GREAT AMERICAN GROUP

JULY 2017

Monitor

Grocery

FOOD FIGHT

Amazon's purchase of Whole Foods rattles the hyper-competitive grocery industry, where pricing pressures are leading to lower profits and further consolidation

ONLINE VS. IN LINE

Online spending on food and beverages is expected to continue to grow to reach close to 20% of total by 2025

PRICE CHECK

Grocery retailers' price investments to drive traffic coupled with food price deflation has pressured profitability

AISLES OF OPTIONS

Non-traditional players such as drug stores, dollar stores, and discounters have been stealing grocery market share

In This Issue

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Overview

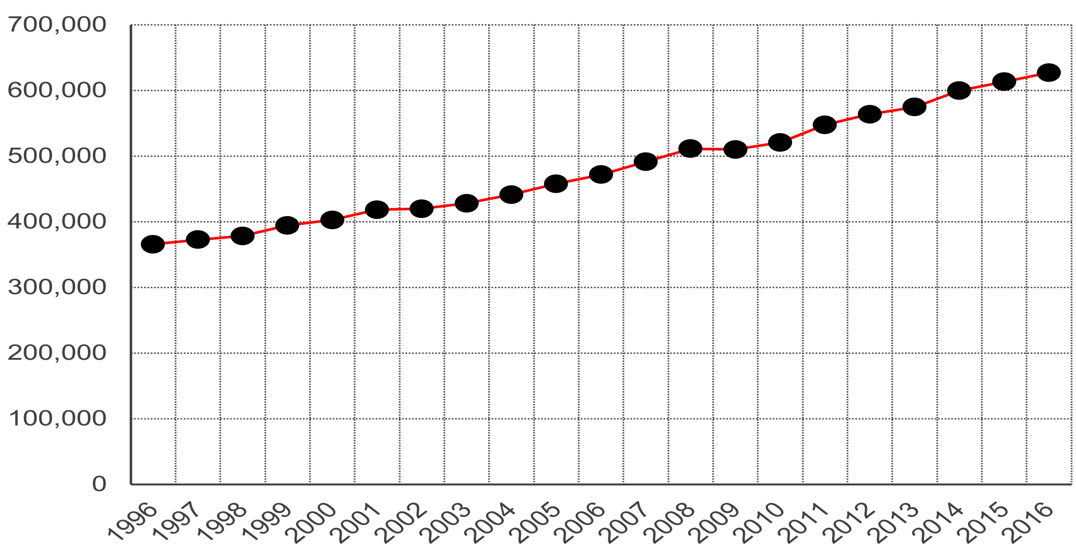
The grocery industry is highly competitive, with traditional retailers facing pressure from alternative formats including supercenters, warehouse clubs, limited assortment discounters, dollar stores, and drug stores. Competition has put pressure on profits and led to consolidation, which will be further exacerbated by Amazon's purchase of Whole Foods.

The grocery stores industry generated $627.0 billion in sales in 2016 according to the US Census Bureau. The industry consists of traditional players such as Kroger, Albertsons/ Safeway, and Publix, as well as smaller chains such as Whole Foods and Trader Joe's, mass merchants like Wal-Mart and Target, and drug stores and dollar stores.

Given the highly competitive nature of the industry and slow growth in recent years, retailers operate on razor-thin margins, relying on volume and cost efficiency to drive profitability. Price competition in the industry has been fierce, with many retailers making price investments in order to drive customer traffic. This has been exacerbated by an unprecedented level of food price deflation, which placed additional downward pressure on profitability. Moody's estimates that operating profits for the industry declined 5% in 2016.

Deflation has taken a bite out of many retailers' top line sales. In 2017, Kroger reported its first decline in comparable stores sales in 52 consecutive quarters, which the retailer attributed to deflation. Many other retailers have been reporting similar results.

