Sysco Corporation SYY [XNYS] | ★★★

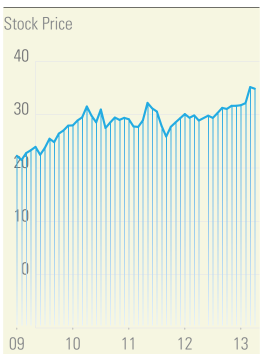
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
34.44 USD	36.00 USD	25.20 USD	48.60 USD	Medium	Wide	Exemplary	A+	Food Distribution

Sysco Falters in 3Q but Competitive Advantages Remain Sound; Shares Modestly Undervalued

by Erin Lash, CFA
Senior Stock Analyst
Analyst covering this company do not own its stock.

Pricing as of May 08, 2013.
Rating as of May 08, 2013.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.



Analyst Note May. 06, 2013

We never envisioned that Sysco's SYY third quarter would be full of positive surprises, particularly as it was lapping a robust period a year ago when sales benefited from warm weather across the United States, and it seems our expectations were spot on. Adjusting for the impact of acquisitions and foreign currency movements, Sysco increased its top line a mere 2.3% in the third quarter (in what has historically been one of the firm's smallest with regards to sales and profits), entirely driven by food cost inflation (up 2.4% versus 5.5% inflation last year) primarily due to higher protein and produce costs. However, a modest level of food inflation (2%-3%) is ideal for Sysco. Case volume performance excluding the benefit from recent acquisitions was also meager, falling 0.2% relative to the year-ago quarter, a marked contraction from the moderate growth the firm has posted of late. Higher payroll expenses took a toll on profitability, as the gross margin slipped 70 basis points to 17.5% and the adjusted operating margin contracted 40 basis points to 4.3%.

While we intend to review the assumptions underlying our discounted cash flow model and may take our current-year earnings forecast down slightly to account for results through the first nine months of fiscal 2013, we don't anticipate this will move the needle on our $36 fair value estimate, which remains in place. Overall, we still think Sysco should be well positioned when there is a more consistent positive cadence to restaurant sales, as it operates with an expansive distribution network (which lends it a wide economic moat) that will enable it to remain the dominant player in North American food-service distribution, generating strong cash flows and outsize returns for shareholders longer term. From our view, the market's concerns regarding sluggish restaurant traffic and food cost inflation are overdone and are unjustly weighing on the shares, which trade at just 16 times consensus fiscal 2014 earnings (versus the implied 17 times in our fair value estimate). With a dividend yield around 3%, we believe the shares should appeal to growth and income investors.

Thesis Oct. 24, 2012

Sysco is the leading food-service distributor in the United States and Canada, with about a 17.5% share of this estimated $225 billion market. Although food distribution is generally a low-margin, capital-intensive business, economies of scale have allowed Sysco to post returns on invested capital that have consistently exceeded our estimate of its cost of capital. The firm distributes more than 400,000 traditional food and nonfood products, serving 400,000 customers in various industries, and has expanded into other profitable niche segments, such as health care, education, and lodging. In an effort to solidify customer relationships, Sysco has made it a priority to consult with clients on how they can drive sales and minimize costs (an advantageous undertaking, given that about 80% of its sales are derived from smaller customers). We think its expansive distribution network and extensive product offering afford Sysco a wide economic moat.

Over the past 40-plus years, Sysco has actively participated in the industry's consolidation, completing more than 150 deals, and management maintains an intense focus on expanding its network, with acquisitions expected to contribute 0.5%-1% of sales growth each year. While smaller local and regional distributors (sales of $10 million-$400 million) remain the most likely prospect, Sysco's openness to pursuing additional deals outside its home market is in contrast to it stance just a year ago. When we asked CFO Chris Kreidler about this apparent shift in strategy earlier this year, he said that although scale is not possible in Europe the way it is in North America (due to different legal and regulatory environments in each country), the firm is still able to leverage the knowledge and experience it's gained, such as in brand management and customer service. In our view, the biggest challenge related to any deal would result from constraints on personnel rather than financial resources. However, given the firm's preference to complete smaller deals and because management has proved to be exemplary stewards of capital, we don't anticipate a potential deal to have a material impact on our fair value estimate.

