Pacific Market: Invest, Sell, or Stay the Same?

“The way I see it, a grocery store like Pacific Market who carries a mix of conventional, natural, and specialty products has three choices moving forward. They either sell, stay the same and become irrelevant, or invest in leadership and infrastructure to stay competitive as the industry landscape changes.” said consultant Tom Scott over the conference table at the Sebastopol Pacific Market store in August 2017.[[1]](#footnote-1) Tom is the former longtime CEO of Oliver’s Market, Sonoma County’s largest locally owned grocery chain.

“No matter what, I just want to take care of the employees who work here. I love the people aspect of grocery.” added owner Vasu Narayanan, a seasoned Silicon Valley tech entrepreneur who purchased Pacific Market in 2014. He acquired the two co-branded stores after a period of financial difficulties where the company’s reputation, sales volume, and store conditions suffered. “I wouldn’t have bought it if the numbers didn’t make sense.” said Vasu, who has built his career on turning around failing businesses.

After immigrating from India in 1991 to attend an MBA program for international business at the University of South Carolina, he started the Good Karma Foundation in 2008 to give back. The foundation was inspired by his grandfather who started a school where children from financially struggling families could study for free. To continue the legacy, the foundation pays for student education in underprivileged communities in Kerala, India. It also finances health care coverage, startup costs for small ventures, or makes up budget deficits at orphanages, senior homes, or for social programs. When Vasu acquired the troubled stores, his dream was to make Pacific Market a “community supported institution,” as he called it; supporting both the communities surrounding the stores, as well as the communities his foundation supports.

A finance person by trade, it is very clear within minutes of speaking to Vasu that his main driving force in decision making is in the best interest of his employees and his ability to fund his foundation. His first move as the new owner was to prioritize consistent leadership by keeping the previous ownership family in place to manage the stores until they retire. “When a business goes through financially uncertain times, the staff gets really nervous. It’s my job to always come in and be a positive presence so they know everything is going to be ok,” Vasu said. Since then, he has developed strong relationships with vendors, made modest investments in improving the store, and brought financial stability back to the business. With former ownership retiring this year, the time to decide the future of Pacific Market is now.

“If you do nothing, sales will remain stagnant and growth will be just above inflation. You’ll also be deferring major maintenance that needs to be done.” said Tom.

“If I choose to invest in the business, there is no guarantee of success and it’s going to take me at least three years to make the necessary upgrades to the store and have proper benefits and compensation in place where the employees are well taken care of. Right now, we’re paying 10-15% less than competitors. If I sell to a company that is already taking care of their employees, then that can happen much faster, but the challenge is finding a company like that who is in a position to buy the store for what it is worth.” elaborated Vasu.

“If you invest, you need to go big or go home. The store hasn’t been remodeled in nearly twenty years and the industry average is ten! But if you do, something really cool could be created here that isn’t being done by anyone else.” said Tom.

“If we go that route, my goal is to share profits. 20% will go to the staff, 20% to the Good Karma Foundation, 20% to store improvements, and 40% to ownership.” Vasu laughed as he added “and 50% of my share will go to the government through tax so that way we all get 20%!”

To implement this profit sharing vision, Vasu believes that store volumes must increase by 50% over the next three years. In order to achieve this, significant disruption to competitor’s sales is necessary.

Industry Overview

While the United States grocery industry enjoys annual gross revenues of $611.9 billion dollars, the average profit margin is only 1.9%. Since 2012, the industry has seen an annual growth rate of 1% and is expected to maintain a similar growth of .8% between 2017 and 2022.2 This growth is mainly due to the strengthening economy. Thus, the projected 1.6% annual per capita disposable income growth over the next five years is the main source of projected industry growth. This means per capita disposable income must increase over time above inflation rates, as well as above a volatile agricultural price index. 2 Within the grocery industry, growth is happening in the natural and organic food category, which saw an 11% growth in 2015 alone with 75% of consumers purchasing organic because they believe it is healthier for them.2 The produce category has also been growing at 2.6% in volume annually.3 Due to being a highly fragmented industry, with no firms having monopoly power, another outlet for growth has been seen in the form of mergers and acquisitions.

Historically, there are three categories of grocery store formats. Conventional formats compete solely on price of products and will sacrifice ingredient quality and customer service in order to achieve their goal of being a low-cost provider. Examples of conventional format chains are Safeway and Kroger. These formats focus on center store offerings and not on perishables. A format that has seen massive growth over the last decade but has since slowed, are natural formats. These stores offer high quality ingredients focusing on organic, non-GMO, and without high fructose corn syrup products. A national chain example of the natural format is Whole Foods. Unfortunately, Whole Foods has garnered the nickname “Whole Paycheck,” due to these products being sold at a premium. By nature of a focus on quality, these stores shine in the perishable category of foods and food service offerings. The third type is specialty formats, typically identified by carrying high end and hard-to-find products that are not necessarily healthy.

Pacific Market’s differentiation strategy up until this point lies within their crossover format. They offer both conventional products, as well as natural and specialty products. Over the last decade, this crossover format has become the norm at stores that cater to affluent shoppers.

