

INDUSTRY REVIEW

Taking Advantage of Industry Consolidation





INDUSTRY OVERVIEW

INDUSTRY OVERVIEW

Current Economic Outlook

- Quote from the front page of the October 1st issue of The Economist
 “Until politicians actually do something about the world economy...”
 “BE AFRAID”
- There is no good news on the horizon that is going to change consumer spending patterns for groceries
- The direction and outlook for the stock market will dictate whether the middle class and retired people on fixed incomes maintain their current buying patterns in the near term
- The Federal Reserve has signaled that they will hold interest rates low until mid year 2013

INDUSTRY OVERVIEW

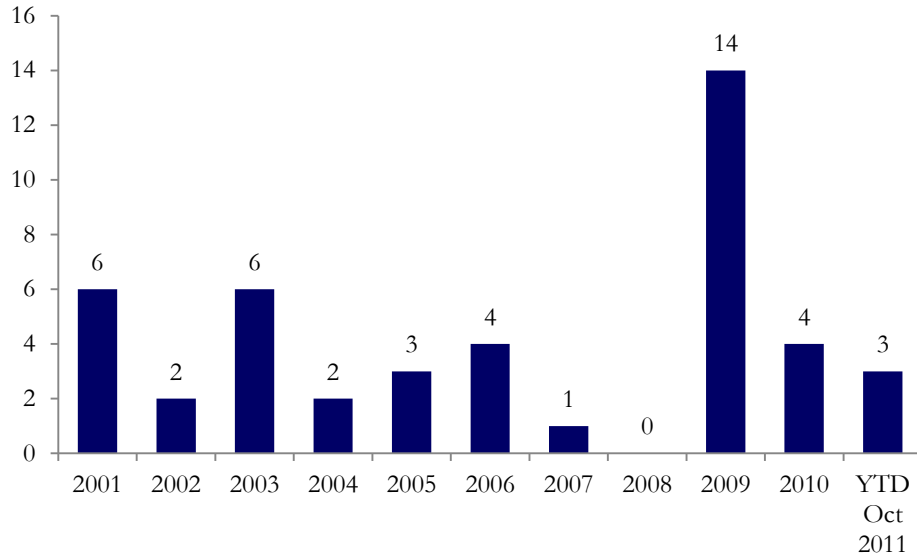
Industry Overview

- Food inflation will offset increases in operating expenses
- Retailers that have reinvested in their stores are seeing 15% to 30% sales increases after major remodels
- During the last 24 months, the majority of free cash flow generated by retailers has been spent on capex or stock repurchase programs rather than organic growth or acquisitions
- Small stores are closing at an accelerating pace in both rural and urban markets
- Underperforming stores are deteriorating at an accelerating rate
- Today's competitive threats include:
 - Walmart's small store format (a major concern in specific markets)
 - Fresh & Easy (continued expansion)
 - Other alternative formats such as Sprouts, Fresh Market and limited assortment stores
 - Drug store operators (which are more and more food)
 - Existing competitors (building replacement stores)

INDUSTRY OVERVIEW

Historic U.S. Supermarket Retail Bankruptcy Statistics

U.S. Supermarket Bankruptcies



Supermarket Bankruptcy Detail (Last 2 Years)

