

# PALI RESEARCH

December 17, 2008

## **Food Retailing Industry** Ominous Trends are Materializing; 2009 Sales Could Prove Dismal

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- **Grocery Industry Sales Growth Totaled 3.5%.** Seasonally adjusted November grocery retail sales growth decelerated to 3.5% from 4.1% and 5.4% in October and September, respectively. Against the backdrop of the current and relatively stable inflation rates, the sales performance is disappointing and suggests meaningful volume pressure.
- **Input Cost and Retail Inflation Remain Elevated.** PPI - Finished Foods held steady at 6.5% growth and CPI - Food at Home moderated slightly to 7.1%. We continue to believe that the reversal in the CPI - PPI spread (turning positive) merely represents a categorical negative turning into a neutral factor. Further we believe that prices can and will be more than offset by promotional activity and pricing by the retailers. For example, Costco recently indicated a significant step-up in food price cuts.
- **Negative Real Sales Growth Persists and WORSENS to negative 360bps.** The combination of continued high inflation but eroding sales growth has led to FIVE consecutive months of negative real sales growth. Specifically, real growth has totaled negative by over 200bps in the last three months totaling -220, -330 and -360 basis points in September-November, respectively.
- **Share Gain from Restaurants Continues But Moderates, AGAIN.** Grocery sales growth outpaced Food & Drinking Establishment sales growth for the 13<sup>th</sup> consecutive month. Specifically, grocery sales growth has surpassed restaurants by 1.5 percentage points on average over the last 12 months and totaled 1.5 and 0.7 percentage points in October and November.
- **Employment a Leading Indicator to Sales Pressure.** We continue to believe that changes in non-farm payroll are highly correlated to industry sales. As a result, the declines in non-farm payroll over the last several months, combined with decelerating industry sales growth, give us confidence that the current cycle will look very similar to the 2001/2003 period.
- **We continue to believe cyclical pressures are mounting on most industry participants and anticipate sales, margin and earnings pressure going forward. In addition, disinflation over the course of 2009 will likely prove particularly painful.**

PALI CAPITAL, INC.

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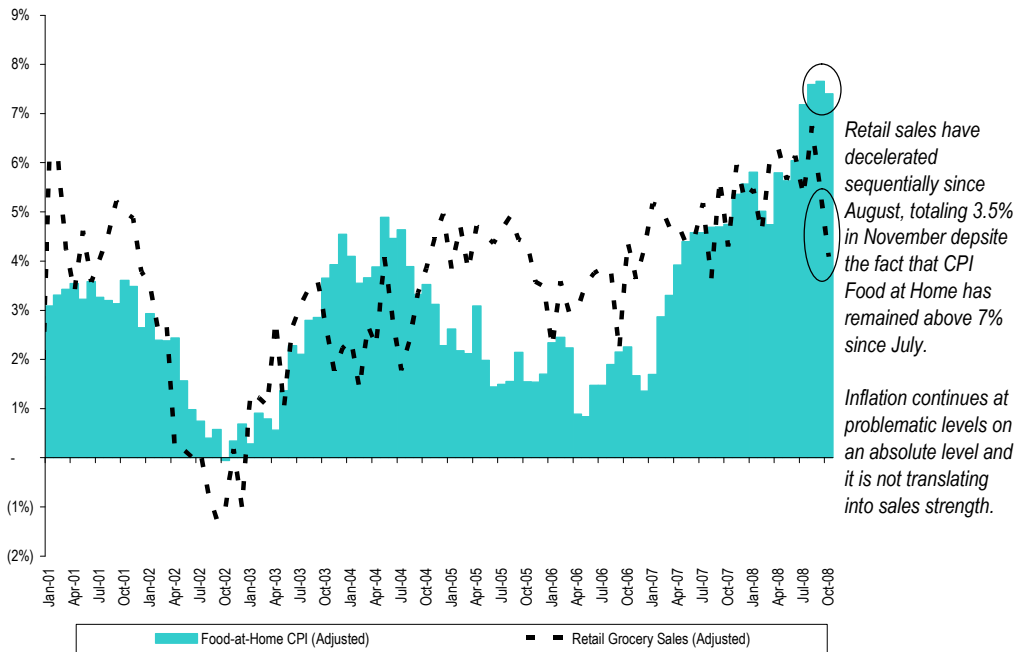
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## **Food Retailing Industry**

