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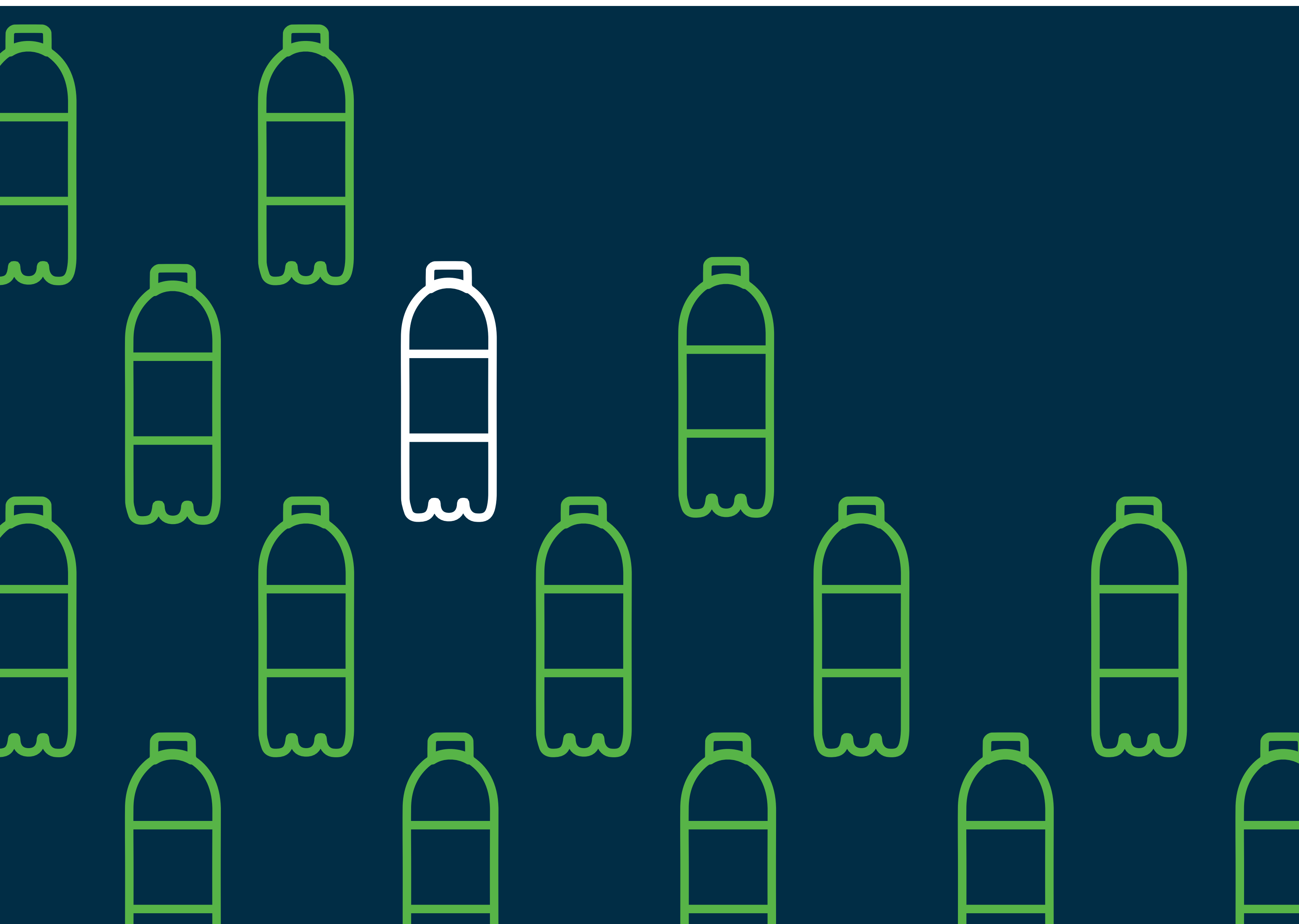
What convenience stores should know—and do—in 2017



At A Glance

1 What's in-store for 2017?

- North American c-stores are aggressively competing against other foodservice players from all segments—many of which are now fighting back.
- New rivals are shaking up the market for c-stores' traditional offerings.
- Trends in fuel prices, tobacco regulations, and healthcare and labor costs present additional challenges.

