Dog Cullers

Retailers cut emotional ties to close, sell or otherwise put underperforming stores out of their misery

By Bill Donahue

Canines and convenience stores share a common bond. Like an ailing mongrel, a store showing little to no hope of reigniting the fires of profitability should be put down and replaced with a new one, according to Doug Deweese, chief executive of Super Stop!, a Meridian, Miss.-based operator of 43 stores.

"A store count is like a portfolio of stocks," says Deweese. "Do you hold on to a stock that's in the tank or tanking? In general, the answer is no if you're paying attention to your business. You've got to be future-oriented and replace the [stores] you get rid of with ones that are going to perform."

But for many, as CSP learned through more than a dozen interviews with retailers, lenders, consultants and real-estate experts, various factors influence the decision to either keep underperforming stores within the family or send them out to the proverbial woodshed for swift disposal. Profit potential (or lack thereof) being the chief metric in determining a store's fate, retailers large and small also consider how parting ways with a "dog" store will affect the community it serves, the employees who run it and the overall marketplace in which it competes.

New Tricks

More than 4,450 convenience stores changed hands from June 2003 to July 2005, according to an analysis of announced public and private

Handling Their Dogs

Last year, Martin & Bayley Inc. implemented an "owner/operator" model, which transformed some of its best store managers into independent retailers as a way to turn around underperforming Huck's stores.

Every year Wawa Inc. rationalizes its store count, taking into account not just financials but every store's ability to meet the chain's exacting standards for image, brand, growth potential and impact on the community it serves.

After taking over Super Stop! in 2001, Doug Deweese cut his chain of 72 stores almost in half by selling or closing units that were draining the company of its profitability. It's now debt-free and in growth mode once again.

transactions compiled by Trefethen & Co. LLC, Scottsdale, Ariz. But shaping up a store portfolio doesn't always have to result in sell-offs or closures. Sometimes a few good "nips and tucks" can inject new life into locations that have lost a few steps. As Martin & Bayley Inc. has found, sometimes putting those nips and tucks into motion requires little more than an infusion of new blood.

In October 2004, the Carmi, Ill.-based operator of 130 Huck's Food & Fuel stores (in Illinois, Indiana, Kentucky and Missouri) implemented a unique store-management model that has recast the fortune of some dog stores, shifting them from puppy-mill mutts to blue-ribbon purebreds. The company's "owner/operator" model, which tasks the company's strongest managers with improving a store's bottom line, has given Huck's a more palatable option—apart from divestment—for dealing with underperformers.

"The key to the whole [owner/operator] program is the person running the store," says Mark McKinney, senior vice president of operations. "We started with 16 stores, and we're 16 for 16 on [profit and sales] improvement. When you give someone the title of 'owner,' it's amazing the response they'll give back to you. It gives them that 'this is my store' mentality."

Even though employees have technically owned Huck's stores since Martin & Bayley implemented an employee stock-ownership plan (ESOP) in 2001, the owner/operator title is in name only. The person running the store has zero dollars tied up in it; there's no investment on his or her behalf other than time, effort and creative energy. Still, a store's turnaround can have a substantial positive effect on the owner/opera-

Photo by Ray Mitchell

A WIN-WIN: Martin & Bayley's owner/operator model has helped the company reap additional sales, according to Mark McKinney, senior vice president of operations. It has also reduced inventory losses and optimized supervision among district managers.

tor's pocketbook. (A "turnaround," coincidentally, applies strictly to in-store performance, meaning the volatility of the motor-fuels market and its subsequent effect on gallon volume do not factor into the equation.)

"How we come up with the financial formula is we take three years' average profit after variable expenses (excluding fuel gross-profit dollars and fixed expenses), or PAVE," says McKinney. "Let's say it's $100,000. Looking at our ROI, we establish a floor—let's assume it's $110,000. Anything over that $110,000 we split with the owner/operator 50/50. They get that plus their everyday salary. And there's no cap."

Each owner/operator signs a one-year "agreement," with successive-year options. Owner/operators are not part of the Martin & Bayley ESOP, and their staffs are not considered Huck's employees. While owner/operators do not have capital tied up in their stores, they take full responsibility for operations, including hiring and training; all terminations must be approved by corporate. Worker's compensation policies and benefits programs, such as health insurance, are also determined by individual owner/operators.

