

Research Paper

Albertson's Turnaround

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I. Executive Summary

The US supermarket industry has undergone significant changes and challenges throughout the past 10 years. Albertson's ("Albertson's", "ABS", or the "Company"), like many other grocers, has attempted to weather the storm, but has not been left unscathed. Massive consolidation occurred within the industry in the late 1990s; Albertson's undertook the second largest deal, purchasing American Stores Company ("American Stores" or "ASC") for just under \$12 billion. While the move was aimed at addressing challenges within the sector by increasing scale, poor integration and the ever-growing "Wal-Mart Effect" left the Company in a dire situation by the end of 2000. In early 2001, ABS hired GE-veteran Larry Johnston as chairman and CEO to turn the Company around. While Johnston's operational focus did produce many significant gains, a lack of strategic re-positioning led the Company to put itself up for sale in late 2005. Now, a SUPERVALU-led consortium has announced plans to purchase ABS. In this paper, we highlight and analyze the steps leading up to and through Albertson's 2001-2005 partially-completed turnaround and use that experience to offer SUPERVALU advice for successfully completing and, more importantly, implementing its pending acquisition.

II. Setting the Stage: Company History and the Lead-up to a Crisis

Historical Backdrop

As of the end of fiscal year 2005, Albertson's stood as the 2nd largest pure-play supermarket in the US, operating 2,500 stores nationwide with over 240,000 employees and annual sales topping \$40 billion. Since its inception in Boise, Idaho in 1939, Albertson's has been a major name and innovator in the US grocer sector. For the majority of the century, ABS grew through primarily organic measures, building new stores in select regions, and internally developing a joint food/drug store model (introduced in 1951). While the Company did undertake some minor strategic M&A moves in the 1960s and 1970s, it was primarily new store openings, increased market share, and the building of its own distribution centers that led ABS to quadruple sales over the course of the 1970s, to over \$2 billion annually.

With the progression of the 1980s came an emerging ideal of one-stop shopping. In response, Albertson's, like most other large grocers, increased average store sizes by introducing specialty products (e.g. magazines, bakeries, gourmet, etc.) to cater to more diverse shopping needs. And with the economic growth in the 1990s came more demanding and sophisticated buyers; ABS responded by making its stores more neighborhood-centric via individually catering to stores based on local produce production and ethnic demands, for example. Throughout these six decades, Albertson's identified itself as a true American success story built on superior customer service and "family" values. In fact, the Company was renowned for promoting from within, and as of the turn of the century, had only appointed top leaders from within the Company.¹

What Happened in the late 1990s?

As Albertson's continued to follow its organic growth model through the mid 1990s, the benefits of scale were not realized at the national level via cost savings, but instead at the regional level, through the ability to exercise market power to raise retail prices in a given region. By design of their historically piecemeal regional expansion strategies, large grocers were better positioned and more accustomed to

¹ www.albertsons.com.

concentrating heavily in specific geographical regions in order to push prices upwards, instead of searching for cost synergies through nationwide distribution, marketing, and supplier economies of scale. To elucidate, a market concentration survey in 1997 showed that in metropolitan areas across the country, the ratio of “four [supermarket] firms” with a combined market concentration of over 70% stood at 62% of metropolitan areas, more than double the number (29%) ten years prior.²

A confluence of factors shortly thereafter, however, led to a spike in large-scale M&A within the industry. The three primary factors leading to this industry-wide structural overhaul were:

1. **Increased Supplier Power:** Despite grocers' heretofore success in raising prices through intense regional market penetration, a consolidation trend amongst food manufactures, along with heightened food brand name recognition, led to the emergence of significantly increased bargaining power of food manufactures. This vertical coordination problem led to an essential double marginalization paid by the consumer due to the market power of both manufactures and grocers; the resultant higher prices were starting to hamper demand from many targeted consumers at traditional grocery stores. With only so many buyers in the high end consumer segment willing to sustain such price hikes for ordinary goods, most traditional grocers aimed to expand in sheer size to both a) mitigate food manufacturer supplier power and b) develop their own national brands so that consumers sought supermarket brands—and to a growing extent, private labels supplied by smaller-scale (e.g., weaker) manufactures—as opposed to food manufacturer brands.³
2. **Growing Trend of “Food Away from Home:”** As the stock market climbed throughout the mid and late 1990s, the growing wealth of US consumers led to a transition away from spending on food at home (e.g. groceries) and towards delivery and restaurant meals. In fact, from 1989 to 1999, real

² Cotterill, Ronald, “Continuing Concentration in the US: Strategic Challenges to an Unstable Status Quo,” University of Connecticut Department of Agriculture and Resource Economics, August 1999; calculated from pg 18.

³ Cotterill, pgs 4-7.

grocery store sales in the US grew at a feeble 0.2% per annum, partially instigated by a decline in disposable income spent on food at home (from 7.1% down to 6.3% over the same period). To cater to the generally deeper-pocketed consumer, most traditional grocers expanded into more high-end products, including prepared foods, increased product varieties (gourmet, kosher, vegan, etc.), and the like. These moves were expensive for grocers, requiring store refurbishments, finding and building relationships with new suppliers, and increasing store staff. This challenge was exacerbated by the surge of premium, specialty food retailers (à la Whole Foods) that attracted many of the most profitable consumers looking for a different shopping experience altogether, including a more “gourmet” ambiance and an even higher level of customer service. Given that most of the larger grocers moved in this upscale strategic direction, not all of these costs were necessarily transferable through to the consumer: supermarkets increasingly needed cost-based scale efficiencies to succeed.⁴

- 3. The Wal-Mart Effect:** While mass merchandisers and discount clubs had been a growing trend in the food retail sector since the 1980s, Wal-Mart Stores Inc.’s (“Wal-Mart” or “WMT”) move into the food market truly threw traditional grocers a curve ball. In 1998, WMT’s first year of full-scale food retailing, the retail behemoth swooped in to take down over 3% of the US grocer market, placing it #6 in terms of national supermarket sales, with nearly one-third of the top seed’s, Kroger (“KR”) market share in just one year! By 1998, the share of retail food purchased at mass merchandisers rose to 8.1%, up from 2.8% a decade prior, while supermarkets’ share had fallen from 65.8% to 60.3% over the same period.⁵ Contrary to the pressures described from on the pricing side, Wal-Mart attacked from the other direction, the cost side. Per estimates in Exhibits 1 and 2, despite WMT’s significant price concessions estimated at roughly 15% versus traditional grocers, its grocer-division gross margins average only 7% below those of grocers, due primarily to efficiencies in collaborative planning, forecasting and replenishment (“CPFR”) and central buying. Additionally, given WMT’s

⁴ Kaufman, Phil, “Grocery Retailers Demonstrate Urge to Merge,” *Food Review*, May/August 2000; pgs 2-3.

⁵ Kaufman, pg 3.

advantages in labor costs, along with scale efficiencies in distribution, occupancy rates, and advertising, WMT has traditionally been able to achieve significantly higher operating margins than its grocer competitors despite meaningfully lower gross margins.

Exhibit 1: How Wal-Mart Prices Low and Keeps Gross Profit Healthy⁶

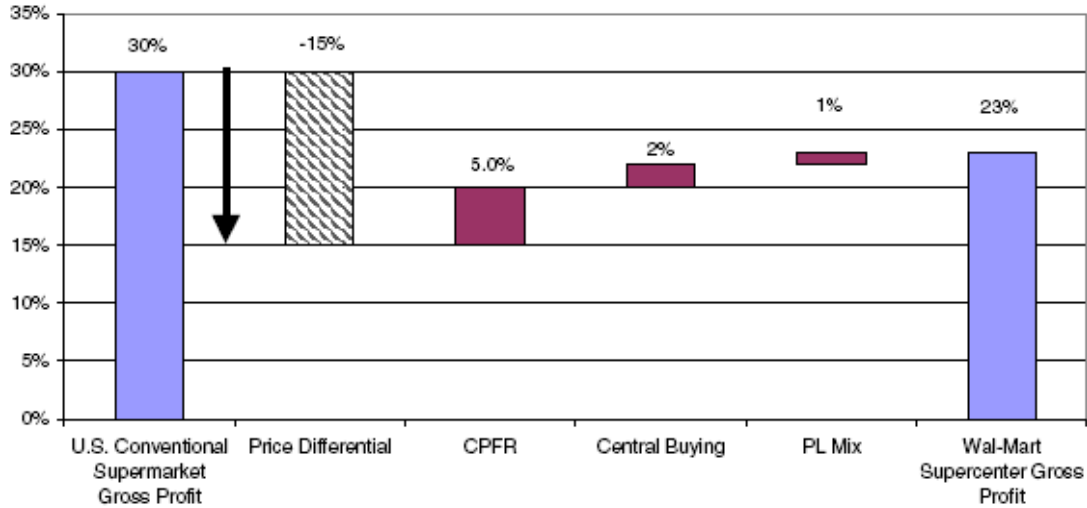


Exhibit 2: How Wal-Mart Converts Low Gross Margins into Higher EBITDA Margins⁷



⁶ Caicco, Perry, "North American Supermarkets 2005: Five Different Grocers, Six Common Issues," CIBC World Markets Equity Research Industry Update, December 14, 2004, pg 8; also A.T. Kearney.

