COVER STORY

Strong Performance, But

The 2005 retail operations survey shows growth, even in a maturing natural

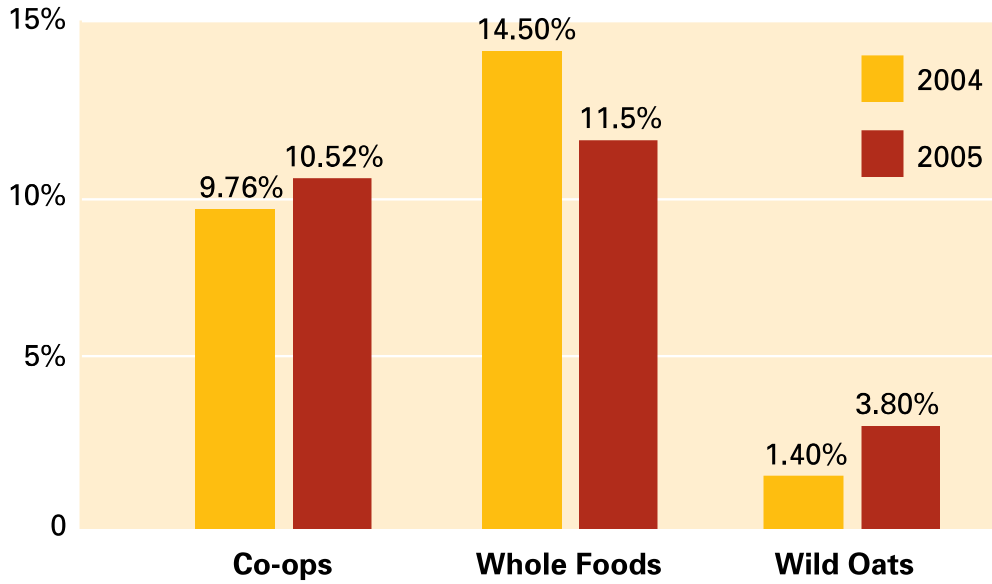
BY THE DATA ANALYSIS TEAM*

Hear, Hear! This year's survey shows positive results for food co-ops. Co-op income statement performance is among the best in the industry, with strong sales growth and robust net income. Co-op balance sheets are again strong and indicate continued capacity for growth and expansion. Aggregate balance sheets are not leveraged and show a lot of liquidity. Overall, co-ops performed well, almost as well as Whole Foods Market (WFM) and much better than Wild Oats Market (WOM).

Co-op performance reflects attention to key indicators, and improved performance gives cause for celebration. However, there are signs that this performance may not be sustainable. An analysis of our co-ops' position within a maturing natural foods industry shows some disturbing trends. For almost all co-ops, things are still good, but we can't use that as a reason to become complacent.

Before we look at the industry trends, let's take a look at co-op performance in 2005.

Identical Store Sales Growth Trends, 2004–2005



Weighted average identical-store sales growth was again strong among co-ops, bettered only by Whole Foods Market, and significantly greater than Wild Oats Market. Median identical store sales growth for co-ops was strong also at 12.7%.

Sales growth

According to the *Progressive Grocer*, the grocery industry as a whole grew by 4.7%, holding steady in 2005.

The *Natural Foods Merchandiser* reports that "for the first time since 1999" natural products retailers posted double-digit sales growth at 10.9% and "outpaced all other channels but the Internet."

Average food co-op sales growth was on par with the natural products retailers, with identical-store sales growth of 10.5%. Food co-ops were outperformed by WFM, which reported identical-store sales growth of 11.5%. WOM reported overall sales growth of only 3.8%. Retail analysts consider identical store sales growth an important indicator because it reflects the core and continuing strength of a chain.

Owner earnings

One way to compare net income between cooperatives and public companies is to add back the patronage refunds (aka patronage dividends) that cooperatives have provided to owners. In a co-op, patronage refunds are booked in the Other Expense category. In a public company, declared dividends are not—they are taxable income.

Additionally, some co-ops assign profit to owners through member discounts at the register. This amount is also added back to net income in order to get an accurate total of owner earnings. Co-op owner earnings at 2.2% compare favorably with those of Whole Foods investor owners at 2.9% and were far better than Wild Oats at 0.3%.

> Overall, co-ops performed well, but analysis of their industry position shows disturbing trends.

Margin minus labor

We consider margin minus labor (MML) to be one of the best predictors of positive owner earnings, and MML for co-ops has been trending up over the past three years. For 2005 this was the result of achieving slightly increased margins (a 0.58% increase) while holding personnel costs at nearly the same percentage of sales (a 0.04% increase).

