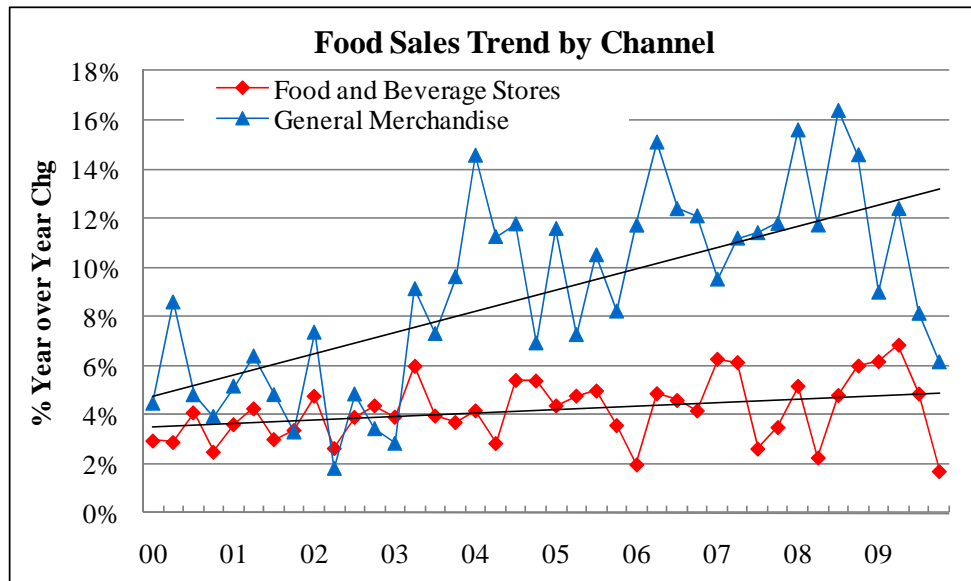


## Channel Sales Update

Statistics Canada tracks commodity sales by channel. According to Statistics Canada, fourth quarter food and beverage stores (grocery mostly) sold 2% more food and beverages than in the fourth quarter of 2008. For the year, total food and beverage sales from grocery stores increased by 5%. Annual sales of food and beverages through drug stores increased by 6% in 2009 compared to 2008. General merchandise stores (Wal-Mart, Zellers, Sears, Dollar Store and Canadian Tire, etc) saw food and beverage sales increase by 9%. From 1999 through 2009 the compound annual growth rate of food sales from food and beverage stores increased by 4%, and by 4% from drug stores. General merchandise stores, however, increased their food and beverage sales by 9% on average over those same eleven years.

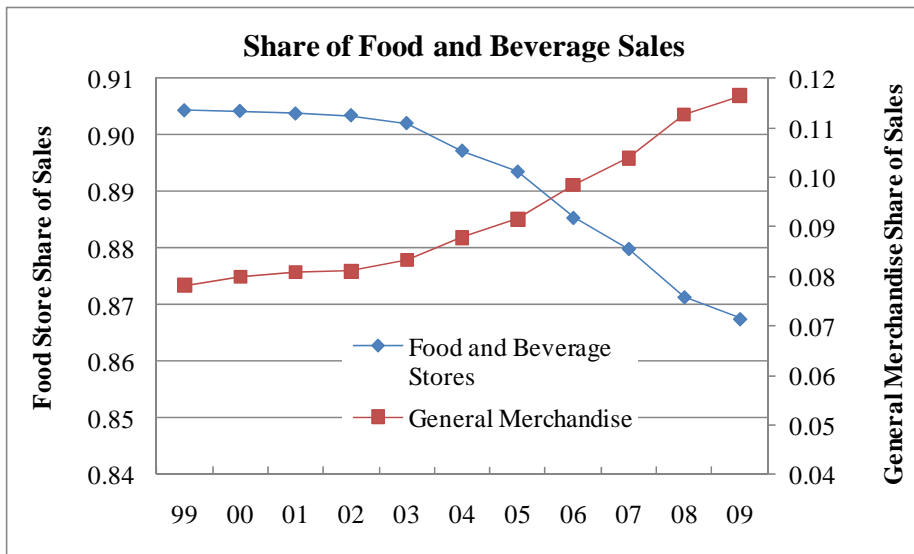
The following graph shows year over year quarterly percentage sales changes of food and beverage commodities from grocery stores and from general merchandise stores. The quarterly sales changes are tracked from 1999 through the end of 2009. The last points on each line shows the fourth quarter 2009 sales change compared to the fourth quarter of 2008. The 6% increase in food sales for general merchandise stores in the fourth quarter was the lowest quarterly increase since early 2003. The fourth quarter increase in sales for grocery stores of 2% was also a relatively low increase compared to the last several years.



