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New Rec: Safeway, Inc. (SWY - $53.20) April 22, 2001

Position: Sell Target: $35 Timing: 2 (1=aggressive; 5=cautious)

000$	Q1 01	Q2 01E	Q3 01E	Q4 01E	FY 00	FY 01E
Revs	7,666.1	8,059.2	8,145.2	11,007.2	31,977	34,878
EPS$	0.55	0.59	0.55	0.77	*2.13	2.47
Y/Y%	15.5%	7.7%	4.9%	33.0%	13.3%	16.0%
PE					25.0	21.5
PSR					0.86	0.79
Consens	0.55	0.63	0.61	0.82	n/a	2.61

* Pro Forma EPS in FY 2000 was $2.26 adjusted for a strike in Q4 00.

Shares Out: 516.2M Market Cap: $27.5B FYE: Dec

Summary: Safeway has been a stellar performer in the supermarket segment. Mainly as a result of its superior margins, its record of good identical store sale growth, and its ability to successfully integrate large acquisitions. SWY shares

are awarded a significant premium over competitors' share prices. SWY shares trade at 20x 2001 consensus EPS and the company has a market value 0.86x year 2000 sales. By contrast, Kroger (KR) sells for 14x 2001 consensus EPS and 0.38x year 2000 sales.

In order to maintain the disparity with its peers, Safeway must continue its record of out performing. However, there are signs that its long run of out performance may be coming to an end.

The quality of SWY's earnings has been deteriorating. This has helped mask a deterioration in core earnings growth. Non-core operating items' contribution to strike adjusted EPS in 2000 was 10.2% of EPS, versus 4.3% in 1999 and 1.9% in 1998. Excluding non-core items, EPS grew just 13.2% in 2000 versus the reported strike adjusted 20.2%. Free cash flow is weak. Free cash flow as a percent of market value was just 1% in 2000.

A central problem appears to be that Safeway is running out of further cost reduction opportunities, despite substantial capital spending. After 30 consecutive quarters of year over year operating and administrative (O&A) cost improvements relative to sales, O&A rose year over year in Q4 00. While management was able to blame the Q4 increase on the Q4 strike, O&A rose yet again in Q1 01.

Indeed, for fiscal 2000, Safeway reported just a 4 basis point improvement in O&A over 1999. However, excluding the benefit of the non-core items included as a reduction to O&A in Safeway's financial statements, O&A would have increased by 43 basis points.

Safeway needs to make gross margin improvements in order to maintain earnings growth in excess of sales growth. However, the company has already achieved a level of efficiency that is higher than that of its pure play competitors. Its plans to reduce "shrink" by 50% and to further increase private label penetration might be difficult to achieve. Safeway also has to negotiate three additional collective bargaining agreements in 2001, which has the potential to increase expenses.

There is anecdotal evidence that it is getting harder to achieve COGS reductions. One industry source reported that Safeway approached a vendor at the end of Q4 with a proposal to sell shelf space at a discount to its regular terms and with an unusual guarantee of a revenue minimum. We assume a 57 basis point gross margin improvement in 2001, above company guidance, but below the most aggressive "street" estimates.

Investor expectations for identical store sales growth also appear to be too high. Investors expect 3%-4% identical store growth in FY 01. However, Q4 00 was a strike adjusted 1.4%, and while Q1 01 was 3.6%, it was against an easy 1.8% in the prior year. Two year growth rates have been declining. Two year sales growth was 3.9% in fiscal 2000, down from 5.46% in 1999. Two year growth would have to accelerate in 2001 in order for Safeway to meet its targets.

The next two quarters' comparisons could be particularly challenging. Q2 00 was 4.4%, and Q3 00 was 4.2%. We think that Safeway could miss sales and earnings estimates in the next two quarters.

Further out, but looming large, is WalMart. With its heavy concentration of stores in California, Safeway has been relatively immune to WalMart's supercenter and Neighborhood Store expansion. However, WMT has been moving west, and is already competing with SWY in Texas, Colorado and Arizona. It is well known that Safeway prices for high volume items average perhaps 20%-30% higher than WMT. Studies have shown that supermarket stores competing with supercenters experience median growth of just 0.7% versus 2.1% otherwise. WMT opened its first west coast supercenter in Oregon on April 11, 2001. WMT has announced that it will open a distribution center in the Seattle area before 2004.

Finally, we think the acquisition market will not offer many good opportunities for acquisition-driven margin and market share growth.

We think that Safeway will have difficulty achieving fiscal 2001 and fiscal 2002 sales and earnings estimates. Our target is 14x our 2001 estimate of $2.47, or $35 per share. $2.47 would represent 9% EPS growth over strike adjusted 2000 EPS of $2.26. Consensus expects 15% growth in adjusted EPS to $2.61. SWY shares now sell at 20x consensus EPS. The PE to growth premium should limit the risk in selling SWY shares. At a $35 price, SWY would still have a market value equal to about 50% of 2001 sales, higher than its peers.

