GROCERY & SUPERMARKETS

TARIFF ALERT

CURRENT TRENDS

- Tariffs on a range of agricultural products are working their way through the supply chain and will impact retail prices over time
- U.S. retail sales for food and beverage stores increased 3.7% in the first eleven months of 2018 compared to 2017
- The Consumer Price Index (CPI) for food increased 0.3 percent for the 12 months ended December 2018 (unadjusted); prices for food at home also increased 0.3 percent for the same period
- December 2018 marked the 18th month of increases in CPI for food at home

PROJECTED VALUES
(12-MONTH OUTLOOK)

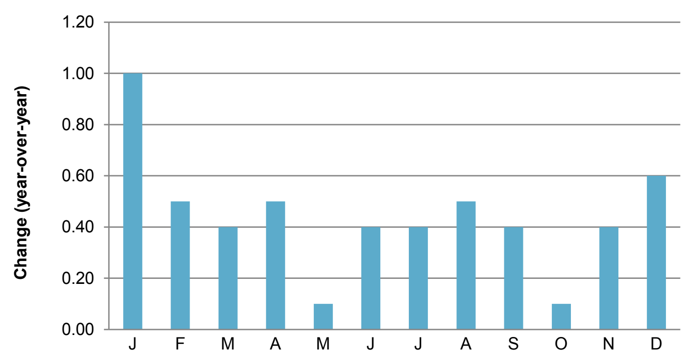
APPROXIMATE NET RECOVERY ON COST

55-70%
national chain inventory

50-70%
regional operator inventory

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

FOOD AT HOME PRICE INDEX - 2018



Source: Bureau of Labor Statistics

REFERENCE SOURCES: USDA, BUREAU OF LABOR STATISTICS, PROGRESSIVE GROCER.COM, THE WASHINGTON POST, EATER.COM, BROOKINGS.EDU, CNN.COM, THE CONVERSATION.COM, WHOLE FOODS MARKET

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TARIFFS IMPACTING SUPPLY CHAIN: Tariffs are hitting some industries, like agriculture, harder than others. According to the U.S. Farm Bureau, the farm economy is suffering under reduced commodity prices and income at the same time that it is facing rising interest levels, increased debt, and lower loan performance. Fixed asset and equipment costs are also rising. Retaliatory tariffs on agricultural exports, such as pork and soybeans, are exacerbating headwinds for many farmers. Further out in the supply chain, increased metals costs, for example, are increasing canned food and beverage production costs. In response to tariffs on soybeans, fruit, and other items, the U.S. government has implemented a $12 billion bailout for farmers, but there could still be a long-term impact of lost markets and customers.

After the United States imposed steep tariffs on steel and aluminum imports worldwide, Canada, Mexico, and the European Union retaliated with their own tariffs, which went into effect in the summer of 2018. The tariffs affect over $19 billion worth of American goods, including coffee, whiskey, bourbon, candy, orange juice, yogurt, condiments, and peanut butter, among others. Similarly, China retaliated against the U.S. by announcing it would impose tariffs on 128 types of U.S. goods, including dozens of agricultural products such as fruit, nuts, and wine, with the additional taxes ranging from 15 to 25 percent.

While the United States will gain marginally greater access to the Canadian dairy market through the yet-to-be-ratified United States-Mexico-Canada Agreement, it remains to be seen how that will affect retail pricing going forward. Additionally, there may be an upside to Canada's agreement to eliminate its pricing structure of what is known as "Class 7" dairy products, which may eventually allow U.S. producers to outcompete Canadian farmers.

The primary issue that grocery retailers face as a result of tariff implementation is increased supplier pricing and potential re-sourcing issues. Any increases in pricing will need to be passed through to the consumer to maintain grocers' already razor thin margins. The long-term impact is still to be seen and will be based in large part on end consumers' response to higher food prices and how that shapes buying habits.

THE BATTLE OVER GROCERY: Amazon's $13.7 billion acquisition of Whole Foods in 2017 has effected little change to the industry from the perspective of retail stores. Amazon however, continues its struggle to make the online grocery channel profitable despite leading the industry in sales. Based on information from Bricks and Clicks and Retail Dive, supermarkets that offer e-commerce options are seeing bigger baskets and more frequent trips. As one example, on a monthly basis, shoppers that use supermarket delivery and pickup services spend $200 compared to just $74 among Amazon grocery shoppers based on a survey of households conducted by Bricks and Clicks.

Meanwhile, Walmart is quickly advancing its grocery business to compete with Amazon, adding perks like "life-changing" free pickup within four hours for online orders and a $10 credit for customer referrals. Grocery pickup is now available in nearly 2,100 Walmart locations, with delivery available in nearly 600 locations. Groceries are the biggest traffic driver to Walmart's stores, comprising more than half of its over $500 billion in sales in 2018. Walmart is redesigning its stores and employing a strategy to offer cheaper and more convenient ways to buy groceries for its low- and middle-income customer base. The plan appears to be working so far with Walmart's grocery sales growth at a nine-year high according to information from CNN Business. Walmart maintains that its extensive store geography is its biggest advantage over Amazon. Although Amazon bought Whole Foods to establish its brick and mortar presence, it cannot easily replicate Walmart's expansive store base across the world. With 490 stores in North America and the United Kingdom, Whole Foods appeals to a much narrower segment of the natural and organic grocery market. Walmart's 3,568 existing U.S. supercenters' proximity to shoppers gives the company a significant advantage over its grocery competition, including other mass merchandisers like Target, which has also increased its focus on fresh and other groceries in the past year to stay competitive.

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

CATEGORY DEMAND DRIVES RECOVERY: Specific categories for grocery retailers can drive significantly higher or lower gross recovery rates depending upon 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 time frame.

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.

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.

SEASONALITY, PERISHABILITY, AND MARGIN ARE KEY CONSIDERATIONS: When closing a grocery store, there are several unique considerations to selling the inventory. Consistent with the majority of retailers, grocery stores and supermarkets typically carry a selection of low-turning inventory in order to provide customers with a range of products. When faced with a bankruptcy filing and subsequent liquidation, these products often have low sell-through rates due to seasonality or lack of demand. Perishability is also a major factor in dispositions. Inventory that is at (or near) its expiration or "use by" date may require additional discounting to sell through quickly. Produce, a higher margin product, typically has heavy shrink due to the need to dispose of non-selling fresh items.

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 normal course 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.

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