The graph shows the very rapid increase in food and beverage sales at general merchandise stores. It also shows how general merchandise stores such as Wal-Mart began to seriously focus on increasing food sales during the mid 2000's. Food sales increased by 9% each year from 1999 through 2009, but sales increased by 11% per year from 2004. In other words, the bulk of the surge in food sales from GM stores has occurred since 2004.

During the last eleven years from 1999 through 2009, the share of food and beverage sales through general merchandise stores has increased from 8% to 12%. The following graph shows the annual share of food and beverage sales through grocery stores and general merchandise stores from 1999 through

2009. Grocery store share has declined over that time from more than 90% to less than 87%.



### Implications and Messages

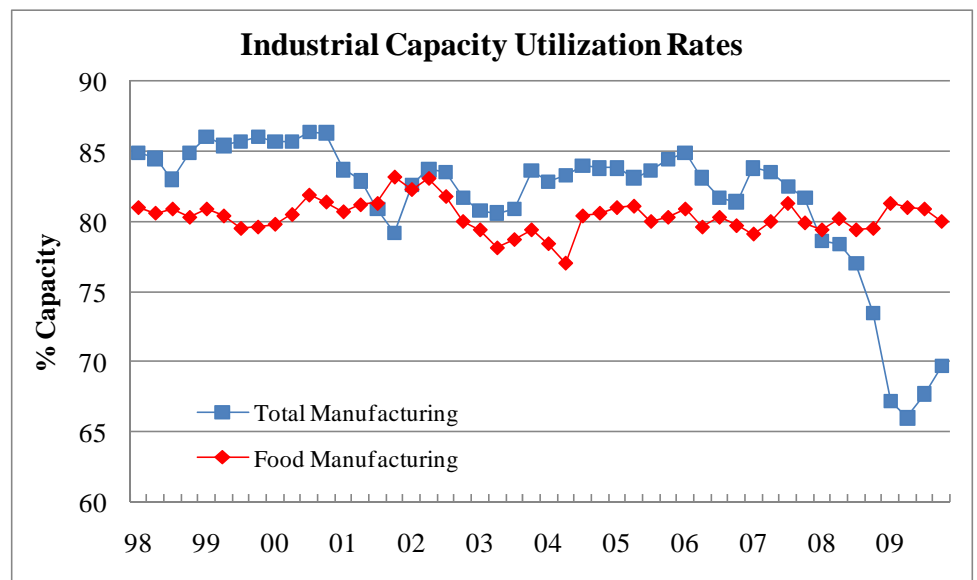
The data show the ongoing trend of lost food and beverage share from grocery stores to general merchandise stores. That trend continued in 2009, although to a lesser extent than in the previous three years. Food sales at general merchandise stores increased by 9% in 2009, compared to 15% increases in 2008 and 11% and 13% in 2007 and 2006 respectively.

Interestingly, the question

becomes whether the “slower” sales gains of 2009 were due to lack of tonnage on real sales or due to price reductions. Given the fact that fourth quarter sales only increased by 6% at GM and 2% at grocery, the chances are that it is a pricing issue. If that is the case, it could signal the beginning of a food pricing battle beginning at Canadian grocery and general merchandise stores.

### Capacity Utilization

Statistics Canada recently updated its quarterly industrial capacity utilization rates data set. The following graph shows capacity utilization rates for food manufacturing as well as for total manufacturing in Canada. The data show the percentage of industrial production capacity being used by industry participants in Canada. The first data point is the first quarter of 1998 while the last point is the fourth quarter of 2009.



