SN:
What's your outlook for the macroeconomic conditions in the year ahead -- and how do you see that affecting food retailers in general?

Scott Mushkin, senior retail/staples analyst, Wolfe Research:
I think you might as well start with the elephant in the room: What's the deflation outlook going to be? We're nine months in to a fairly substantial deflation. We really haven't seen deflation when the economy is growing with low unemployment like we are now. It's somewhat unprecedented. I think because it's so unprecedented it's really hard to look much beyond the next couple of months. It's really hard to think about '17, where we're going to be. We obviously have an election year but an incredibly difficult period for this industry, probably the most difficult I can remember in the almost two decades following it. It's just unprecedented and very difficult.

Bill Kirk, U.S. food retail analyst, RBC Capital Markets
On the deflation topic, we get a lot of questions. Are the retailers beating themselves up? Is this a race to the bottom? Or is there a problem with demand?

I think the answer to that is generally no. If you look at the deflation data, the PPI [Producer Price Index for food] went deflationary before CPI, which suggests it's closer to the supplier level, closer to the grower level. That indicates excess supply. That [PPI] has been deflationary for 18 months. Scott mentioned CPI just went deflationary but there was a nine-month period where the retailers took up price even though their input costs were down. That's a very rational thing. They weren't in a hurry to go beat each other up and pass it through immediately. Yes, it's a persistent headwind, but I think it is supply-based and the retailers are being as rational as possible.

Ajay Jain, senior analyst, Pivotal Research:
I would just say at a high level, the employment cycle has gotten fairly strong. Non-farm payroll data is improving, but more importantly we're finally starting to see some evidence of wage growth and improvement in the labor participation rate.

I'd also say a lot of the conventional operators, Kroger in particular, have benefitted from what I would characterize as an 'as-good-as-it-gets' operating environment for a number of years now. So even though there is this positive backdrop of a favorable employment cycle, clearly the deflationary headwinds are going to have a dampening effect on sales and on margins for the next three to six months. There's not a lot of visibility but in the near-term, we're going to start to see a lot of incremental margin pressure from deflation.

Kelly Bania, director of U.S. equity and research, BMO Capital:

If you want to think about macro conditions, I think consumers are pretty healthy but I do think there are some pockets of weakness. If you look at that consumer in rural communities and Midwest towns stating to be affected by farming economies and low commodity prices, multiple years of low commodity prices. I think you're starting to see some weakness in that consumer, but I think clearly, deflation is one of the biggest challenges.

What's difficult is that you just don't know how your competitor is going to react in a deflationary environment. So you can manage it as well as you can but if competitor A, B, C, D in whatever region decides to get a little aggressive, you either have to respond or suffer less volume. I think that's a challenge for everybody: Just not having the visibility on how to predict, even one month out for some, on what the competitive response is going to be.

Joe Feldman, senior managing director, Telsey Advisory Group :
Just to piggyback on what Kelly said, I think the bigger players like the Krogers and the Walmarts of the world have that capacity to set the price, and they're going to be the ones putting a lot of pressure on regional local players. I agree that deflation is obviously a huge issue for the industry, but the economy is okay right now. I know there's some fatigue going on at the moment with the election, and everybody is kind of concerned with that, but at the same time you need to eat every day and I think the spending levels are there. The volumes are there.

Scott Mushkin:
We're actually a little bit more bearish on the demand side of the equation. If you look at the demographics in the US, consumer consumption is two-thirds of services, one-third goods. If you look at who consumes goods in the U.S. it's driven by households between 35 and 54. If you look at who consumes food and home goods in the U.S. is driven by households really 30 to 45, that's where the growth is driven. The baby bust in the '70s is really playing a role in demand. Then you have the first wave of the Millennial generation that hasn't married and hasn't really had kids, and so we actually think demand is fairly weak. Even to break it down a little further, population growth in the U.S. has slowed to about 70 basis points from 1% in the last three years.

So we think demand is sluggish. Then, we think there's a massive supply concern — not only with supply of product but supply of square footage and shadow square footage with e-commerce and new business models like Blue Apron and Hello Fresh, Door to Door Organics, Thrive, Amazon, and Jet.com which has now been licensed to lose as much money as it can. I think that's why we've got so much deflation at retail. Our pricing surveys show [prices] deflating at rates we've just never seen before. Our basket in Houston was down almost 5% year over year. That's pretty big deflation, especially where you have rising labor costs.

You not only have these rising labor costs that you're having to deal with, and for guys with pensions you're going to have some pension issues because of where interest rates are, but you have falling sales due to how sharp deflation is. It's hard to make up 5% falling prices with volume.

Bill Kirk:
And to further the demand side, I believe the U.S. is still a net exporter of food. The very strong U.S. dollar makes our product less competitive on the international market. So where there is or was international demand for beef or something that has a summer growing season, it doesn't show up. It's maybe some of that demand, an excess supply issue and then a lack of international demand to help get rid of the excess supply essentially. So the breadth of deflation is rather remarkable. I think it's the strong U.S. dollar. Deflation is going across pretty much every category. It's not just beef, not just produce. You're seeing it across the board. I think the strong U.S. dollar is partially to blame for that.

Hopefully, we get to a point where we lap that year-over-year [dollar] strength and maybe that [excess supply] will start working itself out.

Scott Mushkin:
I would just mention one thing. We cover a lot of retail now. It's not just food retailers. We cover Walmart, Target, Home Depot, Lowe's. And if you kind of take a step back and look who's been missing revenues in the last two or three months, it's an amazingly broad group. Restaurants have been missing sales and broadly blaming the food-at-home guys, which is kind of funny. Food-at-home has been missing. Kroger and Whole Foods missing revenues. Even great companies like Costco are missing revenues. Target is missing revenues, Lowe's is missing revenues. Home Depot Supply, which is in the home area, is missing revenues. Casey's General Stores missed revenues. I think that's partly the farm economy out there but they talked about trading down from cartons of cigarettes to packs, and branded to generics.

I think the coasts and the urban areas of the country are better [economically] but as you get outside, to Kelly's point, I think it's really difficult.

Kelly Bania:
I think the devil's in the details. It's hard to paint with a broad brush right now. The regional trends are very different. California has been weak for several months now, some other parts have been stronger. I think it depends on the category, too. I don't think the U.S. is a net exporter of all food and produce. We import a lot. Produce is still slightly inflationary and it's shorter cycles, so that could change in the next couple of weeks. There's a lot of devil in the details.

I think when you're looking at the companies, you have to ask: Where are they? What's going on in that region? What categories are they in? It's really hard to paint with a broad brush right now.

Scott Mushkin:
With everybody missing sales and mostly earnings, we are kind of on the path to retrenchment, I think. Not only in the industry, but maybe broadly. I think the Northeast is in recession right now. That would be my call. The real estate markets around New York City are just awful.

Ajay Jain:
I would also add that coming out of the last recession there was sort of this bifurcated recovery with the low-end and high-end consumer. I really don't think that framework is as relevant in terms of what's going on right now across the sector. There is much more broad-based margin pressure these days. A lot of that is deflation driven but you're starting to see a more widespread impact, particularly across the natural and organic sector. Based on a lot of the recent commentary within the last few weeks from Sprouts and from Kroger and Supervalu, that really offers a lot of confirmation that the near-term outlook is going to be very challenging for the sector across the board.

Bill Kirk:
Kroger made a very interesting comment on the call. They said something to the effect of their basket [prices] are obviously down but the consumers, in their survey work, are saying their basket's up. They're saying their spending is up on groceries, so if they are getting a break they don't even know it yet. That might take them a while to feel better about saving on food because they don't realize it's happening. I mean no one remembers the year-prior cost. We [analysts] remember the year prior costs for things but the consumer doesn't. They remember sequential pricing. So it's very hard for them to realize they're saving four or five percent, whatever it might be until it persists a while.

Kelly Bania:
The other thing I would just add when you look at the whole space, there's a segment of the restaurant industry that's actually healthier than it's been in years. That's the independent restaurant. That's actually growing at a solid low- to mid-single digit for a lot of the large foodservice distributors. That's actually one of the bright spots where there is some pricing and some volume that's very healthy.

Scott Mushkin:
That's really interesting because in some ways I feel like the United States is becoming A Tale of Two Cities in this sense where you have these urban corridors that probably feed off more independent type of restaurants. Then you have the farm economy in recession, maybe depression. The oil economy is in recession, maybe depression. We

think Whole Foods is a tale of almost two different companies at this stage. The urban stores and then everything else. This is very interesting.

Bill Kirk:
Of the top 50 cities in the U.S., all but Cleveland are seeing population growth, so it kind of matches that urbanization theme. Maybe that’s part of why [Whole Foods] can do better in cities than in rural areas.

Joe Feldman:
But what do you guys make of Walmart then? Is it just pricing? They did well, better than expected. So that’s kind of that more rural suburban type customer, lower income. That could be a sign of a recession maybe. It very well could be that.

Scott Mushkin:
People traded down in ’08. People traded down into Walmart and so you’ve got to wonder is that a sign that things are weakening. The consumer has responded so quickly to Walmart’s price cutting it’s weird. I mean, instantaneously. We’re surprised that our research found how quickly the price cuts mattered.

Bill Kirk:
It’s strange because in some of that census bureau data, which they put out their annual report last week. The lowest income wage earners had the best wage growth year over year. So I don’t know if they’re doing better and they haven’t traded out of Walmart and maybe they’re just healthier. That [census data] was interesting because every demographic grew wages, whether it was by race, by gender, by region, and the lowest income earners actually had the biggest year over year boost.

Kelly Bania:
But at the same time you have the dollar stores and the Casey’s of the world.

Joe Feldman:
But even the dollar stores were positive. They were slower, but it was positive and it wasn’t too different than Walmart when you line them up. Yeah, it definitely was disappointing.

Scott Mushkin:
The other thing to look at is what’s happening to these consumers. Dollar General called rising health care costs. We got health care costs up about 9%. Rents are rising about 16% for the bottom 20% of income earners. There’s actually a surprising amount of pressure on spending on services. I mean I think that’s the other thing kind of crowding out goods to a degree. There’s a lot of pressure on the services and health care would be the service and so would rent.

SN:
Deflation has been stronger and longer lasting than many would have expected. I think at this time last year you guys would have said we'd be cycling whatever deflationary problems we had then. So where did everybody go wrong? What happened?

Ajay Jain:
I think for a lot of people the frame of reference for deflation was the 2009 and 2010 deflationary cycle. I think that was a time when the operating environment for the sector was a lot worse than it is right now. I think looking back at that previous cycle there was an expectation that the deflationary impact would be less severe this time around. Deflation always has a dampening effect on the top line - we've seen evidence of that for about a year now. But the second derivative of deflation is incremental margin pressure and we're just starting to see that. I think some of the recent margin pressure came on much more quickly and was a lot more severe than people were expecting.

