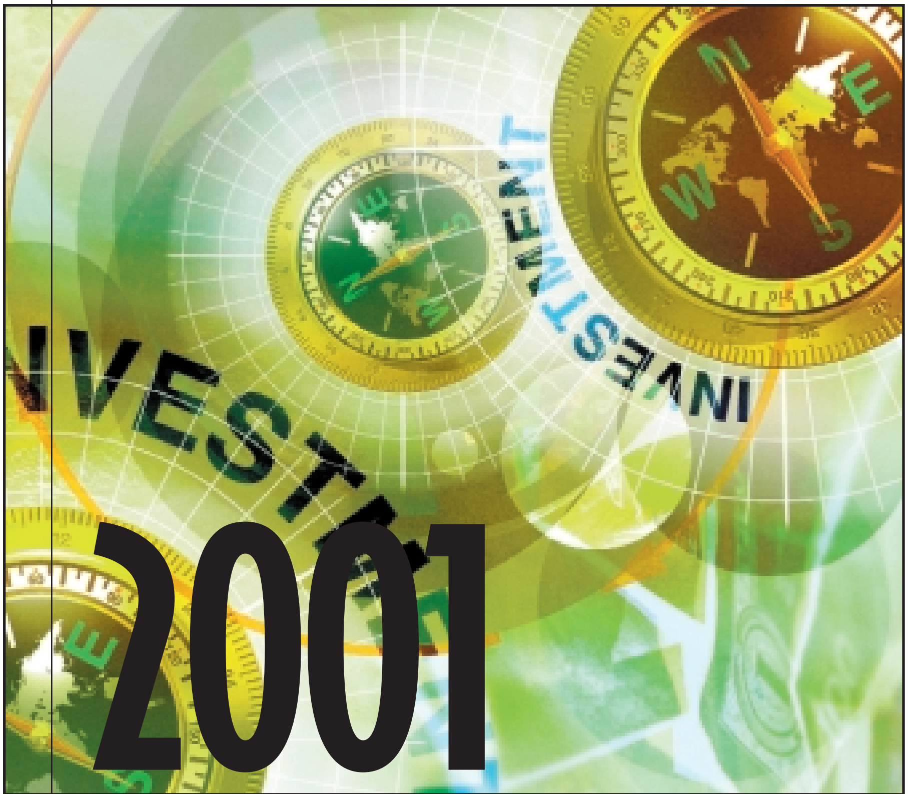

STRATEGIC INDUSTRY ANALYSIS

Jump ship or change course

On average our industry has never learned how to make real profits. A quarter century ago, according to the National Association of Convenience Stores' Fact Book we invested $225,000 in a new c-store venture. Industry average sales totaled $460,000 (including fuel), with a profit of about $14,400.

Twenty-five years later we now invest about eight times as much to build a new c-store and generate six times the sale, but experience only two times the pre-tax profit. What's wrong with this picture? And how does it get fixed?

I don't have all the answers. My intent is to get us to recognize the trends and dynamics and encourage healthy thinking toward enhanced profitability. As an industry, on average, our operating results remain far below our performance potential. This year, there is an even more elevated sense of urgency for us to change our ways, or chance that too many of our colleagues will bear witness to a lot more business reorganizations.

Analyzing the 2001 profit picture

The National Association of Convenience Stores' 2002 State of the Industry report shows per-store pre-tax profits declined 26% in 2001, to $28,300 per store. If that wasn't bad enough, total gross profit dollars declined by an aggregate $9,700 the last two years. On top of this, operating costs increased (not surprising).

While the industry averaged $28,300 in pre-tax profit per store for 2001 (after general and administrative and other costs), the "frequency distribution" indicates that 38% of the reporting companies lost more than $16,000 per store. Another 23% of companies were less than 2 cents per gallon from break-even profits per store.

Essentially, if gas margins were 2 cents less in 2001, more than 60% of the reporting companies would have reported a loss. Some good news: 16% of the companies averaged $50,000 in profits per store and the top 23% averaged $124,000. The bottom line: Those who know how to make money do and those who don't make money have some serious work to do and need to begin now!

Gallons up, margins down

In total, the average number of gallons per store in 2001 grew, up 3.3% over 2000, according to the NACS SOI report. Unfortunately, pooled margin declined from 13.3 to 12.7 cents per gallon.

