

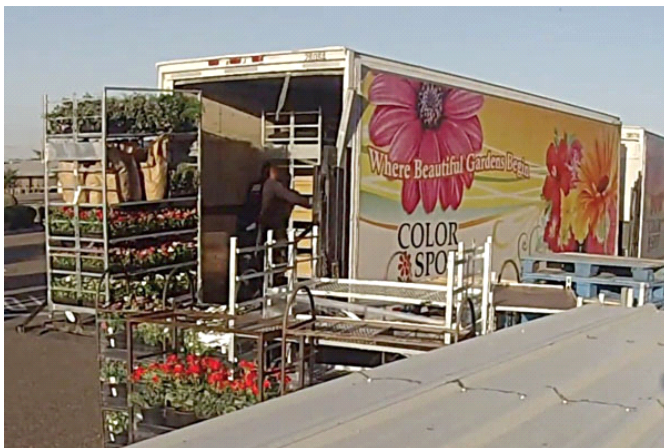
GROWERTALKS

Cover Story

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The Forces That Brought Down Color Spot

Barry Sturdivant, with Jerry Halamuda



Color Spot changed the horticulture world. The innovations they created and services they introduced will live forever. They taught the industry how to be a true partner with its retailer customers. They perfected in-store merchandising and began the practice of making deliveries on rolling racks. They made strategic acquisitions in concert with their valued customers. For a time, they almost made their competitors irrelevant. They gave a shot of adrenaline to a sluggish industry.

Think about it: Long before anyone else had imagined it, Color Spot had representatives on the road calling on

multi-outlet retailers, hired in-store merchandisers to keep plants fresh, put up signage and educated store employees, provided display racks and point of purchase materials, delivered product on rolling racks, and worked with retailers on volume incentives. This all led to an explosion in the sale of annuals and perennials that spread across the nation.

Pictured: Color Spot was a pioneer of rack delivery and merchandising of plants. In the foreground you can see their in-house-made delivery and display racks, with the curved steel tops.

Color Spot had so much going for it: great management and employees, great relationships with its customers, excellent markets, an understanding of its costs, and great product quality. The entire industry learned from their example and copied their practices. On balance, Color Spot was a great success story.

Yet, they didn't make it. Color Spot is gone.

In the end, the Color Spot story cannot be told without also telling the story about an industry that eats its own. An industry whose lenders fail to even try to understand its clients' businesses and never seems to provide constructive credit. Instead, they either starve greenhouses for cash or over-lend them into trouble. An industry in which customers routinely demand double-digit growth from their vendors, never realizing the pressure this puts on vital cash and human resources—not to mention the related financial risk. An industry in which competing growers consistently underprice products and sacrifice profits in order to gain additional sales territory, hurting all growers' profits in the process. Color Spot was part of that and a victim of that.

Rapid growth

Jerry Halamuda, a greenhouse grower in Southern California, met Mike Vukelich, Jr. almost 40 years ago. They were two guys in their 20s who discovered a shared dream: their love for floriculture, their vision for what a large nursery operation could do and their desire to build a business that treated employees like family. It was a great business partnership and lasting friendship. Together, they sought to build a business that left its mark on an industry.

They knew the home improvement stores depended on traffic entering through garden centers to draw customers to other parts of the store and they relished their role in helping these stores grow in number around the country. They also took pride in building a business that supported the more than 5,000 families of the employees that worked for them.

Color Spot grew rapidly, both organically and through acquisitions, adding production space to the properties they already owned. They had many growing facilities located in California, Arizona and Texas to serve their huge market. They recognized this for the challenge it was and hired excellent personnel to run the growing and marketing operations. They treated them like family. Still, it was tough and the company suffered growing pains.

Inventory, for instance, is challenging enough to track at one location, but the difficulty increases exponentially with each additional location. When growing quick-cycling annuals at the same time as slower-cycling shrubs, it gets even more difficult. If, at the same time, you're being asked for double-digit growth each year under the threat of losing business if you don't produce, it's almost impossible to produce the needed cash flow, as more and more dollars go into building inventory.