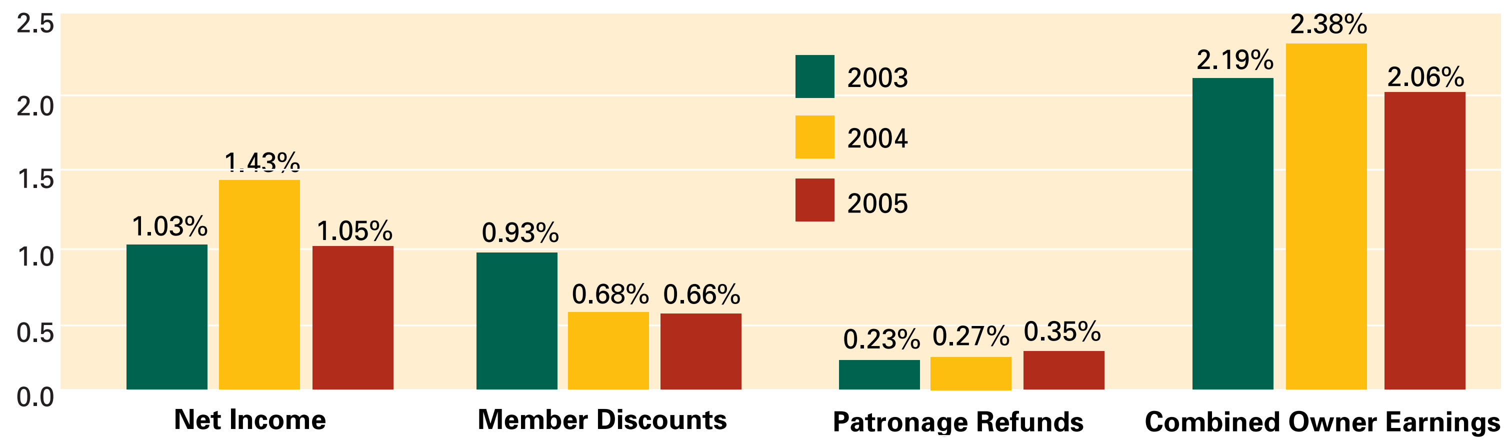
Co-op analyst John Eichholz (Green ■>

* For the names of data team members, see "Methodology," p. 28.

Can We Sustain It?

