U.S. Foodservice Ownership Transition

Potential Outcomes and Implications

Strategic White Paper
Confidential

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INTRODUCTION

Royal Ahold's sale of U.S. Foodservice (USFS) to private equity firms Clayton Dubilier & Rice and Kohlberg Kravis Roberts for $7.1 billion will have significant implications for the foodservice go-to-market system. Our belief is that the new owners will strive to maximize profits within a relatively short time period (4 – 6 years) in order to either sell the organization or take it public. One activity that we believe will have a significant impact on the manufacturing community will be the closing or consolidation of distribution houses (divisions) where applicable.

The Hale Group (THG), in conjunction with our industry partners, has conducted a thorough review of the USFS branch system, and has identified a number of likely branch candidates for consolidation. It is critical for foodservice participants to understand where the most probable consolidation opportunities exist, how their businesses are aligned within those geographies, and to develop plans for future growth. This report provides a view toward USFS's potential actions, and identifies critical issues for manufacturers to address moving forward.

Although we have utilized our resources and contacts to develop this framework, we recognize that this analysis is directional and is not based on USFS-provided information or knowledge.

MANUFACTURER IMPLICATIONS

Due to the "new direction" that USFS will take, the implications to manufacturers will be significant. It is our belief that manufacturers must take a strategic view of the situation by developing a "Strategy of One™" for the USFS business that they currently enjoy or expect to have. While this document is focused on the likely consolidation of operating divisions, the manufacturer should recognize that the following are likely future actions which will/can affect their access to the market.

- Increasing focus on USFS's "labels/brands" by diminishing their efforts on manufacturer brands
  - Putting manufacturer brands in the back of the book
  - Reducing commissions on manufacturer brands to their DSRs
  - Marketing their brands as "the same as…"
- Pursuing avenues to increase shelter/marketing monies
  - Expansion of programs

    - Increasing the number of "participation levels"
    - Additional funding for specific marketing programs
    - Trade show cost increases
    - Etc.
- Likely sale of North Star
- Changing the DSR compensation package
    - Increasing the amount of "direction"
    - This will likely lead to the loss of the "good DSRs"
- Increasing demands on the broker community
    - Brokers who have a large percentage of their activity associated with USFS will need to evaluate their resource allocation
- Willingness to take difficult negotiating stands
    - Holding their position relative to asking for additional funds
- Dropping business that they consider to be unprofitable
    - Although a large portion of their business is "street," they may pursue a "drop size" limit

CONSOLIDATION IMPLICATIONS

The implications of consolidation may be positive or negative, depending on each manufacturer's position.

- Will manufacturers lose business? Or will it shift?
    - Do they need to realign their sales efforts?
    - How strong are they with Tier III & IV distributors?
- Consolidation could be an advantage
    - Full truckloads *versus* partial loads
    - Dealing with fewer houses
- Will USFS adopt the "Sysco Model"?
    - Proprietary brand development

- Operational efficiencies in warehousing and logistics
- System superiority
- Pricing courage

Manufacturers must develop strategies within the geographies that are most likely to be impacted by consolidations. Plans should include:

- Development of a clear understanding of the distribution landscape within each potential consolidation geography, the manufacturers' business across the distribution participants and an estimated market share by participant
- Identification of alternative go-to-market partners within each geography
  - All relevant broadline distributors (Tiers I, II, III and IV)
  - Alternative distribution systems including Clubs and Cash & Carry
  - Local re-distributors and their relationships
- Development of a targeted distribution plan for each market leveraging the various go-to-market entities. The objective is to build a profitable growth plan that capitalizes on all of the appropriate routes to market within each geography
- Creation of specific operator plans to profitably retain and further penetrate existing operator customers, and to acquire new operator customers
- Evaluation of USFS financial programs with a continued effort to shift emphasis from corporate programs to local initiatives
- Leverage their direct or broker go-to-market system to defend and position their volume

USFS OVERVIEW

The USFS business has stabilized over the past 1+ years, delivering sales growth and returning to marginal profitability. Royal Ahold has recently culminated their renovation efforts with the sale of USFS to the financial buyers.
USFS currently operates 61 broadline divisions throughout the U.S., delivering approximately $16 billion in annual sales. These facilities are separate from USFS's North Star locations, which focus primarily on national chain restaurant operators and deliver an additional $3 billion in revenue for USFS.