Scott Mushkin:
I think we were expecting rational activities from the companies. So besides the producer deflation in '09, we had big input deflation in the late-'90s when the economy was growing and unemployment was low and the stocks in the companies did broadly well. Kroger not as much because they had just made a purchase of Fred Meyer and that kind of tripped them up a little bit, but broadly speaking, the industry did well because the retailer and wholesale spread blew out. The restaurants were actually probably more rational when the deflation first hit because they had rising labor costs, so they didn't actually pass on the deflation right away.

It reminds me of gasoline. When cost for gasoline falls it's a good thing. You get more margin. You get more penny profit. I would have thought last year that this wouldn't have been a problem for the industry.

Bill Kirk:
I would argue they are being rather rational about it. The pass-through rates have increased dramatically recently, but that is when the elasticity on stuff like protein is at its highest. So they finally had a pass-through during the time when elasticity is the highest. That's very rational. There's also a nine-month period where they were raising prices while they had input costs going down. The PPI went deflationary nine months before CPI. In the 2009 period, it was four months before they started passing on the PPI deflation. This was a nine-month period. They're not even passing through all of it. We're 18 months in and they finally just started this increase pass through, which it has hurt comparable store sales, has hurt margin but that's a rational actor. That's not people aggressively, at the first sign of deflation, beating each other up.

Joe Feldman:

I would agree with that. I think the biggest structural difference in terms of the current cycle compared to six or seven years ago is that we're not coming out of a recession compared to last time. There are definitely some pockets of irrationality out there but the operating environment is fundamentally more rational.

Scott Mushkin:
We also haven't seen Walmart being a big price mover in a long time either.

Bill Kirk:
I think the U.S. dollar isn't getting the blame it deserves here. I think the curves match too well for it not to be a factor.

Kelly Bania:
I don't think you can ignore the fact that many commodities are at multi-year lows and that that's feeding the deflation, but I think what people missed is that this is rare. If you go back 30 years there's only a couple of pockets [of deflation], in the '90s and in '09. That's a long time to go without deflation. You can go back to the '70s and '60s and you see it was much more volatile but Walmart didn't have 30% share then. Kroger wasn't consolidated across the country. It was a different landscape, so I think the modern food retail in the last 35 or 40 years hasn't seen something like this.

SN:
What about the retailer response, and to the possibility of there being a price war out there in the near-term?

Scott Mushkin:
Our research has confirmed Georgia, North Carolina, Virginia, Pennsylvania, and Tennessee as price investment states for Walmart. We actually believe it's from Pennsylvania down to Florida. And we've heard some noise it's moving into Missouri. So we put them at about 1,000 stores right now. This is a little bit of hearsay but it seems that Ahold feels that Walmart's up to about $1 billion in price investments. So about 20% of Walmart has seen a fairly substantial price investment, taking product [prices] down 15%.

Bill Kirk:
They [Walmart] made the announcement of price investments in October of last year so I think that was independent of the deflationary cycle. Maybe in order to make a true price investment they need to lower prices by more than their input costs are going down, otherwise it's just a pass through. So it could be happening but I think [the price investment announcement] was independent of the current deflationary product cycle.

Joe Feldman:
That's the concern that I think many of us have, that [Walmart] is just starting to get aggressive with this and what will that mean for 2017. Our spot checks show they been a little more aggressive than in the past couple of quarters. We may just be the beginning because they had always said it was going to be more of a 2017 thing. Now, theoretically, deflation could just cycle through early next year, or sometime by middle of next year. I mean it can't stay deflationary forever. It shouldn't. Then again, gas prices have stayed lower than we all thought they would.

Scott Mushkin:
We're all talking about commodity deflation but even on the packaged food side we're seeing [deflating] prices. I was just in North Carolina this weekend. I mean I don't know why Campbell's soup is the hot button item right now, Campbell's Chunky Soup, but it's three for four down in Houston, three for five down in North Carolina.

Walmart's dropped their list price to a $1.54 down from $1.98. Bumble Bee tuna -- I don't know why tuna fish is all of a sudden a hot item -- has gone from $1.50 down to $1.22 at Walmart. That's a pretty substantial price drop. I mean we're definitely seeing milk being advertised and eggs, chicken breasts. Albertson's is going crazy with chicken, 98-cent split chicken breasts down in Houston.

So you have deflation but you also have a competition issue. Which one's worse, are they feeding off of each other a little bit potentially? The one thing I would say is that the supermarket industry does not take Walmart seriously. They do not believe Walmart will do another big investment in '17. They believe Walmart's P&L can't take it and not one company seems prepared for Walmart to continue.

Chuck Cerankosky, analyst, Northcoast Research:
I think another thing to mention here is the shift in the mix. You've got center store losing share to the fresh categories. So while you have some of the chains reacting and overreacting to deflation by running hot promotions, you have some of the center store prices coming down to try to get share of basket. The customer is looking at deflation in some of the fresh categories and saying I'm going to go there anyway because I want to eat healthier, my income is a little better, whatever the case may be. There are a lot of things going on right now.

SN:
Many of you correctly predicted that Kroger would acquire Roundy's. What's your sense as to how that deal has gone so far?

Chuck Cerankosky:

I think it's on track. It's hard to expect a lot from a company that went public at $10, $11 or $12 and then was acquired at a premium for three-and-a-half bucks, I don't know the exact number. But clearly, it suffered from a rearranged strategy along the way. This was supposed to be a dividend play and then became a massive acquirer of former Dominick's stores in Chicago. So a total repositioning of its geography, its balance sheet, its cash uses, and the whole thing was acquired below replacement cost.

Ajay Jain:
I think this is Kroger's first turnaround situation that they've been involved in for as long as I can remember. I think everything has gone according to plan. That being said, I think Roundy's is dragging down Kroger's operating performance this year. I think they mentioned a 30- to 40-basis point dampening effect on sales but our channel checks show that in Milwaukee and Chicago comps are still negative and they're still declining significantly. I think this was largely expected but this is a major transition year for Roundy's. I don't think you're going to see significant improvement there until Kroger starts to cycle out of that acquisition.

Bill Kirk:
When Kroger gave their fiscal year guidance they had a big cap ex increase. They said a lot more money was going to go behind Roundy's as they're remodeling some of those stores, but then in the latest quarter they then slashed their cap ex guidance. I don't know if it's taking money from Roundy's I doubt it. That back and forth, you're either taking from the core cap ex, or your traditional banner cap ex, or maybe you're taking from Roundy's. I honestly don't know the answer.

Scott Mushkin:
Even though [Kroger] said everything is fine, if everything is fine you don't drop cap ex $500 million two years in a row. The other thing I would say is I think they're making a big mistake taking that money and plowing it back into their stock. It may make the short-term investors happy but I think given the unprecedented environment we're in…and Ajay's comment about on-plan on Roundy's, I think what's not on plan is the industry.

I think competition is a big deal. If you look at Milwaukee, look at Wisconsin, Meijer's moved in there with a lot of stores and Wisconsin is not a growing population. It barely grows, maybe it's even shrinking, but it's not a growing state. So you're getting a lot of assets thrown at a state that probably doesn't need them, not to mention all the e-commerce platforms that are out there.

The Midwest is kind of a hotbed. Door to Door Organics is out in the Midwest, so I think they're doing okay. Kroger had to kind of prove they could take their model on the road a little bit with a fixer upper, but I think the industry is not nearly what they thought it would be when they made that purchase.

Joe Feldman:
Don’t you think that it was more to get at the urban store format Mariano’s? I know they have this fixer-upper in Wisconsin but it seems to me that they have a shot to take these Mariano’s learnings and then expand that around the country to other urban markets where they’re located currently.

Scott Mushkin:
Mariano’s is a very good format, but I think if you go to the QFC in Seattle at University Heights, it’s a phenomenal store. It would give any Mariano’s a run. So I’m not sure the DNA wasn’t already at Kroger, but to get that kind of mid- to high-end banner in Chicago, which should be a good adjacent market, makes a lot of sense.

Chuck Cerankosky:
What Kroger got with Roundy’s are those Chicago locations at a very low cost. They’ve got to fix Wisconsin, but I think what else is behind some of the total capex reduction is dealing with an economy that isn’t quite as strong as people thought it would be at this point for whatever reason. You’re seeing that some other retailers and restaurants want cut out some higher-end remodels perhaps and new store projects.

Kelly Bania:
I was just going to say for Roundy’s, clearly they needed to invest in price, and I think that’s what Kroger is doing and that’s one of the factors weighing on the comps right now, but it’s really hard for any retailer to get credit and drive traffic in a massive deflationary environment. So if you take prices down by making investments and price comes down everywhere, I think it will take longer probably than expected.

I don’t think they’re probably going to get quite the progress that they thought they would in a normal environment. I think it’s probably a little disappointing that Bob Mariano is moving on. I think when Kroger talks about making acquisitions it’s about getting the management team in there that can bring something to the table. I think that’s what they saw in Bob and while he’s still around as an advisor, I think that was kind of a disappointing development.

Bill Kirk:
It’s a bit scary, to Scott’s point, to cut cap ex when Walmart is increasing it or Publix is increasing it or Aldi’s is increasing it. So from a multi-year standpoint, your competitors are increasing their spend in the marketplace while you’re decreasing and that sets up the risk for Kroger down the road.

SN:
Then what do you make of Kroger’s Lucky’s Market investment?

Scott Mushkin:
I spent some time in their Naples [Fla.] store. It's a good format. I think as we push a lot of the everyday essentials online like toilet paper and Tide, we have some research that shows that core demographic, group age 30 to 44, really wants to bring these everyday essentials online, and of course, Amazon is pushing that. Is there room for a fresh-oriented, farmer's market type of format? Sprouts obviously fits the bill. That's why Apollo we think was interested in and then purchased The Fresh Market, and Lucky's is fine, but it's tiny. It's not going to move the needle for a long time.

People look at Florida as an opportunity. I've heard that the Albertson's people are somewhat disappointed they got out. Publix has very high prices and kind of owns that market but they have great service. There's a lot of very good attributes about Publix but pricing is not one, and I would say merchandizing is pretty good a Publix, not incredible.

Chuck Cerakosky:
I think the fun thing for Kroger about Lucky's is they have a laboratory for higher-end food service fresh in the store. That's something that has an entrepreneurial flare to it that not every company does right. As they drift more in that direction, some of their stores, like Main & Vine, is another version of that. Like I said earlier, they're going to be maybe a little careful with the way the economy is tracking about spending too much on prepared foods because that's not only capital intensive, it's labor intensive.

Ajay Jain:
It seems that Kroger's management has been a lot more opportunistic with its acquisition strategy in terms of looking at growth vehicles in general. Reportedly, they were looking at Fresh Market when there was an auction being held for that format. So I think the Lucky's investment really just allows Kroger to learn some things and to get more direct operating experience with a dedicated natural and organic format without having to develop its own concept.

