

Wake-Up Call No. 2

Strategic Industry Analysis

Not surprising to most industry observers, profit results in 2000 were down from 1999. More concerning is that current economic and competitive dynamics suggest that 2001's ultimate tallies will report additional profit erosion. From fuel to cigarettes to operating profits, we are facing some major challenges, or to be politically incorrect, dilemmas.

Fuel Dilemmas

Non-traditional marketers are siphoning share of market (SOM) of our No. 1 category as fast as a bulging leak in a dike and this trend is not likely to wane. Meanwhile, higher pump prices have triggered double jeopardy for c-store operators: (a) they've dramatically reduced consumers' inclination to buy premium gas; and (b) escalated credit card fees as much as 33% in 2000.

A quick synopsis of the situation:

- * Prices at the pump were up 28% in 2000, according to the Consumer Price Index, and they may increase as dramatically this year. Higher fuel prices, coupled with a general economic slowdown, resulted in a lower proportion of premium gas (11.2% of total fuel purchases in 2000 vs. 14.2% and 19.1% in 1999 and 1995, respectively).

- * HVRs (High-volume retailers) increased their fuel SOM by about 50% from last year, to 3.2%. One research source believes this niche market,

imported from Europe, will have a 5.7% SOM by yearend and 16% in 2005; I suspect they'll prove fairly accurate. About 8 billion gallons of fuel is now sold outside the c-store channel, with that figure increasing to an estimated 17 billion gallons in 2005.

- * Profits were adversely impacted in 2000 by a 4.8% decrease in gallons sold per store and by higher credit card fees (same % on higher selling price) and record drive-offs. The approximate 3% fee on credit card business, applied to a \$.29 average cost per gallon increase in the selling price in 2000 equals about a penny per gallon hit on the bottom line for credit card transactions at the pump. Consider, too, that consumers used credit cards for 30.3% of all c-store purchases in 2000 vs. 28.0% in 1999.

- * Fuel prices are also impacting consumer habits, according to The NPD Group, Houston. For the first quarter of 2001, NPD's Motor Fuel Index concluded: the average number of gallons purchased monthly was down 7% from first quarter 2000; almost 60% of consumers said that price was the reason for purchasing the brand they chose recently, up from 52.1% in 2000; and the percentage of gasoline purchasers who also make a c-store purchase dropped more than 2.5 percentage points since the second quarter of 1999 to 22.1%.

Cigarette Realities

With all the emphasis on "visible space" and "buy-downs" in recent years, I wonder how many chains forgot the importance of our Most Valuable Patron (MVP), the brand-loyal pack customer. Based on my analysis (see Chart A), which includes a \$360-per-year profit from a brand-loyal smoker, it only takes the loss of 106 smokers per year to forfeit the 2000 industry average \$38,300 profit per store.

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Over the years, Dick Meyer has earned a reputation for monitoring and analyzing industry trends and external dynamics, then prognosticating how these factors might impact retailers. His "meat and potatoes" conclusions on industry trends were first published by CSP in June 1997 and continue to be updated annually.

The first wake-up call came in 1997 with Meyer's interpretation of the impact of cigarette/tobacco stores and other competitive threats (CSP—April, '97, p.14). This is his second wake-up call. Pay attention.

Chart A
Annual Value of Brand-Loyal (Pack) Smoker

Assumption	Frequency	Sale \$	GP\$
Pack a day	250 days	\$750	\$150
Fuel-10 gal/week	50 weeks	\$750	\$60
\$3 in other "stuff"	167 days	\$500	\$150
Annual totals	MVP	\$2,000	\$360
Inventory investment	12 turns	\$50	\$(5)

At an inventory carrying cost of \$5 per year for two cartons, can you really afford to be out of stock of Chesterfield, PM Commander, More, Old

Gold and Tareyton? Even the non-core brands that would not survive the 80/20 criteria for SKU management are critical. Their absence would probably qualify your store to lose that brand-loyal smoker's business for fuel, coffee and other stuff. Can you sustain that risk?

Looking at the contribution of cigarettes to the c-store industry on average for the last five years crystallizes our quandary. While the NACS data shows a 69% increase in cigarette sales in this half decade, cigarettes and total gross profit dollars increased less than \$5,000 and \$15,000, respectively, or 11% and 6% each from 1996 levels. We created a lot more sales dollars, but hardly enough gross profit dollars to pay increasing costs (see Chart B).