Discussion:

Background: Safeway (SWY) is the third largest supermarket chain in the U.S., behind Kroger and Albertsons. As of the end of Q1 ’01, SWY operated 1,697 stores under the following banners:

Safeway – 1,050 stores in Northern California, the Southwest, the Pacific Northwest, metro Washington D.C., and Canada
Vons (acquired April 1997) – 326 stores in Southern California and Nevada
Dominick’s (acquired November 1998) – 118 stores in metro Chicago

Carr-Gottstein (acquired April 1999)– 38 stores in Alaska
Randalls/Tom Thumb (acquired September 1999)– 126 stores in Texas
Genuardi's (acquired February 2001) – 39 stores in metro Philadelphia

1. As illustrated in Table 1, SWY is valued at a premium to its two larger competitors.

Table 1 – Supermarket Chain Valuations ($M)

	Market Cap	Sales - 2000	PSR - 2000	PE - 2000	PE - 2001	EPS Growth
Kroger**	18,686	49,000	0.38	16.6	14.4	14.9%
Albertsons	12,025	36,762	0.33	14.1	13.8	2.4%
Safeway	27,462	31,977	0.86	*23.5	20.4	*15.5%

* comparison is made to the strike adjusted FY 00 EPS of $2.26. Reported EPS was $2.13 in 2000
**Kroger numbers also adjusted for one-time charges

Bulls say that this premium is justified mainly based on the following questionable assumptions about the future:

"SWY is the most profitable supermarket chain. Additional margin expansion is expected in the future."
"SWY has consistently generated higher identical-store (ID's) sales growth (excludes remodels/replacements) than competitors, and this outperformance will continue."
"SWY has little exposure to Wal-Mart supercenter competition, relative to the other large supermarket chains."
"SWY is the industry's acquirer of choice, and will benefit during the continuing period of industry consolidation."

2. As illustrated in Tables 2A and 2B, SWY actually earns very little on a free-cash basis relative to reported net income and to its market valuation.

Table 2A – Free cash flow analysis ($M)

	2000	1999	1998	1997	1996	1995
Free-cash flow	329	155	178	463	283	207
Free-cash return on equity	6.9%	4.3%	6.8%	27.8%	28.6%	28.7%
Net income return on equity	23.0%	27.1%	30.8%	37.3%	46.5%	45.3%

Table 2B – Free-cash return on enterprise value ($M)

Enterprise value	33,503
Free cash flow – FY 2000	329
% return	0.98%

SWY has had to invest in an increasing amount of capital to sustain historical sales and earnings growth rates. As illustrated in Table 3 below, this has

translated into weak free cash flow.

Table 3 – Free cash flow

	2000	1999	1998	1997	1996	1995
Operating cash flow	1,901	1,488	1,253	1,222	825	658
Cash cap-ex	(1,573)	(1,334)	(1,075)	(758)	(542)	(451)
Free cash	329	155	178	463	283	207
Free cash as a % of net income	30.1%	15.9%	22.0%	83.1%	61.5%	63.4%

While there was an uptick in free cash as a % of net income during 2000, we expect this performance to be short lived. SWY is projecting cash cap-ex of $1.9B in 2001, representing a $328M increase over FY 00 as illustrated in Table 4 below. SWY is forecasting 85-90 new stores and 275 remodels in 2001.

Table 4 – Incremental cap-ex ($M)

	2001E	2000	1999	1998	1997	1996
Incremental cap-ex	328	239	258	317	216	91

3. As illustrated in Tables 5a and 5b, SWY is also highly leveraged. SWY borrowed an additional $500M in Q1 01 in connection with its acquisition of Genuardi's. We project interest expense of approximately $470M in 2001.

Table 5a – Debt ($M)

	Q1 01	2000	1999	1998	1997	1996
Debt	7,010	6,496	6,956	4,972	3,340	1,984
Equity	5,692	5,390	4,086	3,082	2,149	1,187
Debt to equity	123%	121%	170%	161%	155%	167%

Table 5b – Interest expense ($M)

	2001E	2000	1999	1998	1997	1996
Interest expense	471 (E)	457	362	235	241	179
% of operating income	17.3% (E)	20.0%	18.1%	14.7%	18.8%	20.0%

SWY may face a liquidity crunch next year, when $3.1B of debt matures. Table 6 below lays out SWY's debt maturities over the next five years.

Table 6 – Schedule of debt maturities ($M)

	2001	2002	2003	2004	2005	2006
Debt maturities	626.8	3,103.6	378.6	698.6	6.5	1,219.0

4. Quality of earnings is also a problem. The quality of SWY's earnings has deteriorated over the past couple of years. SWY has increasingly relied on gains from non-core items to maintain its industry leading EPS growth rates. As illustrated in Table 7, four non-core items contributed $0.23 to EPS in 2000, compared with $0.08 in 1999 and $0.03 in 1998.

Table 7 – Non-core items contributing to EPS ($M)

	2000	1999	1998	1997	1996	1995
Net pension income	77.3	35.1	18.3	4.1	(0.8)	(7.6)
Gain on pension settlement	15.0	0.0	0.0	0.0	0.0	0.0
Gain/(loss) on sale of retired properties	58.5	30.6	(13.3)	12.4	12.6	(20.4)
Non-cash decrease/(increase) in accrued claims & other liab	47.5	8.4	17.5	13.9	17.6	(19.0)
Total	198.3	74.1	22.5	30.4	29.4	(47.0)
EPS contribution	$ 0.23	$ 0.08	$ 0.03	$ 0.04	$ 0.04	$ (0.06)
% of reported EPS	*10.2%	4.3%	1.9%	3.2%	4.1%	-8.8%

* Represents % of the strike-adjusted EPS of $2.26

These gains represented 10.2% of reported EPS in 2000, up from 4.3% in 1999 and 1.9% in 1998. As illustrated in Table 8, if these non-core gains are excluded, SWY grew EPS by just 13.2% in 2000 versus the reported 20.2%.

Table 8 – EPS growth excluding non-core items

	2000 *	1999	1998	1997	1996
EPS growth excluding items in Table 1	13.2%	14.8%	28.8%	30.2%	26.5%
Reported EPS growth	20.2%	18.2%	27.2%	28.9%	42.6%

* Excluding the estimated $0.13 EPS effect of Summit Logistics strike during Q4 '00

The company records the four non-core items as reductions to Operations and Administration (O&A) Expense. However, the first three of these (net pension income, gain on pension settlement, and gains on property retirements) represent non-operating items. A more appropriate classification, in our opinion, would be to record them as "other income" below the operating profit line.