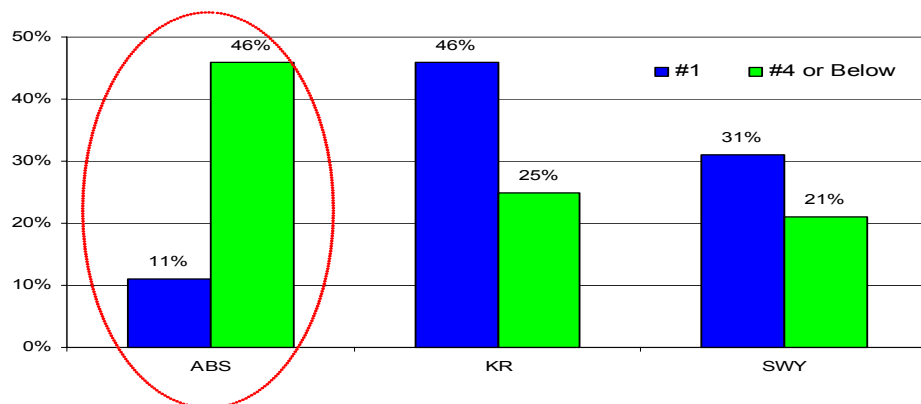
⁷ Caicco, pg 8; also A.T. Kearney.

With these three driving forces, traditional grocers needed to gain scale efficiencies (via procurement, marketing, distribution, etc.) to offset higher costs and pressured prices. And they needed scale fast. Buying up existing stores was not only the quickest means to scale expansion, but was also seen as, for the most part, less financially risky than building new stores. Given the increased size and more expensive design of new supermarkets and super-centers, new stores often required “much higher sales volume to achieve positive profitability...as long as two years [were often] required to develop sufficient sales to achieve profitability, whereas most existing stores had already reached minimum sales requirements.”⁸ Accordingly, the urge to merge quickly became the new driving force within the traditional supermarket industry.

Where did Albertson's Stand?

While Albertson's had followed the regional concentration model with its peers, it lacked the dominant penetration most of its competitors enjoyed. Per Exhibit 3, according to a 1999 report by Metro Market Studies, Albertson's had the number 1 share in only 11% of its markets, and was number 4 or below in 46% of its markets. In contrast, Kroger was number 1 in 46% of its markets, and 4 or below in only 25%; Safeway Inc.'s (“Safeway” or “SWY”) stats were 31% and 21%, respectively.⁹

Exhibit 3: 1999 Market Penetration: % Frequency Supermarket is #1 or #4/Below in Market¹⁰



⁸ Kaufman, pg 5.

⁹ Cartwright, Lisa, ABS: CFO Resigns; Separately, Reducing Estimates,” Salomon Smith Barney equity research report, May 22, 2001, pg 2.

¹⁰ Cartwright, pg 2; Metro Market Studies.

While causality remains debatable, Albertson's lack of market dominance in most regions drove the Company to adopt, primarily during the 1990s, a traditional EDLP (everyday low price) strategy, while both Kroger and Safeway competed on a higher price, promotion-based platform. To address the mass merchandisers, Albertson's frequently expanded stores sizes—with new some stores reaching up to 175,000 square feet—and added peripheral sections (books, cards, beauty care, etc.) to attract one-stop shoppers. However, once Wal-Mart stormed the field in the late 1990s, Albertson's couldn't effectively compete on its EDLP/cost basis strategy with the new 800 pound gorilla, which truly took economies of scale to the next level. ABS initially tried to transition towards a promotion-based competitive strategy, but found itself with minimal experience in the face of both Kroger and Safeway, who were already dominant in the category. Accordingly, **by 1998, Albertson's was truly stuck in the middle between the mass merchandiser market, led by Wal-Mart, and the promotion-based market, mostly locked up by Kroger and Safeway.**¹¹

The Numbers Semi-corroborate the Story

While we noted some of the warning signs of an impending problem above (industry changes, lack of clear strategic plan from management), the financial impact of these trends on Albertson's was not exceedingly concerning in the late 1990s. Near-term and medium term leverage and liquidity measures were very adequate; in fact, the Company had maintained a double-A rating from Moody's throughout the 1990s, until its 1999 acquisition of American Stores and its z-score had been in the 4.0 to 6.0 range through 1999. Payables were not getting squeezed and inventory turns were not problematic. That said, select key financial indicators were sliding: most notably, operating revenue as a percent of sales dropped from 3.6% in 1996 to 2.4% in 1997, down to 2.2% in 1998 and a bottom of 1.1% in 1999. Through mid-1998, the Company was in a relatively early stage of its problems, and we estimate it stood somewhere in between the inaction and faulty action stages of decline. Management had undertaken a handful of small/medium-sized initiatives such as product variety and store refurbishments that were of questionable

¹¹ Cartwright, pg 2.

value, but really had not undertaken any large strategic overhaul or re-engineering steps, faulty or not-faulty, to address its challenges. And while many of these challenges were industry-wide, Albertson's was punished most versus the other larger players given its aforementioned "stuck in the middle" status: from 1997 through 1998, ABS stock gained 20% while both KR and SWY's stock prices nearly doubled (where, arguably, the huge scale of these changes is due to the broader market/economic boom in this period).

A Precursor to Crisis

Seemingly stymied for a solution to the dramatic new challenges in the rapidly changing market environment, in August of 1998, Albertson's, led by CEO Gary Michael, announced the \$11.7 billion acquisition of American Stores. By the end of the year, the combined Albertson's/American Stores entity solidified itself as the #2 player in the US supermarket sector, with 8.9% of the national market, surpassing its next largest competitor by 2.7% (Exhibit 4). On the heels of a truly fundamental strategic change, namely that of nationwide consolidation, the US supermarket industry found itself much more concentrated heading into 1999 with nearly 50% market share in the top 10 players, versus 39% only six years prior.

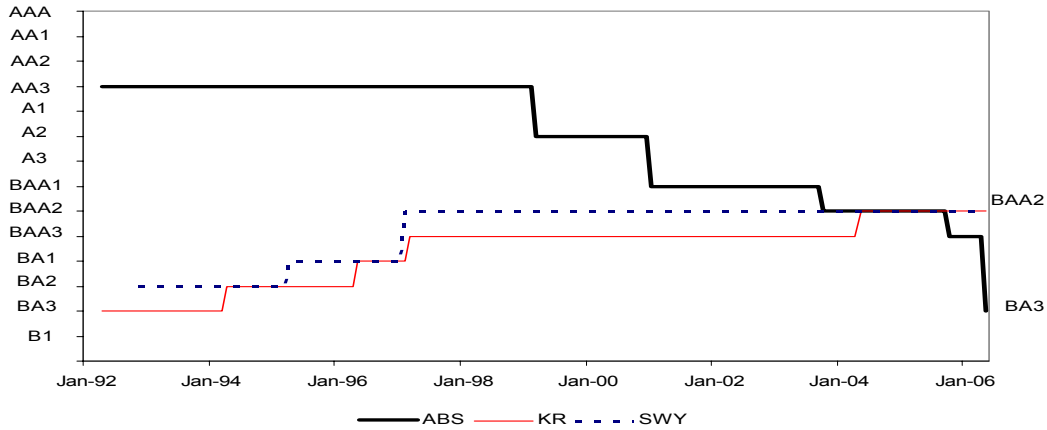
Exhibit 4: Supermarket Market Share Data¹²

Top 10 US Supermarket Chains, 1992				Top 10 US Supermarket Chains, 1998			
Rank	Chain	Sales (\$bn)	Mrkt Share (%)	Rank	Chain	Sales (\$bn)	Mrkt Share (%)
1	Kroger	21.9	7.7	1	Kroger	43.1	10.8
2	American Stores	19.0	6.6	2	Albertson's/American (pro forma)	35.7	8.9
3	Safeway	15.1	5.3	3	Safeway/Vons	25.0	6.2
4	A&P / Tengelman	10.7	3.7	4	AHOLD	23.4	5.8
5	Winn-Dixie	10.3	3.6	5	Winn-Dixie	13.9	3.5
6	Albertson's	10.2	3.6	6	Wal-Mart	12.8	3.2
7	Food Lion	7.1	2.5	7	Publix	12.1	3.0
8	AHOLD	6.3	2.2	8	A&P / Tengelman	10.5	2.6
9	Publix	6.1	2.1	9	Food Lion (Delhaize)	10.2	2.5
10	Vons	5.6	2	10	Meijer	8.6	2.1
		112.3	39.3			195.3	48.6

¹² Cotterill, pgs 14-15.