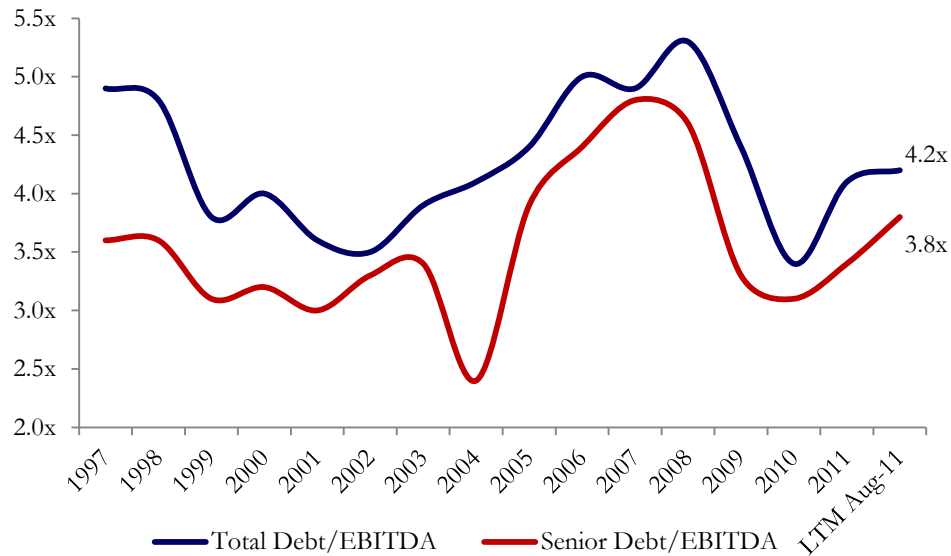
Company	Date Filed	State Filed	Chapter Type
Moo & Oink, Inc.	8/24/2011	IL	7
Andronico's Market, Inc.	8/22/2011	CA	11
Rizk-Co-Zann Foods Corporation	3/10/2011	PA	11
The Great Atlantic & Pacific Tea Co.	12/12/2010	NY	11
Empresas Cordero Badillo, Inc.	11/12/2010	PR	11
Supermercado del Pueblo	4/1/2010	NV	11
Star Food International Inc.	1/5/2010	CA	11