Despite being a low-cost operator, Sysco is keenly focused on trimming additional costs from its already lean operating structure. For instance, it is working to improve its supply chain by more efficiently routing deliveries, as well as optimizing its product sourcing and supplier relationships. However, what has been most impressive to us is the pace at which Sysco is rolling out this vast undertaking. The firm has spent three years designing and testing these new processes and procedures, and after some performance issues surfaced, Sysco extended the testing phase in order to minimize problems on a broader scale--a wise move, from our perspective. Management expects cost savings from this project to amount to around $600 million over the next few years, and we forecast operating margins to improve to 5.3% by fiscal 2016 (up from 5.0% adjusted operating margins in fiscal 2012). In our view, the potential for higher customer retention, the ability to better serve customers, and improved reporting should prop up revenue and limit unnecessary expenses. That said, because the project is still in the very early stages, we don't forecast any meaningful benefit over the near term.

While Sysco is not immune to headwinds (including lackluster restaurant traffic and food cost inflation), some underlying positive trends support our thesis that an expansive distribution network will enable the firm to remain the dominant player in North American food-service distribution, generating strong cash flows and outsize returns for shareholders longer term. Food cost inflation, while still a challenge, continued to moderate throughout fiscal 2012, falling to 3.3% in the fourth quarter, a deceleration from the 7.3% reported in the first quarter. Trends are still up, though; average inflation during fiscal 2012 was 5.5%, up slightly from fiscal 2011 (4.6%) and well ahead of the 1.5% deflation seen during in fiscal 2010. Despite this, we recognize that in light of the unfavorable weather conditions in the U.S. this summer, food cost inflation could accelerate further into calendar 2013. While a modest level of food inflation (2%-3%) is ideal for Sysco, a rapid spike in food costs could pressure the firm and its customers--as it is now. Historically, the company has been able to pass along these higher costs to its customers, but double-digit inflation in categories such as dairy, meat, and seafood makes this pass-through more challenging. In addition, case volume growth has been a notable positive, in our view, amounting to 3.3% excluding acquisitions in the fourth quarter and 2.5% for the full year, despite the lumpy economic recovery that continues to plague domestic consumer spending and ultimately restaurant traffic.

Valuation, Growth and Profitability

After reviewing Sysco's fiscal 2012 results and our own assumptions, we're maintaining our $36 fair value estimate, which implies forward fiscal 2013 price/earnings of 18 times, enterprise value/EBITDA of 9.6 times, and a free cash flow yield of 4.7%. Given the fragile state of today's consumer, we expect that restaurant traffic (and ultimately consumer spending levels) could remain lumpy, hindering near-term sales, but that food cost inflation (as well as the firm's string of recent acquisitions) props up sales growth, offsetting the pressures created by soft consumer spending. As a result, we forecast that sales will increase 5.5% in fiscal 2013 compared with the year-ago period. Longer term, we forecast that Sysco will benefit as consumer spending picks up, resulting in 4% annual sales growth through fiscal 2017. In our view, the firm's constant focus on improving its cost structure will enable Sysco to offset volatile input costs. By fiscal 2016, we forecast operating margins of 5.3% (about 30 basis points above the firm's average operating margin over the past five years). We expect returns on invested capital to average 15% compared with our 8.9% cost of capital assumption during the next five years, providing support to our opinion that Sysco maintains a wide economic moat. Looking out through fiscal 2015, management thinks the firm will expand its underlying business at a 4%-6% rate, which seems reasonable in our eyes. This assumes that there will be little to no real industry growth and nominal sales growth of 4%-6%. In addition, Sysco expects the intensely competitive landscape to persist and for margins to remain

© 2013 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

under pressure, in line with our thinking. While management was originally guiding for $3.00 per share in earnings in fiscal 2015, it now forecasts earnings to approximately $2.50-$2.75 per share. Our current forecast is at the low end of this range.

Risk

If global economic headwinds persist and food inflation accelerates, Sysco's financial results could be pressured. Furthermore, given that around 60% of sales result from the restaurant industry, the firm depends on the strength of consumer spending, which has been fragile, partly as a result of high unemployment. Because input costs (such as food and fuel) are a significant component of Sysco's cost structure, high commodity costs can also weigh on results.

