GROCERY & SUPERMARKETS

TARIFF ALERT

CURRENT TRENDS

- Phase one of a China trade deal has been signed, but ongoing tariffs continue to impact the food industry
- The expanding coronavirus is expected to disrupt the agriculture supply chain in the near term
- Prices for five of the six major grocery store food groups increased from 2018 to 2019, with dairy up 2.4%, meats, poultry, fish, and eggs up 2.3%, and cereals, bakery products, and miscellaneous up 0.3%
- Competition from dollar stores and others are taking market share from traditional grocers

PROJECTED VALUES
(12-MONTH OUTLOOK)

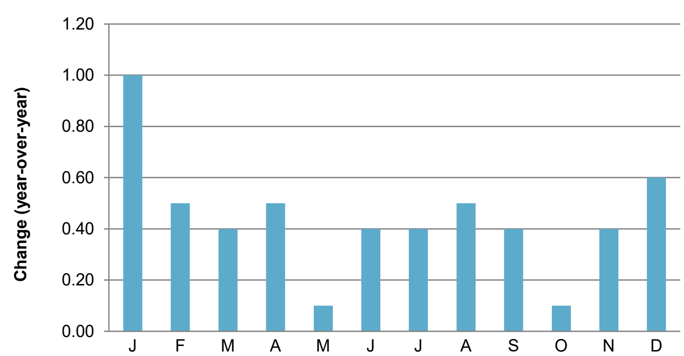
APPROXIMATE NET RECOVERY ON COST

55-70%
national chain inventory

50-70%
regional operator inventory

45-65%
local operator inventory (typically < 5 stores)

FOOD AT HOME PRICE INDEX - 2019



Source: Bureau of Labor Statistics

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GROCERY COMPETITION GROWS: After acquiring upscale grocer Whole Foods in 2017 for $13.7 billion, Amazon has grown the chains' store count to 504 locations from 468. In a bid to expand into the middle-market grocery sector, Amazon will launch a new, as-yet-unnamed concept in early 2020. The location selected for the first store is Woodland Hills, California, an affluent suburb of Los Angeles. The location, which is less than two miles from a Whole Foods store, exemplifies Amazon's plan to stay close to its core Prime members and to supply mainstream groceries and prepared foods while experimenting with products Whole Foods does not offer. Amazon may open additional stores in Chicago, Philadelphia, and elsewhere in the United States, according to reporting from the *Wall Street Journal.*

Alternative retail channels have been moving into the grocery space, chipping away at sales and margin growth for traditional grocery stores and supermarkets. Based on a recent McKinsey report *Reviving Grocery Retail: Six Imperatives,* grocers could lose up to $700 billion to alternative channels by 2026. A channel taking market share is dollar stores, which have expanded food offerings over the past two years in a bid to increase sales, especially in areas where access to traditional grocery stores is low. To compete with discount superstores like Walmart in larger markets, many dollar stores are stocking more food items, including packaged, frozen, and canned goods.

In the fall of 2018, Kroger began piloting a store-within-a-store concept in northern Kentucky Walgreens stores called Kroger Express, offering fresh produce, meat, and dairy, as well as frozen foods, Home Chef meal kits, wine, and other grocery items, according to Progressive Grocer. In late 2019, the pilot was expanded to 35 Walgreens stores in the Knoxville, Tennessee, market. Supermarket News noted that most locations will feature a full Kroger Express assortment of up to 2,700 products. Most stores will also offer Kroger Pickup service, allowing shoppers to place a digital order on Kroger.com or via the Kroger app for curbside pickup at a participating store. Both companies describe the ongoing pilot as "exploratory" adding that customers have responded very favorably in the Kentucky market.

TRADE DEALS ADVANCE, BUT CHALLENGES ARE ONGOING: Two recent trade agreements have eased trade tensions between the United States and some of its major agricultural trade partners. On January 15, 2020, a phase one U.S.-China trade deal was signed by the Trump administration, stipulating that China will purchase an additional $200 billion of U.S. goods and services through 2021, including an additional $16 to $26 billion of U.S. agricultural products. In exchange, the United States has agreed to reduce tariffs on $112 billion of Chinese products from 15 percent to 7.5 percent. Although U.S. agricultural exports to East Asian countries are forecasted to decline by $6.7 billion for fiscal 2019, China and Japan are still major markets for U.S. agricultural products.