2 Customers crave both value and variety

- Many—but not all—c-store customers are loyal to brands. Some may care more about a c-store's location, merchandise selection, and overall value than its brand.
- To win market share, c-stores should compete on value and merchandise selection, coupled with foodservice excellence.

3 Grab-and-go: four steps for success this year

- C-stores should provide foodservice offerings that span dayparts.
- They can also capitalize on digital technologies like mobile loyalty programs and mobile payments.
- They should look to build scale within certain geographies and DMAs. Some should evaluate M&A opportunities, both domestically and abroad.
- They can deploy savvy cost-management strategies to offset rising operating expenses and safeguard profitability.

Pursuing increased profitability, convenience stores have expanded their foodservice offerings. In the process, they've encroached on more traditional players' turfs, including quick-service restaurants (QSRs) and grocery stores.

Those companies have noticed, and they're responding aggressively. Meanwhile, other entrants into the foodservice space—such as mass merchants, dollar stores, and even online retailers—have further intensified the competition. Add to that the challenges and sometimes opportunities stemming from higher operating costs, fuel-price trends, and technology—and c-stores find themselves operating in an environment that's more challenging than ever.

Findings from AlixPartners' *2016 North American convenience store consumer study*—the first to take an in-depth look at consumer behavior in this industry[1]—point to the need for c-stores to master four imperatives to succeed in this space: enhancing the execution of foodservice programs, improving the customer experience, building scale, and launching comprehensive enterprise-improvement programs.

C-stores throughout the United States have recently broken into markets where they hadn't competed aggressively before. Their goal? To pursue profitable growth. To that end, they expanded their higher-margin offerings (particularly foodservice) to appeal even more to convenience- and value-minded consumers. The moves boosted their profitability and helped offset recent revenue losses that came with lower fuel prices.

As a part of their strategy, c-stores began competing against players in other foodservice segments, including QSRs and grocery stores, which have started fighting back. For instance, QSRs are seeking to offer the same level of convenience and pricing that c-stores have offered, and grocery stores are expanding their ready-to-go food offerings.

Meanwhile, new rivals are shaking up the market for c-stores' traditional offerings like in-store merchandise and fuel. Amazon's new brick-and-mortar stores and Walmart's move to a smaller store format in urban areas are cases in point.

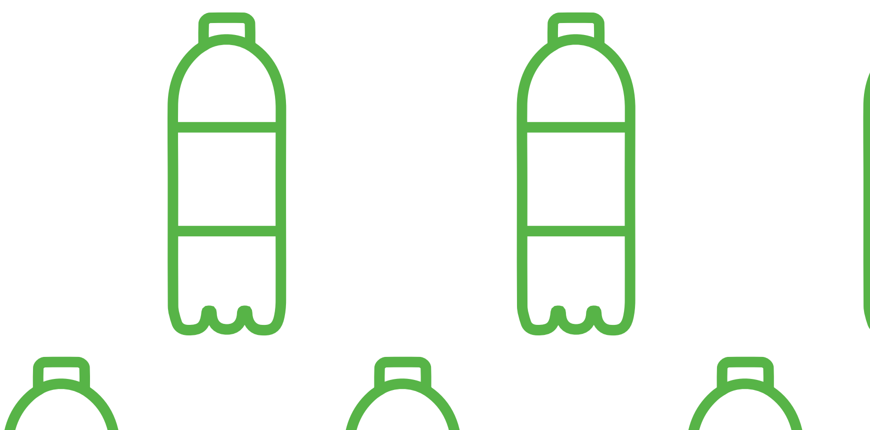
The competitive landscape is growing more complex, presenting both challenges and opportunities for some c-store chains. C-stores are well positioned to operate effectively in this landscape. After all, many have prime real estate locations, and their offerings cover multiple dayparts as well as other major categories such as fuel, which can add value even as a potential loss leader. But to succeed in the future, they'll have to build on those advantages and adapt to the trends shaping their industry.

In particular, they should excel at several winning strategies—including enhancing their execution of foodservice programs, improving the customer experience, building and leveraging scale, and developing comprehensive enterprise-improvement programs that deliver year-over-year productivity savings.