SWY bulls argue that selling real estate and running profitable pension plans are part of the core operating activities of a supermarket business. However, the terms of the CEO's bonus plan (per the FY '00 10K) perhaps better explain the bias to include these items in O&A. The amount of the CEO's bonus is dependent on three performance measures, one of which is operating profit (identical store sales growth and working capital being the other two). As illustrated in Table 9, SWY's operating margin in 2000 would have declined for the first time since 1993 if the pension and real estate gains were excluded from operations, compared with the reported 22 basis point improvement.

Table 9 – Operating profit excluding pension and real estate gains

	2000	1999	1998	1997	1996	1995
Reported operating margin	7.14%	6.92%	6.54%	5.69%	5.16%	4.44%
Margin excluding pension and real estate gains	6.66%	6.70%	6.52%	5.62%	5.10%	4.61%

The real estate sales and pension profits are representative of SWY's recent emphasis on what it refers to as "total asset and liability management." SWY's new CFO has been charged with the responsibility of finding new avenues of generating income from SWY's non-traditional assets, such as its customer lists, customer traffic, etc. Such efforts are fine, as long as the non-core items are not confused with the profitability of SWY's core supermarket operations. The relevant issues for such non-core items are the value, quality and sustainability of the earnings streams. We discuss each of these four non-core items in more detail below.

5. Net Pension Income: The company has an over-funded pension plan, which has provided the company with an increasing source of earnings for the last four years. The EPS contribution from pension income was $0.09 in 2000, up from $0.04 in 1999. In our opinion, this is a low quality source of earnings, given that it is not a cash in-flow and its sustainability is questionable given the volatility in equities prices. Table 10 illustrates the five components of net pension income.

Table 10– components of Net Pension Income ($ M)

	2000	1999	1998	1997	1996	1995
Expected return on plan assets	182.3	162.7	141.5	118.3	148.2	88.3
Service cost	(47.7)	(54.4)	(52.5)	(42.5)	(41.3)	(36.7)
Interest cost	(84.7)	(81.6)	(69.7)	(60.1)	(51.7)	(48.3)
Amortization of prior service cost	(14.8)	(15.4)	(14.3)	(11.6)	(56.0)	(10.9)
Amortization of unrecognized gains	42.2	23.8	13.3	0.0	0.0	0.0
Net pension income	77.3	35.1	18.3	4.1	(0.8)	(7.6)
EPS contribution	$ 0.09	$ 0.04	$ 0.02	$ 0.01	$ 0.00	$ (0.01)

Service cost, interest cost, and the amortization of prior service cost all relate to benefits earned by covered employees. Service cost decreased by $6.7M ($0.01 EPS) from 1999 to 2000 after steadily increasing the prior four years. This decrease was despite the fact that the number of employees was essentially unchanged from year to year, and there was no change in the actuarial assumptions disclosed in the 10K. There are a number of other actuarial assumptions for which disclosure is not required (mortality rates, turnover rates, etc) which may have a significant impact on the amount of service cost recorded during the period.

These benefit costs can be offset by gains earned on the investment portfolio. However, it is important to understand that the gains recorded in the income statement are accounting numbers, rather than actual returns. The following is an analysis of each:

Expected return on plan assets – This amount is calculated by applying the pension fund's long-term expected rate of return to the fair value of the plan assets. GAAP requires the use of this expected return in lieu of the actual return to minimize volatility, given the long-term horizon of the pension obligation. The company uses a 9% expected rate of return, which is consistent with industry practice. By over funding the plan, however, SWY is able to generate a 9% return with a low degree of risk. In contrast to the $182.3M gain recorded in 2000, the actual return was a $60M loss (note: actual returns exceeded expected returns from 1995 to 1999). SWY's plan is invested 50% in equities and 50% in fixed income securities, approximately. SWY's guidance for 2001 is for lower pension income, given the downturn in equity values.

Amortization of unrecognized gains - SWY's pension fund had a $212.5M "unrecognized gain" as of 12/00 (per the 10K footnotes), down from $560M at 12/99. This is an off-balance sheet item which arises from changes in the projected benefit obligation due to one of the following: (a) changes in actuarial assumptions, and/or (b) experience differing from previous assumptions. It is basically a device for reducing what otherwise could be significant year to year volatility in the pension income or expense recorded in the income statement, due to changes in estimates, unexpected market fluctuations, etc. Without getting into the accounting intricacies, GAAP requires amortization of the unrecognized gain once it exceeds a certain threshold. During 2000, SWY recorded $42.2M of gain amortization, up from $23.8M in 1999. We anticipate lower amortization in 2001, given the decrease in the balance of the unrecognized gain at 12/31/00.

6. Gain on pension settlement: SWY out sourced its Eastern Division distribution operations to C&S Wholesale Grocers in 2000, which enabled the company to record a $15M gain ($0.02 EPS) relating to the transfer of the pension obligation to C&S. This is a non-recurring, non-cash gain.

7. Gains on property retirements: The sale of retired supermarket properties generated a $58.5M gain in 2000, up from $30.6M in 1999. Table 11 illustrates the historical EPS contribution from real estate transactions.

Table 11 – EPS contribution from gains/(losses) on real estate dispositions

	2000	1999	1998	1997	1996	1995

EPS contribution	$ 0.07	$ 0.03	$ 0.02)	$ 0.01	$ 0.02	$ (0.03)

According to SWY, the company still has between 300-350 tracts in its real estate ledger. SWY is forecasting $23M-$25M from real estate sales for 2001, anticipating a decreased level of activity and a softer real estate market.

8. Non-cash decrease in Accrued Claims & Other Liabilities: SWY recorded a $47.5M ($0.05 EPS) non-cash decrease in accrued claims and other liabilities in 2000, up from $8.4M ($0.01) in 1999. It appears that the company has dipped in to this reserve in each of the last five years. When we inquired about the 2000 decrease, a SWY representative responded that significant portion of it related to a decrease in accrued liabilities for its capital program. The company uses the percentage of completion method to account for such contracts. This accounting method, while proper, is notorious for being used as an earnings management tool.

