CMBS Research

With Its Shopping Cart Full of Debt, Can Albertsons Steer Clear of Closing More Stores?

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It's no secret that traditional supermarket chains face intense competition from the rise in online grocery shopping and discount grocers, straining already thin profit margins. While these disruptions don't pose the same existential threat to the grocery business that the electronics and office-supply sectors have faced, the changing landscape can't be ignored. The key shift under way is a marked bifurcation in the industry that favors large format discount stores that focus on their logistics and supply-chain advantages, and higher-end experiential stores that have the money and the margins to invest in things like smart data to ensure the customer gets what they expect every time.

Adding to the pressure on midmarket chains, traditional grocers must contend with competitors that are grabbing an ever-larger slice of the market for higher margin products--such as Trader Joe's, Amazon's Whole Foods Market, and Sprouts Farmers Market--while no-frills discounters like Aldi U.S. and Smart & Final Stores, Inc. target the more affordable generic segment of the market. Simultaneously, Walmart Inc. and warehouse chains Costco Wholesale Corp. and BJ's Wholesale Club Inc. have continued their assault on the market, maintaining pricing pressure in the industry.

While this shift has implications for a wide swath of grocers, it's been particularly harsh for those backed by private equity. The industry saw a barrage of corporate bankruptcies over the past several years. Since 2015, seven major grocery chains have filed for bankruptcy protection, including A&P, Haggen Food & Pharmacy, Southeastern Grocers, LLC, and Tops Markets, LLC, all of which were funded by private equity. Struggling with heavy debt burdens, these companies lacked the liquidity to invest in their physical stores and expand their offerings.

As an example, the added pressure of too much debt brought on by private equity ownership may force Albertsons Companies LLC to shrink its store base, putting 99 properties in commercial mortgage-backed securities with an allocated property balance of $1.20 billion at risk.

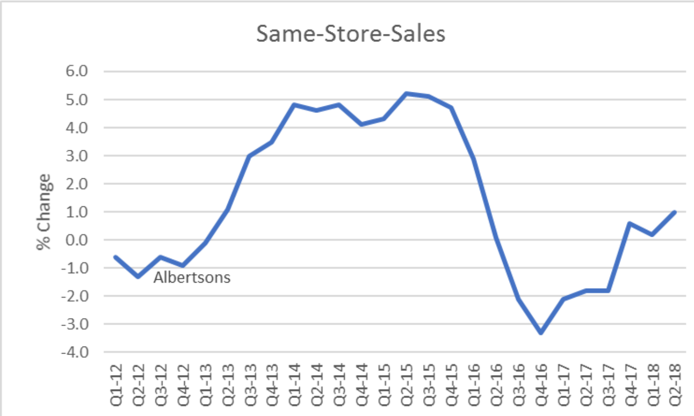
Overleveraged Amid Fierce Competition

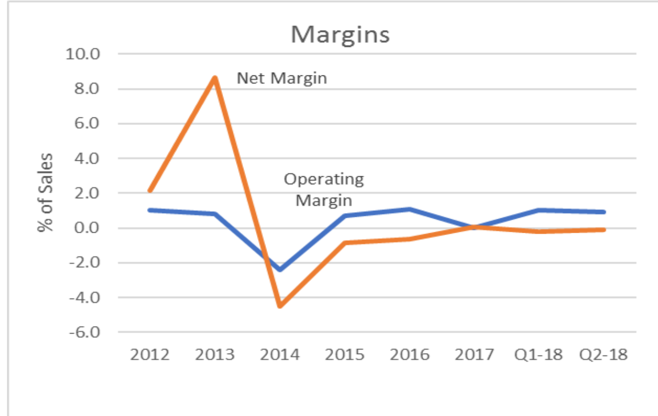
The third-largest grocer based on 2017 sales volume, behind Walmart, Inc. and the Kroger Co., Albertsons closed 30 stores in 2018 and reported a net loss for the first two quarters of fiscal 2018 ended Sept. 8, 2018, which may foreshadow a further decline in the retailer's brick-and-mortar presence. Morningstar Credit Ratings LLC's property-level analysis suggests that weak performance, an already dark store, internal competition from nearby Albertsons' stores, and upcoming Albertsons' lease expiration all raise the risk of nonrenewal and more store closures. The grocer comprises more than 50% of the gross leasable area at 48 properties including 19 where the grocer is the sole tenant, which adds another level of risk because the time required to find a new tenant or renovate the property can be costly.

