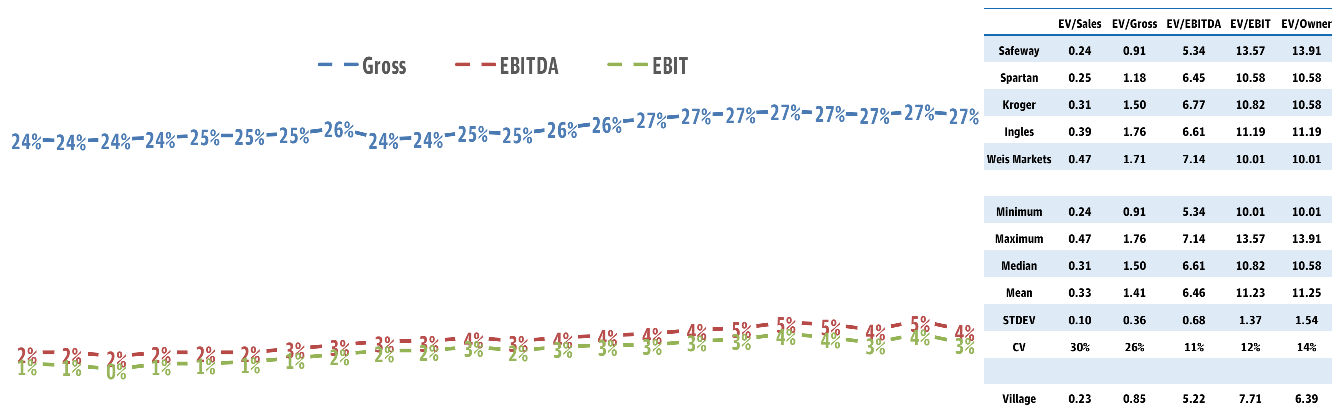
Village Supermarket (VLGEA)

Village Supermarket (NASDAQ: VLGEA)
Stock Price: $25.07



	EV/Sales	EV/Gross	EV/EBITDA	EV/EBIT	EV/Owner
Safeway	0.24	0.91	5.34	13.57	13.91
Spartan	0.25	1.18	6.45	10.58	10.58
Kroger	0.31	1.50	6.77	10.82	10.58
Ingles	0.39	1.76	6.61	11.19	11.19
Weis Markets	0.47	1.71	7.14	10.01	10.01
Minimum	0.24	0.91	5.34	10.01	10.01
Maximum	0.47	1.76	7.14	13.57	13.91
Median	0.31	1.50	6.61	10.82	10.58
Mean	0.33	1.41	6.46	11.23	11.25
STDEV	0.10	0.36	0.68	1.37	1.54
CV	30%	26%	11%	12%	14%
Village	0.23	0.85	5.22	7.71	6.39

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Min	Max	Median	Mean	Standard Deviation	Variation
Sales	715	714	695	677	689	689	704	768	785	821	883	902	958	984	1,017	1,046	1,128	1,208	1,262	1,299	1,422	1,476	677	1,476	893	947	255	27%
Gross Profit	174	173	169	166	170	171	176	196	191	201	222	225	244	257	269	282	305	331	343	350	389	398	166	398	224	246	77	31%
EBITDA	14	14	11	14	15	14	18	21	25	26	32	29	34	38	41	47	52	63	62	57	75	65	11	75	30	35	20	57%
EBIT	6	5	2	5	6	7	10	14	17	19	24	20	25	27	29	34	39	48	45	38	56	44	2	56	22	24	16	69%
Receivables			3	3	3	2	2	2	2	2	2	3	4	5	6	6	7	7	8	9	10	11	2	11	4	5	3	61%
Inventory			26	25	25	25	26	28	30	31	32	33	32	31	30	30	31	34	35	37	40	41	25	41	31	31	5	15%
PP&E			73	71	71	72	73	74	78	84	93	97	99	111	121	124	134	152	169	175	173	175	71	175	98	111	39	36%
Working Liabilities			37	37	39	42	45	48	51	51	51	54	57	61	65	69	73	78	76	81	87	88	37	88	55	59	17	28%
Net Tangible Assets			64	61	59	57	56	57	59	66	76	80	78	85	92	91	99	115	137	141	136	139	56	141	79	87	30	35%
MARGINS																												
Gross Profit/Sales	24%	24%	24%	24%	25%	25%	25%	26%	24%	24%	25%	25%	26%	26%	27%	27%	27%	27%	27%	27%	27%	27%	24%	27%	25%	26%	1%	0.05
EBITDA/Sales	2%	2%	2%	2%	2%	2%	3%	3%	3%	3%	4%	3%	4%	4%	4%	4%	5%	5%	5%	4%	5%	4%	2%	5%	3%	3%	1%	0.34
EBIT/Sales	1%	1%	0%	1%	1%	1%	1%	2%	2%	2%	3%	2%	3%	3%	3%	3%	3%	4%	4%	3%	4%	3%	0%	4%	2%	2%	1%	0.50
TURNS																												
Sales/Receivables			242.49	247.86	266.59	303.99	350.32	415.58	399.62	377.68	406.95	309.59	212.82	181.56	181.41	172.39	169.87	168.68	155.74	146.14	143.72	130.75	130.75	415.58	227.66	249.19	98.03	39%
Sales/Inventory			26.98	27.39	27.94	27.58	27.39	27.20	25.76	26.69	27.50	27.31	30.27	32.17	34.06	35.28	35.88	35.88	35.78	34.73	35.94	35.96	25.76	35.96	29.10	30.88	4.05	13%
Sales/PPE			9.55	9.58	9.75	9.59	9.66	10.34	10.07	9.82	9.54	9.26	9.70	8.90	8.39	8.43	8.43	7.95	7.48	7.43	8.20	8.45	7.43	10.34	9.40	9.03	0.87	10%
Sales/NTA			10.81	11.12	11.64	12.01	12.58	13.56	13.27	12.45	11.68	11.29	12.28	11.54	11.07	11.47	11.42	10.50	9.24	9.23	10.45	10.60	9.23	13.56	11.45	11.41	1.13	10%
RETURNS																												
Gross Profit/NTA			263%	272%	288%	298%	314%	347%	323%	305%	293%	282%	313%	301%	294%	309%	309%	287%	251%	249%	286%	286%	249%	347%	293%	293%	24%	0.08
EBITDA/NTA			17%	23%	25%	25%	32%	38%	42%	40%	42%	36%	44%	44%	45%	51%	53%	55%	45%	40%	55%	46%	17%	55%	42%	40%	11%	0.27
EBIT/NTA			4%	9%	10%	12%	18%	24%	28%	28%	31%	25%	32%	32%	32%	38%	39%	41%	33%	27%	41%	32%	4%	41%	30%	27%	11%	0.41
GROWTH																												
Sales		0%	-3%	-3%	2%	0%	2%	9%	2%	5%	8%	2%	6%	3%	3%	3%	8%	7%	4%	3%	9%	4%	-3%	9%	3%	4%	3%	0.96
Gross Profit		-1%	-2%	-2%	3%	0%	3%	12%	-3%	5%	10%	2%	8%	5%	5%	5%	8%	8%	4%	2%	11%	2%	-3%	12%	4%	4%	4%	1.06
EBITDA		-4%	-19%	25%	5%	0%	22%	21%	16%	6%	20%	-9%	18%	10%	8%	14%	12%	20%	-1%	-8%	32%	-14%	-19%	32%	10%	8%	14%	1.67
EBIT		-10%	-54%	126%	14%	13%	50%	36%	21%	12%	28%	-15%	24%	9%	8%	17%	13%	23%	-5%	-15%	45%	-20%	-54%	126%	13%	15%	35%	2.30
Receivables			-6%	-4%	-7%	-18%	-4%	-12%	27%	-3%	2%	65%	48%	2%	5%	11%	7%	8%	18%	3%	19%	10%	-18%	65%	4%	9%	20%	2.28
Inventory			-4%	-4%	4%	-1%	7%	13%	4%	-2%	11%	-4%	-4%	-3%	-2%	1%	11%	4%	6%	6%	5%	2%	-4%	13%	3%	2%	5%	2.22
PP&E			-4%	-2%	2%	1%	1%	3%	7%	7%	14%	-2%	5%	19%	2%	3%	13%	14%	8%	0%	-1%	3%	-4%	19%	3%	5%	6%	1.35
Working Liabilities			-4%	5%	3%	13%	2%	13%	3%	-5%	8%	1%	12%	4%	8%	4%	8%	4%	-10%	25%	-6%	8%	-10%	25%	4%	5%	8%	1.66
Net Tangible Assets			-3%	-7%	2%	-8%	3%	-1%	10%	13%	16%	-3%	-2%	20%	-3%	1%	15%	18%	20%	-11%	5%	0%	-11%	20%	2%	4%	10%	2.29

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SINGULAR DILIGENCE

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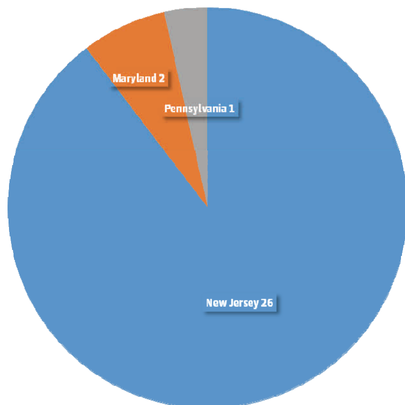
Village Supermarket (NASDAQ: VLGEA) Operates Shop-Rite Superstores in America's Most Densely Populated State