McKinney says all owner/operator candidates must be "proven" with a good management track record. To stack the deck in its favor, Martin & Bayley identified the first crop of owner/operator candidates by looking inward. It chose store managers who displayed an uncommon passion and ability for merchandising aggressively, delivering outstanding customer service and generating new ideas to drive sales.

In addition to increased sales, the owner/operator model has reaped other benefits, such as reductions in inventory loss and optimized supervision. McKinney references one district manager who has grown her territory to 24 stores, seven of which are run by owner/operators. The DM visits owner/operator stores about half as often as other stores on her route, because owner/operators "don't need as much help," says McKinney.

Huck's owner/operator model has stirred some interest among other retailers. Robert A. Buhler, president of Open Pantry Food Marts, Pleasant Prairie, Wis., says the model could be a viable option for retailers looking to breathe new life into struggling stores. He has some experience in discerning what's behind a failing store. It's not always the dirt or the location.

"We've had situations where we've had the wrong manager, and that has caused the store to underperform," says Buhler, whose company operates 34 stores. "We've had situations where we've changed out a manager and seen a $30,000 to $60,000 cash-flow improvement. Sometimes changing out a manager will turn a marginal store into a high-end store."

Management shakeups don't guarantee improved performance, so Buhler keeps other options handy. Recently, at a location near the University of Wisconsin's Milwaukee campus, Open Pantry reshaped an underperforming store into a coffeehouse starring its proprietary Willow Creek Coffee concept. It's considering coffeehouses for other locations, but selling a non-performer in today's market isn't a bad option either.

"The good news for everybody is that our industry has embedded equity," he says. "Say you have a store with an EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) of

> **"Nobody likes to close stores; they're like your babies. Walking away from something where you've invested so much of your time and money can be extremely difficult."**
>
> **HARRY MCHUGH** *Wawa Inc.*

$60,000. You should be able to sell that store for a 5x multiple of $300,000. But instead it goes for a 15x multiple and sells for close to $1 million. That's the advantage for our business: By selling your dogs, you can get a lift out of cash flow by fulfilling this insatiable demand of individual buyers. But how long that lasts I don't know."

Seeing Green

In some cases, an apparent underperformer just might not have hit its stride yet. So says Hans Zietlow, director of real estate for Kwik Trip Inc., La Crosse, Wis., which operates more than 350 convenience stores, travel centers and tobacco outlets in Iowa, Minnesota and Wisconsin. Zietlow, who reviews the chain's store portfolio and growth opportunities religiously, says expanding to emerging markets creates a situation marked by risk … and great profit potential.

"There's a fine line between success and failure in being the first one in a 'green' area that's not yet developed," he says. "When you're building in an area like this, it could be five or 10 years down the road before you know if it's going to be a winner. I look at [Kwik Trip's portfolio] every day and keep track of our construction schedule. I keep tabs on where we're going to be 10 years from now because that's not very far away and you have to know what your potentials are."

Zietlow says Kwik Trip hasn't closed any stores recently; it simply rebuilds and reinvents them. In 2005, the company performed more rebuilds than new store openings, but in an average year it completes five rebuilds for every 10 new stores.

"We just have a hard time closing stores because we've become pretty efficient at operating them," he says. "We don't have too many smaller stores anymore. We've made a conscious effort to reinvent our existing stores, so now we have as many nicer stores as possible. Some companies never took the time to reinvest in their stores, and now it's too late for them to catch up."

Still in Control

Martin & Bayley's executive team expressed optimism for the owner/operator model's potential from the very beginning but wondered if it might fall victim to its own design. Out-of-the-box thinkers have a tendency to become maverick operators—or "cowboys and cowgirls," in the Huck's lexicon—when granted too much freedom. But because an owner/operator's actions are linked to his or her own earnings, their inventiveness has spawned anything but discord.

"You give [owner/operators] a little bit of freedom, but their stores are still being run like any other Huck's store," McKinney says. "They get a share of every sales dollar they improve and of every labor dollar or utilities dollar they save, so we haven't let loose of anything. We're still in control."