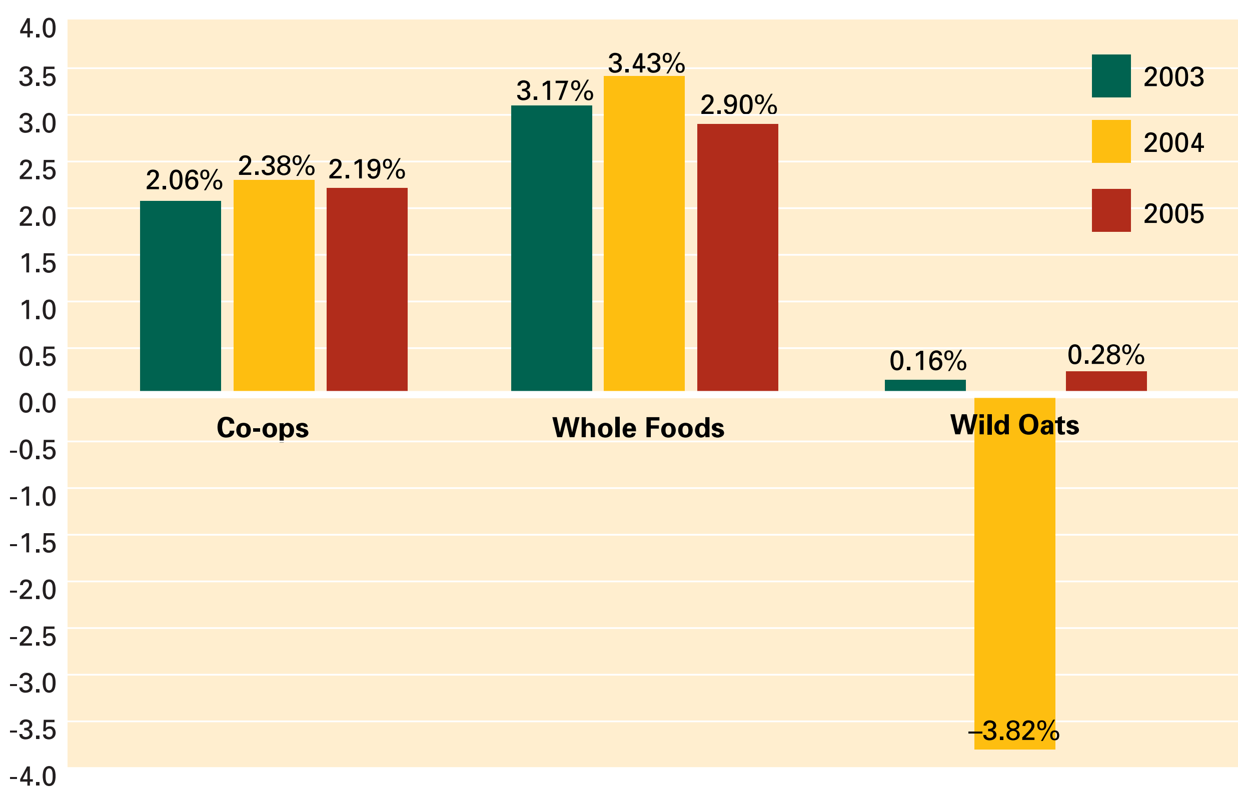
food market

Components of Weighted Average Co-op Owner Earnings, 2003–2005



Owner earnings are derived from three components. Shown together, the weighted average total of net income, member discounts and patronage refunds give a more complete picture of co-op owner earnings. In 2005, member discounts grew while net income and patronage refunds declined.

Comparison of Owner Earnings, 2003–2005



Co-ops continue to capture much of their strong sales growth through owner earnings of over 2%. Whole Foods does even better, but not Wild Oats.

Cooperative Grocer 2005

<■ Fields Market, Mass.) noted that, "Overall, stores of all sizes do seem to be successful, though there are specific stores in each size category that are not performing well at the moment. Variance within size categories can be mostly explained by the bottom 25% of stores."

Small- and large-sized co-ops' results were strong, with both increased sales growth and improved operational performance. However, while the medium and extra-large co-ops posted impressive sales growth, their operational performance for 2005 was poor. The upper quartile and median quartile co-ops in the medium and extra-large size categories still managed a positive operating margin, but the lower quartile posted negative earnings. Labor decreased for the top performing stores in all size categories except for medium-sized stores.

It's relevant to note that 26% of both medium and extra-large stores had expansions during the past two years. Many of these co-ops appear to be struggling to regain their financial composure. Analysis team members Eichholz and Carol Collins (People's Food Co-op, Ann Arbor, Mich.) suggest that there is a higher expansion risk for smaller stores than larger operations because they have fewer resources if something goes wrong. According to Eichholz, "Over time the advent of systems contributes to improving operating expenses. When you grow your sales dramatically, your operation will need systems that may not have been in place before expansion, and it may take you a while to develop them."

Analysis team member Joe Golton (Ashland Food Co-op, Ore.) mined the data for a metric that would predict financial success. Golton found that a lower operating expense (adjusted for deli sales) has a strong correlation with success. According to Golton, "For a given level of deli sales as a percentage of overall sales, there is a higher correlation with low operating expenses and success than with virtually any other metric, including sales growth." He also observed, "Co-ops engaged in an expansion project that were in the lower 50% of all co-ops in operational performance prior to expansion were at a much higher risk when expansion occurred."

During the analysis team discussions, we examined expansions and new store results. Analysis team member Michele Buchanan (New Leaf Market, Fla.) concluded that, "Without analysis we may say 'If only we could get bigger then we could do better.' But that might not be the case. Operational analysis and research is important in determining the risk of a second store, major expansion or relocation." Analysis team member Margo O'Brien (St. Peter Co-op, Minn.) adds, "It is much harder and riskier to open a new store than to expand a current store or take over an existing operation."

Balance sheet

Co-op balance sheets remain strong, with indications that co-ops are investing in improved and expanded fixed assets. This is encouraging news. Fixed assets were 55% of total assets this year, compared to 52% a year ago. Aggregate balance sheet strength is muted by