However, as Exhibit 5 shows via Moody's ratings of the then-top three grocers, this was the starting point of a significant financial deterioration at Albertson's, while both Safeway and Kroger managed to maintain (or even improve, in the latter's case) their ratings.

Exhibit 5: Moody's Senior Unsecured Debt Ratings for ABS, KR, and SWY¹³



Throughout the remainder of this paper, we will address a) what went wrong, starting with the merger with American Stores, at Albertson's, b) the strategies undertaken to address these challenges, c) where the Company stands now, following its pending merger with SUPERVALU et. al, and d) recommendations for Albertson's/SUPERVALU going forward.

¹³ www.moodys.com.

III. The Straw that Broke the Camel's Back: 1999 Acquisition of American Stores

In 1998 and 1999 alone, there were over \$31 billion in supermarket mergers completed. The second largest of these transactions was Albertson's 1999, \$11.7 billion acquisition of American Stores, which pushed Albertson's up from the 6th largest supermarket chain to the 2nd largest, with a combined \$36 billion in sales and 8.9% market share.¹⁴

Strategic Rationale for ASC Acquisition

On June 23, 1999, Albertson's acquisition of American Stores was consummated. ASC, headquartered in Salt Lake City, had 1997 revenues of \$19.1 billion and operated approximately 1,500 stores in 26 states under the names Jewel, Lucky Stores, Acme Markets, Osco Drug, and Sav-On. Gary Michael, chairman of the board and CEO of Albertson's, outlined the strategic rationale for the acquisition in the Company's 1999 Annual Report. The primary rationale behind the move was as follows:¹⁵

- Excellent strategic and geographic fit
 - Allowed Albertson's to serve 4.3 million customer a day in 37 states, including nine of the ten fastest-growing states (grew from 1,000 to 2,500 stores, and 26 to 37 states)
 - Moved into new markets across the country, including major urban markets such as Chicago and Philadelphia
 - Strengthened the Company's position in its current markets, such as California
- Gave customers a wider range of store formats, including a stronger position in drugstores (combined company would operate 1,700 pharmacies, including 750 stand-alone drug stores)
- Shared best practices
- Recognize cost savings of \$100 million in the first full year, \$200 million in the second full year, and an additional \$300 million resulting from the following synergies:

¹⁴ Cotterill.

¹⁵ Albertson's 1999 Annual Report.

- Elimination of duplicate overhead including general office consolidation
- Elimination of systems redundancy, including centralizing administrative functions
- In-market synergies including reduced costs of advertising
- Stronger buying power (reduced cost of goods sold)
- Utilizing ACS's strength in selling general merchandise to enable Albertson's to compete more effectively with mass merchants and other supermarket retailers through better prices and expanded product mix
- Streamlined distribution, particularly in overlapping markets

In addition to the strategic rationale presented above, it was widely believed that the purchase price of \$11.7 billion (8.5x EBITDA), which was funded with \$8.3 billion of equity and \$3.4 billion of debt, was reasonable considering other large supermarket transactions that occurred around the same time, including Kroger's \$12.8 billion acquisition of Fred Meyer (10x EBITDA) and Royal Ahold's \$2.8 billion acquisition of Giant Food (12.2x EBITDA).^{16,17} As a result of the anticipated synergies and "reasonable" purchase price, the merger led many, including most Wall Street equity research analysts, to believe that the potential upside from the acquisition was enormous.

Integration Issues

While the merger between the two large supermarkets had many anticipated benefits, the integration process was fraught with problems, making these benefits difficult to realize. First, Albertson's management may have been in over its head. The management team had no experience with an acquisition of this size and may not have been armed with the manpower to successfully complete the transaction. In addition, ACS likely did not have the right personnel to support Albertson's in this

¹⁶ Cotterill.

¹⁷ Levin, Debra. Morgan Stanley Dean Witter, US Investment Research - Albertson's (ABS), September 18, 1998.

endeavor.¹⁸ The ABS management team needed to make significant operational changes at American Stores which had been struggling recently, including improved execution and investment at the store level, but failed to do so.

Second, assimilating the cultures of the two businesses proved to be a severe hurdle during the integration process. The merger of “strong-willed equals” (particularly at the executive level) quickly transitioned into an “us versus them” culture clash. The two disjointed cultures needed an outside party to bridge them together; however, no outside party was brought into the fold to address this problem.¹⁹ Third, while it was recognized in advance that the systems, controls and logistics utilized by the two companies were different and needed to be integrated, management underestimated how different the systems truly were and how complicated and expensive it would be to convert the stores to a common program. For example, Albertson’s encountered difficulty getting the two companies’ computer systems to connect, making it difficult to track inventory and perform centralized purchasing, two vital tasks necessary to realize the projected merger synergies.²⁰ Lastly, while it was initially anticipated that the Federal Trade Commission would mandate the divestiture of approximately 70 stores to approve of the acquisition, the Company was eventually required to sell over double that number, or a total of 147 stores.²¹

Poor Financial Performance from 1999-2001

The previously discussed integration issues, combined with the other structural issues at Albertson’s, led to poor financial performance following the completion of the acquisition. Included in these structural issues was Albertson’s lack of a competitive pricing strategy (based on its EDLP system)

¹⁸ Bleustein, Bonni. Credit Suisse First Boston, Albertson’s, Inc. Equity Research, August 12, 1998.

¹⁹ Burton, Jonathan. “Bagging Profits,” The Chief Executive, April 2002.

²⁰ Cartwright, Lisa. Salomon Smith Barney, Albertson’s, Inc. Equity Research, May 22, 2001.

²¹ Albertson’s Press Release, June 22, 1999.

and an ineffective promotional strategy, both of which contributed to dwindling sales.²² The Company's poor pricing methodologies led to consistently higher prices than Albertson's nearest competitors, which factored into the declining share in Albertson's major markets. Independent price checks performed by Salomon Smith Barney in Ft. Lauderdale, Las Vegas and Houston indicated that ABS was priced too high by around 3-5% in food.²³ In addition, Albertson's moved its promotional decision making to the local level (as opposed to regional) which resulted in a lack of a clear promotion strategy in many markets due to the limited decision making experience by local managers. These factors combined with the integration issues, not to mention general management distraction with the cultural assimilation, resulted in declining sales and increasing expenses from 1999 to 2001.

In fact, per Exhibit 6, ABS consistently fell short of projected earnings for all three years. By 2000, the Company missed earnings estimates by nearly \$1/share, representing the glaringly painful position the Company was facing. Again, while the Company was not in any liquidity crunch at the time, key ratios like ROA and operating revenue as a percent of sales plummeted to lows in 1999 of 3.8% and 1.1%, respectively (see Exhibit A2 in the Appendix for more information). In the same year, the Company's share price decline erased all of its gains from the previous three years (and more). In fact, Albertson's stock price at the end of 2000 was 20% below its January 1997 level. While Kroger and Safeway both suffered in 2000 too, KR and SWY stock ended 2000 60% and 120% higher than 1997 opening levels (Exhibit 7) – the market was punishing ABS, specifically, for its extreme integration challenges and lack of direction. In tandem, ABS' z-score dropped from 6 in 1999 to just below 4 in 2000. Management had been ineffective at realizing the heralded merger synergies as well as at providing any strategic plan to right the ship. Accordingly, in retrospect, we believe merging with ACS without committing to a full integration moved ABS much closer to the “faulty action” phase, given that the Company simply tried to use sheer size as a solution to increasing industry challenges.

²² Ibid.

²³ Cartwright.