9. Cost reduction has been a focus for SWY over the past decade. Nevertheless, we think that further cost reduction possibilities are becoming more limited, As of Q3 '00, management was able to boast of 30 straight quarters of reduction of Operations and Administration (O&A) as a percentage of revenue (pro forma for acquisitions). That streak ended in Q4, although SWY blamed it on the Q4 strike with Summit Logistics, to whom it out sources its N. California distribution operations.

However, O&A was up again in Q1 '01, this time by 38 basis points Y/Y. Table 12 illustrates the diminishing improvements in O&A. It appears that the "low hanging fruit" has been harvested.

Table 12 – O&A as a % of revenue

	2000	1999	1998	1997	1996	1995
O&A as a % of revenue	22.56%	22.57%	22.56%	22.84%	22.48%	22.96%
Basis point improvement	1	(1)	28	(36)	48	56
Pro forma BP improvement*	4	30	28	35	48	56

* Pro forma for acquisitions in 2000, 1999, and 1997.

We think SWY's problems with cost reduction began long before Q4 '00. As illustrated in Table 13, we think the inappropriate classification of pension and real estate gains has masked underlying problems.

Table 13 – Basis point change in O&A excluding pension and real estate gains

	2000	1999	1998	1997	1996	1995
Reported pro forma basis point improvement in O&A expense	4	30	28	35	48	56

BP change in O&A excluding pension and real estate gains	(43)	7	26	28	41	73

Management gave the following guidance relating to O&A during the conference call: (a) energy costs would be $56M higher than expected for 2001, (b) O&A offsets from net pension income would be approximately $35M, down from $92M in 2000 ($92M includes the $15M pension settlement gains), (c) O&A offsets from gains from the sale of real estate should be between $23M-$25M, down from $58.5M in 2000. Table 14 illustrates OWS' quarterly estimates of these cost increases in FY '01.

Table 14 – FY '01 cost increases - $M (OWS projections)

	Q1 '01	Q2 '01E	Q3 '01E	Q4 '01E
Higher energy costs	17.0	13.0	13.0	13.0
Lower pension income	4.8	11.4	8.0	16.5
Absence of pension settlement gains	0.0	10.0	5.0	0.0
Lower gains on R.E. transactions	11.4	12.0	10.5	0.0
Total	33.2	46.4	36.5	29.5
Basis points	43	58	45	27

As illustrated in Table 15, we are projecting a 30 basis point increase in O&A during 2001. These projections are based on the cost increases in Table 14 above, incremental operating costs associated with the Genuardi's acquisition, and incremental costs due to growth.

Table 15 - O&A, including goodwill amortization, as a % of revenue

	Q1	Q2	Q3	Q4	Year
1999	22.84%	22.49%	22.63%	22.40%	22.57%
2000	22.51%	21.82%	22.55%	23.14%	22.56%
2001 projected (Q1 is actual)	23.00%	22.63%	23.16%	22.70%	22.86%

10. Safeway has reported excellent gross margins. Table 16 illustrates SWY's margin superiority over Kroger and Albertsons.

Table 16 – Supermarket Chain Profitability (performance during 2000)

	Gross margin	Oper. margin	Net margin	EBITDA margin
Kroger	27.0%	5.2%	2.3%	7.2%
Albertsons	28.5%	5.0%	2.4%	7.7%
SWY	29.7%	7.1%	3.4%	9.7%

SWY stated that it now expects future net margin improvements to come mainly from gross margin expansion. Management is forecasting improvements of 30-40 basis points per year, driven by a reduction of shrinkage, better buying, and incremental private label penetration.

In Q1 '01, SWY's gross margins were up a strong 79 bps Y/Y. Management said the improvement was driven primarily by these three elements, with shrink-reduction and better buying especially strong.

As illustrated in Table 17, we are conservatively forecasting gross margin improvement of 57 basis points in 2001 (vs. company guidance of 30-40 bps and some "street" estimates of 80+ bps improvements). We want to be generous, given the strong margin performance in Q1. Nevertheless, we think that management's targets may be too aggressive, and that any margin improvements from these initiatives may be offset by other cost increases, as we discuss later.

Table 17 – Gross margin projections

Gross Margin	Q1	Q2	Q3	Q4	Year
1999 actual	29.80%	29.90%	29.63%	28.94%	29.49%
2000 actual	29.77%	29.68%	29.99%	29.42%	29.69%
2001 E (Q1 is actual)	30.56%	30.30%	30.30%	30.00%	30.26%

Shrinkage stands at 2.65% of COGS, and management would like to reduce that to the industry average of 1.25% within five years. This would cut over $300M out of COGS. The targeted savings translate into a $115K reduction of damaged goods and a $71K decrease in shoplifting/employee theft per store per year, on annual average sales of $19.1M/store. We are somewhat skeptical as to whether SWY can cost effectively eliminate shrinkage to its targeted amounts. How much would SWY have to pay to hire additional security to save the incremental $71K? Table 18 illustrates the components of shrink.

Table 18 – Shrink analysis

	Current ($M)	% of COGS	Target ($M)	% of COGS
Damaged items	300	1.33%	108	0.48%
Employee theft	138	0.61%	72	0.32%
Shoplifting	108	0.48%	54	0.24%
Other	54	0.24%	48	0.21%
Total	600	2.65%	282	1.25%

SWY has strong private label (PL) penetration, at approximately 25 +% versus the 15%-25% range in most of the industry. PL carries margins which are 10% higher on average than national brands. However, trading down to PL has the effect of depressing the top line, as prices are 10%-15% lower. SWY says that its goal for PL is to achieve a better mix, meaning higher margin and better selling items, and not necessarily higher overall PL penetration.

