GEORGE MORRIS CENTRE

Grocery Trade Review

Market Analysis and News for Grocery Product
Manufacturers and Distributors

December 2008

Metro: Now Comes The Tricky Part

The following is a direct excerpt from a CIBC World Markets Equity Research Report, November 19. The report was written by Perry Caicco and Mark Petrie.

Metro is embarking on fundamental changes to the operating formats in Ontario. Latest quarter results were a continuation of its trend of weak sales and strong margins. This indicates a company focused more on the "buy" than the "sell", relying on a strategy of generally raising prices to consumers, while pressing suppliers for more and more rebates. Hopefully, store renovations will glue customers to the business.

Growing earnings by raising prices and hitting suppliers would seem unsustainable to us, since it generally ignores the core consumer proposition. The ongoing changes to the formats in Ontario – the banner changes in conventional and the "clean-up" in discount - are meant to address this issue, but as we have written previously, the tactics are puzzling. The price increases seem to be continuing, the changes to conventional stores are modest at best, and Food Basics is being altered almost beyond recognition. Nevertheless, samestore sales (SSS) growth should slowly improve due to the renovations, and it's clear that margin management is still the most important topic in the business, even if it means not maximizing the enormous sales opportunity in the Ontario market.

However, it is not clear that these risk-averse Ontario strategies will work exactly as planned. Becoming generally less price competitive at the cusp of a consumer downturn; asking beleaguered suppliers to pony up once again; "upscaling" a discount banner; and relying almost solely on a new banner name to draw customers to stores just might result in slow or no progress. These are tricky times, and Ontario is a complex market. Metro may very well alter its tactical course over the next 12 months - at some expense.

Ontario In Bad Shape

Looking at the Q4 results, the changes in Ontario have come none too soon. SSS growth of +1.5% with inflation of about 2% and "better performance in Quebec than Ontario" suggest the depths to which the Ontario business has sunk. It's quite possible that Ontario SSS growth was about -2.0%, and Ontario same-store tonnage (or item count) was as low as -4.0%. Disruptions at the converted stores probably contributed a portion of this, but the numbers still seem frightening.

The changes to the conventional banners in the Ontario market should theoretically be exciting and high-profile, building traffic with a combination of marvelous new stores and strong opening flyers. But these changes are anything but that. The renovated stores are certainly better than what was there before, with stronger efforts in bakery, seafood and grocery; and new fixtures in produce, but they leave us starved for a better shopping experience. On top of that, there is a strong perception among many consumers that Metro has actually raised prices at these already over-priced stores. We do not have any data to test that thesis, but the number of items on in-store special in any given week seems to have been reduced.

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The modest “A Store is Born” advertising campaign, which basically consists of an employee holding a loaf of bread, would be interesting only if the loaf of bread, instead of pretending to be a baby, was priced at 99-cents. The opening flyers – the one primary communication vehicle that most shoppers read before deciding to frequent a store – have been a non-event. Below are the two flyers for this week: on the left is the standard A&P/Dominion ad for unrenovated stores; on the right is the weekly ad trying to draw new customers to the flashy new Metro stores. Can you spot any difference at all in items or prices? Customers are not generally interested in visiting a store just because it has a new name and a loaf of bread wrapped like a baby.

Source: Company websites and CIBC World Markets Inc.

Our belief is that these renovated stores are probably clicking along at mid single digit sales increases, most likely due more to a slightly increased basket rather than traffic growth. These modest results help to move the needle on Metro’s overall same-store sales, but not much.

Metro is not the first company to execute a sizable store renovation and then forget to drive sales into the store. Safeway US made the same mistake for the first year of its important Lifestyle re-model program. When sales of Safeway’s renovated stores failed to crack mid-single digits, and then began to quickly slide back to the chain average, management made the intelligent decision to support each subsequent renovation with a strong local promotional program lasting eight to 12 weeks. These special flyers cost Safeway in margin, but they kick-started the stores into the 10% to 15% SSS growth range, and even when they naturally slid back, the renovated stores stayed above the chain-average SSS numbers for two more years.