OVERVIEW

Village operates 29 supermarkets under the Shop-Rite name. Shop-Rite is the largest supermarket banner in New Jersey. The Shop-Rite trade name is owned by Wakefern Foods. Wakefern is a retail owned cooperative. Village is the second largest member of Wakefern. It owns 13.7% of Wakefern's outstanding stock. There are 47 other members of the Wakefern cooperative. These companies – many local, family owned businesses – operate the 250 Shop-Rite supermarkets in New Jersey, New York, Connecticut, Delaware, Pennsylvania, and now Maryland. Shop-Rite is the 11th largest grocer in the U.S. by sales. Shop-Rite stores did $13.8 billion in sales last year. Shop-Rite stores are larger than most American supermarkets. They are known for high volume on low prices. The average Shop-Rite store is visited by about 25,000 to 30,000 shoppers each week. Shop-Rites tend to do double the national average checkouts per stores. This is partially due to their larger size (the average Village store is 57,000 square feet) and partially due to their location in densely populated states like New Jersey. The average checkout value is also higher, because the cost of groceries specifically – and the cost of living generally – is higher in states like New Jersey than in the rest of the country. Shop-Rite's combination of more customer visits and higher sales per customer results in much greater sales per square foot and per store. Village averages $51 million in annual sales per store and $1,140 per square foot. Whole Foods averages $35 million per store and $937 per square foot. Kroger averages $32 million per store and $523 per square foot. Safeway averages $24 million per store and $506 per square foot. And Weis Market averages $17 million per store and $335 per square foot. The most comparable publicly traded supermarket company to Village in terms of both store size and strategy is Kroger. Kroger's stores are about 61,000 square feet versus Village's 58,000. On average, a Kroger does 37% less sales on 5% more space than a Village supermarket. The reason for this is location. Almost all of Village's sales come from New Jersey. None of Kroger's sales come from New Jersey. New Jersey is the most densely populated state in the U.S. On average, there are 10 times more people per square mile in New Jersey than in America generally. There is nowhere near10 times more supermarket square footage than in the rest of the U.S. Therefore, the number of customers per square foot is higher in New Jersey than it is in the rest of the country. Furthermore, food prices at retail tend to be about 20% higher in a high cost of living state like New Jersey versus a low cost of living state like Texas.



Densely populated New Jersey is home to 90% (26 of 29) of Village's stores

Brothers Perry and Nick Sumas founded Village in 1937. Nick Sumas is the father of Village's current CEO (James Sumas). The company started as a fruit stand in South Orange, New Jersey. South Orange is in Northern New Jersey (the most densely populated part of the state). Village has stayed close to its roots – 18 of the company's 29 stores are still located in North Jersey. In 1949, Village was one of the 12 founding members of the grocery store co-op that would become Wakefern. Wakefern went on to create the Shop-Rite grocery store banner. In the 1960s, a large Wakefern member splintered off from the co-op and rebranded its store under the Pathmark name. In the decades since, the market for New Jersey groceries has been dominated by Pathmark, A&P, Stop & Shop, and Shop-Rite. All of the other supermarket chains in New Jersey have been controlled by outside companies (often public). Wakefern's ownership structure is very different. Most of the owners are founding families with businesses entirely focused on New Jersey and neighboring states. Meanwhile, Pathmark and A&P are owned by A&P (an often publicly traded company of which Ron Burkle is a major shareholder). And Stop & Shop is owned by Ahold (a publicly traded Dutch company). Other local competitors like the high end New Jersey supermarket Kings have also been owned by

outsiders. In the 2000s, Kings was owned by the publicly traded U.K. company, Marks & Spencer. New entrants in the New Jersey market like Whole Foods, The Fresh Market, and even Fairway (originally a local New York City specialty supermarket) are all publicly traded. Most American supermarkets are publicly traded, controlled by private equity firms, or owned by foreign retailers (who are themselves often publicly traded).

Village went public in 1965. At that time, the company ran 6 Shop-Rites. There was a secondary offering in 1987 to fund the acquisition of 4 supermarkets in South Jersey owned by another Wakefern member. From time to time, Village added to its collection of New Jersey Shop-Rites through the purchase of other members of the co-op. Top executives at Wakefern's member companies split their time between running their own business and contributing time to the co-op. For example, James Sumas is Village's CEO. He is also on the board of Wakefern where he serves as the Vice Chairman. All of Village's executives have "@wakefern.com" email addresses rather than addresses specific to Village. Village does not use its company name as a trade name. Nor does Village even operate a website under its own name. The company does not have any investor relations pages or corporate information online. The only online information specifically about Village – rather than Shop-Rite/Wakefern – is found at the SEC's EDGAR database. However, Village is not entirely tight lipped. The company's 10-Ks are much more informative than those of most small, public companies. It gives same store sales guidance directly in its 10-Ks and 10-Qs. The company does not release these documents as press releases. Only a couple analysts coverage Village.

Village's relationship with Wakefern is unusual for a public company. Village must make capital contributions to Wakefern based on the number of stores it operates and the purchases of Wakefern merchandise. Shop-Rite operators are required to buy at least 85% of their merchandise from Wakefern. When a Wakefern member opens a new Shop-Rite or buys an existing one, they must contribute additional capital to Wakefern. Village's investment in Wakefern is carried on the company's books at $24 million. Village must contribute roughly $825,000 to Wakefern each time it adds a store.

Wakefern is a co-op. It does not seek to generate a profit for itself. Instead, it distributes patronage dividends to its members. These patronage dividends are paid out in proportion to the dollar volume of purchases made by Wakefern members. Essentially, these are cash rebates.

Membership in Wakefern has many benefits. Members get the right to use the Shop-Rite name and trademark. They benefit from Wakefern's greater buying power through the volume generated by the entire co-op (Wakefern buys about 7.3 times more merchandise than Village would alone). Shop-Rite private label products make up 12.5% of Village's sales. Wakefern handles distribution and warehousing. Advertising and promotional programs use the Shop-Rite name. And Wakefern administers the Shop-Rite Price Plus card. In 2013, Village paid $30 million to Wakefern for services including advertising, supplies, technology, store services, and insurance.

There are 5 members of the 3rd Sumas generation working at Village. Village's top executives are all members of the Sumas family. The only exception is the CFO, Kevin Begley. Although not a family member, Begley is an insider. He has been Village's CFO for 27 years. For a public company, compensation among the top 5 executives (4 members of the Sumas family and Begley) is unusually equal. Each man tends to make between $1 million and $2 million a year. A family trust (controlled by 7 members of the Sumas family) holds stock with a market value of about $150 million. So the Sumas family's interest is aligned with long-term holders of Village stock with one key exception. It is not in the family's interest to ever sell Village, because the buyer would eliminate the top management positions along with the seven figure annual incomes they provide.

DURABILITY: *High Volume Supermarkets are Durable Local Market Leaders*

Demand for food is stable. Most grocers do not experience meaningful changes in real sales per square foot over time. Changes in real sales numbers almost always reflect changes in local market share. There will be online competition in the grocery business. However, in Village's home market of New Jersey, direct to your door delivery of groceries has been available for 18 years. Peapod started offering online grocery shopping in 1996. The company was later bought by Royal Ahold. Royal Ahold owns Stop & Shop. Peapod has 4 locations in Somerset, Toms River, Wanaque, and Watchung. These locations offer grocery delivery in Village's markets. They are direct competition and have been for years. Peapod does not require a $300 annual fee like Amazon Fresh. Instead, Peapod simply adds a delivery charge. Customers also tip the driver. Since the driver normally carries the bags into the customer's home and puts them on the kitchen counter for the customer – the tip is usually a generous one. Peapod charges $6.95 for orders over $100. The charge for orders under $100 is $9.95. The minimum order size is $60. Customers can also order online and then drive to one of the 4 Stop & Shops mentioned above (Peapod often uses the second floor of a building where the ground level is Stop & Shop's retail store) and pick up their own order. Pick-up is free. However, a Peapod employee still collects the groceries and brings them to the customer's car. So, a tip is still expected. Common tips are probably $5 to $10. So, the total cost of a Peapod home delivery order is probably anywhere from $12 to $20 higher than a trip to a Stop & Shop grocery store. Even a pick-up is probably $5 higher than a

normal Stop & Shop visit – and the customer still has to drive to a store to make the pick-up. Wakefern is a large co-op with similar scale to Stop & Shop nationally and more scale than Stop & Shop in New Jersey. Creating a retail website is easier now than it was in 1996. Therefore, it is no surprise that 87 of Shop-Rite's 480 locations offer online shopping. In fact, online shopping is available from both Shop-Rite and Peapod in certain towns like Somerset. This is important, because the average supermarket customer in the U.S. does not drive far to visit a location. Kroger uses a 2 to 2.5 mile radius to define its local market. Research on the opening of a new Wal-Mart found that supermarkets further than 3 miles from a new Wal-Mart saw no meaningful impact to their sales. This suggests that Wal-Mart Supercenter's do not draw grocery customers from more than 3 miles away. So, a 2-3 mile radius is a reasonable definition of a supermarket's local market. Convenience is the biggest hurdle for online grocery providers to clear. Amazon Fresh requires a $300 annual fee from its customers. Peapod requires a $60 minimum order. The average grocery store visit results in a checkout of less than $60. At Shop-Rite, the average customer pays $52 at checkout. So, online grocery shopping tends to be more expensive and require larger orders than traditional brick and mortar supermarkets. Furthermore, online selection is usually inferior to the largest traditional supermarkets. For example, Peapod has a narrower selection of items on its website than it does at its retail stores – even though its online business is literally housed in actual supermarkets. This is a logistical problem caused by the difference between running a delivery business, an employee collected pick-up order, and a customer's self-selected in store order. Costs tend to be lowest and selection widest when a customer is forced to put their own items in their own cart by going through the store aisles themselves. Another problem with online ordering is the need for scheduling.

