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QUIC RESEARCH REPORT

Consumers & Healthcare

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Canadian Grocery Market Report

A Fresh Look at Some Appetizing Investments

Introduction

The Canadian grocery market makes up the largest segment amongst all food sales in the country. This report will examine major players within the industry, key consumer trends and where current companies in this space are most vulnerable to new competition.

Summary

- The Canadian grocery market is dominated by three major players ("The Big Three") which account for over 50% of total market share – Loblaw, Metro and Empire

- With the addition of Walmart and Costco's "SuperCentre" stores and Amazon's entrance into the grocery landscape, the "Big Three" key players must adapt to new industry trends

- Metro displays all the right ingredients to be a solid investment. MRU possesses the rare combination of holding solid business characteristics while also showing favourable valuation criteria

- While Loblaw and Empire possess some strong characteristics as well, they are inferior to Metro and do not hold the same level of attractive valuation that Metro does

QUIC Research Reports focus on emerging investment themes that affect current portfolio companies and companies under coverage.

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Canadian Grocery Market Overview

The grocery store market in Canada encompasses the largest food retail channel in Canada. These establishments retail general lines of food products, including fresh and prepared meats, poultry and seafood, canned and frozen foods, fresh fruits and vegetables and various dairy products.

Within Canada, the three largest competitors in the landscape include Loblaw (TSX:L), Metro (TSX:MRU) and Empire (TSX:EMP.A). Combined the three companies possess nearly three quarters of the entire market share (Loblaw 30%, Empire 25.7% and Metro 10.5%).

During fiscal year 2016, Canadians spent over $85 billion on groceries, with companies capturing just shy of $2 billion in profits. The industry has grown at an annualised rate of 1.4% in the trailing five years, and analysts expect this rate of growth to persist in years moving forward.

Although industry expansion in recent years, increasing competition from alternative retailers such as warehouse clubs and supercentres and lowered the volume sales of certain goods and further pressured industry operators to lower their product prices.

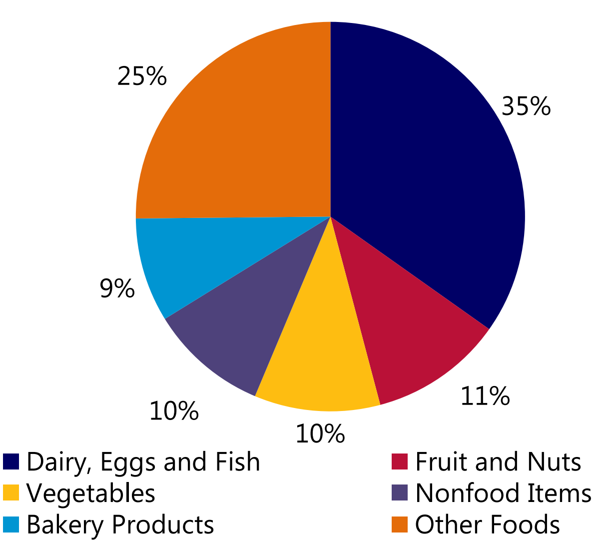
In recent years some of Canada's top grocers have lost market share to a variety of discount retailers, such as Costco and Walmart which have gained market share of the food-retailing sector through efforts of these mega-chains to bolster their grocery sections.

Key drivers for this industry come from per capita disposable income, consumer price indices for food and external competition from new entrants.

In years moving forward, it is expected that Canadian consumers will have more discretionary income to spend on food shopping. With the consumer price food index expected to grow at a faster rate than discretionary income, this could pose a threat to the industry. Lastly, the threat of new entrants stealing market share from current players should concern all existing grocers in the market. As a result, we believe companies that can adapt to changing consumer trends and those who place freshness over prices should prosper.