As can be seen, food manufacturing capacity utilization rates have tended to stay fairly stable over time, regardless of economic conditions. That conforms to pre-conceived notions about the more stable nature of the food industry. Total manufacturing utilization rates dropped dramatically during the current recession and began to recover in the latter half of 2009. Total manufacturing utilization rates also declined in the recession of 2001-2002 but not nearly as dramatically.

### Peace in the Canadian Grocery Industry

The following is a direct excerpt from a CIBC, Institutional Equity Research, April 21, entitled “Metro Inc., Canadian Grocers: Peace In Our Time” by Perry Caicco and Mark Petrie.

With Wal-Mart less of a factor (slowing their food square footage growth, focusing on their new retrofit format and not pressing on prices); and with Loblaw management preoccupied with the SAP

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installation, this could be the calmest, most profitable year the Canadian grocery has seen in half a decade.

The profitable peace could last deep into 2011. This is because:

- a) There is very little sign that any grocer is willing to return to the old 3-5% square footage growth rates, which means sales productivity will be maintained.
- b) Wal-Mart's food square footage growth seems to be slowing to under one million new square feet of grocery per year. In a grocery market with about 177 million square feet, adding 0.5% to that is immaterial.
- c) To the extent Wal-Mart occasionally makes a splash about lowering some prices (most recently a few commodities in western Canada), these programs seem to be narrow, are often time-limited, and may be offset by other price adjustments.
- d) The Canadian dollar may end up being higher than last year's levels all year long.
- e) Tonnage at the Big Three grocers is in reasonable – and certainly improving – condition.

If the Canadian dollar can maintain these levels, then grocers will be purchasing a significant portion of their goods at lower costs than last year for the rest of 2010, and possibly into 2011. The strong Canadian dollar puts a number of powerful tools into grocers' hands, some of which could have positive margin reverberations deep into 2011. These tools include:

1. Not taking the retail prices of proteins, fruits and vegetables down as fast as the costs are declining. Prices are clearly not down as much as costs. This begs an interesting question: Just how committed will the big grocers be to "Buying Local" this summer, when they consider the very low currency-impacted costs of American and Mexican produce? Fruit and vegetable costs have become so low, and prices have remained so high, that more than one grocer has recently put bananas – the most frequently purchased item at most stores – on the front cover of a weekly flyer at a substantial discount. It has been years since this has happened. Unlike the last time we saw bananas on the front page, this is not indicative of any price war. This is happening simply because the margin on bananas has become so large that a 49c/lb front page price actually looks like a deal – but yet is eminently affordable.

2. Working with store brand suppliers to drive product costs down.

Most Canadian store brand suppliers use ingredients whose prices are set in American dollars from American sources. Because there are no marketing costs (or what Dave Nichol calls the "Brand Tax") in store brands, a huge component of their cost-of-goods consists of actual ingredient and packaging costs. Because of the exchange rate, many of these have been declining since last summer and continue to decline. Down the road, when ingredient costs increase, store brand suppliers will have a hard time raising prices, so the new costs could be embedded deep into next year. These product cost declines have, for the most part, NOT been reflected in retail price declines.

3. Pushing Canadian divisions of multinational CPG companies to share their CAD windfalls.

Most Canadian divisions of CPG companies import large quantities of branded product from their parent companies. Because the Canadian divisions purchase these goods with strong Canadian dollars, they have been experiencing windfall profits in their Canadian operations. As the grocers push for their share of these windfalls, the CPG companies, unlike the store brand suppliers, tend to dole the money out promotionally rather than lowering ongoing invoice costs. Frustratingly for suppliers, these "gives" do not always end up in lower retail prices.