STATISTICAL SUMMARY OF RATIOS, 2005

	Small	Medium	Large	Extra Large	All
Sales Growth					
Upper Quartile	19.24%	23.18%	18.04%	13.62%	19.45%
Median	13.85%	16.09%	12.98%	10.12%	12.98%
Lower Quartile	8.77%	11.17%	9.47%	6.18%	9.00%
Sales to Total Assets					
Upper Quartile	5.12	4.85	5.00	4.61	4.89
Median	4.30	3.77	3.94	3.99	3.97
Lower Quartile	3.17	2.54	3.41	3.72	3.20
Sales to Fixed Assets					
Upper Quartile	25.49	12.52	21.16	11.00	18.64
Median	11.78	7.40	8.31	8.47	8.70
Lower Quartile	5.86	4.98	6.01	5.51	5.64
Inventory Turnover (annualized)					
Upper Quartile	9.74	14.46	18.33	22.34	17.43
Median	8.53	13.20	16.78	19.67	14.21
Lower Quartile	7.76	9.55	15.43	15.96	9.87
Current Ratio					
Upper Quartile	5.74	2.65	3.54	1.80	3.44
Median	3.34	1.73	2.10	1.55	1.80
Lower Quartile	1.43	1.04	1.38	1.27	1.17
Debt to Equity					
Upper Quartile	2.15	2.82	1.57	1.53	1.90
Median	1.24	1.00	0.80	0.77	0.91
Lower Quartile	0.40	0.25	0.33	0.40	0.33
Return on Equity (before patronage refund and member discounts)					
Upper Quartile	35.15%	19.41%	34.61%	23.41%	30.96%
Median	20.87%	11.50%	22.24%	14.60%	16.46%
Lower Quartile	8.58%	7.41%	13.90%	0.70%	6.61%
Return on Assets (before patronage refund and member discounts)					
Upper Quartile	18.03%	12.20%	17.52%	13.20%	14.81%
Median	8.44%	4.50%	10.41%	8.29%	8.75%
Lower Quartile	4.61%	-1.41%	6.68%	0.44%	2.86%
Gross Margin					
Upper Quartile	37.54%	39.17%	37.87%	39.11%	38.24%
Median	36.01%	36.57%	37.11%	37.36%	36.97%
Lower Quartile	34.70%	35.68%	36.59%	35.82%	35.71%
Total Labor Expense					
Upper Quartile	25.32%	26.04%	24.67%	25.78%	25.57%
Median	22.86%	23.86%	22.99%	25.00%	23.67%
Lower Quartile	20.92%	22.35%	20.76%	23.18%	21.33%
Margin Minus Labor					
Upper Quartile	14.36%	14.52%	15.80%	13.96%	14.89%
Median	12.80%	13.07%	14.27%	12.50%	13.34%
Lower Quartile	11.38%	11.17%	13.21%	10.72%	11.76%
Total Operating Expense					
Upper Quartile	36.94%	38.55%	36.11%	37.72%	37.48%
Median	35.06%	36.53%	34.18%	35.69%	35.17%
Lower Quartile	32.47%	33.58%	32.35%	34.71%	33.07%
Operating Margin					
Upper Quartile	2.48%	2.44%	3.96%	2.53%	3.28%
Median	0.98%	1.15%	2.93%	1.46%	1.99%
Lower Quartile	0.22%	-1.41%	2.03%	-0.03%	-0.11%
New Income					
Upper Quartile	2.17%	1.70%	3.00%	1.76%	2.68%
Median	0.97%	0.43%	1.95%	0.78%	0.96%
Lower Quartile	-0.42%	-0.87%	0.85%	0.09%	-0.38%
Owner Earnings					
Upper Quartile	3.80%	2.76%	3.64%	3.34%	3.53%
Median	2.34%	1.31%	2.76%	1.84%	2.03%
Lower Quartile	1.31%	-0.42%	1.86%	0.09%	0.80%
EBITDAP Percent					
Upper Quartile	3.75%	4.31%	5.50%	4.50%	4.98%
Median	2.49%	2.56%	4.66%	3.24%	3.55%
Lower Quartile	0.97%	0.64%	3.76%	1.56%	1.59%

Retail Operations Survey

STATISTICAL SUMMARY OF INCOME STATEMENTS, 2005

GROSS MARGIN	Small	Medium	Large	Extra Large	All
Sales	100.00%	100.00%	100.00%	100.00%	100.00%
Cost of Goods	64.07%	62.77%	62.80%	62.08%	62.46%
Gross Margin Total	**35.93%**	**37.23%**	**37.20%**	**37.92%**	**37.54%**
OPERATING EXPENSES					
Personnel	23.06%	23.91%	22.78%	25.24%	24.21%
Occupancy	3.78%	3.89%	3.80%	4.21%	4.03%
Operating	3.48%	4.40%	4.17%	3.70%	3.95%
Administration	1.51%	1.20%	0.98%	0.88%	0.98%
Governance	0.54%	0.52%	0.52%	0.44%	0.48%
Member Discounts	1.08%	0.80%	0.66%	1.06%	0.91%
Marketing	1.40%	1.38%	1.46%	1.11%	1.27%
Operating Expenses Total	**34.85%**	**36.11%**	**34.37%**	**36.64%**	**35.83%**
Operating Income	**1.08%**	**1.11%**	**2.83%**	**1.28%**	**1.71%**
OTHER INCOME, EXPENSES, AND TAXES					
Other Income	0.57%	0.87%	0.50%	0.70%	0.66%
Misc. Other Expense	-0.32%	-0.55%	-0.11%	-0.30%	-0.28%
Interest Expense	-0.42%	-0.64%	-0.60%	-0.20%	-0.40%
Taxes	0.04%	-0.34%	-0.43%	-0.68%	-0.54%
Patronage Refunds	-0.03%	-0.10%	-0.17%	-0.29%	-0.21%
Total Other Income, Expense, Taxes	**-0.16%**	**-0.76%**	**-0.81%**	**-0.77%**	**-0.77%**
Income Statement Total	**0.92%**	**0.36%**	**2.02%**	**0.51%**	**0.94%**
Income Before Patronage Refund	**2.03%**	**1.26%**	**2.85%**	**1.86%**	**2.06%**