EXHIBIT 1

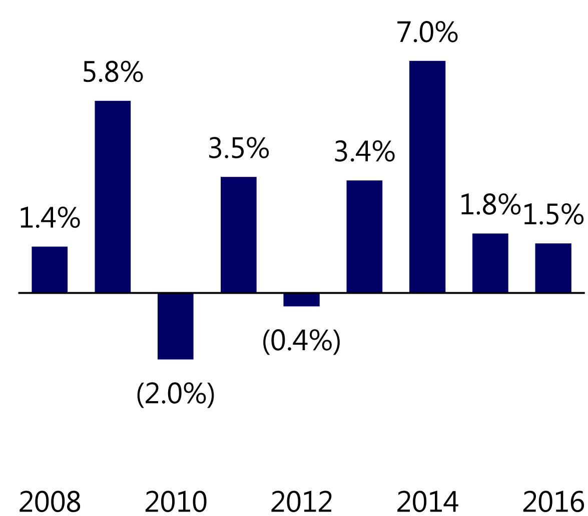
Canadian Grocery Market Product Segmentation



Source: IBIS World

EXHIBIT 2

YoY Revenue Growth for Industry



Loblaw, Metro and Empire – Canada's "Big Three"

Loblaw

Loblaw Companies Limited: Loblaw is the largest Canadian holding company and was founded in 1956. Subsidiaries include Loblaw's Inc., Shoppers Drug Mart, Choice Properties Limited Partnership, Choice Properties Real Estate Investment Trust, Joe Fresh and President's Choice Bank. Loblaw Operates 1000 supermarkets and has a total of 22 segment banners. In 2015, Loblaw had revenues of $46B and net income of $623MM.

Metro

Metro: Metro is a Canadian food retailer operating in Quebec and Ontario. It is the third largest food retailer after Loblaw and Sobeys's. They currently own and operate 365 locations as well as 119 discount stores which are operated by Food Basics. In 2016, the company had $1B in sales and was founded in 1947. They have three private labels including Selections, Irresistibles and Super C.

Empire

Empire: Empire Company Limited is a Canadian conglomerate founded in 1963 that is engaged in food retail investments. It's subsidiaries include Sobeys, Crombie REIT, Safeway Canada, Freshco, Foodland and Price Chopper. They have over 40,000 employees and over 500 locations across Canada. In 2015, its total assets were $12.238B and revenue was $21.93B. They are headquartered in Nova Scotia and François Vimard is the current interim CEO.

EXHIBIT 3

Key Operating Metrics for the "Big Three"

	Loblaw	Metro	Empire
Market Cap	$28.01B	$9.50B	$4.53B
2016 Return	6.97%	1.87%	(31.25%)
P/E	31.4x	17.1x	N/A
EPS	$2.22	2.39	-$8.13
52 Week Range	$61.25-$74.59	$37.80 - $48.19	$14.74-27.03

Loblaw Holding Considerations

On November 13th, 2013 a position in Loblaw Companies Limited was added to the portfolio. Since then, Shares in the stock have returned 57.8%, and have retuned 22.6% for the QUIC portfolio.

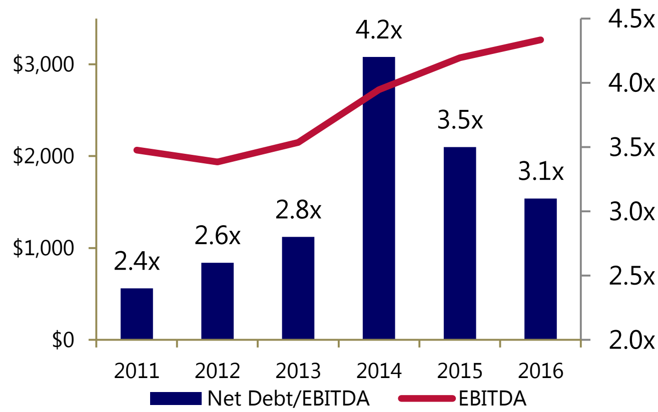
Although the shares have performed very well relative to the broad market, they have been quite stale as of late. The primary event causing growth since 2013 was the acquisition of Shopper's Drug Mart, and many of those synergies have already been realized. The purpose of this segment is to analyze whether or not Loblaw will continue to be a meaningful holding, or if the team should trim/remove our position in the company.

