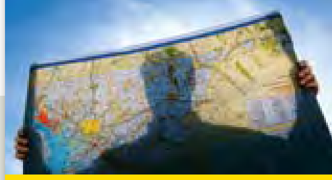
DID YOU KNOW?
From 2006 to 2007, credit card fees increased $1 billion.



SURVIVING THE DOWNTURN

Tough times loom, but savvy retailers who watch the numbers and take advantage of hidden opportunities can weather the economic storm.

BY JERRY SOVERINSKY

Less than two hours into the 2008 NACS State of the Industry Summit opening session, after a succession of industry insiders talked of inflation, deflation, economic slowdown and the dreaded "R-word" — recession — I witnessed one attendee turn to his neighbor and remark, "Should I jump out the window now, or wait until the afternoon session?"

His neighbor, unconvinced but trying to remain upbeat, replied, "Might as well wait. Things are bound to pick up."

He was wrong, of course. The economic climate didn't sound any brighter as the day wore on — not that retailers needed experts to confirm what they already knew. The numbers presented at the summit speak for themselves:

- From 2006 to 2007, convenience store profits decreased $1.4 billion, despite an $8 billion increase in sales.
- From 2006 to 2007, credit card fees increased $1 billion.
- Unemployment is rising — as much as .3 percent in a recent one-month period.

The NACS SOI Summit in partnership with CSP presented a snapshot both of the current state of industry affairs, as well as a prediction of things to come. And while the numbers tell a discouraging story, the collective attitude at the summit was not one of defeat. Indeed, many in attendance had come for guidance as to how to navigate successfully through these difficult times.

Along those lines, an underlying premise repeated at the summit and throughout the industry is one of opportunity, not failure. Perhaps this is more wishful thinking than realistic expectations (or a combination of the two), but industry leaders maintain that proactive retailers can make the most of the current state of the economy, maximizing their returns and — yes — even increasing their profitability.

RECESSION OPPORTUNITIES

NACS Vice Chairman of Research and Technology Greg Parker, president and CEO of The Parker Companies, kicked off the event's motivational messaging with a focus on the positive.

"What are the opportunities in a recession?" he asked, rhetorically. He laid out his case:

1. If you have a strong balance sheet, capital costs are low. Qualifying companies can especially benefit when they look to expand operations. (See "The Numbers Game" on page 30.)

2. Labor and materials are less expensive during a recession. As such, the climate is more attractive for building and remodeling.

3. While unemployment spells bad news for consumers and their purchasing power, it presents a strong opportunity for staffing one's labor pool. Additionally, wages traditionally remain stable during rising unemployment — always helpful for the bottom line.

4. The Economic Stimulus Act of 2008 will increase depreciation opportunities — again, very favorable for the balance sheet. (See "Now Is a Great Time to Buy — Really" on page 42.)

5. New government programs are available, offering development opportunities. Tax rebates will be distributed mid-year for consumers, a boost to short-term spending.

CASH IS KING

While all of this is financially sound in *theory*, it's not exactly what's playing out at stores, says Bill Douglass, CEO of Douglass Distributing Co. While it would be a great time to expand and remodel, the cash is just not available.

The increased retail price of gasoline has dramatically reduced the financial liquidity within the convenience and petroleum retailing industry. While retailers essentially are selling fuel for twice the price they sold it several years ago, they are paying twice as much as they paid several years ago and they have to dedicate twice as much capital to inventory. Meanwhile, gross margins for motor fuels sales have declined and per gallon gross profit as a percent of sales has dropped to its lowest level in history. Compounding this reduction in gross margins is the increase in credit card fees, which have further constricted profits on each gallon.

What does this mean? It means that the cash flow that all businesses rely upon to perform their day-to-day functions, as well as the capital available to fund facility improvements or expansions, has essentially dried up for retailers and put on hold many of their plans to improve their businesses.