In New Jersey: Only Wegman's does more volume per store than Shop-Rite

Online grocery orders require the customer to be home at a specific time. The customer is usually given a window that can be as long as 2-3 hours during which they must be home to answer the door. Meanwhile, in store visits are always at the customer's options. Traditional supermarkets are often open from roughly 10 a.m. to 8 p.m. seven days a week. Customers can drop into their local store at their convenience – including on the way home from work – and pick-up an order of any size. There is no scheduled time, no delivery fee, no tip, and no minimum order size. The selection is usually as wide as the company can provide. For example, Village's largest new store is 77,000 square feet. It includes plenty of fresh foods and prepared foods that are not sold online. So, online competition is not new to the New Jersey grocery market. And groceries are an especially tough business for online retailers to compete in. One problem for online retailers is that all of their offline competitors have local scale. There is no such thing as a "Mom and Pop" grocery store in the U.S. Unlike hardware stores, pet stores, and book stores – the supermarket business is very locally consolidated. It would take an online retailer a long time to have scale locally. However, it would be possible for online retailers to develop bargaining power with suppliers. This is why Shop-Rite is run as a co-op.

Online retailers will continue to enter the grocery business. It is a huge market. The opportunity for growth is enormous. For example, the U.S. grocery business is probably about $600 billion a year while Amazon's entire companywide sales are just $75 billion. Amazon could more than double its sales with just a 13% share of the nation's grocery business. The size of the opportunity in groceries will continue to attract online and non-traditional competitors.

Non-traditional competitors are the biggest threat to Village. In the industry, "non-traditional" refers to both deep discount and high end (especially fresh and/or organic) grocery stores. In New Jersey, the high end is the area of greatest concern. The non-traditional supermarket with the store model best suited for entering New Jersey is The Fresh Market.

Local competitors that segment the market are a risk for existing supermarkets. The one-year customer retention rate in American supermarkets is probably around 70%. About 30% of customers may switch to a local competitor each year. In a Consumer Reports survey, the top reasons giving for switching were: "lower prices" and "better selection". Shop-Rite

generally has the lowest prices and widest selection in its local market. The only exception is in towns with a Wegman's. Wegman's has larger stores and wider selection than even the biggest Shop-Rites. As a result, Wegman's is usually ranked #1 in customer satisfaction.

Supermarkets tend to be durable. However, there is a constant churn of locations at most companies – closing failed stores and relocating stores to better locations – that can be costly. Since a restructuring in the early 1990s, Village has not experienced any store failures. Nor has it relocated a store for any reason other than wanting to increase its size. Over the last 17 years, Village has spent just 1.7% of sales on cap-ex. Meanwhile, Kroger spent 2.7%, Safeway spent 3.0%, and Weis Markets spent 3.2%. Village's low cap-ex advantage is entirely due to not closing stores. Because Village – as a Shop-Rite operator – has the highest sales per store of any supermarket, it also tends to be able to renew leases. Supermarkets are the "anchor" tenant at strip malls. In the last 17 years, there was only one example – in 2003 – of Village failing to sign a new lease. Village has the most durable portfolio of supermarkets of any publicly traded company. For example, in just the last 12 years, Kroger closed 21% of its starting store base. Village owns 4 stores (with 335,000 square feet of selling space) and leases 24 stores (with 1.3 million square feet of selling space). The initial term of a lease is usually 20-30 years. Many have multiple renewal options after those first 20-30 years.

MOAT: *In the Grocery Industry: All Moats are Local*

The market for groceries is local. Kroger's superstores – about 61,000 square feet vs. 58,000 square feet at a Village run Shop-Rite – target customers in a 2 to 2.5 mile radius. An academic study of Wal-Mart's impact on grocery stores, found the opening of a new Wal-Mart is only noticeable in the financial results of supermarkets located within 2 miles of the new Wal-Mart. This suggests that the opening of a supermarket even as close as 3 miles from an incumbent's circle of convenience does not count as local market entry.

In the United States, there is one supermarket for every 8,772 people. This number has been fairly stable for the last 20 years. However, store churn is significant. Each year, around 1,656 new supermarkets are opened in the United States. Another 1,323 supermarkets are closed. This is 4.4% of the total store count. That suggests a lifespan per store of just under 23 years. In reality, the risk of store closure is highest at new stores or newly acquired stores. Mature locations with stable ownership rarely close. So, the churn is partially caused by companies seeking growth. Where barriers to new store growth are highest – like in Northern New Jersey – store closings tend to be lowest. Village's CFO, Kevin Begley, described the obstacles to Village's growth back in 2002: "…real estate in New Jersey is so costly and difficult to develop. New Jersey is not an easy area to enter. This situation also makes it challenging for us to find new sites. It's been very difficult for us, and for our competitors, to find viable locations where there is enough land especially in northern Jersey and where towns will approve a new retail center. With the Garwood store…we signed a contract to develop that piece of property in 1992; it just opened last September (2001). So it can be a long time frame from when you identify a potentially excellent site and when you're able to develop it. Finding viable sites is certainly a challenge that we face, as do our competitors."

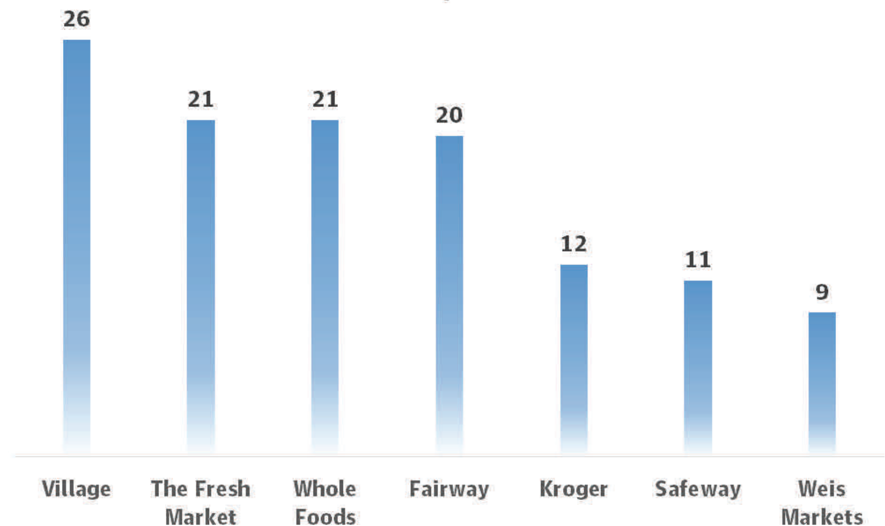
New Jersey is 13.68 times more densely populated than the United States generally (1,205 people per square mile vs. 88). It is about 12 times more densely populated than the median state. This means New Jersey should have about 12 times more supermarkets per square mile to have the same foot traffic per store. The lack of available space makes this impossible. As a result, the number of people visiting a New Jersey supermarket is greater than the number of people visiting supermarkets in other states. The greater population density in New Jersey has several important influences on store economics.

One, it encourages the building of bigger stores. This sounds counter intuitive. If there are a lot of people in a small space and land is difficult to develop, it would be logical to enter the market with a small format store. That is true. However, incumbent stores have big advantages over new entrants. Incumbents have leases in key locations. Their stores are highly profitable. As a result, store owners in New Jersey will favor expanding each existing store to the maximum possible square footage whenever renovation is a possibility. This is what most Shop-Rite members have done. Village does not operate especially large Shop-Rites. However, 58,000 square feet is huge by national supermarket standards. Whenever Village has renovated a store, it has tried to increase square footage. Village has sometimes relocated stores to larger footprints. And Village's most recent new stores have been huge. For example, Village recently built a 77,000 square foot replacement store in Morris Plains. This store is almost as large as the Wegman's superstores (80,000 to 140,000 square feet) that tend to be the biggest supermarkets in New Jersey.

Two, New Jersey supermarkets turn the product on their shelves faster. This changes product economics for the store and the experience for the customer. A Shop-Rite turns its inventory phenomenally fast relative to the grocery section of a Wal-Mart. As a result, stale inventory and lack of help – the two largest complaints from grocery shoppers at Wal-Mart – are unusual in New Jersey supermarkets. More customers per square foot means higher sales velocity. It is not possible to stack more inventory per square foot. It is only possible to restock inventory faster. High inventory turnover can increase customer satisfaction by increasing the freshness of the product without requiring the store to buy different merchandise than a competitor with stale

product on its shelves. More importantly for the stores, gross margins can be lower at a high traffic location and yet gross returns can be higher. In fact, this is exactly what happens at Village. Village's gross margins are 10% lower than Kroger's (27% vs. 30%) while gross profit divided by net tangible assets is 2.32 times higher (290% vs. 125%). A New Jersey Shop-Rite generates much higher returns on capital than any other traditional supermarket around the country. Again, this encourages reinvestment in existing stores. This further raises the barrier to local entry. A new store would need to find an open location where it could put a 60,000 square foot location to rival the breadth of selection and the low prices of the incumbent supermarkets. In most of the country, land is more widely available and the incumbent supermarkets are only around 35,000 square feet. Nationally, the average supermarket does $318,170 a week in sales. In New Jersey, the average Shop-Rite does $1 million a week. The initial investment required to enter a local grocery market in New Jersey is higher because the industry standard is higher and the costs of developing anything are higher. It is important to remember that the barrier is not simply the roughly 100% more expensive real estate in New Jersey versus the country generally. Nor is the barrier simply the lack of available space in New Jersey. The final hurdle to clear is the simple fact that supermarkets in New Jersey have evolved into much larger, lower margin beasts than the competition elsewhere.

Large stores support wide selection, low prices, fresh inventory, and high customer service. A comparison of inventory turns (Cost of Goods Sold / Average Inventory) helps illustrate this point. Village's inventory turns are 26, The Fresh Market 21, Whole Foods 21, Fairway 20, Kroger 12, Safeway 11, and Weis Markets 9. It is easy to imagine a division between two groups: the supermarkets focused on freshness and the supermarkets focused on low cost. However, Village – a low cost generalist – has higher inventory turns than the group of "fresh" supermarkets (The Fresh Market, Whole Foods, and Fairway). Village turns its inventory twice as fast as traditional supermarkets like Kroger and Safeway. Kroger is an especially good comparison because its store size is the same as Village's and its business strategy (big stores, wide selection, low prices, and generalist) is virtually identical. The difference between inventory turns at Village and Kroger is that almost all of Villages' stores are in New Jersey while none of Kroger's stores are in New Jersey. As a result of this higher inventory turnover, Village can charge customers 3 cents less per dollar of sales than Kroger and have double the return on capital (33% vs. 17%). The moat around Village is its portfolio of big, established stores in New Jersey that would take a lot of time, money, and risk to duplicate. If Kroger controlled these locations it would have at least as good returns on capital as Village. But the only way Kroger will ever control key New Jersey locations is through the acquisition of a New Jersey supermarket chain. The time, cost, and risk of introducing a new banner – the Kroger name is unknown in New Jersey – makes entry by any means other than acquisition extremely unlikely. The moat around Village is entirely local and historical. It runs big, mature stores under the well-known Shop-Rite name. Most importantly, it runs them in the best locations in America for supermarkets.