Reducing Leverage and Increasing Dividends

One primary motive for holding the company is for the possibility of increased dividends. Currently, the company has a dividend yield 1.45%, which is fairly low. Alongside cash and share issuance, Loblaw took on a large debt load of $5.1 billion to finance the Shopper's transaction. While this did not impede on capital expenditure plans, it did reduce the company's ability to return cash to shareholders. However, Loblaw is now an excellent cash flow generator with an FCF yield of 6%, far outpacing the industry. Reducing the Net Debt/EBITDA ratio will create value for shareholders.

EXHIBIT 4

Net Debt/EBITDA and EBITDA Growth



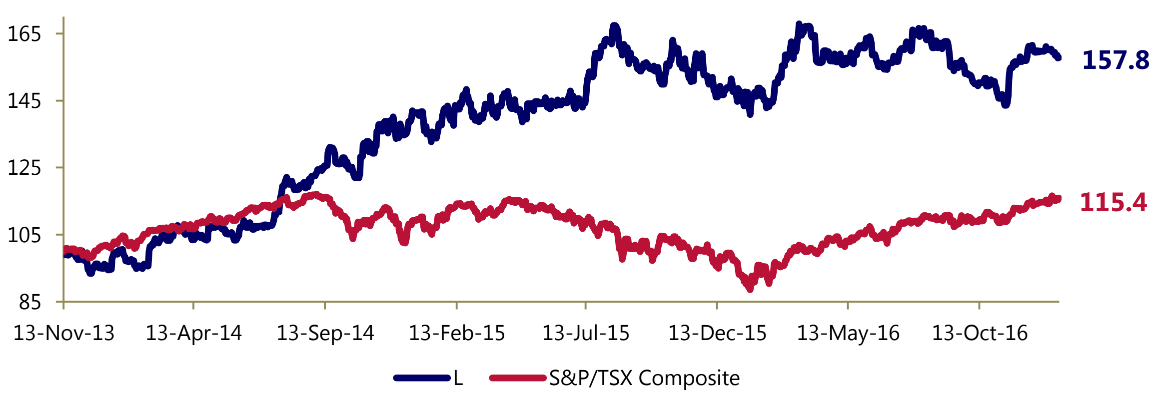
Source: Capital IQ

Finding Competitive Advantages

An advantage Loblaw has over its three major competitors, Empire and Metro, is its size. It is by far the largest food retailer with about 2.400 stores and over 70 million square feet of store space. This large presence in the food supply chain delivers pricing power, which is especially important in the current food deflationary environment. Canadian grocers like Loblaw have not lost margins as significantly as their counterparts in the U.S due to their hold on

EXHIBIT 5

TSX:L Share Performance Since Inception



Source: Capital IQ

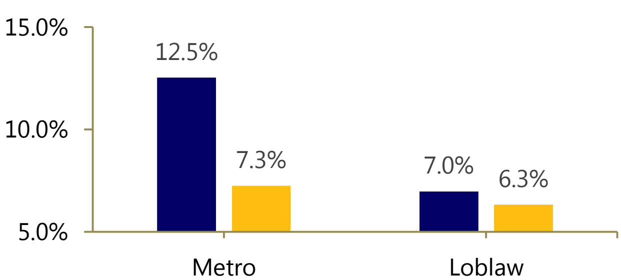
Loblaw Companies Limited Holding Considerations Cont.

the supply chain. This results in generally stable prices in the store. Unfortunately, the extremely low switching costs in this industry have reduced many of these competitive advantages. Over time, Loblaw has built an impressive real estate portfolio with very convenient locations to try to increase switching costs. Loblaw realized much of this value when they spun off their real estate with the IPO of Choice Properties REIT which yields 5.17%, and Loblaw still has a large holding in this company.

Moreover, Loblaw's product portfolio consists of the No. 1 and No. 2 brands in Canada, President's Choice and No Name. These are private-label brands, which means that they are Loblaw's brands placed on the products produced by another company, making for a capital-light method of selling your own products. These are more profitable than national brands, so it is a strong advantage for Loblaw to have such popular private-label brands. And yet, Loblaw has still been struggling to significantly out-return its weighted average cost of capital.