- The number of bankruptcies is expected to increase during the next 24 months

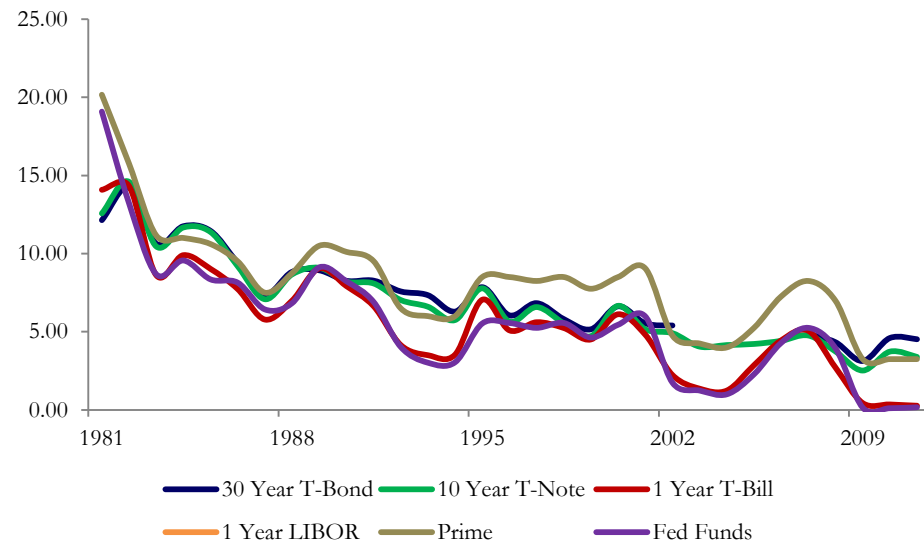
INDUSTRY OVERVIEW

Average Proforma Adjusted Credit Statistics of Middle Market LBO Loans

U.S. Companies with less than \$50 million of EBITDA



Select Interest Rates

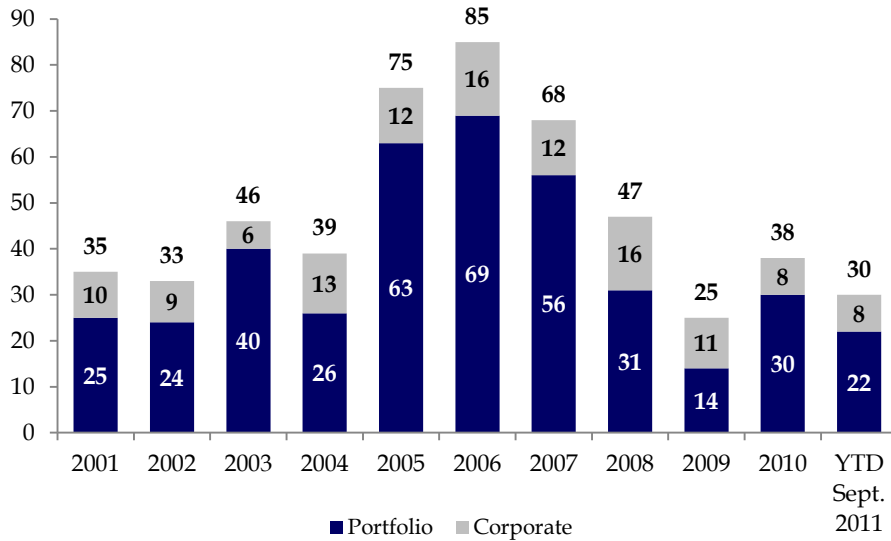


- Retailers undertaking acquisitions have access to debt capital
- Competition between banks remain strong for good performing retail companies
- Absolute interest rates are at a historic lows

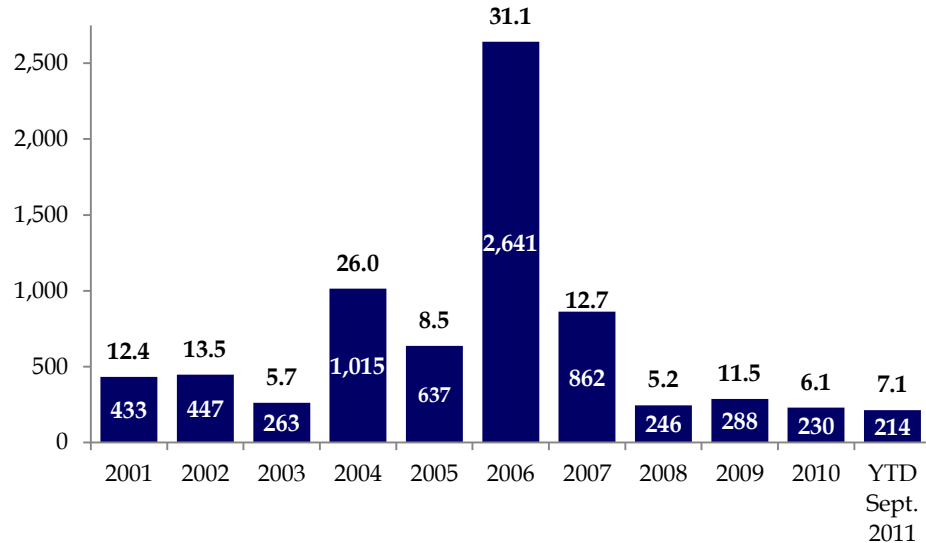
INDUSTRY OVERVIEW

Mergers & Acquisitions

Corporate Versus Portfolio Transactions



Number of Stores Sold / Average Number of Stores per Transaction



- Number of stores sold in 2011 should be greater than 2010
- Average number of stores sold per transaction will increase as larger retailers exit
- Transaction activity is expected to increase in 2012

INDUSTRY OVERVIEW

Summary of Merger & Acquisition Activity

- Proposed changes in federal tax rates have inflated retailers to sell their businesses
- National and regional retail chains continued to prune stores in specific markets but at a slower rate
- The liquidation of distressed retailers provided opportunities for select retailers
- Private equity buyers continued to make acquisitions but none have recently found an exit
- The primary driver for independent retailers to exit the business was the uncertainty about the outlook for their business
- Access to credit was not an issue for strategic buyers to make acquisitions
- Valuation multiples for retail grocery stores held constant from 2010 with specific buyers willing to share a greater portion of synergies with the seller