More recently, stores like Trader Joe’s have challenged traditional categories and created a new type of grocery called limited assortment. This means 80% of their offerings are in the form of their private label brand.2 In 2007, Trader Joe’s eliminated trans-fat, GMOs, and artificial colors from their private label, which allows them to sell high quality products at a lower price.4 Where traditionally private labels have been seen as inferior quality, Trader Joe’s has positioned themselves as an affordable premium private label. Also within the last five years, e-tailers like Thrive Market and Good Eggs, as well as meal kit startups like Blue Apron, have disrupted the grocery industry and are predicted to grow at an annualized 9.5% per year average.2

In August 2017, the innovative tech disrupting giant, Amazon, stepped into this historically low profit, high competition industry with a 13.7 billion dollar price tag.5 Amazon spent their first day as a brick-and-mortar grocer changing the “Whole Paycheck” reputation through slashing prices by 43%, which threatens the traditional premium natural food category of grocery stores.5 Amazon is also experimenting with hybrid formats such as grocery delivery within hours and using new technology for checkout free shopping. Another threat to traditional grocers like Pacific Market are mass merchandisers in a supermarket or warehouse club format like Walmart and Costco. Not only does this drive the convenience factor for consumers being able to get electronics, clothing, and food all at the same place, but it also allows them to purchase higher quality food at a lower price point due to bulk purchasing by these large chains.

“I don’t think small local grocery retailers will go extinct, but I think the mediocre ones will.” commented Tom while discussing a focus group brief, which revealed that the vast majority of Pacific Market shoppers are over the age of 35.

Pacific Market’s Story

Founded by the Mohar family in 1966, Pacific Market was Sonoma County’s leading innovative natural grocer that began supplying pasture raised, wild caught, organic produce in the 1990’s. They have one larger store in Sebastopol and another smaller store in Santa Rosa that was bought in 1998. Both are longstanding neighborhood-oriented stores and the last major investment in infrastructure was through a remodel in the late 90’s. The business was passed on to the founder’s three grandchildren, Brad Mohar and his cousins Ken and Gary Silveira in 1986. Ken Silveira remains the current president of Pacific Market and is nearing retirement. “When we started here (in Sebastopol) there were only three stores and now there are seven!” said Ken in reference to the local competition when meeting in passing. In 2006, they made a strategic move and expanded a third store near Sonoma State University in Rohnert Park, where there was a 2,000 home housing development planned to be built.

With the economic crash in 2008 followed by a recession, the housing development was never built, and left Pacific Market over-leveraged with lower than expected store volumes, which were unable to service the debt loan. This underperformance resulted in shutting the doors of the Rohnert Park store in 2011 and created on-going financial difficulties, which resulted in foregoing investments in the store’s infrastructure and work-force, leaving the stores aesthetically outdate with low morale.

Now that Vasu has brought financial stability back to Pacific Market, he must decide what course of action he will take. If he decides to keep the stores and invest in the future, his first goal would be to assemble a strong management team when the current one retires. This new management team will finalize a new mission statement and agree on core values that will be the foundation of good customer service. “It’s just the right thing to do.” Vasu said when talking about customer service efforts. Tom chimed in by saying “that’s the key to staying competitive in the market moving forward.” Yet to be finalized by the new management team, Tom and Vasu, with input from the current management team, have drafted the following mission statement:

*We are a community market that sells delicious food that nourishes both body and spirit. We work to provide tangible value for our customers by providing the highest quality products, an interesting assortment of products that we sell at fair prices. We support local agriculture and local food manufacturers as an active participant in a local food system. We share our passion for living in Sonoma County through our love of food, our desire to serve, and our commitment to the community we live in. We express this passion through respect and care in all our actions to benefit as many people as we possibly can.6*

While the mission statement and values have yet to formalized by the team, Vasu and Tom are already taking steps to carry these ethos throughout the company by hiring a POS coordinator to ensure accuracy of price scanning and retail pricing. This person will oversee price changes and regularly perform shelf audits. This will help execute the company mission by facilitating an evolution towards a fair-priced, highly curated assortment procured through a large pool of suppliers. Vasu has also recently hired a new Produce Manager and is placing a strong emphasis on this department at Tom’s recommendation that fresh produce is the “backbone of any grocery retailer.”

In discussing the current valuation of Pacific Market under Vasu’s ownership, Tom explained, “Typically, independent grocery stores are valued using a discounted cash flow method and sell for 4 to 7 times a normalized EBITDA and takes into account things other than cash flow, like strength of locations, strength of workforce, intellectual property, and brand power.” In determining EBITDA, items such as one-time/non-recurring costs and shareholder expenses unrelated to running the business should be excluded.7 In addition, adjustments should be made for material deferred capital expenditure (including backrooms, mechanicals, roofs). Other considerations in valuation should include foreseeable impacts from new competitive entrants, lease terms, and on-going supply agreements. 7

In the case of Pacific Market, Vasu’s asking price is an annuity of $500,000 per year for 20 years at a 6% discount rate and he will hand over the keys immediately and sell the business “as is” in terms of operations. His motive for doing an annuity over time instead of a one-time sale is to guarantee funds for his foundation over the next 20 years. Vasu does not consider new entrants to the two Pacific Market trade areas to be a concern due to oversaturation and land use issues.

Current Pacific Market Stores

The Pacific Market store in Sebastopol is 17,350 square feet with the large format feel of a chain store and has estimated weekly sales of $230,000.8 They have a full-service cheese department and a large prepared food selection. They have a 3-star Yelp rating with mixed reviews on customer service. The general consensus is that they are expensive but the deli, hot bar, and meat/seafood quality all have positive comments. (See **Appendix 1** for price comparison chart against local competition.) Currently, the population in Sebastopol within the three-mile trade area of Pacific Market is 85% white, just under 10% Hispanic, and the average household income is $88,551. This average household income is projected to rise in the coming years to $101,010 by 2022.9 The two population groups predicted to have the most growth are the Millennial category, ages 25-34, and Baby Boomers, ages 65-84 (see **Exhibit 1**). 9