4. Keeping a disproportionate amount of CAD-generated rebate dollars at the corporate level.

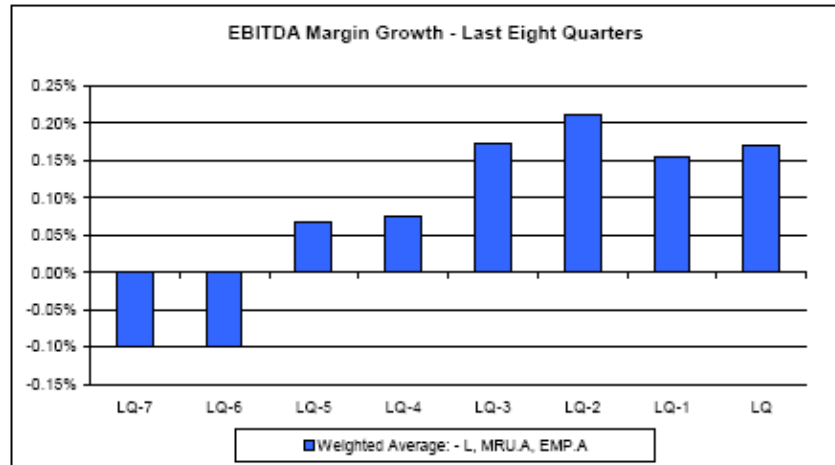
Besides a general reluctance to invest CAD windfalls in retail prices, grocers might not always share these windfalls with their franchisees. All three grocers run large franchise networks and, although there are varying contractual relationships with franchisees, it is not uncommon for corporations to structure certain rebates from suppliers in a way that these monies do not flow completely into franchisee pockets.

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One reason that Canadian grocers are in no hurry to lower prices is that, generally speaking, tonnage growth is just fine. Not only do all the grocers seem to be in positive territory on tonnage, but Loblaw and Metro have been actually trending upward. This upward trend in tonnage can not only be converted to greater rebates and support from suppliers, but also creates an element of calmness around pricing. With no apparent problems in the marketplace, and with Wal-Mart altering its strategy to focus on smaller, less impactful stores, why would anyone even dare to trigger a price war?

### How It All Ends

A market with peaceful pricing, fat margins and few new stores can't go on forever. In Canada, over the past couple of years, times have been good. In the chart below, we show the margin growth for the Big Three grocers (averaged; volume-weighted) for the past eight quarters (two years).



Source: Company reports and CIBC World Markets Inc.

As we always say: all things end badly, or else they wouldn't end. If pricing stays high and margins stay fat in the Canadian grocery industry, this situation will eventually end badly. In any market, anywhere in the world, something usually happens to collapse a great situation: a company gets in trouble, or a new player enters, or a new boss comes to town.

Here are four ways the current situation could change for grocers and investors:

1. Wal-Mart Canada changes strategy.

The most recent direction is to improve return on capital by moving to smaller Supercenters and discount-store remodels. In the meantime, although they are the lowest-priced grocer in the market, they are TIED for that position with No Frills, western Superstores, and just about anybody else operating a discount model (about 35% of the market). A change of management, a change of goals or a change of plan could cause Wal-Mart Canada to embark on a new stronger, lower-priced campaign with a goal of building long-term market share through aggressive pricing, and not overly worrying about Canadian profitability. We do not believe that this is a high probability. For the next few years, Wal-Mart Canada will be preoccupied with retrofitting discount stores to add fresh food, developing a more "shoppable" grocery model, figuring out Quebec, and streamlining its store operations and logistics. Perhaps once those are completed, or at least advanced, Wal-Mart could decide to invest in pricing to "scale up" to the \$10-\$15 billion range (from \$4 billion today).

2. Loblaw finishes its SAP project and invests the savings in pricing.

This supposes that the long-term reconfiguration of Loblaw's information systems eventually ends; that the project actually generates measureable savings; and that Loblaw decides to not put those savings on the bottom line. This looks like a stacked series of low probabilities.

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3. A Canadian grocer gets in financial or customer trouble and is forced to slash prices to generate revenue.

There is nobody even close to this situation and, given the state of operations, analytics and physical plant in the market, there is almost no chance of this happening.