SN:
Kroger has consistently outperformed its peers for a decade plus and appears to be doing so many things right, but what do you think could go wrong for them?

Kelly Bania:
I think it already has gone wrong with deflation. It's outside of their control but it's hitting everybody. There's not really much they can do about it.

Joe Feldman:

An economic downturn [could hurt] because they have pushed some upscale categories, the Marketplace stores require some general merchandise purchasing. The numbers of those stores have gone up considerably.

Ajay Jain:
Kroger has very high overlap with Walmart and I think Kroger has also benefitted from a lot of operational missteps by Walmart in recent years. Walmart is not only investing in lower prices but they're also addressing staffing issues and narrowing the gap in terms of their wage structure. So there are some remedial efforts that Walmart's making to deal with their employees in terms of employee benefit costs and wages. There is a risk that you're seeing evidence that the sleeping giant is starting to awaken and that could have some sustained impact on Kroger. If Walmart finally make some serious efforts to improve their price positioning, then I think Kroger's price leadership could get diminished.

SN:
Let's stay with Walmart here. They're getting a lot of response it would seem from their recent initiatives. I mean how successful has this been, or is it just a function of the economy?

Chuck Cerankosky:
I think it's been very successful on the inside of the store based just on visiting the stores over and over again in different locations. I thought for a long time one of the biggest problems was store conditions. Even the parking lots were off-putting. They made a lot of progress: better in-stock, neater stores, much better looking clothing departments, improved service. But it's still something they are reluctant to spend money on. They've improved their attractiveness to customers but it has been expensive. Then you've got to wonder how much are they going to invest in price net of deflation and still keep their shareholders happy.

Scott Mushkin:
The only shareholder that matters is the [Walton] family though. They own 50.1%. I think the challenge is understanding what the family wants. The company was asleep. They hadn't cut prices since 2004, from what we understand talking to people in the industry. It's funny, we've been tracking their improvements at the store which started really in earnest last fall. I think Greg Foran said that by Columbus Day of 2015 these stores are going to be cleaned up, and he hit that. The in-stock his position is much better. Inventory has been coming down. I think their produce offering still is subpar, but they're working on it.

Maybe it's coincidental, but it didn't seem to matter honestly until they started cutting price. We look at the grocery sales in the Supercenters and they were getting worse, right through their first quarter. Then they started cutting price in their second quarter and they did this big old U-turn.

Joe Feldman:
That also coincided with Walmart raising wages for their own employees. You saw it last year and sales picked up for the corporate U.S. business, not just grocery. But for the Walmart U.S. business the comp picked up in the second and third quarter and then kind of came back down to the one percent or so and stayed there for the next two quarters. Then it does coincide with the pricing where it did shoot up again in the second quarter. So we kind of have to see this third quarter and really if they can sustain it through the fourth quarter.

Scott Mushkin:
It's amazing to see the volumes and the share, almost as soon as they started cutting pricing in May and it's been accelerating. I think it was Ajay talking about how big the overlap is between Walmart and Kroger. Sometimes if it walks like a duck and quacks like a duck, it's a duck. One's going this way and all of a sudden the other one is going that way.

I was very skeptical about the Walmart turnaround. I think the industry has been very skeptical. I think we've all been skeptical about the pricing investments that they are saying they're going to make. How the heck are they going to invest $4 billion and not blow up their own earnings? The bottom line is about 20% through their stores, there's more to come in '17 and '18 and Kroger overlaps hugely with Walmart.

Unfortunately for Kroger, Albertsons at the same time has gotten more aggressive too. So they're kind of fighting a multi-front war right now and not responding all that much except for maybe donating a little share. We'll have to see how this plays out over time but I think it's the most precarious competitive position Kroger has found itself in, especially because they have all that cap ex. They bought Roundy's, got a lot of Marketplace stores coming out of the ground. A little bit more difficult situation than you would have expected. No blame on the management team, because it's hard. It's an unprecedented environment but you're definitely in a difficult position right now.

SN:
You mentioned Albertsons. Will this company successfully get on to the public markets?

Scott Mushkin:
That's a good question. Right now it's going to be really difficult. You have deflation. They tried to get on the markets last October and Walmart made the announcement and they had to pull. So I think as it stands now it's going to be difficult.

The one thing I would say is they are, again, maybe not as dramatically as Walmart but they are moving the needle on volume by investing in price so maybe they're renting customers because they're so high/low but they are moving the volume needle in their direction. They've cleaned up the stores. They're a very old-school management team. I hate to make a big deal about one store but we go to the same Randalls in Houston all the time and we've been going there for years. You can hear crickets there all the time. I didn't even understand why the store was open half the time.

However, I was just there on a Monday at 2 o'clock, which is not necessarily the hotbed of grocery shopping times. It was busy. The produce looked much better. The store was organized. They were still above everyone on price, but the deals were good. That's where we got the 98-cent split chickens. So not yet, not now, but they seem to be doing a better job.

Chuck Cerankosky:
They're looking for the right valuation. They didn't get it a year or so ago, and they've been waiting, and in the meantime they have to keep their sales numbers looking good. Year-over-year numbers mean a heck of a lot. They didn't plan on running into deflation, perhaps a weaker or more cautious consumer, but then you've got to keep sales looking strong so when they do the deal they've got a solid top line story.

Scott Mushkin:
To steal a line from the late, great Prince song 'Let's Go Crazy.' The deals they were running in Chicago were somewhat insane. You know, $4.99 Dunkin Donuts coffee; $1.17 Ragu tomato sauce; $1.49 organic strawberries. This is what Sprouts has run into: Just an incredibly promotional Albertson's out there.

SN:
What's in it for them? It's getting the sales up to look good?

Chuck Cerankosky:
I think it would be hard to go public with a downturn in sales, with visibly weaker sales than they had at the time they first intended to go public.

Scott:
[Albertsons] had been slow in Q1. There's no love lost between the Albertsons folks and the Kroger folks either.

Ajay Jain:
Obviously, it depends on market conditions but it's kind of hard to see a scenario where Albertson's goes public at the kind of valuation that was contemplated last fall because the operating environment is just so different right now. Sector valuations are also very different compared to last September or October.

Scott Mushkin:
I mean all Kroger is going to do is not try to keep numbers up and just bite the bullet. Certainly, their assets are better. They're generally a better executing company, certainly with much better prices. So if Kroger decides to fight back in a meaningful way I would think Albertson's share gains will evaporate.

Ajay Jain:
In terms of what's in it for Albertsons from going public, they have a huge amount of debt, and a public offering would allow them to de-lever the balance sheet following the Safeway acquisition.

Scott Mushkin:
This is part of the reason we think Walmart goes right now though. Deep discount isn't well established here in the U.S.: Aldi's here, but only 1,500 stores, which at 12,000-feet is not that big. Lidl doesn't open until the end of '17. Greg Foran comes from Woolworth's in Australia and of course Australia had a big problem with the deep discounters. Walmart talks almost constantly about as the lessons learned from Asda against the deep discounters. And then you look at the U.S., which is still a very fragmented market. I'm noticing down in North Carolina in Winston-Salem, the amount of new Neighborhood Markets down there was surprising to me.

I think they think there's a lot of share here to be gained here in the U.S. for Walmart, with the likes of Southeastern Grocers that are levered up. Even Albertsons has got a lot of leverage. I think they feel like the opportunity is here to not repeat the mistakes of Asda. If the [Walton] family blessed this idea, then the supermarket industry saying Walmart will never do this [price investment] is going to end up being wrong and they'll be trying to play catch-up. I think that's a dangerous place to be to a 300 and some odd billion dollar retailer.

SN:
Onto Ahold Delhaize. The Ahold banners are finally beginning to show some results of the Project Thunder strategies but has it been enough?

Scott Mushkin:
If you look at their volume data it's been pretty good. They obviously made a smart acquisition here in New York, when they took on some of the A&P assets and so that's worked well for them. The Food Lion renewal seems to be doing okay. They seem to be withstanding Walmart a little bit right now. We'll see how that goes over time, but again I think they're underestimating the threat from Walmart as we would look at it. I would say generally you look at their Northeastern markets, they are more protected, not historically run as well as maybe they could have been, and you're starting to see them try to improve that, especially in the perishables.

So I think it's one to watch but one that you worry about price distance to Walmart over time. Even Food Lion was showing about 9% premium down in the Carolinas.

Bill Kirk:
In terms of competitive response, they do have some synergy ammunition. I think the number they gave was 550 million euros in synergies. So they have some ammunition if they need to invest in price or try to do things that other retailers that haven't done deals can't from a competitive standpoint.

They made a comment on their 2Q call in August, basically we're talking to all our European suppliers. And then in September we're going to go to all our U.S. suppliers and push back on them. So that becomes a C&S problem, and it becomes a UNFI problem. For UNFI, [Ahold] is its second biggest customer behind Whole Foods.

So if they're going to their suppliers and asking for better deals and then Ahold ultimately can maybe do something behind price to help offset some of those competitive or macro pressures.

Scott Mushkin:
But it is a good point, the fact that they're going through a merger. Let's just say they probably lowball that, it does give them some ammunition to fight. They also confirmed that Walmart in Pennsylvania is lowering prices on that Giant was having to respond.

SN:
What will happen to Supervalu's retail divisions?

Chuck Cerankosky:
They hang on to it, try to improve some of it, and there will probably be some net closures over time as leases run out. But it was neglected when they had the Albertsons and now they're trying to make it better with not the greatest balance sheet and need to fix the entire business. They know there is a response to capital investment in those stores, the problem is they need to do a lot of things at the same time, not the least of which is Save-A-Lot.

Bill Kirk:
If they're spinning Save A Lot, why hold on to 200 stores if you're just a wholesaler. I think a lot of wholesalers have a dozen banners just so they have some end market in their system but you don't need 200. So if you're going to be a wholesaler it would kind of follow the logic of they won't own all 200 forever.

Scott Mushkin:

They want to keep the distribution contracts. These assets have been rumored to have been for sale for a while. Look at Farm Fresh and Shoppers, they don't want to deleverage their own distribution facilities. So this has been the challenge.

Bill Kirk:
They've done this with Rainbow. They just did one more recently with Food Lion in Pennsylvania. The idea is we [Supervalu] took them in-house, we're going to give them back out to someone else and then we're going to maintain the distribution relationship. They've done it in the past with Rainbow, they're trying it again. Maybe that becomes the playbook for the other 200 stores.

Chuck Cerankosky:
The tricky thing about those selling those 200 stores, not saying they couldn't be sold, is that you're going to ask the buyer for a distribution contract and sell them something that needs a lot of cap-ex and maybe some price investment as well.

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SN:
How about Save A Lot. What's going to happen?