Quick inventory turns support fresh food, low prices, and lots of help

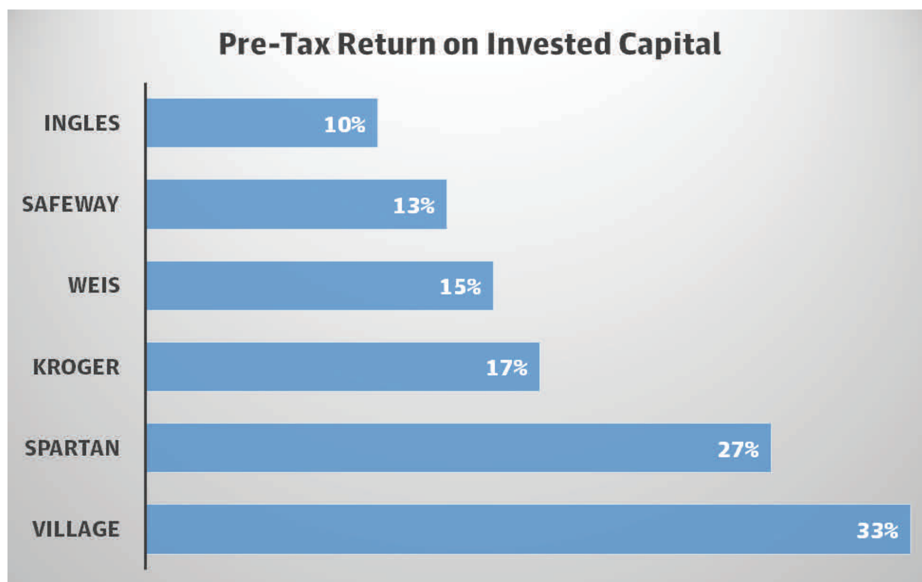
QUALITY: *Village Can Achieve a 19% After-Tax Return on Equity without Using Debt*

Village has some of the highest returns on capital of any supermarket. This is because Village has some of the largest stores and highest sales per square foot. There are two possible local exceptions to this rule. There is an operator of truly superstore sized supermarkets – 80,000 to 140,000 square feet – in the Northeast called Wegman's. Wegman's is not a public company. But what data is available suggests Wegman's has higher sales per store than Shop-Rite. However, it may have lower sales per square foot. Regardless, a Wegman's location is a very high traffic and high sales volume location. It is special to the point of being almost unique. In many parts of the country, there are no supermarkets as big as a Wegman's. Even in New Jersey, supermarkets in the 80,000 to 140,000 square foot range are an anomaly. Village's largest store is just 77,000 square feet. Wegman's gets the highest customer satisfaction ratings in the Northeast. Each store averages $81 million in sales. The company operates a total of 83 stores and generates $7 billion in sales. This makes each Wegman's location much bigger than a Shop-Rite

and makes the Wegman's chain half the size of Shop-Rite ($7 billion vs. $13.6 billion).

The other competitor of equal or greater quality to Shop-Rite is The Fresh Market. This is a public company. It is relatively new to New Jersey. However, it now operates some stores within the local "circle of convenience" of a Shop-Rite. For example, in late 2013, The Fresh Market opened a location in Bedminster, New Jersey. Bedminster is close enough to both Village's Bernardsville and Stirling Shop-Rites to draw customers. This is especially true for special occasions. However, The Fresh Market is not a direct competitor of Shop-Rite in the sense that it can replace a household's largest weekly trip to the supermarket. A Fresh Market location is very small. Often, the gross selling space is 22,000 square feet or less. In some cases, a local Fresh Market will be about one-third the size of the Shop-Rite in that same town. The majority of what The Fresh Market sells is perishable. For example, the stores carry no packaged meat. There is chicken, beef, pork, etc. cut up and ready to be brought home and cooked. But, none of it is packaged. In that sense, it is truly "fresh". The Fresh Market is more similar to Whole Foods or Fairway (a local New York City and now New Jersey as well) grocer. Also, while The Fresh Market is technically labeled a supermarket – it would be more accurately described as a pure grocery store. It mostly sells fresh, prepared, and specialty food items. The Fresh Market has an excellent business model. It is able to enter the New Jersey market with lower start-up costs and occupy smaller retail spaces than traditional supermarkets. Both Quan and Geoff consider The Fresh Market to be the most dangerous future competitor to Shop-Rite in New Jersey.

Aside from these two outliers on the very big (80,000 to 140,000 square feet) and very small (17,000 to 22,000 square feet) end of things, Shop-Rite is the highest quality supermarket chain in New Jersey.



Village has the best return on capital among" traditional" supermarkets

Most of Shop-Rite's advantages are the result of its higher sales volume per store. So, it is best to start there. The average Village store does $1,140 in annual sales per square foot and $51 million per store. This is 22% and 46% more than the $937 per square foot and $35 million per store that Whole Foods does. It is 118% and 59% more sales than the $523 per square foot and $32 million per store that Kroger does. It is 126% and 113% more than the $506 per square foot and $24 million per store that Safeway does. And it is 240% and 200% more than $335 per square foot and $17 million per store that Weis Market does. Most of the difference in performance is due to location. Most of these chains have no stores in New Jersey. Whole Foods has some New Jersey locations. But the state is a small part of their business. New Jersey makes up virtually all of Shop-Rite's business. And even the Maryland stores are in equally densely populated towns.

The local competitors in New Jersey are companies like Pathmark (owned by A&P), A&P, Stop & Shop, Wegman's, and Kings. Pathmark was originally a member of Wakefern. It broke off decades ago and started operating under the Pathmark name. It was later bought by A&P. The company has been in bankruptcy a couple times. The Pathmark banner has $4 billion in sales and $29 million per store. This is poor for a company that operates in Delaware, New Jersey, New York, and Pennsylvania. A&P has $7.2 billion in sales. It does $23 million per store. Stop & Shop is owned by the Dutch company Royal Ahold. Royal Ahold USA has $25 billion in sales and averages $33 million per store. Stop & Shops are in the same size range as Shop-Rites (generally 45,000 to 80,000 square feet). Wegman's has $7 billion in sales and $81 million per store. This is much higher than Village's $51 million per store. The difference is due to Wegman's smallest stores being 40% bigger than Village's average store (80,000 square feet vs. 57,000 square feet). Kings has over $500 million in sales. Shop-Rite is bigger than all of these chains except the combined supermarket holdings of Royal Ahold USA. Royal Ahold USA (the owner of Stop & Shop) also runs the online grocer Peapod. Shop-Rite is more locally focused than all of these chains except Kings.

Village's greatest weakness is its high operating costs. The company is unionized and operates in New Jersey. Employee costs are high compared to the national average. Electricity costs are high. Rent is high. However, inventory turnover is a big factor. Simply put: stores with more sales per square foot tend to employ more people per square feet.

For example, the Southern supermarket operator Ingles employs one person

per 481 square feet. At Weis market, it is one employee per 462 square feet. At Safeway, it's one per 456 square feet. At Kroger, one per 434 square feet. At Village, it's one employee per 272 square feet. At Whole Foods, one per 176 square feet. And at Fairway, it's one employee for every 154 square feet. Kroger and Village have the same sized stores. This means Village has 60% more employees per store than Kroger. That is almost exactly proportional to Village's 59% greater sales per store versus Kroger. So employees tend to scale proportionately with sales.

Excluding rent – which is much higher in New Jersey than the rest of the country – Village still has some of the highest operating costs per square foot of any supermarket. For example, Weis spends $67 per square foot on operating costs. Kroger spends $100 per square foot. Safeway spends $117. Village spends $195 per square foot. That means the average Village store costs 95% more money to operate than the average Kroger. It is important to keep in mind that despite having nearly double the operating costs of a Kroger, Village gets double the return on capital (33% vs. 17%) that Kroger does. Since 1993, Village's operating expenses have averaged 21.7% of sales. Since 1991, Kroger's operating expenses have averaged 17.7% of sales. This gives Kroger a huge 400 basis point advantage in store economics. Despite this, Kroger earns a lower return on capital. This is because Kroger's gross profitability (Gross Profit/Net Tangible Assets) is just 125% vs. 290% at Village. This difference is entirely due to turnover (Sales/Assets) rather than margins of any kind (gross or operating). Village simply moves so much more stuff relative to the capital tied up in its stores that it can earn double the return on equity of the competition. Over the last decade, Village has often earned a higher return on equity without using leverage than competitors have earned while using leverage.

CAPITAL ALLOCATION: *Village's 4% Dividend Yield Will Grow faster than its Earnings per Share*

Capital allocation at Village is simple to understand. The company only operates supermarkets. As a member of Wakefern, Village only operates Shop-Rite branded supermarkets. And, because it helps to have a supermarket branded with a locally known banner, Village only runs Shop-Rites in New Jersey (26 stores), Maryland (2 stores), and Pennsylvania (1 store, near the New Jersey border). The 2 Maryland stores were recently acquired. The Shop-Rite name is not known in Maryland. As a result, the performance of those 2 stores has been poor.