Additionally, on January 16, 2020, the United States-Mexico-Canada Agreement was ratified by the U.S. senate, replacing the North American Free Trade Agreement and modernizing technology, addressing trade issues, and promoting opportunities for residents of North America.

While progress on trade agreements with China are a positive for the food industry, the growing fear of supply chain disruption stemming from the coronavirus has increased since China's government provided initial confirmation on February 11, 2020, that the spread of the virus could affect its compliance with purchase commitments as part of the phase-one trade deal. After the announcement, White House national security adviser Robert O'Brien commented, "We expect the Phase 1 deal will allow China to import more food and open those markets to American farmers, but certainly as we watch this coronavirus outbreak unfold in China it could have an impact on how big, at least in this current year, the purchases are."

As of February 16, 2020, the United States had not issued a quarantine order on imports of Chinese goods; however, the virus has negatively affected the movement of goods to Chinese ports. Chinese provinces have set up checkpoints at their borders where drivers are stopped for inspection, or in some cases quarantined for a two-week period. At a minimum, these delays may create temporary shortages for some imported food products.

The primary issues that grocery retailers face as a result of ongoing tariffs and potential supply chain disruption are increased supplier pricing and potential re-sourcing issues. Any increases in pricing are often passed through to the consumer to maintain grocers' already razor thin margins. Based on U.S. Census Bureau data, prices for five of the six major grocery store food groups increased from 2018 to 2019, with dairy up 2.4 percent, meats, poultry, fish, and eggs up 2.3 percent, and cereals, bakery products, and misc. up 0.3 percent.

CATEGORY DEMAND DRIVES RECOVERY: Specific categories for grocery retailers can drive significantly higher or lower gross recovery rates depending on customer demand and level of inventory availability. The highest-recovering categories include high-turning categories such as meat, deli/prepared foods, dairy, bakery, and produce. These categories typically sell through very quickly in a disposition event. Managing the discounts on slower-selling categories once the major perishable categories are sold through is critical to maintaining customer interest in "re-shopping" the sale beyond the opening days. High-turning dry grocery sub-categories such as branded staples including crackers, cookies, and pasta, along with infant formula and popular branded health and beauty products, typically require less discounting to sell through regardless of season. Conversely, grocery sub-categories including spices and kitchenware are typically in lower demand and require additional discounting to sell through in an accelerated period.

The delta between high- and low-recovering categories in the grocery segment can be significant on a retail basis. Even within stronger-recovering categories such as health and beauty, there is potential for a lower recovery on items with depth in the inventory, including vitamins, and less popular first aid and beauty products. Supermarkets may also include gas stations or stock cigarettes and alcohol, all of which are very high-recovering categories. However, it is important for lenders to be aware what (if any) additional licensing or permitting may need to be in place in order to sell these highly controlled and restricted commodities in a bankruptcy scenario.

Maximizing recovery rates can also be challenged by sale term duration. Going-out-of-business sales in the grocery sector are short, typically lasting a maximum of six weeks and often less. Seasonality can also be a major driver in periods immediately preceding holidays such as Thanksgiving, Christmas, and Easter, which drive higher volume during the normal course of business.

Grocery stores operate with extremely low margins and depend on volume to generate profits. In some cases, grocery stores net less than a penny per dollar of retail sales. Competition limits a company's ability to raise prices. Although gross recoveries on retail (by category or in the aggregate) may be higher than average, the blended gross recovery on cost typically does not exceed 100 percent due to the lower-margin nature of the sector.

Managing discounts on high- and low-recovering inventory in tandem with seasonal demand and on-hand inventory levels is critical to a successful GOB event. Understanding and predicting gross recovery rates by category, brand, region, and season comes with experience.

Gordon Brothers applies the firm's extensive real-world grocery and supermarket disposition involvement to each appraisal analysis, which assists asset-based lenders in offsetting risks associated with low-turning inventory.

The Expert: Becky Goldfarb

Bringing over 15 years of experience in the disposition and valuation of retail and consumer products, Becky Goldfarb oversees all aspects of retail asset valuations. Prior to that, Becky was responsible for the financial analysis of retail dispositions across all industry sectors. Read her full bio here

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