The model is not infallible, however. To guard against failure, Martin & Bayley worked in a 30-day out-clause "safety net," meaning if the arrangement isn't working out from either party's perspective, the two can part ways without ramifications. In the first go-around, no one evoked the 30-day clause. Even so, McKinney expects a few candidates to falter as more and more owner/operators come online, making the one-year terms ideal.

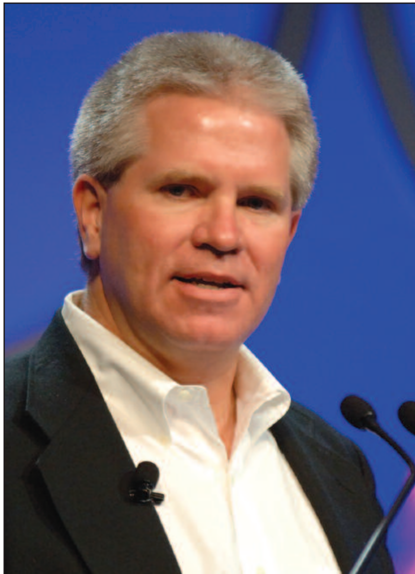
"We are getting ready to double the number of our owner/operators right now, and after that we'll have a combination of newer and older stores on the program," says McKinney. "The profitability line of our owner/operator stores is growing at a quicker rate than our average stores, and the percentage of sales has been higher than the average. We're sure [this model] won't work with every person, since you can't have 100% success all of the time. But I also know there's not a store this won't work in; you just might be one person away."

'Reinvent or Die'

Wawa Inc., Wawa, Pa., didn't get to become one of the industry's premier retailers by retaining stores that no longer fit into its plans. Today, Wawa operates more than 560 stores in the Mid-Atlantic and Northeast, and while its store count may soon climb north of 600, the company will likely close as many as it opens along the way.

In 2005, Wawa opened 28 stores and closed approximately 20. This year, the company plans to open as many as 38, at an average store size of 5,600 square feet, according to Harry McHugh, senior vice president of operations

"Nobody likes to close stores; they're like your babies," says McHugh. "Walking away from something where you've invested so much of your time and money can be extremely difficult. But if you're not constantly growing and reimproving your stores, you're going to die. This is an abiding principle: Reinvent or die."



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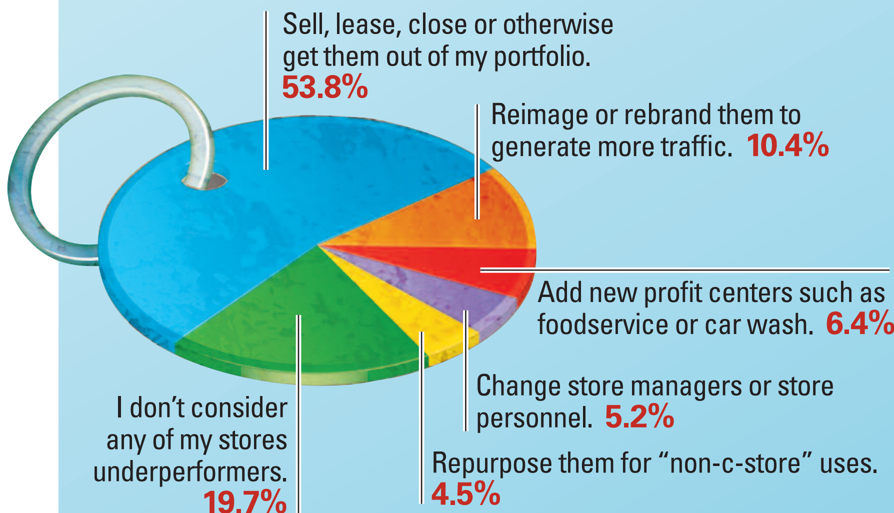
>
> **DOUG DEWEESE** *Super Stop!*

Wawa reviews its entire store portfolio annually, analyzing each property through a financial lens, but also taking into consideration its image, offer, ability to deliver growth and contribution to the community it serves. Ultimately, it's about the brand and the image it projects.