The Santa Rosa Pacific Market store by contrast is 8,500 square feet with an intimate neighborhood feel and has estimated sales of $120,000 per week.10 With a higher Yelp average than its Sebastopol counterpart, the Santa Rosa store is ranked at 3.5 stars with mixed reviews again on professionalism and quality of customer service. Shoppers seem to feel this store is more affordable since it is only ranked at two dollar signs instead of Sebastopol’s three. This perception of price elasticity is largely due to servicing a more affluent clientele. Once again, there is positive feedback on the deli and meat selection. There are also comments on the store having a nice selection of products given its small size. Currently, the population in Santa Rosa within a one mile trade area (due to smaller store size) of Pacific Market is over 80% white, 13% Hispanic, and the average household income is $56,738. This average household income is projected to rise in the coming years to $60,905 by 2021.10 Similar to the Sebastopol store, the Millennial and Baby Boomer age categories are expected to rise by 2022 (see **Exhibit 2**). 10

Through a series of interviews with consumers living in the Sebastopol and Santa Rosa Pacific Market trade areas who are currently in the “rarely” or “sometimes” category of shoppers, it was discovered that they shop at Pacific Market mainly when they’re in the area or if they live close to the store and forgot something in their normal shopping trip. The general consensus in their biggest deterrent to being regular shoppers is the price point being seen as higher than competitors, but the prepared foods section had good reviews along with the beer and wine selection. One interviewee stated in reference to the Sebastopol store, “Maybe they even need to become THE go-to store for locally grown/raised/created food. Every store has a little bit of that, but no one has cornered the market on it. Whatever their niche might be, they need to find it. Otherwise they're your average, run-of-the-mill store with higher prices.”11

Sebastopol Competitors

The Sebastopol Pacific Market store has six competitors within a three-mile radius. These stores comprise of chains such as Lucky’s Market, Safeway, and Whole Foods, as well as locally owned stores like Community Market, Fircrest, and Andy’s Produce. Two of those stores are a conventional format, Safeway and Lucky’s. These stores have Yelp reviews of 3.4 and 3.7 respectively, with feedback about the lack of customer service, attention to quality and cleanliness, and lack of natural/organic product selection.8 By contrast, there are two natural format stores in the trade area: Whole Foods Market and Community Market. Whole Foods Market includes a full-service cheese department, juice bar, deli, salad bar, and a large bulk food area comprising of their private label 365 brand. This store is the highest volume estimated in the trade area at $375,000 per week.8 (See **Appendix 2** for supply of trade area markets.) Their Yelp reviews are at 3.7 although they just recently introduced same day grocery delivery, which may alter their Yelp rating in the future depending on quality of that service.

In terms of locally owned competitors, Community Market is the newest grocery store to the trade area and is a 100% organic food co-op. They have a vegetarian deli and salad bar, a large holistic body care department, a cafe/taproom with a lot of seating, and Yelp reviews of 4.5. Being employee owned and having high integrity product is their forte, although they are underperforming at an estimated $100,000 in sales per week.8 Andy’s Produce is a small format natural food store that has the niche of a retro open-air produce market. Recently they have added shelf stable bulk foods, dairy, meat, cheese, and natural body products. They also have an outdoor coffee shop serving local coffee and a very strong customer following with 4.6-star Yelp reviews.8 Fircrest is the furthest south of town and is able to corner a market based on location alone. Largely conventional, it has been around since 1961. Because of this, they benefit from low occupancy costs, which is reflected in their pricing. With mixed Yelp reviews at 4.6, customers like the prices and friendly staff but feel the lack of variety and natural food product selection.8

Santa Rosa Competitors

The Santa Rosa Pacific Market store has four competitors within a one mile trade area. There are two different Safeway's offering conventional formats. The one servicing the Montgomery Village and Western Rincon Valley neighborhoods have Yelp reviews at 3.9 with comments indicating a lack of service and quality perishables. Even so, the store is estimated to be performing well at $650,000 sales per week.10 The Safeway servicing Steele Lane west of Mendocino Ave, as well as the entire Pacific Market trade area is also performing strongly at an estimated $800,000 in sales per week and have a Yelp rating of 3.9 with customers saying they’re satisfied but not impressed with pricing, quality, and service.10

The only locally owned competitor in the Santa Rosa trade area is Community Market co-op’s other store. This is the first of the two stores, founded in 1975. It is much smaller and difficult to access on the backside of a building, but carries the same ethos as the Sebastopol store. Unlike the Sebastopol store, the Santa Rosa Community Market does not carry any meat products and does not have a prepared foods section or taproom. They have a 4.4 Yelp rating with customers indicating that they enjoy the employee ownership and product integrity of the store.10 Grocery Outlet is the last store in the trade area, having the “extreme value” niche. They sell overproduced products, brands that have recently changed packaging, or are about to expire. With Yelp reviews at 4.2, customers appreciate the value-oriented pricing but have concerns with quality and short shelf life of the product selection.10

Potential Buyers

Oliver’s Market is a locally owned chain that was founded in 1988 by Steve Maass and has since grown to four locations, but without a store in the Sebastopol Pacific Market trade area (see **Exhibit 3**). Oliver’s Mission Statement is:

*At Oliver’s Markets, our mission is to provide Sonoma County with the finest grocery stores in the marketplace. We are committed to delivering excellent customer service and we allow people to make their own choices by offering the broadest possible selection of local, organic, and conventional products. We work closely with our vendors to offer quality, variety and value to our customers. As a Social Purpose Corporation, we are committed to managing our business for the benefit of our employees, our communities, and the environment; aligning our purpose with our values. We strive to create a shopping and working environment that is fun, diverse, and welcoming to all. We honor the lives and interests of our employees and support their desire to maintain a work-life balance. We recognize that each employee’s unique talents and creativity contribute to the overall success of Oliver’s Markets. We value integrity and encourage our employees to be themselves. Our commitment to our employees includes an Employee Stock Ownership Plan, providing them with a personal stake in our growth and success.12*

Oliver’s sells 6,000 local products, making up 26% of sales.13 Yelp reviews for Oliver’s range between 4 – 4.5 with positive comments about the large chain prices and product availability but with a “mom and pop” feel. The produce and deli department have significant positive feedback, as well as the customer service. Recently in June 2017 Oliver’s became 43% employee owned through an Employee Stock Ownership Plan (ESOP).13 Employees with over ten years of service had their shares immediately vested, while those employed in January 2017 will be fully vested in three years. With 600 qualifying employees, they are now the largest ESOP in Sonoma County. At the same time, Oliver’s registered as a Social Purpose Corporation. Oliver’s offers a generous benefit package for full-time employees that includes medical, dental, vision, and a 2% 401(k) match, in addition to the ESOP. They offer a 10% employee discount which can increase to 40% with active participation in the company’s wellness and community service programs.