The broadline locations service local "street" operators, non-commercial purchasing organizations and regional chain operators with complex menu needs such as Premier, Avendra, Novation, etc. THG estimates that local operators account for approximately 60% of USFS's broadline sales, with the chains/buying groups accounting for the remaining 40%.

Many of USFS's broadline locations were acquired during USFS's aggressive growth phase in the 1990s. The nature of their expansion created overlapping or duplicate divisions servicing the same geographies. In the period since the acquisitions, USFS has not aggressively pursued consolidation opportunities, as their focus was first on growth, and then financial stability and systems integration. With the recovery plan executed and the business sold, the new owners are likely to explore consolidation opportunities to improve efficiencies.

The following table summarizes the relative tiers within USFS's broadline divisions. Understanding each USFS division's dynamics and aligning resources against the greatest sales volume and profit opportunities is critical to manufacturers' go-to-market plans.

USFS Estimated Sales by Branch Size

Branch		Estimated		Internal USFS Share	
Sales Range (MM)	# Branches	$ Sales (B)	% Chain	# Branches	$ Sales
≤ $150	11	$1.1	33%	18%	7%
$151 - $250	23	$4.6	44%	38%	30%
$251 - $400	14	$4.4	37%	23%	28%
$401+	13	$5.6	38%	21%	35%
Total	***61***	***$15.7***	***39%***	***100%***	***100%***

44% of branches account for 63% of sales

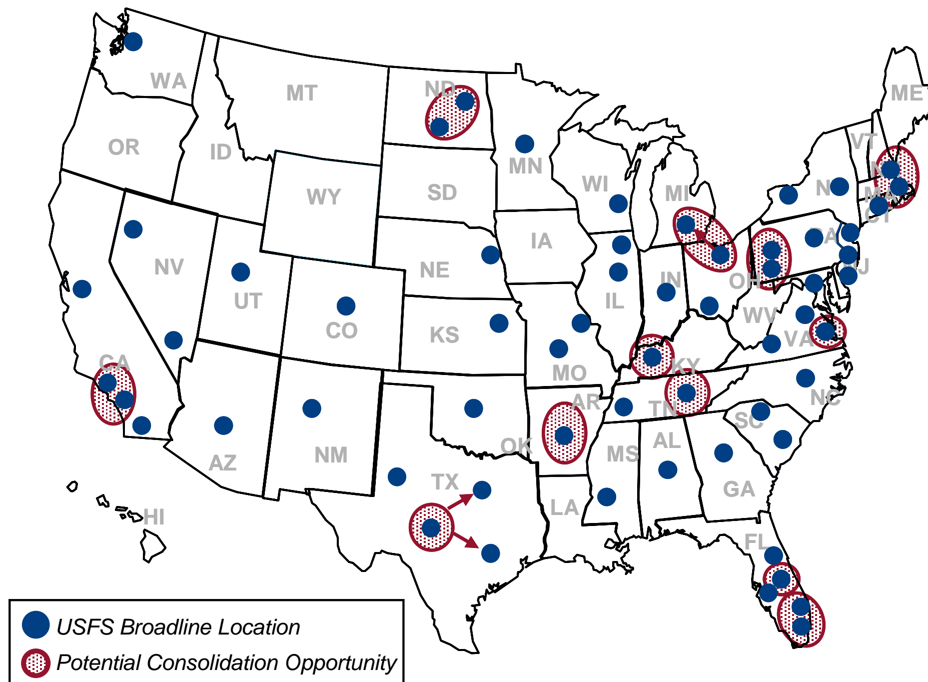
USFS Consolidation Assessment

Based on our research, THG estimates that USFS may consolidate up to one dozen, or twenty percent, of their 61 broadline branch locations. These divisions are estimated to account for approximately $2.7 billion in sales. All of the one dozen branches are either under-performing, are heavily chain-oriented and

therefore present a North Star conversion opportunity, or represent clear geographical consolidation opportunities. In some instances, the ability to execute a consolidation is relatively easy, while in other cases, capacity constraints may inhibit the ability to consolidate.

While consolidation opportunities exist across the country, the majority are located in the Eastern third of the U.S.

USFS Potential Consolidation Opportunities



Each potential consolidation opportunity has its own unique characteristics and rationale. The following table provides our view of the target branches' business structure and identifies issues or rationale to support a consolidation effort. It is unlikely that all twelve branches will be consolidated, but contingency plans should be developed within each potential geography to proactively prepare for the future. An overview of the other USFS houses is attached in the Appendix.