Ajay Jain:
I think they're taking a two-pronged approach. The Save-A-Lot strategy has been pretty well telegraphed. They're looking at the possibility of selling the business as well as a spin. I think unfortunately the timing is not all that great because fundamentals at Save-A-Lot have really gone downhill at the same time they're pursuing the spin. Things have taken a step backwards because of a lot of the recent deflationary pressure. Save-A-Lot is a format where based on the specific product mix, they've seen very heavy deflationary pressure on the top line.

Scott Mushkin:
As a shout out to an old panelist, Meredith Adler, who has retired, when I was working for her back in the day we always wondered why Supervalu didn't give us more details on Save-A-Lot. We always internally debated what the issue was. The issue really I think is the business is not nearly as good as some of the dreamers wish this business to be. It's really a wholesale business primarily that has a lot of commodity focus. I think it's fine but I think the multiples that people used to throw on Save-A-Lot and the dream scenario like a Dollar General multiple – nine times, 10 times, 11 times EBITDA. The business is just not nearly as attractive as I think a lot of people wished it to be. Too much commodity focus and it's mostly a distribution business. Hopefully growing a little faster, although I've got to say the low end has seen a lot of square footage plowed at it so we'll see how the growth rate looks over time.

Joe Feldman:
It should be a better competitor to Aldi. I think that's what the hope from the investment community: "This will be Aldi. I can buy it now." But it's just not Aldi. And comps have slowed. They've gone negative.

Bill Kirk:
I feel like there's some conflicting strategies at Save-A-Lot. They're a value operator and yet they're bringing in national brands, which probably won't give them the value advantage. They're not going to have national brand pricing advantages. So there's some conflicting things and questions out there.

Scott Mushkin:
I think that [Save-A-Lot moving to more national brands] partly has to do with Aldi. Aldi uses almost a special buy. They don't have brands all the time but I think they're in there if a brand is overrun and stuff. So Aldi can bring in some brands, but they're certainly not a branded store. But I think Aldi is a tough competitor. I've got to say, Aldi's strategy is really to go across the street or next to a Walmart.

Chuck Cerankosky:
There's a couple things that Aldi has done that Save-A-Lot missed the opportunity to match at the time. One is being in these what I call "division areas" where it's a nice location that's close to a rich neighborhood, close to a poor neighborhood. They pull from both sides of the equation there. It's too easy to find a beat-up, Save-A-Lot store and it's hard to find a run-down Aldi store. There's some catch up needed at Save-A-Lot.

SN:
Let's stay with the discounters here and talk a little bit about Aldi. They've been in California for a year. We can't find any retailers who admit to feeling any pain whatsoever from their arrival. So, how do we think about Aldi as a force in the marketplace?

Joe Feldman:
I think that's part of Walmart's response from a year ago is to start talking about price investment again. You could argue if you really wanted that maybe having a little impact on the dollar stores…I mean we have seen the dollar stores slow. It's that same customer. I always toss out this anecdote to people. My mother-in-law used to shop at Neighborhood Markets down in Florida and now she shops at Aldi a lot more. It's taken a huge portion of that. So it is competitive. I think maybe there's only 15, 16 hundred of these things right now. To argue that with 20,000 dollar stores that it's have that much of an impact or 4,000 Walmart stores.

But to Scott's point, you can go down in Fayetteville, the home of Walmart down there near the college and there's an Aldi right across the street from one of their newer Walmart Supercenters. They're exactly across the street. They know they're going to just draft on it.

Scott:
They love that. Adjacent, across the street. I mean that is their real estate strategy.

Bill Kirk:
In terms of Southern California I think they have over 35 stores so far and there's 24 million people in Southern California. So that's not that many stores for the competitors yet to notice the impact. I'm sure someone has to be the donor of share, but it probably is small for that person right now.

Scott Mushkin:
The thing that surprised us about Aldi, is the acceptance of very discounted formats by middle-income people. We do focus groups of women and go to different stores. We do it in the Midwest sometimes and just self-reporting, as we were in a Walmart Supercenter, how many of the women actually went to the Aldi.

To Chuck's point about where they put the locations, one of the women had moved from Michigan where a lot of the Aldi's were in not such great areas to Illinois about five years ago, and the Aldi in Illinois was across the street from a Walmart. She wandered in there and had good luck with the product. She's like "Why would I spend twice as much for the branded item when it's the same quality or better?" I think you really are getting experimentation by U.S. middle income shoppers into some of these discount formats.

Bill Kirk:
Aldi is now accepting credit cards and the middle income or higher consumer uses credit for grocery to earn points, so that kind of speaks to their desire to upstream or their ability to upstream.

Scott Mushkin:
Lidl is rumored to be in more middle, lower-middle, areas as well. I think this is what's motivating Walmart too.

Ajay Jain:
I think the number of Aldi stores in Southern California is consistent with what Bill mentioned. All but a handful of those stores are in the Los Angeles area. There are a few in San Diego.

We think they've got about one half of one percent of market share in L.A., but that's meaningful market share for that kind of a market. So if they can capture 50 basis points of market share right out of the gate, that's meaningful.

What I think is interesting in terms of some of Aldi's entry into new markets is that in markets like Dallas and Los Angeles, there's already a lot of excess retail capacity. Los Angeles is one of the most over-stored markets in the U.S. and yet there's still a lot of captive demand for a hard discount format like Aldi. Same thing in Dallas. When they entered that market six or seven years ago, I think Dallas and Houston were already among the most price competitive markets in the country, and yet Aldi popped up with about 30 stores very quickly.

Scott Mushkin:
Well, Walmart's private label, the last time we checked, was about 20% over Aldi. In quality, Aldi is actually pretty darn good.

Kelly Bania:
For Aldi I think they kind of slowed their store growth post-recession, maybe '10, '11, '12. They really started to pick it up, I believe in 2014, and I don't think it's a coincidence that that was a time when Walmart was comping negative and slowing growth. So I think the question from here going forward is what happens? Is Walmart going to really start comping in grocery because you might see some of these square footage numbers over the next couple of years from some of these formats that were taking from that share. That may change.

Scott Mushkin:
We have too many physical assets chasing too few sales. As we said earlier, the demand is kind of tepid yet we have a lot of square footage being thrown at the space. On top of that, you've got the e-commerce platforms and Amazon just scratching the surface of consumables, in particular re-orderable consumables.

I don't see how we don't get a big wash out in this industry over the next couple of years. I think you're going to have to really have some consolidation unless the economy takes off like crazy or something different happens. There's just too much. That goes right back to the beginning of the discussion. Why so much deflation all of a sudden in a growing economy?

What I'm saying is we need dark assets. In Supermarket News today you were talking about Tom Thumb reopening the Fresh Markets. I call this the "fed effect." Almost every project is good because the cost of capital is zero.

Chuck Cerankosky:

It takes a long time for a bad food store to die, especially when interest rates are zero. Look how poorly run A&P was for years before it finally went bankrupt.

Scott Mushkin:
They get recycled a lot.

Chuck Cerankosky:
Yeah. They're coming back.

SN:
Related to that, the big discount opportunity in the country is one of the things that Lidl is after. How seriously is the industry taking it? How significant a player is Lidl going to be?

Chuck Cerankosky:
They want to be big. We'll have to wait and see.

Scott:
They want to be big, and they're private, so they could lose a lot of money trying.

SN:
How is their store going to be different from an Aldi considering it's twice the size?

Scott Mushkin:
It's almost three times the size. I think.

Chuck Cerankosky:
They might have a lot more fresh product. That's a good way to use space.

Ajay Jain:
There's also more focus on general merchandise at Lidl.

Scott Mushkin:
I think Chuck's right, fresh is definitely going to be a focus. You see much bigger fresh areas if you look at what they're doing other places.

SN:
Is some of the activity we're seeing in the Southeast motivated by the fact that Lidl is coming?

Scott Mushkin:
It's got to be. They broke ground on their third DC in Maryland not too long ago. You guys reported last week that they are looking for store managers in 12 market areas.

Chuck Cerankosky:
Walmart's got to be aware that they're a price operator. Nobody goes to Walmart for their fresh seafood, so they've got to be ready for them.

SN:
Kroger is reportedly interested in Rite Aid assets. Thoughts on that?

Scott Mushkin:
It does seem like Kroger wants to get bigger in that business. They just bought their second specialty pharmacy operator. I think they had standalone drug stores a long, long time ago, so it would be interesting to get back into the business but I think there's something to that rumor.

Joe Feldman:
There's a lot you could do with that. You get it cheap.

Ajay Jain:
You've got a motivated seller and you could get it for below market multiples. I think that would be an interesting angle.

Scott Mushkin:
Maybe that's why they're holding off on price investments until they have the money to actually fund them. We'll see when this thing comes out of the FTC.

SN:
Regarding Sprouts: They have ambitions on the one hand of becoming a much bigger volume player and at the same time I think they're encountering more and more competition. Where do you see Sprouts today?

Kelly Bania:
I think if you're in one or a couple of regions where there's heightened competition, that's showing up in your numbers. If you're more national broad-based you have some regions that are experiencing some challenges, some that are okay and Sprouts is still regional at this point. I think a lot of their markets are under competition from this deflation and they're working through it, but I look at it as a little less structural than some others. Last year when the produce deflation turned, Sprouts performed much better. I think at least this deflation will last at least for the first half so I don't think the

challenges are not there, but they're clearly seeing some competitive activity in their market and they're reacting.

Bill Kirk:
I agree with Kelly on the structural versus cyclical. Besides August it seems like their traffic count has been kind of at pre-deflation levels. Basket volume hasn't really decelerated. So they have more people going into their store, buying more stuff when they're there. That becomes a beautiful compounding factor if and when deflation returns to inflation. So I'm in the same camp with it being cyclical, and the problem is the cycle is a lot longer and deeper than we thought.

Chuck Cerankosky:
I don't think there's anything wrong with the format but they are boldly going to markets and they want to go after the conventional stores more than anybody else and the conventionals are aggressively promoting produce. Sometimes a lot of other stuff. They get caught in this scenario while they're rapidly expanding. This is their peak year of store openings ever.

Scott Mushkin:
I like Sprouts. I have an outperform on them because I think the format fits well. While everyone hyperventilates over the 365 format coming out of Whole Foods, if you want a Millennial format you've got one already in Sprouts.

That said, to see how quickly those comps have slowed — and deflation is clearly a part of it — but just how the competition has just ramped up in produce. They have a very young store fleet to be comping flattish right now. That would certainly give me great pause. Sprouts is always thought of as a very well-run company. I think it is a very well-run company. I think the management team does well.

Whole Foods, we would say they made some mistakes but clearly a unique format that had comped high for years and years and years. Kroger, the fact that the market was able to take their guidance of a half a percent comp somewhat in stride…And of course Sprouts sales have slowed materially too. So, a lot of companies that have different ways to go to market, pretty good management teams, and they're all doing not so well. I think the question here is 'Do we have too many assets in the mix?' Chuck was saying that this was their peak year of building for Sprouts. When is Whole Foods, comping negative for over a year now, going to really pare back that store portfolio?