Nugget Market was founded in 1926 by Mack and William Stille and is still owned by fourth and fifth generation Stille family members. They have nine locations in the Sacramento area, three in Marin County, and just recently acquired two Sonoma County locations in Glen Ellen and Sonoma in 2016.14 While they do not have any stores in the Pacific Market trade areas, the recent purchase of stores in Sonoma County could signal a desire to enter the affluent Sonoma Count market. Similar to Oliver’s Market, they focus on offering high quality customer service and fresh produce, as well as natural, conventional, and specialty food items at affordable prices. Most notably, Nugget Markets has made Fortune Magazine’s “100 Best Companies to Work For” consecutively for the last ten years.14 Not only do they make this list for the warm and friendly work culture set by the management team, but also because even part-time employees pay zero healthcare premiums and everyone gets a 4% match for their 401(k) account.15 Their Yelp reviews average in the 4.5 - 4.6 range with customers noting very friendly and happy staff, high quality prepared foods, and often calling it a better Whole Foods.

Future Challenges

While Vasu has brought the company back to financial stability with modest profitability, he needs to decide on what future direction of the business will serve the best interests of his employees and his foundation. He can hire a new management team and keep operations the same but based on the financial statements is unsure if the necessary future benefit will come from it, along with the threat of deferred maintenance looming and resulting potential brand erosion (see **Exhibit 4** and **5**).

Vasu can invest heavily in a remodel and differentiation strategy to create a unique local-oriented, community supported profit sharing institution not currently being done anywhere else in the area, but is uncertain if disrupting his competitor’s sales to achieve a 50% sales volume increase over the next three years is realistic. (See **Appendix 3** for competitive store attributes.) He can invest in both stores at the same time or use one store as a trial first to test the differentiation strategy before implementing it at the other store.

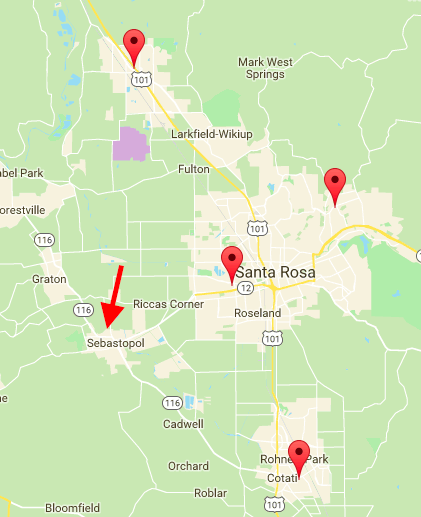
He can try to sell the business to a local grocery store chain that has an employee-focused infrastructure already in place, such as Oliver’s or Nugget Market but with recent large investments both potential sellers have made, he feels their cash flow and interest in making another investment right now may be low. With this, he could sell one of the Pacific Market stores and use the profits from the sale to invest in the other store.

Vasu is not concerned about the fiscal discipline required to maintain financial stability but he fears the unknown of what next step is required in this mature industry in order to grow the business to a place where he can take care of his employees and support his foundation.

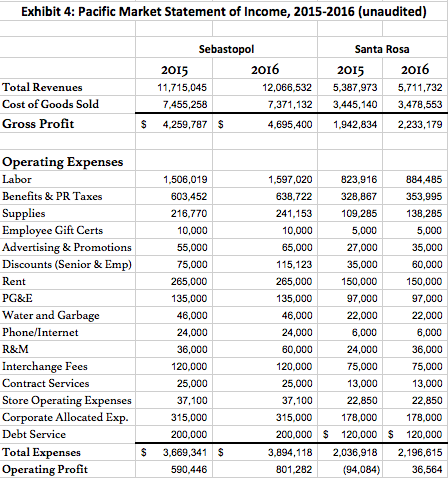
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Source: ESRI Demographic Report

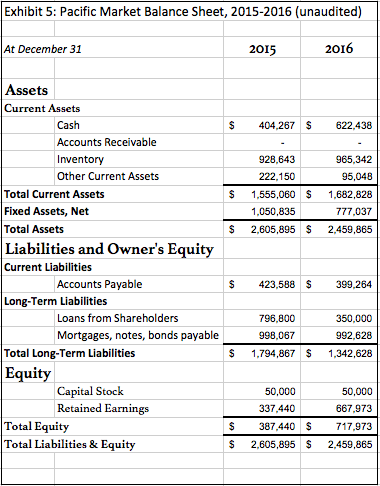
**Exhibit 3: Oliver’s Store Locations**

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Source: https://www.oliversmarket.com/store/