Bulls Say

- Sysco is the largest food-service distributor in North America, with 17.5% share of the market. It's followed by U.S. Foodservice with 9% share and Performance Food Group with 5%.
- The firm's supply chain initiatives should allow Sysco to consolidate inventory and negotiate more favorable procurement terms with suppliers.
- Case volume growth has been a notable positive, in our view, amounting to 3.3% excluding acquisitions in the fourth quarter and 2.5% for fiscal 2012, which is despite the lumpy economic recovery.
- Although operating margins only amount to about 5%, Sysco has generated returns on invested capital (including goodwill) of about 19% on average during the past five years.
- We are encouraged by the diversity of the firm's customer base, as no single customer accounts for more than 10% of Sysco's consolidated sales.

Bears Say

- Erratic changes in energy prices, which affect packaging and distribution costs for Sysco, as well as volatile input costs are proving to be a major headwind for food-service distributors.
- Given that more than 60% of Sysco's sales result from the restaurant sector, we don't expect volume pressure to meaningfully abate over the near term, as today's consumer remains fragile.
- Sysco is undergoing a major business transformation, the results of which are far from a guarantee. In addition, any implementation challenges could distract management from the firm's core business operations.
- Elevated gas prices and stubbornly high unemployment levels are plaguing an already fragile consumer, and as a result, restaurants may back away from raising prices over the near term, which would ultimately force Sysco to bear the brunt of higher food costs.

Financial Overview

Financial Health:We aren't concerned about the amount of financial leverage on Sysco's balance sheet. At the end of fiscal 2012, the total debt/capital ratio amounted to around 0.4, and operating income covered interest expense nearly 17 times. During the next five years, we forecast the debt/capital ratio to decline to 0.3 on average and EBIT to cover interest expense 23 times. We give Sysco an issuer credit rating of A+, implying low default risk.

Company Overview

Profile: Sysco operates as the largest North American food-service distributor, controlling 17.5% of the $225 billion market. The firm distributes more than 400,000 food and nonfood products to 400,000 customers, including restaurants, health-care and educational facilities, and lodging establishments. From its founding in 1969 through

© 2013 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

the end of fiscal 2012, Sysco has acquired more than 150 companies or divisions of companies to expand its footprint. Nearly 100% of the firm's sales are derived in North America.

Management: Overall, we think Sysco's management has proved to be exemplary stewards of shareholder capital. The firm has returned in excess of our cost of capital estimate each of the past 10 years. In addition, while Sysco has used acquisitions to build out its geographic footprint and assume the dominant position in the North American food-service industry, we contend it has been a disciplined acquirer. For instance, Sysco sat on the sidelines when the economic environment became more challenging a few years ago, stating that because of the reduced capital investments required, smaller competitors weren't suffering as much as Sysco, or we, had anticipated. As a result, the valuations of potential targets weren't attractive enough to warrant a deal. As case volume growth has picked up steam, Sysco has once again become an active acquirer, completing a number of small deals this year, and we expect the firm will remain an active acquirer when valuations warrant.

Bill DeLaney, 56, assumed the role of CEO in 2009. With his 25 years at Sysco, we believe DeLaney's experience is a huge asset to this food-service distributor, particularly given the challenging economic landscape. In our opinion, executive compensation appears reasonable, with about 80%-90% of management's annual pay based on the firm's performance. We commend executive management for taking a 5% reduction in its base pay in 2008 in light of the difficult economic environment. We believe this was a strong signal to the rest of the managers as to how committed the firm is to maintaining strict expense control. We're pleased that Sysco operates with different individuals holding the CEO and chairman positions. Manuel Fernandez, 66, was appointed as executive chairman in April 2012 (he previously served as nonexecutive chairman since June 2009). The firm already enacted majority voting for board members (which we applaud), and we're encouraged that Sysco is moving away from its staggered three-year election structure.

© 2013 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

Sysco Corporation SYY [XNYS] | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
34.44 USD	36.00 USD	25.20 USD	48.60 USD	Medium	Wide	Exemplary	A+	Food Distribution

Analyst Notes

Sysco's Hunger for Acquisitions Yet to Be Satiated; Shares Still Look Tasty Jan. 10, 2013

We have little doubt that Sysco SYY still maintains a thirst for acquisitions, following Thursday's announcement that the firm completed four acquisitions last month. The leading North American food-service distributor scooped up three domestic food-service distributors (Appert's Foodservice, Buchy Food Service, Central Seafood Company) and one Canadian-based firm (Distagro). Financial terms for the deals were not disclosed, but management said the combined annual sales of all four companies amount to around $520 million (around 1% of Sysco's annual sales). As such, we aren't making any changes to our $36 fair value estimate based on this news, but we think the shares look attractive at the current market price. We continue to believe the market's concerns regarding sluggish restaurant traffic and persistent food cost inflation are overdone and are unjustly weighing on Sysco, and given a dividend yield of nearly 4%, we think income investors should consider the shares.

