

A Holy Grail for tobacco?

Seeking better ways to manage the cigarette category as a means of securing more gross profit dollars? A “six-step” analysis may help uncover hidden profits. By Dick Meyer

Even though the “same firms” database of CStoreXchange (CSX) shows that 2004 cigarette dollar sales may approximate 1% more per store versus 2003, when you factor in tax and price increases the real trend is negative. As a handful of retailers began looking at their chains’ personal benchmarks for 2004 versus the prior year, noting a slide in their No. 1 in-store category, they asked me if I knew of a “holy grail”—some better ways to manage the category to enhance gross profit dollars.

Challenged to serve, I called several retailer friends and a few wholesalers to learn what may have escaped my “intelligence net” during the year—I caught nothing. Then, I returned to thinking about the basic management issues in this category, a solution that has worked many times in the past, regardless of the dilemma. My conclusion left me comforted that I had found some key ideas worthy of re-focus.

Sometimes when we get beat up so bad on one or more product categories (e.g. fuel by the supermarkets; cigarettes by discount tobacco outlets, Internet sales, etc.) we rebound with short-term strategies that prove to be about as effective as Don Quixote’s fight against the windmill. No doubt several market-specific initiatives have won cigarette share of market (SOM) from the competition for certain retailers, but I’ve also heard of many marketers that chased lost volume by selling cheaper cigarettes—without improving gross profit dollars.

Last year I heard someone estimate that more than 100 fourth-tier brands had vanished from the landscape. Of those companies that remain today, a few have improved their SOM, but I know that more retailers are looking closely to see how the sale of these products are affecting a store’s total gross profit dollars from the category, in addition to peripheral sales.

Years ago, when cigarette/tobacco outlets started to siphon off our industry’s SOM we didn’t have half the tools we have now. Today, many larger chains—and an increasing number of small to mid-size retailers—have access to “market-basket” studies that supplement their scanning systems and tell them what other items are sold with an item-specific SKU. Does anyone really think, for example, that a regular fuel buyer’s market basket value is as high as the premium fuel buyer, or that a fourth-tier cigarette purchaser’s gross profit value is even close to that of a brand-loyal Marlboro or Camel smoker?

I recently suggested to one retailer that his company perform a self-audit to determine if his cigarette category management “engine” was running smoothly. Maybe this won’t uncover added gross profit for every chain 100% of the time, but at least this due diligence can help validate whether you’re doing everything right. Typically, I’d bet that many retailers could see at least a 10% to 20% per-store cigarette sales improvement in at least 20% of their stores by reviewing the following ideas, listed in order of the highest return on investment (ROI) potential:

1. Market basket findings. Run market basket analyses for fourth-tier products and the major brands from Philip Morris, R.J. Reynolds/Brown & Williamson and Lorillard. This exercise will help you view the gross profit dollar potential of each brand smoker, understand their contribution to overall cigarette gross profit dollars and discover the market basket potential for each smoker’s brand. In almost every case, the premium brand smoker will generate much higher gross profit dollars per visit than any fourth-tier brand. If this assumption proves valid you’ll want to assure that your pricing and in-stock performance on all major brands is at least competitive with the marketplace.

2. Manufacturers’ SOM data. Years ago I discovered that all the major tobacco manufacturers utilize the same database on wholesale shipments of cigarettes to c-store retailers, by brand and store. Once I learned that and took into consideration the value of the “MVP” (Most Valuable Patron—the brand-loyal pack purchaser that shops your stores four to six times per week), I encouraged retailers to study their SOM on every major brand by market at least quarterly. When manufacturers say you are behind in SOM for a particular brand or brand group versus competitors in the same market, customers may be shouting out to you that you’re not competitive on price and/or promotions. The manufacturers can even calculate (and I believe their premises are valid) how much you are forfeiting in gross profit dollars from your lesser SOM on each brand, in each store or region.

3. Center stage & signage. Two years ago, in connection with analyzing industry dynamics related to 2002 operating results and estimates for 2003 trends, I identified seven marketing suggestions to improve EBITDA in the shortest period of time. My first recommendation was that our industry’s counter and back bars be modernized to maximize sales from the most valuable real estate in the store. My second idea talked about “marketing” cigarettes more aggressively to communicate the message that you sell key brands—meaning promoting the brand and the price. At a possible \$5,000 to \$10,000 per store remodeling investment range for any stores that may fall into this category, that investment would provide one of the best ROIs I can envision.

4. Co-existence. There hasn’t been much talk of manufacturer “exclusivity” the past four or five years, since most of the squabbles about “visible space” have quieted substantially. Regardless, one new contract or another may always feel tempting to a retailer but, in the end, the “Consumer is King (or Queen)” maxim holds true. In my opinion, our stores cannot price-promote Pepsi and not Coke or

Marlboro and not Camel or vice versa, lest they wish to forfeit the traffic benefits of the loyalists prejudiced to the brand of choice that's not being promoted.