**Please Read: Important disclosures and analyst's certification appear in Appendix**

Sales and Retail Inflation

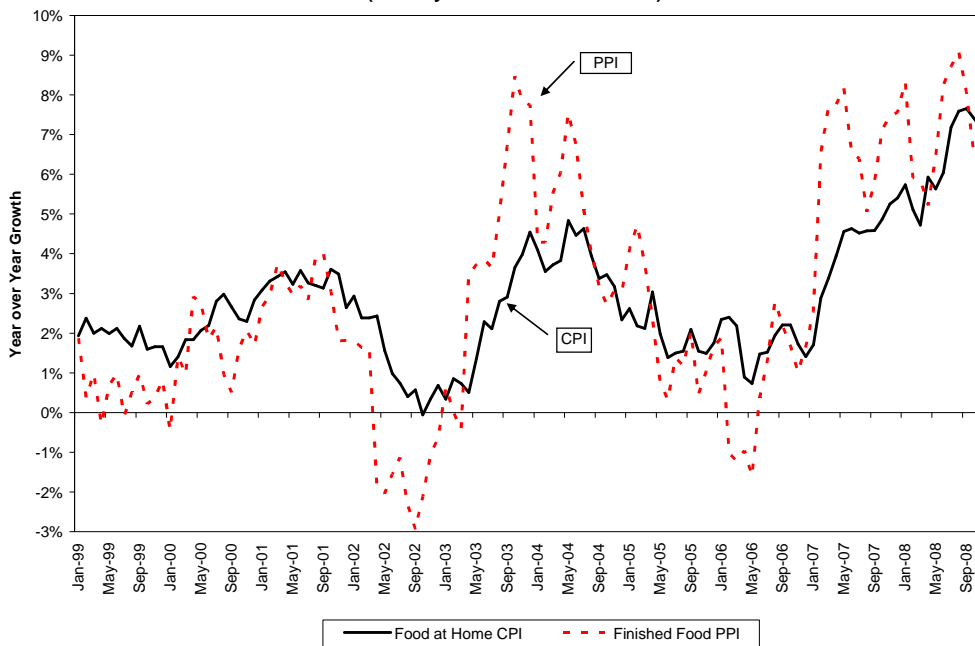
Inflation and Sales Trends



Source: Pali Research & Government Data

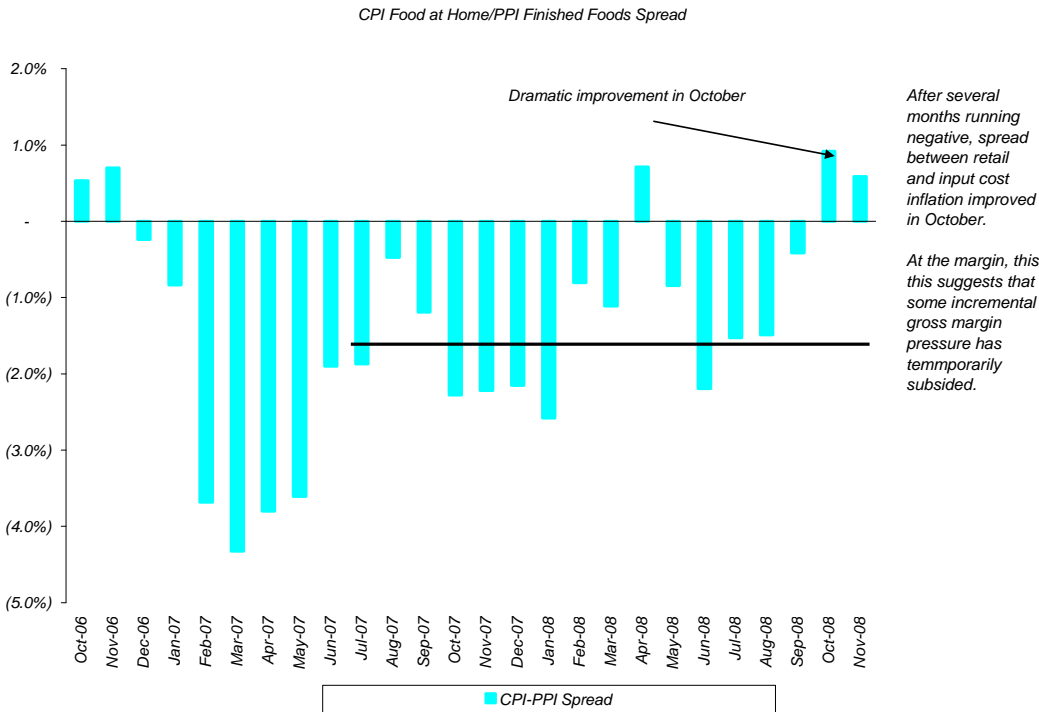
Input Cost and Retail Inflation

Year over Year Growth in CPI Food at Home and PPI Finished Foods (January 1999 to November 2008)