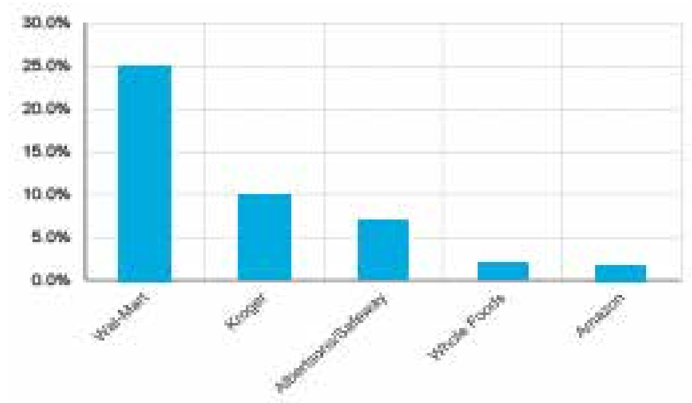
1 Grocery sales (Source: US Census)



Overview

Grocery stores are also learning to adapt to changing consumer preferences and behavior. Today's consumers are seeking fresh, healthy food options and convenient meal solutions that fit their budgets. They are less loyal to retailers, more targeted in their shopping habits, and more willing to purchase groceries online. The industry has experienced a significant amount of consolidation over the past several years, with much of the industry growth stemming from acquisition rather than organic store growth.

2 Market Share



Giants like Kroger and Albertsons have grown through mergers and acquisitions, eating up smaller regional players that are struggling to compete with these behemoths. Most recently, Amazon announced its acquisition of Whole Foods, a move that sent shock waves throughout the industry and has many grocers rethinking their e-commerce strategies.

Unlike other retail sectors, e-commerce represents only a small percentage of grocery sales. According to estimates, online sales represent only 2% of grocery sales. However, this figure is expected to grow; FMI-Nielsen is forecasting online grocery sales to reach closer to 20% of total US food and beverage sales by 2025. Growth will be driven by millennial shopping habits, busy lifestyles, and more consumer acceptance about shopping for groceries online. Analysts within the industry are going as far as to say that companies that do not develop online shopping capabilities within the next year will be at a distinct disadvantage. However, many retailers, particularly smaller chains, continue to grapple with the cost and disruption of adding such services. These grocers will not only miss out on sales, but also the opportunity to compile and leverage detailed customer data.

SALES BY FORMAT

Format	2017			2012			Change		
	# of Stores	% of Total Stores	% of Total Sales	# of Stores	% of Total Stores	% of Total Sales	# of Stores	% of Total Stores	% of Total Sales
Conventional Supermarket	26,712	69.5%	63.4%	26,830	73.4%	68.2%	(118)	(3.9)	(4.8)
Supercenter	4,327	11.3%	25.2%	3,645	10.0%	23.3%	682	1.3	1.9
Limited Assortment	3,396	8.8%	3.5%	2,909	8.0%	2.4%	487	0.8	1.1
Natural/Gourmet Foods	3,382	8.8%	6.4%	2,531	7.0%	4.5%	851	1.8	1.9
Warehouse Grocery	455	1.2%	0.8%	476	1.3%	0.7%	(21)	(0.1)	0.1
Military Commissary	169	0.4%	0.7%	178	0.5%	0.9%	(9)	(0.1)	(0.2)

*Source: Progressive Grocer   Note(s): Sales in millions

Grocery

KEY INDUSTRY DRIVERS

- **Competition from non-traditional players:** Drug stores, dollar stores, and discounters have been steadily taking market share by expanding their food assortments and adding a better selection of fresh items. Drug stores and dollar stores in particular have catered to customers looking for the convenience of a quick trip to a smaller, nearby store. For example, Dollar General is ramping up its perishables expansion by doubling the amount of coolers in 300 of its traditional stores (to 34 coolers). By the end of 2017 it expects to have an average of 17 refrigerated units per store compared to 10 in 2012. Family Dollar is also adding frozen and refrigerated cases in 300 stores this year.

  Wal-Mart continues to be the number one grocery store with estimated grocery sales of $170 billion in 2016. After taking significant market share from traditional supermarkets in the early 2000s, the retailer reached a saturation point and supermarkets learned how to compete more effectively. However, according to a report by Loop Capital, in the first quarter of 2017, Wal-Mart's grocery comparative store sales outperformed traditional supermarkets by 2.9% compared to 1.6% in the prior quarter. This is the first period of sustained outperformance since 2012. Wal-Mart is enhancing its food departments (particularly the fresh departments) and making significant investments in its online operations. In the fall of 2016, Wal-Mart expanded its price investments, creating an increase in price competition industry wide. These "Rollbacks" have been fairly significant and include key traffic drivers such as fresh produce. The retailer is also testing pickup locations that offer free same-day pickup of online grocery orders, grocery essentials, and grab and go items. Wal-Mart also offers discounts to those who order online but pickup in stores, to drive traffic and leverage its physical stores as an advantage over Amazon.

