move. Never say never, though.

There was a lot of talk about the privately owned Aldi expanding to New Zealand from Australia after it registered its name here in 1998. The world’s lowest cost grocery retailer is legendary for its secrecy, with a worldwide policy of “total silence and firm intent”. Tim Morris of Coriolis Research says when Aldi opened in Australia in 2000, its prices were around 15-20% lower than Woolworths Australia, and it is slowly gaining ground.

Another long shot is the South African supermarket group Pick ‘n Pay, which recently bought part of the Franklins group in Australia. It would compete well against Foodstuffs’ highly successful Pak’N Save. With a duopoly in place, the game is now that much harder for any new competitor.

The strongest speculation has Foodland as a takeover target and Woolworths Australia as the lead contender. “They would have to pay a fair premium to get it, I think,” says retail analyst David Spry. “They could afford to, given their share price, but knowing Woolworths, they’re certainly not going to pay too much for anything.”

Worldwide, retail supermarket globalisation is expected to be the defining force in the food industry in the next decade. A report on globalisation by Coriolis Research (which helped Progressive in its Commerce Commission application) says the globalisation process is still in its infancy but there is growing investment in Australia by South African chains and German-owned Aldi.

Analysts say it is not the Progressive/Woolworths New Zealand deal that Foodstuffs is worried about so much as the next — how hot the competition would get if Foodland is consequently taken over by one of the global supermarket players who could afford to get really competitive. That same global player couldn’t be so aggressive if it bought only Woolworths New Zealand’s 18-20% market share.

It’s the old shark-eats-shark theory. The little fish in New Zealand gets eaten by the bigger fish in Australia, which in turn could get munched by the bigger Aussie fish or gobbled whole by the international shark. Or is this just another fishy tale?