INDUSTRY OVERVIEW

Merger & Acquisition Looking Forward

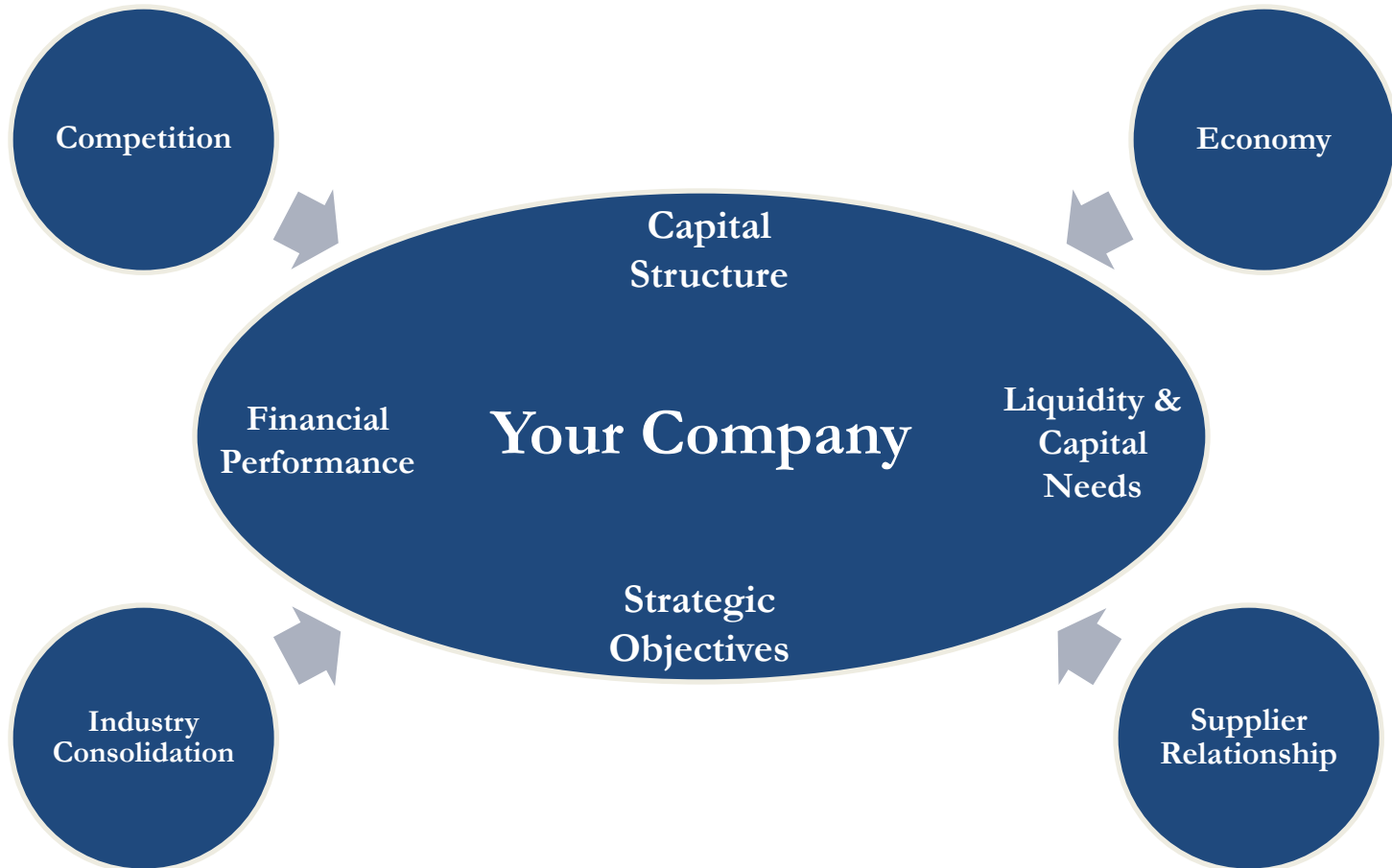
- The reality of substantial increases in federal tax rates will increase divestiture activity
- Healthcare reform will influence some retailers to consider selling
- The number of one and two store operators exiting the business will increase
- Independents facing increased competition that have 10 or fewer conventional stores will look to exit
- National and regional retail chains that have unionized labor will prune underperforming stores that do not fit their current format
- The number of negotiated transactions is expected to increase as retailers in a growth mode accelerate looking for acquisitions
- Valuation multiples should remain relatively stable as long as borrowing costs remain low and access to financing is available