4. An international player salivates over the fat Canadian margins and plots a market entry. German discounter Lidl has examined the market previously. Compatriot discounter Aldi has 1,000 stores in the U.S. and is poised across the border in Buffalo. Aldi has experience entering new countries where it thought margins were too high and its low-cost discount model could make headway, (recent entries include Australia, Poland, Portugal, Greece and Hungary). Both companies operate much lower-cost stores than even No Frills. We would give this type of event the highest probability and would speculate that if fat conditions continue in Canada, we could see Aldi or Lidl entering this market by 2012.

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## **Trend Briefings**

- Revenue at packaged food companies is expected to rise just 3% next fiscal year, according to consensus estimates. Meanwhile, big retailers like Wal-Mart Stores continue to exert leverage on food companies, capping price increases. That may force some firms to take a step many have been skittish about in the past: joining forces with competing firms to improve their purchasing power. The benefits could be crucial after companies run out of ways to cut costs internally. With business looking flat, some companies may yet find the benefits of a closer friendship hard to resist. (wsj.com, April 5)
- **There are some signs the U.S. foodservice industry is poised for a recovery**, the NPD Group reported. NPD research that measures same-store sales trends for quick-service and family-style chains showed same-store sales increases over year-ago periods in four of the past six weeks. That is a trend not seen in 11 months, according to NPD. NPD also noted that fewer consumers are saying they are trading down in restaurant selection, fewer are searching for good deals, and fewer are sacrificing a restaurant visit so that they can do other things. (meatingplace.com, April 13)
- Emerging from first-quarter corporate earnings is a picture of a spender who still needs to be wooed extensively before parting with cash. Industrial order rates are rising, but with high unemployment and stagnant wages, questions remain about consumers' future stamina. Consumers are spending what is in their wallets, but they're not going deeper into hock for more. (wsj.com, April 22)

## **Manufacturing Briefings**

- **Kraft Foods plans to use Cadbury's distribution network in emerging markets such as India and Mexico to sell more Kraft products, by sharing trucks and store contacts.** In the U.S., Kraft wants to use Cadbury's strength in convenience stores to sell more Ritz crackers. The Northfield, Illinois company is counting on those channels to deliver growth. (wsj.com, April 19)
- **Hershey Co.'s first-quarter earnings doubled as it continued to profit from belt-tightening and price hikes**, though sales volumes also climbed. The Hershey, Pennsylvania firm also announced plans for an ad-spending boost, putting this year's growth at 35% to 40%. As the company faces greater competition from its bigger rivals, Hershey may seek acquisitions. The company now trails Kraft, the world's largest confectioner and Mars, whose 2008 purchase of Wm. Wrigley Jr. Co. pushed Hershey into a fight for shelf space in the U.S. (wsj.com, April 22)

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- **Kellogg's first-quarter profit jumped 30%, as revenue grew and margins widened on cost savings.** Gross margin widened to 42.9% from 41.1%. Operating profit in North America climbed 23%. Sales rose 2.9% as volume rose 1%. International profit climbed 9%. Still, profit fell last quarter as the company's food-service business struggled. (wsj.com, April 29)

