ALL RETAIL IS NOT CREATED EQUAL

THE AMERICAN GROCERY STORE
PAST, PRESENT, AND FUTURE

FALL 2017

The mass-market brick-and-mortar retail strategies that proliferated over the past 30 years were based on cookie-cutter tenant formulas that were created by national retailers for national retailers. During this period, retail developers rushed to build bland, generic shopping centers across the country, and the results can be seen primarily in today's Class B malls and department stores. In the absence of compelling competing models, the developers had little motivation to cater to the tastes of consumers. The advent of e-commerce, however, has provided a more cost-effective, convenient, and personalized online shopping experience in which goods can be delivered to the consumer's home without the traditional hassle of brick-and-mortar shopping. To remain relevant today, retailers need to combine an attractive retail aesthetic with a curated selection of goods and services, and must provide a welcoming space where local communities can convene and socialize. As discussed in Longpoint's Spring 2017 Review, "Know Thy Community," incorporating these principles is critical to providing consumers with a capitivating and rewarding experience.

"ONE OF THE VERY NICEST THINGS ABOUT LIFE IS THE WAY WE MUST REGULARLY STOP WHATEVER IT IS WE ARE DOING AND DEVOTE OUR ATTENTION TO EATING."

– LUCIANO PAVAROTTI[1]

Why does the average American consumer go to the grocery store twice a week? Why does that same consumer go to five different grocers over the course of a month? Why do Millennials shop at grocery stores more than any other generation? Why did Amazon spend $31.3 million per grocery store to become a tenant in neighborhood shopping centers? Why do online grocery sales constitute only 1.5% of the total grocery sales business? It is clear that the massive growth of online retail sales seen in other sectors has not translated to similar growth in online grocery sales because buying food is distinctly different from buying any other commodity.

The rhythms of everyday life are organized around the procurement and consumption of food. It is the foundation of human health, which in turn creates the backbone of a strong and unified society. Food provides a common purpose, enabling people to connect with each other, to better understand one another, and to celebrate our many wonderful cultures. Food is the essence of all life, and the procurement of food, no matter one's geography or circumstance, is a central component of the human experience. Chef James Beard captured this truth when he wrote that "Food is our common ground, a universal experience."[2] Today, grocery-anchored retail centers have an exceptional opportunity to become culturally relevant town squares, and it is up to landlords to create such experiences. At their core, grocery-anchored shopping centers are places where people can gather to share in the economic exchange of the very commodity that sustains their way of life. These centers can act as a bonding medium to local communities in a world where people are often glued to their smartphones and computer screens, and as a result feel disconnected, lonely, and displaced.[3]

> ALL GREAT CHANGE IN AMERICA BEGINS AT THE DINNER TABLE.
>
> – RONALD REAGAN[4]

In this paper, we will analyze the grocery business and share our view on why all retail is not created equal. Brick-and-mortar retail is not in a fight with e-commerce; rather, these two mediums represent two complementary pieces of the modern consumer delivery system. For a grocer to find success in today's competitive landscape, it must offer a rewarding in-store experience, convenient pick-up locations, and cost-effective home delivery.

