Business Week Grades Safeway

F

Note: average grade across eight measures of financial success as reported in *Business Week*, 4/5/04

The Wall Street Journal Grades Safeway

979

out of

1000

Note: Based on five-year total returns as reported in *The Wall Street Journal*, 3/8/04

The Corporate Library Grades Safeway

D

“Overall the company's Board Effectiveness Rating suggests that the weaknesses of the board contribute a HIGH degree of investment or underwriter risk to this stock.”

The Corporate Library, 1/16/94.

Note: Overall Board Effectiveness rating, The Corporate Library, 1/16/94.

What Safeway Says About Our Vote No

1. Driven by political pressure from labor unions
2. Corporate governance concerns lack legitimacy
3. Safeway's directors are independent
4. Safeway has produced excellent results for shareholders

Source: Safeway Press Statement, 3/25/04

Safeway Fails to Make the Grade

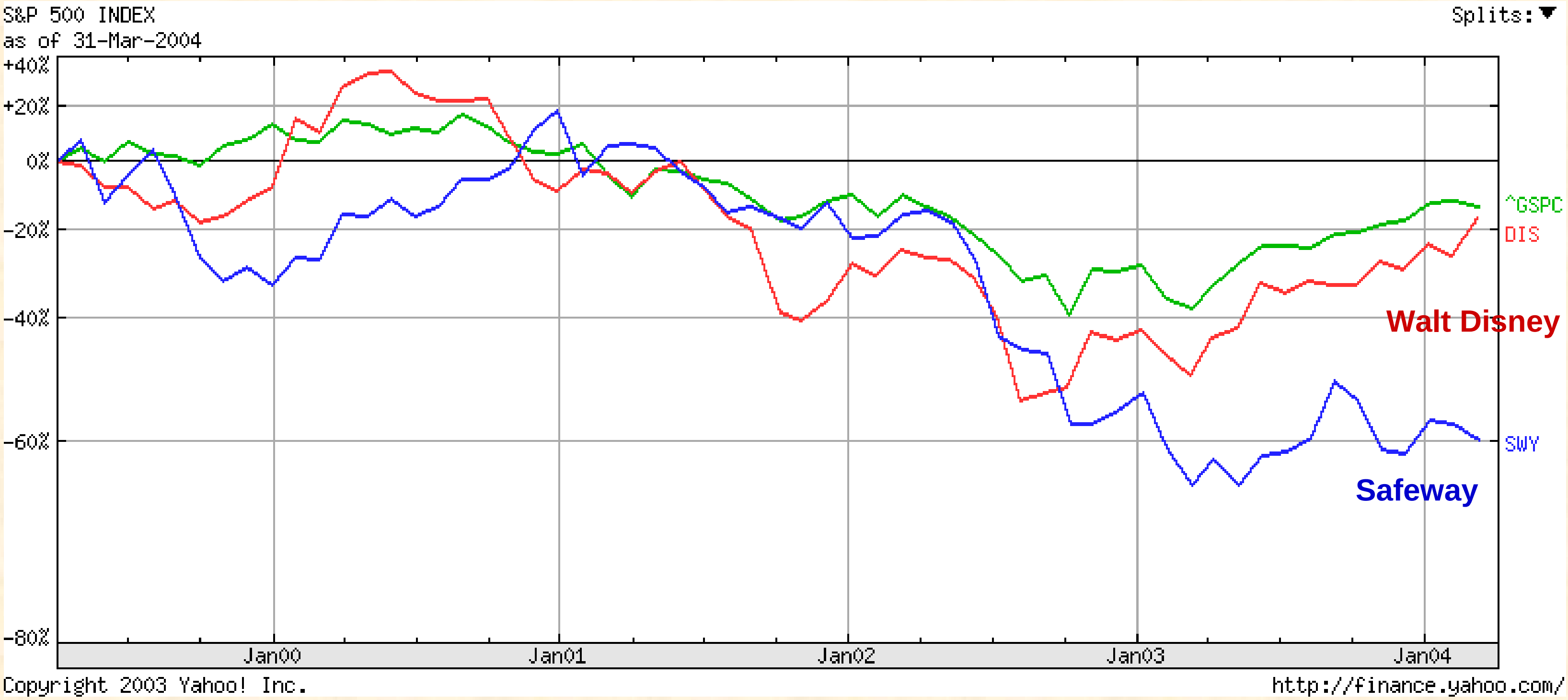
Stock Performance	F
Investment Strategy	F
Employee Relations	F
Customer Relations	F
Corporate Governance	F
Board Independence	F