This builds on a period of rapid consolidation for Sysco; it has announced nine deals since June 2012, which will add about $750 million annually to its top line. Over the past 40-plus years, Sysco has been an active acquirer, completing more than 150 deals, and management maintains an intense focus on expanding its network, targeting for acquisitions to contribute 0.5%-1% of sales growth each year. These efforts have enabled the firm to expand its distribution platform and maintain its dominant share, as Sysco says it controls 17% of the North American food-service market, more than double the 8% share U.S. Foodservice possesses and 4 times the 4% share held by Performance Food Group. While acquiring smaller local and regional distributors (with sales of $10 million-$400 million) is still the most likely prospect, the biggest challenge related to any deal would result from constraints on its personnel, rather than financial resources. Given that the firm prefers to complete smaller deals and management has proved itself to be an exemplary steward of capital, we don't expect any potential deal to have a material impact on our fair value estimate.

Sysco Delivers Another Step Forward; Shares May Whet the Appetites of Growth and Income Investors Feb. 04, 2013

While the uncertain economic landscape remains and Sysco SYY could still be plagued by potential missteps in its massive business transformation, we think things are looking up, following decent second-quarter results. Excluding the impact of acquisitions and foreign currency movements, Sysco increased its top line 4.3% in the second quarter. Food cost inflation remained moderate, ticking up just 2.5% in the quarter (down from 6.3% in the year-ago period), primarily reflecting higher poultry and meat costs. A modest level of food inflation (2%-3%) is ideal for Sysco, but high food costs could pressure the firm and its customers. Adjusting for the impact from recent acquisitions, case volume growth also edged higher by 1.8%, which we think is notable given that domestic consumer spending and ultimately restaurant traffic are still lumpy.

Overall, we think Sysco should be well positioned when there is a more consistent, positive cadence to restaurant sales, as it operates with an expansive distribution network (which lends it a wide economic moat) that will enable it to remain the dominant player in North American food-service distribution, generating strong cash flows and outsize returns for shareholders longer term. Results through the first six months of fiscal 2013 are generally tracking in line with our full-year outlook, and we don’t intend to make any changes to our discounted cash flow model or our $36 fair value estimate. We think the market's concerns regarding sluggish restaurant traffic and food cost inflation are overdone and

© 2013 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

Analyst Notes (continued)

are unjustly weighing on the shares. At 14.6 times our fiscal 2014 earnings estimate (versus the implied 16 times in our fair value estimate) and with a dividend yield around 3.5%, the shares are slightly undervalued and should appeal to growth and income investors, in our opinion.

The leading North American food-service distributor scooped up three U.S. food-service distributors (Appert's Foodservice, Buchy Food Service, Central Seafood Company) and one Canada-based firm (Distagro) in December 2012, which in the aggregate are expected to contribute around $520 million (around 1% of Sysco's annual sales) on an annual basis. We anticipate that Sysco will put its cash flow (which averaged about 2% of sales historically) to use by continuing to participate in the industry's consolidation. Over the past 40-plus years, the company has completed more than 150 deals, and management maintains an intense focus on expanding its network, with acquisitions expected to contribute 0.5%-1% of sales growth each year. However, given the firm's tendency to complete smaller deals and because management has proved itself to be an exemplary steward of capital, we don't expect any potential deal to have a material impact on our fair value estimate.

Sysco's focus on driving further cost savings aided profitability in the quarter, as the adjusted operating margin held flat relative to last year's second quarter at 4.5%, despite a 20-basis-point contraction in reported gross margins to 17.8%. In light of the unfavorable weather conditions that plagued the United States last summer, we think food cost inflation could accelerate into calendar 2013 (particularly for proteins). Sysco is working to redefine associates' sales and marketing functions to improve execution; standardize, centralize, and automate functions to the cost structure; and capture and utilize the data received to better serve customers. However, not dissimilar from others that have undertaken such a major initiative, the project is taking longer (and subsequently will cost more) than Sysco's original forecast. We think the firm will invest the bulk of any savings realized back into the business (rather than letting these savings fall to the bottom line) in order to target larger chain customers that were previously unprofitable for Sysco to serve. As a result, we forecast sales growth of 5.5% in fiscal 2013 and 4% annual sales growth through fiscal 2017, and by fiscal 2016, we forecast operating margins of 5.3% (up from 5.0% on average over the past five years).

