NO BUTTS ABOUT IT

As cigarette sales smolder, OTP sales represent a strong growth opportunity for retailers, led by the rise of electronic cigarettes.

BY JERRY SOVERINSKY

Ask any convenience store operator what the future holds for tobacco and the answer will undoubtedly be a variation of, "Hmmmm."

Rising taxes, stiffer regulations and growing public awareness of the health impact of tobacco have eroded the sale of cigarettes over the past six years, long the reigning champion of in-store sales for convenience store retailers. While cigarettes are still a major revenue source and traffic driver, the weight of these external forces is diminishing the cigarette smoking population. And commensurate with that change has been the ascendancy of the OTP category.

From 2000 to 2011, while the consumption of all combustible tobacco products dropped 27.5%, according to the Centers for Disease Control, that figure incorporates a 32.8% drop in cigarette consumption and an *increase* of 123.1% in non-cigarette combustible tobacco.

Indeed, while cigarette sales have steadily declined, the OTP category has prospered, with competitive pricing and less restrictive regulations — for now — that make it an attractive alternative for smokers. And for retailers whose balance sheets reflect the erosion of cigarette sales, the public shift toward the OTP category has been reassuring.

By the Numbers

According to the *NACS State of the Industry Report of 2012 Data*, OTP generated nearly $7 billion in sales for U.S. convenience stores in 2012, up 4.0% in sales dollars and 3.9% in units from 2011. As a percentage of in-store sales, the category generated 4.38% of revenue for convenience stores in 2012, rising 0.19 points from 2011 (4.19%) with average annual sales per store ($78,864) up 6.48% from 2011. (2013 State of the Industry numbers will be released April 1-3 at the NACS State of the Industry Summit in Chicago.)

Make no mistake, OTP sales are still modest compared to cigarette sales ($78,864 per store in 2012 vs. $622,248), but the difference between gross profit margin dollars is far smaller ($24,096 in 2012 vs. $88,908) and contracting. And whereas the gross margin percentage for cigarettes was 14.29% in 2012 (down 0.26 points from 2011), the gross margin percentage for OTP was 30.55% (up 0.20 points from 2011).

Among all in-store categories, OTP generated 4.38% of sales (up 0.19 points from 2011) and 4.32% of total gross margin contributions. OTP subcategory performance varies dramatically from smokeless, which represented 61.09% of OTP category sales in 2012 (up from 59.56% in 2011), to pipe/cigarette tobacco, which registered a meager 1.79% of OTP sales (vs. 1.83% in 2011).

Subcategory Detail

Among the five subcategories of OTP tracked in 2012, smokeless represented the largest percentage of sales, followed by cigars, papers, pipe/cigarette tobacco and other tobacco. It's important to note that NACS added

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electronic cigarettes to the OTP category in the March 2013 Category Definitions and Numbering Guide, so its specific totals are not included.

According to NACS data, 2012 industry sales of smokeless, which include chew, dip, moist snuff and snus, reached $4.2 billion, a 6.7% sales change and 4.8% unit lift. And this growth can be directly attributed to the eroding population of cigarette smokers.

"At least 75% of moist snuff consumers also smoke cigarettes, which means there are a lot of nicotine occasions up for grabs and shifting away from cigarettes due to high cigarette prices, smoking restrictions and growing social acceptability of using smokeless tobacco," said Joe Teller, director of category management for Swedish Match. "These smokers have always been a large part of what is driving moist snuff growth, and now e-cigs also. There are enough of them to continue driving OTP growth."

Just the Facts:

From 2010 to 2011, there was a 32.8% drop in cigarette consumption yet an increase of 123.1% of non-cigarette combustible tobacco.

Cigar sales fell 1.2% in 2012 to $2.2 billion, according to NACS SOI data, while units were up 4.0%. As the second largest OTP subcategory, cigars represented 32.11% of category sales. Average store sales for cigars were relatively flat at $25,323 in 2012, as were gross profit margin dollars ($8,800) and gross margin percentage ($34.75%). However, there's a silver lining in the cigar subcategory: foil pouch packaged cigars.

"[The foil pouch segment] is the only growing segment in cigars, with [most of the decline] coming from old-fashioned cardboard cigar packs," Teller said, adding that unflavored represents the fastest growing sub-segment. "Unflavored cigars do not have a strong flavor profile and are sold in different colored packages to highlight the flavor differences, just like cigarettes are packaged. This is an important trend that retailers are getting behind since no one knows if FDA will regulate cigars, and if they will ban some traditional flavors."