Exhibit 6: Albertson's 1999-2001 Financial Variance Analysis^{24,25}

(\$ in millions, Except EPS)

	1999				2000				2001			
	Actual	Projected	Variance	%	Actual	Projected	Variance	%	Actual	Projected	Variance	%
Sales	\$37,478.0	\$37,384.1	\$93.9	0.25%	\$36,762.0	\$39,150.1	(\$2,388.1)	-6.10%	\$37,931.0	\$42,178.3	(\$4,247.3)	-10.07%
Gross Profit	10,386.0	10,301.2	84.8	0.82%	10,483.0	10,800.2	(317.2)	-2.94%	10,811.0	11,702.8	(891.8)	-7.62%
Operating Income	1,959.0	2,305.3	(346.3)	-15.02%	1,853.0	2,512.9	(659.9)	-26.26%	1,808.0	2,837.7	(1,029.7)	-36.29%
Net Income	972.5	1,142.9	(170.4)	-14.91%	872.3	1,292.8	(420.5)	-32.53%	794.6	1,483.3	(688.7)	-46.43%
EPS	\$2.30	\$2.70	(\$0.40)	-14.81%	\$2.08	\$3.05	(\$0.97)	-31.80%	\$1.95	\$3.50	(\$1.55)	-44.29%

Exhibit 7: Historical Share Performance, last 10 years, Albertson's and Peers²⁶



²⁴ Actual Results – Toomey, Robert. RBC Dain Rauscher, Albertson's, Inc. Equity Research, March 14, 2002.

²⁵ Projected Results – Levin, Morgan Stanley Dean Witter.

²⁶ www.marketwatch.com

IV. The Turnaround, Part I – 2001 to 2005, The Johnston Era

With Wall Street closely following the situation, and unduly unimpressed by the merger, some argued that the Company was “deeply distressed.”²⁷ Amidst the dire financial situation in 2000, Gary Michael, Albertson’s chairman and CEO since 1991, announced that he would retire by June 2001 at the age of 60.²⁸ His last legacy was the January 2001 announcement of a “new” strategy, which included plans to grow sales, lower expenses, and improve return on capital. While much of Albertson’s growth occurred during Michael’s reign, so too did the Company’s less-than-impressive turn-of-the-century position within the industry. As an Albertson’s employee since 1966, Michael was typical of an ABS executive in that he had been promoted from within and likely found it easier to manage according to the status quo as opposed to “shaking things up.” Upon the announcement of Michael’s pending retirement, the Company’s board of directors began an internal and external search for his replacement.

A New Chairman and CEO...and CFO

On April 24, 2001, Albertson’s announced that Lawrence (“Larry”) Johnston, a 30 year General Electric (“GE”) veteran, would replace Michael as the Company’s chairman and CEO effective immediately. Research analysts viewed “this announcement as dramatic” because a) Johnston had no experience in leading retail or supermarket companies and b) Albertson’s had historically promoted from within its own ranks.²⁹ In fact, there was much speculation that Albertson’s COO, Peter Lynch, was the clear choice to replace Michael. Johnston did, however, possess a wealth of general management, turnaround, logistics, supply chain management, merger integration, and consumer focused business management expertise as he most recently served as head of GE’s \$6 billion appliance division. Johnston’s hiring sent a clear message to Wall Street that the board of directors was serious about changing Albertson’s for the better.

²⁷ <http://www.referenceforbusiness.com/biography/F-L/Johnston-Lawrence-R-1949.html>.

²⁸ Albertson’s 2000 Annual Report.

²⁹ Morgan Stanley Dean Witter company update, 4/24/01.

In order to assess Johnston's effectiveness as a leader and, more importantly, as an appropriate manager to lead Albertson's turnaround, it is first necessary to understand his background. Johnston had joined GE as a management trainee in 1972 after earning his undergraduate degree from Stetson University in DeLand, Florida. He moved up within GE, holding a number of marketing and sales positions, as well as being president of GE's international operations in Puerto Rico. In 1989, he was named vice president of sales and distribution for GE Appliances, corporate vice president, and board member, and in 1997 became president and CEO of GE Medical Systems in Europe. Before leaving for Albertson's, Johnston served as president and CEO of GE Appliances and corporate senior vice president.³⁰ While Johnston never managed a business as large as Albertson's, or within the same industry, he followed Jack Welch's management philosophy and deeply wanted to run his own company. Further, he had effectively turned around GE's European medical systems business and integrated 26 acquisitions there, implemented and expanded GE's retail strategy in appliances, and had a "goal to unleash shareholder value" at Albertson's.³¹ Based on his credentials and previous success, Johnston appeared to be up to the challenge of turning around the large supermarket chain; Wall Street agreed as ABS' stock increased 7.5% on the day of the announcement.³²

Less than a month after Johnston joined Albertson's, the Company's CFO, Craig Olson, resigned to pursue other opportunities. Olsen joined Albertson's in 1974 and we speculate that Johnston's style and outsider/change agent status clashed with Olsen's "bred from within" view of the Company and need for change. At the time, research analysts speculated that the Company would have further management shake-ups as Johnston sought to hire executives that could be strong forces in pushing the turnaround forward.³³ In August 2001, Albertson's announced that Felicia Thornton would join the Company as executive vice president and CFO. Thornton had most recently been group vice president of Kroger's

³⁰ GE and <http://www.referenceforbusiness.com/biography/F-L/Johnston-Lawrence-R-1949.html>.

³¹ Morgan Stanley Dean Witter company update, 4/24/01 and Salomon Smith Barney, 4/24/01.

³² ABS stock closed at \$30.95 on 4/24/01, up from \$28.80 the day prior; Yahoo! Finance.

³³ Salomon Smith Barney, 5/22/01.

retail operations and had responsibility for identifying and coordinating best practices across Kroger's retail stores and distribution facilities; she previously held finance and operations roles and was involved in merger integration at Kroger.³⁴ This diverse expertise made her an ideal candidate for Albertson's turnaround as her functional *and industry* experience complemented Johnston's background well.

The First Step

Forty-four days into his job, Johnston announced five new strategic imperatives (the "Imperatives") to address Albertson's problems of a lack of promotional strategy (leading to flat/reduced sales), uncompetitive pricing, and poor market share and, longer term, to achieve its vision of being the best. Further, he discussed the possibility of exiting underperforming stores or even entire markets, but did not unveil a detailed turnaround plan. Importantly (for psychological reasons), he acknowledged that out-going CEO Michael's goals to grow sales, decrease costs, and increase return on capital would serve as the foundation for a turnaround, but refined this foundation into the Imperatives highlighted below:

Exhibit 8: The Imperatives³⁵

Imperative #1	Aggressive cost and process control (trim the fat)
Imperative #2	Maximize return on invested capital (invest in the best)
Imperative #3	Customer-focused approach to growth (customers first)
Imperative #4	Company-wide focus on technology (set the curve)
Imperative #5	Energized associates (energize us)

The Imperatives represented a departure from Albertson's past strategy and highlighted that Johnston would leverage his (and his CFO's) expertise in controlling costs, reengineering processes, and utilizing technology. Johnston's Imperatives were to be the "guideposts" for the Company's restructuring going forward. Specifically, they had the following intended purposes:

³⁴ Salomon Smith Barney, 8/7/01.

³⁵ Discussion of the imperatives is from Albertson's website and various equity research reports primarily from Salomon Smith Barney and Morgan Stanley Dean Witter.

- #1. Albertson's cost structure was too high versus its peers. In order to lower it, management would focus on monitoring and analyzing every expense item. Further, Johnston announced that a store review was underway in order to develop a plan to standardize and implement best practices.
- #2. Johnston committed to reviewing Albertson's assets and closing and/or selling those (whether a store, distribution center, entire market, or particular format) that were underperforming (e.g., ones that didn't cover their cost of capital). Additionally, going forward, capital expenditures would be allocated only to projects that achieved an acceptable return on capital, thus making the capital allocation process much more rigorous.
- #3. Put simply, Albertson's would focus its growth efforts and investments in those markets where it could most significantly impact customers and, in turn, customers could help it grow.
- #4. Johnston's past experience with supply chain and logistics management was clearly behind Johnston's goal to utilize technology to optimize businesses processes. This was particularly important given the integration problems across Albertson's and American Stores' different systems and technologies.
- #5. As was the case at GE, Johnston saw Albertson's employees as its most important resource and would develop a program to reward and recognize them for superb work.