As for reducing its cost of goods, SWY is already known for having one of the most efficient supply chains, so it seems doubtful that there are significant excess costs left to target. We think an increased emphasis on slotting fees, which are recorded as a reduction to COGS, may have been a significant factor in recent gross margin improvements.

SWY, like the rest of the industry, has become more aggressive with slotting fees, which are recorded as a reduction to COGS. For example, supermarkets have recently begun charging slotting fees for produce, even though the risks assumed by the supermarket with respect to product failure are very slim. Slotting fees pursuant to exclusivity or "pay-to-stay" arrangements have come under increased scrutiny from the FTC, particularly within the context of supermarket consolidation.

One source told us that SWY approached a vendor at the end of Q4 and offered additional shelf space for a cash slotting fee. The source says that the fee was at a discount, and that SWY also guaranteed a minimum amount of revenue. The vendor had never before been offered a guarantee. SWY would not comment on the quantity of its slotting fees. We wonder if SWY is using slotting fees to make its numbers.

11. An increase in promotional and employment costs also could potentially mitigate some of the targeted gross margin improvements.

Promotional costs represent approximately 9.7% of COGS. SWY has acknowledged an increase in promotional activity by competitors such as ABS, as well as an increase in competitive openings, which we think include WMT supercenters. We think SWY will become more promotional or price competitive to prevent market share losses.

Regarding employment costs, SWY has to negotiate three collective bargaining agreements during the remainder of FY 01. The most acrimonious negotiations may be with the Teamsters at its Eastern Division distribution center, where a contract expires May 12th. In our opinion, the Teamsters seem resolved not to let SWY come away with another victory similar to what occurred in Northern California in December, where the Teamsters ended up with a worse deal than the last offer made to them before the strike. Teamster President James Hoffa held a rally with Safeway Teamsters in Washington, D.C. on March 19, 2001, telling them that he was ready to walk the picket lines with them if necessary (also see Eastern Division workers' web page at http://maxpages.com/safewayeastdiv). N. California Teamsters picketed Safeway retail stores and disrupted distribution, with a cost to Safeway of approximately $113M ($0.13 EPS) in Q4.

SWY also has to negotiate contracts with UFCW food clerks in Seattle (May 6th expiration) and Northern California (September '01). We think that investors will be less willing to shrug off the "one-time" costs of another strike, especially after the costs of the N. California action came in much higher than SWY had led investors to expect.

12. Growth in identical store sales has perhaps been the most closely watched performance metric for SWY. Table 19 illustrates SWY's superior performance.

Table 19 – Identical Store (ID's) Sales Growth

	1998	1999	2000	3 Yr Growth
Kroger	1.1%	2.3%	1.6%	5.0%

Albertsons	0.5%	1.7%	0.3%	2.5%
SWY	3.7%	1.7%	* 2.2%	7.7%

* excluding the effect of the strike in Q4, which SWY estimates cost 50 bps in growth

However, there are indications that this out-performance may be diminishing. Q4 '00 came in at negative 0.2%, or a positive 1.4% adjusted for the strike, following 2.9% growth in Q4 '99. Even the strike adjusted number was well short of management's guidance for 3%- 3.5% growth in Q4. The explanation for the shortfall was that management was distracted by the strike. We are skeptical of this explanation. SWY reported 3.6% growth in Q1 '01, but it had an easy comparison at 1.8% (Q1 '00 had an overhang from the Y2K shopping sprees which occurred in late Q4 '99).

SWY is forecasting 3%-4% growth for FY '01, and 2.5% – 3% growth for Q2 '01. However, SWY faces tough comparisons over the next two quarters, at 4.4% and 4.2%, respectively. As illustrated in Tables 21 and 22 below, the company's guidance would represent a significant reversal of performance trends over the past four years. The 3%-4% growth for FY '01 would result in 2 year growth of 5.3%-6.3%, reversing the steady downward trend from 9.93% in 1996 to 3.94% in 2000 as illustrated in Table 20.

Table 20 – Identical Store Sales Growth

	Q1	Q2	Q3	Q4	Full Year	Compounded 2 Yr Growth
1993	0.30%	1.40%	3.10%	3.20%	2.10%	n/a
1994	4.20%	4.20%	3.70%	5.20%	4.40%	6.59%
1995	5.00%	3.40%	5.30%	4.70%	4.60%	9.20%
1996	5.20%	5.80%	4.50%	4.90%	5.10%	9.93%
1997	3.60%	2.00%	0.50%	3.20%	1.30%	6.47%
1998	1.20%	4.40%	4.20%	2.40%	3.70%	5.05%
1999	2.20%	0.70%	0.50%	2.90%	1.70%	5.46%
2000	1.80%	4.40%	4.20%	1.40%	2.20%	3.94%
2001	3.60%	2.5– 3% (E)	*	*	3 - 4% (E)	5.3 - 6.3%(E)

* no specific guidance from management
E = management's guidance

As illustrated in Table 21, the 7.0% -7.5% two-year growth for Q2 '01 would be the largest two-year gain since 1997.

Table 21 – Two-year compounded growth – ID sales

	Q1	Q2	Q3	Q4
1994	4.51%	5.66%	6.91%	8.57%
1995	9.41%	7.74%	9.20%	10.14%
1996	10.46%	9.40%	10.04%	9.83%
1997	8.99%	7.92%	5.02%	8.26%
1998	4.84%	6.49%	4.72%	5.68%

1999	3.43%	5.13%	4.72%	5.37%
2000	4.04%	5.13%	4.72%	4.34%
2001	5.46%	7.0 - 7.5% (E)	*	*

* no specific guidance from management for Q3 & Q4 '01

Bulls point to SWY's strong management team and the "secret breakaway sales strategies" as the catalysts which will help drive out-performance in the ID sales growth. There are 11 of these sales strategies, although management said that it is currently focusing on five of them, including the "big one" which was launched at the end of FY '00. The company has kept these strategies secret, although it has said that 7 of them are technology oriented.

