



ACCOUNTANTS, CONSULTANTS, & BUSINESS VALUATORS

# **GROCERY STORES**

## **AN INDUSTRY STUDY**

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In a forensic accounting setting, the purpose of an industry analysis is to allow a comparison of the subject company to its industry. This comparison is vital to assess the strengths and weaknesses of the subject company, as well as its industry and company specific risks.

The following study contains a brief, selected analysis of the specified industry. It is based upon a review of current economic statistics, articles in the financial press, reviews found in current business periodicals and information posted on numerous internet sites. It does not purport to be all-inclusive or to contain all of the information which a prospective investor or lender may require. Projections and opinions are based upon information provided by third parties. We make no representations or assurances that this information is complete or accurate. Neither Mark S. Gottlieb, CPA, PC nor any of its officers, employees, or representatives make any representation as to the accuracy of completeness of this report or its contents, nor shall any of the foregoing have any liability resulting from the use of the information contained herein or otherwise supplied.



## Industry Overview

The U.S. grocery industry, with annual sales approaching \$820 billion, is extremely competitive. Supermarkets account for two-thirds of industry stores, and claim most of the industry's revenues. Because of the industry's fragmented nature, however, the top five supermarket chains account for less than 25 percent of total industry revenues. For purposes of this report, "supermarket" may be defined as any conventional, combination, superstore or warehouse facility with over \$2.5 million in annual sales. "Hypermarts", like Walmart and Target, are a recent evolution in the supermarket vein.

Convenience stores, also included in the industry, generate roughly \$105 billion in annual sales, accrued from 130,000 stores. Sales from drug stores make up a much smaller share of the grocery market. Smaller still are online grocers, which, after a disastrous start, have begun to show promise. In all, there are 33,841 supermarkets, 12,959 grocery stores, 994 wholesale club stores, and a small handful of online grocers in the U.S.

The largest traditional supermarket chains include: Kroger Co. (\$51 billion in annual sales); Albertson's Inc.; Royal Ahold, NV; Safeway Inc.; and Publix Super Markets, Inc. With \$95 billion in annual grocery sales, Walmart is now the largest U.S. grocery chain and holds 14 percent of the market. Sam's Club, Walmart's popular wholesale operation, accounts for a large share of the hypermart's grocery sales. Costco and BJ's Wholesale Club are other large wholesale operations, with the latter operating almost exclusively in the Northeastern U.S.

In the convenience store sector, leading retailers include: 7 Eleven (17 percent of total stores); The Pantry; and Quik Trip. Convenience stores are generally divided into two categories: those which sell gasoline and those that do not. Though typically small in size, convenience stores comprise a majority of units in the industry, with nearly 100,000 U.S. outlets. These small, high-margin, easy-access enterprises offer a limited line of items, including staple groceries, nonfoods, and ready-to-eat foods.

Peapod, a web-based grocer, was the first successful U.S. online operator. Online startup Fresh Direct is also doing well. Launching its New York City operation in 2003, Fresh Direct reported approximately \$90 million in revenues the following year. Despite these success stories, however, the majority of web-based grocers went belly up in 2001 following the tech crash, and recovery has been slow. Companies such as Safeway and SuperValu have begun to experiment with online shopping of late, but only in regional markets. In June 2006, amazon.com quietly introduced an online grocery department, dealing exclusively in non-perishables. Web-based grocers have been challenged by complex delivery issues, coupled with a general lack of consumer interest.



## **Operations**

The grocery industry obtains goods from distributors and manufacturers, marking up shelf price to cover costs and ensure profit. Larger grocery chains tend to manufacture or prepare a limited line of goods for exclusive in-store sale. These goods include those prepackaged under a private label or store brand, and those offered ready-to-eat through in-house bakeries and delicatessens.

The choice of which goods appear on grocery shelves and how many of each is carefully calculated by both manufacturer and grocer. In the mid-1970s, supermarkets began selling shelf space to manufacturers and distributors on a contract basis. So-called "slotting fees", which are very negotiable, typically start at \$3,000 per product for a regional chain and may run as high as several hundred thousand dollars for a national chain.

On the retail side, grocery stores continuously monitor inventories via scanning technology integrated with cash registers. Frequency and volume of sales are recorded for each product, allowing maximum efficiency in order placement. It is in the interest of both manufacturers and retailers to maximize sales volume by giving ample shelf space to high-volume items, while leaving room for lower volume and niche products. Also competing for space are the thousands of new products introduced every year, many of these "organic" brands.

Half of all industry sales come from perishables (e.g. produce, bread, meat, and dairy). Snacks and condiments contribute 11 percent of sales, while beverages, including alcohol, run around 10 percent. Main meal items comprise 8 percent. Pharmacy items, health and beauty care, and other non-food grocery items fill out the remainder of sales.