Johnston's quick comments and willingness to make tough decisions quickly cemented his role as a turnaround leader. And while his Imperatives were not meant to serve as a specific restructuring roadmap, Johnston should have used this opportunity to address a few other key issues in his first public comments about Albertson's turnaround. In particular, Johnston should have created a special task force that would be responsible for quickly addressing and correcting the problems associated with the integration of American Stores. Additionally, he would have benefited by adding a sixth imperative to address Albertson's response/view about the current competitive landscape, notably how the Wal-Mart Effect was changing the supermarket business and where, exactly, Albertson's saw its

strategic/competitive advantage in comparison to WMT as well as other grocers—Kroger and Safeway in particular.

Moving Forward

After the June 2001 announcement of the Imperatives, Johnston moved quickly to take actions to improve Albertson's business. Throughout the remainder of 2001, he executed strategies (clearly guided by the Imperatives) to reduce overhead and streamline processes (Imperative #1), close stores (Imperative #2), and reinvest savings from these actions in stronger markets (Imperative #3). Specifically, the Company reduced corporate overhead by eliminating 15% to 20% of its managerial and administrative jobs above the store level and reduced the number of operating divisions from 19 to 15 *immediately*. Albertson's closed 165 underperforming stores (6% of total stores), which previously accounted for \$1.4 billion in annual sales. In total, the Company targeted to reduce annual expenses by \$250 million (2.75% of 2002 SG&A expense) with these and future actions, but took a nonrecurring charge of \$550 million (\$470 million non-cash) to cover the restructuring.³⁶ In line with Imperative #3, savings from these reductions were to be plowed back into strong stores in strong markets.³⁷ In addition to this announcement, Albertson's also began lowering prices within its stores to more competitive levels.

In September 2001, the Company hosted an analyst meeting that provided Wall Street with its first face-to-face meeting with Johnston and his lieutenants. Exhibit 9 provides a summary and analysis of Johnston's comments/strategies as they pertain to the Company's turnaround by using three broad headings for his initiatives.

³⁶ These layoffs were expected to save \$100 million on an annual basis.

³⁷ Salomon Smith Barney, 7/18/01 and Morgan Stanley Dean Witter, 7/19/01.

Exhibit 9: Restructuring Strategies Update, September 2001³⁸

Increase sales	Reduce costs	Increase return on capital
<ul style="list-style-type: none"> - Institute employee rewards - Customer loyalty card rollout - Expand food/drug store combo - Emphasize private label - Emphasize “focus on fresh” - New marketing strategies - Expanded merchandising - “Sharper” pricing - Realign distribution centers 	<ul style="list-style-type: none"> - “Swift” program - Re-engineer processes and roll-out system-wide - Focus on accountability and best practices - Reduce energy consumption 	<ul style="list-style-type: none"> - Increase returns on new stores by: <ul style="list-style-type: none"> - Good locations - Appropriate level of investment - Correct merchandising mix

We commend Johnston for his ability to deliver specific goals and measures quickly, and applaud him for indirectly addressing at least some of the structural issues that were weighing on the Company. For example, his push for private labels was most likely aimed at mitigating the growing power of food manufacturers, while his “focus on fresh” initiative was arguably aimed at lessening the impact of the “food away from home” category growth. Nevertheless, we still see minimal high level, strategic repositioning of the Company in these initiatives. While he argues for a re-engineering on the cost side, given the structural overhaul of the industry at this point in time, the re-engineering should have been at a much more macro level, truly re-addressing the question as to Albertson’s strategic and competitive role within the supermarket industry.

Despite the economic impact of the September 11th attacks and an increasingly difficult competitive environment, Johnston ended 2001 on a strong note and continued to execute his strategy in 2002. Albertson’s announced its intent to sell 80 stand-alone Osco pharmacies to Canadian drug store operator, Jean Coutu, in December. The \$240 million purchase price provided the Company with cash to appropriately plow back into its operations and, more importantly, signaled Albertson’s willingness to exit markets where they were not capable of commanding a strong market share (the Osco’s were largely

³⁸ Adapted from Salomon Smith Barney, 9/05/01.

profitable, but not market leaders).³⁹ In early 2002, Albertson's indicated it would exit six underperforming markets (Missouri, Miami, Houston, San Antonio, Nashville, and Memphis), sell its Tulsa distribution center, and close its Houston distribution center. Johnston began heralding that phase one of Albertson's restructuring was progressing well with 80 of 165 targeted locations already closed and that the market exits and closures represented the start of phase two of the turnaround. Johnston believed that the Company was now stabilized, somewhat healthier, and slightly smaller.⁴⁰

A Stalled Effort?

In May 2002, *Barron's* touted that "since Lawrence Johnston became Chief Executive Officer of Albertson's, the supermarket chain has *completed a restructuring*, boosted cash from operations 17%, paid down \$600 million in debt...and seen its stock-market value climb 20%."⁴¹ We disagree with *Barron's* assessment of the turnaround, however, as Albertson's still had to execute on its restructuring plan amidst a difficult economic and competitive environment. In fact, the Company's stock price had retreated from a 52-week high of over \$35 to \$21 by December 2002.⁴² Simply put, Albertson's was not increasing revenues (primarily through pricing initiatives) or profits quickly enough to meet Wall Street's expectations. Johnston noted that "we are pleased with the respectable performance the Albertson's team turned in during a year of major restructuring and economic uncertainty."⁴³ The numbers for Albertson's in 2003 (represented by the "2004" column due to February fiscal year end) in Exhibit 10 highlight the impact of Johnston's restructuring efforts through 2003, but clearly show that the Company was not performing as well as a fully restructured entity, as sales remained flat in 2004 and Gross and EBIT Margins fell to 28.6% and 3.7%, respectively. It is important to note, however, that the decline in sales was due, in part, to store closures and that margin compression was due to both the incompleteness of the

³⁹ Salomon Smith Barney, 12/7/01.

⁴⁰ Salomon Smith Barney, 3/20/02.

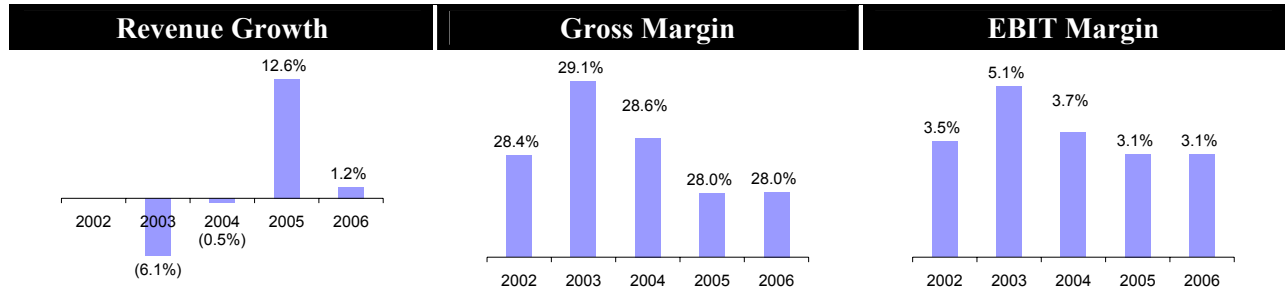
⁴¹ "Grocer on a Diet: Albertson's sheds stores and plumps up its prospects." *Barron's*. 5/6/02.

⁴² "Views Split On Albertson Progress." *Dow Jones News Service*. 12/19/02

⁴³ "Rosy Future is Predicted." *Chain Drug Review*. 9/15/03.

Company's turnaround as well as the continued growth and power of Wal-Mart as a dominate player in the supermarket industry.

Exhibit 10: Financial Performance⁴⁴



Note: years represent fiscal years ended February 20XX.

Albertson's was clearly making progress on its five Imperatives by focusing on the customer and investing in positive NPV projects, but the progress failed to translate into improved financial performance because of its high cost structure and broader competitive and economic environments. This caused Craig Dean, principal and managing director at turnaround firm AEG Partners, to say that these forces "will likely lead to consolidation in the [supermarket] industry...or possibly even bankruptcy" for Albertson's or its peers.⁴⁵ While revenues increased 12.6% for the year ended February 2005, Albertson's Gross and EBIT Margins declined further and in 2006, all measures were virtually flat compared to the prior year. In September 2005, Albertson's announced that they would explore strategic alternatives for the business, including a possible sale, but would continue to aggressively execute its five Imperatives and turnaround strategy.⁴⁶

Our Evaluation of the Turnaround...So Far

In the four and a half years since becoming Albertson's CEO, Johnston had swiftly sized up the grocer's situation, implemented a multi-tiered turnaround plan, and executed on each of the five Imperatives he outlined. He used tools such as layoffs, closures, and divestitures to cut costs and he

⁴⁴ Albertson's.

