SPECIAL REPORT

Marcus & Millichap

PROPOSED KROGER-ALBERTSONS MERGER
Implications for Investors

DECEMBER 2022

Landmark Merger to Offer Mixed Results for Shopping Center Owners

Agreement's disposition requirements to have major impact. The proposed union of Kroger and Albertsons, the nation's top pure play supermarket organizations, will have significant implications for the retail sector, if approved. By assembling nearly 5,000 stores under the Kroger umbrella, the agreement will alter grocer competition and create numerous possible scenarios for owners of shopping centers with a tenant subject to the merger. If the Federal Trade Commission (FTC) were to approve of the deal, the two grocery chains will be required to divest 100 to 650 stores, with disposal of these assets achieved in a variety of ways. It is this potential divestiture that poses the most risk for shopping center owners. The most straightforward strategy appears to be the bulk sale of stores to expanding regional grocers. However, Albertsons' acquisition of Safeway in 2014 — and the subsequent sale of nearly 150 stores to then regional grocer Haggen — serves as a cautionary tale. Additionally, a bulk sale to another party may prove difficult as Albertsons' family of stores are unionized, making them less attractive to potential bidders.

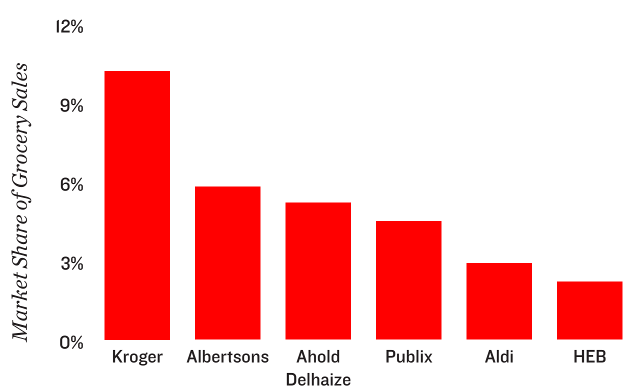
Spin off strategy would impact property valuations. If unable to divest assets via portfolio transactions, the parties plan to spin off a collection of stores to Albertson's shareholders prior to the closing of the merger, with the newly-formed entity operating as a standalone public company. The properties included in a potential spin off will ultimately be determined by the FTC, with the newly-formed company, dubbed as "SpinCo," expected to carry no initial debt. Shopping center owners with tenants included in the spin off will have no recourse and likely face a window of uncertainty, as it remains unclear if the SpinCo will sell, close or rebrand certain stores. The viability of the SpinCo is also questioned by the premise of the merger, which argues smaller-scale businesses are challenged in the sector. Regardless, these owners' property valuations will be impacted, as they will transition from having a relatively high-credit anchor tenant to one with no proven track record. This shift may activate lender provisions that negatively impact owners with property level debt.

Some investors stand to benefit. Shopping center owners with tenants that remain under the Kroger umbrella will face a more certain, less volatile situation than those included in the SpinCo. Those currently with Kroger-brand flags in a metro with minimal or no Albertsons-related competition will see their circumstances adjust nominally, apart from operational changes. Meanwhile, owners with an Albertsons-brand store in a market with minimal Kroger overlap stand to emerge as winners. These landlords will see the credit quality of their grocery tenants improve, equating to greater interest from potential buyers.

Merger Highlights

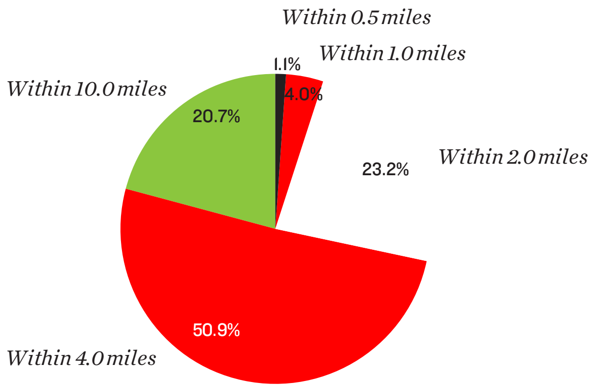
- Companies are willing to divest up to 650 supermarkets to secure regulatory clearance for the $24.6 billion deal.
- If companies are unable to divest stores outright, a "SpinCo" would be spun off to Albertsons' shareholders prior to the closing and would operate as a standalone public company.
- The SpinCo is expected to include a mix of properties, including some better-performing assets and stores in markets where overlap exists between Kroger and Albertsons.
- If the merger falls through, Kroger will owe Albertsons a breakup fee of $600 million.
- Kroger and Albertsons have a combined customer base of 85 million households, with the two companies accounting for an estimated 16 percent of U.S. grocery market share as of early 2022.
- Kroger owns 2,720 stores nationwide. Its family of companies includes: Kroger, City Market, Dillons, Food 4 Less, Foods Co., Fred Meyer, Fry's Food Stores, Gerbes, Mariano's, Pay Less Super Markets, Pick 'n Save, Ralphs and Ruler Foods.
- Albertsons owns more than 2,260 U.S. stores. Its roster of companies includes: Albertsons, Safeway, Vons, Jewel-Osco, Shaw's, Acme, Tom Thumb, Randalls, United Supermarkets, Pavilions, Star Market, Haggen, Carrs, Kings Food Markets and Balducci's.