Source: Tom Scott, Pacific Market consultant



Source: Pacific Market

Appendix 1: Price Comparison Chart, June 2017

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **ITEM** | **Safeway** | **Lucky** | **Andy's** | **Fircrest** | **Community Market** | **Grocery Outlet** | **Whole Foods** | **Pacific Market** |
| **Guyaki Cans** | 2.49 | N/A | 2.29 | 1.99 | 2.19 (1.79 Ad) | N/A | 2.49 | 2.29 |
| **Racer 5 IPA** | 9.99 | 9.99 | 9.49 | 9.79 | 9.79 | 9.49 | 9.99 | 10.49 |
| **Clover Organic Milk** | 7.99 | N/A | 8.19 | N/A | 8.99 | 4.99 | 7.99 | 7.99 |
| **Amy's Soup** | 2/$6 | N/A | 3.79 | 3.25 | 3.29 | N/A | 2.99 | 3.39 |
| **GT Kombucha** | 2/$7 | 2.99 | 3.29 | 3.39 | 2.99 | N/A | 2.99 | 3.29 |
| **Bananas Organic** | 0.99 | 0.99 | 1.39 | 0.99 | 1.39 | 0.79 | 0.99 | 1.49 |
| **Organic Packaged Lettuce** | 3.99 | 3.49 2/$5 Ad | 5.99 | 3.99 | N/A | 2.99 | 4.69 | 3.99 |
| **Avocados** | 2.49 ea | 2/$5 | 1.29 | 0.79 | 1.99 | 2/$5 | 1.99 | 2.99 |
| **Organic Onions** | 2.29 | 1.49 | 1.49 | N/A | 1.49 | 1.69 | 1.69 | 1.59 |
| **Bella Rosa Coffee** | 9.99 | N/A | 10.19 | 8.95 | 10.99 | N/A | N/A | 9.99 |
| **Traditional Medicinal tea** | 3.99 | 5.49 | 5.69 | 5.25 | 5.49 (3.99 on Ad) | N/A | 4.99 | 5.99 |
| **Rock Island Fertile Eggs** | 4.49 | 4.69 | N/A | 3.99 | N/A | N/A | 4.19 | 3.99 |
| **Cowgirl Red Hawk Cheese** | N/A | N/A | 27.49 | 33.99 | 27.99 | N/A | 29.99 | 29.99 |
| **Hot Bar** | N/A | N/A | N/A | N/A | 8.99 | N/A | 8.99 | 9.99 |
| **Salad Bar** | N/A | N/A | N/A | N/A | 8.99 | N/A | 8.99 | 8.99 |
| **Kind Bars** | 0.99 | 1.79 | 2.19 | 2.05 | N/A | 0.99 | 1.69 | 2.19 |

Source: Tom Scott, Pacific Market consultant

Appendix 2: Supply of Trade Area Markets

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Supply of Trade Area Markets - Sebastopol** | | | | | |
|  | **Estimated Square Feet** | **Estimated Weekly Sales** | **Estimated Weekly Sales per Foot** | **Proximity to Pacific Market** | **% of Sales in Trade Area** |
| Pacific | 17,350 | $230,000 | $13.26 | - | 10.80% |
| Lucky's | 40,000 | $200,000 | $5.00 | 0.2 | 9.39% |
| Whole Foods | 14,500 | $375,000 | $25.86 | 1.1 | 17.61% |
| Safeway | 45,000 | $700,000 | $15.56 | 0.6 | 32.86% |
| Andy's | 12,500 | $350,000 | $28.00 | 1.2 | 16.43% |
| Community Market | 8,500 | $100,000 | $11.76 | 1.2 | 4.69% |
| Fircrest | 13,000 | 175,000 | $13.46 | 1.7 | 8.22% |
| Trade Area Totals | 150,850 | 2,130,000 | 14.11 |  | 100.00% |
|  |  |  |  |  |  |
| Shortage/(Surplus) Supermarket Space | 19,002 |  |  |  |  |
| Trade Area Leakage |  | $210,563 |  |  |  |

Source: Tom Scott, Pacific Market Consultant

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Supply of Trade Area Markets - Santa Rosa** | | | | | |
|  | **Estimated Square Feet** | **Estimated Weekly Sales** | **Estimated Weekly Sales per Foot** | **Proximity to Pacific Market** | **% of Trade Area Sales** |
| Pacific | 8,500 | $120,000 | $14.12 | - | 11.00% |
| Safeway -  Fourth Street | 45,000 | $650,000 | $14.44 | 0.7 | 43.00% |
| Safeway - Mendocino | 50,000 | $800,000 | $17.00 | 1.3 | 33.90% |
| Grocery Outlet | 18,500 | $250,000 | $13.51 | 0.7 | 9.10% |
| Community Market | 10,000 | $110,000 | $11.00 | 1 | 3.00% |
| Trade Area Totals | 132,000 | 1,980,000 | $14.62 |  | 100% |
|  |  |  |  |  |  |
| Trade Area Leakage (Surplus) | ($1,291) |  |  |  |  |

Source: Tom Scott, Pacific Market Consultant

Appendix 3: Competitive Store Attributes

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Attributes | Pacific Market | Safeway Fourth Street | Safeway Mendocino Ave | Grocery Outlet | Community Market |
|
|
| Checkstands | 4 | 12/6 Self | 17/6 Self | 6 | 3 |
| Hours of Operation | 7:30AM to 8PM Sun 8 AM to 8PM | 24 Hours | 6AM to Midnight | 8AM to 10PM | 8AM to 7:30PM |
| Bank | No | ATM | US BANK | No | No |
| Pharmacy | no | No | Yes | No | No |
| Service Deli | 24Feet | 24 Feet | 28 Feet | No | No |
| Sushi | AFC | AFC | AFC | No | No |
| Salad Bar | Yes | No | No | No | Yes |
| Hot Bar | Yes | No | No | No | No |
| Service Bakery | No | Scratch | Scratch | No | No |
| Service Meat | 32 Feet | 12 Feet | 12 Feet | No | No |
| Service Seafood | 4 feet | 12 Feet | 12 Feet | No | No |
| Outdoor BBQ | No | No | No | No | No |
| Service Gourmet Cheese | Yes | No | No | No | No |
| Floral | No | Yes | Yes | No | No |
| Organic Produce | Mixed | 12 Feet | Mixed | 16 Feet | 100% |
| Bulk Foods | No | 27 Bins | 172 Bins | No | 216+116 Herbs |
| Espresso/Café | No | Starbucks | Starbucks | No | No |
| Tap Room | No | No | No | No | No |
| Juice Bar | No | No | Yes | No | No |
| Natural HABA | Some | No | No | Some | Yes |
| Water Purifier | Glacieir | Glacier | Glacier | Glacier | No |
| Inside Dining | No | Yes | Yes | No | No |
| Outside Dining | Yes | No | Yes | No | Yes |
| Delivery | No | Yes | Yes | No | No |
| Community Donation Program | No | No | No | No | No |
| Go Local Card | Yes | No | No | No | 2% |