Trend Tracker

NOLVs	Mixed	▲▼
Sales Trends	Mixed	▲▼
Gross Margin	Mixed	▲▼
Discounting	Mixed	▲▼

COMPARABLE STORE SALES TRENDS

	Most Recent Quarter	Prior Quarter	Two Quarters Ago	Three Quarters Ago
Kroger	(0.2%)	(0.7%)	0.1%	1.7%
Ahold USA	(1.8%)	(0.2%)	0.3%	1.2%
Delhaize America	0.0%	2.2%	1.3%	2.9%
Publix	(2.1%)	2.2%	0.9%	1.1%
Supervalu	(5.8%)	(5.7%)	(5.9%)	(4.5%)
Whole Foods	(2.8%)	(2.4%)	(2.6%)	(2.6%)
Weis Markets	0.5%	3.4%	2.7%	2.0%

*Note(s): All sales exclude fuel. The most recent quarter for Kroger ended May 20, 2017; Ahold USA and Delhaize America ended April 2, 2017; Publix ended April 1, 2017; Supervalu ended February 25, 2017 and reflects Retail Food operations only and excludes Save-a-Lot; Whole Foods ended April 9, 2017; Weis Markets ended April 1, 2017. Ahold and Delhaize Group merged in July 2016. Results for three quarters ago reflects pre-merger operations. Results for the most recent quarter, prior quarter, and two quarters ago reflect the post-merger structure.

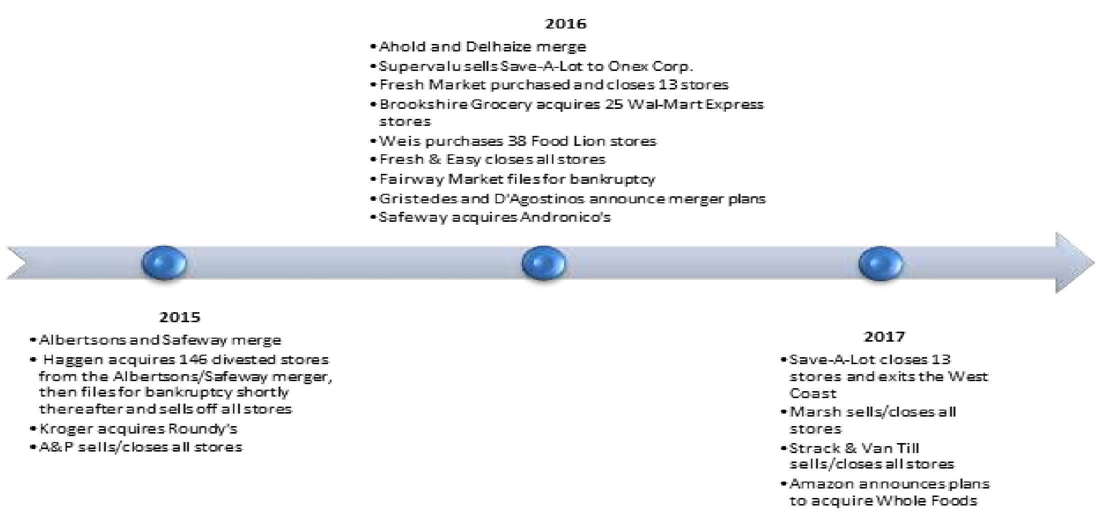
Grocery continued

Target has had less success in the grocery space. Eight years after the debut of its PFresh format, the retailer continues to grapple with high fresh food spoilage rates and an assortment that does not resonate with shoppers.

- **Growth of limited-assortment discounters:** Although not new to the grocery space, limited assortment discounter Aldi is growing rapidly. Aldi currently has 1,600 stores in the US, with plans to reach 2,000 stores by the end of 2018. The retailer is also making a big push into organics, is reformulating many of its private label products to eliminate artificial ingredients, and will offer more gluten free options. German retailer Lidl entered the US market in June 2017 with 10 stores and plans to open 100 stores by summer 2018, beginning on the east coast. Experts believe the rise of Aldi and Lidl pose the biggest threat to Wal-Mart. A recent article predicts these two retailers could account for a combined $53 to $67 billion in sales and 3,500 stores by 2021.