I kind of call it the three stages a company goes through. The first stage is denial, then acceptance, and then doing something about it. They still seem to be mostly in the denial stage.

Joe Feldman:

I would tend to agree. I don't actively cover Sprouts, but I feel like you're just seeing what happened to Whole Foods starting to happen here is my concern. We debate all the time about picking up coverage. We still might, but I think is it Albertsons getting more aggressive in some parts of the Southwest? Is it Walmart? You wouldn't think that [Sprouts] customer would be going to some of these other stores but why not? I mean that's what happened, I think, to Whole Foods. They went to Kroger or other places, the HEBs of the world, the Wegmans of the world, and you don't need to go to a specialized retailer for that.

Scott Mushkin:
I believe John Mackey said that. He said there was blurring of lines between specialty and traditional, [that] the specialty channel doesn't exist as it once did. I couldn't believe he said this on the call but he said you don't really need to go to a Whole Foods anymore like you did 10 years ago.

Kelly Bania:
I think that's the difference between Sprouts and Whole Foods. I mean obviously price is a huge difference. I don't think you go to Sprouts just to get something special or different. You go because you really get good prices and you have a good experience and those prices are what drives the loyalty, especially in the produce where consumers have their own element of shrink. So if you can keep your own consumer shrink down in a category where you throw a lot of stuff away, there's a loyalty factor there. To me, that's the difference. It's not just a specialty trip. You've always been able to get a lot of those conventional produce items at Sprouts.

Scott:
It's a value trip.

Kelly Bania:
It's not just a specialty trip. So for Whole Foods, they have the specialty trip challenge and the price challenge.

Scott Mushkin:
And the price challenge is getting worse for Whole Foods as everything else deflates. But to Kelly's point, I think it's really important, the challenge for Sprouts really is it going to keep the spread. You see $1.49 organic strawberries in a market, well what are they going to charge? A dollar? So that's the challenge right now is everyone is promoting, and Kelly said this before as well, is not deflationary right now so I thought it was interesting what Amin from Sprouts said that retailers are now anticipating the deflation they think will be coming. That's a euphemism for just cutting prices.

Chuck Cerankosky:

Sprouts' other challenge is that they can't draw from a long distance to get as many incremental customers, and they don't have the breadth of product for someone to spend the money they are saving on produce. The shopper can't buy more batteries or light bulbs at Sprouts. They just don't operate that way. But they have been very good at what somebody just mentioned as being an alternative source for what looks like organic. I have a lot of fun just sort of cataloging these days what is a substitute term for an organic product: 'non-GMO', or 'local,' which is huge draw right now. It could be grown in a drainage ditch and some see 'local' and say "this has got to be good for me."

I have a dear wife who can't pass a fruit stand without assuming it's the best produce in the world— but God knows how it's actually grown. The reality is you say non-GMO, gluten free, natural, or fresh and the meaning of real organic slips away. Some of these guys rely on selling true, organic products but marketing is a wonderful thing.

SN:
We segued right into our Whole Foods discussion. Initial impressions of 365 stores?

Chuck Cerankosky:
If they get 20 of them open it's still a small percentage of the entire company, so it's not going to change the direction of the company.

Bill Kirk:
Well, the third one that they've opened [in Bellevue, Wash.] is the first that would overlap with a legacy store, so it's the first where they can finally put some analytics behind cannibalization rates, how far do they drive from, what the return is.

But what they've said so far is baskets are bigger, productivity per square foot is higher, build out costs are 50% to two-thirds lower, and they found 1,000 basis points of cost to take out of the store relative to the legacy stores. So insofar that 365 is an incremental customer they could maybe make the real estate decisions to minimize cannibalization. That is a very ROIC-accretive and EBIT margin-accretive way to recruit new people into your system, so I'm fully onboard with 365.

Joe Feldman:
What do you do with the old stores?

Bill:
They're the annuity that pays for 365 expansion. I predict 365 going forward is the bulk of unit expansion.

Scott Mushkin:
The challenge is when we look at pricing in the greater Glendale, Silver Lake MSA, 365 is pricing with Trader Joe's a half a mile away. The Whole Foods in Glendale is about

four to five miles away so it's not that close, but if you draw circles around the stores you will overlap. So the pricing at the Whole Foods, outside of fresh, is basically matching 365.

Kelly Bania:
We found the exact same thing.

Scott Mushkin:
So what's the problem? We haven't done a pricing survey in Glendale before but we look at pricing in Huntington Beach, Calif. The Huntington Beach store was nicely above the Whole Foods store in Glendale. On top of it, we also priced Houston. There's no way you would ever have lower prices in Glendale, Calif. than you would in Houston. So it just makes me chuckle because there's no way what they're saying is actually correct that that Glendale store didn't bring pricing down. That was just one example. I would also put forward competing against Trader Joe's private company is probably not a great avenue to go.

Bill Kirk:
Why would they bring down the Glendale store that we would all go price check? Wouldn't they want to show that 365 is far cheaper than the legacy stores?

Scott Mushkin:
The guy that runs it. He's losing traffic.

Joe Feldman:
I mean I just felt like if I had that [365] store close to me and I had a Whole Foods three or four miles away that I used to go to, I would never have to go to Whole Foods again. Between the two I thought 365 is a compelling concept. It competes with Trader Joe's. But I didn't think you need Whole Foods anymore. I'm very curious to see what happens in Bellevue. That'll be really the test.

Bill Kirk:
Whole Foods legacy stores are in 48 states but there's only one in Iowa. There's places in this country that are very, very far from a legacy Whole Foods. I think they're intentionally putting some very close like Belleview and the one in Florida is going to be like 70 miles from a legacy Whole Foods. I think the variety there of respective distances is intentional so they can gage maximum profitability, maximum cannibalization of these various locations. Once they have that figured out I think expansion accelerates rapidly.

Kelly Bania:
But they already have 20 leases signed.

Bill Kirk:
Yeah, 20. I mean Supervalu just bought 20 stores. Twenty is not a big number. Twenty for now is a small number and they have already learned that they need conveyor belts at checkouts. When we went there were no conveyor belts. So those are small things they could apply to make the next 18, 17 better.

Scott Mushkin:
But you have no idea what the returns are out of 365 at all.

Bill Kirk:
So in 2012, 2013 they ran a small square-footage store in Columbus, Ohio. It didn't have many of the amenity counters. It was within 10 miles from one legacy stores, 14 miles from a legacy store. We hear it was more profitable on an EBIT margin basis than both of the legacy stores in the market. So the people who say this is a panicked maneuver from Whole Foods, I think it's coincidental that the 365 announcement came with a comp decline. They were obviously testing it four or five years ago, and there's some evidence than it's EBIT margin accretive.

Chuck Cerankosky:
They've got over 100 stores on the docket to open, 17 now are 365. We'll see if that number creeps up. They have the opportunity to convert more.

Scott Mushkin:
It's very unorthodox to not test the concept before going with a full rollout. I mean it may work but to bet your franchise on it seems risky…I think a much better strategy would be to fix the core, which is in great need of fixing.

SN:
That's the next question. What does Whole Foods need to do to fix their core?

Scott Mushkin:
Stop cutting store labor. Stop building so many stores.

Bill Kirk:
My core premise on the legacy stores — and if I'm wrong, I'm wrong about Whole Foods — [is that] Kroger, Costco, whomever has had great success in natural/organic and overlapping assortment of Whole Foods over the last three years. That is the general narrative: Conventionals have replicated what's special about Whole Foods. Over that three-year period of conventional success, Whole Foods' customer count is still flat to slightly up.

I think [conventionals are] a big competitive factor but I think more importantly they prevent Whole Foods from finding any new customers more than they steal existing Whole Foods customers. So over those three years Whole Foods has the same amount of customers within their comp definition … until this year.

So if the premise is that Kroger is stealing the incremental customer, 365 becomes the first weapon Whole Foods has ever had of recruiting new people that are just entering the category. That's a long way to say I think the existing customers are a little stickier than people give them credit for.

Chuck Cerankosky:
I think a lot of people are entering the category at many, many retailers. Cleveland's dominated by Giant Eagle. They've long offered natural and organic.

Whether it's Publix or Wegmans, they're getting the new household shopping, the natural / fresh / organic category. There are a lot of competitors to Whole Foods out there. They've got this big pipeline of new stores and they want to talk about alternatives to just building more legacy stores. So they've debuted 365. I don't think they could put the brakes on expansion as quickly as we might like them to.

Ajay Jain:
I would agree with Scott's point about the core issues with the legacy business – and whether the high rate of square footage growth is appropriate based on all the competitive threats that are out there and with all the operational challenges — a lot of which are self-inflicted. For Whole Foods there's also been a lot of reputational damage that a lot of us have heard about over the past year. I think regaining that trust with consumers takes a long time. But to be adding high single digit square footage growth even as they're cycling negative traffic from last year – the backdrop of negative comps is a problem that they really have to address before they sign up for such a huge pipeline of new stores.

The other thing is the cost structure — they've really held the line very aggressively on operating expenses this past year. Usually their operating expenses are in the high double digits, growing 15% to 20% on a normalized basis. This past year, Whole Foods' operating expenses have basically been flat and that's not really sustainable.

I think they're already running out of steam in terms of how aggressive they can be in terms of store labor costs. They're already dealing with rising health care premiums so I don't think it's really realistic to expect that they can have flattish operating expense growth for the foreseeable future. If they did not hold the line on expenses so aggressively over the past year the earnings would be a lot, lot worse. So heading into next year the potential for comps to remain negative, and the potential for a more normalized type of increase in operating expenses, is really not contemplated by the Street at all.

Scott Mushkin:
You can't run negative comps with a high cost structure model. This also is happening at Target. Running negative comps with these companies is an incredibly difficult thing. That's why I'm surprised everyone shrugged their shoulders with the half a percent comp Kroger is saying they're putting out right now.

I mean this is a very difficult position because as Ajay is talking about we've got 75% of your SG&A is probably just flat-out labor costs. So you've been cutting people and consolidating jobs and doing all this stuff while people's friends that don't work at Whole Foods are probably getting pay raises. We've seen the store conditions deteriorate. We've seen challenges written up in the Wall Street Journal. I mean they're just not on a sustainable path. This company is going to have to be restructured unless comps turn positive, but there's no catalyst for it.

Ajay Jain:
I think even assuming a modest level of gross margin investment -- which is a realistic expectation over the foreseeable future – [with] negative comps [and] some SG&A deleverage -- that kind of combination could be really catastrophic.

Scott Mushkin:
Sales per square foot and profits per square foot crossed within 24 months. That's the path they're on.