The papers subcategory suffered the biggest drop, off 3.0% to settle at $219.3 million for the industry. This represented a 4.4% drop in unit sales, but the decline did little to impact retailers' bottom line. Other tobacco, meanwhile, recorded a

Category Definition

OTHER TOBACCO PRODUCTS

- Smokeless
- Cigars
- Papers
- Pipes
- Pipe/Cigarette Tobacco
- E-Cigarettes

NACS category definitions can be used to establish performance benchmarks and a framework for retailers and suppliers to discuss market performance comparisons. For more NACS category definitions visit nacsonline.com/categorydefinitions.

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— Bonnie Herzog, managing director for beverage, tobacco & convenience store research, Wells Fargo Securities

steep 36.2% lift in sales to $125.5 million and a 49.9% increase in units sold. However, the subcategory represented just 1.82% of OTP sales for $1,435 in average store sales.

Finally, pipe and cigarette tobacco grew 2.0% to $123.3 million, while units were off 0.8%. Stores that offer a generous assortment of loose tobacco and supplies to roll-your-own have fared better in this subcategory. "We've done well with roll-your-own," said Justin Samona, CMO for Wild Bill's Tobacco, which operates 48 tobacco superstores in Michigan. "It's much more affordable, saving [consumers] more than half on the cost [of traditional cigarettes]."

E-Newcomer Takes Center Stage

Electronic cigarettes will no doubt help anchor the OTP category in the foreseeable future. Indeed, the meteoric rise of e-cigarettes has prompted industry analysts to make some dramatic predictions.

"Is this the beginning of the end for combustible cigs?" wrote Bonnie Herzog, managing director for Beverage, Tobacco & Convenience Store Research at Wells Fargo Securities, in an October 2013 report. According to Herzog, the category was expected to reach $1 billion in annual sales in 2013 ($1.8 billion including online sales) and could overtake the cigarette category within 10 years. Not bad for a product that didn't arrive in the United States until 2007. "We continue to believe e-cigarette consumption could surpass traditional cigarettes and the combined operating profit pool could generate a CAGR in excess of 7% over the next decade," Herzog wrote.

OOTP
(other *other* tobacco products)

Putting the "other" in other tobacco products is Danvers, Massachusetts-based Jake's Mint Chew, which produces USDA-certified organic mint chew. It contains 0% tobacco but still allows those with a hankering for some chew to, well, get their chew on. For tax purposes, it's categorized as a food product rather than tobacco, which is welcome news to retailers, said Adam Benezra, CFO for Jake's. "A lot of these tobacco guys are reeling from taxes and restrictions," he said, adding, "The margins are great." According to Benezra, Jake's has achieved strong, steady growth since its launch, rising 132%, 86% and 41% year over year.

Of course, the product's success could be dampened, depending on any restrictions that the FDA passes down (an appeals court ruled in 2010 that the federal agency has the authority to regulate electronic cigarettes). Until then, cities are already placing their own restrictions on the vaping products, with Chicago treating them as tobacco cigarettes.

There is much to be sorted out, including sales to minors, which prompted 40 states attorneys general to send a letter last September to the FDA urging the agency to regulate e-cigarettes like traditional cigarettes. "People, especially kids, are being led to believe that e-cigarettes are a safe alternative, but they are highly addictive and can deliver strong doses of nicotine," Massachusetts AG Martha Coakley said. "We urge the FDA to act quickly to ensure that these products are regulated to protect the public."

Will Squier, vice president of product & channel marketing for Tryst Electronic Smoking Devices, which sells e-cigarette smoking devices, says his company welcomes the impending regulations and is poised to take advantage of their impact. "We see that as a benefit, we've done our homework; we're concentrating on quality and safety and that will weed out the companies that are sourcing products off [shelves] in China."