Market Share by Pure Play Grocers*

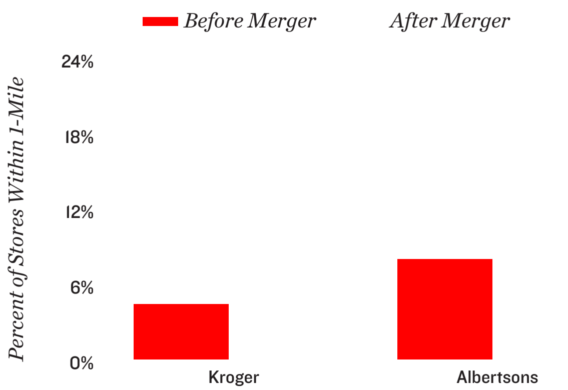


* As of 1Q 2022
Source: Marcus & Millichap Research Services; Numerator

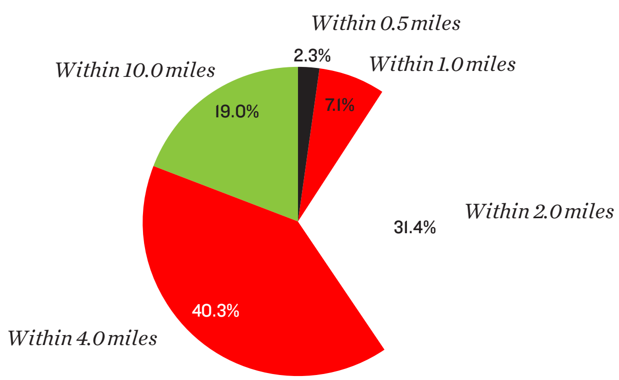
Store Distribution: Kroger & Affiliates



Merger Would Increase Store Proximity



Store Distribution: Albertsons & Affiliates



Note: Store distribution examines only stores within 10 miles of another in the same organization.
Sources: Marcus & Millichap Research Services; Kroger, Albertsons