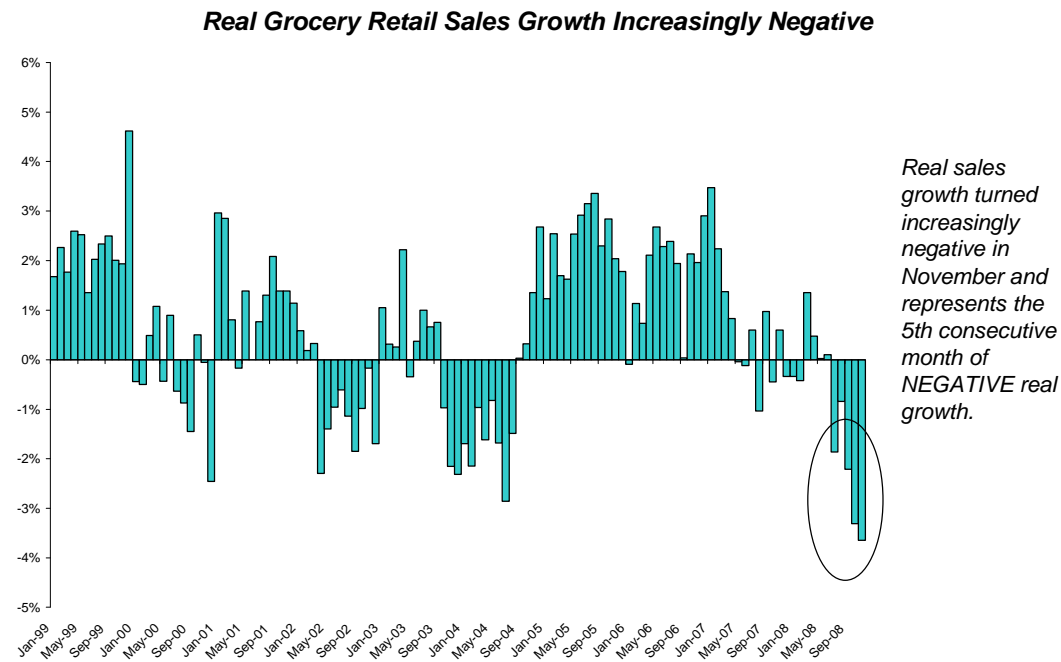
Source: Pali Research & Government Data

**Inflation Spreads: Input versus Retail**



Source: Pali Research & Government Data