## Distributor Briefings

- **Every day last year, six convenience stores closed in Canada** on average. The industry says it has to reinvent itself and cut its dependence on sales of gasoline and cigarettes. Roughly 9% of Canada's 23,228 stores shut their doors nationwide during 2009, the Canadian Convenience Stores Association trade group said in a report. Three-quarters of those were independent operators in Quebec and Ontario, the victims of contraband tobacco sellers. Others couldn't balance their books in the face of increasing minimum wage pay standards, rising credit card fees, and volatile gas sales. (financialpost.com, April 6)
- **Family Dollar Store's fiscal second-quarter earnings rose a better-than-expected 33%.** Family Dollar of Matthews, North Carolina, said its comparable-store sales are being lifted by more customer traffic as well as increased spending. Discount retailers have fared well during the downturn thanks to sales of basics. **Family Dollar benefited from the trend with an expanded emphasis on food.** (wsj.com, April 8)
- **Shoppers Drug Mart, Toronto, was downgraded by several analysts following drug-reform proposals by the Ontario government** that would severely cut reimbursement to all pharmacists. The province is proposing that generic prescription drug prices for patients under the Ontario Drug Benefit Program be reduced from the current level of 50% of the equivalent brand-name price for multi-source generic prescription drug products to 25% of the equivalent brand-name price. Shopper's is an operator of more than 600 pharmacies in Ontario alone. (wsj.com, April 8)
- **Wal-Mart, Bentonville is cutting prices in an aggressive campaign to reinforce its reputation as a discount leader,** as the company seeks to reverse months of slowing U.S. sales. Wal-Mart's sales at U.S. stores open a year or more have edged lower recently, while other retailers have started to see an upturn in consumers' discretionary spending. **It is cutting prices on roughly 10,000 items, mostly food and other staples.** (wsj.com, April 9)
- **Wal-Mart's first wave of price rollbacks doesn't look overly threatening to traditional grocers,** according to a price analysis in Dallas and Chicago by Morgan Stanley. In Dallas, everyday pricing by Wal-Mart, Kroger and Tom Thumb on 50 common grocery items remained steady with past price checks, with Wal-Mart's prices 14 percent to 16 percent lower. While the price cuts to date don't appear overly threatening to the grocers, the threat of ongoing reductions does leave a cloud over the group. (dallasnews.com, April 13)
- **Wal-Mart is exploring opening a number of small outposts to penetrate the nation's cities** and fight the spread of no-frills grocery chains. U.S. expansion will center less on its warehouse-sized Supercenters and more on far smaller urban stores, as well as condensed locations where consumers can pick up merchandise they order online. Wal-Mart has markedly slowed its openings of U.S. Supercenters in recent years—from 132 in 2007 to just 49 in 2009, leaving it with about 2,747. The company is focusing on reaching customers in large metropolitan areas with "more-efficient formats." They point to smaller prototype Wal-Marts that feature drive-through lanes where customers can pick up online purchases. (wsj.com, April 27)
- **Planet Organic Health, Edmonton, is seeking court protection from creditors** under the Companies' Creditors Arrangement Act (Canada) ("CCAA"). The CCAA filing will provide POH

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with the time to restructure its affairs. Planet Organic Health is a natural products retail company. Planet operates nine natural food supermarkets throughout Canada under the Planet Organic Market banner and eleven natural food supermarkets in the U.S. under the Mrs. Green's Natural Markets banner. (press release, April 30)

- Starbucks is rolling out its Via brand instant coffee to tens of thousands of supermarkets, mass merchandisers and other outlets in coming weeks. **The product's migration from coffee counter to grocery aisle reflects one of the food industry's hottest trends: putting more restaurant brands into grocery aisles.** Starbucks plans to roll out a "pipeline" of new products in the next 12 to 18 months. Creating a "very significant consumer packaged goods" business is a "centerpiece" of the company's strategy, said Starbucks (wsj.com, April 29)
- **Loblaw posted stronger first-quarter earnings and sales, with both measures coming in ahead of expectations,** despite internal retail food-price deflation. The Toronto-based retailer earned C\$137 million, up from C\$109 million a year earlier. Sales of C\$6.93 billion were up from C\$6.72 billion, bolstered by the acquisition of T&T Supermarket. Same-store sales rose 0.3%. Operating margin was 3.8% versus 3.4% and EBITDA rose 15%. Loblaw said it will now begin to ramp up its major investments in information technology and supply chain as part of its renewal program, which it expects will lower 2010 operating income by about C\$185 million. (wsj.com, May 4)