However, we have yet to see evidence that they are working. The strong 4+% comps in Q2 and Q3 of last year followed very easy comparisons of 0.70% and 0.50%, respectively, and then Q4 00 and Q1 01 comps were unimpressive. Management acknowledged in the Q1 conference call that any gains from these strategies in the short term may be offset by market share losses from competitive activity.

SWY is also highly exposed to the consumer-centric element of the energy crisis in California, where the company operates 31% of its stores. According to a recent study by the Federal Reserve Bank in San Francisco, the average household will have to spend an additional $450 on natural gas and electricity bills in 2001, as well as an additional $300 in higher prices for goods and services as producers pass along costs to the consumer. Given SWY's relatively higher pricing, we think that the company is vulnerable to the prospect of consumers trading down to every day low price chains.

We are forecasting ID sales growth of 1.6% and 2.0% for Q2 01 and Q3 01, respectively. We think that these projections are very reasonable, since they would yield 2 year growth of 6.1% and 6.3%, respectively, which would be the company's best performances since Q2 1998.

13. While Wal-Mart supercenter competition may still seem distant to some, it appears that SWY is experiencing an increase in Wal-Mart (WMT) competitive openings. WMT expects to open between 170-180 supercenters (combo supermarket & discount store) each of the next five years. The average supercenter is 180,000 sf with annual sales of $75M, versus averages of 44,000 sf and $19M per store for SWY. It also plans to open 15-20 of its Neighborhood Stores in 2001, which are 45,000 sf supermarkets. The following are some geographic areas where SWY appears to have significant exposure:

Dallas/Fort Worth, TX – SWY operates 58 stores under the Tom Thumb banner in this metro region. WMT operates 24 supercenters and 6 Neighborhood Stores within a 50-mile radius of Dallas. We mapped the precise locations of the WMT and SWY locations within the metro area. Both the Tom Thumb and WMTs are primarily located in the suburbs immediately outside central Dallas and central Fort Worth. The vast majority of the supercenters are located in very close proximity to at least one Tom Thumb, and there are numerous instances in which a supercenter is located among a cluster of Tom Thumb locations. A pattern of proximity between the competitors is clearly distinguishable.

Houston, TX – SWY operates 46 stores under the Randalls banner in the metro Houston area. WMT operates 10 supercenters within a 30 mile radius of central Houston. Eight of these ten supercenters have at least one Randalls supermarket operating within a 4-5 mile proximity. WMT has announced that it plans to open 5 Neighborhood Stores in Houston over the next 2 years, with a long term goal of 10-15 stores in the area.

Arizona – SWY operates approximately 100 stores in Arizona, including the recently acquired ABCO stores in Tucson (7 locations) and Phoenix (4 locations). Safeway is primarily exposed in the metro Phoenix and Tucson regions. WMT operates 7 supercenters in the metro Phoenix area, and 2 in Tucson. In Phoenix, all 7 of the supercenters have at least one Safeway store operating within a five-mile radius. In Tucson, both of the supercenters have multiple Safeways in close proximity.

Colorado – Safeway operates 107 stores in Colorado, where WMT operates 18 supercenters. WMT operates 3 supercenters in Colorado Springs, all of which have at least one Safeway within a 3-4 mile radius. WMT also operates supercenters in very close proximity (4 miles or less) to Safeway stores in the following locations: Greeley, Parker, Castle Rock, Salida, La Juenta, Pueblo, Canon City, and Fountain. In many instances, the supercenters are located within a few blocks of the Safeway.

Supercenter penetration is currently highest in the Southeast, the Texas/Oklahoma region, and the central mid-west. However, WMT is slowly making its way westward into prime SWY territory, having opened multiple supercenters in Las Vegas (where it directly competes with Vons) and food distribution centers in New Mexico in 1998 and in Utah in 2000. Until recently, WMT had zero supercenters are in California, Oregon, and Washington, where SWY operates 47% of its stores. However, WMT opened its first west coast supercenter in Hermiston, Oregon on April 11th. WMT has also announced that it plans to open a food distribution center in the Seattle area prior to 2004.

The heavily unionized supermarket industry in California has been lobbying hard against supercenter expansion to California by trumping up fears of economic devastation to be inflicted on local businesses by the "big box" format stores. A bill passed through the CA legislature in the Fall of 1999 which would have prevented food sales at stores greater than 100,000 sf. However, it was vetoed by the governor, who claimed that it was anti-consumer and anti-competitive.

We think penetration of the west coast is simply a matter of time. The new Neighborhood Store format should make it easier for WMT to find real estate in the tight CA real estate markets and to avoid the big-box issue. The company has been piloting this format with stores in OK, TX, and AK, and has said that it expects to open 15-20 more in 2001. However, sources tell us that WMT may be actually much closer to a large scale roll-out.

Supercenter competition has a significant impact on supermarket operators. A study by the Retail Food Industry Center at the University of Minnesota concluded that supermarket stores competing with a supercenter experience median sales growth of 0.7% versus 2.1% for other stores. Large operators such as Albertsons and Winn Dixie, which has virtually 100% exposure to supercenters, have experienced permanent market share losses.

Other studies have illustrated the downward pressure on pricing which manifests almost immediately after a supercenter opens nearby. We have reviewed one price comparison study which illustrates that SWY reduced its pricing immediately after WMT opened a supercenter nearby. While this is highly anecdotal, we think it is a valid indicator.