Source: Tom Scott, Pacific Market Consultant

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12. Mission & ESOP. (n.d.). Retrieved November 11, 2017, from https://www.oliversmarket.com/mission-esop/

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Pacific Market: Invest, Sell, or Stay the Same?

Instructor’s Manual

**Case Synopsis**

Based in Sonoma County, California, Pacific Market was acquired from its founders in 2014, at which time it was a floundering upscale regional supermarket chain. Using skills acquired from turning around failing tech startups, new owner Vasu Narayanan was able to stabilize Pacific Markets and somewhat stanch negative cash flows. Vasu pondered whether to try to sell Pacific Market to another local chain, hire a fresh management team to return the firm to a growth trajectory, or create a path to eventual employee ownership. In any event, a consultant to Vasu insisted that major investments were necessary to grow store volumes by 50 percent from 2018-2021. The case includes data on the U.S. grocery industry and local competition, and regional demographic forecasts through 2022. The case can be used as a graduate level group project in Strategic Management.

**Intended Courses and Levels**

The case can be used as a graduate level group project in Strategic Management. The case should be introduced to students towards the end of the semester, after learning about external and internal market factors, evaluating strengths and weaknesses of internal resources, and strategy formation. The case is highly suitable for a written assignment and/or team presentations.

**Case Topics**

Competitive and industry analysis

Evaluation of internal resources

Strategy formulation

Goal evaluation

**Research Basis for Gathering Information**

I worked closely with the owner of Pacific Market, Vasu Narayanan, and with his consultant, Tom Scott, who is the former CEO of a locally owned grocery store called Oliver’s Market. Together they helped to develop company history with the understanding of their new vision and long-term goals in the ownership change during three on-site meetings, one in August, one in October, and one in November. Tom Scott provided operating information and trade area analysis, while Vasu Narayanan provided financial statements. Interviews with six consumers who live in the trade area were conducted. Primary case data was supplemented with secondary research into published and electronic sources on the grocery industry and demographic information of the Sebastopol and Santa Rosa area.

**Basic Pedagogy**

Instructors in a strategic management course should review concepts of competitive and industry analysis, differentiation strategies, goal setting, and financial analysis.

1. Saloner, G., Shepard, A., Podolny, J. 2001. *Strategic Management*. First Edition. Hermitage Publishing Services. See Chapters 3 - 7.
2. Wheelen, T. L., Hunger, J. D. Hoffmann, A. N., and Bamford, C. E. 2015. *Concepts in Strategic Management and Business Policy,* Fourteenth Edition. Upper Saddle River, NJ: Pearson. See Chapters 4 – 8.

**Learning Objectives**

1. Develop an understanding of market changes in the grocery industry and apply analytic tools to identify external forces impacting Pacific Market.
2. Evaluate Pacific Market’s resources relative to external forces through applying a SWOT analysis.
3. Generate and interpret a financial analysis in order to determine if sales volume goals are realistic.
4. Develop, evaluate, and choose among strategic options through various ethical lenses, such as balancing employee benefits with the goals of achieving revenue and profitability growth sustainably.
5. Require students to show the implications of alternative approaches and carefully consider the pros and cons of each approach.

**Questions for Assignment/Discussion**

1. Identify key environmental changes in the grocery industry. Which have most aided the growth within the US grocery market?
2. How attractive is the US grocery market? Use Porter’s five forces to assess the market attractiveness.
3. Evaluate the strengths and weaknesses of Pacific Market’s current strategy. How likely is it that they will be able to maintain this strategy in the future without a new strategy?
4. Are Vasu’s goals of sales volume growth realistic given the financial health of the business?
5. What recommendations would you make concerning the next steps for Pacific Market? How will Vasu ensure his employees are taken care of?
6. Identify the pros and cons of recommended strategy and two alternative approaches to achieving their goals and justify your strategy recommendation.

**Answers to Questions for Assignment/Discussion**

1. **Identify key environmental changes in the grocery industry. Which have most aided the growth within the US grocery market?**

**“STEEP” Analysis for Pacific Market**

| **Macro-Environmental Force** | **U.S. Grocery Industry** |
| --- | --- |
| Socio-cultural forces | **++**   * Consumer attitudes shifting towards healthy eating * Increased demand for organic and natural food * Trend towards higher quality options at a lower price (private labels) * Increase in produce volume purchased * Projected increase in 25-34 and 65-74 age demographic by 2022 |
| Technological factors | **+**   * Grocery delivery by brick and mortar is newly implemented * Meal kit delivery and e-tailers are growing 9.5% annually * Checkout free shopping is being tested |
| Economic conditions | **++**   * Industry growth is dependent on strengthening economy * Increase in per capita income projected over next 5 years * Agricultural price index volatility * Food inflation rates |
| Ecological forces | **+/-**   * Balancing employee benefits with maintaining profitability and revenue goals * Food waste |
| Political & Legal factors | **+/-**   * Tax laws * California labor laws |

**KEY:**

**++ = Strong impact**

**+ = Moderate impact**

**+/- = Possible impact**

Socio-cultural and economic forces have played the largest role in growth of the U.S. grocery industry.