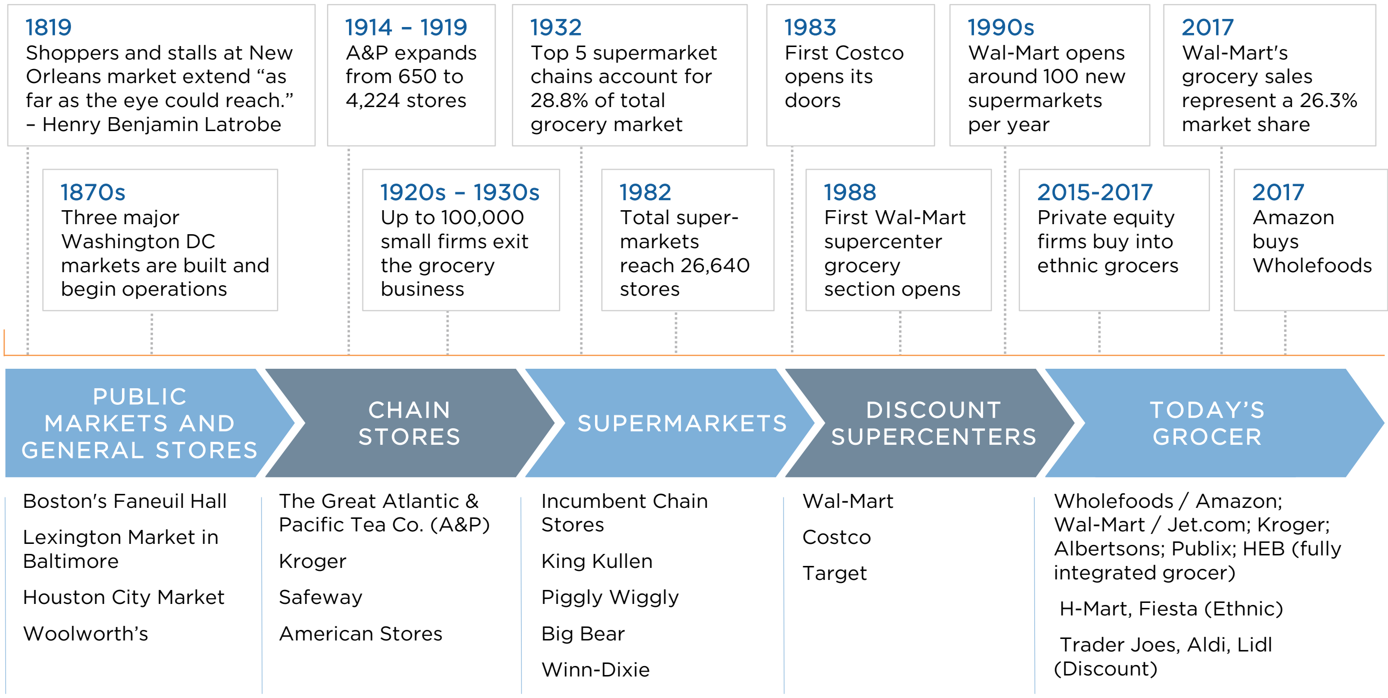
EVOLUTION OF THE U.S. GROCER

The business of selling food in America has undergone a number of transformational cycles over the past two centuries. See Figure 1. Grocers first evolved from local marketplaces and general stores to chain stores, then to supermarkets, and finally to discount supercenters.

Early in this country's history, agricultural goods were exchanged at small local marketplaces. These marketplaces, serving as vibrant centers of public life, emerged part-and-parcel with the growth of major eastern cities.[5] By the turn of the 20th century, a wide array of general and specialty stores had become the primary distributors of food in America, totaling an estimated 500,000 stores. The general stores, as well as butchers, fishmongers, bakers, and farmers, established locations in densely populated neighborhoods within walking distance of their customers, and offered home delivery for goods that were bought on credit.[6] Stores were small, typically fitting into the size of a large living room, and provided personalized service wherein shopkeepers would retrieve items for the customer. This intimate experience, however, came at the cost of an inefficient process. The many layers of distributors and wholesalers between food manufacturers and the stores themselves led to limited selection and high prices, making way for the first major grocery store format transformation: the chain store.

In 1912, The Great Atlantic and Pacific Tea Company (A&P) opened its first grocery store, introducing a chain-store concept comprising consumer-facing stores with a common layout backed by a vertically integrated supply chain of distribution and warehouses. The new grocery concept invented by

FIGURE 1: The Phases of Grocery Transformation [8,9]



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A&P did for retailing what Henry Ford's Model-T did for automobiles, introducing both standardization and scale, enabling A&P to offer prices below those of general store competitors. A&P abandoned customer delivery and offered fewer credit purchase options, converting grocery stores into a cash-and-carry business. A&P also pioneered the use of private label or "store brand" products, a concept that saw a resurgence in 2008 during the Great Recession as grocery stores aimed to provide reliable products at affordable prices.[7] Consumers grew accustomed to cheaper prices, resulting in the extraordinary growth and widespread adoption of the chain-store concept.