EXHIBIT 6

5 Year Average ROIC and WACC



Source: Bloomberg

Shopper's Drug Mart

The Shopper's business is the largest pharmacy retailer in Canada and has twice the margins of Loblaw's grocery business, improving the profitability within the combined company. The Canadian healthcare system is facing rising healthcare costs and an aging population, so generic alternatives will become increasingly more favored to expensive brand-name drugs. At the same time, the government is planning to cut the generic : branded drug price ratio from 0.5 to 0.25, which would be disadvantageous to Shopper's should the bill pass.

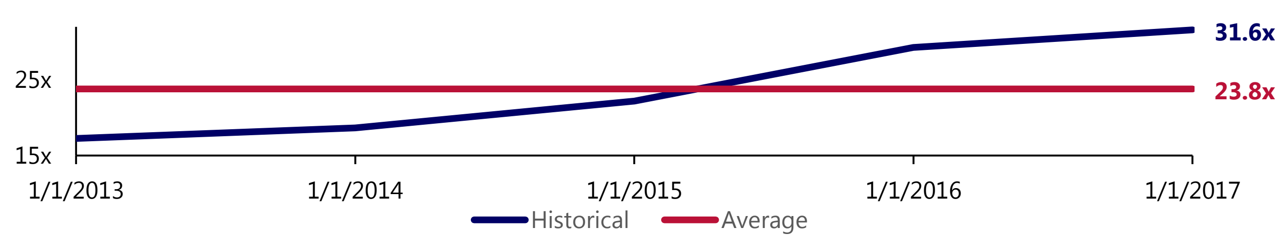
In 2016, Shopper's applied to be a primary distributor of Marijuana, should the legalization bill be passed. Investors were speculating this well ahead of the official announcement, so Marijuana's addition to Loblaw's bottom line has been largely priced in. There is also very little clarity on the supply chain the company will use, and the large number of distributors will reduce much of the pricing power, leading to a minimal increase in the spread between the company's ROIC and WACC.

Valuation

When the team added Loblaw to the portfolio, the stock was cheap and undervalued. Over time, multiples have expanded and the stock has become expensive. We do not believe that the future growth at Loblaw is significant enough to justify these high multiples, therefore Loblaw should not represent such a large portion of our portfolio.

EXHIBIT 7

Historical and Average Price–to–Earnings Ratio



Source: Capital IQ

Mini Pitch: Metro (TSX:MRU)

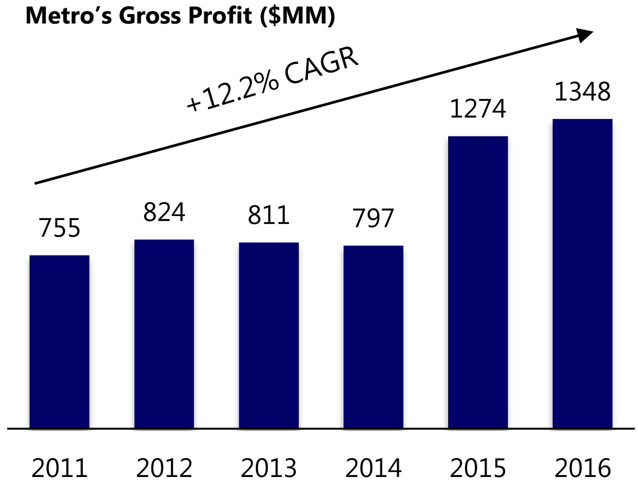
Investment Thesis I: Cost Discipline Focus

Many analysts praise Metro for the company's ability to keep costs low despite growing revenues. Clear emphasis of this fact is displayed by the company's gross profit growing from $755 million in 2011 to $1,347 million in most recent 2016. While revenues grew modestly over this period of time, it was Metro's ability to increase costs by much smaller amounts, despite increased business size.

With changing consumer trends moving forward, Metro's relentless focus on cost cutting should continue to pay off. With major entrants such as Costco and Walmart (possessing large scale efficiencies) entering the industry, other retailers which charge consumers higher prices to create the same margins may suffer.