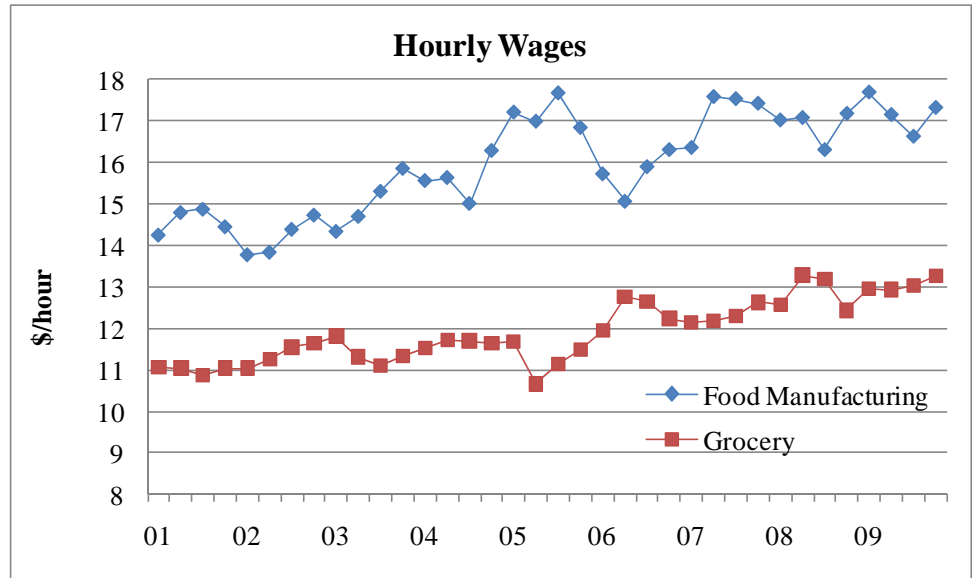
## Euro Briefings

- **Kraft Foods, North Field, Illinois, acted "irresponsibly" and "unwisely" during its acquisition of U.K. confectioner Cadbury PLC and has undoubtedly damaged its reputation in the U.K., lawmakers said in a report.** Kraft said throughout its pursuit of Cadbury that it believed it could keep open Cadbury's Somerdale factory in South-West England, one that Cadbury's management had pledged to axe. Kraft announced a week after its acquisition that the closure would go ahead after all. Kraft had planned to keep U.K. manufacturing at Somerdale and to use Cadbury's new plant in Poland to expand its own capacity, only to discover in January that Cadbury had spent tens of millions of pounds fitting the Polish factory to manufacture Cadbury's U.K. products. It, therefore, decided to proceed with the transfer of production and close Somerdale (wsj.com, April 6)
- **Carrefour's sales rose 5.5% in the first quarter, lifted by an improvement in business in France.** In France, Carrefour's most important market, the company posted a 2.1% rise in sales, lifted by business from supermarkets and a smaller drop in sales from its large, out-of-town hypermarkets—giant supercenters selling a wide range of general merchandise and food—than in previous quarters. Demographics, as families shrink, and competition from specialty electronics and clothing chains have eroded the popularity of the stores in recent years. In June, the Paris-based company is expected to reveal details of its plans to turn around the hypermarkets. (wsj.com, April 15)
- **Wal-Mart's supermarket group Asda Group set out plans for a big expansion of its stand-alone general-merchandise stores, saying it aims to become the U.K.'s number one non-food retailer by market share.** The group plans to increase the number of its 'Asda Living' stores, with an average size of 28,000 square feet, to around 150 in five years' time, up from 24. The company also said it wants to consolidate its position as the number two food retailer, behind market leader Tesco PLC. Asda is expanding its food-stores footprint by aiming to have 100 supermarkets, with an average size of 17,000 square feet, in the same period, up from 22 currently. (wsj.com, April 15)
- The EU is the largest exporter and importer in food and drink products worldwide, with a trade surplus of €1.1 billion in 2008. The European food and drink industry is the EU's single largest manufacturing sector in turnover and employment terms (ahead of automobile, chemicals and

machinery) and is number two in the EU in terms of value added and number of companies. (<http://www.ciaa.be>, April 19)

## Food Industry Statistical Highlight

The following graph shows hourly wages at food manufacturing operations and grocery stores each quarter from 2001 through 2009. In 2009, food manufacturer wages averaged \$17.19/hour while grocery store wages averaged \$13.04/hour. On an annual basis from 2001 through 2009, wages at both food manufacturing and grocery stores saw average increases of 2% each year.



## Final Briefing



Source: WSJ.COM

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