⁴⁵ "Restructuring Specialist Sees Trouble for Grocers." *Corporate Financing Week*. 9/3/04.

⁴⁶ "Albertson's Announces Second Quarter 2005 Results." *PR Newswire*. 9/7/05.

improved the Company's pricing behavior. Additionally, Johnston reinvested savings in the areas that could best drive profitable growth, including through innovative stores that provided better shopping experiences for customers. On a side note, Peter Lynch, Albertson's COO, was hired by grocer Winn-Dixie in December 2004 as president and CEO to oversee a turnaround at that Southeastern US supermarket chain – Johnston had also helped Lynch become a turnaround manager in his own right!⁴⁷

Despite Albertson's progress, the Company failed to generate impressive sales growth, margins, and other financial metrics. Rather than poor execution, we believe that much of the underperformance was due to fierce competition within the supermarket industry. In addition to adding a sixth Imperative to Johnston's plan to address Wal-Mart and Albertson's other competitors as well as a merger integration task force, we would suggest several other strategies to Johnston.

- Albertson's should have made deeper cuts in terms of closing or selling its marginal stores and other assets. While it is difficult for an executive to embrace a large-scale "shrink-to-grow" strategy, Albertson's would still have achieved significant economies of scale (in purchasing, distribution, etc.) by exiting a second tier of markets where they weren't a leader.
- The Company should have considered pursuing a full "re-engineering" process. While the turnaround plan was focused on the customer, Johnston attempted to slowly morph the Company from a depressed behemoth into a fiercer, more profitable competitor. By re-engineering, he should have started with a clean sheet of paper and determined how Albertson's could best serve its customers. Additionally, this would have provided ABS with an updated, high level strategy detailing its competitive advantages, strategic fit and vision within the industry, as well as key performance metrics (e.g. maybe total market share isn't that important, but urban market share is).
- Albertson's could have used market research and consumer insights to better position the Company's stores for their target consumers. Although Johnston highlights Imperative #3 as "Customer First," we were unable to find data indicating that Albertson's explicitly went to its customers with a goal of

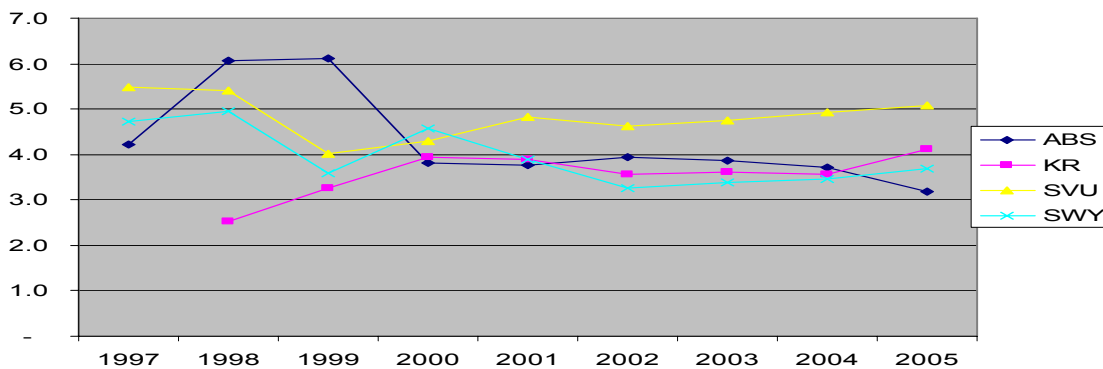
⁴⁷ "Winn-Dixie Names Peter L. Lynch As New CEO." *Dow Jones News Service*. 12/10/04.

determining their primary wants and needs. Accordingly, we believe that management assumed they knew what their customers wanted, when in fact they did not.

- The Company should have been focused on tirelessly communicating more financial metrics that Wall Street uses to evaluate firms. Based on our financial analysis of Albertson's from the fiscal year ended February 2002 (includes 10 months of performance with Johnston at the helm) until the fiscal year ended February 2006, some of the Company's financial metrics improved while others (not just slow sales growth and margin deterioration) worsened. Positively, we believe that working capital management was effective, as demonstrated by the fact that inventory turnover increased from 8.0x to 9.4x per year. Negatively, however, return on assets declined from 4.3% to 3.5% and operating margins dropped to 1.1%, both 10-year lows; and the ratio of current assets to current liabilities declined slightly from 1.3 to 1.1. By touting more of its successes (and rationalizing the failures), Johnston may have been able to divert Wall Street's attention partially away from weak sales growth and lackluster margins.

So, at the end of the third calendar quarter of 2005, Albertson's had not completed its turnaround, but was by not in danger of declaring bankruptcy. That said, the Company's z-score was lingering near 3, its lowest level in over 10 years and still below the scores of its major competitors (Exhibit 11). The Company's "exploration of strategic alternatives" would be the next phase of the turnaround.

Exhibit 11: Z-Score Analysis of Albertson's and Peers⁴⁸



⁴⁸ Company 10-Ks, Morningstar.

V. The Turnaround, Part II – Pending Sale to SUPERVALU

On September 2, 2005, Albertson's announced that it had hired Goldman Sachs & Co. and The Blackstone Group to help it explore strategic alternatives. With the release of this announcement, Albertson's shares jumped 23% on expectations that it was positioning itself for sale and would be bought quickly. Within weeks, three financial buyers – consortiums led by Kohlberg Kravis Roberts & Co., Thomas H. Lee Partners, and Cerberus Group – had formed, but no strategic buyers had shown great interest. Speculation that the sale was turning into a private equity play grew on the belief that an acquisition by competitors such as Kroger and Safeway would not be approved by regulatory/anti-trust authorities. There were, however, rumors of interest in competitors buying pieces of Albertson's after an LBO was completed.⁴⁹ Also, Albertson's owned 60% of its retail space – some in prime locations – and many analysts believed that a successful financial buyer would aim to sell unprofitable stores and operate a smaller number of profitable assets rather than keep Albertson's in its current state; this could be something similar to Eddie Lampert's strategy around the Sears/K-Mart combination and subsequent asset sales.

Strategic Buyer Interest

On October 21st, Kroger (as part of a consortium) placed a bid for Albertson's, much to the chagrin of several financial bidders. The entry of the #1 food retailer in the country significantly raised the prospects of a higher sale price for Albertson's due to the synergistic opportunities that a Kroger-Albertson's merger could provide and that the financial bidders lacked. In early December, another strategic consortium, led by SUPERVALU and Cerberus, placed a bid for Albertson's that looked very promising and would double the size of SUPERVALU. After negotiations that lasted through the beginning of 2006, Albertson's finally accepted a \$9.7 billion offer (approximately 7x EBITDA) from SUPERVALU and Cerberus on January 23. As part of the deal, SUPERVALU will purchase 1,124 of Albertson's more successful food stores, CVS will acquire nearly 700 freestanding (Osco & Sav-On)

⁴⁹ "Albertson's Auction in Flux" by Vipal Monga in TheDeal.com, September 26, 2005.

drugstores, and Cerberus will purchase 655 of the remaining properties. Cerberus will operate those profitable properties and close and sell the remaining ones, thus unlocking value held in the properties' owned real estate.

SUPERVALU's Plan for Creating Sustainable Success

SUPERVALU, based in Eden Prairie, Minnesota has its roots in food distribution but has acquired regional retail grocery stores under names such as Cub Foods, Biggs, and Farm Fresh over the past 25 years. On March 14, 2006, SUPERVALU's chairman and CEO, Jeff Noddle, briefed the investment community on the planned acquisition of Albertson's and the reasons why the purchase made sense for all involved.⁵⁰ Within his presentation, Noddle detailed three strengths of the new SUPERVALU that will help it create sustainable success: 1) scale & diversity of retail formats, 2) strong supply chain backbone, and 3) empowered people.

SUPERVALU is confident that its scale and diversity of retail formats will allow it to capitalize on serving diverse customer needs from price-conscious "extreme value" customers to traditional shoppers who are accustomed to full services (bakeries, florists, etc.), and even to higher-end customers looking for gourmet or organic options in their food stores. To achieve this goal, SUPERVALU is aiming to invest over \$1 billion (3% of retail revenues) to remodel and enhance stores in strong and growing markets. SUPERVALU aims to effectively use these funds to properly segment and target the many different kinds of customers (even in the same geographic area) with a specific store and design from its varied mix of stores and formats.