Bill Kirk:
I do think there's some excess fat left that has nothing to do with the in-store experience, whether they're willing to harvest it or not I'm not sure. To give you one example of the mentality there, when they ran out of corporate office space in Austin, you can pick a lot of locations for excess space. They rented two floors of the most expensive residential high rise in downtown Austin. If you found religion and you want to cut costs, they're there. That has nothing to do with in-store experience. They haven't done it yet. I know they're still in the building. Yes, the deleverage is a risk but that's a testament to there being some organizational fat.

Scott Mushkin:
There's roughly $300 million corporate G&A coming out of Whole Foods. They need about $350 million of a price investment still, probably more now that prices are collapsing as the price spreads are blowing out because Whole Foods is not following the market down so we're getting 20-plus percent price differences. Even if you cut all G&A you can't fund your gross margin investment.

Chuck Cerankosky:
I think management is really shocked at this slowdown in comps and they've got all these service departments and they cut out some man hours in the stores. It's a little bit like Walmart did a few years ago. Then your comps get even worse because it's not the experience the customer is used to. This is unusual ground for Whole Foods. They had this problem after they bought Wild Oats but a lot of that was due to paying too much for Wild Oats. This is a whole different cycle for them and yet the economy is still in recovery.

Scott Mushkin:
Imagine if the economy rolls over. This company could do a negative seven comp.

Kelly Bania:
Just going back to what we were saying in the beginning, talking about the rural economies being a little bit more under pressure and the urban economies better. If you think about Whole Foods running negative comps now, they're supposed to be in mostly a lot of the regions that are doing a lot better. That makes me a little bit worried about what could happen if they don't get a lot more aggressive.

Joe Feldman:
My concern with them, even if you get aggressive on price, and the loyal customers are still there, you're just giving them a discount. They've already lost that aspirational guy that's gone back to Kroger or wherever else they can get this stuff.

Bill Kirk:
I think that's why the amount of gross margin investment might be smaller than the general consensus.

Kelly Bania:
When we do quarterly surveys, it tells us that the typical Whole Foods shopper shops there once a month. So if you think about that, that customer is in many other stores probably nine to 10 times a month.

So there's some customers that shop eight times a month. That's a very small percentage of their customer. That customer is still shopping there. The typical customer goes once a month to get those special items they're now getting at Costco, that they're getting everywhere. So over time, that traffic from that customer is still decreasing.

Bill Kirk:
So Kroger and Costco are now, I think by their admission, the number one and number two natural organic retailers in the country. Kroger – 11%-12% of their sales is coming from natural/organic. That's about the industry saturation. That's the current industry

number so unless you think they're going to pass the industry number and become some sort of specialty store, the headwind they are to Whole Foods just can't mathematically be the same. They went from a smaller number than 11 to 11. That's share gain, so unless they can gain share again — and maybe they can, but maybe not at 50% annual growth rate clip — I don't know that they can be the same headwind.

Kelly:
Costco is already 70% organic alone, which is much bigger than the four to five for the industry.

Scott:
So why are their sales cycled over the negative comps?

Bill Kirk:
Well, we cycled with another negative story. I mean it was another negative FDA story cycling the New York City weights and measures. They did themselves no favors certainly. I expected comps to improve.

Scott Mushkin:
I mean the challenge when you reduce store labor is like what we see in their Darien, Conn. store…it can be very dirty. The store was actually written up for poor health conditions by the town. It has gotten one of the worst ratings in Darien. This is the problem when you take out store labor and you have a model that is high service and has a lot of prepared food. They're looking for their Chipotle moment. They're in search of it. Superior store execution historically was one of the company's biggest advantages. Its really unbelievable to see Whole Foods sacrifice store conditions and we believe it is a very big mistake.

Whole Foods, however, has a great brand so we think it can be rescued, and we especially believe that the company's urban stores still do very well.

But what do you do?

First, the ubiquitous items that are available all over, you get them priced right because no one wants to be fleeced. Second, you slow down store growth significantly and you probably have some stores you need to close. For example, we were in a store outside of Elmhurst, Ill. It was one of the stores the company purchased from Safeway when it shut down Dominick's. The store is out on Route 83 in Illinois, a very busy local highway, it was hard to get into the parking lot from the south bound side of the road. I also noticed that it was adjacent to a Kmart and a Party City…usually chains that are not necessarily going to attract the Whole Foods demographic. So it is not surprising in talking team members that they described the store as "Very slow."

Finally you do what Walmart did, you bite the bullet on store labor. You put it back in and you pay your people. That store staff is what made you great.

If you do these things, earnings likely fall to a buck and you could get the stock down to $18, but I think you could rebuild from there.

Then, 365 becomes icing on the cake if the economics work because I do think it's potentially a good format.

Ajay Jain:
I think 365 is a good format. We have some preliminary data on the Silver Lake store, which we think is doing really well. In terms of sales productivity, we just have one or two months of data for one location. Ultimately, it will be higher sales productivity based on sales per square foot than a legacy Whole Foods store but I don't think you're going to see it ever approach the level of Trader Joe's, which is around $2,500 in sales per square foot. I don't think anybody else can replicate that.

Bill Kirk:
I think what they're doing is smart. It's kind of an admission moment. They basically said a year ago we're going to emulate Sprouts and Trader Joe's. They are two of the few concepts that score better with customers than the legacy Whole Foods. People love Trader Joe's and Sprouts. So they're at least emulating the right people.

Kelly Bania:
It's funny, if we're talking about Trader Joe's is a big source of the new pressure for Whole Foods in the last couple years. Trader Joe's has always been there.

Scott Mushkin:
I think the challenge for Whole Foods is the competition that's come in from the high end, Blue Apron, Hello Fresh. You've got so many of these meal deliveries services, but then Amazon Fresh as well. Amazon Fresh expanded out into the suburbs of New York not too long ago, into Connecticut. Amazon Fresh just went into Boston. People using those types of services are clearly Whole Foods' type of customers.

Bill Kirk:
And the geographic overlap. E-commerce does best with high population densities, Whole Foods of course is in some high population densities.

SN:
Natural Grocers had a little bit of a setback this year also. How do you see their challenge?

Chuck Cerankosky:
It's a very different store in my mind and it doesn't have the broad appeal that Sprouts has or Whole Foods had in better days. Narrow product selection, fresh protein is very limited, so it strikes me as another example of The Fresh Market model that went public with a high growth story, reached out to expand fast and couldn't do it because each needed to carefully handpick the new store sites. Fast growth didn't work well for either company.

Bill Kirk:
I think their deceleration has been more company specific than some of the other people we've talked about. The organic items aren't as deflationary and they're probably still slightly inflationary compared to what some other people sell, so they've been less impacted there. They're blaming some of the oil production states at times and then Costco will speak a week later and they'll highlight some of the oil production states as an area of strength. Their narrative doesn't really match. I think 2015 for them, their comp benefitted from increased store hours. They went from 74 store hours a week to 88.

So the 2015 number looked great but the core started to slow. When they started lapping the tests of those extended stores that's when comps started to go from 5% to 3%. When they started lapping the full rollout now we're at zero comp. That's fine, but they haven't articulated that. I don't mind that as an excuse because then at least maybe you know the floor for comparable-store sales is there. The issue there is where's the bottom on Natural Grocers but if they were to articulate that was the reason for the deceleration and that was the reason 2015 was as strong maybe you could start saying things won't get worse there.

Scott Mushkin:
It's another company building a lot of stores and they're completely off their maturation cycle. So Sprouts is off theirs, Whole Foods is clearly off theirs and Natural Grocers is off theirs. That's problematic, speaking of saturation, too many assets, too few sales. It is a very differentiated format, but the numbers speak for themselves. They have a very young store base that's not putting up any comp, and that was without deflation so we're starting to finally get some deflation in natural and organic so this is the next shoe to drop and then we're starting to see natural and organic get much more promotional and a lot of those commodities year over year I think have come down some. That might be something the natural organic has to deal with in the months ahead.

Bill Kirk:
I'm sure the natural organic industry is feeling the substitute effect of egg prices being down 30%. That makes the organic egg look far less attractive.

Scott Mushkin:
That's actually a really good point. This is anecdotal but I was talking to someone in my travels. They normally bought organic eggs but the [conventional] eggs were 98 cents and they're like "there's no way I'm paying $3.98."

Bill Kirk:
That could turn into a consumer-fed deflationary issue, which is far worse that the too-many-organic-eggs issue.

SN:
We hit a little bit on the consolidation or at least the need for some capacity reduction. There are rumors of some private companies looking to sell. Is the industry getting too tough for a $2 billion dollar company to survive? And what else might you expect in consolidation in the months and years ahead?

Chuck Cerankosky:
Because of information technology these days, economies of scale can be had in ways that you didn't have in the past. You can more closely to monitor mix and price. You don't have to rely on an owner/operator if you go back 50 years. The chains have been getting bigger. Some of them do their own manufacturing, most of them do their own distribution. They have a sophisticated real estate departments. It does make sense to get bigger. Ahold and Delhaize just did it, especially following what Kroger did with Harris Teeter, and Safeway merging with Albertsons. And the trend should continue. Plus, you have some generational issues with private companies. You don't know if the families always want to stay in the business.

Joe Feldman:
There's more bankruptcies in grocery than anywhere else in retail. I think it's because of these mom and pops, the small regionals, and that's likely to continue.

Ajay Jain:
We talked earlier about whether there's a viable exit strategy at Supervalu for their conventional retailing business. I think if you look at the background of the current CEO at Supervalu, I don't think it leaves that much to the imagination to figure out what the endgame is. Clearly his expertise is in M&A so I don't think the current operating structure at Supervalu is going to remain intact in its current form. They are going down this path of simplifying the business into a pure wholesaler. Whether they can evolve into a pure wholesaler in two to three years, I don't have a view on that, but I think the intent is to divest underperforming businesses and to do the Save A Lot sale or spinoff.

Scott Mushkin:
I think this is an extend-and-pretend economy: Extend the terms and pretend everything is okay. Something is going to have to give here. We're spiraling down. It seemed to

accelerate meaningfully in June. There's a lot of pressure. We talked about Natural Grocers, we talked about Whole Foods. Private operators like Southeastern Grocers are feeling lots of pressure. I think the guys at Albertsons are feeling some pressure as to keep their sales going. Something's got to give here eventually. We're going to have to consolidate this business.

It seems like the climate should force some significant consolidation on this industry. Again, I was in Winston Salem, N.C. We had a Lowe's, which is the private guy, we had Neighborhood Market, we had Harris Teeter, we had a Food Lion. I could have thrown a net over these guys. It's just too much.

SN:
Who's going to be the likely buyers and sellers here?

Scott Mushkin:
I think Kroger is there and that's why I wish they hadn't spent the $500 million on their stock. I think Ahold could be a buyer of some things too.