STATISTICAL SUMMARY OF BALANCE SHEETS, 2005*

ASSETS	Small	Medium	Large	Extra Large	All
Cash	15.56%	16.86%	26.60%	18.46%	20.46%
Inventory	28.08%	14.22%	13.47%	13.79%	14.18%
Other Current Assets	2.23%	2.64%	3.75%	4.52%	3.81%
Fixed Assets	51.97%	61.67%	52.52%	53.33%	54.96%
Other Assets	2.15%	4.61%	3.66%	9.90%	6.59%
Assets Total	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**
LIABILITIES AND EQUITY, RETURN ON EQUITY (BEFORE PATRONAGE REFUND)					
Accounts Payable	12.32%	10.07%	9.06%	14.60%	11.87%
Other Current Liabilities.	5.20%	8.45%	9.84%	10.63%	9.75%
Long Term Liabilities	41.81%	47.38%	34.59%	19.32%	30.79%
Total Liabilities	59.33%	65.89%	53.49%	44.54%	52.41%
Equity	33.60%	16.83%	21.79%	29.23%	24.54%
Retained Earnings	7.08%	17.28%	24.72%	26.23%	23.05%
Total Equity	40.67%	34.11%	46.51%	55.46%	47.59%
Total Liabilities & Equity	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

* Totals based on rounded figures

co-ops' inability to easily transfer underused cash from one co-op to another co-op where it could provide higher member returns. And cash represents more than 20% of total aggregated assets. However, this balance sheet independence does decrease risk, because a co-op in trouble only risks its own balance sheet and not any others'. Co-ops have figured out clever ways to leverage balance sheets among cooperatives, as in the cases of Sacramento, River Valley, and Tidal Creek, as well as through cooperative lenders such as Northcountry Cooperative Development Fund, Cooperative Fund of New England, and the National Cooperative Bank. These are current examples of practical application of the cooperation among cooperatives principle.

Additional signs of strength are both the percent of assets financed by owners and the ratio of liquid assets to short-term obligations (current ratio). Almost 50% of assets are financed by member owners in cooperatives. Ironically, too high of a percentage might not be in member owners' best interest. If members own 75% of the assets, is the member investment leveraged to the best use? On the other hand, too low of an investment by members creates a risky situation for the business and incurs more interest expense. Furthermore, a co-op might be building up cash in order to expand next year. The right amount of equity as a percent of assets is not formulaic, but generally speaking the co-op system appears to be underleveraged—that is, we aren't working our members' investments hard enough.