Safeway seems particularly exposed, given its high/low pricing format. It is well known that Safeway has higher average prices than the other large supermarket operators. There have been numerous pricing comparison surveys which indicate that WMT's pricing on standard items is between 20% and 30% lower than competing Safeway stores. Safeway argues that its customers represent a market segment that is different from the supercenter customer base, presumably less price sensitive. However, we think that significant price discounts on equivalent merchandise will transcend factors such as relative convenience, service, and presentation. It is our opinion that supercenter competition will result in market share losses for competing Safeway stores, just as it has for all other competitors.

14. It also appears that SWY will have difficulty finding attractive acquisition candidates which are large enough to provide meaningful accretion. It is doubtful

that SWY will be able to execute another deal the size of Vons. Table 22 below illustrates the size of SWY's acquisitions relative to its store base as of the acquisition date.

Table 22 – Acquisitions - # of stores acquired as a % of base

Date	Acquisition	Revs	# of stores	Base	% of Base
April 1997	Vons	$5.4B	316	1,052	30.0%
November 1998	Dominick's	$1.8B	113	1,381	8.2%
April 1999	Carr-Gottstein	$602m	32	1,500	2.1%
September 1999	Randalls	$2.6B	117	1,506	7.8%
February 2001	Genuardi's	$1.0B	39	1,688	2.3%

Supermarket consolidators have some significant factors working against them these days, including unreasonably high multiples and a more scrutinizing FTC.

The FTC has all but eliminated in-market deals in the supermarket industry, and it has indicated that it is not in favor of large mergers in any market. In June of 2000, the FTC killed Kroger's attempt to buy 74 Winn Dixie stores in TX and OK, because about half of those stores were in Fort Worth where Winn Dixie is the #2 operator and Kroger #3. In 1999, it required Albertsons and American stores to divest of 144 stores as a condition of their merger. This was the largest retail divestiture in Commission history. In the case of Ahold's attempted acquisition of Pathmark in 1999, the FTC reinforced its position that any divestitures must be made to buyers strong enough to maintain the same level of pricing, service, operations, etc., offered by the divesting entity prior to the deal, such that there would exist the same level of competition as prior to the divestiture. Ahold could not find such a buyer, and the deal collapsed.

There has also been a wide disparity between the price that sellers want and that which buyers are willing to pay. Sellers have been reportedly looking for 8x – 8.5 x forward ebitda, and sometimes more, while buyers were looking to pay much less. SWY has indicated that it has passed on a number of prospective targets over the past year because the seller was seeking a too high multiple.

SWY's own criteria further limit the prospects. The criteria are as follows:

Strong market share (#1 or #2 operator)
Revenues of $1B +
Potential to expand EBITDA margins 300-400 bps
Union operator only in a union market; non-union operator anywhere.
Self-distributing if non-contiguous.

We would add one more: not in a market with a high level of supercenter

penetration. SWY has been careful to avoid markets where WMT is expanding supercenters. This would likely rule out operators such as Winn Dixie, Publix, Harris Teeter, Marsh, and Giant, all of which have been rumored to be for sale.

Management has indicated that it would like to expand east of the Mississippi, ideally with a contiguous deal. Based on SWY's stated criteria and on our analysis, we think there are few attractive prospects. If SWY does do a deal in the near future, we think that the most likely target could be one of the following (both are reportedly for sale):

Pathmark (Rev - $3.8B; 5.0% EBITDA margin) – Operates 143 stores in the metro NYC area, and thus would be contiguous with Genuardi's in Philadelphia and Safeway in Washington D.C. Pathmark has a strong brand name and market share. However, it has been a troubled operator, having just emerged from bankruptcy in September 2000. SWY's prior acquisitions were stronger operators.

Weis Markets – (Rev - $2.0B; 6.4% EBITDA margin) – Operates 166 stores in (136 in PA, 23 in MD, with the rest in NJ, NY, WV, and VA). Weis operates primarily in central Pennsylvania and the outer suburbs of Philadelphia. Weis has strong market share has been very profitable, but its earnings growth has reportedly reached a point of diminishing returns due to an increasingly competitive environment. However, Weis backed away from a potential buyer last year after the controlling family members became divided over whether to sell.

Finally, we think that Albertson's and Kroger's recent (and costly) struggles with integrating larger acquisitions may make SWY more cautious.

15. Financial Projections $M

	Q1 2000	Q2 2000	Q3 2000	Q4 2000
Sales	7,086.3	7,418.1	7,457.2	10,015.4
COGS	4,976.6	5,216.4	5,220.5	7,069.0
Gross profit	2,109.7	2,201.7	2,236.7	2,946.4
O&A	1,565.7	1,589.6	1,652.7	2,278.6
Gdwill amort	29.1	29.2	29.1	38.8
Oper profit	514.9	582.9	554.9	629.0
Interest exp	109.8	108.3	104.1	135.0
Equity in affil	7.1	3.4	7.5	13.2
Other income	1.3	2.1	3.3	4.1
IBIT	413.5	480.1	461.6	511.3
Tax	171.6	199.2	191.6	212.2
Net income	241.9	280.9	270.0	299.1
Diluted EPS	$ 0.48	$ 0.55	$ 0.53	$ 0.58
Diluted shares	507.9	510.5	511.7	515.0

% of Revenue	Q1 2000	Q2 2000	Q3 2000	Q4 2000
Sales	100.00%	100.00%	100.00%	100.00%
COGS	70.23%	70.32%	70.01%	70.58%
Gross profit	29.77%	29.68%	29.99%	29.42%
O&A	22.09%	21.43%	22.16%	22.75%
Gdwill amort	0.41%	0.39%	0.39%	0.39%
Oper profit	7.27%	7.86%	7.44%	6.28%
Interest exp	1.55%	1.46%	1.40%	1.35%
Equity in affil	0.10%	0.05%	0.10%	0.13%
Other	0.02%	0.03%	0.04%	0.04%
IBIT	5.84%	6.47%	6.19%	5.11%
Tax	2.42%	2.69%	2.57%	2.12%
Net income	3.41%	3.79%	3.62%	2.99%