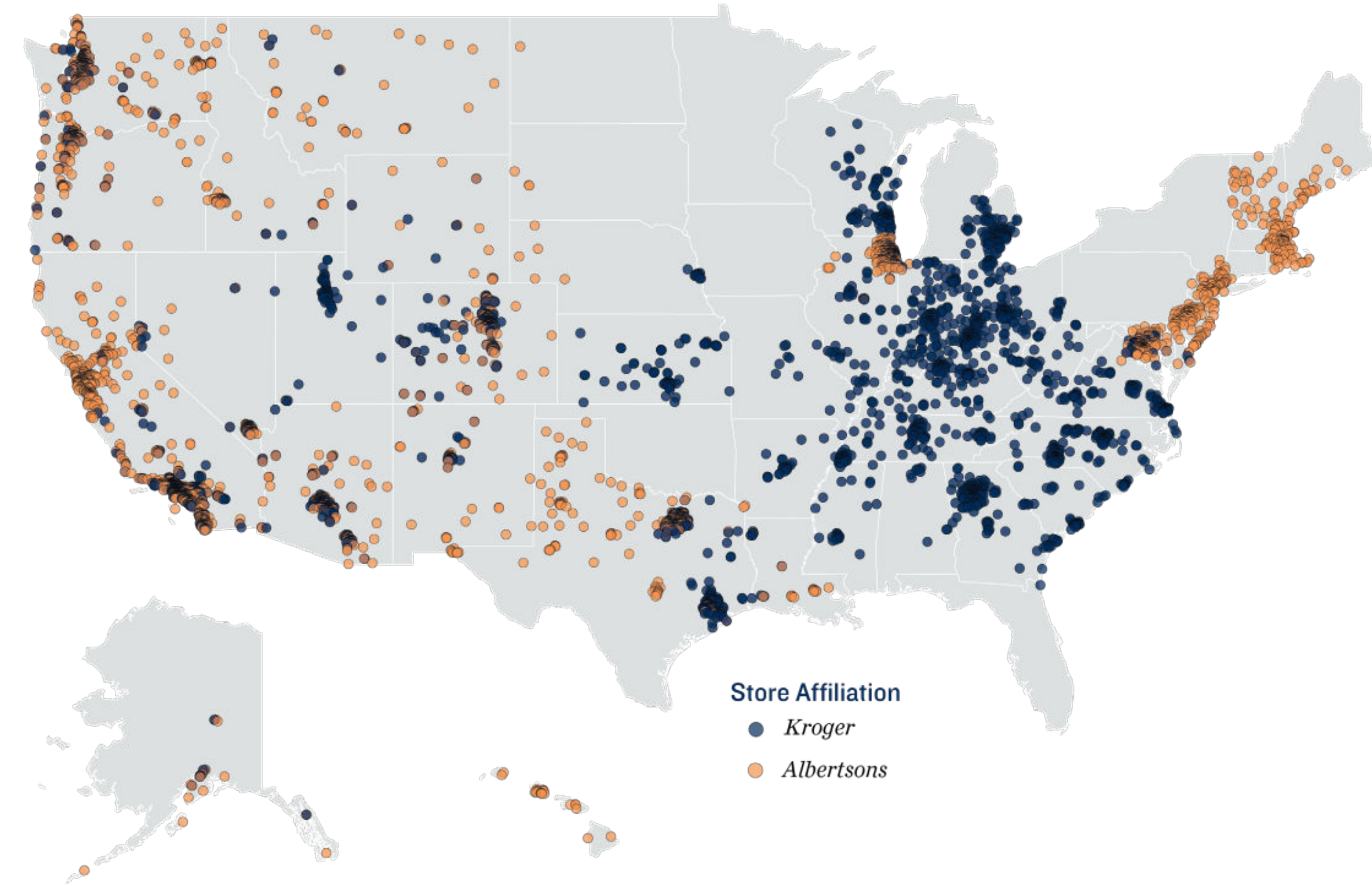
Merger to Increase Store Overlap

Unification may create a grocery monopoly in certain metros. Currently, less than 5 percent of Kroger stores are within a 1-mile radius of another company-owned supermarket. Should the merger be approved, significant overlap between brands under the same ownership umbrella will be created, elevating this figure to 15 percent. Furthermore, 20 metros would have at least 25 Kroger-owned stores. Such locations may be ripe for store consolidation by the merged entity down the line. More immediately, supermarkets in these areas of conflict appear likely candidates for inclusion in the potential spin off portfolio, which is envisioned to also include some better-performing assets.

Uncertainty surrounds spin off framework. A group of scenarios potentially await shopping center owners with grocery tenants subject to the SpinCo. Some owners may attempt to restructure existing leases or request the space back from the new entity, namely if the current lease is slated to expire over the near term. Considering the strength of the supermarket sector and ongoing expansions by regional grocers, this may be attempted by a collection of owners keen on securing a higher-credit tenant at a rental rate well above the prior lease. Spanning the past five years, heightened demand for available space has allowed the sector's average asking rent to climb by more than 10 percent, with vacancy at a nearly 20-year low entering the fourth quarter. Still, other owners may look outside the grocery sector to junior or big-box retailers. Tightening multi-tenant availability and moderate shopping center construction is limiting options for these users. Other owners may extract value via a property sale, as over the past five years the nation's average multi-tenant sales price rose 16 percent.

Smaller market owners potentially face more risk. Stores in metros of significant overlap are likely to account for a substantial share of the proposed SpinCo. However, grocers in smaller cities should also comprise a sizable portion of the new entity's portfolio. Currently, more than 30 percent of Kroger and Albertsons' collective store count is spread across tertiary markets, with most home to one to five company-owned supermarkets. Because of these cities' modest populations and often rural locations, shopping center owners with grocers subject to the SpinCo carry more potential risk exposure regarding the viability of the new company. Currently, the type of ongoing service agreement that would exist between the new entity and Kroger is unclear, with the latter unaccustomed to providing distribution services to another platform. If tertiary stores are sold or rebranded under the SpinCo, foot traffic at the shopping centers they anchor could be acutely altered, negatively impacting adjacent tenants and the property's overall performance and valuation.