Maximizing Sales

As the OTP category continues to grow (and as the cigarette category continues to shrink), retailers may need to refine their merchandising strategy. "There is only so much space behind the category for tobacco products. With cigarette

SUBCATEGORY PERFORMANCE
2011 VS 2012

	% of Sales		Avg. Store Sales		GP Margin $		GP Margin %	
	2011	2012	2011	2012	2011	2012	2011	2012
Smokeless	59.56%	61.09%	$44,113	$48,178	$11,728	$13,143	26.59%	27.28%
Cigars	33.80%	32.11%	$25,034	$25,323	$8,757	$8,800	34.98%	34.75%
Papers	3.42%	3.19%	$2,533	$2,516	$1,290	$1,288	50.91%	51.21%
Pipes/Cigarette Tobacco	1.83%	1.79%	$1,355	$1,412	$354	$369	26.10%	26.14%
Other Tobacco	1.39%	1.82%	$1,029	$1,435	$347	$496	33.69%	34.54%

(Source: *NACS State of the Industry Report of 2012 Data*)

growth flat-lining in c-stores and expected to actually decline in coming years, retailers will need to adjust the space for tobacco. They will reduce the footprint for cigarettes and add more space to OTP and e-cigs," Teller said.

However, some retailers insist some perspective is in order, and that any adjustments must be measured. "E-cigarettes are absolutely cutting into cigarette sales but not to the degree people are worried," said Sam Odeh, president of Elmhurst, Illinois-based Power Mart. Odeh said that if one of his stores sells, for example, $50,000 in total tobacco products, less than $3,000 of that total is actually e-cigarettes. "So e-cigarettes are important to carry, but they haven't taken our focus away from tobacco."

And just because cigarettes sales are on the wane, it doesn't mean customers will ask for OTP alternatives. They need to be presented with the options. "Some electronic cigarettes and vaporizer products are still relatively new to consumers; they must be kept visible," said Kraig Knudsen, vice president of business development for DNA Distributors, which sells Cigalectric Electronic Cigarettes and Just Juice Vaporizers. "When evaluating brands, retailers should look for attention-grabbing merchandising solutions. Counter displays work best. Consumers want to see clean, organized displays, with POS that clearly communicates product benefits."

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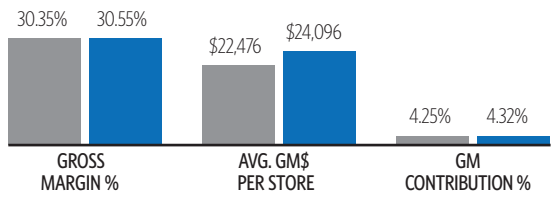
Kevin Frija, CEO of e-cigarette supplier Vapor Corp., agrees, and points to store personnel as an excellent source for stimulating sales. "Educating clerks to suggest new products and [to] support new product launches to make sure their customers are aware that they carry new products [is essential for engaging consumers]."

The future of OTP appears to be strong, as con-

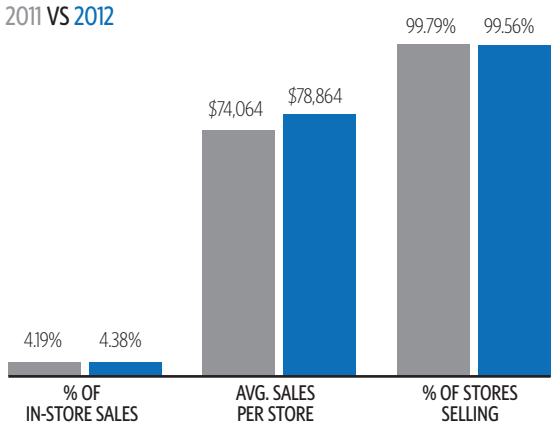
INDUSTRY GROSS MARGINS

2011 VS 2012



INDUSTRY SALES

2011 VS 2012



(Source: *NACS State of the Industry Report of 2012 Data*)

sumer smoking preferences shift and e-cigarettes become more established. "Ten percent dollar sales growth for OTP including e-cigarettes is a safe bet for the foreseeable future," Teller predicts. "Given the declining consumption of cigarettes, I expect cigarette category trends to be negative for the c-store industry as a whole, with continued margin contraction for retailers. This makes the explosive OTP growth very attractive." NACS

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PER STORE, PER MONTH SALES

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
2011	$6,374	$6,380	$6,383	$6,383	$6,383	$6,374	$6,377	$6,387	$6,375	$6,370	$6,362	$6,365
2012	$6,397	$6,405	$6,397	$6,390	$6,414	$6,421	$6,417	$6,419	$6,409	$6,403	$6,397	$6,414
2013	$6,412	$6,421	$6,433	$6,425	$6,438	$6,432	$6,433	$6,447	$6,505	$6,435	$6,427	N/A

(Source: CSX LLC, csxllc.com)