**Socio-Cultural Forces:**

* Living in an era of health crisis and increased lifespans, consumers attitudes about food are trending towards purchasing more organic food products and produce. The case states that consumers purchase these foods because they believe they are healthier for them.
* Due to bulk buying by large warehouse format stores, consumers want healthier food options at a lower price point. This is evidence by the growth of Trader Joe’s private label brand and their ability to offer organic and natural products at a lower price.

**Economic Forces:**

* In a commodity industry like food, growth is small and stated to be at the mercy of a strong economy. As consumers have more disposable income to spend, they are going to purchase higher priced food, which stimulates growth in the industry.
* Because this industry is based on unpredictable agricultural conditions, food prices are volatile and growth in the produce category may be negatively impacted by this force.

1. **How attractive is the US grocery market? Use Porter’s five forces to assess the market attractiveness.**

**Threat of New Entrants: Direct – Low, Indirect – High**

As stated in the case, due to over-saturation of grocery stores in the trade area and land use issues, the direct threat of a new grocery store being built close to a Pacific Market store is low. But with e-tailers and meal kit companies growing at a rate of 9.5% annually, as well as warehouse format stores starting to carry more natural food options at a lower price point, the threat of indirect new entrants is high.

**Bargaining Power of Suppliers: High**

As to the benefit of large warehouse formats carrying a wide variety of products, the more bulk ordering that happens, the more leverage stores have with their suppliers. Otherwise, they’re at the mercy of their pricing. This is to the disadvantage of small local stores like Pacific Market, which reflects in their prices to customers, but if they can grow their store volume, they’ll have more leverage and be able to offer products at a lower price point.

**Bargaining Power of Buyers: High**

Because of bulk ordering and lower prices of similar products by warehouse formats, online, and large chain stores, if buyers can find the same products at a better price somewhere else then they will not shop at a smaller local retailer.

**Threat of Substitute Services: Medium**

Since Amazon has bought Whole Foods, technology is going to disrupt the grocery industry with their testing of check out free shopping and grocery delivery within a few hours of ordering. Fortunately, the low profit margin nature of the industry, mixed with the high price of technology integration will make the industry changes slower than they would be otherwise. Other substitute services like meal kits will continue to grow but will not replace grocery shopping due to the need to eat other meals outside of the kits.

**Rivalry Among Competitors: High**

With so many different options of stores within the trade areas, direct rivalry among competitors is high. The cross-format differentiation strategy of Pacific Market is no longer unique and in order to stay competitive they’ll need to invest in a new strategy. As stated by Tom in the case, customer service is the key to staying competitive by creating the most enjoyable shopping experience. While outside of the trade area, there is definitely high sales leakage to indirect competitors such as online retailers, warehouse format stores, or grocery stores in other neighborhoods as well.

**Attractiveness of the Grocery Industry: Medium**

While the low margin and high competition aspects of grocery makes the industry low in attractiveness, with a people-centric person like Vasu, there is a strong mission-oriented element of the industry to make an impact in the community that makes it attractive to someone like him, especially if he has high margin investments elsewhere in tech.

1. **Evaluate the strengths and weaknesses of Pacific Market’s current strategy. How likely is it that they will be able to maintain this strategy in the future without a new strategy?**

Pacific Market’s past differentiation strategy was in their cross-over format offering conventional, natural, and specialty food products. Over the last decade, this format has turned into the norm for any grocery store servicing a more affluent demographic. Since late 2014, Vasu has practiced an integrated cost leadership strategy in terms of managing costs behind the scenes to have a more efficient and lower cost delivery of products but it has not changed the price of the products to consumers. This strategy of financial discipline is good in a turnaround scenario, but will not be enough for growth in the future. Pacific Market needs to determine a new differentiation strategy in order to be competitive. A SWOT analysis must be performed to determine their current position.

**SWOT Analysis for Pacific Market**

|  |  |
| --- | --- |
| **Strengths** | **Weaknesses** |
| - Strong leadership in owner and consultant  - Offer a variety of products in cross-over format  - Practicing financial discipline with profitability  - Neighborhood feel and legacy  - Scale – small enough of a business to have  quick response time to feedback  - Loyal following of customers over the age of 35 | - Brand erosion from financial difficulties  - Mixed reviews on customer service  - Low Yelp ratings  - Ten years overdue for a remodel  - Management turnover through retirement  - Lack of firm mission and values  - Outdated differentiation strategy  - Weak employee compensation and benefits |
| **Opportunities** | **Threats** |
| - Annuity is an attractive sale option to cash flow  tight buyer  - Offer attributes in remodel not currently offered  by anyone else such as tap room  - Local partnerships with businesses and organizations  - Owning the “small local products” niche  - Marketing to a younger growing demographic  - Non-financial employee perks | - Disruptive technology developments with high entry cost  - Poor hire of new management team  - Poorly executed differentiation strategy and renovations  - Mass merchandiser entering trade area  - Economic crash  - Poor crop season leading to produce price volatility  - Competitor implementing unique attribute before Pacific Market |

1. **Are Vasu’s goals of sales volume growth realistic given the financial health of the business?**

Vasu’s goal of a 50% sales volume increase within three years is a 14.47% CAGR in an industry that averages 1% growth annually. With financial discipline, the CAGR from 2015 to 2016 was 3.95%. Even though Pacific Market has a lot of opportunities available to improve their customer experience under new management, it is a very large growth requirement and requires significant disruption of competitor’s sales through a large renovation and is a stretch goal in a three-year time frame. Given the mixed reviews of customer service and low Yelp ratings, if Pacific Market invests a lot of money in a renovation and the customer service, fair prices, and product curation is not improved then their differentiation strategy will not be successful.