## **Affiliated Independents v. Corporate Chains**

Supermarkets are divided into affiliated independents and corporate chains, the former characterized by wholesaler-retailer interdependence. Under the terms of an agreement between the wholesaler and retailer, the retailer takes advantage of the wholesaler's purchasing power and may use the wholesaler's name. In return, the wholesaler maintains the retailer's business for products purchased and also for services provided by the wholesaler.

Chain supermarkets control a much larger segment of the market, with almost four times the annual sales volume of affiliated independents. These store are company operated and include outlets like Safeway, Kroger, A&P, et al. Chain supermarkets typically bypass wholesalers and purchase in bulk directly from manufacturers, with each chain operating a sophisticated distribution system.



## **Competitive Landscape**

In the last decade, the U.S. grocery industry has become extremely competitive, and supermarkets have evolved to compete with hypermarkets. According to Progressive Grocer, 2,000 supermarkets close annually due to Wal-Mart's escalating grocery market share. Because of increased efforts by chains like Target and Costco, Supermarket News projects that hypermarkets will control 18.5 percent of the market by 2008, followed by food and drug combination stores with 13.1 percent, and conventional grocery stores with 11.6 percent.

In the face of this intense competition, stores must cut costs to remain viable. A side effect has seen retailers gain strong bargaining power with regard to producers and suppliers; the supermarket industry expanded 30 percent between 1998 and 2002 on the strength of lowered costs. While the industry fell off slightly amid a recessed economy shortly thereafter, hypermarkets and gas stations continued to grow during this period.

In addition to cutting costs, most grocery retailers have sought out niches within the industry. Gasoline-vending convenience stores have maximized efficiency by making a push toward more pronounced integration of fuel and grocery vending. Some have cut into traditional grocer's sales by offering products like fresh produce. Drug stores have sought out a niche as well, targeting consumables as optimal ground for development. Overall, the most pressing issue for small and mid-sized grocers is keeping costs low in order to compete with the hypermarkets, as new growth opportunities are few.

## **Marketing Strategies**

Radio, television, and online and print advertisements all serve to draw customers to supermarkets. Advertising among the top four supermarket chains (Kroger Co., Albertson's Inc., Safeway Inc. and Publix Super Markets, Inc.) ran to combined annual totals of \$1.9 billion in the early part of the 21<sup>st</sup> century. Recently, however, spending on advertising and publicity has waned and emphasis has shifted to the increased utilization of in-store promotional tools.

## **Workforce**

According to the U.S. Department of Labor, Bureau of Labor Statistics, grocery stores rank among the largest U.S. employers by industry, providing approximately 3 million wage-and-salary jobs. About 31 percent of grocery store employees work part time, and the average workweek of nonsupervisory workers is 30.8 hours. Some self-employed workers also work in grocery stores, but mostly in smaller establishments.

Unionization, once very strong in the industry, has declined of late. Entry into the market by non-unionized wholesalers and discount chains has forced many grocery chains to challenge unions in order to cut salary costs. Regional strikes are normal, as many supermarkets still employ unionized workers. Wage and salary employment in grocery stores is expected to



increase about 7 percent by the year 2014, only half the growth increase projected for all U.S. industries combined.

As many grocery store positions are part-time, do not yield benefits and do not require experience, the industry workforce is young: 33 percent of workers are under the age of 25. College graduates fill most new management positions, while other positions require little or no formal education.

Cashiers make up the largest occupation in grocery stores, accounting for 34 percent of all workers. Stock clerks and order fillers are the second largest group, comprising 15 percent of workers. Butchers and processing workers comprise a smaller percentage of workers, followed by bakers, warehouse workers, clerical workers and managers.

## Research & Technology

Research in the grocery industry has yielded technologies to help reduce costs and inefficiency. Specialized software, marketed by Grocer Systems Support, offers programs for all aspects of store management, from inventory control to accounts receivable analysis. All but the smallest stores currently work with computer technology.

Scanning systems have also progressed over the past decade. The Efficient Consumer Response (ECR) scanning system immediately records sale of a product, sending a signal to the central computer system, which then orders a replacement product. In addition to ensuring that grocers are adequately stocked while streamlining inventory, this technology helps grocers understand which products are selling, and in what volume. Paper invoices are eliminated and much of the accounting process is bypassed.

Recently, various card-scanning devices have allowed customers to use credit, debit, or store-issued check cards at checkouts. This development has eliminated the common practice of requiring the customer to provide multiple forms of identification at the point-of-sale for each visit. Quicker checkout lines have followed, as well as more thorough validation of checks. Fewer bad checks are passed. Smart cards and customer self-checkout are becoming increasingly common as well.

## Industry Opportunities

**Private Label Brands** — Private labels, or “store brands”, are product line offered exclusively by a given chain, and have proven an effective selling point for supermarkets. Store brands are attractive to shoppers as they offer low-cost options at the same general quality as national brands. According to a recent Gallup study, more than 90 percent of all consumers are familiar with store brands, and 75 percent of consumers rate them on par with national brands.