INDUSTRY SNAPSHOT

C-stores' in-store revenues are up because of a sharpened focus on foodservice, but overall revenue is down because of lower fuel prices. Operators have seen their profitability improve slightly, thanks both to growth in higher-margin categories like foodservice and to an increase in the number of fuel gallons sold. However, the industry has also experienced sluggish growth in the number of individual c-stores nationwide, suggesting a saturated domestic market.

Because of the increased focus on driving foodservice sales, foodservice sales now represent 15% of the industry's total in-store revenue. And because of their hefty margin, growth in foodservice profit dollars will likely outpace growth in merchandise profit dollars. And even though merchandise contributes to about 85% of in-store sales, the average gross margin on merchandise is only 23.8%—versus foodservice's 43.7%.[2]



[1] "The *North American convenience store consumer study*" reflects responses from 1,000 United States–based consumers regarding their choices and preferences when visiting and shopping at c-stores. The survey was conducted from August 8 through September 26, 2016.

[2] "Convenience Store News Industry Report", June 2016.

Overall, the near-term outlook for c-stores appears positive. However, several trends could threaten c-stores' sales and profitability:

- **Fuel price and volatility.** Fuel prices are expected to start edging back up during 2017, given demand-and-supply dynamics. For example, demand for oil by countries that are nonmembers of the Organization for Economic Co-operation and Development will likely keep rising, mostly in China and India. Meanwhile, reduced US shale production, combined with the November 2016 production-limiting agreement of the Organization of the Petroleum Exporting Countries could constrain supply, putting additional upward pressure on fuel prices. What this likely means for c-store operators is a potential recovery of fuel revenues but a decline—or at least a leveling off—in the number of fuel gallons sold. Profit percentages could also tighten as rising prices and a cost-plus pricing model compress margins. High-fuel-price volatility could provide an opportunity to offset some of that margin compression, but this is difficult to predict. In short, operators should be prepared for incrementally higher fuel revenues but tighter margins. Finally, a decline in the number of gallons sold could also negatively affect in-store sales if consumers make fewer trips to the gas pumps.
- **Tobacco regulations.** Cigarettes remain an important category for c-stores, constituting roughly 30% of in-store sales.[3] But in the long term, the category could shrink in size compared with other tobacco products. That would be especially likely if more states and localities increase the minimum legal sale age for tobacco products to 21—as California and Hawaii already have—and if federal, state, and local legislation push taxes on cigarettes higher.

  On the other hand, several trends could exert a positive impact on c-stores' cigarettes category. Examples include retailers' exiting the tobacco market—similar to CVS's move—and a reembracing of traditional cigarettes by consumers dissatisfied with e-cigarettes and vaping products.[4]
- **Healthcare and labor costs.** Increases in healthcare and labor costs have translated directly into rising operating expenses for c-stores. And that has exacerbated the hits to their bottom lines already coming from trends affecting their fuel and tobacco product revenues. Minimum-wage legislation and new laws regarding overtime pay would only worsen the cost picture for operators, but uncertainty about the future of the Affordable Care Act makes predicting the cost picture difficult.

45%

Fuel is still the primary c-store purchase according to 45% of survey respondents.

CONVENIENCE STORE CUSTOMERS: WHO THEY ARE AND WHAT THEY WANT

Consumers' opinions and preferences regarding c-stores further point to operators' need to step up their in-store sales games if they're going to expand their profitability and market share. Our *2016 North American convenience store consumer study* found that, not surprisingly, location remains the top factor in customers' choice of c-stores to visit. But in-store considerations—including product value and price, merchandise selection, promotions, and overall value—also powerfully influence customers' decisions (figure 1).

The lesson? These considerations trump brands in consumers' convenience store choices, though this is truer for some brands than it is for others. Because the level of brand loyalty is generally low, operators can win market share by competing on value and the merchandise selections they offer.

Also not surprisingly, fuel is still a primary c-store purchase according to 45% of our survey respondents. But food-related items were the top secondary purchase options among those fuel consumers. Indeed, for 77.5% of our survey participants, buying food or beverage products is either a primary or secondary reason for stopping at a convenience store.

