Mattress Firm’s Moral Bankruptcy
by John McNellis • Nov 6, 2018 • 24 Comments
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It may be that moral bankruptcy is one of the quickest preludes to Chapter 11.

Wolf here: On August 6, about two months before Mattress Firm filed for Chapter 11 bankruptcy, I published my expose: “Mattress Firm Considers Bankruptcy to Get Out of its Real Estate Scams. This is so thick it’s hard to believe.” In December last year, I covered its Enron-like parent company, Steinhoff, that collapsed after admitting to “accounting irregularities.” Now there is another chapter in this sordid story, this one by John McNellis, who, as landlord of a strip shopping center, had his own dealings with the Mattress Firm.

By John E. McNellis, Principal at McNellis Partners, for The Registry:

Mattress Firm, the nation’s largest mattress retailer, filed Chapter 11 bankruptcy last month. Why did it go bankrupt? Simple. The company had far more stores, more than 3,600 nationwide at its 2016 peak, than could ever possibly be profitable. The intriguing question is how did MF end up with too many stores? Was it the hapless victim of the internet, was its management incompetent or was it something else?

First, let’s dispense with the internet-ate-my-homework nonsense. MF’s partial explanation for its collapse is a variation on the usual story: Consumers flop on a bed in a MF store, bounce up, go home and buy it online. That this Texas two-step only happens on items consumers test in
person when the bricks & mortar retailer can’t compete on price or availability was apparently lost on MF. E-commerce is not the lump in the mattress.

Now, a bit of background: Sophisticated retailers research what the “total addressable market” (TAM) is for their product; that is, if they managed to capture every single buyer in the country, what would that total number be? And then—this is where hubris or bungling can arise—they decide how much market share they can capture from their competitors.

If four equally strong companies are selling a given product, an individual company’s market share might reasonably be 25%. If there are twenty competitors, one’s share might be 5%. You get the picture. And when everyone and their mothers are selling mattresses (they are), your realistic market share should be lower than your height, particularly since consumers only buy a new mattress once every 7 to 10 years.

Everyone at MF knew this, everyone knew that you cannot stack mattresses to the sky. In fact, they publicly stated the company wants a population of 50,000 in a trade area as a condition to locating a store there. They also knew, however, that you can’t create big value for your shareholders and, more importantly, yourself if you fail to meet Wall Street’s insatiable demands for growth.

Until 2016, MF grew like a sunlit jungle vine by rolling up one regional mattress chain after another under its flag and opening hundreds of new stores. Senior management could only have justified this warp-speed expansion to its board of directors and Wall Street by inflating its probable market share. How much did it over-expand? If it takes 50,000 people to support one successful mattress store, then, at 3,600 outlets, the company had stores for more than 180 million people, about half the U.S. population, meaning it had to capture an enormous share to succeed.

It didn’t. And maybe it never really intended to.
Bringing this down to the street level demonstrates the company’s true regard for market share and profitability. When MF rolled up the Sleep Train chain in 2014, it acquired an outlet in our shopping center in Petaluma. A town of 60,000, Petaluma had 6 separate mattress shops and a number of home stores that also sold beds. Since this meant the town had more mattress stores than 7-11s, we were sure MF would close our location to protect its existing store 300 yards away.

Wrong again. When it opened in our center, I asked our local partner, “WTF, how can four mattress stores at the same freeway off-ramp possibly survive?” He mumbled something about MF’s drive for market share and “four-squaring” a location, controlling every corner, about capturing all available consumer dollars.

MF’s approach to Petaluma was not unique. Rather, its nationwide market over-saturation is so apparent to even casual observers that conspiracy theories abound. Some outraged landlords are wondering whether MF long ago hatched an evil plot to pin down all of the best locations and then reject the also-rans as part of an eventual bankruptcy.

This suspicion squares with the company’s announced reorganization plan: It will shutter at least 700 stores, 200 (including ours) immediately and then—here’s the fun part—it will pit its remaining loser-landlords against one another to see who among them will blink first to save her location by cutting her rent the most.

More plausible is that the evil plot had nothing to do with landlords, but rather with Wall Street. Perhaps, the company at heart wasn’t about selling mattresses profitably. Maybe it was about opening new stores, about driving its gross sales ever higher to impress gullible analysts into giving its stock a “buy” recommendation, about over-inflating its balloon and then selling out just before it burst. In hindsight, it appears that this may have been exactly what MF did, selling itself to the South African company, Steinhoff International, for $3.8 billion in 2016.
The charitably-minded might wonder whether the MF management team truly thought it could make the company profitable.

Maybe.

But here’s something to consider: MF was beset by internal rot. In addition to the internet’s depredations, CEO Steve Stagner blames his company’s plight on his own real estate department. In Mattress Firm vs. Bruce Levy et al., a lawsuit filed a year ago in Texas, MF accused its senior real estate managers of approving hundreds upon hundreds of unnecessary and over-market leases in a multi-year, massive scheme of fraud, bribes and kickbacks from complicit brokers and developers.

The complaint is a stunning portrait of greed and duplicity. The defendants have countered, insisting that everyone on the executive committee, from the CEO on down, had full knowledge of their lease transactions and that they were merely implementing MF’s market saturation plan. In short, different day, same story: CEO blames his troops, while they swear they were only following orders.

Whom to believe? Who benefits more in a public company from colossal expansion, the CEO or his second-tier underlings? How hard would it have been for a CEO of even the meanest understanding to look at a competition map and figure out that Petaluma had more beds than an army barracks?

It must be the case that sometimes the most honest and best-intended business people avail themselves of the bankruptcy court’s protection. It may also be that moral bankruptcy is one of the quickest preludes to Chapter 11. By John E. McNellis, author of Making It in Real Estate: Starting Out as a Developer. This article was first published on The Registry.

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