Store brands also benefit retailers as these products typically are manufactured by the supermarkets themselves, or in conjunction with third-party contractors. This increases profit margins significantly, especially as these products continue to sell in high volume. According to the Private Label Manufacturers Association, "store brands now account for one of every five items sold every day in U.S. supermarkets, drug chains and mass merchandisers."

**Introduction of Larger Stores** — Spurred by the success of hypermarkets and warehouse club stores like Sam's Club and Costco, supermarkets have sought to expand retail space as much as possible. In the last ten years, the average size of a new store has increased to over 60,000 square feet, a 33 percent increase. Almost all new endeavors by chain supermarkets seek greater retail space than the chain's current median.

**Ready-To-Eat-Dishes** — Fresh produce and ready-to-eat offerings are a prime growth area for supermarkets. Many grocers have developed expansive ready-to-eat offerings, often emphasizing in-house delicatessens. Currently, deli revenues are the fastest growing segment of total supermarket sales, and have helped smaller stores remain competitive with hypermarkets and wholesalers.

**Niche marketing** — Grocers have benefited tremendously from the increased popularity of natural and organic products, as well as ethnic foods categories. These niche markets have expanded into highly profitable sections for many grocers, and have helped many to hold the line against hypermarkets, which generally lag in this area.

**Nonfood Offerings** — Pharmaceuticals, health-and-beauty items, and food-related specialty products, pioneered by combination stores and hypermarkets, have proven exceptionally profitable. On average, nonfood offerings allow for markups twice as high as those of traditional grocery product. The expanding size of most stores has seen an influx of nonfood offerings, and has enhanced the concept of a typical "grocery store."

**Savings Cards** — Most large chains now offer savings cards to attract and retain customers. Rather than seek out and clip coupons, card-holding customers are entitled to discounts on select merchandise simply for holding a card. Some supermarkets have even teamed up with outside businesses to offer additional benefits to card-holding customers.

**Coupons** — For decades, retailers have issued coupons to customers. Coupons are distributed to promote new products, as well as to boost store traffic. They are typically not issued with manufacturer participation. Coupons have seen a resurgence of late as supermarkets have utilized them to compete with the low pricing of hypermarkets. With coupons, grocers designate items with trimmable margins, moving product quickly while offering value to customers. Some stores have begun to issue coupons electronically, of late.

**"Responsible Vending"** — Many supermarket chains have adapted to meet consumer concerns over animal welfare and environmental issues. Some stores take steps with suppliers



to ensure the humane treatment of livestock, and many have begun to carry “free-range” chicken and beef. Also, increasing amounts of grocers now boast sections with organically certified foods, expanding into a growing market previously claimed by specialty stores.

## Industry Challenges

**Slim Profit Margins** — Though grocers generally have strong pull in pricing with producers and suppliers, at heart the industry is highly competitive and profit margins are slim. Supermarkets have adapted with precise monitoring of inventory and a proliferation of store brands, but as both convenience stores and hypermarkets expand in size and number of outlets, mid-sized supermarkets in particular have struggled to maintain viable profit margins.

**Economic Dependence** — When overall spending slows due to sluggish economic conditions, grocers have difficulty keeping costs down. Although food is a basic necessity, changes in the spending and shopping habits of consumers affect grocers’ profitability. According to a survey of consumer attitudes conducted by the Food Marketing Institute in 2002, price was considered a major factor in food purchase for 84 percent of respondents, up from 77 percent the previous year, when economic conditions were brighter.

**Consumer Attitudes** — Many consumers have begun shopping as a form of entertainment, leaving small and mid-level grocers at a great disadvantage. It is estimated that hypermarkets have reached two in three U.S. households, eroding the customer base of smaller grocers. Many supermarkets have sought to capitalize on fresh food offerings such as meats, produce and deli, as these are staple areas in which hypermarkets do not yet excel. This emphasis, however, does nothing to address the “entertaining” pull of the hypermarkets.

**Labor recruitment and retention** — Labor costs represent an average of 69 percent of a food distributor's total cost of operation, and annual staff turnover rates of more than 20 percent are not uncommon. Of particularly pressing concern is the dwindling labor pool for industry executives. According to the Progressive Grocer, "the shortfall in talent could reach critical proportions in less than a decade." Grocers are striving to establish visibility in executive recruitment firms, universities and various retail channels in order to remain appropriately staffed.

## Industry Outlook

Dealing with cost is arguably the most important issue facing all types of grocers. The ability to attract new customers while retaining existing customers will be important as well. By nature, the grocery industry is slow-moving and somewhat static; its recent growth, attributable largely to the development of hypermarkets, may soon curtail. Large chains will continue to feel the pinch from both hypermarkets and convenience stores. Many have sought to expand through acquisitions, though these are closely regulated by the Federal Trade Commission. At best, industry growth will be steady and slow.



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