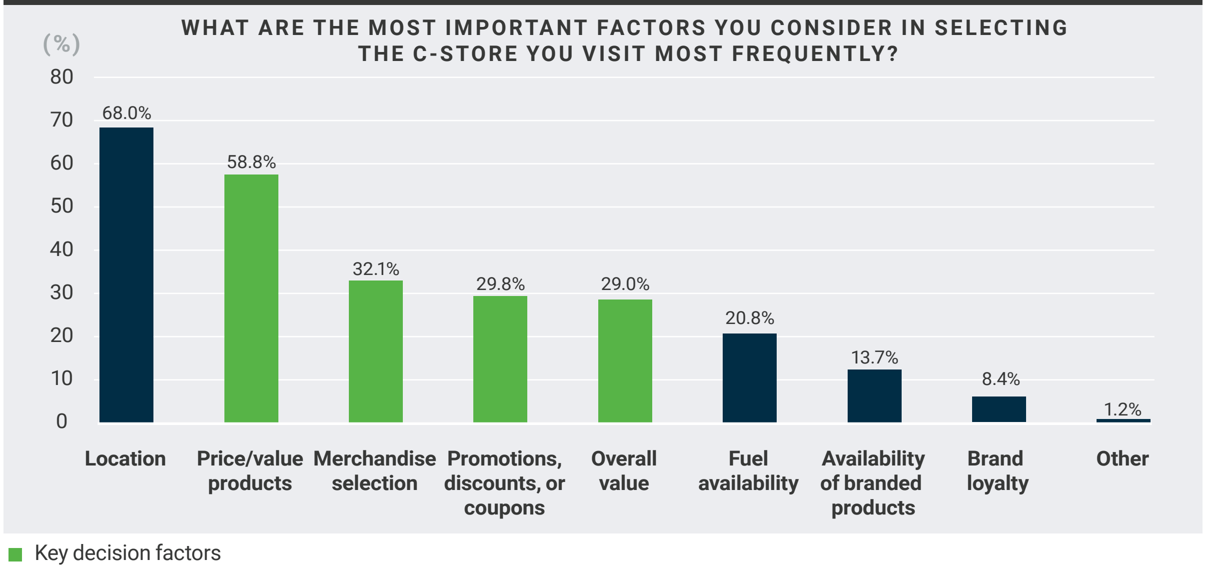
In this industry, fuel is clearly not a differentiator. Rather, it's an easily copied me-too strategy. The path to success, therefore, lies in foodservice excellence, including providing offerings that span dayparts.

Equally important, hungry consumers are apparently moving away from frequenting traditional restaurants. Since 2012, the frequency of buying food at c-stores and grocery stores has increased 10.5% and 9.5%, respectively, while flattening or even declining in restaurant segments.

What explains the change? Our study findings suggest that consumers view c-stores as better than restaurants in several respects. For instance, when asked how they'd compare c-stores against QSRs and fast casuals, many respondents gave c-stores higher

[3] "Convenience Store News Industry Report", June 2016.
[4] NACS State of the Industry Summit 2016, CSP.

FIGURE 1: In-store considerations powerfully influence consumers' convenience store choices



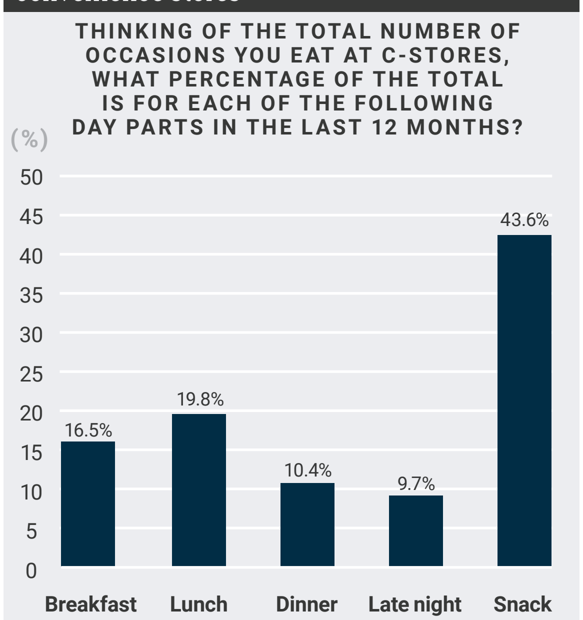
Source: AlixPartners

Note: Percentages may not sum to 100% as respondents were permitted to select multiple responses

ratings than the restaurants on speed of service as well as price.