We are attending the Consumer Analyst Group of New York conference in a couple weeks, where we hope management will address the progress of its business transformation rollout and its expectations for the release of the program across its network. In addition, the company has been quite active on the acquisition front (announcing nine deals since June 2012) and we'd like to garner a better sense of whether its hunger for additional deals has been satisfied.

Sysco Falters in 3Q but Competitive Advantages Remain Sound; Shares Modestly Undervalued May. 06, 2013

We never envisioned that Sysco's SYY third quarter would be full of positive surprises, particularly as it was lapping a robust period a year ago when sales benefited from warm weather across the United States, and it seems our expectations were spot on. Adjusting for the impact of acquisitions and foreign currency movements, Sysco increased its top line a mere 2.3% in the third quarter (in what has historically been one of the firm's smallest with regards to sales and profits), entirely driven by food cost inflation (up 2.4% versus 5.5% inflation last year) primarily due to higher protein and produce costs. However, a modest level of food inflation (2%-3%) is ideal for Sysco. Case

© 2013 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

Analyst Notes (continued)

volume performance excluding the benefit from recent acquisitions was also meager, falling 0.2% relative to the year-ago quarter, a marked contraction from the moderate growth the firm has posted of late. Higher payroll expenses took a toll on profitability, as the gross margin slipped 70 basis points to 17.5% and the adjusted operating margin contracted 40 basis points to 4.3%.

While we intend to review the assumptions underlying our discounted cash flow model and may take our current-year earnings forecast down slightly to account for results through the first nine months of fiscal 2013, we don't anticipate this will move the needle on our $36 fair value estimate, which remains in place. Overall, we still think Sysco should be well positioned when there is a more consistent positive cadence to restaurant sales, as it operates with an expansive distribution network (which lends it a wide economic moat) that will enable it to remain the dominant player in North American food-service distribution, generating strong cash flows and outsize returns for shareholders longer term. From our view, the market's concerns regarding sluggish restaurant traffic and food cost inflation are overdone and are unjustly weighing on the shares, which trade at just 16 times consensus fiscal 2014 earnings (versus the implied 17 times in our fair value estimate). With a dividend yield around 3%, we believe the shares should appeal to growth and income investors.

© 2013 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

Sysco Corporation(USD) SYY

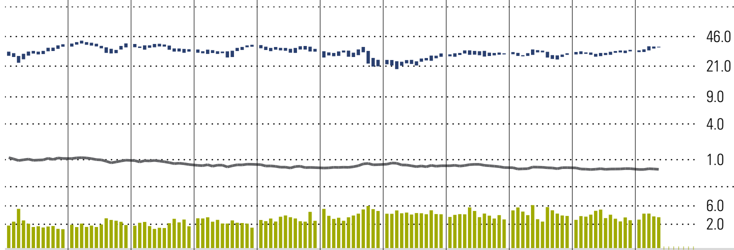
Last Close $	Sales $Mil	Mkt Cap $Mil	Industry	Currency
$35.02	$43,434	$20,258	Food Distribution	USD

Sysco Corporation, through its subsidiaries and divisions, is a distributor of food and related products mainly to the foodservice or 'food-away-from-home' industry.

Morningstar Rating	Fair Value Uncertainty	Fair Value	Economic Moat	Style	Sector
★★★ As of 05-01-2013	Medium	$36.00	Wide	Large Core	

1390 Enclave Parkway
Houston, TX 77077-2099
Phone: +1 281 584-1390
Website: http://www.sysco.com

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD	
37.57	41.27	38.04	37.04	36.74	35.00	29.48	31.99	32.76	32.40	35.62	Annual Price High
23.00	29.48	29.98	26.50	29.90	20.74	19.39	26.99	25.09	27.05	30.55	Low
											Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low $
35.62-27.05
10 Year High/Low $
41.27-19.39
Trading Volume Million