Our feeling is that Metro will have to kick-start the renovated stores in the same manner, or else be satisfied with modest sales growth – growth that could slide back to the company average all too quickly. We would be surprised if by Q3 next year, Metro has not begun investing in prices to kick these stores into high gear.

Outlook For The Discount Segment

In previous reports we have been clear about our opposition to many of the new tactics at Food Basics. Although the stores needed to be sharpened and cleaned up, new ideas such as taking away procurement responsibilities, adding 1,000 SKU’s, raising prices, and installing the weak Super-C produce program are all recipes for underperformance. In the near-term, costs are under control and higher pricing will result in a higher average order and higher margins. But in the long-term, the move away from the standing strategy of a strong EDLP program bolstered by special buys – and doing so just as a recession hits their low-income and ethnic customers – will cause traffic to melt away.

To be fair, Food Basics has sharpened up their flyers from the weak efforts in September and October, and promotional strategies have never been more important than they are in this economy. But our belief is that you cannot fool consumers who are on limited incomes – they know their everyday prices and they know when they are being asked to pay too much. Much as Metro's renovated conventional banners will contribute modestly to SSS growth over the next several quarters, Food Basics could – after a few months – drag SSS in exactly the opposite direction. Margins will rise - temporarily – but in the discount world, if you don't have volume growth, eventually you don't have a business. Our belief is that Metro will eventually have to take costly remedial action to recover the Food Basics business.

The Supplier Wild Card

It has been reported in the press that Loblaw is asking for 1% from all CPG suppliers going into 2009, and it is possible that there is more to this program than what has been publicly speculated. With that out there, Metro will want its taste as well, and we would guess that they are asking for a similar discount to help support the store renovation program. If all goes well, that could generate as much as $35 million before spending on price investments.

The final amount of any incremental supplier contribution is the biggest wild card in our earnings estimate. As mentioned, we believe that Metro is seeking another sizable sum from CPG suppliers, this time to help pay for the renovations. Metro's culture was built on wholesaling, and as such it is still very much a procurement-driven company. When in need, its first move is typically to tap suppliers. As long as the company has been in growth, suppliers have basically turned their heads and coughed up.

But times may be changing. The vast majority of these suppliers are Canadian divisions of multinationals. The bulk of the product from these multinationals is produced in the US and shipped to Canadian divisions on a transfer-pricing formula. The problem is that those transfer-pricing formulas are about to be subject to massive price increases because of the huge recent swing in the CAD/USD exchange rate. Those increases need to be clawed back from retailers, so the source of an incremental $25 million or $35 million is currently unclear. On top of that, it has been at least three years since Metro has been able to deliver real tonnage growth across its supplier base, making its case for more support just a little bit weaker.
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Quarterly Financial Update

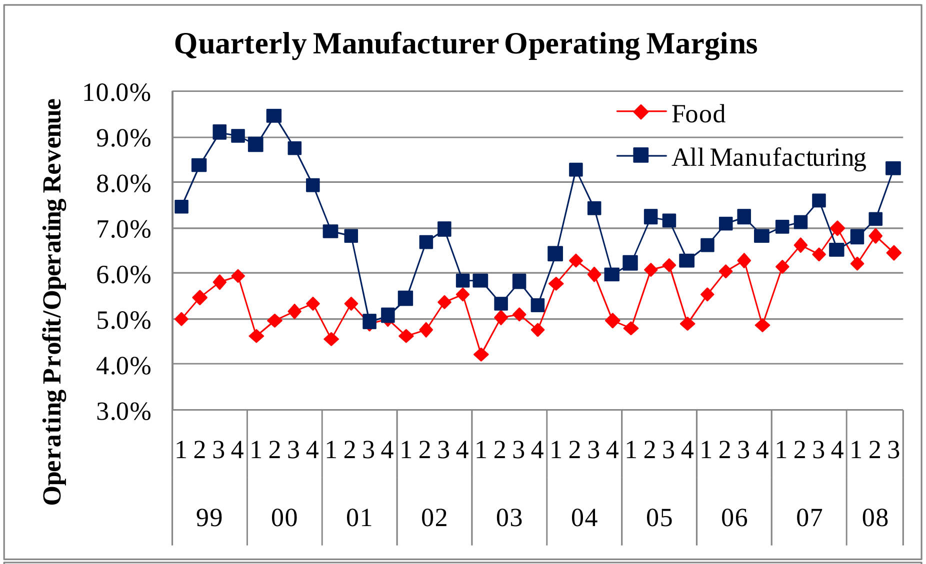
By Kevin Grier, George Morris Centre
Each quarter Statistics Canada provides an update on quarterly profits for Canadian industry. George Morris Centre receives special runs on food distributor and manufacturer performance. The following is an analysis of the third quarter data.