Major cigarette dynamics include:

- * Prices were impacted by an 11% Consumer Price Index increase in 2000, while consumption of this major in-store category was flat.
- * Margins on cigarettes declined to 15.1% in 2000 from 16.9% in 1999. This is after including the impact of "buydowns" and RDA allowances. Caution: cigarette metrics have become so distorted in recent years with heavy promotions, inflation, etc., that it's virtually impossible to know a company's progress in this category by looking at sales dollars. Many retailers, instead, are monitoring cigarettes like fuel. They watch their cartons per week (CPW) sold this year vs. prior and the

Chart B
Cigarette Contribution

Metric	1996	2000	% Increase
% total inside sales	24.5%	35.8%	46%
Total cigarette sales	\$184,000	\$311,800	69%
Gross profit %	23%	15.1%	(34%)
Cigarette GP \$	\$42,320	\$47,080	11%
Total inside GP \$	\$232,800	\$247,200	6%
Cigarette GP \$ % total	18.2%	19%	4%

total gross profit dollars from cigarettes and other merchandise this year vs. prior. Retailers that don't modify their internal systems to provide these new metrics can make faulty strategic and tactical decisions that could jeopardize this core category.

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* Competition-wise, the growth of cigarette/tobacco stores appears to have leveled off, except for markets where higher margins encourage independents to risk encroachment. This niche requires constant surveillance by smart c-store operators.

* Native Americans continue to reap a free lunch as too many politicians won't do what's right and require these merchants to collect taxes on sales of cigarettes and fuel to non-Native Americans.

* FDA regulation may solve financially driven motivations of those pushing for this legislation. However, the mega cost and government hassle implications to retailers are scary. Anyone thinking that the government "is here to help" is living in la-la land but, then again, that's strictly this man's opinion.

Operating Results

Relative to our industry's history of average pre-tax profits per store, I've always said,

"You can't afford to be average!"

The industry invests well over \$1 million in a new

store, average sales exceed \$2.5 million, and it's staffed with an average of 24 employees. With that amount of risk capital and other resources at play, why would I celebrate making less than \$40,000 pre-tax profit? It doesn't

compute!

In reality, retailers should target themselves to reap the returns on investment of NACS Top Quartile companies. In 2000, about 23% of the reporting companies averaged pre-tax profit of \$121,790 per store, an admirable improvement over \$89,039 in 1999. Alternatively, 36% of the reporting companies reported an average loss of about \$2,000 per store in 2000 and another 24% of the reporting companies were about 2 cents/gallon away from breakeven or negative bottom lines.

Thus, with about 60% of reporting companies within 2 cents/gallon of profit or loss per store, we have a financial situation begging for additional definition.

Symptoms of stress and relief:

- * Sales of other "stuff" (inside sales that are not cigarettes or foodservice) continue to decline in real dollar terms. Between 1999 and 2000 these sales increased a paltry one-half of 1%. What is far worse is that this category's sales declined \$19,800 per store from 1996 to 2000, a 4% sales decrease in the wake of, say, a 10% to 15% hike in prices from inflation. We must reverse this trend fast!

- * Gross profit dollars remain the primary revenue source to counter rising expenses and enhance bottom-line profits. Yet in 2000, a mixture of the lowest inside sales margin since 1973 (28.4%), a 4.8% decrease in gallons sold per store, and a 1/10th-a-penny reduction in fuel gross margin per gallon resulted in a \$19,800 decline in the industry's average total gross profit dollars per store. It's comforting, however, that this is not the trend of the top performers, whose total gross profit dollars increased from \$303,200 to \$437,300 between years. They have a few success formulas in their modus operandi!

- * Store labor costs, including payroll taxes and benefits, exceed \$10 an hour and store employee turnover exceeds 160% per year. And, with the Republicans' recent fumbling of the Senate control, the Democrat agenda is already calling for another increase in the minimum wage. History reminds us that even when operators are paying much higher than the minimum wage, any federal hikes require tremendous resourcefulness by retailers to fund the "ripple effect" of such legislation.

- * Non-operating costs, like interest expense and overhead (general & administrative) costs appear to have remained level in 2000 and/or dropped, according to NACS. My caution to retailers is that they examine their debt leverage and G&A costs very closely as these are areas where savings can emanate with proper planning.

Industry Dynamics

The convenience store industry is not in major disarray. Its fundamental strengths (e.g. large number of convenient locations with good product relevance and speed of service) will continue in vogue. Further, clearly at least the top 25% of reporting companies are still earning healthy ROIs and planning more development.