Village has budgeted $45 million for n cap-ex in 2014. Cap-ex is generally spent on expanding stores at their existing location or moving them to a larger site nearby. In the last 20 years, Village has not closed stores. Nor has Village relocated stores due to poor sales. Instead, all cap-ex has been geared toward either expanding stores or – very rarely – building new stores. Historically, Village also acquired stores. Because it is difficult to build new stores in New Jersey, acquiring existing stores is a common way to grow. Village either buys out members of Wakefern and thereby gains existing Shop-Rites or buys nearby non-Shop Rite locations and rebrands them. The Maryland stores are rebranded.

Village's cap-ex has been used to expand the average store from 46,000 square feet in 1995 to 57,000 square feet in 2013. The added space is usually dedicated to specialty items. This improves gross margin. Unlike most supermarkets – which improved during the 1990s, but have mostly seen stagnant margins since the early 2000s – Village improved its financial performance during the last decade. From 2000 to 2013, EBIT rose from $16.7 million to $44.2 million. This 7.8% compound annual growth in operating income far exceeds GDP growth in Village's home market of New Jersey.

Compared to the other publicly traded traditional supermarkets Village's balance sheet is ultra conservative. Supermarkets are often leveraged buyout targets. Most of the biggest traditional supermarkets carry a lot of debt in addition to their leases. Village has $110 million in cash on hand (which it keeps at Wakefern). Village has $41 million in capital and financing lease obligations. It also owns 4 of its locations. Throughout this report, Village's rent has not been capitalized to calculate operating lease obligations. There are several reasons for this. One, Village's leases are very long-term (generally 20-30 years before multiple renewal options). Two, it is impossible to determine the value of the property Village controls for those years compared to the obligation that would be counted at 8 times rent (or some similar capitalization).Three, Village has been able to sign new leases for the same locations in all but one case in the last couple decades. Finally, in cases where Village would vacate a location, the most likely replacement tenant would be another supermarket. This is because of the traffic Village brings to the strip mall. There are no other potential tenants in New Jersey who would bring as much customer traffic to the strip mall as a Shop-Rite does. Losing Village as a tenant would likely reduce the attractiveness of the attached commercial spaces. Because Village seeks to stay at each location indefinitely, it seems most appropriate to consider leases as a fixed charge that is renegotiated once every few decades rather than as a form of capital. Regardless of how leases are treated, Village's $100 million of net cash results in a solid balance sheet generally and a very solid balance sheet relative to other companies in the same industry. Village's strong balance sheet provides it with the opportunity to acquire other stores without issuing stock.

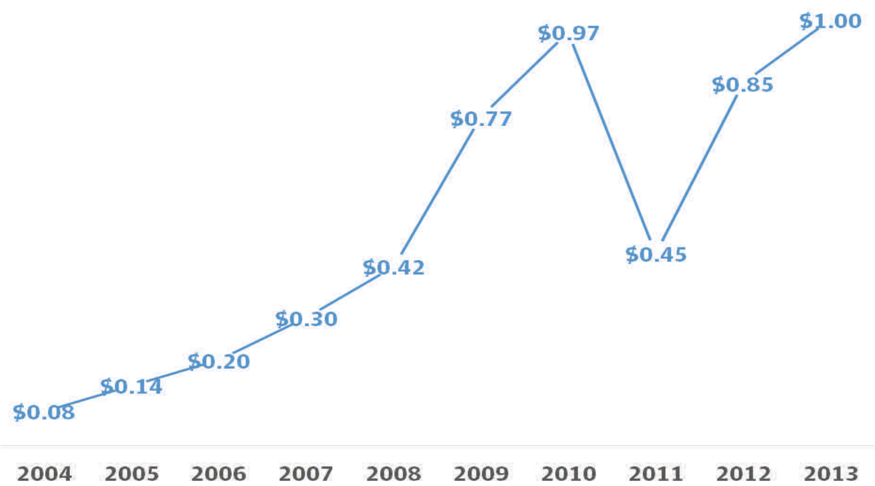
Over time, Village has generally diluted shareholders by increasing shares outstanding 1% a year. This 1% in stock goes to pay executives. Village's top executives are very well paid for a family company of this size. They generally

make between $1 million and $2 million a year including stock options. Cash compensation alone is often $1 million or more. Base salaries are $750,000 and up. To put this in perspective, the CFO of Village tends to make a little more money than the CFO of Berkshire Hathaway.

Village has two classes of stock. There are 9.47 million A shares and 4.38 million B shares. The B shares are super voting. Each B shares gets 10 votes. Each A share gets one vote. The A shares get a 54% higher dividend than the B shares. The B shares can be converted into A shares. Before the death of Perry Sumas (the co-founder of Village) the B shares were unchanged. However, as his estate has been settled, it appears his B shares have been exchanged into A shares and then the A shares have been sold in the open market. It is likely that virtually all of Perry Sumas's estate was in Village B shares. So, the estate would need to liquidate the shares over time whenever it needed cash.

Village is still controlled by the Sumas family. There are 7 people or entities (one is the estate of Perry Sumas) that control the company. Of these 7 parties, 5 are employees of the company. All 5 of those Sumas family members serve on the board. The only non-family member in top management is the CFO Kevin Begley. He has been CFO for 27 years. Other than Begley, every key position is held by a Sumas family member. There are independent board members who are not from the family. None of the non-family members are part of management. All of the family members on the board are also involved in the business. Historically, Sumas family members have continued to serve in management and on the board even when they were very old. The younger members of the Sumas family are third generation.

As a group, the Sumas family has 65.4% of the voting rights at Village. This gives them complete control of the company. The family is not spread out. These are not absentee owners. The members of the family group who own stock are also involved in the operations of Village. So, the Sumas family is essentially an owner-operator. Village is both family owned and family run.



Over the last 9 years, Village has grown its regular dividend by 32% a year

The combined share count of A and B shares rose from 12.6 million to 13.8 million from 2004 to 2013. The dividend has been increased in recent years. The A shares paid a $1 regular dividend in 2013. There was also a $1.25 special dividend in 2011 and $1 per share special dividend in 2013. Village is capable of paying $1.50 to $2 in cash dividends per A share. The company's 10-year average free cash flow was $23 million and the 5-year average was $29 million. The company has built up its cash balance in recent years. Since paying an 8 cent dividend in 2004, Village has increased its dividend per share 32% a year over the last 10 years. This does not include special dividends. Over time, it is likely that – since Village has never bought back meaningful amounts of its own stock – the company will increase its dividends per share much faster than it grows its earnings per share. The 11% a year growth in the cash balance over the last decade demonstrates Village's ability to pay a higher dividend in the future than it has in the past. At $25 a share, Village's dividend yield of 4% is higher than most U.S. stocks. And – over the next 10 years – Village will almost certainly grow its payout faster than other dividend paying stocks. Village's regular dividend payout has rarely exceeded 50% while the economics of the business would allow it to pay up to 90% of its earnings in dividends if it was unable to buy or build new stores. It is difficult to expand in New Jersey. So, aside from some one off – and impossible to predict – acquisitions of clusters of Shop-Rites owned by other Wakefern members, Village will most likely become a higher and higher dividend paying stock over time.

VALUE: *Village's Enterprise Value Should Be Between 20% and 40% of Sales*

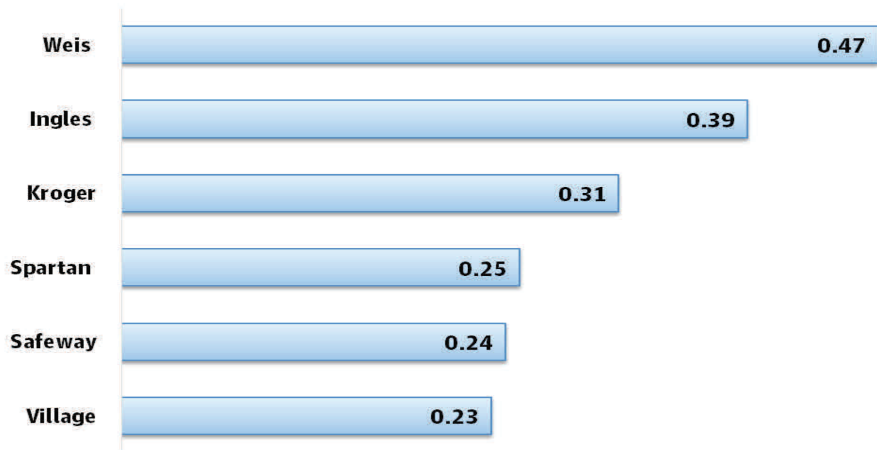
Village's value depends on what its operating margin will be in future years. Right now, Village is trading at 8.8 times pre-tax profits if those profits are assumed to be 2.6% of sales. It is trading at 7.7 times pre-tax profits if those profits are assumed to be 3% of sales. And it is trading at 6.4 times pre-tax profit if those profits are assumed to be 3.6% of sales. Since 1993, Village's operating margin (EBIT divided by sales) has ranged from 0.3% to 3.9%. The median margin during that time was 2.6%. The mean was 2.3%. During this entire period, Village's EBIT margin appears quite volatile. However, this is due to Village's turnaround in the earlier part of the 1990s. Once that turnaround had been achieved – smaller and underperforming stores sold

and the focus put entirely on superstores – Village's operating margin stabilized at a much higher, and much more normal (for the industry) level of profitability.

Since 2003, Village's operating margin has ranged from 2.2% to 3.9%. The median was 3.0%. The mean was 3.1%. The margin was generally stable. The range has been even tighter since 2009 (basically the post financial crisis yeas), with a range of 2.9% to 3.9%, a median of 3.6%, and a mean of 3.5%. If this level is normal, Village is trading at just 6.4 times pre-tax profits.

The best way to value Village is on an enterprise value (without capitalized rent) to sales ratio. Most traditional supermarket companies trade in a very tight EV/Sales ratio. Profits may rise or fall relative to sales in the short-term. However, the profitability of a supermarket over time is closely tied to its sales level. Sales are the greatest constraint on most traditional supermarkets. They all have low operating margins. It is usually impossible to achieve operating profit margins much higher than the competition. So, a given level of sales tends to translate into a similar level of operating profit.