EXHIBIT 8

Metro's Gross Profit ($MM)



Source: Capital IQ

Investment Thesis II: Management Team Strength on All Fronts

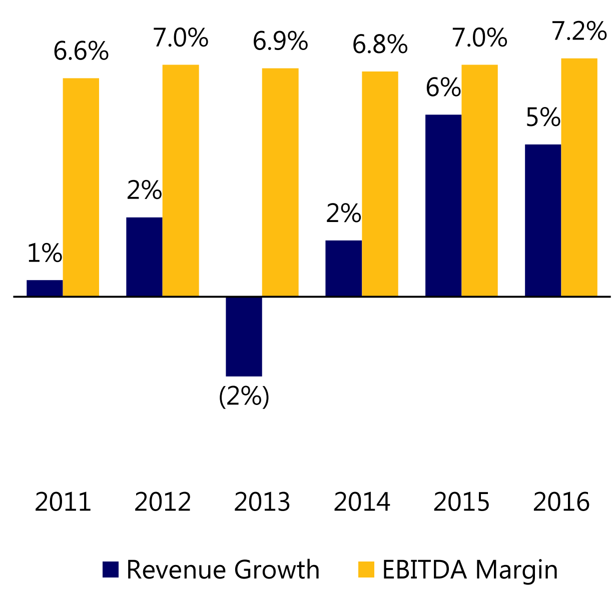
Compared to other Canadian grocers which focus primarily on price matching and low costs for customers, Metro has instead placed emphasis on having food on the shelves all the time. This was in response to consumer complaints of not being able to find the products they wanted, especially when they were on sale. The "in stock" guarantee has created challenges for the company, however strong IT systems have aided MRU in this area.

Management also has a strong focus on capital allocation, proved by best in class ROIC figures. In addition to the company's strong returns on capital employed, Metro rewards shareholders fruitfully with a dividend that has grown yearly since 1999 and a strong buyback program. Management has stated that it has no problem holding excess capital to wait for a golden investment opportunity to present itself.

Bay Street shares these same views of Metro's leadership personnel. RBC published a report praising Metro's management team showing traits of *Outsider CEO's* – focusing on capital allocation, long-term vale creation, having the patience to sit on capital and thinking outside the box.

EXHIBIT 9

Historical Revenue Growth vs. EBITDA Margin



Source: Capital IQ

Mini Pitch: Metro (TSX:MRU) Cont'd

Investment Risks

While analysts believe Metro possesses all the fundamentals to be a strong company, the question as to whether it is a *strong investment* is not so clear. MRU already has the highest margins in the industry, has locations in almost every major area of Ontario and Quebec and trades at a premium on many key valuation standpoints.

However, the company has still shown no signs of slowing down. Metro has beat EPS estimates in trailing quarters, while also showing strong SSS growth consistently for past years.

Another risk to Metro's investment comes from it's large stake (roughly 6%) of Alimentation Couche-Tard (ATD.B), representing 20% of the firm's value. While many analysts view ATD.B as a blue-chip stable investment, it is imperative that an investor in Metro also pays attention to this large subsidiary.

Valuation

Metro (Excluding ATD.B)		**Investment in Alimentation Couche-Tard**	
EV/EBITDA Valuation Method		***Market Value Method***	
2017E EBITDA	967.4	Current Price Per Share	$63.14
EV/EBITDA Multiple	11.0x	Number of ATD.B Shares owned by MRU	32.2
Enterprise Value	**$10,630**	**Total Ownership Value**	**$2,033**
Net Debt	1229		
Equity Value	**9402**		
MRU Shares Outstanding	230.7	MRU Shares Outstanding	230.7
Equity Value Per Share	**$40.76**	**ATD.B Value per MRU Share**	**$8.81**
MRU Equity Value Per Share			**$49.57**

Food Retailers	Market	Enterprise	EV / EBITDA			Price / Earnings		Net Debt / EBITDA			2016 EBITDA	FCF	Dividend
Company Name	Cap ($MM)	Value ($MM)	LTM	2016E	2017E	2016E	2017E	2016E	2017E	ROIC	Margin	Yield	Yield
Loblaw Companies Limited	$28,166	$38,144	11.7x	10.0x	9.5x	17.1x	15.5x	2.6x	2.5x	4.9%	8.3%	6.1%	1.5%
Metro Inc.	$9,402	$10,630	11.6x	11.0x	10.6x	15.8x	14.6x	1.3x	1.2x	11.2%	7.6%	3.2%	1.4%
Empire Company Limited	$4,533	$6,282	7.2x	7.8x	6.8x	26.4x	19.3x	2.2x	1.9x	4.0%	3.3%	3.9%	2.5%
Mean	$14,034	$18,352	10.2x	9.6x	9.0x	19.8x	16.5x	2.0x	1.9x	6.7%	6.4%	4.4%	1.8%
Median	$9,402	$10,630	11.6x	10.0x	9.5x	17.1x	15.5x	2.2x	1.9x	4.9%	7.6%	3.9%	1.5%