Y/Y Growth	Q1 2000	Q2 2000	Q3 2000	Q4 2000
Sales	15.92%	17.06%	15.17%	0.81%
COGS	15.96%	17.43%	14.58%	0.14%
Gross profit	15.82%	16.18%	16.57%	2.47%
O&A	13.75%	13.19%	14.45%	4.21%
Gdwill amort	45.50%	39.05%	35.35%	0.00%
Oper profit	21.10%	24.13%	22.41%	-3.22%
Interest exp	49.80%	45.96%	41.83%	-4.39%
Equity in affil	-11.25%	-34.62%	17.19%	-11.41%
Other	8.33%	162.50%	-400.00%	46.43%
IBIT	14.51%	19.61%	19.83%	-2.87%
Tax	10.50%	20.73%	18.42%	-4.03%
Net income	17.54%	18.82%	20.86%	-2.03%
EPS	18.68%	19.41%	21.26%	-1.23%

	Q1 2001	Q2 2001E	Q3 2001E	Q4 2001E
Sales	7,666.1	8,059.2	8,145.2	11,007.2
COGS	5,323.5	5,617.2	5,677.2	7,705.1
Gross profit	2,342.6	2,441.9	2,468.0	3,302.2
O&A	1,732.0	1,791.4	1,853.6	2,455.8
Gdwill amort	31.3	32.5	32.5	43.3
Oper profit	579.3	618.1	581.9	803.0
Interest exp	109.2	111.0	109.0	142.0
Equity in affil	5.9	6.5	6.5	9.0
Other income	3.5	3.0	3.0	3.0
IBIT	479.5	516.6	482.4	673.0
Tax	195.6	210.8	196.8	274.6
Net income	283.9	305.8	285.6	398.4
Diluted EPS	$ 0.55	$ 0.59	$ 0.55	$ 0.77
Diluted shares	516.2	516.0	516.0	516.0

% of Revenue	Q1 2001	Q2 2001E	Q3 2001E	Q4 2001E
Sales	100.00%	100.00%	100.00%	100.00%
COGS	69.44%	69.70%	69.70%	70.00%
Gross profit	30.56%	30.30%	30.30%	30.00%
O&A	22.59%	22.23%	22.76%	22.31%
Gdwill amort	0.41%	0.40%	0.40%	0.39%
Oper profit	7.56%	7.67%	7.14%	7.30%
Interest exp	1.42%	1.38%	1.34%	1.29%
Equity in affil	0.08%	0.08%	0.08%	0.08%
Other income	0.05%	0.04%	0.04%	0.03%
IBIT	6.25%	6.41%	5.92%	6.11%
Tax	2.55%	2.62%	2.42%	2.49%
Net income	3.70%	3.79%	3.51%	3.62%

Y/Y Growth	Q1 2001	Q2 2001E	Q3 2001E	Q4 2001E
Sales	8.18%	8.64%	9.23%	9.90%
COGS	6.97%	7.68%	8.75%	9.00%
Gross profit	11.04%	10.91%	10.34%	12.07%
O&A	10.62%	12.69%	12.15%	7.78%
Gdwill amort	7.56%	11.30%	11.68%	11.68%
Oper profit	12.51%	6.03%	4.87%	27.67%
Interest exp	-0.55%	2.49%	4.71%	5.19%
Equity in affil	-16.90%	91.18%	-13.33%	-31.82%
Other	169.23%	42.86%	-9.09%	-26.83%
IBIT	15.96%	7.59%	4.51%	31.63%
Tax	13.99%	5.80%	2.73%	29.41%
Net income	17.36%	8.86%	5.78%	33.21%
EPS	15.48%	7.70%	4.90%	32.95%

	1999	2000	2001E
Sales	28,859.9	31,976.9	34,877.7
COGS	20,349.2	22,482.4	24,323.0
Gross profit	8,510.7	9,494.5	10,554.7
O&A	6,411.4	7,086.6	7,832.7
Gdwill amort	101.4	126.2	139.6
Oper profit	1,997.9	2,281.7	2,582.3
Interest exp	362.2	457.2	471.2
Equity in affil	34.5	31.2	27.9
Other income	3.8	10.8	12.5
IBIT	1,674.0	1,866.5	2,151.5
Tax	703.1	774.6	877.8
Net income	970.9	1,091.9	1,273.7
Diluted EPS	$ 1.88	$ 2.13	$ 2.47
Diluted shares	515.4	511.6	516.0

% of Revenue	1999	2000	2001E
Sales	100.00%	100.00%	100.00%
COGS	70.51%	70.31%	69.74%
Gross profit	29.49%	29.69%	30.26%
O&A	22.22%	22.16%	22.46%
Gdwill amort	0.35%	0.39%	0.40%
Oper profit	6.92%	7.14%	7.40%
Interest exp	1.26%	1.43%	1.35%
Equity in affil	0.12%	0.10%	0.08%
Other income	0.01%	0.03%	0.04%
IBIT	5.80%	5.84%	6.17%
Tax	2.44%	2.42%	2.52%
Net income	3.36%	3.41%	3.65%

Y/Y Growth	1999	2000	2001E
Sales	17.87%	10.80%	9.07%
COGS	17.22%	10.48%	8.19%
Gross profit	19.46%	11.56%	11.17%
O&A	17.29%	10.53%	10.53%
Gdwill amort	80.11%	24.46%	10.64%
Oper profit	24.74%	14.20%	13.18%
Interest exp	54.13%	26.23%	3.06%
Equity in affil	21.05%	-9.57%	-10.58%
Other income	123.53%	184.21%	15.74%
IBIT	19.84%	11.50%	15.27%
Tax	19.13%	10.17%	13.32%
Net income	20.35%	12.46%	16.65%
EPS	18.81%	13.30%	15.96%