**Real Sales Growth**

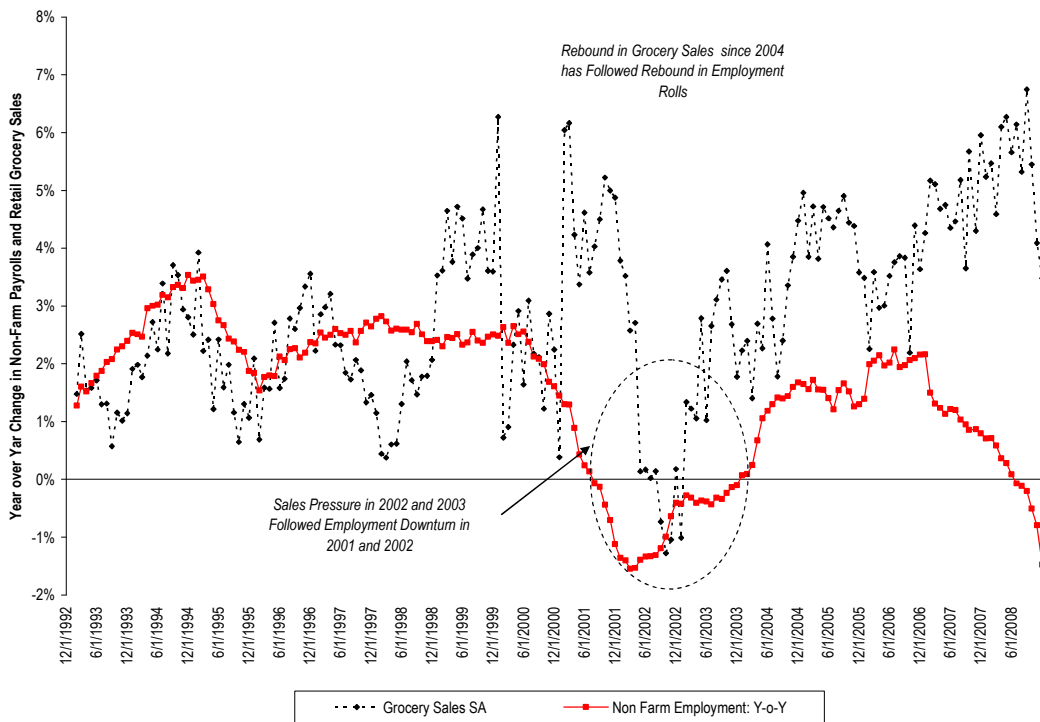
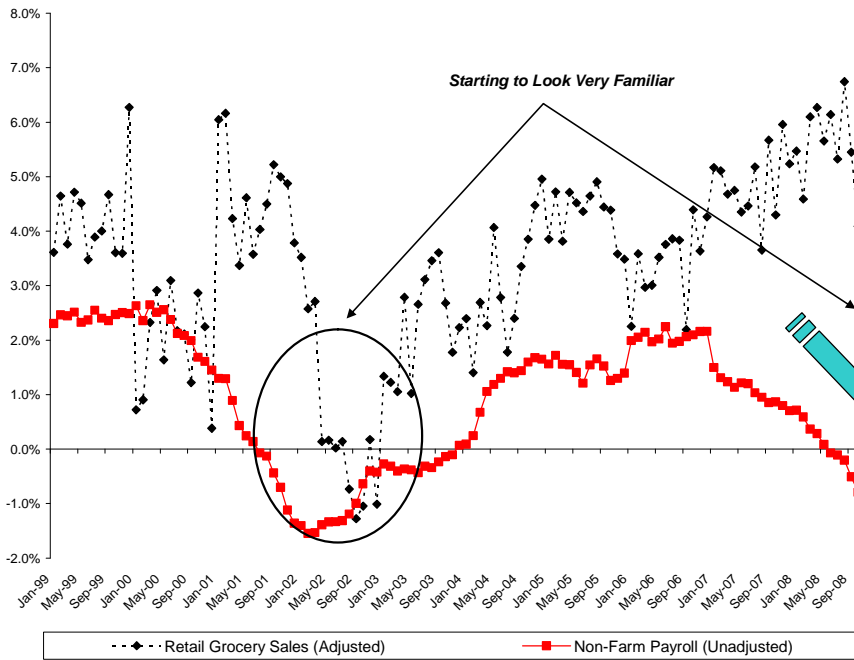


\*\*Adjusted grocery sales growth minus CPI - Food at Home (adjusted)