Today, Village's peer group of traditional supermarkets trade at about 11 times operating profit. If we round that number down and assume Village should trade at 10 times normal pre-tax earnings and that Village's operating margin in the future is likely to be just 2%, then Village should now trade at an EV/Sales ratio of 0.2. If the operating margin is likely to be 2.5%, Village should trade at an EV/Sales of 0.25. If the margin will be %, Village should trade at an EV/Sales of 0.30. If the margin will be 3.5%, Village should trade at an EV/Sales ratio of 0.35. And if Village's margin is likely to be 4% in the future, Village should trade at an EV/Sales ratio of 0.40. Village has never had an operating margin above 3.9%, so there is no need to go further. Village's lowest operating margin is the last 10 years was 2.2%. So, a range of 2% to 4% is reasonable. This means Village's



Village has the lowest EV/Sales (0.23) among "traditional" supermarkets

business value is likely somewhere between 20% and 40% of the company's sales. Over the last year, Village had $1.49 billion in sales. That suggest the business value of Village is between $298 million and $596 million. Basically, Village's operations are worth between $300 million and $600 million. The company also has $110 million in cash. However, Village has $41 million in lease obligations and a $20 million pension liability. That leaves about $60 million in net cash. This suggest the market capitalization of the stock should be in the $350 million to $650 million range. There are 9.05 million A shares and 4.36 million B shares of Village's stock outstanding. The voting interests and dividend rights of the two share classes are different. So, the value of the shares can be considered in 3 ways. One, some value can be assigned to the voting rights of the B shares (which is 10 times the A shares). However, the Sumas family controls Village through the B shares, so these voting rights are useless in all matters where the Sumas family is in agreement. The A shares are entitled to 54% higher dividends than the B shares. However, the B shares are convertible – at the loss of 90% of their voting power – into the A shares. Calculating the value of the A shares versus the B shares is therefore complicated. However, it is certainly true that a minority investor should value the A shares higher than the B shares. The Sumas family only has about 62% of the votes at Village. For that reason, they tend not to convert as many B shares into A shares as would give them the highest possible dividend. As a result, the A shares receive a greater proportion of the economic benefit of Village than would be suggested by the theoretical equal economic interest of the two shares (the shares are theoretically equal in the sense that you can always convert B to A to gain higher dividends). As a result, the value assigned to the A shares (which are the shares discussed and valued in this issue) is lower than their actual value. It is important to understand this fact. The appraisal of the A shares given in this issue is inaccurate. While it is difficult to precisely value the A shares, it is certainly true that they are worth more than if Village had only one class of stock. This is because the voting rights of the A shares would be equally valuable in all cases where the Sumas family controlled Village. However, the Sumas family must pass on the chance to get the highest possible dividend to maintain their voting control. For this reason, the A shares get a 54% greater economic benefit than the B shares and yet holders of the B shares do not immediately convert their shares into A shares. The actual value of a Village A share is somewhere between the value of a B share and 1.54 times the value of a B share. This applies to minority investors (the public) only. Because the public cannot control Village through any number of B shares, the 54% higher dividend of the A shares makes the A shares more valuable for non-Sumas family investors. Put simply, the Sumas family pays a control tax by holding shares with a lower dividend

payout. This benefits non-control shareholders. As a result, the value of a Village A share is higher than the number discussed in this issue.

If the A shares and B shares are treated as being equally valuable, Village has 13.86 million shares outstanding. As discussed above, the market cap of the stock should be in the $350 million to $650 million range. So, the value of each of the 13.86 million shares should be in the $25.25 to $46.89 range. Given the 54% greater dividend on the A shares and the tendency of the Sumas family not to prioritize voting rights over dividend rights – the A shares are worth at least $25 to $50 a piece.

As a controlled company and a member of Wakefern, Village is unlikely to be taken over. An acquirer would need to become a member of Wakefern and use the Shop-Rite name. For this reason, the most likely acquirer of Village is either another Wakefern member (only one is bigger than Village) or a financial buyer. The Sumas family controls Village and 4 members of the family earn $1 million a year and up in pay at the company. For these reasons, Village is a very unlikely acquisition target. As a result, the value of Village stock is primarily related to the dividend rights of its shares. The A shares collect a dividend that is 54% higher than that paid on the B shares. The B shares are what the Sumas family owns. Therefore, it is in the Sumas family's interest to pay high dividends on the B shares and thus even (54%) higher dividends on the A shares.

GROWTH: *Village Can Achieve Average EPS Growth on Below Average Sales Growth*

Village has limited growth potential. Since 2000, the company has grown sales per square foot by 2.4% a year. Meanwhile, selling square feet actually grew slightly faster at 2.6%. This allowed the company to compound sales at greater than 4% a year. The increase in square footage is mostly driven by new stores. Since 1995, the average store has expanded from 46,000 square feet to 57,000 square feet. This is an annual increase of 1.3% a year. Most retailers barely add any square footage to existing stores over time (they just open new stores instead), so the renovating of all stores to add additional square footage is an unusual strategy. Village's sales square footage increases tied to new store growth is more volatile. The company has had one major expansion about every 1 to 3 years. The biggest increases in selling square footage happened when Village bought existing stores. In 207, Village bought a 55,000 square foot Shop-Rite in Galloway Township, New Jersey from Wakefern. In 2011, Village bought 2 Maryland stores and rebranded them as Shop-Rites. One was a 57,000 square foot store in Timonium, Maryland. The other was a 64,000 square foot store in Silver Spring, Maryland.

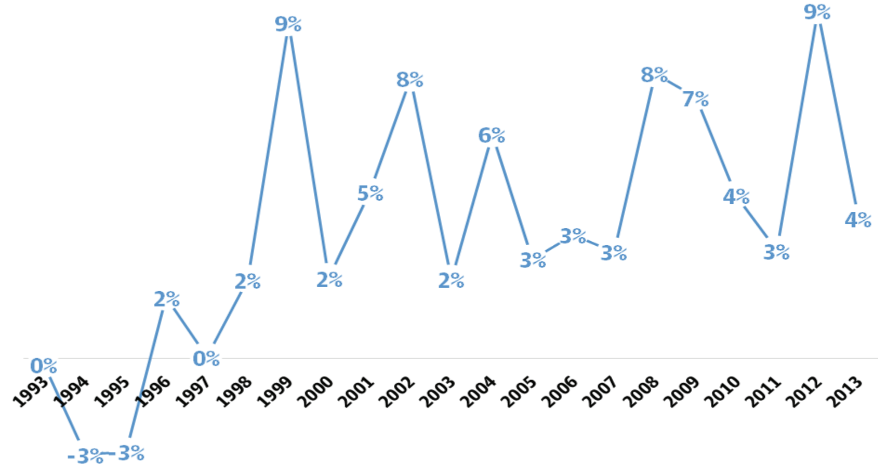
Village's average store can grow its sales by some rate between inflation and GDP growth. There is no reason for groceries – which are a basic category – to grow as fast or faster than nominal GDP (which includes non-basic categories people can spend more money on as they become wealthier). Groceries are a necessity. They may fail to grow as fast as nominal GDP. However, they cannot grow slower than the population of the area they serve unless there is deflation in the entire grocery category (which rarely happens, since supermarkets pass on higher gross costs) or the store loses market share. Market share losses are less likely in New Jersey to the extent new store openings are more difficult.

Since 1993, Village has grown its operating profit and EBITDA much faster than it has grown sales. The company's gross margin has improved. Meanwhile, the ratio of operating costs to sales has stayed steady at about 21.7%. The range of Village's operating expenses to sales (its operating cost ratio) has been extraordinarily tight. Operating costs have ranged from 20.5% ro 22.2% over the last 20 years. Their median level is 21.7%. The mean is 21.5%. The volatility of this number has been much, much lower than that of other ratios in Village's financial results. In other words, the relationship between sales and operating costs has been extremely tight from year to year. Since 2001, Village's gross margin has also been fairly stable. The company's gross margin was not stable in the 1990s, because it was constantly improving at a rapid rate. This constant improvement slowed in the 2000s, resulting in a more stable gross margin. From 1993 through 2013, Village's gross margin ranged from 24.2% to 27.4%. The median was 25.5%. The mean was 25.7%. Rent adds a fraction of one percent to Village's sales. Therefore, the median and mean operating expense ratios including rent are 22.4% and 22.2% respectively. Using the median gross margin (25.5%) and the median operating cost to sales ratio (22.4%) would leave an EBITDA margin of 3.1%. In fact, this EBITDA margin based on the median results in gross margin and operating expenses over the last 20 years, is probably misleading. Operating expenses have been stable (they hit almost the exact same peak in 1994, 1999, 2011, and 2013 – suggesting there is no discernible trend over time). Meanwhile, gross margin was lowest (24.2%) in 1993 and highest (27.4%) in 2009. Gross margin has trended upward over time. If the peak gross margin is used (since gross margin has tended to rise over time) then a "normal" year in terms of EBITDA margin would be a 27.4% gross margin minus a 22.4% median operating expense. This would give Village a 5% EBITDA margin. The median depreciation and amortization expense is 1.2% a year. That would leave Village was an estimated 3.8% normal pre-tax profit margin. If the two assumptions that gross margin tends to rise or stay stable while operating expenses follow sales is correct, then this is a good estimate of Village's normal earning power. The company has $1.48 billion in sales. So, this method would project normal EBITDA to be $74 million and normal pre-tax profit to be $56.24 million. Village pays a 42% corporate income tax (a 35% federal tax and 9% New Jersey tax where the 9% New Jersey tax is deductible on the 35% federal tax). A $56.24 million pre-tax profit would translate into $32.62 million in after-tax income when Village

uses no leverage. The company has 13.85 million shares outstanding. So, this would result in earnings per share of $2.36. Village's 4.3 million B shares pay a lower dividend than the 9.4 million A shares. So, this $2.35 a share estimate understates the actual economic interest of the A shares to the extent earnings are paid out in dividends and some B shares remain unconverted into A shares. In other words, the $2.35 a share estimate is an understatement of the dividend paying capacity of the A shares (because it is an overstatement of the dividend paying capacity of the super voting B shares).