PLANNING FOR GROWTH

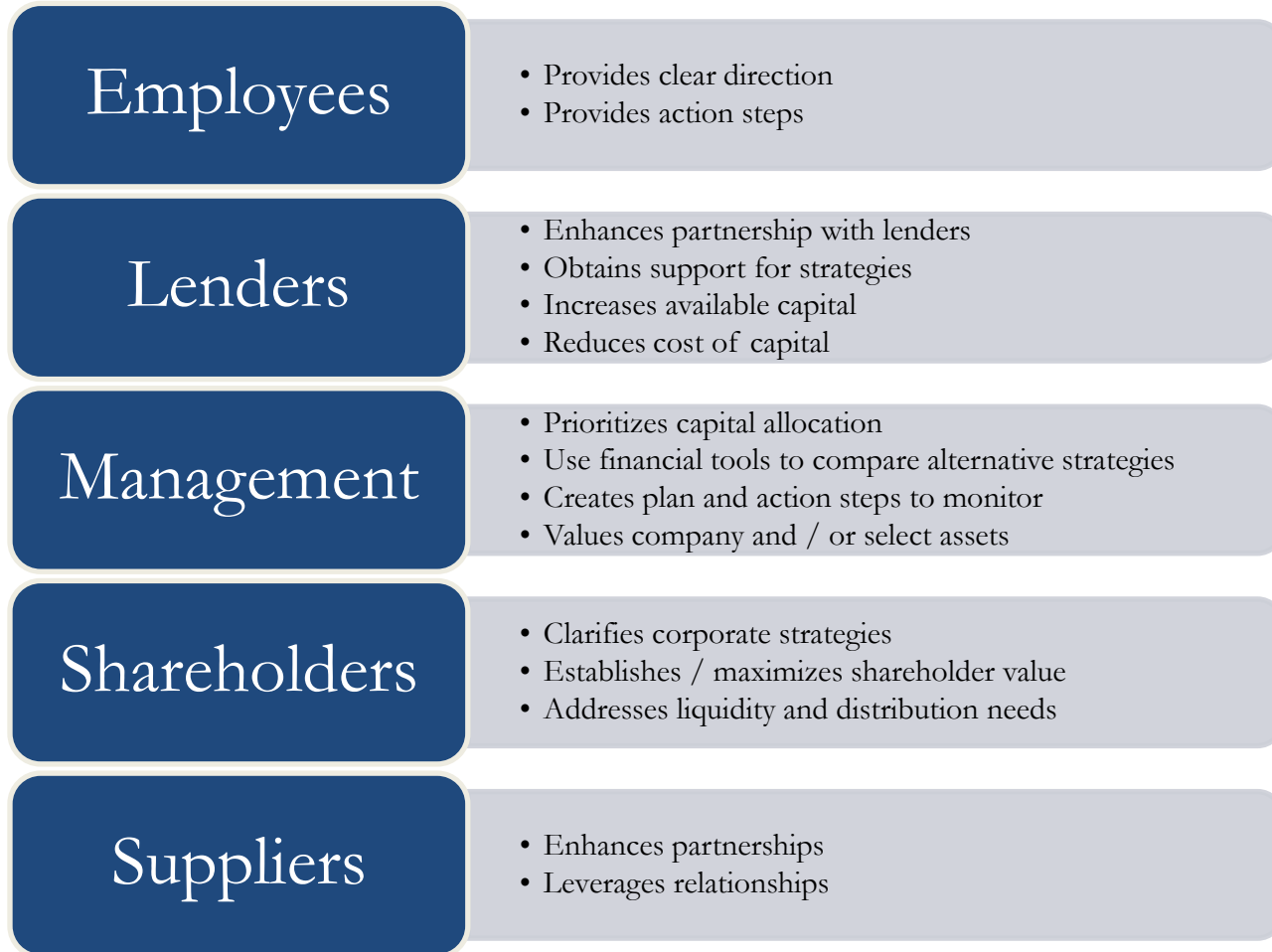
PLANNING FOR GROWTH

Why do Companies Need a Strategic Review?