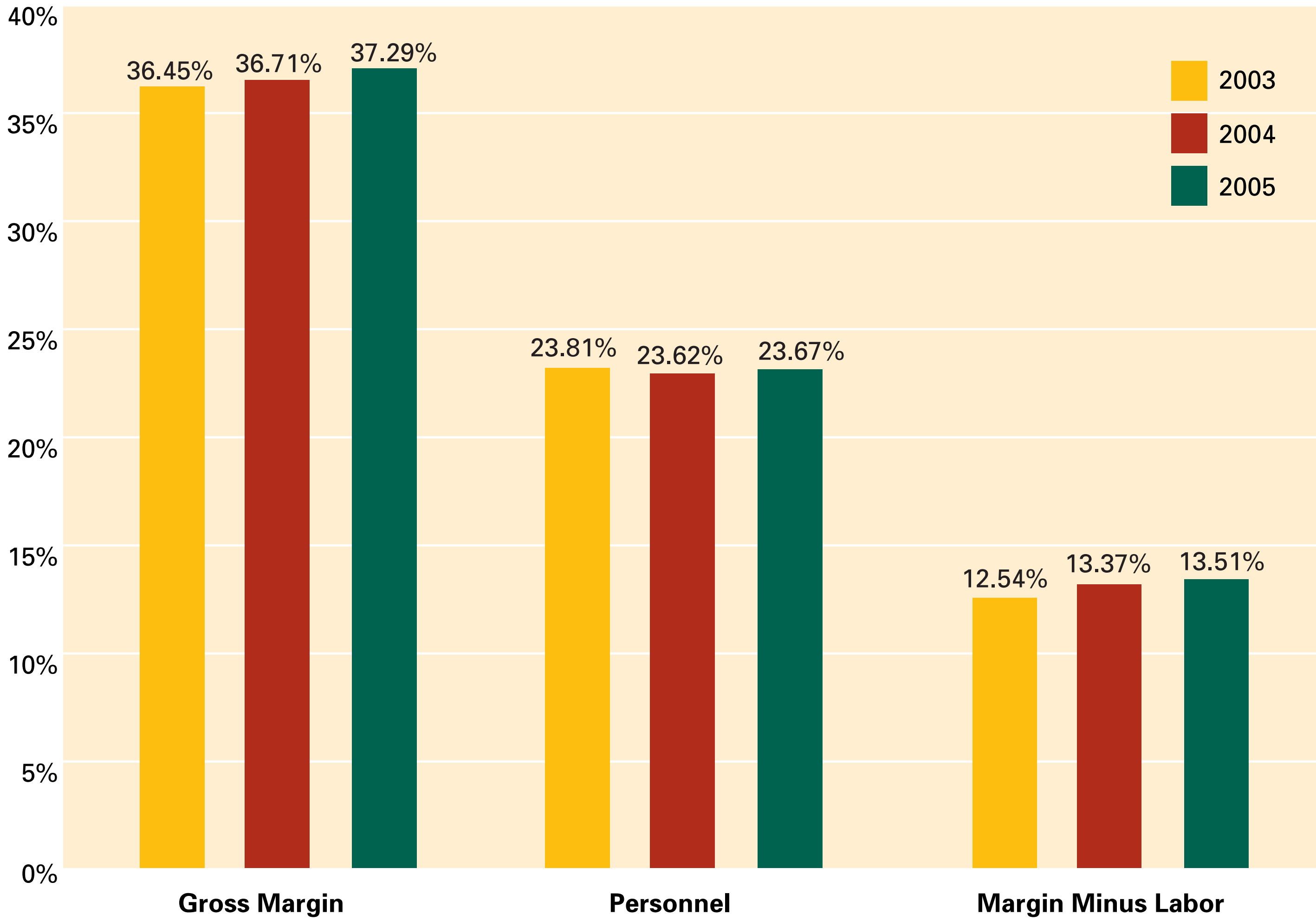
Data analysis team member Lee Lancaster (Food Front, Ore.) summed up a lesson the team realized: "Just looking at the centerfold aggregates gives a false view of uniformity." The team encourages all participants to use CoCoFiSt tools to dig deeper into the data and not rely solely on the aggregates reported here.

Maturing natural foods industry

In addition to analyzing results for last year, it's important to analyze whether good co-op performance is sustainable into the future. An analysis of our co-ops' position within a maturing natural foods industry shows disturbing trends.

The natural foods industry is changing rapidly. To understand the impact of these changes on food co-ops, it's helpful to apply Harvard Business School Professor Michael Porter's "Competitive Forces" model. Porter believes that industries frequently become less profitable as they mature. This reduced profitability typically affects many companies within the industry—in CoCoFiSt terms, it's a common cause. ■>

Median Gross Margin, Personnel Costs and Margin Minus Labor, 2003–2005



Co-ops continue to improve gross margin while controlling labor expenses, consequently improving the amount of margin available for all other expenses and for owner earnings.

<■ Moreover, as an industry becomes less profitable, the profitability spread within the industry widens. "In most industries, some firms are much more profitable than others, regardless of what the average profitability of the industry may be," writes Porter.

Porter's model can be used to analyze competitive forces in the natural foods industry. One key competitive force is the entry of new competitors and new strategies of current competitors. Wal-Mart has announced that, beginning this summer, it plans to sell organic versions of name-brand groceries for just 10% more than their conventional equivalents.

"With its 2,000 supercenters and desire to sell more organic food, Wal-Mart is poised to become the nation's largest seller of organic food," reports the *New York Times*. And they are already the biggest seller of organic milk. (For more on organic milk issues, see p. 12.)