This resulted in $2,800 less fuel gross profit per store. The only glimmer of hope in this year's fuel data is that the average selling price per gallon stabilized in 2001, actually declining by 5 cents to $1.38. The average selling price of fuel increased 29 cents in 2000 over 1999, a whopping 25%.

Two dynamics initially caught many companies off guard: (a) increased credit card costs, which came right off bottom

Per-store profits *(25 year snapshot)*	1977	2001	% change
GP $—Inside	$93,900	$254,900	171
GP $—Fuel	$13,100	$165,200	1,161
Total GP $—Fuel site	$170,000	$457,700	328
Total all costs	$92,600	$391,800	323
Profit B/4 taxes	$14,400	$28,300	97
Capital per new store	$225,000	$1,831,800	714

Looking at the statistics between 1977 and 2001 shows less-than-exciting facts. As an industry, we are now generating six times the sales we did 25 years ago but only taking to the bank two times the profits.

Store volume and profits	2000	2001	% Chang
Inside sales/store	$870,000	$917,000	5.4%
Gallons sold/store	1,262,000	1,303,000	3.3%
GP $—Inside store	$247,200	$254,900	$7,700
GP $—Fuel sales	$168,000	$165,200	–$2,800
GP $—Total store	$415,200	$420,100	$4,900
Pre-tax profit/store	$38,300	$28,300	–26.1%

Declining c-store profits paint a bleak picture. What I predicted last year came true: economic and competitive dynamics proved to contribute to additional profit erosion in 2001. Pre-tax profits declined 26% to $28,300 in 2001.

Profit picture	2000	2001	2 YRs
Total gross profit $	–$14,600	$4,900	–$9,700
Interest exp	–$1,800	$5,100	3,300
G&A costs	$10,300	–$3,200	$7,100
Store op expenses	$2,700	–$15,700	–$13,000
Other income—net	$700	–$1,100	–$400
Net profit change	–$2,700	–$10,000	–$12,700

Even bleaker than the drop in pre-tax profits is the decline in total gross profit dollars, down $9,700 in two years. Showing a bit of sunshine, however, is the fact that total gross profit dollars did go from red to black in 2001, coming in at $4,900 in 2001 compared with a negative $14,600 in 2000.

Cigarette contributions	2000	2001	% Change
% Total inside sales	35.8%	38.7%	8%
Total cigs sales	$311,800	$355,800	14%
Gross profit %	21.1%	19.5%	–8%
Cigs GP $	$65,800	$69,400	6%
Total inside GP $	$247,200	$254,900	3%
Cigs GP % total GP$	26.7%	27.2%	2%

Cigarettes continue to be a critical category for the industry, gaining a higher percentage of inside sales in 2001. The category jumped 8%, capturing 38.7% of inside sales in 2001, up from 35.8% in 2000.

Source: 2002 NACS/CSNews Industry Databank, Meyer and Associates

lines; and (b) the negative impact higher fuel and cigarette prices had on customers' total disposable income in 2000. These impacts remain huge challenges.

Cigarette dynamics

While U.S. total cigarette inventory volume (i.e. consumption) declined 1% in 2001, our industry's share of market increased from 58.7% to 61.6%. As a category, cigarettes held a higher percentage of inside sales in 2001. Per-store sales of cigarettes were up also, rising 13.9% over 2000.

If we presume that 7.9% of that percentage increase is related to the consumer price index change in 2001, then the 6% additional rise actually reflects higher sales taken from other venues. There is also the possibility that a change in mix of companies reporting to NACS impacted the numbers.

The category represents almost 40% of total inside sales and it's already 27% of inside gross profit dollars. Accordingly, every threat to the viability of cigarettes is essentially a threat to our industry's economical survival.

Unfortunately, the actions of politicians related to cigarettes weigh in on overall strategic planning. State governments will continue to add excise taxes to make up for their fiscal ineptness. It's also a given that the issue of Native Americans' selling tax-free product to non-Native Americans will not be resolved short term. Finally, the major tax hikes in some states, like New York, are sure to breed a new illegal industry—interstate cigarette bootlegging.