By 1930, macro-level changes in American society helped King Cullen pioneer the next major store format: the supermarket. A steep rise in vehicle ownership, development of the interstate highway system, and increasing usage of refrigerators in homes enabled consumers to visit stores less frequently and purchase more per visit. The new supermarket format augmented all of the efficiencies born of the vertically integrated distribution networks developed by chain stores with (i) larger stores, increasing in size by five to ten times; (ii) more selection, generating better economies of scale at the store level, (iii) cash-only purchases, simplifying accounting and overhead costs; and (iv) self-service formats, enabling stores to operate with fewer employees. In addition, King Cullen and its competitors built sophisticated demand forecasts to efficiently manage large inventories that boasted increasingly popular nationally branded products from consumer packaged goods companies. The popularity of the "one-stop-shop" approach allowed national supermarket firms to grow their share of overall grocery sales from 3.2% in 1935 to 74.5% in 1982. At the same time, the rise of supermarket chains caused the fall of many general and chain stores across the country. In total, an estimated 100,000 small firms exited the grocery business in an era that grocery historian Paul Ellickson calls "a period of creative destruction."[10]

The market entry of Wal-Mart signaled the next round of transformation in the history of American grocery stores. Wal-Mart rose to prominence as a retailer long before it entered the grocery business in the 1990s. Its extensive logistical and distribution network allowed it to quickly attain a greater selection of products at lower prices than competing firms. Grocery data suggests that Wal-Mart's prices from 1998 to 2001 were on average 15 to 25% below prices for identical food items at traditional supermarkets. As a result, sales volume of competing grocery chains during this period declined by 17%.[11] Wal-Mart has continued to retain its advantage in price and selection, and is now the largest grocery store in the country by sales volume, with a 26% market share of the grocery business and with grocery now accounting for 55% of its overall revenue.[12, 13]

For supermarkets, the financial stress of competing with Wal-Mart and similar discount supercenters resulted in a wave of restructurings and mergers. The Albertsons family of stores offers a prime example of such upheaval. In the 1990s, Albertsons bought the American Stores chain, which had itself acquired two other grocers in the late 1980s.[14] When Albertsons encountered difficulties integrating these diverse grocery chains into its operating model, it sold itself to an investor conglomerate in 2006. Several years later, after another period of restructuring, Albertsons merged with Safeway in 2014 to create a formidable grocer operator.[15] It has since continued to consolidate with smaller chains as well as larger ones such as the iconic A&P, which sold 70 stores to Albertsons in 2015 after filing a second bankruptcy.[16]

As history shows, success in the grocery business has been measured and attained by grocers growing bigger and offering greater selection at lower prices than the competition – until today. Yet a new era has arrived, and grocers are now waking up to the fact that bigger is not better; better is better. The survivors of this transformational change will have to choose one of two paths: (i) become a fully integrated grocer providing all available delivery options to their customers, or (ii) specialize by catering to a narrower but dedicated audience. The middle ground is not an option.

Though the paths are quite different, they both start with consumer-centric thinking, as described by Seth Godin in his book, *The Purple Cow*.[17]

The OLD rule	The NEW rule
Create safe, ordinary products and combine them with great marketing.	*Create remarkable products that people seek out.*
Retailer-Centric Model	Consumer-Centric Model[18]