Vote for Director Independence and Accountability

Vote No on Burd, MacDonnell and Tauscher

Safeway's Strategic Crisis

Safeway's Strategic Crisis
Shares Down 60% for 5 Years Ending 3/31/04



Safeway Shareholders have lost over $20 billion since 12/31/98 (adjusted for stock buybacks)

BW Gives Safeway Failing Grades
WSJ Puts Safeway on its Worst Performer List

RANK		COMPANY	PERFORMANCE GRADES							
RANK 2004	RANK 2003		TOTAL RETURN (1 YEAR)	TOTAL RETURN (3 YEAR)	SALES GROWTH (1 YEAR)	SALES GROWTH (3 YEAR)	PROFIT GROWTH (1 YEAR)	PROFIT GROWTH (3 YEAR)	NET MARGIN	RETURN ON EQUITY
448	345	Safeway	F	F	D	C	F	F	F	F

148 | **BusinessWeek** | April 5, 2004

- – ***Business Week*** **ranked Safeway 448th out of the S&P 500 using eight criteria of financial success over the past 1 and 3 years.**
- – ***Business Week*** **ranked Safeway 9th out of 10 in its industry group, edging out Winn-Dixie (460th overall).**
- – ***The Wall Street Journal*** **included Safeway among its Top 25 Worst Performers over the past 5 years (out of 1000 largest companies).**

Source: Business Week, 4/5/04; The Wall Street Journal, 3/8/04

Wal-Mart Is Not the Problem

Table 4: Share Gains In Wal-Mart Markets Versus Share Losses Attributed to Wal-Mart

	% of Stores Overlapping With WMT, E	# of Markets Share Gains of □+0.5% or more	# of Markets Where Losses Can Be Mostly Attributed to WMT	4Q Comp Hit Due to WMT, Est. %
Ahold	28	5	6	-0.4
Albertson's	28	3	12	-1.0
Delhaize	55	1	8	-0.8
Great A&P	7	1	2	-0.3
Kroger	29	9	10	-0.3
Ruddick	25	2	3	-0.6
Safeway	18	5	3	-0.2
Winn-Dixie	70	1	11	-2.0
Supervalu	18	3	1	-0.2
Publix	65	7	1	-0.6

Source: MSA Data in Trade*Dimension* Market Scope & Merrill Lynch Research

So the most important answer to "who loses?" is usually "retailers in small town America." As most of the companies we analyze have only a small proportion of their stores and sales in small towns, they do not lose much.

Merrill Lynch, 5/9/03

"We continue to believe that new sales and market share data do not support the Bear argument that Wal-Mart is the root of all food retailers' problems

Merrill Lynch, 5/9/03

Source: Merrill Lynch, 5/9/03; Goldman Sachs, 9/3/03

Wal-Mart Is Not the Problem

"For us, it's not the supercenters, it's not the clubs that are creating the soft sales that we had in 2002 and certainly in the first part of 2003. …It's really predominately the business slowdown that has affected our top line sales growth and not either the supercenters or the clubs that we have competed with, really, for decades.

Steven A. Burd, Safeway Chairman and CEO
Goldman Sachs Conference, 9/3/03

Costly Acquisitions, Failed Integration
$4 Billion Invested, $3 Billion Written Off

Dominick's Supermarkets – Nov. 1998

- acquired for $1.2B cash plus repayment of $560M in debt/lease obligations
- impairment charges totaling $1.97B in 2002 & 2003

Randall's Food Markets – Sept. 1999

- acquired for $1.3B in cash and stock
- impairment charges totaling $1.26B in 2002 & 2003

Genuardi's Family Markets – Feb. 2001

- acquired for $500M in cash
- apologizes to shoppers in late 2002 for sweeping post-acquisition changes

Source: Safeway documents; The Philadelphia Enquirer, 11/1/02

$1.8 Bil Dominick's Acquisition Highlights Failed Leadership

Steve Burd promised only modest changes

"The consumer may not notice anything different six months from now."[1]