Commentary

Metro trades at a premium on EV/EBITDA yet at a discount from a P/E standpoint, receognizing the company's favourable capital structure and ability to save costs all the way down to the bottom line. The company is also underlevered compared to its peers on a Net Debt/EBITDA basis. The company bolsters strong ROIC and EBITDA figures as well.

When valuing Metro, it is evident that Metro's current share price is captured solely in the value of all operations without its ownership in Alimentation Couche. Once adding in Metro's $2 billion stake in ATD.B, it is evident that there is the potential for 20% upside based on the combined value of MRU's entity.

Empire Company

Company Overview

Empire Company is a Canadian conglomerate with headquarters in Stellarton, Nova Scotia. Empire operates in two different areas – food retailing and investments. This past year, Empire experienced a modest increase in sales of 2.9%. In 2013, Empire acquired Safeway in a $5.8 billion deal to gain better access to the Western Canadian market.

Food Retailing

Under its food retailing unit, Empire offers food, liquor, pharmacy, fuel, and wholesale. Its subsidiary, Sobey's Inc., operates across Canada under a number of different names, notably Sobey's, IGA, FreshCo, and Safeway. Empire's flagship private label brand in their food retailing business is Compliments. Revenues have been increased by the inflation in food prices most recently, however low fuel prices this past year have offset this gain by lower fuel station revenues.

Empire has introduced beer to 15 stores this past year with the authorization of the sale of beer in Ontario grocery stores. Additionally, Empire has a strong foothold in the liquor retailing business in the rest of Canada, having 80 locations under three different names (Sobey's Liquor, Safeway Liquor, and Thrifty Foods Liquor).

Investments

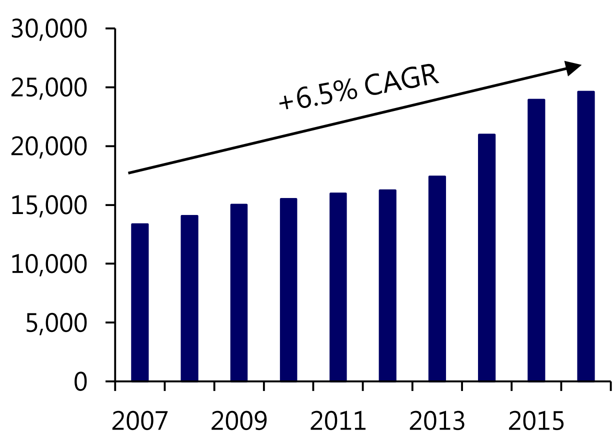
Alongside their food retailing business, Empire has a 41.5% equity interest in Crombie REIT, a portfolio of 261 office and retail locations across Canada. Additionally, the company has a real estate partnership with Genstar Development, a residential land developer.

Bearish Outlook

The negative outlook for Empire stems from their failed integration of Safeway into their business. Customers are left with a frustrated sentiment after Safeway's loyalty program and private-label brands were terminated and groceries were frequently out of stock. Essentially, Empire failed to recognize Safeway's customer's loyalty to their in-house brands and was not able to provide the excellent service that was achieved under the prior ownership. Additionally, Safeway's transition to Sobey's SAP software system was a technical disaster, leaving employees unhappy.