Color Spot produced a quality product and they got it into the stores on schedule—no small task. The trick was not getting caught with too much material after Mother's Day, when sales slowed; they had a tough time dialing that in at all of their locations. Shrink hurt them when the weather wasn't perfect. Pioneers are justifiably lauded for blazing trails, but in the process, they're also the ones that take the scrapes and bruises—and risk, as they ascend the learning curve on behalf of the industry.

Color Spot didn't have the luxury of learning pay-by-scan and in-store merchandising from someone else—they had to invent it. And they had to do it in a territory that spanned from all of California through Texas and Louisiana. Coordinating production, scheduling, assembly and delivery from multiple growing locations over such a vast geographical region is a gigantic task. Other large growers that appear to be succeeding either have production in just one or two locations, or have a done a good job with a specialty crop, such as orchids or succulents. As Color Spot found out, it's tough to be a generalist when serving a large sales territory.

Enter private equity

Around 2010, Color Spot was at the top of their game. They had come through the Great Recession as well as anyone in the industry. Against steep odds, they figured out and coordinated each location's growing schedules, delivery and merchandising, and they maintained quality in the process. They weren't stuffing stores with inventory, and hence, sustaining credits and low scan rates. Shrink was under control, both on the farms and in the stores.

Margins during this period, however, were seriously compressed for the entire industry, regardless of how much growers were improving efficiency. Price increases were hard to come by, as they always seem to be in agriculture. Color Spot management worked hard to cut costs, which had a positive impact on their earnings and cash flow. It was hard to stay profitable while paying the additional people needed for in-store merchandising at growing hourly rates, but somehow they were making it work.

Then, a series of events worked to upend their delicate balance. The first was the death of Mike Vukelich in August

2011 after a year-long battle with brain cancer. The loss of his best friend was devastating to Jerry, but it also put more of the management burden on him—which was considerable, as Color Spot grew to double in acreage and almost double in sales volume between 2011 and 2016.

The second was an unexpected competitor. Competition is fierce for high-volume and high-scan-rate stores, and Color Spot's batting average in getting assigned the better stores was average at best, despite their size and abilities. Meanwhile, a competing grower was able to purchase some growing facilities in Texas and Colorado for unbelievably low prices, thanks to a seriously flawed and ill-advised bank-enforced liquidation. (This came, by the way, after an earlier cash offer by Color Spot, which seemed fair and was well in excess of the price eventually accepted by the bank.) Suddenly, Color Spot found itself battling in the Southwest with a competitor that had a much lower cost structure.

The third setback was an unwise—and unwanted—acquisition. While Color Spot seemed to be getting its operations dialed in, another competitor, Hines Nursery, was struggling with financial issues born out of overpaying for a dozen nursery and supply operations back in the '90s. Their debt load was enormous, as anyone who listened to their quarterly calls or read their reports when they were listed on NASDAQ might recall.

The private equity group that owned Hines, as well as a minority position in Color Spot, came to own a majority percentage of Color Spot after buying out another group's position. It recommended that Color Spot acquire Hines, thinking Color Spot's management could fix Hines' ills. An analysis by multiple investors indicated that the transaction would not be in the best interest of the shareholders. However, the principle investors felt the deal would be positive in the long run, and so Color Spot made the purchase. This saddled the combined companies with a huge debt load, along with all the other financial baggage Hines brought to the table. The acquisition never got on track.

A fourth factor that handicapped Color Spot was a very poor loan structure by their lenders, which coincided with a post-recession financial environment that put pressure on banks to tighten their lending standards. Lenders had been structuring loans in a way that encouraged higher and higher levels of inventory. At their core, nurserymen are farmers and it's hard for them to resist planting "fence row to fence row." The high inventory investment consumed a good portion of their available cash on products that didn't turn fast enough to service the debt.