PLANNING FOR GROWTH

What are the Benefits of Using the Strategic Review





THE FIT CHART PROCESS

THE FIT CHART PROCESS

Sample Fit Chart

TARGET COMPANY CHARACTERISTICS

Company	Headquarters	Sales	Criteria										TOTAL SCORE	Weighting	
			1.50	1.40	1.30	1.20	1.10	1.00	0.80	0.70	0.60	0.40			10.00
Company #1	City	St	xxx	8	10	8	3	5	7	5	10	3	9	6.89	
Company #2	City	St	xxx	8	8	8	7	10	7	5	0	3	9	6.94	
Company #3	City	St	xxx	9	7	5	9	7	8	4	10	4	6	7.13	
Company #4	City	St	xxx	8	8	4	8	6	5	7	10	4	5	6.66	
Company #5	City	St	xxx	9	4	8	6	5	6	5	10	9	7	6.74	
Company #6	City	St	xxx	5	7	3	7	3	7	7	10	10	5	6.05	
Company #7	City	St	xxx	6	4	4	9	6	7	4	10	4	7	5.96	
Company #8	City	St	xxx	8	8	4	3	6	4	4	0	8	8	5.38	
Company #9	City	St	xxx	5	6	3	8	6	7	6	10	5	3	5.90	
Company #10	City	St	xxx	6	6	4	6	4	6	6	10	3	4	5.54	
Company #11	City	St	xxx	7	4	3	7	5	7	4	10	4	2	5.43	
Company #12	City	St	xxx	5	4	6	7	7	7	5	0	3	7	5.26	
Company #13	City	St	xxx	7	7	5	6	7	5	5	0	2	6	5.43	
Company #14	City	St	xxx	5	8	5	5	4	6	4	0	8	8	5.28	
Company #15	City	St	xxx	1	7	8	5	2	4	3	10	3	8	4.83	

THE FIT CHART PROCESS

Potential Target Characteristics

- Capex requirements
- Company size
- Competitive position
- Competitive threats
- Contractual obligations
- Culture/management
- Demographics
- Financial performance
- Geography
- Growth opportunities
- Market Share
- Store formats
- Supply contracts
- Supply synergies
- Union or non-union workforce
- Willingness to sell



ACQUISITION CONSIDERATIONS

ACQUISITION CONSIDERATIONS

Assessment of Pharmacy Departments

- Healthcare reform will put continued pressure on reducing prescription drug costs
- Reimbursement under Medicare and Medicaid will be reduced
- Managed care programs will continue to reduce pharmacy margins for retailers
- Retailers evaluating acquisition targets are rethinking whether they want to acquire stores with pharmacy departments or continue to operate existing pharmacies
 - Pharmacists are typically the highest paid employees in a store and difficult to retain
 - Support staff for pharmacies can be costly
 - Retailers have a more profitable use for the space in their stores
 - Retailers are questioning whether pharmacy departments are driving incremental customer counts and sales
 - Increased competition from traditional drug stores
- A number of retailers have elected to divest of their pharmacy departments and reemploy the capital in their operations or make acquisitions
- Drug store chains are actively seeking to buy script files

ACQUISITION CONSIDERATIONS

Changing the Banner

- The current cost to convert the banner of a grocery store ranges from \$100,000 to \$1 million for signage, rebranding the interior of the store and adding departments to match the acquirer's store format
- Conversion costs can negatively impact projected cash flow and the valuation of the store
- Over the last 24 months, retailers that have made acquisitions have had mixed results of retaining existing customers after converting a store banner – customers don't like change in these troubled economic times
- A number of retailers have adopted an acquisition strategy of not changing a store's banner or making any material change for a interim period of time
- What is the risk/reward of operating multiple formats and banners?

