

## Grocery Channel: Premium is the New Mass Market

The playbook for growth within the food industry has always been to identify and capitalize on favorable consumer trends. It requires a surgical approach to weave through the nuances in each category or channel to find the emerging "gold-rush." We see examples of this time and time again. Yogurt is flat, but Greek yogurt is booming. Bakery has slow growth, but gluten free continues to explode. Now we are observing a similar phenomenon in the grocery channel. Although grocery is flat overall, the "premium grocery" channel is expanding approximately 15% per year, with strong growth expected to continue.

Playing to the top end of the hour-glass economy, premium retailers like Whole Foods, Natural Grocers, Sprouts and The Fresh Market are providing a unique shopping experience that consumers love. Grocery shopping in these establishments is not a check-the-box chore, it's an experience. Between the live piano players, wine tasting areas, sushi bars, grilling stations and espresso bars – it feels more like a stroll through a cruise ship than a grocery store. Not to mention you can pick up your favorite organic produce, grass-fed beef or GMO-free packaged goods while you're at it. And some of them carry the mainstream brands you love but you thought you could only find in a traditional grocery store.

To be clear, there is no formal definition of "the premium grocery channel." It's not a food, drug, mass merchandiser and convenience stores (FDMC) channel that can be pulled from

Nielsen or IRI (Information Resources, Inc.). But it is a very real segment that is worth tracking (see Figure 1). We have gathered publicly available data from four premium grocery retailers that, in aggregate, have grown at 14% and 16% annually in terms of store counts and revenue, respectively, since 2009 (Whole Foods, Natural Grocers, Sprouts, and The Fresh Market). To be sure, the four retailers cited in Figure 1 are all dwarfed in size compared to industry behemoths like Walmart or Kroger – but a \$20B retail segment growing at 15% per annum is nothing to ignore.

So this must be a flash in the pan, right? Premium grocers beg to differ. They have announced expansion plans to add around 400 to 1,000 outlets...each! (See Figure 2). To put this into perspective, 68 of the top 75 grocers in the U.S. have fewer than 1,000 outlets, according to *2014 What's in Store*. While we believe some of these growth projections may be a bit lofty (and often don't have a time frame associated with them), Sprout's management recently asserted that their growth estimates were conservative.

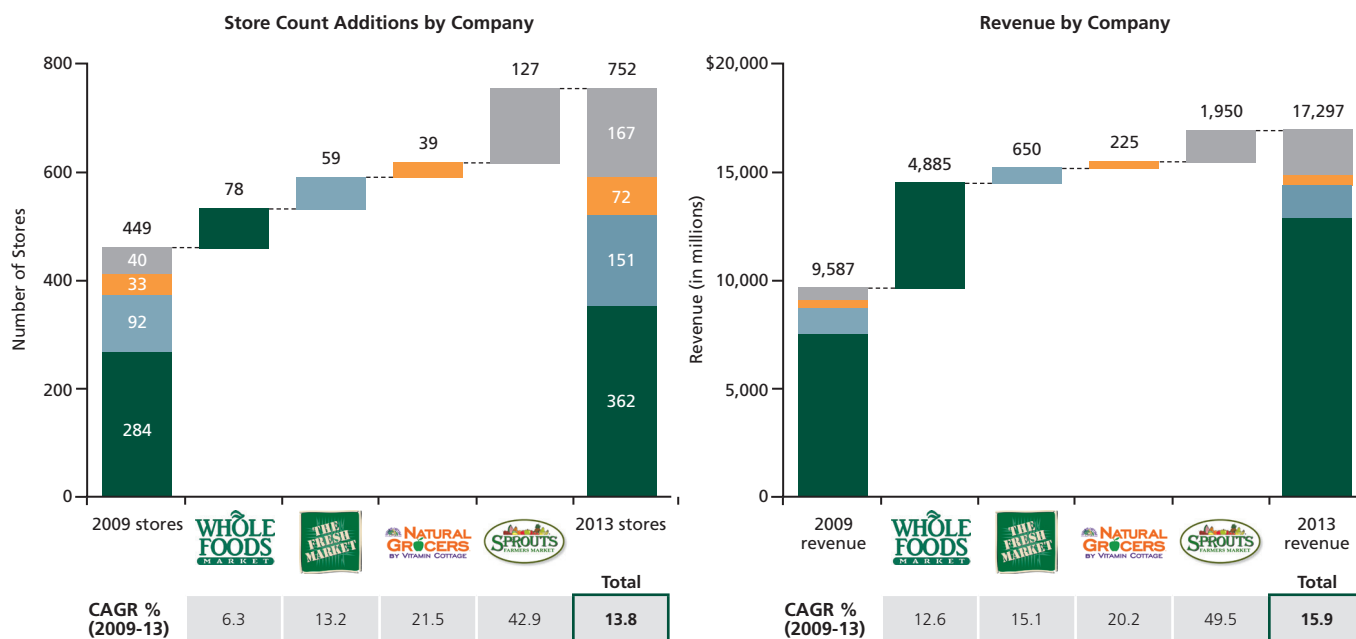
As reported in Bloomberg.com (June 2014), Sprouts Farmers Market Inc. (SFM), the natural-foods retailer that went public last year, may exceed its goal of opening 1,200 U.S. stores in the next decade and a half, the chain's chief executive officer said. "That was the low end, the most conservative estimate," Doug Sanders said.