5. Benchmarking progress monthly.

Waiting for annual results to measure your effectiveness in cigarettes or any category can be harmful to a company's fiscal health—and it's no longer necessary. Four years ago I started CSX with Gene Gerke to realize a passion of mine since discovering 28 years ago the absence of timely and meaningful benchmarking data. The NACS State of the Industry Report provides important metrics on an annual basis, including a projection of total industry results, and I encourage your continued awareness of this valuable document. However, you also need to measure your monthly performance, inclusive against national and regional monthly trends. It's a lot easier (and more profitable) effecting needed changes based on monthly or quarterly facts instead of calculating what-

ifs on a retroactive basis.

In the chart below, I've analyzed per-month percentage changes in cigarette dollar sales using the CSX "same firms" database for the 11 months ended November 2004 versus 2003. I also plotted the percentage change in average fuel selling price during this timeframe. Notice that cigarette sales were tracking about 5% higher than the prior year for the three months ended April 2004. Then, as fuel prices began to climb, cigarette sales began to recede. If you conclude that expendable income does affect cigarette sales, that's all the more reason to stay price-competitive on all major brands.

6. Inventory management. At the per-carton cost of cigarettes, have you calculated the potential cashflow that may be sitting on your cigarettes' back bars and overheads? Is there one "owner" of cigarette inventory in your company, or is it up to each store manager as part of their litany of duties? If you haven't done an Excel

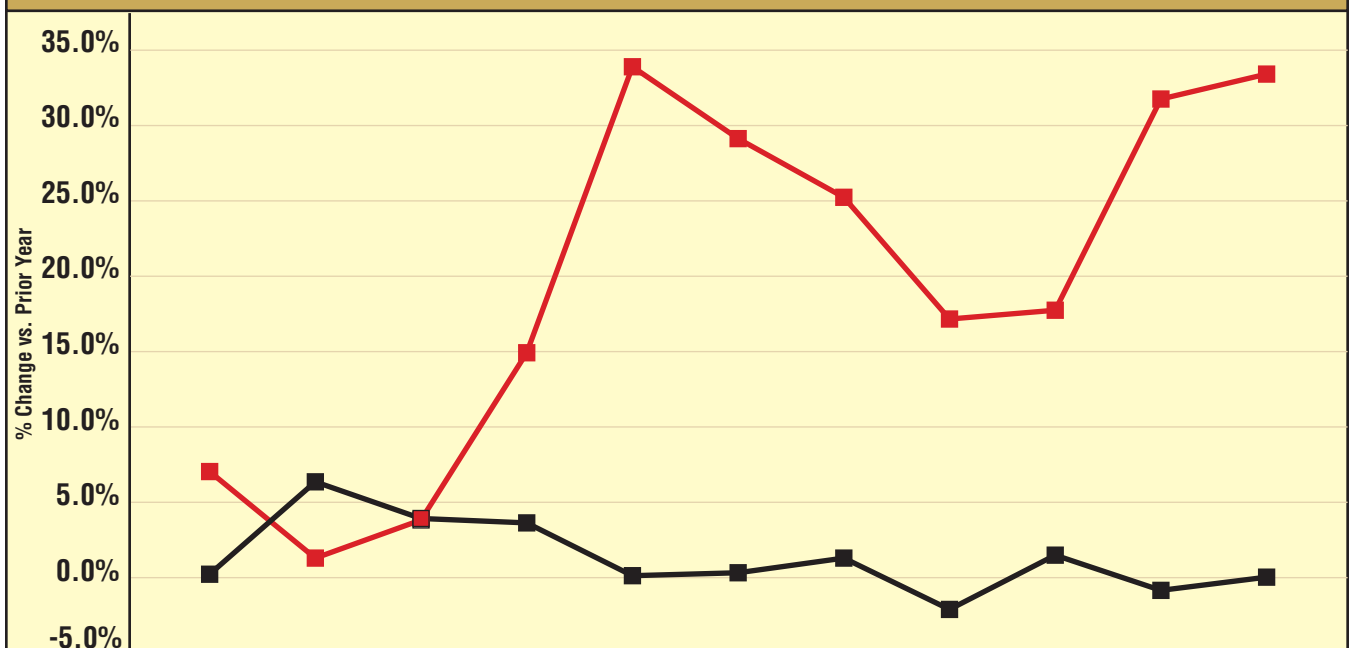
worksheet recently that shows your cigarette turns per store, per supervisor and per company, including a ranking of highest to lowest turns, I'll wager that you have some very precious cash reserves available for quick recovery.

One of the most effective analyses that I've seen is to calculate the potential "liberated" cashflow if all stores in the chain that are below the chain's average cigarette turns: (a) improved to the chain's average; and (b) improved turns to the average of the top 10% of stores. I guarantee such an analysis will "encourage" you to implement an immediate action plan.



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Change in Per-Store Cigarette Sales Compared to Change in Average Fuel Selling Price – 11 Months Ended Nov. 2004 vs. 2003



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|--------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov |
| Cig \$ Sales | 0.2% | 6.5% | 4.0% | 3.7% | 0.1% | 0.3% | 1.3% | -2.2% | 1.5% | -0.9% | 0.0% |
| Avg Fuel SP | 7.2% | 1.3% | 3.9% | 15.3% | 34.8% | 29.9% | 25.9% | 17.6% | 18.2% | 32.6% | 34.3% |

Source: CSX LLC Database
 * "Same firms" sample represents 17 companies operating approx. 700 stores that segregated "cigarette only" sales by month for 2003 and 2004