- **Pricing pressure:** Price deflation began during the second half of 2015 and has continued into the first half of 2017. According to the US Bureau of Labor Statistics, supermarket prices declined 1.3% in 2016 compared to 2015, marking the first annual decline since 1967. Initially, some retailers were able to capitalize on this by leaving retail prices the same, thus translating to higher gross margin. Eventually, many were forced to lower prices to remain competitive, leading to lower sales on a dollar basis. This price deflation has put increased pressure on supermarkets to raise volumes with promotions and pricing activity. However, price declines have been moderating, and May's price decline was lower than what was recorded earlier in the year. Experts predict prices could level out over the next few months; Moody's is reporting that prices in 2017 should rise 1%.

- **Consolidation:** The past few years have seen several mergers, acquisitions, and divestitures as depicted below. Industry insiders believe that the industry is entering a new phase of consolidation as retailers seek to increase their footprint through store acquisition versus building from the ground up. Mid-size companies with $3 to $5 billion in annual sales are said to be the biggest targets for consolidation over the next few years. Experts expect consolidation will continue as unprofitable stores are divested and regional players continue to expand their reach to gain scale and efficiencies to better compete with behemoths like Kroger, Albertsons, Ahold/Delhaize, and Publix.



Online Grocery

OVERVIEW

Online grocery sales are estimated to represent approximately 2% of total grocery sales. Although increasing, online grocery sales have grown more slowly than overall online retail sales. The grocery business presents a challenge given the small profit margins, delivery expenses, and the high cost of storing and managing perishable items. In addition, many consumers still like to select their own produce and meat. This is why Amazon has not been as successful in penetrating this market.

Online capabilities vary widely throughout the industry:

- **Click and collect:** Click and collect is by far the most common practice, with customers placing their order online and picking up the groceries at the store. Retailers are experimenting with a variety of services including curbside pickup, stand-alone pickup sites, and unmanned kiosks. This is expected to be the primary type of online method in suburban and rural areas.

- **Home delivery:** Some retailers offer online ordering with home delivery for a fee, but often this is limited to certain markets. Peapod is the largest, leveraging its sister companies for both online ordering and in-store pickup. Wal-Mart has been testing product delivery using Lyft and Uber drivers. Uber's "Uber Rush" program is also available to other retailers.

- **Pure play e-commerce:** Companies such as FreshDirect and Amazon Fresh operate as pure online grocers with no physical stores.

- **Third party partnerships:** Unable to offer an e-commerce option, some retailers partner with third-party companies like InstaCart. Customers place orders online through InstaCart's website, and an InstaCart employee will shop and deliver the items to the customer for a fee.

AMAZON/WHOLE FOODS

In June, Amazon announced its acquisition of Whole Foods, which is expected to close by the end of the year. The announcement shocked many in the industry and caused stock prices for several grocery retailers to plummet. So far, Amazon has been tight lipped about its plans, but there has been much speculation about how this could change the industry as we know it. The combined entity would represent $22 billion in annual sales, making it the 5th largest grocery retailer.

- **Whole Foods:** Whole Foods operates 466 stores throughout the country and achieved sales of $15.7 billion in fiscal 2017. Whole Foods has been struggling recently, reporting seven consecutive quarters of declining comparable store sales and minimal top line sales growth. The retailer has been sacrificing margin to drive sales and the roll out of its new, lower-priced format, 365, is well behind schedule. Although the retailer is revered for its natural and organic products and shopping experience, it has a reputation of being overpriced, hence its nickname "Whole Paycheck." There is significant overlap between Amazon's and Whole Foods' customer bases. Research from Morgan Stanley shows that 62% of Whole Foods Shoppers are Amazon Prime members.

- **Amazon:** Amazon has been dabbling in the grocery space for some time with its AmazonFresh and Prime Now services, as well as its new store prototype Amazon Go. It is estimated the retailer does $6 billion in annual grocery sales, less than 2% of total industry sales. It has not been able to break into the industry in a significant manner due to the challenges associated with selling perishables online. Its delivery services for perishables are limited to areas in which it already operates large warehouses. As a result, since its debut approximately 10 years ago, AmazonFresh is only available in 16 cities.