PATH #1 – FULLY INTEGRATED GROCER

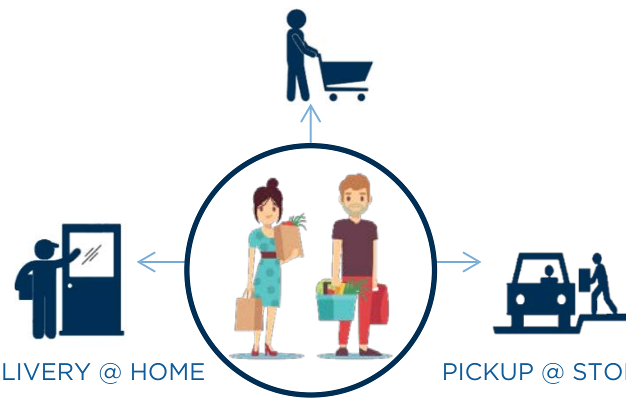
The grocery business is in the early stages of another transformational phase, this time spurred by the emergence of e-commerce channels. Thanks to the proliferation of supermarkets and supercenters over the last 30 years, consumers today have more options for buying groceries than at any other time in history. This breadth of selection is now complemented by a burgeoning online grocery delivery network. Historically, access to convenience meant working or living near a grocery store. Today, convenience is defined by having groceries dropped off at your doorstep or handed to you in your car. The unparalleled ease provided by online grocery services has created the impetus for grocers to redefine their value propositions to consumers, or else share the fate of many recently defunct grocery chains. Today, a successful grocer must satisfy the consumer's desire for a great shopping experience, convenience, and value.

The Amazon-Whole Foods merger is emblematic of this shift to a consumer-centric ecosystem in which customers receive goods how and when they want them, based on their personal preferences and willingness to pay.

While e-commerce has forever changed retail, online grocery still remains a small component of overall grocery sales at 1.5%. Though this share is expected to grow, it is projected to increase to only 7.5% by 2027.[19] The failure of e-commerce to achieve a high degree of penetration in the grocery sector is largely due to the high costs and challenges of delivering perishable goods. Peapod, the oldest and largest online grocer with a 6.8% share of the online grocery market, was profitable in only three of its 12 markets in 2016, highlighting the challenges facing the online grocery business.[20] According to Matt Fassler of Goldman Sachs, even using predictions that aggressively roll forward the current e-commerce growth rate of 15%, 70% of all retail sales will still occur in a brick-and-mortar store in five years' time. "Along this path, they (retailers) will disrupt the store to enhance the store, rather than replace it."[21]

The online grocery model is extremely challenging to successfully execute. It requires an extensive network of facilities and vehicles equipped for handling and shipping perishables. As Peapod's produce guru Tony Stallone noted, "if you break the cold chain on the way to the customer's refrigerator…even the healthiest-looking berries could rot too quickly…[in which case] we suddenly become inconvenient."[22] While providing competitive online grocery services is not a sustainable standalone business model, delivery service is vital for the survival of large scale grocery companies competing with Wal-Mart and Amazon.

FIGURE 2: Consumer-Centric Delivery System



Today's consumers demand convenience in all aspects of life, and how they acquire groceries is no exception.

Success in the grocery business will be defined by providing the consumer with simultaneous access to three main delivery channels: web-enabled home delivery, curbside pickup at physical stores, and brick-and-mortar grocery stores. See Figure 2.

Some analysts predict that over the next five years, Whole Foods-Amazon concept stores will reach 2,000 locations, will offer curbside pickup, and will

> ALBERTSONS
>
> TODAY'S CONSUMER IS LOOKING FOR A VARIETY OF PERSONALIZED SHOPPING ALTERNATIVES, AND THIS TRANSACTION IS THE LATEST EXAMPLE OF ALBERTSONS COS. MEETING OUR CUSTOMERS WHEREVER AND HOWEVER THEY LIKE TO SHOP.
>
> - Albertsons' CEO, Robert Miller commenting on the Plated acquisition[26]

> WAL-MART
>
> HOW MUCH TIME AND MONEY WILL OUR OMNICHANNEL EFFORTS TAKE?
>
> - Question from Wal-Mart Board Member
>
> IT WILL TAKE THE REST OF OUR CAREERS AND AS MUCH MONEY AS WE'VE GOT. THIS ISN'T A PROJECT, IT'S ABOUT THE FUTURE OF THE COMPANY.
>
> - Response from Neal Ashe, Wal-Mart's former President of Global e-commerce[27]

be complemented by online delivery options.[23] Wal-Mart is pursuing a similar approach, augmenting its vast network of brick-and-mortar retail stores with an online presence provided by the recently acquired Jet.com. Other chains are also following suit; under Stop and Shop, Peapod built a separate brand and distribution network that complemented its parent company's brick-and-mortar store footprint and procurement network. Additionally, more physical stores are merging with online channels in a unique mixture of affordability and convenience, such as Wal-Mart's Online Grocery Pickup and Kroger's Clicklist. Grocers have invested billions of dollars in strengthening their delivery networks, and are making pledges to spend even more. Publix recently announced its partnership with meal delivery service Instacart, which will allow the company to offer same-day grocery delivery from all stores by 2020. Albertsons recently acquired meal-kit delivery service Plated, which will allow the company to offer fresh ingredients along with easy-to-follow recipes delivered to its customer's doorstep or through curbside pick-up.

