Food for Thought: A Turnaround Story

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When the state of Washington's fourth largest private company reported losses in its 2000 fiscal year that wiped out 66 years of accumulated equity, its lenders responded to the crisis by mandating that the company engage a turnaround manager, which resulted in an assignment for Partners for Corporate Renewal (PCR). What happened in the ensuing 15-month period became the basis for the 2002 Large Company Turnaround of the Year Award, given by the Turnaround Management Association to PCR's managing partner, Robert Hoyt. With PCR's leadership spearheading the turnaround effort, Seattle-based Associated Grocers, Inc. (AG) not only avoided bankruptcy but quintupled its operating earnings before interest and taxes, reduced its debt by 75%, recovered shareholder equity to the tune of $73 million, and saved thousands of jobs.

THE SITUATION

AG was a 67-year-old, retailer-owned wholesale grocery cooperative with more than $1 billion in sales, serving 340 independent grocery stores in the Pacific Northwest, Alaska, Hawaii, and the Far East. It had 1,400 direct employees and was comprised of 180 member stockholders who employed an additional 20,000 people.

By early 2000, AG was suffering from a continuing decline of its independent retail grocery customer base—mostly because of competitive business conditions within the industry—and had lost one of its largest customers.

AG's attempts to cope with the changing business climate met with less than stellar results. Although it tried to offset the loss of one of its major "close in" customers by acquiring the Oregon distribution business of another wholesaler and investing in a retail grocery chain in Alaska, it incurred a significant increase in capital and operating costs in the process. Additionally, the company had major internal problems that included information system failures, a large troubled customer loan portfolio, high infrastructure costs, pervasive management turmoil, high debt levels, lender defaults, and a lack of liquidity.

Responding to fears generated by ubiquitous warnings concerning the Y2K computer glitch, AG completely abandoned its existing computer system in favor of a new one. During the implementation process, the new system frequently failed, causing major disruptions of the company's basic business functions. This further undermined customer allegiance and produced a general but pervasive erosion in sales.

The company's business focus had gotten out of balance to the extent that it was operating more for the benefit of its member retailers, at the expense of its own long-term viability, and had lost its direction on sustaining its core business: efficient procurement and delivery of grocery products and services to its retail customers. More specifically, the company was attempting to accommodate an unsustainably broad range of customer product and service requests to sustain revenues. In concert with this philosophy, management compounded the problem by liberally lending money to its members without sufficient economic justification. As a result, debt and leverage rose to record levels and coincided with deteriorating operating results and negative cash flows, producing a liquidity crisis.

THE TURNAROUND PROCESS

With PCR providing interim leadership, we began building a turnaround team. The team's requisite skill sets were determined by focusing on the needs of the company's top 20 customers, which represented about half of its business. We held our customers' hands and got them to help us. Team building is not just about top management; it's also about mid-level employees, customers, and vendors. But our most immediate challenge was to get AG's creditors to buy into a turnaround process.

Assembling the team also meant quickly replacing most of AG's top management group. Interim CFO Jeff Kessler from PCR came on board three months into the turnaround, and joined a new CIO followed by an HR director, and eventually a general counsel. The recently hired chief operating officer was a critical resource that rounded out the team.

While dealing directly with the challenges at hand, the team quickly conducted a viability analysis. A game plan was developed based on an assessment of the company's core competencies, the competitive realities, and how to best position the company strategically to win in the long run.

Cash Is King

At the same time, the turnaround team found ways to generate cash and establish short-term liquidity. There was a need to create a lot of cash flow to fund the company because AG didn't have any credit facilities. Trade-offs were made between short-term liquidity needs and long-term value preservation. From this, a viable game plan was developed that was used to gain the buy-in of our key constituencies.

The turnaround team quickly turned a $10 million overdraft position into a positive cash balance through aggressive working capital management and by launching an accelerated asset sale program. Within a year, more than 20 parcels of commercial real estate, including some in Alaska and Canada, were sold at a collective profit. In addition, in an aggressive cost-cutting program, AG sold one of its two primary warehouses; shut down the company's meat-cutting operation; exited a cash-draining Alaskan joint venture; entered into a sale/leaseback of the transportation fleet; and outsourced the company-owned pallet yard, transportation/maintenance facility, and selected warehouse functions.

In addition to selling company assets, the team reduced operating expenses by instituting an early retirement program combined with replacing a defined benefit pension plan with a portable cash value plan. Further savings were realized by modifying overly rich benefit programs (especially healthcare), gaining employee expense participation, and investigating employee-identified expense reduction opportunities. The team further bolstered cash flow through an aggressive internal loan workout and recovery effort with the AG customer portfolio.

Selling the Plan

One of the immediate and most difficult challenges was the task of bringing AG's many lenders into a working group. We had to deal with 18 institutional lenders, each with unique issues, concerns, strategies, tactics, and lawyers using varying degrees of aggressiveness in pursuing their positions. It was a bit like being in a war zone with the unexpected coming at you continuously from all directions. Understandably, with "one-off," long-term, generally unsecured, lending relationships and the surprisingly rapid deterioration of AG's credit quality, the workout guys brought a lot of ammunition to bear on the target. As to be expected, we focused considerable time dealing with the demands of creditors. Also, preserving trade credit was paramount for a company that is heavily dependent on vendor trade terms to finance most of the inventories in a distribution system.

With a realistic turnaround plan in hand supported by some early successes, the team was able to negotiate two successive forbearance agreements and avoid the worst-case scenario: a bankruptcy filing. Initially, the lending group gave us some time because they did not like the bankruptcy alternative, but in the second negotiation, they went along because they were starting to believe that the company was going to come up with a better solution. That accomplishment was rather unusual because we needed 100% approval from a diverse group of lenders that included domestic and foreign banks as well as insurance companies—all thinking differently. Because there was no lead lender or agent bank, the process required a highly attentive and extensive communication effort.