Pacific Market is increasing their liquidity from 3.67 in 2015 to 4.21 in 2016. They are also increasing their gross profit margin from 36% in 2015 to 39% in 2016 and reducing their debt to asset ratio from 85% in 2015 to 71% in 2016. One important metric in the grocery industry is the amount of labor relative to sales. In both 2015 and 2016, labor remained at a constant 14% of sales. This will be an important metric to watch moving forward in the invest of improved customer service. Overall, the financial health of Pacific Market is solid.

1. **What recommendations would you make concerning the next steps for Pacific Market? How will Vasu ensure his employees are taken care of?**

* Since Vasu’s main goal is to take care of his employees and fund his foundation, I recommend approaching Oliver’s or Nugget Market to determine sale interest first since that is the quickest avenue to achieving this goal. If they are not interested, I recommend moving the 50% sales volume growth timeframe to five years instead of three for a more realistic CAGR of 8.45% given financial discipline and investment opportunities.
* Investing in the business is a must in order to achieve Vasu’s goals of taking care of his employees and funding his foundation. I recommend implementing profit sharing as soon as possible, even if it is a very small amount, as well as non-monetary employee benefits such as an employee training program. Both of these will immediately improve morale and customer service and lead to a byproduct of increased sales volume from current customers and a stronger word of mouth marketing. It will also allow some money to be invested in the foundation to ensure both parties are taken care of.
* As sales volumes increase, I recommend slowly investing in updating the infrastructure of the store with cosmetic changes first. Research further the customer response to a “local focused” differentiation strategy and focus on interviewing the Millennial demographic in order to reach a younger demographic. Determine what percentage of products or product sales should be local and what types of products should be curated in order to create this competitive edge. The local offerings would need to be higher than Oliver’s 26% of sales to reduce trade area sales leakage.
* Test the differentiation strategy in the smaller more price elastic Santa Rosa store first and use sales volume, profit margin, average age of shoppers, and product mix as quantitative metrics to determine success of strategy. Qualitative measurements could be customer satisfaction levels asked at the checkout stand.

1. **Identify the pros and cons of recommended strategy and two alternative approaches to achieving their goals and justify your strategy recommendation.**

|  |  |
| --- | --- |
| ***Recommendation #1: Sell to Oliver’s or Nugget Market*** | |
| **Pros** | **Cons** |
| - Employees will be taken care of with compensation and benefits package faster  - Foundation will have guaranteed funds for 20 years from annuity  - Brand power and increased bulk purchasing leverage will improve customer perception and fair price points quickly  - Financial resources to make upgrades to stores will be available, along with high standards and store layout plan already in place | - Becoming part of a larger chain may lose the “neighborhood feel” of Pacific Market  - The larger a chain becomes, the less control they have over customer experience – very heavily reliant on store management instead of ownership  - Employees will have to go through another ownership change in a relatively short amount of time, which may affect customer service  - Local food producers will not gain exposure due to larger order process of chains  - Local community will get less focus with the companies being located in multiple cities. |

|  |  |
| --- | --- |
| ***Recommendation #2: Invest over a five-year period*** | |
| **Pros** | **Cons** |
| - Profit sharing will positively improve morale and customer service due to increase in compensation  - Small company lends for full control over customer service and employee experience, as well as quick response to feedback  - The “comeback” from financial trouble to vitality under Vasu’s ownership may help morale of long-time employees  - Will help give small local food producers exposure they don’t achieve elsewhere from competitors  - Local businesses and organizations can be supported  - Helps local community have a global impact by contributing to Vasu’s foundation in India  - Can reach a larger demographic by appealing to Millennials | - Will take five years to have an attractive compensation and benefits package for the staff  - Will require a sizable investment from Vasu  - Implementing a training program and non-monetary benefits is labor intensive  - Threat of five-year timeframe allows for competitors with more resources to move on this differentiation strategy quicker  - Investment and differentiation strategy may fail with poor execution and not produce sales increase |

|  |  |
| --- | --- |
| ***Alternative #1: Stay the same*** | |
| **Pros** | **Cons** |
| - Employees can keep doing what they are doing, nothing new will be required of them or change  - Current customers will maintain their current experience  - No financial investment will need to be made | - Employee compensation and benefits package will remain lower than the competition  - Company growth will barely clear inflation  - Foundation in India will not receive funding from Pacific Market  - Ten-year outdated infrastructure and maintenance will continue to decline along with the brand  - As competition invests to stay relevant, Pacific Market sales may decline until they are no longer profitable and they could sell for less than it’s worth |

|  |  |
| --- | --- |
| ***Alternative #2: Sell one and invest in the other*** | |
| **Pros** | **Cons** |
| - Will have immediate cash for investment  - More control over customer and employee experience with a smaller focus  - Employees at other store taken care of quickly with foundation modestly funded | - Lose buying leverage with suppliers by being a smaller company  - Cannot get much money from Santa Rosa store for investment in Sebastopol  - If Vasu sells Sebastopol then Santa Rosa loses administrative team and shared expenses so overhead costs will increase and profitability will suffer |

*Suggestion for Wrap Up*

With financial stability brought back to Pacific Market but with an outdated differentiation strategy, Vasu needs to decide on the best strategy in order to take care of his employees and fund his foundation in India. The main takeaway for students in this case analysis should be the balance of profitability and proper infrastructure maintenance with the ethics of corporate social responsibility in taking care of employees and serving both local and global communities to make an impact. Considerations in these decisions should be industry trends, critical internal resource evaluation, and the different paths to achieve this balance with the pros and cons of each.

1. T. Scott and V. Narayanan, personal communication, August 2017. All subsequent quotations with the owner and consultant are from interviews by the case writer. [↑](#footnote-ref-1)