We can't give up fighting government,

The big picture

What is most troublesome in the big picture statistical summary is that pre-tax profits are heading the wrong way, dropping to $28,300 per store from $38,300 the prior year. Notably, as profits dipped, there was an obvious direct correlation to EBITDA (earnings before interest, taxes, depreciation and amortization) which went south, declining $13,300. Overall the trend line for 2001 was far less than a positive one. Retailers, now more than ever, need to pull up the boot straps to turn things around.

Volume Data *(Per Store)*	2000	2001	Amount	% change
Avg. cigarette sales[1]	$311,800	$355,000	$43,200	13.9%
Avg. foodservice sales	$115,400	$104,300	–$11,100	–9.6%
Avg. other merchandise sales	$442,800	$457,700	$14,900	3.4%
Avg. merchandise sales	$870,000	$917,000	$47,000	5.4%
Avg. motor fuel sales *(per gas store)*	$1,807,000	$1,792,000	–$15,000	–0.6%
Avg. total sales *(per c-store with fuel)*	$2,677,000	$2,709,000	$32,000	1.2%
Avg. gallons of gas sold *(per gas store)*	1,262,000	1,303,000	41,000	3.3%
Avg. selling price per gallon *(line 5/line 7)*	$1.43	$1.38	–$0.05	–3.5%

Source: NACS State of the Industry Reports 2001 & 2002, NACS/CSNews Industry Databank

Product Mix and Gross Margin *(Per Store)*	2000	2001	Amount	% change
Cigarettes *(% of total inside sales)*	35.8%	38.7%	2.9%	8.1%
Foodservice *(% of total inside sales)*	13.3%	11.4%	–1.9%	–14.3%
Composite merchandise *(GP %)*[2]	28.4%	27.8%	–0.6%	–2.1%
Motor fuel margin *(cents per gallon)*	13.3¢	12.7¢	–0.6¢	–4.5%
Total gross profit *(inside sales)*	$247,200	$ 254,900	$ 7,700	3.1%
Motor fuel gross profit *(per gas store)*	$168,000	$165,200	–$2,800)	–1.7%
Average total GP *(per gas store)*[3]	$415,200	$420,100	$4,900	1.2%

Source: NACS State of the Industry Reports 2001 & 2002, NACS/CSNews Industry Databank

Profitability Analysis *(Per Store)*	2000	2001
Pre-tax profit *(per store, prior year)*[4]	$ 41,000	$ 38,300
Change in total GP *(vs. prior year)*	–$19,800	$4,900
Change in stores/admin expenses &/or other income, net of other expenses	$22,500	–$14,900
Increase in pre-tax profit *(vs. prior year)*[4]	–$2,700	–$10,000
Pre-tax profit *(per store, current year)*[4]	$ 38,300	$ 28,300
Earnings before interest, taxes, depreciation and amortization (EBITDA)	$90,100	$ 76,800
Earnings before interest, taxes, depreciation, amortization and rent expense (EBITDARL)	$117,100	$105,000
Investment per new urban store	$1,860,800	$1,831,800

Source: NACS State of the Industry Reports 2001 & 2002, NACS/CSNews Industry Databank

but in the basics of category management we do have some opportunities, such as:

▶ **Leveraging the category.** Our industry owns this category, but some marketers feel they're a slave to it. Be the master. Don't let one manufacturer tell you what to do with shelving in *your* stores. Don't mortgage your future for a few extra buy-downs, deals or retail display allowances.

▶ **Focusing on SKU management.** I introduced the Most Valuable Patron (MVP) concept last year and many retailers said it helped them put the brand-loyal pack smoker in proper perspective. The premise is that the MVP has an annual gross profit potential to retailers of about $360. Lose 79 MVPs in a year (one every 4.6 days) and you forfeit the industry average pre-tax profit of $28,300.

MVPs visit your stores four to six times a week—carry their brands.

▶ **Increasing traffic.** Two retailers recently voiced a concern I hadn't heard before. The concern is that promotions like "Buy 3, Get 2 Free" may have an overall negative impact on the c-store's main objective: Increase traffic to the store while enhancing gross profit dollars.

One speculation was that pack-a-day smokers were being encouraged to stock up, cutting down on daily visits to stores. Another speculation was the negative effect on sales after such a promotion, especially if it's routine and smokers wait for it.