The Boise, Idaho-based grocer operates 2,291 stores under 20 banners including Acme, Albertsons, Haggen, Jewel-Osco, Market Street, Pavilions, Safeway, Shaw's, Star Market, United Supermarkets, and Vons. Overall, there are 123 loans with an allocated property balance of $1.88 billion in commercial mortgage-backed securities with exposure to Albertsons.

Albertsons is owned by private-equity company Cerberus Capital Management. Through a series of acquisitions, which culminated with the purchase of Safeway in January 2015, Albertsons' debt ballooned to nearly $12 billion, up from $3.7 billion in 2013 before the acquisition of Safeway and other chains.

Compared with Kroger, Albertsons' better capitalized and more profitable competitor in the traditional grocery space, Albertsons' adjusted debt leverage ratio at the end of the second quarter of fiscal 2018 of 7.0x based on the past 12 months EBITDAR of $3.2 billion and adjusted debt of $22.4 billion is more than twice Kroger's adjusted debt leverage ratio of 3.1x for the same period. Morningstar forecasts limited debt reduction with only about $300 million in annual free cash flow over the next several years because of substantial cash obligations. At the same time, while operating margins have recovered somewhat over the past few quarters, they remain tight in the face of intense competition. Further, the retailer recorded a net loss for the first half of fiscal 2018 after turning a marginal profit in fiscal 2017, despite growing comparable store sales at a 1.2% rate.





The company, which had grown through acquisitions to 2,291 stores as of September, up from 1,075 in 2013, has tried multiple times to shore up its balance sheet through public offerings or offloading Albertsons altogether. It abandoned an initial public offering in 2015, while separate attempts in 2017 to combine with Sprouts Farmer Market and Whole Foods Market were both unsuccessful. Cerberus attempted another IPO in April 2018. Most recently, Rite-Aid and Albertsons in August called off their planned merger because of growing opposition from Rite-Aid shareholders.

Albertsons remains under constant pressure to lower prices in order to remain competitive. Further, periodic bouts of food deflation can also limit the grocer’s ability to maintain growth. For example, in 2016 through the first half of 2017, industrywide food deflation was prevalent in the U.S., which both reduced same stores sales growth and lowered net income. Minimum-wage pressures exacerbate the problem, especially for Albertsons, which has roughly two thirds of its employees covered by collective bargaining agreements.

With lackluster growth and a heavy debt load, Albertsons may lack the resources to invest in its physical stores and expand its offerings. But it is trying. It acquired meal kit company Plated and MedCart Specialty Pharmacy, and it expanded its partnership with grocery delivery service Instacart. Albertsons has also created an investment fund to develop grocery-sector technology, and it remodeled nearly 600 stores and incorporated over 4,000 merchandising initiatives, touching a combined 1,800 stores. In addition, the company has focused on expanding its portfolio of private label products, which generated over $11.5 billion of revenue in fiscal 2017. Still, at the end of the second quarter, Albertsons had $4.8 billion or 40% of its balance sheet debt due over the next five years. Further, ownership by an investor group led by Cerberus Capital Management could limit significant debt reduction. Practices such as the $250 million distribution that Cerberus issued to investors in fiscal 2017 intensify the problem.

Still, the company maintains good liquidity. At the end of the second quarter ended Sept. 8, 2018, the company had approximately $1.7 billion of cash and $3.2 billion of availability (after letters of credit) under its $4.0 billion asset-based loan facility. In addition, with about 40% of its store base owned, the company has additional flexibility. Over the past 12 months, Albertsons raised $1.8 billion in cash from asset sales and sale-lease back transactions.

Loans of Interest

While not all loans are at risk in the short term, we expect to see additional store closures, as Albertsons' high level of debt hampers its ability to adapt to a changing grocery landscape. Factors include poor property performance, upcoming lease expirations, already-dark locations, as well as competition from locations that are close to each other. In addition, Albertsons is more likely to close stores in areas with high concentrations of grocery stores.