Canadian corporations earned $77.3 billion in operating profits in the third quarter of 2008, up 7.6% from the second quarter. Profits in the non-financial sector grew 9.1% to $58.1 billion, while those in the financial sector increased 3.3% to $19.2 billion. These results can be attributed to the strong performance by oil and gas extractors and petroleum and coal manufacturers, and improved margins for other industry groups, despite modest revenue growth. Revenue growth slowed in the third quarter but, coupled with lower increases in expenses, profits came in higher for 13 of 22 industry groups. Oil and gas extractors and petroleum and coal manufacturers led the way. Banks and other depository credit intermediaries experienced the largest drop in the financial sector, while motor vehicle and parts manufacturers reported the largest operating loss in the non-financial sector.

Food Manufacturing

Operating profits for food manufacturers increased by 9% in the third quarter compared to the third quarter in 2007. While operating profits did decline 6% compared to the second quarter, it is not unusual for a 2-3 quarter decline. In the past five years, including 2008, margins declined three times from the second to third quarter. On a year to date basis through the third quarter, operating profits have increased by 9% compared to the first three quarters in 2007. Operating profits have increased on a year over year basis for seven straight quarters.

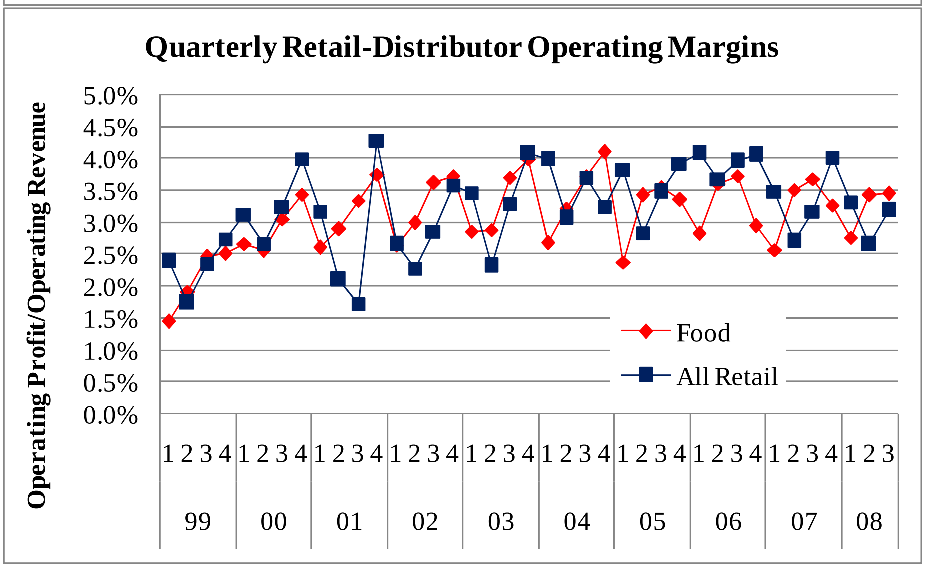
In comparison, total manufacturing operating profits increased by 15% in the third quarter, but profits have decreased in three of the last seven quarters. Furthermore, on a year to date basis, operating profits for all manufacturing has increased 4%.



The first graph shows manufacturer operating margins (operating profit/operating revenue) on a quarterly basis from 1999 through the third quarter of 2008. As can be seen, operating margins have been on a steady, gradual upward trend over the time period.