SUPERVALU also believes that its strong supply chain backbone will increase current distribution strength and profitability. In fact, SUPERVALU began in 1926 in dry goods distribution and

⁵⁰ SUPERVALU meeting with the investment community, 14-17 March 2006.

distribution activities continue to generate approximately 50% of SVU's revenues.⁵¹ It wasn't until 1980 that SUPERVALU ventured into retail store management with the purchase of Cub Foods in the Minneapolis area. SUPERVALU hopes to achieve operational efficiencies by fully integrating its existing distribution network into the newly acquired stores and using the most advanced technology to order, process and deliver goods to over 2,500 locations in 48 states. SUPERVALU has also built up robust expertise and technology in regards to perishable logistics, supplying a large portion of groceries for the Target Corporation; SVU expects distribution revenues of nearly \$9 billion in 2006.

Lastly, SUPERVALU believes that its strong, localized management will be instrumental to the merger's success. Rather than dictating store composition from corporate merchandisers, SUPERVALU allows local managers to order and sell the right combination of goods that are optimal and desired for each area. This strategy differs from that of Albertson's in that Albertson's decentralized its entire operations and ran its different brands as separate companies. SUPERVALU, on the other hand, will consolidate distribution and back office operations while allowing regional managers to make decisions with decentralized store operations and sales.

Realizing Synergies

The combined Albertson's-SUPERVALU aims to achieve \$150 to \$175 million in synergies over the next three years in three distinct areas.⁵² Retail leverage and efficiencies will account for 50% of expected synergies by gaining more buyer power with suppliers and realizing operational efficiencies of 2,500 stores nationwide. Corporate synergies of \$50 to \$60 million are also expected with the integration of corporate administration in Eden Prairie, MN, elimination of redundant activities and reduced marketing/advertising costs. Lastly, SUPERVALU plans to add the newly acquired stores into their massive distribution system which is projected to produce \$25 to \$30 million in annual cost savings.

⁵¹ SUPERVALU Annual Report, 2005.

⁵² SUPERVALU meeting with the investment community, 14-17 March 2006.

SUPERVALU is also expecting its EBITDA Margins to increase from 4.8% to 6.2% initially, then to 6.5% once synergies are fully realized. This initial boost is primarily due to the lower margins currently achieved in its distribution operations, which will become less than 20% of revenues after the acquisition. Lastly, SUPERVALU preached to analysts that SVU is committed to a 15% ROIC after the acquisition of Albertson's.

VI. What's Next/Advice for SUPERVALU

Under the leadership of Larry Johnston, Albertson's clearly began a significant turnaround in 2001 amidst a strongly competitive industry environment and after only modestly integrating its American Stores acquisition. What is more, the Company made strides to execute components of its turnaround plan and become a fiercer competitor against the likes of Wal-Mart, Kroger, and Safeway. It is important to note, however, that Albertson's did not fully achieve the goals of its turnaround and, as such, that SUPERVALU is purchasing an entity that may not have fully addressed the issues that prompted Albertson's turnaround in the first place.

Based on our research of the supermarket industry, its major participants, Albertson's, and SUPERVALU, we have identified a number of concerns and strategies that SUPERVALU should be aware of when it officially acquires Albertson's and begins the integration process. The remainder of this paper highlights a number of these issues.

Lack of strategic rationale/direction. We are concerned that SVU may be committing the same error that ABS did with its purchase of American stores. Specifically, SUPERVALU may be too focused on achieving scale and size without articulating or developing a real strategic direction supporting a much larger organization. In our opinion, it appears as though SUPERVALU may be trying to mimic WMT's supply chain efficiencies while indirectly competing with the massive discounter in areas where WMT is not concentrated. Clearly, SUPERVALU will not be able to compete with Wal-Mart's prowess in operating its supply chain due to Wal-Mart's significant size advantage and years of experience in executing and improving upon its strategies. Further, the synergies SUPERVALU articulated seem quite low and SVU must determine its critical success factors beyond basic merger-related cost-efficiencies in order to create longer term, higher value to make the merger worthwhile.

Lack of clear competitive advantage. With its current portfolio (including the acquisition of Albertson's), SUPERVALU is trying to be all things to all people by offering a full range of store types/formats, from high-end, niche gourmet to fairly value-conscious. In order to be successful in the long term, however, we believe SVU must focus on differentiating itself from its competitors. For example, since Albertson's still has fairly high average prices (notably in urban areas where Wal-Mart has a minimal presence), SUPERVALU could concentrate on "high-end" and/or urban shoppers and seek to create incremental value worthy of the company's comparatively higher prices (e.g., through a superior shopping experience or superior product selection/quality). In following this strategy, SUPERVALU would achieve two important goals: 1) differentiation vis-à-vis Wal-Mart and 2) more competitive costs and offerings as compared to Kroger and Safeway by executing on potential supply chain synergies and the new SUPERVALU's scale and breadth.

Competing with its customers. SUPERVALU's acquisition of Albertson's makes SUPERVALU a large, formidable competitor to one of SUPERVALU's largest distribution customers, Target. It is not clear whether Target considers SVU to be a viable-enough threat yet, but SVU could see much of its distribution revenue dry-up as it becomes more and more competitive with its distribution customers in the retail channel. One benefit of pursuing the previously-discussed high-end/urban strategy is that SVU won't be as direct of a competitor to Target (due to Target's focus in suburban areas), so ideally, this strategy will not hamper SUPERVALU's distribution revenues as much as if SVU were to continue executing its "everything to everybody" strategy.

Geographic positioning. To SUPERVALU's credit, it has heretofore built a geographic foot print that avoids areas in which Wal-Mart has especially strong presences (e.g., rural areas). What is troubling, however, is whether or not this is a sustainable strategy. With combined pro forma revenues of \$44 billion, SUPERVALU will soon compete more directly with Wal-Mart as both firms will have to enter each others' strongholds in order to achieve long-term growth. To reiterate one plausible strategy,

SUPERVALU should strongly consider more deeply penetrating urban areas where it can build a more sustainable competitive advantage.

Financial performance. Exhibit 12 highlights EBITDA margins for the most recent fiscal year and clearly shows Albertson's EBITDA margins below the expectations of SUPERVALU. We are concerned that SUPERVALU may find it much more difficult to realize increased margins and operational efficiencies – many of the same problems that Albertson's faced when it purchased American Stores.

Exhibit 12: Key Financial Metrics Comparison, Albertson's and Peers⁵³

	Albertson's	SUPERVALU	Kroger	Safeway
Latest FY EPS	\$1.24	\$2.26	\$1.31	\$1.40
Market Capitalization	\$9.4 bn	\$3.9 bn	\$14.2 bn	\$11.0 bn
Number of Employees	234,000	50,000	290,000	201,000
Number of Stores	2,471	1,381	3,636	1,800
Revenue	\$40,358 mil	\$19,864 mil	\$60,553 mil	38,416
Latest FY Oper Margin	5.9%	4.6%	5.4%	5.9%
Latest FY Net Income	\$462 mil	\$322 mil	\$958 mil	629.1mil

In conclusion, the new SUPERVALU must fully evaluate and plan its strategy in order to transform itself into a supermarket powerhouse that can successfully occupy a niche that is protected from Wal-Mart's low price strategy and better able compete with higher end grocers like Kroger and Safeway. In acquiring Albertson's, SUPERVALU is getting a company that has undergone a partial transformation over the last five years, but one that may still be searching for a sustainable competitive advantage. In other words, size and scale don't conquer all.