Albertsons Exposure – 10 Largest Loans at Elevated Risk

Deal	Property	City	State	Property Balance ($)	% GLA	Lease Expiration
CGCMT 2015-P1	Piazza Carmel	San Diego	CA	64,000,000	34.1	12/31/2021
GSMS 2012-GC6	Audubon Crossing and Audubon Commons	Audubon	NJ	41,757,046	14.7	3/31/2020
MSBAM 2014-C19	Victory & Tampa Shopping Center	Reseda	CA	29,253,189	16.3	12/31/2020
JPMCC 2006-CB17	Hawaii Kai Shopping Center	Honolulu	HI	28,123,551	29.5	12/31/2021
JPMCC 2006-LDP9	Kimco PNP - Olympia Square	Olympia	WA	25,400,000	32.5	11/30/2018
GSMS 2013-GC12	Stetson Village	Glendale	AZ	25,123,980	44.0	7/31/2028
GSMS 2010-C2	Fox Run Shopping Center	Bear	DE	24,382,826	23.5	10/31/2019
CGCMT 2015-GC27	Natomas Town Center	Sacramento	CA	23,077,381	42.8	1/31/2025
GSMS 2013-GC12	A&P Mahwah	Mahwah	NJ	22,395,531	100.0	2/28/2024
WFCM 2016-C34	Old Mill Village & Enterprise Center	Oakhurst	CA	22,308,756	17.5	12/31/2019

Source: Morningstar Credit Ratings, LLC

Among the deals with properties at risk, CGCMT 2015-P1 has the largest exposure with two loans totaling $83.2 million, of which the $64.0 million Piazza Carmel loan is the largest. The Pavilions store occupies 34.1% of the 144,574-square-foot shopping center and has a lease that expires in 2021. With the vacancy rate in the Del Mar/Rancho Santa Fe submarket at 5.0%, according to CBRE Econometric Advisors, we believe that the probability of a default is low if the grocer does not renew. Further, San Diego, where the store is located, is a heavily developed area, and land is costly. The loan, which is current, had a debt service coverage ratio of 1.79x for 2017 on 100% occupancy.

The $41.9 million loan backed by the Audubon Crossing and Audubon Commons in Audubon, New Jersey, amounts to 4.3% of GSMS 2012-GC6 and matures in October 2021. The 449,170-square-foot shopping center outside Philadelphia has struggled, with net cash flow tumbling more than 30% from issuance. The loan posted a 1.15x DSCR for the first six months of 2018 with 89.0% occupancy. The Acme market occupies 14.7% of the space on a ground lease that expires in March 2020. A glut of grocery stores within three miles, including two other Acme stores, could be adding to the property's struggles. Further, leasing activity in the Audubon market has slowed in October to an average of nearly 14 months on the market, up from about 11 months this time last year. Assuming the store closes when the lease expires, that loss could push cash flow below the break-even point, and the borrower could have trouble re-leasing the space. We believe that a closure will worsen our value deficiency for the loan because Acme contributes 10.7% of total revenue. Morningstar values the collateral at $38.9 million using a discounted cash flow approach that assumes that it will take three years to backfill the vacant space.

We already project a $9.3 million loss on the specially serviced $25.4 million Kimco PNP - Olympia Square real estate owned property. The asset, which makes up 3.10% of JPMCC 2006-LDP9, was transferred to the special servicer in 2015 because of diminished cash flow and low occupancy. Losing Albertsons at the Olympia, Washington, shopping center would compound the loss potential for this loan. Elevating the risk, Albertsons' lease expired in November, and a departure would leave the center nearly 70% vacant.

Under Pressure

Albertson's high leverage leaves the company more exposed to outside risks, such as from increased competition, wage pressures, or a strike from its heavily unionized work force. Somewhat offsetting this risk is the maintenance of good liquidity. The loss of some sales to online outlets and discounters like Aldi will add to the pressure on already-low margins. Not only does Albertsons compete against traditional supermarkets such as Kroger, but it must contend with increasing competition from warehouse clubs such as Costco, discounters such as Walmart, dollar stores, convenience stores, and inroads from Amazon's grocery expansion. To keep pace with its competitors, Albertsons needs to pay down its debt. Its recent initiatives and good liquidity hold promise but still leave it in a precarious position. Its forays into meal kits--delivery service and technology notwithstanding--and significant challenges within the food and drug retail subsectors are likely to continue to pressure margins and could force more store closures.

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