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD	Stock Performance
26.5	3.6	-17.1	20.6	-13.0	-22.9	26.0	7.9	3.3	11.6	11.2	Total Return %
-2.2	-7.3	-22.0	4.8	-18.5	14.1	-0.4	-7.2	1.2	-4.4	-2.7	+/- Market
-1.5	-3.3	-1.4	-2.7	-1.1	2.2	0.3	-3.8	-1.9	-0.2	-1.5	+/- Industry
1.2	1.4	1.9	1.9	2.4	3.9	3.5	3.4	3.6	3.4	3.2	Dividend Yield %
24093	24421	19260	22722	18981	13744	16543	17201	17188	18532	20258	Market Cap $Mil

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Financials (USD)
26140	29335	30282	32628	35042	37522	36853	37243	39323	42381	43434	Revenue $Mil
19.7	19.3	19.1	19.3	19.3	19.2	19.1	19.3	18.8	18.1	18.0	Gross Margin %
1324	1533	1590	1495	1708	1880	1872	1976	1932	1891	1816	Oper Income $Mil
5.1	5.2	5.3	4.6	4.9	5.0	5.1	5.3	4.9	4.5	4.2	Operating Margin %
778	907	961	855	1001	1106	1056	1180	1152	1122	1077	Net Income $Mil
1.18	1.37	1.47	1.35	1.60	1.81	1.77	1.99	1.96	1.90	1.83	Earnings Per Share $
0.42	0.50	0.58	0.66	0.74	0.85	0.94	0.99	1.03	1.07	1.09	Dividends $
660	662	654	629	626	611	596	594	589	589	589	Shares Mil
3.66	4.44	4.37	5.15	5.48	5.50	6.64	6.83	8.00	8.37	8.36	Book Value Per Share $
1373	1191	1192	1124	1403	1596	1577	885	1092	1404	1252	Oper Cash Flow $Mil
-436	-530	-390	-515	-603	-516	-465	-595	-636	-785	-612	Cap Spending $Mil
937	661	802	609	800	1080	1112	291	455	620	640	Free Cash Flow $Mil

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Profitability
12.0	12.3	11.9	9.9	10.8	11.3	10.4	11.5	10.6	9.6	9.0	Return on Assets %
36.0	38.1	36.1	29.4	31.6	33.1	30.8	32.4	27.0	23.9	22.5	Return on Equity %
4.04	3.97	3.76	3.78	3.79	3.83	3.64	3.64	3.62	3.61	3.64	Asset Turnover
3.0	3.1	3.2	2.6	2.9	3.0	2.9	3.2	2.9	2.7	2.5	Net Margin %
3.2	3.1	3.0	2.9	2.9	3.0	2.9	2.7	2.4	2.6	2.5	Financial Leverage

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-12	Financial Health (USD)
1249	1231	956	1627	1758	1975	2467	2473	2280	2764	2809	Long-Term Debt $Mil
2198	2565	2759	3052	3278	3409	3450	3828	4705	4685	4902	Total Equity $Mil
0.57	0.48	0.35	0.53	0.54	0.58	0.72	0.65	0.48	0.59	0.57	Debt/Equity
928	725	544	1173	1260	1676	2121	2067	2158	2661	2672	Working Capital $Mil

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Valuation
29.1	26.9	21.8	25.4	17.5	12.7	14.6	15.2	15.1	17.3	18.9	Price/Earnings
0.0	0.0	—	—	0.0	0.0	0.0	0.0	—	0.0	1.1	P/E vs. Market
0.9	0.8	0.6	0.7	0.5	0.4	0.5	0.5	0.4	0.4	0.5	Price/Sales
10.2	8.6	7.1	7.1	5.7	4.2	4.2	4.3	3.7	3.8	4.1	Price/Book
19.1	21.2	17.8	17.0	15.3	7.9	14.2	17.0	12.8	14.9	16.3	Price/Cash Flow

Growth Rates Compound Annual

Grade: C	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	7.8	4.8	3.9	6.1
Operating Income %	-2.1	0.3	2.1	5.0
Earnings/Share %	-3.1	2.4	3.5	6.5
Dividends %	3.9	4.4	7.7	12.2
Book Value/Share %	0.5	11.0	8.3	9.5
Stock Total Return	26.1	6.8	4.7	4.0
+/- Industry	2.6	-2.8	-2.2	-1.9
+/- Market	7.5	-5.9	-0.3	-3.8