This type of loan structure is called "asset-based lending" and it doesn't serve to instill discipline in the borrower—at least not for perishable inventory. It looks at working capital as collateral rather than as a measurement of cash liquidity, allowing for needed cash to be diverted into growing inventory levels. Additionally, the lenders focused on EBITDA (earnings before interest, taxes, depreciation and amortization), never realizing this is an inadequate measure of cash flow. They never took into account the glaring fact that the "I"—interest—is a real expense for which any business has to write an actual check. The "E"—earnings—was impacted by annual inventory increases to support those double-digit sales increases the big boxes were demanding.

In accrual accounting, an increase in inventory creates a similar increase in earnings. That's good for earnings, but bad for cash flow if your analysis ends with a discussion on EBITDA—which it apparently did for their lenders. At the same time, Color Spot faced a couple of back-to-back poor-weather years, which exposed the strain on cash flow caused by the excessive inventory.

If all that wasn't hard enough to deal with, in 2016, CEO Jerry Halamuda suffered a debilitating injury that forced him to step away from day-to-day operations. The lenders opted to insert a finance person into the top position, which led to massive cost-cutting measures of which MBAs seems so fond. Customers felt the change—to Color Spot's detriment.

When the banks finally realized everything that was going on, they appeared to have little patience to work with Color Spot/Hines to improve the situation. They wanted to liquidate.

This is where it gets wonky

Bankers have to look in the mirror and accept some share of the blame for Color Spot—and a lot of other good companies, too—going out of business. When I came into this industry in 1985, few lenders wanted to finance it. Commercial banks didn't understand the seasonality and financing of living, perishable inventory. And traditional ag lender Farm Credit struggled to finance a commodity that wasn't listed on the Chicago Board of Trade or shipped directly to supermarket shelves without the protection of PACA laws that guarantee quick payment.

However, as the economy grew, banks were hungry for assets (in other words, to make loans). Their attention turned to an industry that was rapidly growing in concert with hundreds of new store openings by home improvement chains. When a hiccup hit the economy, or when there was a challenging weather year, cash became tight because it was all invested in slow-turning inventory or greenhouse structures that weren't paying for themselves. Thus starts a dangerous domino effect: the need for cash outweighs the need for profits; prices are cut; customers expect the rest of the industry to also cut their prices; the industry does; everyone's profits are compressed or losses are sustained; operations are liquidated at pennies on the dollar; banks begin hating the industry they once loved; credit gets harder to come by; the growing operations that survive come into some low-priced assets that should help profits for a while—but it may only be temporary.

Greenhouse lines of credit are best placed on a crop loan budget, just like corn, wheat and soybean farmers. This is because 65% to 85% of their plant material is sold in the spring. But the lenders didn't do that. In fact, they wouldn't allow that to happen until the past couple of years. What they did instead (and still do today, for the most part) was put them on an asset-based lending structure, where they loaned against accounts receivable and inventory.

The problem with this is that greenhouses need funds in January, February and March, and often don't have the "borrowing base" in A/R and inventory to serve as collateral. Therefore, they're starved for cash when they need it most. This causes growers to unfairly ride the credit of seed, plant and hardgoods distributors. The industry needs strong allied suppliers and many of them have been hurt by banks forcing suppliers to become de facto bankers.

As bad as asset-based lending was for greenhouses, it was truly disastrous for woody ornamental nurseries. Bankers were fat, dumb and happy, with their lines of credit apparently well-secured by inventory. They loaned the industry into oblivion because asset-based lending allowed growers to expand fence row to fence row—which was fine until the recession hit. What lenders should have done was recognize that, for slow-growing tree and woody ornamental plant material, an increase in inventory is similar to buying a piece of equipment: It generates cash flow over time from profits. Therefore, it would be better financed from current earnings on a four- or five-year installment loan. This would have instilled discipline and would have put nurseries in a better position when the recession hit.

The moral of the story

A famous quote from Mark Twain goes like this: "When I was a boy of 14, my father was so ignorant I could hardly stand to have the old man around. But when I got to be 21, I was astonished at how much the old man had learned in seven years."

Similarly, a retrospective on the life of Color Spot gives us all valuable lessons on how to be better. They went down every street and had every experience, good and bad, that a greenhouse operation can have. The industry—including growers, suppliers, investors and lenders—should continue to study Color Spot's life and learn from it.