Proactive planning is the key to driving growth in the evolving foodservice landscape. We recommend that manufacturers evaluate their current position and consider alternative scenarios, which can then be converted to planning strategies and tactics.

Potential USFS Consolidation Branch Dynamics

Market	Location	Estimated $ Size	Estimated % Chain	Comments
Arkansas	Little Rock	$100-$110	35% - 40%	Struggling division. Efforts to enhance margins have restricted potential to grow sales.
California	Santa Ana	$240-$250	75% - 80%	Designated as a broadline division, but primarily servicing system/program accounts. Potential opportunity to incorporate into North Star.
Florida	Lakeland	$220-$230	35% - 40%	School business is a significant portion of portfolio. Potential to consolidate into Tampa and Ormond Beach if USFS eliminates some low margin bid business.
	Pompano Beach	$170-$180	70% - 75%	Scheduled for consolidation into Boca Raton. Division is not profitable. Subway and Avendra account for more than one-half of total volume.
Kentucky	Paducah	$170-$180	50% - 55%	Merged with Paris, TN two years ago. Poor location, high contract volume, low margins.
Massachusetts	Everett	$240-$250	50% - 55%	While there is no plan to close either Boston house, they could be merged into a common facility. Currently, neither location has capacity for the combined business. There are also issues with computer system integration and union, non-union facilities.
	Peabody	$210-$220	35% - 40%	
North Dakota	Bismark	$150-$160	10% - 15%	Combined sales estimate. Potential opportunity to consolidate operations in a relatively small market.
	Grand Forks	--	--	
Ohio	Cleveland	$185-$195	45% - 50%	Potential to combine with Detroit. Recently lost significant Cleveland Clinic business to GFS.
Pennsylvania	Altoona / Greensburg	$450-$460	40% - 45%	Management and purchasing already merged; buildings may not merge due to school bids.
Tennessee	Knoxville	$200-$210	35% - 40%	This division could be consolidated if USFS creates a Nashville facility. Nashville was under consideration for possible market expansion. Without Nashville, division could still receive consideration for consolidation into Ft. Mill, SC and Atlanta
Texas	Austin	$125-$135	25% - 30%	There has been some discussion regarding funding for a new facility needed for growth, but could consolidate with Dallas and Houston.
Virginia	Virginia Beach	$150-$160	30% - 35%	Poor facility. Could be consolidated into Roanoke, Manassas, or Baltimore.
	Total Sales	**$2,610-$2,740**	**40% - 45%**	