Chuck Cerankoky:
Kroger's there, Albertson's is a buyer. I think some of the some of the private chains are going to be buyers. Some are pretty well-heeled compared to others.

Ajay Jain:
Publix has a lot of cash.

Chuck:
Publix has a lot of cash. Giant Eagle's acquired in the past.

SN:
Some private companies like Publix and HEB are significant in the industry. Can you comment on where you see those particular companies and how they will affect the companies you cover?

Scott Mushkin:
HEB is going into Dallas. HEB is an animal. It's probably the best staples retailer maybe globally. I mean the combination of incredible merchandizing, fresh, being able to run the format for the neighborhood and the pricing will crush anyone that comes near them. Just crush them. The most aggressive company I've ever seen. I think the challenge for HEB is Charles Butt who runs it is not young anymore, but that's got to be your best private company out there by far.

On the flipside, Publix is a very good company but the pricing is high at Publix. So you wonder in the longer term how that model works. It's one of the few guys that's still around that price is meaningfully above the mass merchants and gets away with it. The customer does not seem to mind.

Bill Kirk:
What happens when Wegmans and Publix overlap for the first time? I think both are planning to go into Virginia. I don't know if the first locations will touch each other, but that's two private, well-regarded retailers going up against each other for the first time. I'd be curious what would happen.

Scott Mushkin:
Wegmans is in Northern Virginia and Wegmans prices are a lot closer Walmart, sometimes they're actually below. And it's and very different format. Publix is like a traditional food and drug supermarket.

If you go to one of the Kroger flagships, it's like a giant compared to Publix. There's a Raphs in Los Angeles -- Westwood, Calif. If anyone gets out there go see it. It would give any Whole Foods a run for its money. Organic salad bar, sushi, beer on tap. I mean Kroger can really put up some wonderful stores.

Chuck Cerankosky:
It wouldn't surprise me to see a couple of these private guys who are separated regionally to get together to complement each other. It wouldn't surprise me at all.

Scott Mushkin:
A lot of [private retailers] are in groups together already. In fact, HEB is the one that helped Wegmans through the Walmart onslaught years ago.

Chuck Cerankosky:
They know each other. Their courtships take a while but it happens. Giant Eagle has helped some of the other ones learn about gas.

SN:
How successful have supermarkets been in preventing shoppers from flocking to restaurants?

Chuck Cerankosky:
I don't think they try to prevent them. So much of going to a restaurant is the ambiance or celebrating an event or my kids are in town so we go to a restaurant. The idea of substituting a trip to even a nice in-store restaurant probably wouldn't work for celebrations. But on the other hand, a store like Whole Foods that has a nice, in-store,

sit down restaurant, is attractive, serves alcohol: That could take away from some of the unplanned trips to a traditional restaurant. The quality, the price, they need to be at the right levels. I don't think they want to try too hard to compete with the restaurants' entertainment mentality.

Joe Feldman:
I think you have a pricing situation. We've been talking about deflation this whole time. According to the restaurant analysts at my firm, they're raising prices. Prices are up 5% to 7% at the restaurants versus down at the grocers, so it's a lot easier to pick up that steak and make it yourself and maybe have a better experience at home. You have to cook it but I think there is something to do with the pricing structure in the past year or so.

Bill Kirk:
Generationally it seems like the younger generation wants to spend more on experiences and doing things. I think restaurants would be taking a bigger part of their consumption wallet than maybe previous generations had. So whether it's travel restaurants, kind of that hospitality industry seems to just take dollars and food occasions away from cooking at home. I think year over year cooking at home time spent per week is down every year for the last 30 years.

Scott Mushkin:
I think food away from home just surpassed food at home dollars in the last several months.

Bill Kirk:
I mean I think to Joe's point at some level with grocery stores lowering prices, and restaurants raising prices they created a 10 percentage point gap from where they were two or three years ago. Maybe that's why promotional activity was so high during the summer because maybe it was pass through. Maybe it was the grocery store saying "Don't go out for that cheeseburger, grill it anyway, it's summer."

Scott Mushkin:
This is the next potential problem for the food-at-home space. You're already seeing the casual diners get more promotional. Looks like we are starting to see a ramp-up in promotional spend out of some of these casual diners.

Joe Feldman:
There's too many of them as well.

Scott Mushkin:

There's way too many. While the industry has been growing, square footage in the industry is growing even faster so it creates challenges. So it's another pressure point as we get to the holiday season.

The challenge the food-at-home space has to deal with is just a ramp up in price competition from the restaurants. And with the experience and service [in a restaurant], it would probably sway people back.

Bill Kirk:
I talked a little bit about grocers for 18 months capturing margin. The restaurant guys, their input costs are down too, and they have been raising prices. The CPI says 3%. So they have a lot of gross margin capture over the last couple of years that they can give back.

Scott Mushkin:
The reason they raised prices is because their labor costs are skyrocketing.

Kelly Bania:
And rent.

Ajay Jain:
The excess supply issue in casual dining still needs to be corrected. I actually do think in the current deflationary environment that on a relative basis, the price/value perception for a lot of the conventional food retailers improves relative to casual dining — but that's a relative argument. So I think with all the discounting that's going on with conventional supermarkets and in the natural and organic space, I don't know that the relative argument of spending in supermarkets compared to restaurants is all that meaningful. It's kind of like you're trying to pick the best address out of a bad neighborhood.

Scott Mushkin:
The problem is restaurants think the food-at-home channel is stealing share from them. But look, the volume didn't come from us, guys. But I think this is a manifestation of an incredibly slow-growing economy. As Chuck said, people were expecting the economy to be a lot different.

Chuck Cerankosky:
I think you'll remember when the economy turned down everybody said "Let's buy supermarket stocks." People traded out of restaurants and they traded down in supermarkets because the economy was so badly hit.

I think the populous is bifurcated in terms of their current purchasing power. They've clearly traded up in supermarkets, whether it be a high-end Kroger or a high-end Publix or Wegmans. Cleveland has no population growth, but it seems we've got a high-end steak joint opening every other week.

Bill Kirk:
No one wants to Instagram their grocery shopping. But people love to Instagram their restaurant occasion. It's that "Look at me" type of thing going on with that generation. I don't think that stops. Generational habits are pretty strong.

SN:
Do we think that the entire food space in aggregate is oversupplied?

Scott Mushkin:
I mean at least the restaurants don't have the demographics problem because Boomers are now entering their high service consumption years. So I say broadly speaking if you look at consumption, restaurants tend to be in the upper quartile of getting a lot more dollars. It's really just over expansion. Unfortunately, in the food-at-home space you've got overexpansion, and you're in that lower left-hand quadrant where you're not seeing a lot of incremental dollars. Again, I call this the fed effect. When interest rates are zero almost every project looks good.

SN:
Talk about the meal replacement delivery service business. How significant can that emerging business be and what kind of threat do they represent?

Chuck Cerankosky:
That's like when a store puts meal solutions on display. In fact, it's been done in the past. Build this recipe, buy the dinner recipe of the week. The Fresh Market was doing it.

Scott Mushkin:
Giant's doing it in Philadelphia.

Joe Feldman:
HEB does it. They put it in a sack for you.

Scott Mushkin:
As an analyst we've got to experiment with all this stuff so we do a lot of it in our household, we've done Blue Apron, Hello Fresh, we've done a lot of them. I was very reluctant but now we find that we use them a lot. The data I've see is that the average person that starts using starts engaging, reduces grocery shopping by about 4% to 6%.

The other problem, again is the Fed effect. They have plenty of money. We thought maybe we were going to start to consolidate some of these in the spring when things got a little tighter in the credit markets, but they have plenty of money and a lot of them are offering very aggressive coupons, 50% off. I get them so I send them to the young people in our office. I'm like 'Here, happy birthday.' I'm getting them for free.

It's a challenge. I mean I think broadly speaking you're going to see with Amazon Fresh, Amazon Pantry, Jet, the U.S. consumer, particularly consumers 50 and under is very willing to experiment with their consumable purchases and interactions and how they're going to receive those goods is certainly part of that equation.

When you don't have a lot of population growth, when your demographics are already unfavorable, these new business models are just another nick at you. It doesn't feel good. They're sucking away some of your best customers. People that are doing these services tend to be your over $100,000 crowd that spend more, that trades up to the steak, trades up to the better wine.

Joe Feldman:
I would think Kroger buys one of these. Any of these guys could or just do it themselves. I don't know the profitability of the model, but obviously it's good for the customer.

Scott Mushkin:
Blue Apron's profitable and I think part of it is that it's all done at a warehouse, very inexpensive space. They can't have 20 or 40 different recipes. They really focus. So it's kind of like the Model T. You could have black, black, and black. I mean it's not that extreme but there's fairly limited options and so there's a lot of repetition in the model.

Kelly Bania:
If you think about how many different meal services there are out there I'm not sure where they're sourcing from. Maybe they're going directly to farms but if they continue to get bigger and want to scale profitability, eventually they might buy from the distributors.

Scott Mushkin:
The one thing I would point out is this is something we weren't even talking about two years ago. They weren't even on the radar. Now Blue Apron's serving 15 million, 18 million meals a month. That's not a ton because there's 300 million people in the country, but it's amazing how quickly they become part of our thought process where two years ago, if we sat at this table I don't even know if I knew who Blue Apron was.

Chuck Cerankosky:
In the suburbs, that's where it could be knocked off so easily with good merchandizing at a supermarket.

Scott Mushkin:

But they've got money and they're learning. Hello Fresh has a wine club so you actually can utilize their wine experts. They send you out little bottles and they test your palate so it also becomes efficiency driving for the household, where if you were spending 30 bucks for a bottle of wine now you've got experts helping you out and it takes your expenditures down a lot, especially drinking as much wine as we do at our house.

SN:
Shifting over into e-commerce. Are food retailer investments in e-commerce going to work out?

Chuck Cerankosky:
The thing I'd say about Walmart is that in my opinion the biggest trouble they have in e-commerce is not enough service in the stores and that led to poor store conditions. This is going back a couple of years. It's left a lot of people with a bad impression of how good they can be in e-commerce. Amazon doesn't have that problem. If you walked into a Walmart store and there was garbage on the produce department floor and out of stocks in the toy department and the sporting goods was in disarray, you're probably not going to have a good feeling about the website.

Bill Kirk:
A $40 basket at Kroger after taxes and everything is maybe netting one or two dollars. Any costs you add to that makes it unprofitable very quickly. So you better be the first one to offer some sort of click-and-collect, or whatever e-commerce solution you think you need; otherwise, for the entire industry it's a bigger cost burden on the same pie that isn't growing, and may be shrinking. In my mind you've got to be first or it's going to be a very unprofitable proposition for you.