"Wherever we have an opportunity to scrap a store and rebuild it if we can get the additional space, we'll do it," he says. "We have a preference to stay within the community and move or acquire additional property if needed. We'll try to bend heaven and hell to get a store to continue to reflect the brand, the brand image and the offer. But it has to make financial sense."

TO THE WOODSHED

How do you intend to remedy your underperforming, or "dog," stores in 2006?



Source: U.S. Postal Service/CSP Daily News Poll. Based on 173 respondents.

In some instances, closing a store has more to do with employee safety than financials. McHugh remembers closing a financially viable store in Camden, N.J., in April 2005 as a result of a deteriorating neighborhood. The company feared that rising crime levels might endanger its store-level team, so it sold the non-gas store to another operator.

"One of our primary values is associate and customer safety," he says. "There was a shooting [near] the Camden store. Regardless of the financials, we cannot compromise safety. [That's] the last headline we want."

Wawa opened a new, larger store with gasoline and expanded parking opened less than a mile away from the one it sold. "We moved only a mile away, but it might as well have been a continent away, as far as that community was concerned," McHugh says. "We couldn't do much with that store as is, so we had an opportunity to get into a much bigger store and cast a much wider net. But for those folks in the neighborhood who walked there. … Oh Lord, was that painful."

While Wawa has closed some stores because of its commitment to employees, some chains will keep underperforming stores open for the same reason. Worry over employee well-being in the aftermath of a store being sold or shuttered has stayed some retailers' hands, according to Evan Gladstone, executive managing director of NRC Realty Advisors LLC, Chicago.

And then there's the issue of inertia.

"Profitable companies tend to overlook underperformers when the bottom line is good because there's no easy fix for these stores," Gladstone says. "When companies are not profitable

and are having problems, sometimes they're forced to look at [culling] underperformers as a way to reduce losses. The best and most astute companies are always looking to shake up the deck. Larger retailers may be churning 5% of their stores every year."

Feast or Famine

"It's always a good time to sell an underperforming store," says NRC's Gladstone. And it also seems to be a good time to buy. Decent interest rates and less-restrictive covenants from lending sources have made acquisitions more attractive to execute, combined with the fact that there's more money available … for the moment, primarily from sale-leaseback funding sources.

Private and publicly traded real estate investment trusts (REITs) pursuing the convenience retailing industry for the first time, along with a growing number of commercial bank and Small Business Administration loans, has led to an influx of capital up and down the buying spectrum, according to Tom Kelso, managing director of Matrix Capital Markets, Richmond, Va.

"It's either feast or famine, in that you've either got a surplus or no capital, and it's probably reaching the peak of the capital-availability cycle right now, which drives up the prices of the assets," says Kelso. "A retailer may only have $250,000 in cash tied up in a site, but if the site is worth $1 million, are they getting the return on that $1 million? We're suggesting that retailers are better off taking that $1 million and redeploying the capital to get a much better return."

If retailers want to act on an underperformer, Kelso says, they must first determine their desired return on capital invested per site. A store with an EBITDA of $100,000 that's worth $2 million is producing a 5% return. If the retailer expects, say, a 12% return, the

A Holistic Barometer

In 2002, Martin Smith wondered whether his company still had the chops to make it in the convenience store business. He scrutinized each of his company's three business units—retail, wholesale and common carrier—to determine their short- and long-term viability.

Smith, president of Elmer Smith Oil Co., Clinton, Okla., which operates 12 Domino Stores, signed with benchmark specialists CStoreXchange LLC (CSX), Columbia, Mo., in late 2004 to better analyze performance metrics that could help improve the company's financial fitness. One of the most critical areas Smith was able to rein in: labor costs. With his executive team, Smith determined attainable productivity, gross margin and control goals, then implemented a "more fair and equitable" incentive program for managers, based on cost reductions in utilities, shrink and, of course, labor.

"We implemented the system in January [2005] and by March we had started to see things turn around," says Smith. "We were scared to death because margins were so low, but by April we had the biggest profit per store in our company's history. Every month since, it's been the same."