APPENDIX

USFS Branch Dynamics

Unlikely To Consolidate

Market	Location	Estimated $ Size	Estimated % Chain	Comments
Alabama	Montgomery	$505 - $515	35% - 40%	Strong business fundamentals. No possibility of closure.
Arizona	Phoenix	$375 - $385	50% - 55%	One of the more profitable USFS houses in the country.
California	Los Angeles	$445 - $455	10% - 15%	Not expected to close due to size and relatively strong profit performance.
	San Francisco	$440 - $450	50% - 55%	Strong management and great track record. Very successful President (20 years).
	Vista (Webb)	$290 - $300	5% - 10%	One of USFS's highest profit divisions.
Florida	Ormond Beach	$240 - $250	40% - 45%	Good division. Schools and Avendra are a significant portion of portfolio. Facility is land locked and may have to be relocated if a Lakeland consolidation strategy is developed.
	Tampa	$310 - $320	40% - 45%	Good division. Completed facility expansion within the last 12 months. No potential for closure.
	Boca Raton	$170 - $180	40% - 45%	This division is currently scheduled for consolidation with Pompano Beach Facility. Boca building will be expanded to accommodate the incremental volume. Project is in the design stage.
Georgia	Atlanta (Fairburn)	$490 - $500	35% - 40%	Great division. Has experienced rapid sales and profit growth. No potential for closure.
Illinois	Bensenville	$370 - $380	45% - 50%	Landlocked and 98% capacity. Major chains are healthcare (Premier, Novation), Avendra, Starwood, Old Country Buffet.
	Streator	$310 - $320	65% - 70%	Marginal location, but Bensenville capacity constraints limit consolidation options. Lots of chain business (Subway, Perkins, IHOP, etc.) , but can't move to Northstar due to capacity and margin issues.
Indiana	Indianapolis	$220 - $230	25% - 30%	Solid branch has a stronger position in the market than SYSCO. Unlikely consolidation target.
Maryland	Baltimore	$465 - $475	40% - 45%	Not a consolidation opportunity due to size and proximity to USFS headquarters. Attempting to address labor issues.
Michigan	Detroit	$430 - $440	55% - 60%	A feasibility study was recently completed to merge Cleveland (under performing) and Detroit into the Detroit facility. Consolidation is a real possibility, especially if additional chain operators leave the Cleveland branch.
Minnesota	N. Central	$310 - $320	30% - 35%	Strong performer. One of USFS's best branches.
Mississippi	Jackson	$270 - $280	50% - 55%	Division is dependent on Gulf Coast Casino business. Not a likely candidate for consolidation or closure unless a major loss of casino business is incurred.
Nevada	Las Vegas	$410 - $420	25% - 30%	Large casino business
	Reno	$70 - $80	30% - 35%	If casinos were included in the chain data, the chain number would be closer to 70%. Just finished a bad season relative to prior year.
New Jersey	New York Metro	$140 - $150	30% - 35%	Not likely to consolidate given the need for a NYC presence. Old, inefficient facility.
	Philadelphia	$325 - $335	20% - 25%	Philadelphia and Swedesboro are run by the same management team.
	Swedesboro	$270 - $280	55% - 60%	Swedesboro is primarily chain (Premier and Novation) while Bridgeport / Philly is primarily street. Facilities have no avaialble capacity, and utilize outside warehouses. Prior to the recent ownership change, there had been rumors of creating one super-center in central NJ for Philly / Metro NY.
North Carolina	Raleigh	$415 - $425	15% - 20%	Good division in growing market. Currently undergoing an expansion project. No potential for consolidation.
Ohio	Cincinnati	$190 - $200	50% -55%	Good branch with strong financial performance.
South Carolina	Fort Mill	$510 - $520	85% - 90%	Large, highly profitable division that is somewhat constrained by a limited footprint. No potential for consolidation or closure.
	Lexington	$540 - $550	10% - 15%	Considered by some to be the best division in USFS. Highly profitable. No potential for consolidation.
Tennessee	Memphis	$150 - $160	20% - 25%	Fits into a potential Little Rock, Knoxville conslidation strategy. Geography favors this division remaining intact.
Texas	Dallas	$310 - $320	25% - 30%	Opening a new facility in August. One of the leading sales producers in the Western Division.
Virginia	Roanoke	$340 - $350	35% - 40%	Good house with solid business fundamentals.
Washington	Seattle	$200 - $210	55% - 60%	Closed Portland branch in May, 2007. Must keep Seattle branch open to support Premier, Novation and other National Accounts in the NW.
	Total Sales	***$9,510 - $9,800***	***40% - 45%***	

USFS Branch Dynamics

Uncertain Future

Market	Location	Estimated $ Size	Estimated % Chain	Comments
California	Santa Ana	$235 - $245	75% - 80%	Designated as a broadline division, but primarily servicing system/programmed accounts.
Colorado	Denver	$400 -$410	30% - 35%	
Connecticut	Norwich	$200 - $210	40% - 45%	Majority of chain business is healthcare (Premier, Novation)
Kansas	Topeka	$190 - $200	35% - 40%	
Missouri	Salem	$245 - $255	40% - 45%	
	St. Louis (Allen)	$250 - $260	20% - 25%	
Nebraska	Omaha	$80 - $90	70% - 75%	
New Mexico	Albuquerque	$75 - $85	25% - 30%	
New York	Albany	$240 - $250	35% - 40%	
	Buffalo	$150 - $160	40% - 45%	
Oklahoma	Oklahoma City	$260 - $270	10% - 15%	
Pennsylvania	Allentown	$385 - $395	20% - 25%	Lost Compass business recently; rumored to be picking up new business.
Texas	Houston	$160 - $170	40% - 45%	Future direction is unclear, yet Texas market is critical.
	Lubbock	$130 - $140	45% - 50%	
Utah	Salt Lake City	$150 - $160	25% - 30%	
Virginia	Manassas	$240 - $250	35% - 40%	
West Virginia	Hurricane	$120 - $130	20% - 25%	Premier 20% National Chains -15%.
Wisconsin	Milwaukee	$100 - $110	35% - 40%	It has been speculated that this branch may be targeted for consolidation, but Chicago facilities are capacity constrained.
	Total Sales	***$3,610 - $3,790***	***35% - 40%***	