BizJournals.com (05/26/06) reported that

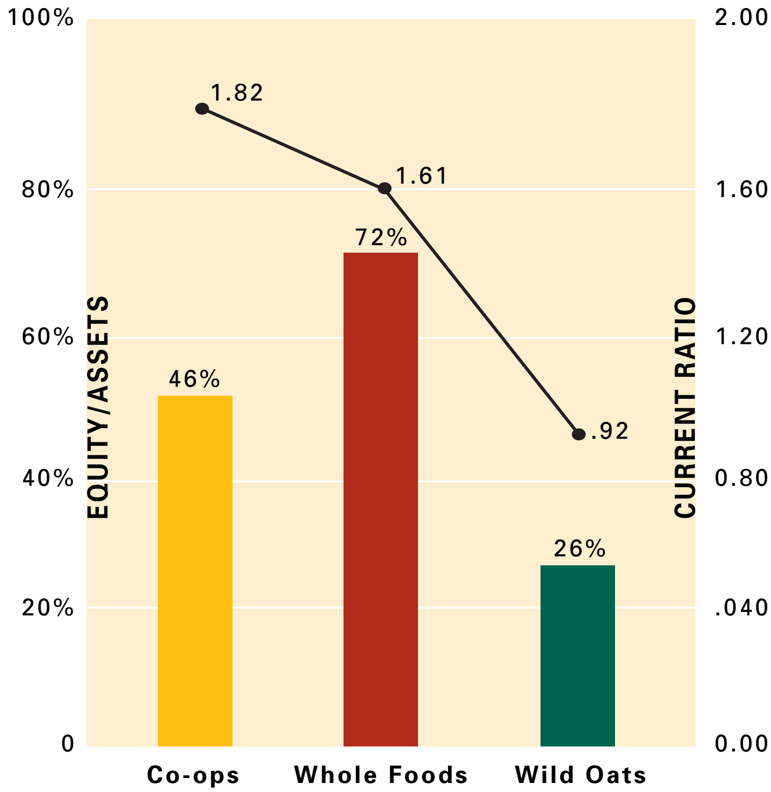
"Safeway's Lifestyle store format brought the company recent growth, according to CEO Steve Burd. The grocer spent $1.2 billion on the format program in fiscal 2004 and $1.4 billion last year, and will spend $1.6 billion during 2006 to build or remodel stores. Virtually all of the company's 1,772 stores in the U.S. and Canada will be converted to the Lifestyle format by the close of fiscal 2009.... Lifestyle stores feature expanded product categories including housewares and organic produce, and grocery items, and a wide array of upscale cosmetic touches like faux wood floors in produce departments, dark wood shelving and subdued lighting."

In addition to new competition from supercenters and supermarket makeovers, co-ops are in jeopardy of losing sales to alternative formats such as Trader Joe's, Wal-Mart's Neighborhood Markets, and Super Valu's Sunflower Markets. Trader Joe's has developed a cult-like following thanks to the high quality and low prices of its products, 80% of which are private labeled and not easily copied. In addition, gourmet stores and new deli formats are slicing off a share of the natural and organic market.

Co-ops are also threatened by alternative distribution systems, particularly online shopping. *Progressive Grocer* notes that Amazon.com is "fixing to be the Web's Wal-Mart Supercenter. The leading e-tailer took what might be a first step in that direction yesterday, by adding a new grocery store to its mega e-merchandising site that will hawk more than 10,000 non-perishable grocery items 'with convenience and low prices.' Online food retailing may never be the same."

Co-ops are also affected by rapidly changing distribution dynamics. Wal-Mart is using its unprecedented buying power to encourage manufacturers to develop organic versions of their products. With demand increasing so rapidly, supplies are sure to be tight, at least in the short run. This will drive up prices for ■>

Equity/Assets and Current Ratios, 2005



Co-op balance sheets continue to be strong, when measured by the percent of assets owned by members and the ratio of liquid assets to short-term obligations.

<■ businesses that don't have supplies locked in. In addition to retailers flexing their buying muscle, the consolidation on the supply side has created a single dominant national distributor for natural products, United Natural Foods, that faces limited competition.

At the same time that co-ops face an array of new competitive forces, our historic competitor Whole Foods is growing at a rate that far outpaces the growth of co-ops. While our same-store sales growth is comparable to that of Whole Foods, Whole Foods is opening more, larger stores that are performing better than its existing stores. In contrast, many co-op store openings and moves have been problematic. One reason Whole Foods can open new stores so much more successfully is that it significantly outperforms co-ops in terms of operating income, which allows it to finance much of its new growth from operations. Many of the co-op "cash cows," by contrast, build bank accounts but not new stores. Further compounding co-ops' slow growth is the fact that frequently a co-op's new store is the first for its management team, which results in many learning-curve mistakes. Unlike Whole Foods, co-ops don't have a replicable model that can significantly improve our rate of growth as well as reduce the cost of growth.

The co-op response

In response to industry changes, it is imperative for co-ops to develop a significant differentiator on par with Wal-Mart's low price, Whole Foods' broad selection, or Trader Joe's unique products. Each of these companies does a superb job of differentiating itself. How about co-ops?

In a maturing industry, Porter warns against being "stuck in the middle" trying to do too many things and not being unique and best

Methodology for the 2005 CoCoFiSt Annual Report on Retail Operations

For the past several years *Cooperative Grocer* has contracted with Cooperative Development Services (CDS) to compile and analyze Common Cooperative Financial Statements (CoCoFiSt) data and write a report. Financial data was taken from the CoCoFiSt program, compiled from data submitted by participating co-ops.

This year the data collected through the CoCoFiSt program included 102 co-ops with 128 outlets and represents $820,632,049 in gross sales. The 128 outlet operations do not include restaurants, wholesale operations, production operations, etc., but the total gross sales volume does. For the centerfold summary, some co-ops, including two with largely conventional grocery products, were taken out of the data pool to allow for more accurate comparisons.