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**Figure 1**  
**Premium Grocer Store Count Additions and Revenue (2009-2013)\***  
 Select premium grocers growing approximately 16% per year

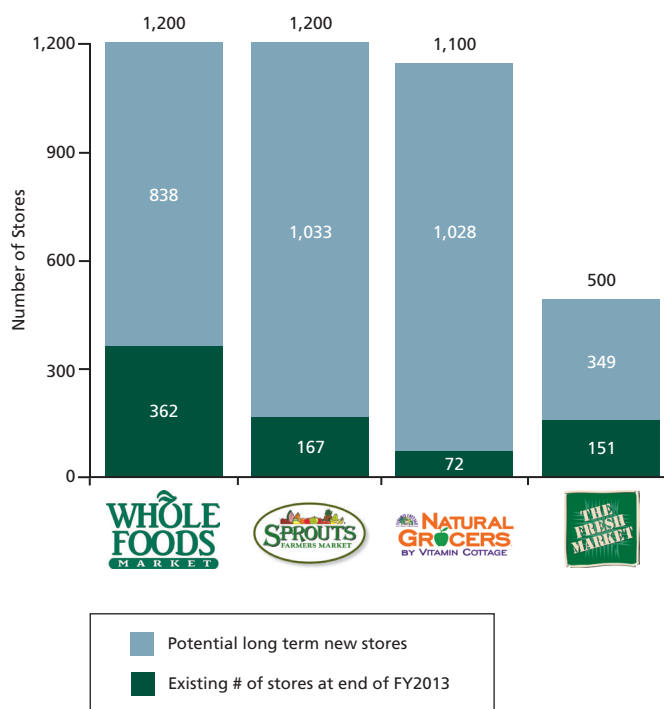


Note: \*Select premium grocers with publicly available data valued at end of each fiscal year, including acquisitions  
 Source: Company press releases, L.E.K. analysis

The premium grocery channel goes well beyond the five examples we've identified here. There is a long-list of others, including Fairway Market, Earth Fare, Mrs. Green's, King's, Gelson's, Lund's, Bristol Farms, Plum Market, Kowalski's, Dean & DeLuca, Straub's, Roche Brothers, Nugget and New Leaf, to name just a few.

One of our favorite examples is Mariano's, a premium concept in Chicago developed by Roundy's, a Milwaukee-based retail grocery company. In short, Mariano's has taken the market by storm – and is premium grocery at its finest. The company doubled its outlets in 2013-2014, growing from 13 stores to 29 by building five new stores and acquiring 11 closed Dominick's locations. Mariano's eventually plans to have 50 outlets in the Chicagoland area, which is noteworthy considering Chicago's leading grocer in 2010 was Jewel, with 36 locations, followed by Aldi with 37, and Dominick's with 16 (source: WBEZ). We're not talking about a small footprint here either – each store averages about \$50M per outlet per year (source: Chicago Tribune).

**Figure 2**  
**Projected Store Growth**  
 Select premium grocers with aggressive expansion plans



Source: Company press releases, L.E.K. analysis

## Implications

The premium grocery channel has quickly grown from an interesting niche to a strong growth engine for the food industry. Although leading retailers in the channel are small compared to leading grocery stores, their growth trajectory warrants increased attention from a number of market participants.

- **Premium grocery retailers** must prepare for a more crowded market, continue to focus on differentiation from competitors and increase customer loyalty.
- **Traditional grocery retailers** will need to step up their game as premium players become more pervasive and likely more price competitive; specifically, traditional players will need to increase their focus on customer segmentation and capital allocation, while recognizing that their "me too" premium/natural aisles will no longer be sufficient.
- **Food and nutraceutical brands** need to include premium grocery retailers as a key segment of their growth strategy and differentiate their offerings in both premium and traditional segments; and the same strategy that worked with traditional retailers (e.g. heavy promotion/BOGO) may be less effective with premium players.

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