Ajay Jain:
There's a really high level of complexity with e-commerce in the grocery space in terms of the order fulfillment aspect and also with delivery. To be able to master both of those challenges and do it in a profitable way is very difficult, as a lot of people have learned the hard way over the years.

It's still a big unaddressed opportunity. I think online grocery is less than 5% and it's growing at a higher rate than the category growth of natural and organic products, for example. I think consumers are probably going to embrace some click and collect or click and mortar type of approach going forward, versus a pure e-commerce approach.

Scott Mushkin:
There's so many challenges here. Looking at what Walmart is doing. They have a drive-through pickup depot in Rogers, Ark. and I sat there for an hour-and-a-half and I didn't see one person come in the parking lot during the middle of the day.

This is the Amazon impact on the U.S. psyche. Amazon has conditioned us to expect it to be delivered to our home, or maybe our office. We do a big survey of women and we asked them last year, do you prefer your products delivered to your home or office, or pick up? Ninety-five percent said delivered. So this is the challenge Walmart has or anybody has.

Let's just say you're commuting to Katy, Texas from downtown Houston, you're sitting on the I-10 in traffic. Do you really want to get off and go to that Walmart parking lot? Do you really want to do that? The idea that "Everyone drives by my store so of course they're going to want to stop in"? I sometimes wonder if that's really true.

Bill Kirk:
I don't doubt that's true. But Amazon and others have also conditioned you to expect a better deal if you buy something online. Generally speaking, you think you can find cheaper electronics online than you can by going to a brick and mortar store. Whether that's a reality I'm not sure but that mindset limits the e-commerce potential because it suggests customers aren't willing to take any of the grocers' extra cost burden. If they're not willing to pay up much for any of these services, again you're wildly unprofitable.

Scott Mushkin:
The other challenge is you don't have the impulse buy. Even at a grocery store you're probably talking 30% of the goods are bought on impulse, people are off their lists.

Bill Kirk:
And the highest margin stuff.

Joe Feldman:
The problem we're all describing is delivery is great for the customer. It's awful for the retailer. That's why Kroger and Walmart and everybody else is trying to figure out click-and-collect. At some point, my view is there's got to be some pushback. You're going to have to charge for the delivery.

Bill Kirk:
Anybody who goes with Instacart would incur the least additional costs to provide that e-commerce service. Now, whether Instacart's a viable business model I'm not sure, but if you wanted some e-commerce solution without ruining your P&L, Instacart or a third-party picker is probably the best way to go.

Chuck Cerankosky:

The interesting thing about Instacart this time around, if you go back to the first e-commerce concepts, there was that assumption that the order selection and delivery was free. Instacart shows that people do have some sense that there's a cost component here that has to be paid for.

Bill Kirk:
So we're 20-ish years from Webvan, and they [Internet grocers] still only have about a 2% to 3% share.

Chuck Cerankosky:
Underlying all this is a supposition that everybody hates grocery shopping. That's not at all true.

Scott Mushkin:
We've been thinking a lot about this, about how people spend their time, because the desire to move re-orderable consumables online like Tide and Cheerios is high when we survey. When I say high, I mean like 20% of women. That's a lot.

We run these focus groups where in we're in a supercenter and I had the women check health and beauty care items at the store. Check the price on Amazon, their Prime account versus the store, and I'd say about two thirds of the time the price was at or below Walmart. One of the women turns to me and says, "I don't have to come here anymore, do I?"

Think about how much of our time is spent going to pick up those everyday items, and if we didn't have to do it, got it at a reasonable price, and spent that time doing other stuff. If you think about dual income households, do you really want to spend your Saturday morning going to Target and Walmart and Kroger? Or do you not? Even if 20% of people say no, it's a big problem even though I think fresh may be different.

Ajay Jain
I think there is a subset of consumers that really enjoy that personalized shopping experience, especially for perishables. They like that in-store experience. I don't know what the universe of customers are that are never going to embrace online grocery. But I do think that there is an aspect of in-store shopping that's very unique to the supermarket sector.

Scott Mushkin:
I read where Piggly Wiggly invented the modern grocery store. Before that you actually handed a list to someone. They went into the backroom, got you your stuff or you handed them the list and they would deliver it to wherever you were. So it's only been

100 years since this existed and I would say Amazon and some of these other services are going to challenge Piggly Wiggly's idea.

Bill Kirk:
It's the return of the milkman.

Scott Mushkin:
My grandfather was a milkman.

Kelly Bania:
I think the challenge is you have Amazon as the biggest in digital, $2 billion in online grocery sales [according to SN]. If you talk to a lot of the companies, the companies will tell you "I just don't know how to make a delivery on a $40 dollar basket profitable." What we know about Amazon is they want to be big in grocery, but we don't know how profitable they have to be because they have a different business model. How do you compete with that?

Scott Mushkin:
Are you familiar with these Dash buttons? We experiment in our house. I didn't have any idea what it was, or why would I ever pay $4.99 for one, though it gets rebated. So I convinced my wife to try it, and now we have 15 of them. We have them in a jar by the washing machine. When we run out of paper towels, click. Toilet paper…Click.

SN:
It doesn't seem like Costco is having a particularly great year, what's your view?

Joe Feldman:
I don't think it's that bad actually. I think it's relative. Relatively speaking to where they've been a few years ago, maybe it's not as great but flipside is relative to the rest of the world it's not so bad. I think the effects, deflationary pressures, gas pressures, that's all shown through but if you exclude that they're still picking up two to three percent traffic month after month. They're still getting 2% to 3% comps.

Ajay Jain:
I don't follow Costco that closely but I think they have disproportionate exposure to California. That may be a factor behind the sales weakness but they're also phasing out tobacco.

Chuck Cerankosky:

Part of their model is come in for the groceries and walk out with a trampoline. I did that. But it's a discretionary buy. If the economy is showing signs of weakness here or there or people are reapportioning where they spend their money, Costco could lose a few incremental sales. The company's been doing very well for a long time.

Scott Mushkin:
We think Costco might be at a pretty important crossroads. If you look at the demographics, if you look at the overlap between Prime membership and Costco membership it's really high. When you ask a younger consumer which one you want to give up, Costco gets kicked to the curb two-to-one.

At a very high level their renewal rates have kind of peaked out. While they are kind of doing better than most they're not doing as well as Costco has historically done. I always loved going to Costco. My weekend was either Walmart, Target, or Costco. Costco was an easy pick because of the electronics and all the other stuff that they offer. It was a fun trip.

What was motivating that trip for our household is that we have five kids and we're massive consumers of products. So, our Trip to Costco was generally to get those bulk items that we needed, the toilet paper, the dishwashing detergent, the cleaners. We haven't been to Costco in a long time because we have Dash buttons now. I went there for the first time and I realized it's not as pleasant of an experience as I thought it was. Waiting in the parking lot, going in and pushing your own cart around, waiting in line.

I think Costco is an incredibly well-run company with an innovative, thoughtful management team. I think we're going to see some different things out of Costco in the years to come as they adjust that business model. What those are exactly I'm not sure. I do think that Prime in particular has hit an S curve inflexion and is seeing acceleration. This, in combination with the Millennials coming of age are going to put some pressure on Costco to change and evolve.

Ajay Jain:
So there are some disruptive forces, whether it's external, like Scott's talking about the Dash buttons, or some company-specific factors like the transition away from the Am Ex credit card deal. I think all of those things have been pretty disruptive in the case of Costco.

Kelly Bania:
I agree with Scott on a lot of the Amazon and the consumables, but I think at the end of the day the core customer can save a lot of money going to Costco, and get high quality things, but they really go there for the food. Amazon is making strides in food but they're not there yet.

I think that [Costco] trip is food-driven and if you can save 26% on the basket of consumables you will keep that membership. You may not go quite as often but you probably will really stock up and still have those impulse purchases when you go there because you really don't go shopping anymore.

Scott Mushkin:
I also think you made an important point. I think they're going to try to understand where the price point is going to overcome the convenience of e-commerce. Kelly's right, the prices are incredible. We're also at a time in the economy where convenience is trumping price generally.

Chuck Cerankosky:
The interesting thing about Costco, they have a great response to price points in selling bulk. You don't buy a little bit of anything there. That's a great way to get to the low price. They also still have that entertainment factor. People like to go there and see what they didn't need, or buy what they didn't know they needed. That's just part of the whole allure. Then the third point is you're seeing household formations rebound; existing home sales have really recovered nicely and new home construction isn't far behind. Homeowners belong to wholesale clubs more likely than people who live in midtown Manhattan.

Kelly Bania:
Amazon has millions and millions of products. Costco has 4,000 and they focus on being the best on those 4,000. So you may buy a toothbrush on Amazon and it cost you $3, who cares, but next time you go to Costco you can get 10 for $3. You're going to do that next time. You're going to save up to do that because the typical family needs that affordability. So I think that puts a barrier around their model more than a lot of retailers.

SN:
Your thoughts for your Supermarket News headlines of 2017?

Chuck Cerankosky:
I think a couple of these well-known regionals might get together. I don't know who it's going to be. It could be HEB and Wegmans for some reason. Giant Eagle and somebody else. It just seems to me that with the consolidation going on among the public companies, why shouldn't it be happening with the private ones? They're just as sophisticated and they certainly would benefit from the economies of scale such a combination would generate.

Ajay Jain:

I would say comps remain negative at Whole Foods. On the surface that doesn't sound like a big deal, but I think it would be a disaster for earnings if that turns out to be the case. Another headline may be that Kroger does another opportunistic, non-traditional acquisition such as any divested stores from the Walgreen-Rite Aid merger.

Joe Feldman:
I think a year from now we'll be saying inflation has returned.

Kelly Bania:
Maybe towards the back half of the year.

Bill Kirk:
365 becomes the go forward, the bulk of Whole Foods' unit expansion.

Scott Mushkin:
I don't have one and the reason I don't have one is because I think it's too unclear. We're in unprecedented deflation. If you look at Japan in the '90s, the birth rate and household formations had been not hitting expectations. Deflation persisted as they had some significant challenges, productivity was really low, workforce participation went down. There's a lot of similarities to where we are today, and the supermarket industry was terrible over there for a while as these problems persisted. So the future right now I think is incredibly unknown. We have an election. We have the potential that the way things have been are going to continue, and maybe we have the potential for who knows what.

One thing I would say is that the country plus our industry needs much faster nominal growth rates. I see a very important fork in the road, either a continuation and maybe a spiral down or somehow, some way we start to grow a lot faster and dig ourselves out of a hole. I don't think the industry realizes that we're on the precipice of falling into that hole like Japan did in the '90s if we continue to have very low birth rates and demographic challenges and overbuilding and low interest rates and deflation.

Chuck Cerankosky:
Economic growth is like comps. You have to have it to really do well.

Scott Mushkin:
That's a great analogy. At 1% GDP growth it's like our country is a supermarket. It's very hard to leverage our expenses. It's very hard to get ahead.