Food Distribution-Retail

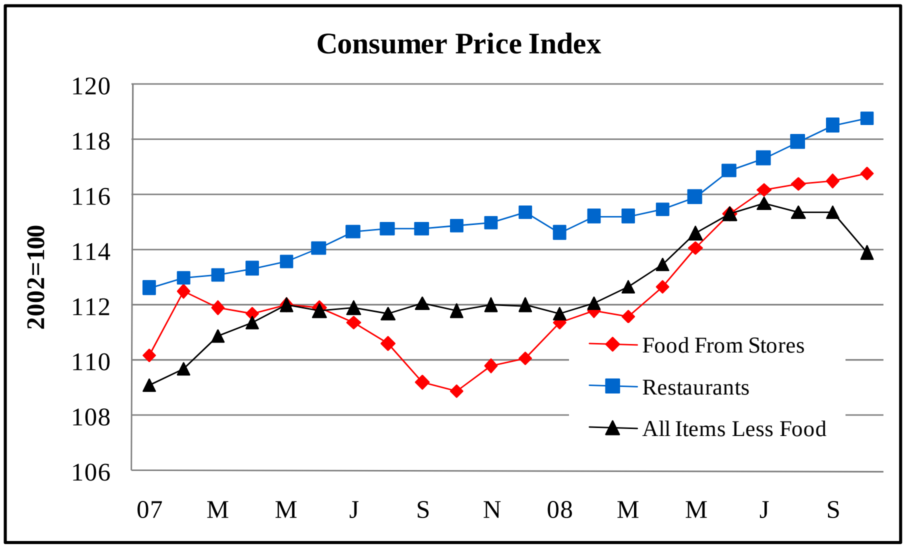
Food distributors saw their operating margins decline by 2% in the third quarter. On a year to date basis, operating profits have increased by 2% compared to the total profits in through the third quarter in 2007. On a quarter to quarter basis, the third quarter of 2008 saw profits increase by 8%. Total retailing saw third quarter profits increase by 7% compared to the third quarter in 2007. On a year to date basis total retail operating profits are up by 4%. In the last seven quarters since the beginning of 2007, quarter to quarter profit has declined three times. In fact, quarter to quarter changes in profit for food distributors have been extremely volatile. Swings of thirty or more percentage points from quarter to quarter have been common during the past few years.



The second graph shows food distributor operating margins compared to all retailer operating margins. As can be seen, the overall trend since 1999 has been modestly higher. Nevertheless during the past five years, margins have been basically flat-lined at 3%. Total retail operating margins have also averaged about 3% over the past five years.