The company's best year in terms of EBITDA was $75 million (in 2012) versus a peak gross margin and normal operating expense ratio model that gives $74 million as normal EBITDA. Likewise, peak EBIT was $56 million. So, the above numbers simply reflect the idea that Village's peak results (in 2012) may be normal for the company going forward.

Village's Maryland stores may fail. Without these stores, it is likely Village's normal EBITDA would already be around $75 million. Village's median sales growth rate over the last 20 years was 3%. This is about two-thirds of the nation's 4.5% a year nominal GDP growth rate over the same time period. Sales growth equal to two-thirds of nominal GDP is a good estimate of Village's future growth potential. However, the company has operating leverage as gross profit tends to improve versus sales while operating expenses do not worsen as a percent of sales. For this reason, EBITDA should be thought of as having a normal base of the former peak $76 million number and a future growth potential of more than 3% a year. Put in per after-tax, per share terms the company has normal EPS of $2.25 and should grow 3% a year. Both of these estimates are slightly conservative. EBITDA has actually grown 8% a year over the last 20 years. This wide range (3% to 8% annual EBITDA growth) captures the most likely long



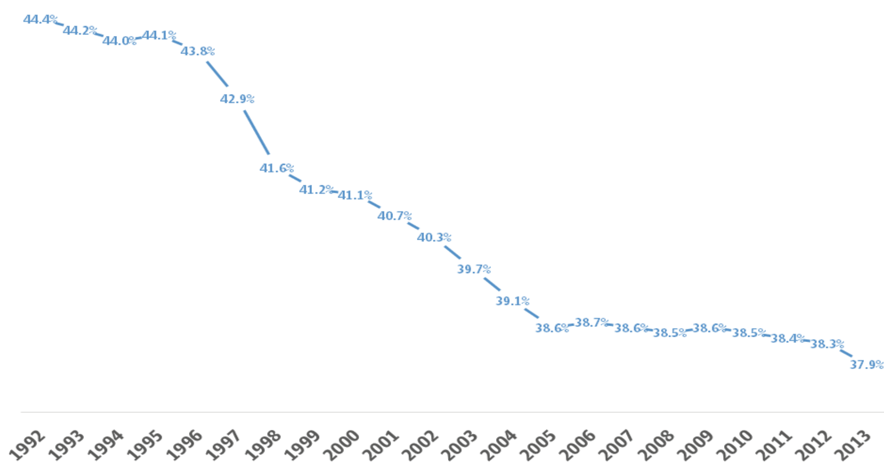
Over the last 18 years, Village has compounded sales at 4.3% per year

-term growth rate for Village's earnings. A reasonable yet conservative theoretical model of the value of Village's A shares would be to assume a $2.35 payout potential that grows 3% a year in perpetuity. A simpler (static) approach would be to value Village at 15 times normal after-tax earnings of $2.35 on the A shares. This would give a value of about $35.25 a share. Assuming 1% annual share dilution and using Village's past EBITDA growth as the absolute maximum future growth rate would give a 2% to 7% a year annual EPS growth range. This is almost exactly the EPS growth rate investors can expect from the average U.S. stock going forward (4.5% a year). Since a P/E of 15 is typical and Village has fairly typical future growth prospects and unleveraged returns on equity, a value of $35 a share on the A shares is perfectly standard. An unleveraged supermarket is probably a lower than average risk stock. So at $35 a share, the A shares would combine average return potential with below average risk. For this reason, $35 is a good appraisal price for the A shares. Value investors looking for a 33% margin of safety could then use $23 on the A shares as the perfect price to buy into Village.

MISJUDGMENT: *Non-Traditional Grocers May Drive Down Profits in Specialty Categories*

There is a risk of misjudging future competition in the New Jersey grocery business. Amazon Fresh is entering the New York City area. This will put Amazon Fresh in competition with Village. The Fresh Market has already entered Village's local market and will continue to open new stores in New Jersey. The Fresh Market is an especially powerful competitive threat in New Jersey. It focuses on perishables. The store format is just 17,000 to 22,000 square feet. So, the level of investment in a new store is low. The number of possible locations to put a Fresh Market is higher than it is for traditional supermarkets. The New Jersey market is space constrained, so the smaller store format is a major advantage for The Fresh Market when it comes to overcoming barriers to entry. Village's higher gross margin in recent years (gross margin has consistently widened for the last 20 years) is due to selling more and more specialty, fresh, and prepared items. A large format store can have a complete selection of general groceries and also include sushi bars, salad bars, prepared food counters, bakeries, pharmacies, ethnic food aisles, etc. Village does this in many of its stores. The "groceries" category only accounts for 38% of Village's sales. The second largest category is dairy and frozen at 18%. Meats are 10%. Non-food is 8%. Those categories are all fairly

general. They are the standard fare that every traditional supermarket must carry with a wide selection at competitive prices. Some are not especially attractive. For instance, Village’s sales of groceries and non-food products have not kept pace with its overall sales at all. Both categories have declined over the last 20 years relative to all other categories. This is actually a positive trend, because it is hard to have a lot of gross profit per square foot in these categories. Just 4 categories (groceries, dairy and frozen, meats, and non-food) make up about 74% of Village’s sales. Sales in some of those categories – especially meats – can vary a lot in terms of profitability. It is possible to have specialty meat sales that are much more profitable than other items in that category. But these 4 sections together are the most general part of Village’s selection. The other sections that account for 26% of sales are very much specialty. These sections are often lacking in small format traditional supermarkets. Village’s produce sales are 12% of total revenue. Prepared food is 6%. Seafood is 3%. Pharmacy is 4%. And bakery is 2%. Bakery is a small category for supermarkets. Pharmacy is a declining category because of increased competition from prescription filling retailers especially drug stores and other prescription focused companies with scale and extensive customer databases and technology assets. Village’s pharmacy sales have declined in the last few years. This will probably continue. The same trend is likely at all supermarkets. Over 20% of Village’s sales are items that greatly benefit from higher inventory turns delivering extra freshness. These categories are: produce (12%), prepared food (6%), seafood (3%), and bakery (2%). Freshness is the key concern in each of these categories. These fresh sections – which make up about 20% of Village’s revenue – are the categories The Fresh Market targets. As the company’s name suggests, fresh is what they do best. The Fresh Market is the biggest new threat to Village, because the company has



“Groceries” share of total sales has declined in 18 of the last 21 years

not had much of a presence in New Jersey.

However, the average Shop-Rite customers spends $60 per trip to the store and makes multiple visits a week. The Fresh Market is a category killer in the fresh categories. But it is very weak in all other categories. For example, the selection of soda at The Fresh Market is virtually non-existent. This is a weekly staple for many American households. That means The Fresh Market is unable to serve as the primary grocery shopping destination for the household. While the number is impossible to quantify, it is almost certain that the vast majority of Shop-Rite sales are to customers who use Shop-Rite as their primary grocery shopping destination. Village gets sales of prepared foods and other specialty items. However, it gets these sales by encouraging existing customers to trade up and to expand their definition of what can be bought at a traditional supermarket. It does not attract customers to the stores merely to buy these specialty items. The core attraction for customers is the wide selection and everyday low prices on general grocery products.

The Fresh Market is the biggest new competitive threat to Village. However, it is not even necessarily the most damaging direct competitor. Village already competes in some areas with Wegman’s. Wegman’s is the most potentially harmful competitor to Shop-Rite because it has a huge store format (80,000 to 140,000 square feet), very high customer satisfaction (sometimes ranked #1 in national surveys), and the kind of focus on fresh, organic, and specialty items that is most associated with The Fresh Market and Whole Foods. The two key differences between Wegman’s and these other two chains is that Wegman’s is locally focused. On average, a Whole Foods is about twice the size of a Fresh Market. Even a small Wegman’s is more than twice the size of a large Whole Foods. Wegman’s does more sales per store ($81 million) than Village ($51 million). And Wegman’s reinvests the free cash flow from its Northeastern stores back in the Northeast. Whole Foods and The Fresh Market scatter their profits across the country. This greatly limits the harm they do to each individual supermarket chain. Regional competitors like Wegman’s are much more likely to reinvest the profits from their stores in Village’s home market.

In the long-run, competition in any market damages the entire group only to the extent it increases the long-term supply (supermarket square footage within 3 miles) faster than demand. Uneconomic supermarket locations close. The marginal ones close first. Village’s best stores and biggest sales bumps are in areas where a competing Stop & Shop, Pathmark, or A&P finally gives up. As The Fresh Market moves into an area it will hurt the sales of all local

competitors. However, when the weakest of these competitors closes, it will help the sales of the surviving stores. Chains that closely mimic each other often cause little lasting harm, because they knock a similar store out of the local market. In most towns in New Jersey, the local Shop-Rite is not the weakest incumbent supermarket. So it will not be the first store to close. As a result, the closing of a weak incumbent may eventually mitigate the competition from a new entrant.

Two competitors are different. The Fresh Market can survive on lower sales and occupy smaller locations. It can add new competition and depress returns on capital in a local market. Meanwhile, Amazon Fresh does not make decisions based on local economics.

Most other competition – such as Whole Foods and Wal-Mart – are less problematic for Village in the long-term. These store only impact sales in very small areas (usually 2-3 miles at most). They need the same large locations as Village. And they compete for similar customers and in similar categories. Finally, if and when these stores are successful, they encourage the weakest competitor – often the one with the lowest sales per store – to close first. This causes the depressed local returns on capital to rebound. The entry of another supermarket into a town with 3 good established competitors tends not to result in a stable situation where 4 good competitors all earn permanently lower returns. Instead, the weakest store feels the greatest pressure and eventually closes. Village runs Shop-Rites. And Shop-Rites are rarely the marginal competitor in their local market. In many cases, they have the highest or second highest sales per store in their town. This means they will usually be the last store to close. Village's history of not closing any stores due to poor sales in almost 20 years is proof of this. During the same time, plenty of Stop & Shops, Pathmarks, and A&Ps have closed in Village's market.