Growers: Watch your cash! Meeting a working capital ratio or complying with a borrowing base are poor indicators of liquidity. As "the big short" that caused the Great Recession 11 years ago proved, just because a bank agrees to

loan you money doesn't mean you should take it and it doesn't mean you won't eventually lose your house.

Suppliers: Most of you can't afford to be in the lending business. Make sure your customers' lines of credit extend well beyond the shipping season to allow for the collection of accounts receivable so you can get paid. Seasonal terms are up to you, but they're risky.

Investors: You've probably already noticed several major banks will have little or nothing to do with private equity groups. There's a reason and I'll leave it at that. For other investors, the greenhouse industry still has a world of potential. The key seems to be keeping the family ownership involved and motivated, or at least a management team that has a passion for the business. Book knowledge alone doesn't seem to cut it in the greenhouse and nursery industries.

Lenders: You all proudly announce that you're cash-flow lenders, but you're not. Not really. I offer asset-based lending as proof, along with operations—several of them showing profits—that ran out of cash, due in part to poorly structured loans, and were liquidated. A crop/cash flow budget needs to be prepared, in concert with a borrowing base, and adhered to instill discipline and to give an early warning to you and the grower to get an early start on correcting a cash shortage. Also, set working capital goals in dollar amounts to ensure bills are paid on time as the business grows.

Like Mark Twain's father, I suspect Color Spot will look a lot smarter in the future. If their lessons are ignored, other growers could find themselves in the same predicament. It doesn't have to be that way. Resources are becoming available, such as through Professor Charlie Hall of Texas A&M and others, to help us avoid future problems. It all begins with identifying the issues and then openly discussing them as an industry. We all need to participate in that discussion. **GT**

Barry Sturdivant provides term real estate loans to growers, as well as occasional consulting. He may be reached at (951) 541-4004. Jerry Halamuda is co-founder and CEO/president of the former Color Spot Nurseries. Now semi-retired, he serves as a consultant and advisor to the horticulture industry.

Jerry Halamuda, on His Passion

As you read this story, it's critical to understand that my partner and dearest friend, Mike Vukelich, Jr. and I loved this business and built our business over 38 years together (he passed in 2010). Our journey wasn't one of the industry being out of alignment, or of the vendor community lacking integrity, but one of us choosing to grow our business using capital from equity partners who didn't have the same goals and objectives as we did.



Pictured: Best friends and business partners Michael Vukelich (left) and Jerry Halamuda, circa 2009.

While we were running the business, we were capable of directing traffic and keeping the wolves away from the door. But as soon as we were no longer physically capable of leading and driving the business, the MBAs took over. Unfortunately, our large customers are used to seeing nursery owners walking through the door to take care of their stores. The issue of big box retailers and their selling models can be challenging and can compress margins, however, that is the "buy-sell" dynamic, and it needs to be managed by buyers and sellers.

I started working in the tomato fields at 17, became a farm/nursery owner/operator at 20 and spent the last 52 years having fun and helping build this industry. I want that beauty that Mike Jr. and I experienced to be clearly understood. —Jerry Halamuda

Seven Questions for Barry

As this story was in the editing process, a large mass-market grower posed these seven questions to Barry Sturdivant. We thought it appropriate to include them here:

Q: Should a grower consider signing on with a venture capital group?



Barry: *(pictured)* If a venture capitalist wants to invest and keep the owners deeply involved in management, use that VC. Unfortunately, that list is pretty short. Just be sure to negotiate their cash buy-in up front. And give a pass on an earn-out provision.

Private equity groups are usually run by smart people, usually Ivy Leaguers. Being a humble product of public schools, I don't know what goes on in those hallowed institutions of higher learning. I suspect they have advanced classes on how to screw owners by paying as little cash up front and promising an "earn out" over the next three years that rarely materializes, how to screw banks by orchestrating bankruptcies with a friendly judge, identifying a stalking-horse bidder before the bank even knows there's a problem, and getting a cash collateral motion simultaneous to the filing, which keeps the bank and suppliers from collecting the accounts receivable on which it had a first lien.