⁵³ www.valueline.com

Appendix

Exhibit A1: Z-Score Analysis of Albertson's and Peers⁵⁴

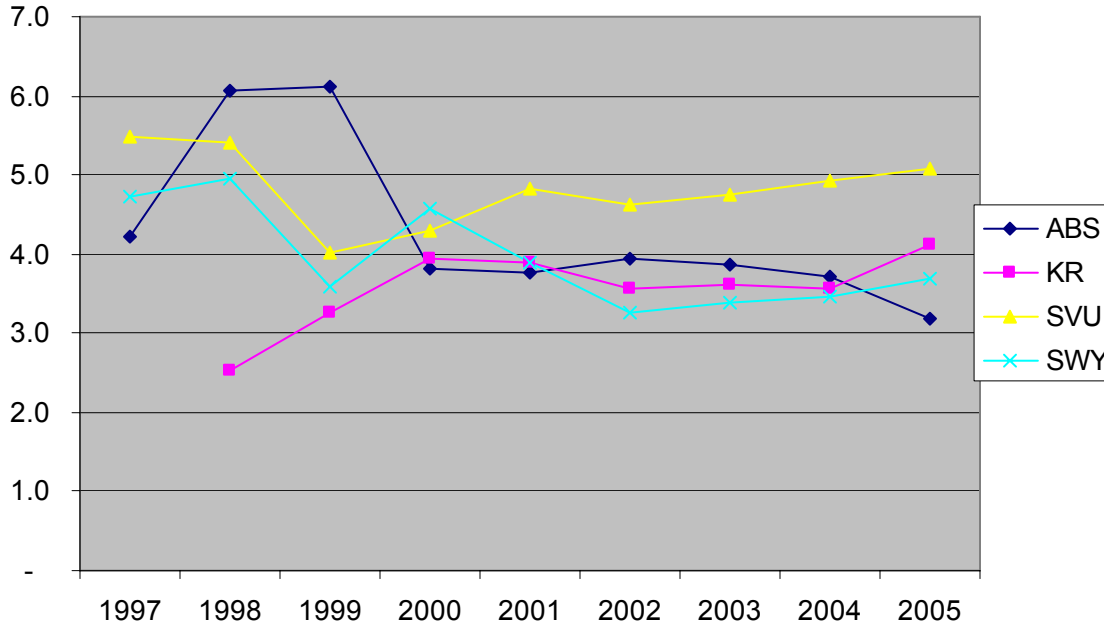


Exhibit A2: Select Albertson's Financial Ratios, Past 10 Years⁵⁵

	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996
Current Ratio	1.12	1.05	1.19	1.24	1.29	1.28	1.13	1.26	1.28	1.40
Total Asset Turnover	2.23	2.34	2.27	2.28	2.28	2.23	2.43	3.53	6.81	-
LT Debt/Equity	1.10	1.23	0.89	1.01	0.90	1.04	0.88	0.92	0.47	0.47
Sales Growth	1%	13%	-1%	-3%	3%	-5%	4%	6%	NM	NM
SG&A % Sales	25%	25%	25%	24%	24%	24%	23%	22%	22%	20%
Operating Rev / Sales	1.1%	1.2%	1.6%	2.4%	1.4%	2.1%	1.1%	2.2%	2.4%	3.6%
Return on Assets	3.5%	3.6%	4.6%	4.1%	4.3%	5.8%	3.8%	9.2%	18.5%	11.0%

⁵⁴ Company 10-Ks, Morningstar

⁵⁵ Calculations from Albertson's 10-Ks.

Exhibit A3: Key Financial Ratio Comparison, Albertson's and Peers, FY05⁵⁶

Profitability	Albertson's	SUPERVALU	Kroger	Safeway	Industry (*)
Gross Profit Margin	30.90%	16.44%	24.75%	31.35%	16.73%
Pre-Tax Profit Margin	1.77%	2.28%	2.52%	2.25%	3.50%
Net Profit Margin	1.11%	1.04%	1.58%	1.48%	2.45%
Return on Equity	7.80%	7.80%	21.80%	11.30%	26.60%
Return on Assets	2.50%	3.20%	4.70%	3.70%	8.90%
Return on Invested Capital	3.70%	5.00%	8.70%	5.10%	15.60%

Valuation	Albertson's	SUPERVALU	Kroger	Safeway	Industry (*)
Price/Sales Ratio	0.23	0.2	0.24	0.29	0.38
Price/Earnings Ratio	20.93	19.84	15.42	19.44	16.43
Price/Book Ratio	1.65	1.49	3.35	2.22	4.1
Price/Cash Flow Ratio	5.88	6.55	6.63	7.36	10.66

Operations	Albertson's	SUPERVALU	Kroger	Safeway	Industry (*)
Days of Sales Outstanding	6.45	8.35	4.08	2.97	17.92
Inventory Turnover	9.1	13.2	10.3	9.9	16
Days COGS in Inventory	40	27	35	36	22
Asset Turnover	2.2	3.1	3	2.5	3.7
Net Receivables Turnover	57.7	45.5	80	120.3	21
Effective Tax Rate	35.30%	35.30%	37.20%	34.10%	37.70%

Financial	Albertson's	SUPERVALU	Kroger	Safeway	Industry (*)
Current Ratio	1.12	1.33	0.96	1.04	1.38
Quick Ratio	0.3	0.6	0.2	0.1	0.7
Leverage Ratio	3.13	2.44	4.67	3.06	2.98
Total Debt/Equity	1.11	0.61	1.65	1.27	0.8
Interest Coverage	2.3	5	4	3.1	8.8

(*)Industry: Grocery retail

⁵⁶ Hoovers

Exhibit A4: Albertson's Summarized Financial Statements⁵⁷*Balance Sheet*

(\$ mil)

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Cash and Equiv	406	273	561	162	61	57	245	116	108	91
Accts Receivable	723	675	625	647	696	547	581	612	121	98
Inventory	3,036	3,119	3,035	2,973	3,196	3,364	3,481	3,249	1,309	1,201
Other Current Assets	190	228	412	486	670	374	284	231	90	86
Total Current Assets	4,355	4,295	4,633	4,268	4,623	4,342	4,591	4,208	1,628	1,476
Net PP&E	9,903	10,472	9,146	9,029	9,282	9,558	8,911	8,545	3,383	3,055
Intangibles	3,148	3,190	1,562	1,649	1,703	1,727	1,761	1,738	0	0
Other Long-Term Assets	465	354	325	265	373	451	456	640	207	184
Total Assets	17,871	18,311	15,666	15,211	15,981	16,078	15,719	15,131	5,219	4,715
Accts Payable	2,203	2,250	2,045	1,984	2,077	2,163	2,176	2,185	743	682
Short-Term Debt	51	238	14	14	14	82	639	68	96	9
Accrued Liabilities	743	739	659	599	584	702	809	219	268	217
Other Short-Term Liabilities	883	858	1,185	851	921	448	445	879	168	147
Total Current Liabilities	3,880	4,085	3,903	3,448	3,596	3,395	4,069	3,351	1,276	1,055
Long-Term Debt	6,278	6,649	4,804	5,257	5,336	5,942	4,990	5,107	1,131	1,052
Other Long-Term Liabilities	2,006	2,156	1,578	1,309	1,134	1,047	958	1,151	393	361
Total Liabilities	12,164	12,890	10,285	10,014	10,066	10,384	10,017	9,609	2,799	2,468
Total Equity	5,707	5,421	5,381	5,197	5,915	5,694	5,702	5,522	2,419	2,247
Total Liabilities & Equity	17,871	18,311	15,666	15,211	15,981	16,078	15,719	15,131	5,219	4,715

⁵⁷ Disclosure Inc.; Note: fiscal years end in January.

Income Statement

(\$ mil)

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Revenue	40,358	39,810	35,107	35,626	36,605	35,501	37,478	35,872	33,828	13,777
COGS	29,038	28,648	25,061	25,242	26,179	25,409	27,164	26,156	24,821	10,211
Gross Profit	11,320	11,162	10,046	10,384	10,426	10,092	10,314	9,716	9,007	3,565
	28.0%	28.0%	28.6%	29.1%	28.5%	28.4%	27.5%	27.1%	26.6%	25.9%
SG&A	10,082	9,936	8,738	8,596	8,691	8,444	8,641	7,846	7,330	2,716
Operating Income	1,238	1,226	1,308	1,788	1,735	1,648	1,673	1,870	1,677	850
	3.1%	3.1%	3.7%	5.0%	4.7%	4.6%	4.5%	5.2%	5.0%	6.2%
Non-operating Income	5	1	7	13	(447)	(27)	(421)	(195)	(33)	10
Interest expense	529	499	409	396	425	378	353	337	294	65
Earnings Before Taxes	714	728	906	1,405	863	1,243	899	1,338	1,350	795
Income Taxes	252	254	350	540	367	497	472	537	553	301
Earnings After Taxes	462	474	556	865	496	746	427	801	797	494
Extraordinary Items & Discontinued Operations	(16)	(30)	0	(380)	5	19	(23)	0	0	0
Net Income	446	444	556	485	501	765	404	801	797	494
EBITDA	2,390	2,327	2,277	2,754	2,761	2,649	2,584	2,673	2,475	1,144
	5.9%	5.8%	6.5%	7.7%	7.5%	7.5%	6.9%	7.5%	7.3%	8.3%