But Burd quickly implemented major changes

- cut pricing and marketing execs who knew local market preferences
- centralized buying out of Safeway's California headquarters
- scaled back the number of different sizes & quantities of products
- reduced size of perishables and prepared-foods sections
- replaced familiar brands with Safeway's private label
- damaged previously productive relationship with union
- failed to change course as problems became apparent

Leading to drastic decline in performance & value

- market share down more than 8% since Safeway acquisition
- impairment charges totaling $1.97 billion in 2002 and 2003
- unsuccessful attempt to sell Dominick's for estimated $350 mil in 2003

[1]Steve Burd, as quoted in *Supermarket News*, 10/19/98

Source: Safeway documents; Supermarket News, 10/19/98, Crain's Chicago Business, 11/11/02, Daily Herald, 2/2704

Declining Investment in Stores
Cash Flow Used to Buyback Stock at High Prices

$millions	1999	2000	2001	2002	2003
Net CF from Operating Activities (NCFO)	1,488	1,901	2,232	2,035	1,610
Capital Expenditures	1,334	1,573	1,793	1,467	936
Capital Expenditures/NCFO	90%	83%	80%	72%	58%
% of YE Stores Remodeled	15%	16%	14%	11%	4%
Purchase of Treasury Stock	651	-	768	1,503	-
Treasury Stock/CFO	44%	0%	34%	74%	0%

– **Safeway's capital expenditures have fallen steadily as a percentage of net cash flow from operating activities**

– **Safeway's has significantly cutback its store remodels, remodeling only 4% of its year-end stores in 2003**

– **Safeway spent $2.9 billion over five years to repurchase stock at an average price of $33.74 per share.**

Confrontational Labor Strategy
Costly Distraction with Long-Term Consequences

Led to 139-day strike in Southern California

- cut pre-tax earnings by $168 mil in 4th q4 2003 (included 84 strike days)
- long-term impact on shareholder value due to lost market share and damaged customer and employee relations
- jeopardizes brand reputation

Expiring labor contracts in other markets this year

Undermines Safeway's competitive advantages

- According to Safeway, "the principal competitive factors that affect the Company's business are location, quality, service, price and consumer loyalty to other brands and stores."

Executive Exodus Deepens Strategic Crisis
Four Top Execs Quit Since Jan. 2003

The exodus of so many senior, long-time Safeway executives is a clear negative in our view, and indicates to us that many might not agree with CEO Steve Burd's past strategic decisions (aggressive approach to centralizing procurement) or his current firm stance with the labor union. Right or wrong, Mr. Burd seems to either be 1) unhappy with his senior management or 2) unable to sell his vision, neither of which in our view is a positive for the stock longer term.

Citigroup Smith Barney, 2/5/04

Safeway named new CFO on March 23rd, but other positions remain open

Safeway's Corporate Governance Crisis

Corporate Governance Overview

Pervasive conflicts of interest on Board of Directors

Failure to address 2003 majority shareholder votes

- stock option expensing
- board declassification – Jan. 2004 response follows shareholder and press attention on board of director conflicts

Combined CEO/Chairman

Director attendance problems in 2003

- 71% attendance for directors Magowan & Roberts

Safeway Board Overview
Eight of Nine Directors Lack Independence

Safeway Insiders	KKR-Affiliated	Conflicted Outsider	Outsider
• Burd • Magowan • Ley Lopez	• Greene • Hazen • MacDonnell • Roberts	• Tauscher	• Stirn

Safeway has re-nominated Burd, MacDonnell and Tauscher for election at the company's annual meeting on May 20th

Director Independence

An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.

Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

Council of Institutional Investors' ("CII") Independence Definition:

CII considers someone not to be independent if they have not met the above standards within the last five years

Robert I. MacDonnell

Material Conflicts as KKR-Affiliated Director

Retired as KKR partner in 2002

Brother-in-law of Safeway director and KKR founding partner George Roberts

Beneficiary of numerous related-party transactions

Serves on Safeway's audit & executive compensation committees

The KKR Connection
Randall's Buyout Highlights KKR Conflict

April 1998: KKR acquires 61% of Randall's for $225 mil

- 3 KKR principals join Randall's board (Greene, Roberts & Kravis)

Sept. 1999: Safeway acquires Randall's for $1.3 bil

- KKR earns estimated 252% return in 19 months
- KKR receives $8.6 mil for advisory services in connection with merger
- 4 Safeway directors affiliated with KKR, which then owned 9% of Safeway

2000: KKR liquidates remaining Safeway shares

- Safeway share price hits all-time high of $62.50 on December 29th

2002-2003: Safeway takes impairment charges totaling $1.26 bil at Randall's

- Safeway share price closes at $21.91 on December 31, 2003

Source: Safeway documents, The Houston Chronicle, 4/4/97

Other Transactions with KKR Entities

Pacific Resources Associates & Property Development Associates

- Safeway transferred or sold 172 properties valued at over $130 mil to real estate partnerships affiliated with KKR between 1990 and 2001
- Safeway paid PDA $19 mil in RE fees and rent from 1990 to 2000

Pacific Realty Associates ("PacTrust") – LP owned by 45 individuals

- Safeway sold 8 properties to PacTrust for $2.6 mil and paid PacTrust (and affiliates) over $2 mil for rent and related expenses in 2002.
- Owners include KKR-affiliated directors Greene, Roberts & MacDonnell

GroceryWorks – Safeway's exclusive on-line grocery channel

- Accel-KKR, a KKR affiliate, owns approximately 3% of GroceryWorks
- Safeway Director Paul Hazen is Chairman of Accel-KKR
- Safeway Directors Roberts, Greene and MacDonnell have indirect interests totaling approximately 2% of the equity of Accel-KKR.

Source: Safeway documents

William Tauscher

$3.5 mil in Related-Party Transactions

InaCom

- Undisclosed 1998 agreement with Safeway vendor entitled Tauscher to $1 mil bonus if certain companies, including Safeway, remained customers.

MainStreet USA Corporation

- Safeway forgave a $2 mil loan to MainStreet while Tauscher was its CEO

Future Beef Operations Holdings

- received 100,000 Safeway options as apparent compensation for his role

Safeway's outstanding loan to Tauscher

- funded purchase of his only shareholdings in Safeway
- would not be permitted today under the Sarbanes-Oxley Act of 2002

Tauscher serves on all three key board committees

Lack of Key Committee Independence

Audit Committee	Executive Compensation Committee	Corporate Governance and Nominating Committee
Hazen (Chair) **MacDonnell** Stirn **Tauscher**	**Tauscher (Chair)** Greene Hazen **MacDonnell** Stirn	Stirn (Chair) Hazen **Tauscher**

Audit Committee
Includes MacDonnell & Tauscher

No auditor rotation
- Same outside auditor since 1987

Excessive non-audit fees
- Audit-related, tax & all other fees exceed audit fees in 2002 & 2003

Executive Compensation Committee
Includes MacDonnell & Tauscher

Proposed stock option re-pricing plan

- Middle managers would get their underwater options replaced
- 6 month exchange period allows Safeway to avoid expensing and creates incentive to keep stock price low during exchange period

Opposes option expensing

- despite 60% shareholder vote on shareholder proposal in 2003

Awarded execs $9.4 mil in restricted stock grants

- despite poor performance & pending demands for hourly wage and benefit cuts

Allowed Burd to sell over $15 mil in stock

- Shares received from exercising stock options since September 2003
- also realized $11.8 million from stock option exercises in 2002

Safeway's Response to Government

EXECUTIVE OFFICES
SAFEWAY INC.
5918 STONERIDGE MALL ROAD
PLEASANTON, CA 94588-3229

February 20, 2004

VIA FACSIMILE

The Honorable Denise L. Nappier
State of Connecticut
Office of the Treasurer
55 Elm Street
Hartford CT 06106-1773

Dear Ms. Nappier:

I am responding to your letters of December 18, 2003 and February 11, 2004 to Rebecca Stirn, one of Safeway's directors. Apparently neither the Company nor Ms. Stirn received a copy of your December 18 letter until this past week. I apologize for the delay in responding.

We appreciate your interest in these issues. If you have any additional questions, please do not hesitate to contact me at 925-467-3858.

Sincerely,

Robert A. Gordon
Senior Vice President
& General Counsel