Holding the Business Together

At the same time the team was dealing with viability and liquidity issues, management was careful to keep an eye on the customers. While keeping the wolves at the gate, we were also striving to maintain operations so that our customers were not adversely impacted. Obviously, otherwise, the company would suffer a further deterioration of its customer base and exacerbate an already difficult situation.

The company used surveys and a retailer advisory committee to identify customer needs and to address the company's shortcomings. AG subsequently formulated a new standard supply agreement with guaranteed service levels and more competitive product pricing to restore marketplace confidence in the company.

The turnaround team reached out to AG's customers, vendors, and the surrounding community by initiating a comprehensive communications program that would build overall confidence in the company's future. This new openness signified a radical change in the company's culture, as did employee initiatives that were implemented to change the prevailing focus away from one of an entitlement orientation to a pay-for-performance environment. AG had been a safe employer for a long time, as evidenced by average employee longevity of 14 years. We went through a paradigm shift that energized people to perform at higher levels. We replaced non-performers with some high-energy people to be role models for those in the organization interested in long-term careers. Business unit delineation, establishment of operating plans with performance measurement, and manager accountability became a new way of life.

Communications, Communications, Communications

Wanting to keep our customers and our best employees from packing their bags and going somewhere else, we applied considerable effort to calm their fears about the company's viability. Obviously, our trade creditors were concerned, so AG needed to assure everybody that there was a light at the end of the tunnel. Throughout the turnaround process, management communicated frequently with all of the company's constituents to see how we were progressing with our initiatives, reinforcing the fact that we were paying attention to their special concerns and issues.

A good communication program is a critical component of any turnaround plan. It further served AG as an excellent morale builder because it balanced the bad news with news of the positive developments that had begun to materialize. It helped convince everyone that the company was headed in the right direction and provided the positive momentum instrumental to overcoming the continuing challenges of the turnaround process.

In particular, the communication program helped to make the forbearance agreements a reality. As we accumulated successes, we made sure that everyone heard about them. Then we started to convert some of the skeptics who began to think that, perhaps, the company could make it after all. To engender renewed confidence, real results, changes, and improvements had to be demonstrated in a fairly short time. The management group stayed the course and increasingly dealt with challenges in an enlightened way, recognizing the varying constituents' motivations, and learning how best to respond.

Setting the Right Tone

Among the major improvements that the turnaround team accomplished was the reorganization of AG's procurement program. This began by informing vendors that AG would be buying in bigger volumes, in a more streamlined way, from a select number of vendors and in turn would expect bigger discounts. We got significantly larger discounts, which were passed along in the form of price reductions to our customers, helping them become more competitive and stable operators in the marketplace.

To ensure long-term viability and position the company for future growth opportunities with new retail customers, a number of governance changes were instituted. These initiatives called for adding independent directors to the Board to achieve a minimum independent composition of 50%, instituting term limits for directors, recalculating shareholder votes to be based on share ownership interest versus number of stores operated, and paying dividends based on volume of annual purchases to aid AG's top line growth.

Implementing improved business processes, revamping the management organization, and hiring new permanent leadership all contributed to enhanced management effectiveness. New providers for outside professional services were found, including legal and auditing firms, which also helped bring new ideas to the table and distance AG from its past.

One of the final components of the recovery process was obtaining legislative relief from the State of Washington and the City of Seattle that allowed the company to accomplish a necessary recapitalization. It was an extraordinary situation. In about three weeks' time, the company got approval from the state legislature that provided critical relief that applied very narrowly to our interests. They were responsive because of the merit of our argument and breadth of our constituency: we had as many as 12,000 people throughout the state whose jobs would be at risk.

In addition to the tangible benefits, the legislation also made AG's creditors, unions, and employees sit up and take notice. With more positive momentum, business transactions became easier and employee morale got a significant boost.

THE OUTCOME

As a result of the turnaround effort, Associated Grocers avoided the doomsday scenario and was restructured out of court. The company was able to call off the distressed sale of the business that had been driven early on by concerned customers and creditors, making it unnecessary to sell out on unfavorable terms. Through numerous negotiations, extensive pending litigation was avoided, deferred, or settled as the signs of AG's resurgence became more evident.

While operating earnings before taxes and interest rebounded sharply, AG's balance sheet was spectacularly restored. The dramatic improvement in the company's capital structure came through the recapitalization program that was finally agreed upon by all the institutional lenders.

Leading up to this event was substantial groundwork. Alternative recovery scenarios were openly and fully discussed. Focus turned to an asset-based lender takeout as the best solution with the highest profitability of occurrence. At that point, AG needed a flexible financing commitment (contemplating a number of alternate capital structures) from a financing source with intimate working knowledge of the food industry. This would allow for a rapid closing once an agreement had been reached on the amount of debt to be refinanced and the structure of any remaining obligations from the existing lender group. GMAC's Structured Finance Group was AG's preferred choice because of their ability to fully underwrite a "one-step" solution with an extended amortization real estate facility, as well as its in-depth understanding of the credit nuances of lending to food cooperatives.

Some lenders decided to stay in and get paid over a longer period of time and some others were willing to cash out and accept the immediate opportunity to liquefy their loans. The flexibility of choice to the institutional lenders was one of the more unusual and dynamic elements contributing to the successful outcome. It enabled the company to gain the required 100% approval of a lender group that historically had been unable to agree on the time of day. The deal closed a little over two weeks after the events of September 11, 2001.

In the end, AG's retail customers received improved product pricing and now enjoy a positive cooperative environment that is conducive to attracting growth capital. With more than 1,100 direct employees and thousands of retailer-based employees, AG has reclaimed its competitive market position in the Northwest.