So, how do we measure the overall pulse of the industry, and then figure out where we want our own company to position itself? Maybe part of the answer comes from examining some of the global factors below, then evaluating them in concert with where your company fits in connection with the industry's averages.

Industry pulse indicators include:

- * Consolidation is likely to continue. Unlike some deals that industry veterans questioned over the last few years, I find comfort in transactions like the Phillips and Tosco deal and Alimentation Couche-Tard's recent purchase of Johnson Oil. The industry will be stronger when acquiring companies watch their debt coverage and integrate the variable cultures of acquired companies.

- * Free-flowing funding sources have dried up with two previously high-profile securitized lenders biting the dust. So far this year we've seen a few of their borrowers file reorganization plans, perhaps giving testimony that buying emotions are best balanced by more knowledgeable due diligence.

- * Foreign influence is growing as we learn new names and look anxiously to monitor and learn from the modus operandi of companies like Ahold, Alon and Delek; welcome to the U.S.

- * Portals and vortals and ASPs are terms we began learning about in early 2000. The value proposition of retailers concentrating on their core competencies (operating stores) and outsourcing support tasks (such as information systems) to specialists

is valid. I expect that a few early e-commerce suppliers will fade from our industry's landscape shortly, while one or two players will prosper.

* Development of new stores, according to NACS, gave way in 2000 to wheeling and dealing of stores between entities. I wouldn't mind more of this if the result were a more logical concentration of operations to headquarters and better bottom lines for all.

For status quo-minded c-store chains, I recommend that they enlist investment bankers ASAP to help them sell or limit the losses from their ultimate demise. For the 25% top performers, they're likely to continue fine-tuning their dedication to discipline, aggressive/informed marketing, and logic-based management decisions. Their formulas provide evidence that hard (and smart) work matters and accountability has a place with properly motivated employees who know the plan and feel the vision.

Fundamentally, consumers haven't lost their love or expectations for convenient shopping locations, thus a good many of our approximate 120,000 sites are on safe footings. What we have to figure out as an industry, however, is the old adage: "Who do we want to be when we grow up?" And this, my friends, will take some thinking!

Any retailer that has sustained a high-volume retailer (Wal-Mart, HEB, Albertsons) entering their market to sell fuel this last year deserves a sympathy card. Often, despite whatever proactive and/or counter competitive attacks they might aggressively initiate, they sustain major hits in volume and a dramatic loss of important gross profit dollars. Effectively countering this growing threat, then, is probably the industry's most difficult dilemma that I've observed since starting to study our dynamics over two decades ago. I have no magic solutions to offer at this time except those proposed by others wiser than me: reduce your dependency on fuel margins and cigarettes. Wow, it was easy to say that, but I look forward to learning how to implement and execute that vision!

What solutions are visible right now?

Could it be that one tested solution is managing lean and mean, working with actionable/timely information, holding people accountable, exhibit-

ing passion, developing and implementing informed and aggressive marketing strategies, and evolving to an increasing independence of 12-cent fuel margins? I like this plan.

Best practices to consider:

* Category management has to expand from fuel, foodservice and cigarettes. We continue to build bigger sales floors but the average per-store sales of other "stuff" are down; that's illogical. Our opportunity is to learn from real "merchants" and figure out how to get back in the dairy business big time, and sell more beer, soda, candy, batteries, etc. Why not?

* Loyalty programs are long overdue and, I guarantee it, they will prove a major competitive differential for retailers that enlist cost-effective and easy-to-use applications. NACS reports that 9.7% of the stores reporting in this year's survey use these programs, up from zero in 1999. This has been my favorite dream for over five years—let's make it happen as an industry, please!

* Balance sheet attention will help many companies that, heretofore, have managed solely from the income statement. Why not sell remote and/or tired non-productive or geographically challenged properties? Take the cash and lower some debt and/or re-deploy it for some meaningful remodels.

* General and administrative costs deserve independent critique at least every five years. I believe that the majority of traditional c-store/petroleum marketers have multiple prospects for becoming more lean and accountable. When is the last time you've done a zero-base budget to examine all major costs at headquarters, while concurrently determining how your G&A resources can be much more responsive to the customers you're serving, the stores?

* Benchmarking data should be utilized weekly to gauge store progress against regional and industry trends. The industry needs to take the pulse of its key performance barometers (e.g. same store sales/gallons growth, productivity, etc.). With all the dynamics in play, if we only submit to an annual checkup on our operating symptoms, I believe that posture could prove hazardous to your company, and our industry's health!