"We don't have the same access to capital we had prior to this meltdown," Douglass said. "That affects the amount of expansion [and] the working capital... We're not building a new store. We want to remodel and we have to cut back on that. Our bank is the biggest bank in the world and they've lost $10 billion in the last quarter...When the economy is in a contraction, what you need to do is lower your expectations, you don't buy new equipment because it's more difficult to obtain funds."

Despite the grim assessment, though, there are things you *can* do in such situations, suggested NACS Vice Chairman and Treasurer Sonja Hubbard, CEO of E-Z Mart Stores Inc.

"If you have a good relationship with the bank, you should sit down and explain to the banker how the industry works," she advised, "especially with

liquidity issues. Tell them that some flexibility is needed, that increased gas prices don't mean increased profits."

"Also, take a hard look at operations and the balance sheet. If there are areas of the business that don't make sense, minimize them or get rid of them. Evaluate your entire business operation. Sometimes, you still need to turn over all those rocks."

ARE WE RECESSION-PROOF?

Even if the economy is entering (or has entered) a recession, the future impact on convenience retailers might not be so severe.

In the fall, at the 2007 NACS Show in Atlanta, a panel of industry CEOs addressed the topic of recession and its effects on convenience stores. Some maintained that even during the harshest economic times, convenience stores have a leg-up on other retailing industries. Because convenience stores deal in everyday commodities — fuel and food — they're not quite recession-*proof*, they said, but perhaps recession-*resistant*.

"[B]ecause most of the items that we sell in our stores at least are consumed every day and almost immediately by the consumer, I don't think we're as vulnerable [as other industries]," said RaceTrac CEO Carl Bolch.

Relative is the key concept here, agreed several executives.

"[I]t's really a matter of degree," said Core-Mark International President and CEO Michael Walsh. "You have to ask yourself the question, 'If a recession hits, do I want to be in the automobile manufacturing business or would I rather be in the packaged consumable goods business?' Well, I think I'd rather be in the latter. People are going to give up buying their cars and refrigerators more readily than they're going to give up buying their sandwiches, beer, bananas, smokes… I think overall we've weathered recession pretty well in the past, and I think the industry is strong enough to weather it again. I don't think that it's a strategic threat to the industry."

Others positioned their answer not as to how the industry in general will fare, but rather, what individual retailers can do to succeed.

"[A] retailer's goal is to always try to improve their same-store sales," said Stan Sheetz, CEO of Sheetz Inc. "I happen to believe that much of that sales growth is driven by innovation. [Our industry] is not recession-proof. If your innovation was going to take you up x-percent, you know the recession is going to pull you down to a growth of less than x-percent…[W]hen you head into a recessionary environment, that battle gets a little bit tougher."

At this year's SOI Summit, during one of the more lighter moments, Walter Zimmermann of United Energy joked that he didn't think times would be so tough. He commented: "When people are stressed more they're probably going to smoke more, drink more… that's right up your guys' alley."

FUEL PRICING FOR PROFIT

Innovation often requires reexamining traditional operational practices, with an eye toward improving efficiencies. At the SOI Summit, attention was focused on fuel pricing, and Parker concluded that "fuel price volatility is here to stay." As such, the need for retailers to price fuel optimally is paramount.

Along those lines, price optimization software is becoming an important tool as retailers look for ways to find the "sweet spot" for buying and selling product.

"Most retailers have a sense that the market is different day to day," said Ian Thompson, vice president of global professional services for New Jersey-based KSS, a supplier of pricing intelligence and optimization solutions for the petroleum and convenience store industry. "The market dynamics are different on a Monday versus a Tuesday, and especially on a weekend. To maximize your profitability, you should price differently on those days."

"'IF A RECESSION HITS, DO I WANT TO BE IN THE AUTOMOBILE MANUFACTURING BUSINESS OR WOULD I RATHER BE IN THE PACKAGED CONSUMABLE GOODS BUSINESS?' WELL, I THINK I'D RATHER BE IN THE LATTER."
— MICHAEL WALSH

AS GAS PRICES HAVE RISEN, ONE SURPRISING TREND HAS EMERGED: CUSTOMERS BUY FEWER GALLONS OF GASOLINE DURING EACH VISIT, BUT THEY RETURN MORE FREQUENTLY.