Pricing Update

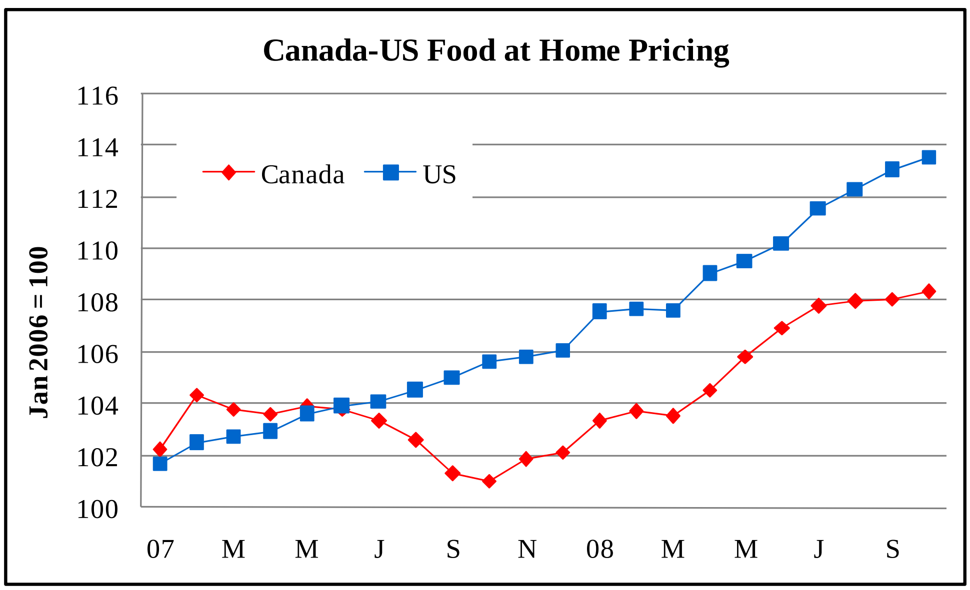
By Kevin Grier, George Morris Centre



Statistics Canada reported that the prices of food purchased from stores stayed steady in October compared to September, but on a year over year basis October prices at stores were up by 7%. That received a certain amount of media attention because the month to month change in all items not counting food actually declined. The year over year change in all items less food increased just 2%. Furthermore, October was one of the few months where restaurant price increases fell short of increases in stores. As noted in this report last month, however, the reason food from store prices is up sharply on a year over year basis is because prices were falling last year at this time. Those prices were falling due to the appreciation of the US dollar and its impact on certain food products. The following graph shows monthly CPI since the beginning of 2007.

Also of interest is the fact that food manufacturer prices increased by 6% in October compared to last year. The Industry Price Index shows price changes at the manufacturer level. Once again, however, last year at this time, the IPI for food manufacturers was trending lower due to the dollar. Furthermore, October was the second month in a row that food manufacturer price fell.

In the US, the Bureau of Labor Statistics reported that the Consumer Price Index for food at home increased by 8% this October compared to last. The next graph shows Canadian prices for food purchased from stores in comparison to the US food at home index (both measure the price of food eaten at home). Both price series are set so that January 2006 is equal to 100. As can be seen, US pricing has been increasing much more rapidly than Canadian pricing.



Trend Briefings

- The number of newly introduced **gluten-free products has skyrocketed** from about 135 in 2003 to 832 that debuted in 2008, and the forecast is for steady 15-to-25-percent growth in gluten-free product sales in coming years. (US News and World Report, November 11)

- **Growth rates for organic food and drink will decline**, especially as the economy struggles. The market for organic foods and beverages should reach $7.2 billion in 2008, an increase of more than

140% from the $3.0 billion recorded during 2003. But year-over-year sales growth is slowing. (Yahoo, November 7)

- This recession will have a dramatic impact on a convenience store industry that will also be stymied by flat store growth and reduced consumer spending. **Foodservice sales are expected to again become the focus of c-store retailers' efforts to recoup lost sales** and profit. (CSNews, Nov20)

Manufacturing Briefings

- **Campbell**, **Camden, New Jersey, warned that a stronger U. S. dollar would hurt full-year earnings**. Campbell and other food-makers have benefited as a contracting U. S. economy forces more consumers to stay at home and prepare more of their own meals. Food companies have also managed to raise prices for their products to offset higher commodity costs. But Campbell said a stronger U. S. dollar, which lowers the value of sales overseas, would reduce fiscal 2009 sales and earnings growth rates by about five percentage points each. The world's largest soup maker derives about 25% to 30% of its sales from outside the United States. (Financial Post, November 25)

- **Heinz, Pittsburgh scored the highest consumer satisfaction rating of any company in the food manufacturing secto**r, according to the University of Michigan's American Customer Satisfaction Index (ACSI). This is the ninth year that Heinz has been the index's top-rated food company. (Business Wire, November 18)

- **Heinz** net income increased 22% to US$276.7-million, from US$227-million a year earlier, Pittsburgh-based Heinz sales rose 3.5% to US$2.61-billion from US$2.52-billion for the three months through Oct. 29. **That was Heinz's seventh profit increase in eight quarters.** Sales in North America climbed 9.4%, driven by Ore-Ida frozen potatoes, Heinz Ketchup and frozen meals. European sales rose 1.8% on higher prices after the dollar's gain against other currencies depressed revenue by 6 percentage points. Costs for packaging, potatoes, tomatoes, edible oils and meats increased almost 15%. (Financial Post, November 21)