National Distribution of Kroger and Albertsons Affiliated Stores

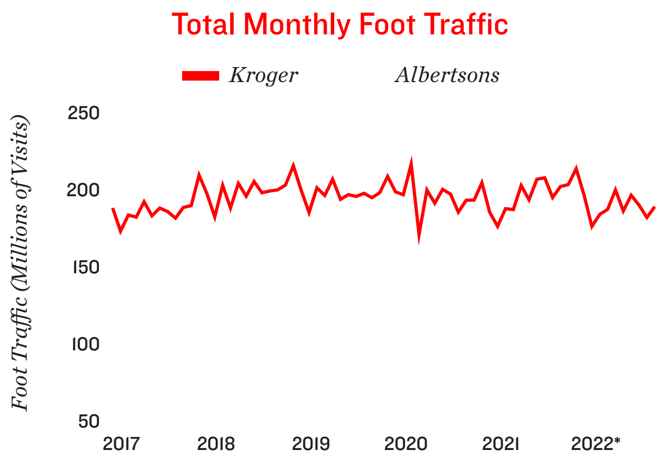


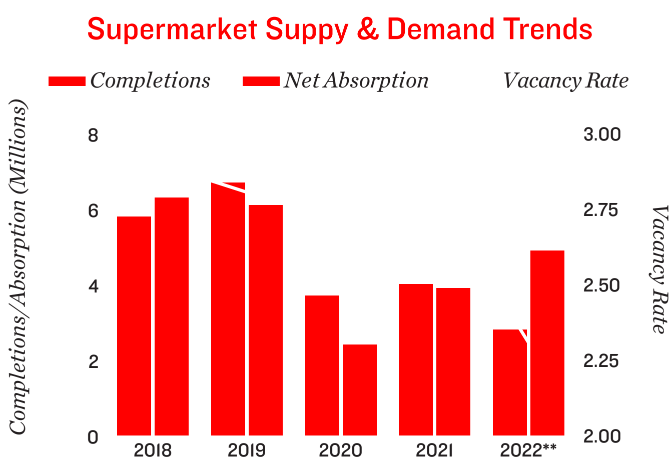
As of November 3
Sources: Marcus & Millichap Research Services; Kroger, Albertsons

Merger Would Heighten Overlap in the West, Raising Risk of Future Consolidation

Midsize grocers presented with bulk acquisition opportunities. Kroger and Albertsons' willingness to divest up to 650 stores to secure regulatory clearance may create expansion avenues for regional grocers intent on growing their national footprint without taking on construction risk. Should the two companies strategically dispose of properties in bulk, Ahold Delhaize — which operates on the East Coast under Stop & Shop, Giant Food, Food Lion and Hannaford — may represent a potential partner, as the company has publicly declared its plans to expand westward. Leaders in recent store openings, Aldi and Publix may also emerge as viable buyers.

Companies' overlap potentially telegraphs areas of upcoming dispositions. The western U.S. could be the epicenter of Kroger-Albertsons divestitures, as the two companies have notable overlap here. Specifically, an estimated 54 West Coast stores owned by either company have at least two other Kroger- or Albertsons-family supermarkets within a 1-mile radius — with competition most significant in Los Angeles and Orange counties. In contrast, minimal overlay exists in the Northeast, South and Midwest, suggesting the scope of dispositions may be smaller in these regions.





** Through October 1*

*** Trailing 12 Months through 3Q 2022*

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Placer.ai

Outlook for Supermarket Sector is Strong

Grocery sales reflect a preference for in-store shopping. The proposed merger is occurring alongside encouraging spending at supermarkets. This October, shoppers spent a record $72.6 billion at grocery stores, supporting a 1.4 percent gain, the largest monthly increase this year. This improvement coincided with a 0.4 percent monthly rise in the food at home price index, indicating spending rose in real terms. Additionally, grocers accounted for their highest share of store-based spending in nearly two years, a percentage that excludes purchases made online or at bars and restaurants. This performance can be attributed to consistent in-person shopping and a recent decline in online grocery sales. Across Albertsons-owned stores, monthly foot traffic has collectively remained above pre-pandemic levels this year. The Kroger family of companies cannot make this claim; however, total patronage over the past 12 months ended in October was nearly on par with the prior yearlong interval. These foot traffic trends may foster tenant demand for available space in grocery-anchored shopping centers, a boon for multi-tenant leasing activity.

Limited availability and reduced pipeline enhance forecast. Improved shopping behavior is backing strong property fundamentals. Entering the fourth quarter, availability in the grocery sector had held at or below 3.0 percent for 19 straight months, a span in which tenants absorbed a net of more than 22 million square feet. Highlighting this performance, vacancy stood at 2.4 percent this October, the lowest rate since 2003. Tight conditions are supporting asking rent growth. However, the average marketed rate trails the prior peak by a notable margin, suggesting room for further gains exist amid record consumer spending and moderate construction activity. During the yearlong stretch ended in the third quarter, developers expanded the nation's supermarket stock by just 0.6 percent. Moderate inventory growth is poised to continue over the near term, as roughly 3.1 million square feet was underway at the onset of October, a total well below the long-term mean. Mirroring recent delivery trends, projects in the South and Northeast comprise a large share of the active pipeline.

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Sources: Marcus Research Services; Company websites for Kroger and Albertsons; CoStar Group, Inc.; Placer.ai; Numerator