Since more stores now consistently participate in CoCoFiSt, the analysis team was able to compare financial results from 2004 with 2005 results from nearly the exact same set of co-ops. Therefore, variances are real and cannot be attributed to a different group of co-ops reporting.

100 co-ops with 124 total stores were included in the following store size categories:

- SMALL: . . . . Sales under $2 million: . . . . . 21 co-ops . . . . . . 28 stores
- MEDIUM:. . . . . Sales $2–6 million: . . . . 35 co-ops . . . . . . 39 stores
- LARGE:. . . . . Sales $6–12 million: . . . . 27 co-ops . . . . . . 41 stores
- EXTRA LARGE:. . . . Sales over $12 million: . . . . . 17 co-ops . . . . . . 16 stores

Note: a multi-outlet co-op may have various size stores and that is why there are more extra-large co-ops than there are extra-large stores.

In the centerfold statistical tables of the income statement and balance sheet (pp. 24–25) we present composite ratios using weighted averages—for these averaged percentiles, large co-ops have more weight than small co-ops.

In the ratios section, we provide median and quartile results, which are frequently more balanced measures than the average. Quartile results are calculated on each variable: for example, the sales trend upper quartile contains the 25% of stores that have the highest growth rates, while the upper quartile on gross margin could represent a different set of co-ops. Also, "upper quartile" does not necessarily mean "better"—for example in operational expenses, where the lower quartile reflects the more desirable result.

"Identical store sales" figures exclude co-ops that did not participate in CoCoFiSt in 2004 and 2005 and new store units.

The reporting and analysis of the data has been made much more consistent and less labor intensive. Store size categories stayed at four, with the break points revised last year. (Some additional data not appearing in *Cooperative Grocer* will be found at www.cooperativegrocer.coop.)

For other sources, we used *Progressive Grocer*'s "73rd Annual Report of the Grocery Industry," *Natural Foods Merchandiser*'s "Market Overview 2005," Whole Foods Inc. and Wild Oats Inc. annual reports and 10K reports, *Supermarket News*, and Food Marketing Institute data.

Data analysis was done with a team of people from around the country. Many thanks to the following for their generous assistance with this project: Walden Swanson, Kate Sumberg, Peg Nolan, Ruffin Slater, Dave Gutknecht, Joe Golton, Lee Lancaster, Carol Collins, John Eichholz, Margo O'Brien, Michele Buchanan, Marilyn Scholl, and John Foley. Inquiries concerning the data: Walden@CoopMetrics.coop.

at anything. "Industry maturity tends to widen the performance differences between firms with a winning strategy and those that are stuck in the middle, because it exposes ill-conceived strategies that have been carried along by rapid growth," says Porter.

According to National Cooperative Grocers Association's Hartman study, co-ops have historically and instinctively adopted a differentiation strategy with a narrow focus on the core natural food market. As the industry has changed, successful co-ops have started to change too. But will co-ops adapt swiftly enough to survive? What will be our differentiator? Do we have the focus and commitment to develop it now, while we are still performing relatively well financially?

While new competitors may hurt co-ops in some ways, it's important to identify ways in which we can turn increased competition to our advantage. Lindy Bannister, general manager at the Wedge, likened Wal-Mart organic customers to primary school students, in relation to natural and organic products. They might graduate to Whole Foods and Wild Oats—the high schools in this analogy—and if they go to college, well, that would be the co-ops. In other words, Wal-Mart might be creating greater overall natural and organic demand from which we may derive new core customers.

> Does being locally owned and democratically operated create an opportunity that can't be duplicated by the competition?

Does being locally owned and democratically operated create a competitive opportunity that can't be duplicated by the competition? Can our commitment to providing a marketplace for products that are locally produced or economically sustainable be enough to distinguish us from our competitors? Is the service and information that our co-ops offer enough to build a loyal relationship with owners and solidify our competitive edge?

An example of a co-op differentiation strategy is the 3,400 outlets of U.K.'s Co-operative Group, which is rolling out a new national brand designed to tout the cooperative advantage. Its new identity, "The Co-operative," substantially increased sales in the 16 stores in the year-long pilot study compared to a similar control group. Zoe Morgan, director of marketing for the group, said, "This will have a major impact on the way consumers perceive our operations on High [Main] Street. For the first time our family of businesses will be united under one common brand, which will go hand in hand with defined operational standards for each business." A group of U.S. co-op leaders is scheduled to meet with U.K. counterparts this summer to study their experience.

The grocery industry reported that stores that performed very well in 2005 embodied a strategy for creating distinction within the marketplace, good operations, and the capacity to change. Co-ops will be caught in the middle unless they are good operators that are able to adopt an effective strategy that differentiates the co-op from its competition. This is a strategy that we can develop together, cooperatively. Maybe being ourselves *is* the best way to be different. ■