CONCLUSION: *Village "A" Shares Offer an Adequate Long-Term Return with Low Risk*

As a supermarket, the demand for Village's products is more durable than most companies. The company's New Jersey stores are also in durably high traffic locations. The threat to Village's staying power is a threat to the Shop-Rite banner. Competitive pressures from non-traditional grocers like The Fresh Market and Amazon Fresh are the greatest risk to Village. However, Village already competes with the online grocer Peapod. In the fresh and organic categories, both Whole Foods and Wegman's already have a presence in New Jersey. So, while Village's biggest direct competitors are traditional supermarkets like Stop & Shop, A&P, Pathmark, and Kings – there has been some online and naturally focused supermarkets in New Jersey since the 1990s.

Village's capital allocation is clear. The company has grown its dividend from 8 cents a share in 2004 to 97 cents a share in 2010. Right now, Village pays a dividend of 25 cents a quarter ($1 a year) on the A shares. This is about a 50% dividend payout. Village's normal owner earnings are probably around $2 per share. The company has not historically bought back much stock. With Village's limited growth prospects, it is likely the company will eventually end up paying $1.50 to $2 per A share in dividends each year.

The biggest risk to Village is future competition. The store model that has the greatest chance of entering and taking share in New Jersey is the one used by The Fresh Market. Unlike traditional supermarkets, The Fresh Market does not need to look for good 60,000 square foot locations. The stores can be squeezed into more locations. They also have a quicker payback period for their initial – much smaller – cash outlay.

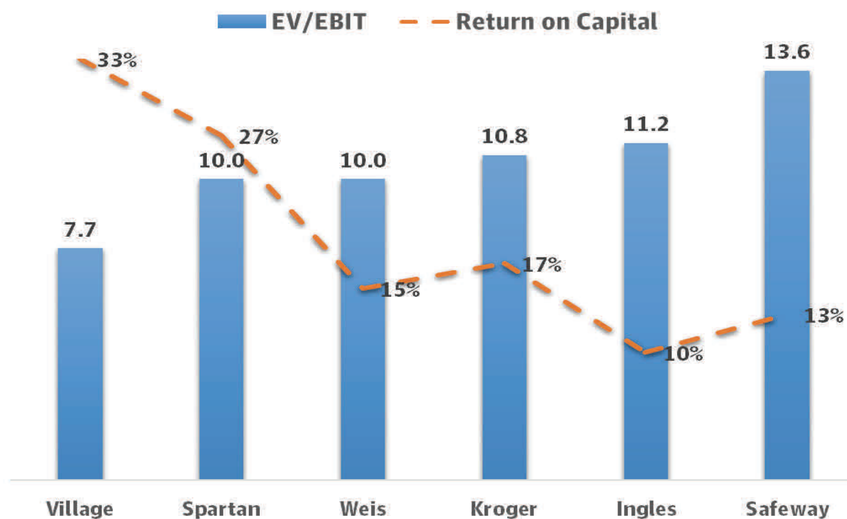
Village has clear but limited growth prospects. The company can grow sales per square foot at the rate of inflation. It can increase the square footage of existing stores by up to 1% a year through remodels. And Village will get the opportunity to acquire other Shop-Rite operators or owners of supermarkets that can be rebranded with the Shop-Rite name. These opportunities are rare. But Village has taken advantage of them in the past. And the company has the net cash and free cash flow to take advantage of them in the future. The timing of these acquisitions is impossible to predict. But they will appear from time to time. This could easily provide Village with another 1% a year in growth over the long-term. Sales growth is likely to be no less than inflation but no more than nominal GDP. A range of 2% to 6% is very likely. The lower end of that range is more likely for sales growth. With even a small improvement in margins, the higher end of that range is more likely for EBITDA growth. Village's gross margins (and therefore also its operating margins) have consistently widened over the last two decades. If this trend continues at all, Village will be able to achieve mid-single digit rather than low single digit rates of earnings growth. This number rather than the sales growth number is what matters most to investors.

Village is not extraordinarily cheap on an absolute basis. At $25 a share, the company is selling for about 6 times pre-tax owner earnings. The A shares have a dividend yield of 4%. Village's dividend will certainly grow by at least 3% a year. As a result, the stock is almost certain to return 7% a year or more.

Like Town Sports, Village has location based advantages. The company has over two dozen established Shop-Rite branded stores with long-term leases in New Jersey. This is the hardest state in the U.S. to develop a cluster of new stores. That makes the replacement value of Village's business high. In one case, it took Village about 10 years from the time it decided to add a store until the time it was able to open that store. The space requirements for a Fresh Market location are not as great. That is one reason – along with a

quicker investment payback period – why The Fresh Market may become one of the toughest new entrants in New Jersey.

Village is a controlled company. It is very unlikely to be sold. As a member of Wakefern, an acquirer would need to be a Shop-Rite operator to get the full benefit from Village's stores. The Shop-Rite name can only be used by Wakefern members. And even if an acquirer wanted to rebrand Village's stores, it would need to pay a large penalty to Wakefern based on the lost sales from the acquisition. This makes an acquisition of Village by any non-Wakefern member nearly impossible. The $1 million to $2 million a year annual incomes for 4 different Sumas family members also discourages the controlling family from selling the company to anyone – even another Wakefern member – who might replace top management or reduce salaries. Village is the second largest Wakefern member. The company has excess cash. And it is publicly traded. It would be a huge acquisition for any other Wakefern member to swallow. The only possibility would probably be the use of a significant amount of borrowed money. Village has the kind of business and balance sheet that could support a leveraged buyout. This combination of factors makes an acquisition of Village very unlikely at any point in the future. Village has been owned by the Sumas family for more than 80 years. The company has been public with majority voting control in the hands of the Sumas family for more than 50 years. This is unlikely to change. Village will most likely remain a public, controlled company throughout even the longest of long-term investor's time frames. So, the return an investor earns in Village stock is likely to come from a combination of dividends and stock price appreciation in the open market. This is different from some other supermarkets. If it were not for the Sumas family control and the requirement that makes it almost impossible for a non-Wakefern member to buy Village, the company



Village is the highest quality and lowest priced "traditional" supermarket

would be a very attractive acquisition target given its current store locations, balance sheet, and cheap stock price.

Because a buyout of the company is unlikely, the best way to value Village is to use the expected dividend yield and growth in dividend payments. Village pays a 4% regular dividend (in some recent years, there have also been special dividends). The return in the stock over the long-term will be roughly equivalent to the dividend paid each year plus the growth rate in the dividend. It may be possible for Village to return 10% a year by paying a 4% dividend yield and then growing the dividend by 6% a year. This rate of growth is reasonable for Village over the next few years. So a 10% stock return may be reasonable. Village pays a 4% dividend yield. So, the company would only need to increase its dividend by 3% to 4% a year to provide a 7% to 8% annual return (a result the S&P 500 is unlikely to beat). Village's payout ratio is not especially high. And the company's balance sheet is conservative. So, Village should increase its dividend faster than its earnings per share. The company's share count may be diluted by about 1% a year for stock options. However, a growth rate in both earnings per share and dividends per share of 5% is possible even with that dilution. This growth rate coupled with the current dividend yield, should provide returns in the high single digits per year under most circumstances. The possibility of very high annual returns in Village stock is not great. However, the probability of high single digit returns is very high. And a 10% annual return is possible. There are very few opportunities for such returns in today's high priced stock market. And many of those opportunities are leveraged. Village is an unleveraged company in a defensive industry. The stock combines adequate long-term return potential with low risk.

Village Supermarket (NASDAQ: VLGEA)
Appraisal: $38.02

Margin of Safety: 38%

Owner Earnings	(in millions)
Pre-tax Owner Earnings	
Revenue	$1,476.00
* Normal EBIT margin	3.60%
= Pre-tax Owner Earnings	$53.14

Business Value
Village's business value is $478 million.
- Pre-tax owner earnings are $53.1 million
- Fair multiple = 9x pre-tax owner earnings
- $53.1 million * 9 = $478 million

Fair Multiple
Village's business is worth at least 9x pre-tax owner earnings
- Quan thinks: "Village's quality of earnings is among the highest in the industry. But the company's 42% tax makes it worth only 9 times pre-tax owner earnings instead of a more typical 10 times."

Share Value
Village's stock is worth $38.02 a share
- Business value is $478 million
- Net cash is $49 million
    - Cash and notes receivables: $110 million
    - Capital lease obligation: $41 million
    - Pension liability: $20 million
    - $110 million - $41 million - $20 million = $49 million
- Equity value is $527 million
- $478 million + 49 million = $527 million
- Equity Value = $38.02/share
    - 13.86 million total diluted shares
    - $527 million / 13.86 million = $38.02

Margin of Safety
Village stock has a 38% margin of safety.
- Business Value = $478 million
- Enterprise Value = $298 million
- Discount = $180 million ($478 million - $298 million)
- Margin of Safety = 38% ($180 million / $478 million)

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Safeway	0.24	0.91	5.34	13.57	13.91
Spartan Stores	0.25	1.18	6.45	10.58	10.58
Kroger	0.31	1.50	6.77	10.82	10.58
Ingles Markets	0.39	1.76	6.61	11.19	11.19
Weis Markets	0.47	1.71	7.14	10.01	10.01
Minimum	0.24	0.91	5.34	10.01	10.01
Maximum	0.47	1.76	7.14	13.57	13.91
Median	0.31	1.50	6.61	10.82	10.58
Mean	0.33	1.41	6.46	11.23	11.25
STDEV	0.10	0.36	0.68	1.37	1.54
CV	30%	26%	11%	12%	14%
Village (Market Price)	0.23	0.85	5.22	7.71	6.39
Village (Appraisal Price)	0.37	1.36	8.35	12.34	10.22

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).