Online Grocery

Amazon Go is still currently in a test phase and it has been reported that the endeavor has been plagued by technical difficulties. This 1,800 square foot brick-and-mortar store offers a limited assortment of meal kits, prepared foods, and grocery essentials. The store does not have checkout registers. Instead, customers can simply walk out and be billed later via their Amazon account.

Some of the post-acquisition synergies/changes could include the following:

- **Distribution hubs:** It is possible Amazon could use Whole Foods' stores as refrigerated distribution hubs for its online grocery operations to solve its "last mile" delivery problem. However, it would be limited by the relatively small store size, which averages 39,000 square feet.
- **Pricing:** Given Whole Foods' reputation of being overpriced, some expect that Amazon will work to reduce prices in order to drive sales. However, there will be a fine line between broadening Whole Foods' appeal to increase traffic, while maintaining the company's brand cache and overall store experience and not turning it into just another mainstream grocery store.
- **Brand integrity:** Amazon will now have access to the Whole Foods brand, which lends it instant credibility in the grocery space.
- **Omnichannel opportunities:** Whole Foods, which currently partners with InstaCart for online ordering, can leverage Amazon's e-commerce capabilities to offer click and collect as well as sell products online and into markets it does not currently serve. Amazon can put its private label brands into Whole Foods stores, along with its other proprietary products such as the Kindle and Echo.
- **Data analytics:** Data analytics is becoming an important part of grocery retailing. Whole Foods is behind many of its peers in this category, while Amazon is well known for its ability to analyze its customers' shopping trends. Detailed customer data related to shopping habits would allow for more targeted promotions and tailored assortments. Amazon could also install other technology into the Whole Foods stores, including its new checkout technology being tested in its Go stores.

While none of these changes have been discussed or confirmed by Amazon or Whole Foods, industry players are sure of one thing: change is on the horizon. Although it will take some time for Amazon to make any significant changes, Amazon has been known to disrupt industries, most notably the book industry, which resulted in Borders ultimately going out of business. It remains to be seen how the grocery store sector will be impacted, but major players are almost sure to experience increased price competition, particularly for their higher-margin natural and organic offerings, which have been key sales drivers recently. Retailers will have to invest in technology in order to remain competitive and relevant to their customer base and maintain their piece of a shrinking pie. In addition, meal kit delivery companies, such as Blue Apron and Home Chef, could also have a bite taken out of their sales if Amazon decides to leverage the relationship with Whole Foods to tap into this market in the future.

Monitor Information

GA's *Grocery Monitor* highlights key industry drivers within the grocery sector and their relation to GA's valuation process. GA strives to contextualize important indicators to provide an in-depth perspective of the market. Any comparable store sales illustrated in this monitor reflect figures as they have been reported by public retailers. The methodology for calculating comparable store sales may vary by company. GA welcomes the opportunity to make our expertise available. Should you need any further information or wish to discuss recovery ranges for a particular segment, feel free to contact your GA Business Development Officer.

The information contained herein is based on a composite of GA's industry expertise, contact with industry personnel, liquidation and appraisal experience, and data compiled from a variety of well-respected sources believed to be reliable. GA does not make any representation or warranty, expressed or implied, as to the accuracy or completeness of the information contained in this issue. Neither GA nor any of its representatives shall be liable for use of any of the information in this issue or any errors therein or omissions therefrom.

Experience

GA is one of the largest liquidators of retail inventory and has been involved in a variety of liquidations, ranging from the disposition of excess inventory and the closing of underperforming stores, to full-scale liquidations of national retailers with hundreds of stores. GA has experience with full and partial liquidations of companies throughout a variety of retail sectors, including the grocery industry. Examples include A&P, Haggen, The Markets, C&K Markets, and Penn Traffic.

These experiences provide GA with valuable insight into the market trends and the consumer response that can be expected in a liquidation. They give us an understanding as to recovery values that can be achieved for retailers.

GA has also worked with and appraised numerous retailers. While our clients remain confidential, GA's extensive list of appraisal experience includes:

- Many of the country's largest grocery store operators including those with sales in excess of $10 billion and upwards of 800 stores;
- Smaller regional supermarket chains; and
- Wholesale distributors of grocery products.

In addition to our internal personnel, GA maintains contacts within the retail industry that we utilize for insight and perspective on recovery values.

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About Great American Group

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