Source: Pali Research & Government Data

Correlation of Non-farm Payroll and Industry Sales

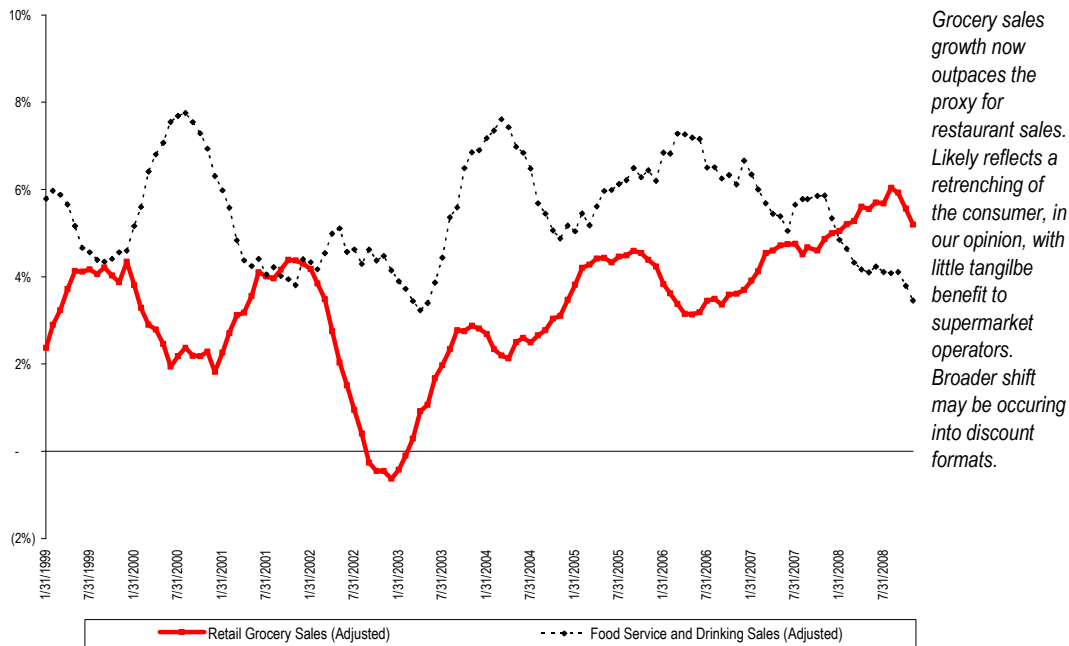
**Non-Farm Payroll Highly Correlated With Industry Sales Growth**



Source: Pali Research & Government Data

**Grocery versus Food Service & Drinking Establishment Sales Growth**

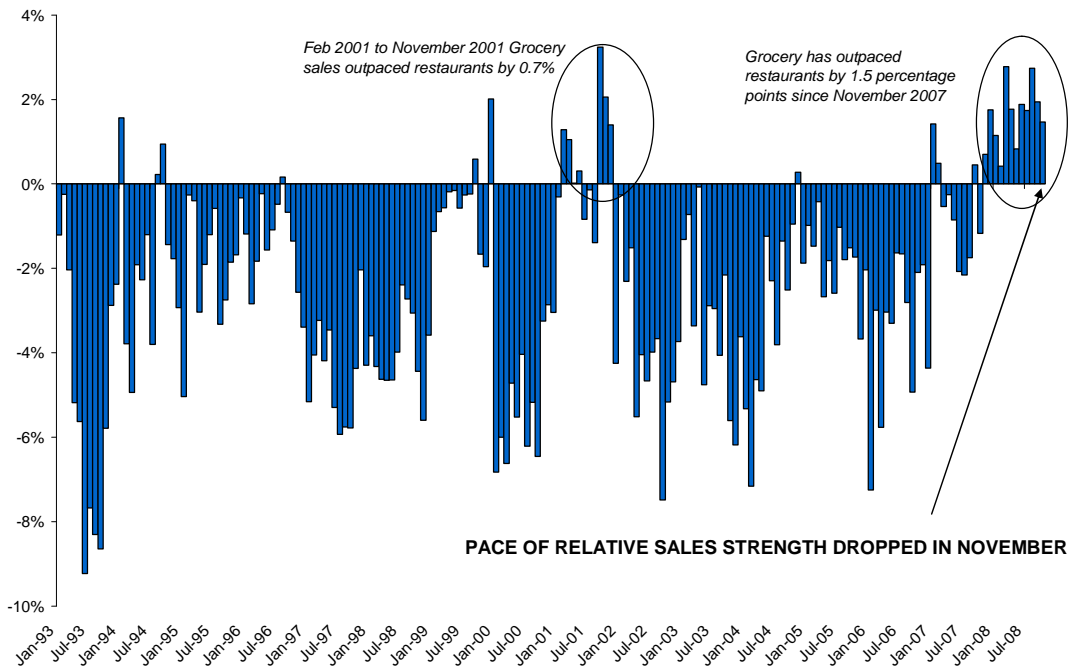
Six Month Rolling Average Growth - Grocery vs Food Service & Drinking



Source: Pali Research & Government Data

**Growth Spread: Grocery Sales Growth less Food Service**

Grocery Sales Growth Less Food & Drinking Establishment Growth



Source: Pali Research & Government Data

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*APPENDIX***IMPORTANT DISCLOSURES AND ANALYSTS' CERTIFICATIONS****Analyst Certification**

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