Dick Meyer, president of Meyer & Associates, New Berlin, Wis., and a founding partner of CSX, says measuring financial and operational performance represents a core part of any store rationalization process, but he also urges retailers to balance external benchmarking with a diagnostic "state of the stores" analysis at least once a year with the people closest to each store. Such analyses help retailers stay attuned to the various factors governing individual store performance to complement historical trends as a holistic barometer of each store's overall health.

"Once a year you go to the doctor's, and in this case the doctor means visiting the store manager and the district manager for a two-hour appointment," Meyer says. "Looking at the marketing issues and the site-specific dynamics of each store helps you understand the marketing pulse behind the site's numbers. Considering that the average investment is over $1 million per store, two hours is a smart investment of your time, plus it certainly brings the store manager into the game.

"If and when you do have a [store] failure, you have to cut out the cancer," he continues. "Otherwise you'll spend 80% of your time on 20% of your stores. People used to say that it was a hard decision to close an underachieving store, but it's actually a bad decision if you don't because it could become a cancer that spreads."

The last store Martin Smith "closed" went up in 1990 but had an inefficient design and suffered from excessive labor and shrink costs. He opted to tear it down and start over because "it was the best piece of real estate we owned." The store reopened in October 2005 after being down for seven months, but it's already beginning to produce returns. Sales inside and out have greatly exceeded those from this point last year, a good sign considering the store is still regaining customers lost during its seven-month hiatus.

site would need to generate an EBITDA of $240,000. In that case, retailers may be better served selling the store and reinvesting elsewhere.

There's no shortage of buyers, with consolidators such as The Pantry, Sanford, N.C., and Alimentation Couche-Tard, Laval, Quebec, making strategic acquisitions and smart tuck-in buys. To a lesser extent, mid-size companies such as Kum & Go, West Des Moines, Iowa, have grown by gobbling up smaller chains in its 13-state network. Kum & Go remains on the hunt, seeking chains of 10 to 50 stores that pump a minimum of 100,000 gallons a month, complemented by $90,000 on the inside.

"There has been a change in the dynamics of this industry that has made it not quite so much fun, specifically volatility in the wholesale fuel market and threats from larger hypermarkets," says Kum & Go chief acquisition officer Brian Thompson. "Larger chains have a better opportunity to survive by maximizing their portfolio and spreading the pain by region compared to a smaller operator."

Kum & Go started its growth binge in 1998, when it acquired 100 7-Eleven stores, and made its most recent significant addition in 2004 by absorbing 68 Git-n-Go stores in Missouri and Oklahoma. As a buyer, Kum & Go treats all acquisitions delicately, because in many cases it's not only acquiring the business but the blood, sweat and goodwill of its owner. Flexible buying terms and the ability to pick up supply agreements (Kum & Go runs its own fuel-transport business) also make Kum & Go an attractive option for potential sellers looking to preserve their legacy.

The 470-store chain continues to rationalize its own store count while ferreting out acquisition targets. This year, it plans to turn over what Thompson terms "a short dozen." One strategy, he says, involves maximizing the value of the dirt by investing in business opportunities other than convenience stores.

Letting Go

Soon after the terrorist attacks of Sept. 11, 2001, Super Stop!'s Deweese lost his father and, as a result, assumed responsibility for a 72-store network in dire need of culling. Initially, Deweese identified 16 stores, based on their draining effect on the bottom line. Two stores, where the leases had expired, closed their doors entirely, while buyers scooped up the remaining 14. Super Stop! managed the process entirely, a decision Deweese regrets because it diverted his company's focus.

"It was painful in the amount of time we spent," he admits. "We were more selling real estate than tending to the business. You're satisfying the buyer's needs for information and getting them to the point of achieving financing and closing the deal. You have a lot of assistance toward the buyer when you're doing it yourself; it's like selling a house without a real-estate agent."

Even after relieving his chain of the 16 underperformers, Deweese decided he still had more work to do. This time, he hired NRC Realty to assist in a sealed-bid auction of more locations, "and we were not disappointed." With the closing of one more location and the leasing of another, this process took another 15 stores out of the mix, putting the chain at 41.

Deweese has taken his own advice by swapping out less-than-desirable assets with ones that show greater promise. Now debt-free and its financial health having improved greatly, his Super Stop! chain has begun to grow again. The company recently picked up two stores in Fairhope, Ala. ■

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