ACQUISITION CONSIDERATIONS

Ownership of Real Estate

- Sellers retained real estate and leased stores to buyers at historical market rates
- Many retailers elected not to allocate capital to the ownership of real estate
- Retailers are rethinking the ownership of real estate:
 - Proposed changes to FSAB will require operating leases to be capitalized
 - Capitalized leases are treated like debt on the balance sheet
- If a buyer believes that it can materially increase sales in a location, they do not want the seller to get the upside in the long-run
 - Buyers want control of the real estate if they are going to undertake a major remodel or expansion
 - It doesn't make sense to pay an 8% to 10% cap rate to the seller when the buyer can finance the real estate at a substantially lower interest rate
 - Buyers don't want to lease the property and pay rent bumps or percentage rent
 - Buyers want to control the real estate so they can close a store or change to an alternative format if the store becomes non-viable in the future

ACQUISITION CONSIDERATIONS

Unionized Labor

- Independents have fought hard to maintain a non-union workforces
- The cost of acquiring a store with unionized labor and converting it to a non-unionized workforce is very time consuming and expensive
- Many retailers have declined acquisitions that are a “perfect fit” because they could not overcome the union
- A number of retailers have successfully adopted a “double-breasted” strategy of operating both non-union and union stores
- There are a number of key issues when considering such a strategy:
 - Can you insulate your existing stores?
 - What is the cost of union health and welfare benefits and can employees be converted to your plan?
 - What are the current union pension benefits and the amount of underfunding?
 - Are union work rules a barrier to achieving productivity?

ACQUISITION CONSIDERATIONS

Integration Plan

- The key component of making a successful acquisition is executing an integration plan that minimizes disruption at the store level
- A number of factors contribute to the failed integration of stores:
 - The integration plan the retailer developed was flawed
 - The communication of the integration plan to employees was poor
 - Buyers did not conduct sufficient due diligence on information systems and lost control of both the front-end and financial reporting
 - Buyers changed the primary suppliers the day of the acquisition
 - Buyers terminated key members of the management team the day of the acquisition
 - Buyers closed the corporate office immediately
- There is a balance between deriving synergies and minimizing integration risk

ACQUISITION CONSIDERATIONS

Other Current Acquisition Issues

- Buyers projected cash flow is less than the sellers actual cash flow
 - Seller is buying deal merchandise and produce “on the street”
 - Seller’s wage scale is lower and provides no employee benefits
 - Seller does not advertise
- Union pension obligations
 - Many union pension plans are in the critical zone
 - Current pension contributions are subject to a surcharge
 - Future pension fund contributions are expected to increase dramatically
 - Benefit accrual levels have been reduced for new hires and it is not clear when they will be made up
- The acquisition target has a radically different pricing strategy and the net impact on sales and gross margins is not clear
- The seller’s leases contain “go dark” provisions, radius restrictions for new stores and other provisions that are not acceptable to a buyer



www.thefoodpartners.com

WASHINGTON \ IDAHO \ TEXAS \ WASHINGTON, DC

David Schoeder
(202) 589-0436
dschoeder@thefoodpartners.com

Matthew Morris
(202) 589-0434
msmorris@thefoodpartners.com

Ernie Smith
(202) 243-0578
esmith@thefoodpartners.com

James Floyd
(817) 416-7006
jfloyd@thefoodpartners.com

Carlos Garcia
(202) 589-0437
cagarcia@thefoodpartners.com

Douglas Herman
(202) 589-0438
dherman@thefoodpartners.com

Jesica Mitchell
(208) 426-9220
jmitchell@thefoodpartners.com

Jodi Kusak
(425) 453-1341
jkusak@thefoodpartners.com

Maureen Bates
(202) 243-0576
mbates@thefoodpartners.com

5335 Wisconsin Avenue, NW, Suite 410, Washington, DC 20015

CONTACT INFORMATION

For copies of this presentation,
please visit our website at
www.thefoodpartners.com