- **PepsiCo said last month that soft-drink volume in North America fell 3% in the fiscal third quarter,** hurt by weak demand for beverages like Pepsi, Sierra Mist and bottled water, as consumers cut back in a contracting economy. The Purchase, a New York firm also said that a restructuring plan and an impairment charge at its largest bottler, Pepsi Bottling Group, are expected to hurt Pepsi's reported full-year earnings, but would not affect its core earnings results. Pepsi Bottling's restructuring plan includes cutting 3,150 jobs. The restructuring is expected to yield US$150-million to US$160-million in annualized pre-tax savings when completed, starting with savings of at least US$70-million in 2009. (Financial Post, November 21)

Distributor Briefings

- Britain-based **Tesco has rowed back expansion plans for its Fresh & Easy stores in the United States** in the wake of the economic meltdown. Plans to expand into northern California could be put on hold and Tesco's goal of having 200 stores operating across California, Arizona and Nevada by February has been pushed back to November, 2009. Fresh & Easy recently opened its 100th store in Orange County, Calif. Instead of focusing on expansion, the company is now putting more emphasis on price promotions to emphasize its claim to be 20% cheaper than traditional US supermarkets. (Meatingplace.com, November 13)

- When times get tough, consumers trade down. Canadians have lots of choice in this regard. **Sobeys** Inc owns 115 Price Chopper stores and its private-label products are branded Compliments. **Metro** which runs 61 Super C discount supermarkets in Quebec and 116 Food Basics stores in Ontario, offers the Irresistibles and Selection private brands. **Loblaw** operates No Frills in Ontario and Western Canada, as well as Maxi stores in Quebec. No Frills stores used to only sell No Name products, but in the 1990s the President's Choice line was introduced. Only Loblaw and North West Company Fund, which caters to more remote communities, had dividend yields greater than 2.5% and returns on equity above 5%, according to FPinfomart data. Consumers can "trade down" at North West's Giant Tiger discount stores, while Loblaw's superior private label and greater exposure to discount banners, relative to its peers, suggest it may be better off than the others during a slowdown. Loblaw should be in relatively good shape when the Canadian consumer begins to trade down. **Loblaw's grocery business will remain relatively resilient in an economic downturn**. (Financial Post, November 11).

- **Retailers are catering to environmentally-conscious consumers** by introducing biodegradable, recycled and other “green” private-label products. Retailers capitalizing on the trend include **Costco** for its Kirkland Signature Environmentally Friendly Dish Soap, made with biodegradable cleaning agents and a plant-based formula; **Giant Eagle**, whose Organic Baked Beans include a statement on pack that the company supports farms with earth-friendly methods; **Safeway**, Lucerne Cage-Free Eggs; and Pathmark, Essentially You breakfast cereal in a 100% recycled paperboard box. The green private-label movement comes at a time when the number of consumers who “always or almost always” buy green tripled to 36% between August 2006 and December 2007, according to a Mintel study. (Supermarket News, November 17)

- **Wal-Mart is reaping big gains from the souring economy** even as consumers cut back, retail chains struggle and thousands lose their jobs. After bad news from retailers such as Best Buy Co. and Starbucks Corp., Wal-Mart said earnings for the third quarter rose 9.8% while sales rose 7.5%. At stores open at least a year, sales rose 3%, twice as much as a year before, and far better than nearly every other US retailer. Wal-Mart and other discounters have fared relatively well during the economic downturn. Behind the figures is a confluence of trends fueled by the downturn. As strapped consumers look for cheaper goods, and weaker retailers go out of business, Wal-Mart is using its unmatched economies of scale to drive down prices, undercut competitors and squeeze costs out of suppliers ever more dependent on the Bentonville, Ark. behemoth. Indeed, the downturn is increasing Wal-Mart's clout just as its dominance was being threatened by diminishing returns on its big-box expansion formula, more-selective consumers and a growing field of rivals. The company's size is now turning to its advantage: **For every $1 spent in the last year on goods other than cars in the US, 8.2 cents went to a cashier at a Wal-Mart store or a Sam's Club**. Even with unemployment rising, Wal-Mart said that it had hired 33,000 new employees in the 12 months prior to October. Its US work force now stands at 1.45 million, making it an economic driver for millions of other jobs dependent on Wal-Mart. (wsj.com, November 14)