"Anyone not under a direct contract to buy gas should consider how to acquire product more cost effectively," said Cathy Duncan, DTN's director of product management for refined fuels. "Whether you buy in the morning or afternoon, staying on top of market intelligence is a good way to better manage profitability so that when you set... price, you're in a [stronger] position."

BOOSTING INSIDE SALES

As gas prices have risen, one surprising trend has emerged: Customers buy fewer gallons of gasoline during each visit, but they return more frequently. As such, retailers are searching for ways to maximize in-store sales. Kum & Go, a 400-plus store retailer with locations in 12 states, is promoting incentives along several fronts, including selling premium coffee, offering a free newspaper with fuel purchases and expanding its fountain drink selection.

"In a time when consumers are looking for more value, we know we have to offer more inside the store," Dennis Folden, COO of Kum & Go, told the *Des Moines Register*.

Acknowledging an increase in the frequency of customers' visits, Ankeny, Iowa-based Casey's General Stores Inc., a 1,464-store chain, reports robust in-store sales. Pizza and doughnut revenue have increased 9.5 percent, and other food items have spiked 8.5 percent during a recent 9-month period. According to Bill Walljasper, Casey's senior vice president and CFO, these "feel good" items are resistant to slow economies. At the same time, the chain reports that its less expensive brand names are also faring well, an effect he labeled as "trading down."

NACS SOI Summit Chairman Fran Duskiewicz, senior executive vice president for Nice N Easy Grocery Shoppes, also maintains the importance of retailers focusing on inside sales. He stresses paying attention to every element of retailing.

"You need to provide a number of reasons why someone should stop [at your store] besides gasoline — food, products, other services. Even if customers go down the street to buy gas, they come to you for goods and services. If the only reason for someone to stop at your place is gas, then you're held hostage to that. Then you've got to be the cheapest guy around. But consumers are consolidating trips, and that number is growing. That's an important point for retailers."

TARGETED DEMOGRAPHICS

Improving inside sales is also a reflection of retailers responding to evolving consumer preferences and changing demographics, said Todd Hale, senior vice president of consumer and shopping insights for The Nielsen Company, at the SOI Summit. As such, it's vital for retailers to refine their product lines.

Hale suggested, "If you want to drive growth, look at the aging population," noting that this demographic will likely make an impact on store sizes and formats, growth in functional foods and easy-opening packaging. Retailers that focus on seniors offer discounts and free coffee and recognize that this age group does most of their shopping on weekdays.

And what should health and wellness mean to convenience stores? A lot. Better-for-you items are even available for the family dog, and more manufacturers are diversifying their portfolios with 100-calorie snacks and trans fat-free foods. And while fitness foods are growing in popularity, Hale points out that 30 percent of consumers are resigned to the "I am who I am" syndrome. As a result, he concludes that pork rinds and cigarettes will always find a strong consumer base.

Competing retail channels present unique challenges for convenience stores, as dollar stores and warehouse clubs offer strong value incentives for consumers. To compete, Hale says that convenience retailers need to focus on their strengths. When it comes to competing against supercenters, convenience is far greater at convenience stores. And convenience store variety is far more extensive compared with dollar stores.

Communicating those distinctions is part of an overall branding strategy, said Lisa Wollan, head of consumer insights and brand strategy for Wawa. It's vital to address every sensoral aspect of a consumer's visit to your store, ensuring that your message (fresh, fast, etc.) is clear and unambiguous.

THE FUTURE

Collectively, the above paints a rather ambiguous picture for retailers. The economy is down, the short-term outlook appears bleak, but there are proactive steps retailers can take to survive. Perhaps Bill Douglass summed up the uncertainty best:

"I'm not sure it's wise to go to the retailer and say that the sky is falling," he said. "But it's changed. And the retailer's behavior is going to be altered by this crisis. We need to adjust our expectations to a very different economic climate."

Brace yourselves. ■

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