Q: How does a grower know when it's time to close the doors?

Barry: It's time to hang it up when you look at your earnings and in the past five years you've either lost money or your inventory increases have exceeded your net income number. The good news is the bank hasn't yet figured out that the business is in trouble, so sell the place now while the bank will be more than happy to finance your buyer.

Q: If you're a distributor, how can you know if you should sell to a customer that's in distress?

Barry: Find out when their line of credit matures. If the bank fully intends to work with the grower, the renewal date will be sometime from September to December. If they have some thought about pulling the plug, they'll have a maturing date of sometime around July 1 so they can collect the accounts receivable from the customers before you can get paid.

Q: How the heck did it happen?

Barry: In the end, everyone was just doing their job. I never had the opportunity to work with Color Spot, but I believe I know enough of the participants and the dynamics between them to figure out what happened.

Mike Vukelich and Jerry Halamuda followed a passion and pursued it with a lot of effort and innovative ideas. They grew a large business. People noticed and they wanted on board. Major retailers wanted a supplier that could scale to meet their growing demand. Private equity groups had money to invest and were looking for opportunities. Banks, likewise, were looking to grow their portfolios.

During the ascent of Color Spot, the business environment changed in America. Everyone talks about being relationship-oriented, but they're not. American business has become largely transactional. Color Spot was a relationship business in a transactional world. Their customers were trying to meet growth and income numbers at the expense of Color Spot. Banks, due in part to the regulatory environment, had no patience or willingness to work with a business that had a bad year.

Bad years happen in agriculture. Private equity groups wanted their investment back within a time period that proved

impossible in the compressed profit environment. In a transactional world, inexplicable mistakes happen. In 2014, I was dumbfounded to hear Color Spot's lender approved the private equity group to take a \$15 million dividend out of the operation. You can't blame the equity group for asking, but it shouldn't have been allowed to happen.

Q: *How can retailers know which growers they should trust?*

Barry: In my opinion, it wouldn't be an intrusion for a retailer to ask to see the borrowing base on December 31 and June 30, or a year-to-date actual versus projection on a crop budget at June 30. If the grower doesn't want to share that info, find another grower. It's okay to share some small amount of information with the people who are important to their business.

Also, in my opinion, retailers should worry more about giving reasonable price increases and worry less about whom they should trust.

Q: *And how can vendors know which growers to trust?*

Barry: Vendors need to know the maturity date of the line of credit and they, too, should see the borrowing base or crop budget versus actual performance.

A more simple approach: No more seasonal terms. If a bank won't take the risk with its first lien on the trading assets, you certainly shouldn't. Net 30 going forward.

Q: *If I'm a retailer (large or small), what signs should I be looking for that might indicate a grower is in trouble?*

Barry: Well, if you're a retailer that just kicked a major supplier out of Texas, that may be a sign something is about to go wrong. Otherwise, see the previous two paragraphs.

Whatever Happened to Size = Leverage?

Isn't it ironic that, after all the effort to consolidate to (supposedly) gain efficiencies, the remaining much-larger greenhouses across the U.S. and Canada almost certainly need to see some significant price increases in order to ensure their financial viability?

Buyers for several of the big box retailers have told me they need a strong green industry to help them get footsteps into their stores. And yet, they're partially responsible for the consolidation of green goods suppliers over the past 20 years. In the process, they've been able to reduce their buying staffs and in-store personnel in the garden centers. We all bought into it, but I wonder if it was such a great idea? Maybe it was when they were adding 100 new stores each year? Now that the rapid growth period has seemed to pass, I wonder if those retailers wish they still had those plant suppliers that fell along the wayside?

One would think that the fact there are fewer suppliers would have moved the leverage to the growers' side of the table during line reviews, but that doesn't seem to be the case. A fair number of growers are still traveling to the retailer's buying offices, hat in hand, hoping to get sales increases, many of them still incorrectly focused on the top line instead of the bottom line.

—B.S.