- **Loblaw, Toronto said it will start charging customers a fee for every plastic shopping bag they use**. The company, with more than 1,000 grocery stores across Canada, said it would begin charging shoppers 5 ¢ a bag on April 22, 2009, which is Earth Day. The company said it would also encourage customers to use alternatives to plastic bags and enhance its offer of affordable reusable bag options. Loblaw currently offers reusable fabric bags to its customers for a small fee. "We believe this ... represents the next natural step forward as we continue to acknowledge and respond to Canadians' desire to support environmental initiatives," said Galen Weston, Loblaw executive chairman. (Financial Post, November 28)

E-Commerce Briefings

- **Pizza Hut**, which recently crossed the $1 billion benchmark in online sales, is launching a Facebook application that allows placing orders without leaving their profiles. Although online ordering isn't new -- the chain has offered it in some form since 2001 -- **the bulk of that $1 billion in sales has come in the past 18 months**. The chain is also launching text-ordering capabilities and e-gift cards, which can be purchased, exchanged and redeemed online.

A number of the nation's biggest fast-food chains are beginning to embrace text and iPhone ordering capabilities, at least as tests. Already for the three months ending in August, food marketers sent almost 1.4 million text-message ads, up 37% from the same period last year, according to ComScore's M:Metrics data. Consumers seem to want the offers: of all the ad categories using SMS marketing, restaurants had the highest response rate, with 15.5% of consumers responding to the ads. Some Subway franchisees have begun to offer ordering via text and iPhone applications. McDonald's experimented with text-message ordering in Chicago last summer, with signs encouraging consumers to text in their late-night orders. There were "some very good learnings from this campaign about how to execute future campaigns". (Advertising Age (Nov 10)

- **Online retailing will continue to grow this holiday season, with a record 71% of consumers spending at least part of their holiday budgets on the Internet**, according to Deloitte's 23rd Annual Holiday Survey of retail spending and trends. This figure is up five percentage points from 2004. This popular medium for holiday gift shopping ranked #2 this year, behind discount department stores. More than one in five consumers (21%) surveyed plan to shop primarily or entirely online this holiday season (up from 19% last year), and almost one-quarter (24%) of total dollars are expected to be spent on the Internet, compared with 22% last year and only 19% in 2004. (PRNewswire, November 10)

- **More Canadians used the Internet to purchase goods and services in 2007, placing almost $12.8 billion worth of orders, up 61% from 2005**. This increase was driven by a larger volume of orders, which rose from 49.4 million in 2005 to 69.9 million in 2007. The proportion of orders placed with Canadian vendors declined slightly from 57% of the total in 2005 to 52% in 2007. More than 8.4 million Canadians aged 16 and over made an online purchase in 2007, up from nearly 6.9 million in 2005. They accounted for 32% of Canadians in this age group, compared with 28% in 2005. The top 25% of "online consumers," who spent an average of $5,000 during 2007, were responsible for 46% of orders and 78% of the total dollar value. Internet shoppers were also more likely to pay directly online. About 82% paid directly online for some or all of their purchases, up from 75% in 2005. Even so, 77% of these online consumers expressed concern about online credit card use. (Statistics Canada, The Daily, November 17)

- ComScore found **consumer web spending dropped 4%** so far in November versus the same period last year -- the first time e-commerce figures have shown a year-to-year drop. Consumers spent an estimated $8.19 billion online over the first 23 days of the month, compared to $8.51 billion a year ago. During the first 10 months of 2008, e-commerce sales were $102.1 billion, a 9% increase from the $93.6 billion spent in 2007. (Advertising Age, November 25)

- A ChoiceStream survey found that **75% of respondents will do at least some of their holiday shopping online and that the top reason consumers will go online is convenience**, not price (61% of respondents indicated they shop online because it's more convenient for them; only 25% indicated that finding the best price is a top reason for shopping online). The survey also found that more than 70% of respondents indicated that they purchased from 4 or fewer online retail sites while holiday shopping last year and only 23% indicated they will shop at more online retail sites this holiday period. (Yahoo, November 20)