FIGURE 3: Grocery Market Share (% of Sales)

	Company	Market Share
1	Wal-Mart Stores Inc	26.3%
2	Kroger Co (Ralphs, Harris Teeter, Lucky's)	10.2%
3	Albertsons Inc	5.4%
4	Ahold Delhaize (Stop & Shop, Bfresh, Peapod)	4.0%
5	Publix Super Markets Inc	3.3%
6	HEB Grocery Company, LP	2.4%
7	Meijer Inc	1.8%
8	Whole Foods Market Inc	1.6%
9	Target Corporation	1.4%
10	Trader Joe's Co	1.3%
	TOTAL	57.7%

Source: "Grocery Retailers in the US." Euromonitor International. March 2017.

Successful grocers have not only invested the capital necessary to execute a multi-channel delivery network, but are also improving the in-store experience that consumers cannot get through online delivery. This means focusing on providing products with a distinct value proposition within the store. Michael Ruhlman, author of the book "Grocery," argues that "...commodity groceries – the Cheerios, the cranberry juice...will [be] delivered, because it's the same no matter where it comes from."[24]

This trend is compelling grocers to shrink the middle aisles of their stores, where commodities such as condiments and canned goods have historically been shelved, to make more space for "fresh perimeter" groceries such as produce, meats, fish, and baked goods that consumers want to smell, touch, and individually choose. In addition, some grocers have begun offering restaurant-like experiences ("grocerants") in their brick-and-mortar stores. In 2014, food sales from eating out topped home food sales for the first time in history. The response from grocers such as Whole Foods was to provide more in-store restaurants and prepared foods for the busy consumer.[25]

Now that it has been acquired by Amazon, whose stated mission is to become *Earth's most customer-centric company*, Whole Foods is launching the next cycle of transformation in the grocery business.[28]

PATH #2 - SPECIALTY GROCER

Unlike the ten largest U.S. supermarket chains, which must provide a multi-channel delivery network to compete, the remaining grocers (approximately 41,000 operators according to IBISWorld) have instead chosen to focus on the customer value proposition.[29] See Figure 3. Not all grocers have the size and scale – nor the urge or obligation – to be "all things to all people." For instance, the seismic demographic shifts rippling throughout the country are creating a proliferation of ethnic and specialty grocery stores that provide a selection of groceries tailored to the tastes of distinct cultural populations. Notably, the Hispanic population grew four times faster than the total U.S. population from 2000 to

2010, and is projected to comprise almost 30% of the total U.S. population by 2050.[30] This trend has drawn the attention of outside capital, as seen in the recent investments by private equity firms Acon Investments, Victory Park Capital, and KKR in Fiesta Mart, Mi Puebla Food Center, and Cardenas, respectively.[31] Asian grocery chains such as H Mart and Zion Mart that are popular among shoppers of Korean, Japanese, and Chinese descent have also benefited from outside capital investment.

In addition to ethnic shifts in America, generational changes have occurred with Millennials now emerging as the most populous group in the United States. As this group's disposable income rises, industry operators will increasingly gear their services towards these individuals, who are typically characterized as being both health-conscious and value-driven.

