The Retail/Wholesale Food Industry looks to be making decent progress in 2011. Inflation has returned to the industry, leading to higher prices and increased sales. The impact on the bottom line, though much more mixed, still appears to be generally positive.

Our Timeliness Ranking System continues to look favorably on the group, placing it 13th out of roughly 100 industries. The relatively noncyclical nature of the business helps to give many of these stocks some appeal as defensive holdings. The sector, as a whole, has had limited success living up to this billing during the recent turmoil in the broader market, performing no better than the broader market since mid-summer.

Rising Prices

For food retailers and wholesalers, one of the primary things 2011 will be remembered for is the return of inflation to the supermarket aisles. For the most part, this has been a welcome development. Same-store-sales comparisons, which turned negative at a number of these companies during the recession, have been picking up in recent quarters. Granted, costs have increased, as well, but the competitive environment looks to be benign enough to allow the retailers to recoup the added expenses by raising prices. In fact, we look for most of the industry to show solid profit gains when the final results for 2011 are tallied.

Not surprisingly, there are indications that consumers are adapting their shopping habits to the higher prices. This can take a variety of forms, including trading down to lower priced goods or buying fewer items. Likely the biggest concern for each retailer (and their shareholders) is that shoppers will simply take their business to a rival with a stronger reputation for offering a better bargain. If these fears gain traction in the industry, the result would likely be an intensified battle for market share, with the customary damage to margins and profits. While we don't see evidence of this at the moment, the threat is likely to remain, particularly in view of the increasingly cloudy economic climate (and stubbornly high unemployment rate).

A Lost Decade

The past 10 years or so have been very trying times for the biggest supermarket operators. Profits at *Kroger*, *Safeway*, and *SUPERVALU* are all below the levels reached in the opening years of this century. Most of the problems look to be related to increasing competition from an expanding array of alternative formats. Price-conscious consumers, for instance, have a wide variety of shopping options beyond their local grocery store. In particular, supercenters, such as Wal-Mart and Target, have been devoting more square footage to selling food and other items typically found in grocery stores. At the other end of the spectrum, *Whole Foods* and others have been carving out niches by focusing on selling natural and organic foods to a fairly affluent clientele.

These nontraditional rivals figure to remain very much a part of the competitive landscape in the years ahead. On the positive side, the traditional supermarket operators have spent a considerable part of the past decade positioning there businesses to compete more effectively in such an environment, and we are cautiously optimistic that these efforts will support stronger profits over the next three to five years.

INDUSTRY TIMELINESS: 13 (of 98)

Conclusion

The months since our July report have been turbulent ones for equity investors, with stock prices reacting sharply to the latest news (good or bad) on the halting progress of the U.S. economy or the efforts to resolve ongoing sovereign debt problems in Europe. Overall, the broader market has fallen modestly over this stretch, and Retail/Wholesale Food stocks, on the whole, have performed only about as well, with several equities, *Nash Finch*, *Safeway*, and *The Pantry* among them, taking big hits.

Our Timeliness Ranking System continues to look favorably on the group, ranking it 13th out of roughly 100 industries. Too, this collection of stocks is heavily seeded with low beta issues that would figure to appeal to investors seeking some downside protection should the broader market remain subject to wide price swings.

One stock that has been able to come through the recent market turmoil relatively unscathed is *Whole Foods*. Notably, the company caters to more affluent consumers. On the whole, these shoppers appear to be returning to their prerecession spending habits much more quickly than those less well off.

Robert M. Greene, CFA

Composite Statistics: RETAIL/WHOLESALE FOOD INDUSTRY

2007	2008	2009	2010	2011	2012		14-16
268278	292926	282887	291731	***304750***	***316250***	Sales ($mill)	***370000***
21.9%	21.8%	22.0%	21.8%	***21.7%***	***21.8%***	Gross Margin	***22.0%***
5.7%	5.4%	5.3%	5.2%	***5.2%***	***5.3%***	Operating Margin	***5.5%***
9243	11238	11339	11528	***11600***	***11700***	Number of Stores	***12250***
4872.2	4962.7	4499.4	4482	***4925***	***5450***	Net Profit ($mill)	***7700***
35.9%	35.3%	35.6%	35.2%	***35.5%***	***35.5%***	Income Tax Rate	***36.0%***
1.8%	1.7%	1.6%	1.5%	***1.6%***	***1.7%***	Net Profit Margin	***2.1%***
d95.2	4926.0	7285.5	5739.3	***7250***	***8000***	Working Cap'l ($mill)	***12000***
30485	31570	30653	29976	***29500***	***28250***	Long-Term Debt ($mill)	***26000***
31460	30826	31436	30282	***32750***	***35500***	Shr. Equity ($mill)	***46000***
9.6%	9.6%	8.9%	9.1%	***9.5%***	***9.5%***	Return on Total Cap'l	***10.5%***
15.5%	16.1%	14.3%	14.8%	***15.0%***	***15.5%***	Return on Shr. Equity	***16.5%***
11.6%	11.6%	10.1%	10.4%	***10.0%***	***11.0%***	Retained to Com Eq	***12.5%***
27%	30%	32%	32%	***32%***	***30%***	All Div'ds to Net Prof	***25%***
18.1	15.0	13.3	15.7	***Bold figures are Value Line estimates***		P/E Ratio	***14.0***
.96	.90	.89	1.00			Relative P/E Ratio	***.95***
1.5%	1.9%	2.4%	2.0%			Avg Ann'l Div'd Yield	***1.8%***