NOTES:

1. The NACS report indicates that the cigarettes Consumer Price Index were 11.2% and 7.9 for 2001 & 2001, respectively.
2. NACS adjusted Y 2000's margin to reflect buy-downs and retail display and other vendor allowances as part of the composite gross profit percentage.
3. This line excludes sundry gross profit from commissions, ATMs, car washes
4. Pre-tax profit defined is traditional GAAP accounting, i.e. the income left after all charges for G&A costs, interest expense and other income-net. It's the net profit before income taxes.
5. This line is the change in gross profit dollars between years, these are the only monies available to absorb higher costs and improve profits·

"Twenty-five years later we now invest about eight times as much to build a new c-store and generate six times the sale, but experience only two times the pre-tax profit. What's wrong with this picture?"

Dick Meyer
Meyer and Associates

My advice is to analyze transaction counts and do some benchmarking against your other stores for transactions and sales per customer.

▶ **Remember: You are what you sell.** A combination of economic factors and higher cigarette and gasoline retail prices are transforming buying habits. More consumers are trading down from premium gasoline to regular unleaded; premium beer to less-expensive beer; and premium cigarettes to so-called 4th tier/low-end cigarette products.

Strategies for change

Focusing on the importance of a critical category, like cigarettes is a great way to enhance profitability. Here are some others:

▶ **Get rid of the "dawgs."** Don't continuously invest valuable resources to turn around a marginal or losing site. Rank stores in order of total contribution to overhead (before general and administrative costs) and earnings before interest, taxes, depreciation and amortization (EBITDA). Then, make a timetable for estimating the potential proceeds from selling the losing locations and the candidate operators who might buy them.

▶ **Play Monopoly.** I just participated in a great win-win for 12 stores. These were no longer in the strategic markets of the selling company but were great fill-in locations for the acquiring chain.

Two responsible parties did their separate calculations of value, and in less than a few weeks, good people made good decisions. I'll bet your company has a few Boardwalk locations. Instigate a c-store game of monopoly with another chain to better leverage market concentration and organizational infrastructure.

▶ **Learn from the top performers.** NACS profiles the key attributes of the Top 25% profit performers in its SOI report. This year's report shows this group averages $110,000 profit per store, sells an average of 2.5 million gallons of fuel and has inside sales of about $1.1 million to $1.5 million per year.

These retailers accept 2 to 3 cents per gallon less gas margin, but make up for it in volume. Studying the analysis around top performers challenges you to crystallize objectives, strengths, weaknesses and opportunities. I'm not implying every company should emulate them as many will not have the capital dollars or execution skills to do so, but everyone can uncover new go-to-market strategies that may prove profitable.

▶ **Use what you have.** Gerke & Associates completed a technology survey in 2001 that held no punches: We have an "implementation gap." In short, new technology can get up and running, but the real work of weaving the new processes and information power falls short. Leverage your information technology investment.

▶ **Benchmark.** Gene Gerke, Gerke & Associates, and I have organized a confidential data exchange to provide retailers with quarterly, monthly and weekly performance measurements against industry, state and, ultimately, regional industry averages.

Hank Armour, president of West Star Corp. and current NACS chairman recently said that the 1960s through the 1990s were about "dirt, dirt, dirt and dirt." He added that this decade is about data.

We're hoping retailers conclude that it's time to stop living in an information vacuum and embrace actionable and timely information power such as our CStoreXchange.

▶ **Assume Chapter 11.** Run your business as diligently and with the same sense of urgency as you'd have to in a post-bankruptcy situation and chances are you'll never come close to a Chapter 11 filing to begin with.

We have a lot of smart retailers and an equal number of bright suppliers in the industry, and we have some of the best pieces of real estate across the states. We're the best at convenience and we're an expected resource for consumers, every day, every hour.

Every once in a while we just have to look in the mirror and do a little self-examination. Our industry has always found a way to bounce back from adversity—it's time to rally again! ■

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Dick Meyer's "meat and potatoes" observations of industry trends and dynamics have been a welcome complement to CSP's coverage of the State of the Industry for six years. Dick has earned a reputation for monitoring and analyzing industry trends, external dynamics, and the impact on retailers.

Accordingly, every threat to the viability of cigarettes is essentially a threat to our industry's economical survival.

The bottom line: Those who know how to make money do and those who don't make money have some serious work to do and need to begin now!