Discount grocers represent another specialty niche. Rather than focusing on the costly delivery method of sending goods to the consumer's home, discount grocers concentrate on the cost of goods sold in-store. Over the past five years, "discount" or "limited assortment" grocers such as Trader Joe's, Aldi, and Lidl have experienced the most rapid growth in the industry, and are promising to deliver even more growth through additional locations. These stores are often located in densely populated areas, and are much more compact and efficient than traditional grocery stores. In lieu of offering dozens of brands of the same product, these stores provide a smaller selection primarily comprising private label products that are both less expensive for consumers and more profitable for industry operators. For example, Trader Joe's, the leading supermarket in sales per square foot and America's favorite grocery retailer every year from 2012 to 2015, sells more than 80% private label goods, according to David Ager and Michael Roberto of Harvard Business School.[32] The success of these discount grocers has caught the eye of national supermarket chains, which are now bolstering their own private label selections. Albertsons and Kroger have been particularly successful with this approach, building up selections of thousands of store-brand products. This trend includes the increasingly popular natural and organic foods categories, with product lines such as Albertsons' "O Organics," Kroger's "Simple Truth," and Whole Foods' "365."

As grocers continue to reconfigure their economic models, the few real estate operators who understand the changing landscape of the grocery business will be ideally positioned to harness the tremendous opportunities in redefining grocery-anchored community shopping centers.

CREATING COMMUNITY CENTERS – THE LONGPOINT WAY

Throughout history, owners of grocery-anchored retail have had a long, profitable, and stable partnership with grocery tenants. At Longpoint, we believe this will continue to be the case, especially in dense, urban locations. According to NCREIF, grocery-anchored retail has been one of the best performing real estate sectors of any time frame during the past 40 years.[33] The breadth and consistency of grocery-anchored retail has positioned the asset class as a staple of core real estate portfolios. U.S. grocery-anchored shopping centers have proven to be resilient real estate holdings, with an average occupancy of 95% since 2007, higher than both power centers and malls. Further, among these retail subtypes, grocery-anchored shopping centers have the largest percentage differential in rental rates between Class A and Class B/C centers. As the grocery business model once again transforms via multiple variations of brick-and-mortar and online models, ample investment opportunities exist for seasoned real estate operators.[34]

Today's infatuation with the idea of e-commerce resistant investment strategies is akin to chasing rainbows.

Many sectors of the retail industry will face a challenging environment in the years ahead, but not all will be impacted equally. We do not see e-commerce as a competitor to brick-and-mortar real estate, but rather as a complement.

We have a clearly defined strategy that seeks to take advantage of the widespread re-urbanization movement and the multi-generational desire for rewarding shopping experiences. It is a community-based strategy rather than a bet on the future of U.S. retail as a whole. The focus is on creating "districts" or communities where individuals can stroll, commune with their fellow citizens, and, as Amazon has figured out, shop for groceries. For our purposes, we look to build or reposition grocery-anchored neighborhood shopping centers ranging from 75,000 to 175,000 square feet, anchored by an appropriate grocer and complemented by in-line tenants offering goods and services germane to the surrounding community. We transform bland, often overlooked centers into vibrant community gathering places.

At Longpoint, we focus on the consumer. As you may have read in Longpoint's Spring 2017 Review, our overarching ethos when investing in retail is to "Know Thy Community."[35] Our leasing strategies are consumer-centric and address the distinct needs of the surrounding community. Our shopping centers and our tenants offer preferred destinations to the surrounding local communities.

Today's grocery initiatives – fully-integrated delivery networks, grocerants, fresh-perimeter departments, ethnic foods, and private label products – reflect the aspects of the 3Cs framework (community, curation, and convening) that we believe drive brick-and-mortar retail success.[36] First, a strong community of loyal shoppers develops when a grocer combines unique offerings with an in-store experience that caters to members of the local community. Second, the increased emphasis on private label offerings is a good example of relevant curation, and further builds chain-store loyalty. Third, the "convening" element is captured by the in-store food service options provided by grocerants, for example, as well as through staging community-based events.

In conclusion, we believe landlords must focus on the consumer, incorporate aspects of the 3Cs framework into their properties, and select tenants that provide access to the modern consumer delivery system: in-store experience, convenient pick-up, and cost-effective home delivery. Those that do not will achieve certain mediocrity.

Stayed tuned for our next white paper, addressing how the logistics industry is redefining the retail supply chain and the growing importance of infill industrial buildings.

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