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	22.5	29.4	22.0	19.6
Return on Assets %	9.0	10.7	8.7	8.1
Revenue/Employee $K	908.7	817.1	—	1034.5
Fixed Asset Turns	11.3	12.2	13.2	7.0
Inventory Turns	15.3	16.9*	12.4	12.4
Gross Margin %	18.0	18.9	16.5	43.2
Operating Margin %	4.2	5.0	4.2	18.5
Net Margin %	2.5	2.9	2.4	13.1
Free Cash Flow/Rev %	1.5	1.9	1.5	11.6
R&D/Rev %	—	—	—	—

Financial Position (USD)

Grade: A	06-12 $Mil	12-12 $Mil
Cash	689	321
Inventories	2179	2436
Receivables	2967	3168
Current Assets	6085	6160
Fixed Assets	3884	3961
Intangibles	1779	1956
Total Assets	12095	12428
Payables	2260	2288
Short-Term Debt	255	296
Current Liabilities	3424	3487
Long-Term Debt	2764	2809
Total Liabilities	7410	7526
Total Equity	4685	4902

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	18.9	15.0	16.2	16.8
Forward P/E	15.7	—	—	14.1
Price/Cash Flow	16.3	13.4	16.1	9.9
Price/Free Cash Flow	31.8	28.7	32.1	39.0
Dividend Yield %	3.2	3.6	2.3	2.3
Price/Book	4.1	4.0	2.3	2.3
Price/Sales	0.5	0.4	0.4	2.6
PEG Ratio	1.7	—	—	1.9

*3Yr Avg data is displayed in place of 5 Yr Avg

Quarterly Results (USD)

Revenue $Mil	Mar	Jun	Sep	Dec
Most Recent	10504.0	11045.0	11086.0	10796.0
Previous	9761.0	10425.0	10586.0	10244.0
Rev Growth %	**Mar**	**Jun**	**Sep**	**Dec**
Most Recent	7.6	5.9	4.7	5.4
Previous	9.1	0.8	8.6	9.2
Earnings Per Share $	**Mar**	**Jun**	**Sep**	**Dec**
Most Recent	0.44	0.52	0.49	0.38
Previous	0.44	0.57	0.51	0.43

Close Competitors

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
Kroger Co	17814	96751	12.3	36.6

Major Fund Holders

	% of shares
First Eagle Global A	2.98
Yacktman Svc	2.17
Yacktman Focused Svc	2.05

©2013 Morningstar. All Rights Reserved. The information, data, analyses and opinions contained herein (1) include the confidential and proprietary information of Morningstar, (2) may include, or be derived from, account information provided by your financial advisor which cannot be verified by Morningstar, (3) may not be copied or redistributed, (4) do not constitute investment advice offered by Morningstar, (5) are provided solely for informational purposes and therefore are not an offer to buy or sell a security, and (6) are not warranted to be correct, complete or accurate. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages or other losses resulting from, or related to, this information, data, analyses or opinions or their use. This report is supplemental sales literature. If applicable it must be preceded or accompanied by a prospectus, or equivalent, and disclosure statement.

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

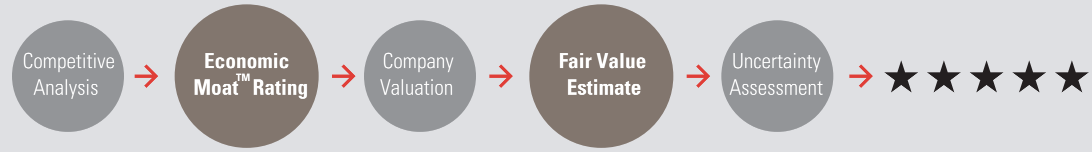
Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

Morningstar Research Methodology for Valuing Companies



Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade-show visits
- Competitor, supplier, distributor, and customer interviews

The depth of the firm's competitive advantage is rated:

- None
- Narrow
- Wide

Analyst considers company financial statements and competitive position to forecast future cash flows.

Assumptions are input into a discounted cash-flow model.

DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework.

An uncertainty assessment establishes the margin of safety required for the stock rating.

★
★★
★★★
★★★★
★★★★★

The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

© 2012 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.

economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

© 2012 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. Data as originally reported.
The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.
Redistribution is prohibited without written permission. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6869.