EXHIBIT 10

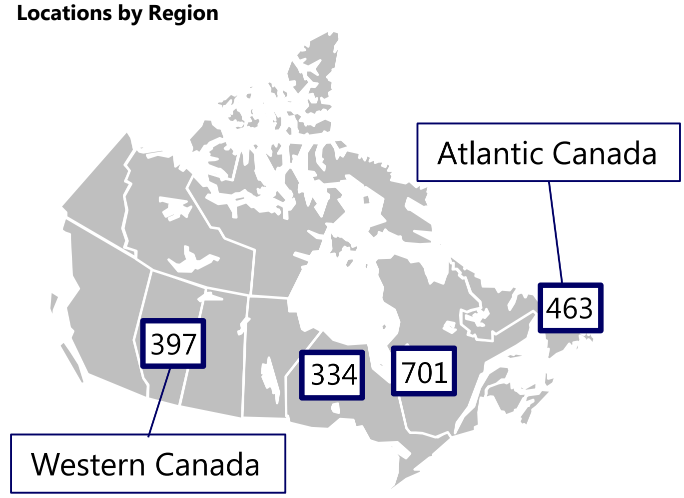
Revenue Growth ($MM)



Source: Annual Report, Financial Post

EXHIBIT 11

Locations by Region



Source: Annual Report

Innovation and Disruption in the Grocery Industry

Grocery Pick-Up

E-commerce is becoming a growing and disruptive presence all over the world. In Canada, this trend has spread to the last line of retailers: grocery stores. However, implementation is still in its early stages as e-commerce makes up less than 1% of Canada's $120 billion of annual grocery sales. In similar markets like Britain, e-commerce sales make up more than 6% of annual grocery sales. Revenues from this segment are expected to be gradual at first, and then grow significantly all of a sudden as the adoption rate hits a certain level of popularity.

Leading Canadian grocers, Loblaw and Wal-Mart, are beginning to develop their e-commerce presence by offering a method of selecting their items on-line, then picking them up in store freshly packed to make for an easy and convenient shopping experience. Empire and Metro are also following suit, although on a smaller scale so far.

We believe that this situation could be harmful for a retailers "impulse" items. For example, when browsing in a grocery store to find the items on your list, you may run into items such as a chocolate bar and make an impulsive purchase decision. On-line, this would be more difficult to accomplish since you would be browsing by product category and potentially re-using the same order cart over and over. Mondelez. a confectionary and beverage producer, sells many of these "impulse" products in grocery stores all over the world. For them, grocery pick-up may be disruptive, however no significant data has proven this to date.

For a long time, consumers have been treated with the ability to order restaurant food and have it delivered right to their home. Today, they are beginning to do the same with their groceries. While this may be lucrative for consumers, for retailers grocery delivery has all the same costs of pick-up with the added costs of delivery. It is possible that this method would put more strain on an already low-margin business, so Loblaw and Wal-Mart are doing their best to push pick-up onto their customers instead of delivery before Amazon gets a chance to enter the market.

AmazonGo and AmazonFresh

The titan of e-commerce is not done yet. Amazon believes that the grocery industry can still be much improved and be made more convenient.

Amazon Go plans to open 2,000 brick-n-mortar stores over the next decade, starting with 20 by the end of 2018. The grocery industry largely competes based on price, and Amazon is well known for being a cost leader. The company plans to increase speed and reduce costs in grocery stores by eliminating the employee count and replacing them with technology.

For just $15/month added on top of the Prime membership, customers can have groceries shipped to their home directly from AmazonFresh's refrigerated warehouses. The problem is, this area has been slow to grow. Since Amazon relies on large warehouses and long shipping routes to deliver their products, perishables are not the ideal item to transport. Amazon, like Loblaw and Wal-Mart, is realizing how costly it is to actually deliver groceries. While this is certainly an area to watch, it seems unlikely that AmazonFresh will significantly disrupt the grocery industry, especially in Canada where the logistics are even more challenging.

Supercenters

Grocery stores are also facing competition from supercentres, who's business encompasses that of department stores but also offers groceries. This makes supercentres a "one stop shop" for consumers, and as a result leading department stores have begun the conversion process to supercentres. A notable industry player who has undergone this process is Wal-Mart. Grocery stores like Loblaw, Metro, and Empire are unlikely to make the shift to supercentres and add a retail department.

References

1. Bloomberg
2. Capital IQ
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4. IBIS World
5. Fidelity
6. Morgan Stanley
7. Globe and Mail
8. IBIS World