In addition, we see a mismatch between consumers' perceptions of the things c-stores are best at with regard to food offerings—and where consumers are spending most of their money on food. Specifically, most of the consumers in our study said they stop at a convenience store to buy a snack when they're hungry (figure 2). Nevertheless, snacking still counts among the least important dayparts for consumers, besting only late-night eating among all the dayparts. That is, when consumers buy something to eat versus cooking at home, it's primarily dinner out, followed by lunch and then by breakfast. Our respondents don't expect to change this behavioral pattern all that much, other than perhaps lunching or dining out somewhat less frequently than they did last year and purchasing snacks slightly more often.

FIGURE 2: Consumers view snacking as the most common occasion for eating at convenience stores

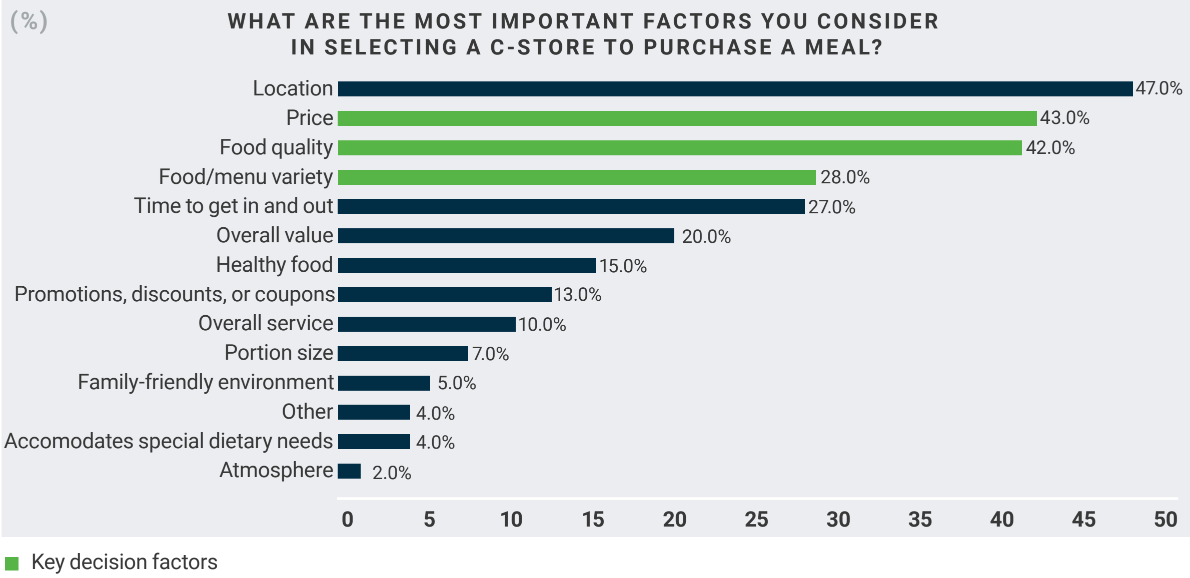


Source: AlixPartners

How can operators grow their foodservice sales—and positively influence consumers' perceptions of c-stores as great places to get breakfast, lunch, or dinner? They'll have to strengthen their foodservice offerings so they can better cater to those dayparts. To do so, operators should focus on food price, quality, and variety. As our survey findings indicate, those factors exert the biggest impacts on which c-stores consumers choose when seeking to buy food (figure 3). In fact, that finding was particularly pronounced among millennials and Generation X respondents.

Location is critical for chains seeking to aggressively open new stores. And price deserves special attention, given consumers' sharper focus on getting maximum value for money they spend on food. Across all foodservice channels and dayparts, our study findings suggest that consumers' average spend per meal will decrease by 5.5% in the next 12 months. Equally telling, 62% of our respondents said they planned to spend more time seeking discounts in 2016 and 2017 than they did in previous years.

FIGURE 3: Operators should continue developing foodservice programs focusing on price, quality, and variety



Source: AlixPartners

WINNING IN A MORE COMPLEX LANDSCAPE

To win in this business environment, c-stores will have to excel across multiple dimensions of their business. For instance, in addition to executing savvy foodservice strategies, they'll have to find new ways of enhancing the customer experience, building scale through organic growth or M&A, and launching comprehensive enterprise-improvement programs.

EXCELLING AT FOODSERVICE

In all foodservice segments, players are jockeying to win on-the-go and bargain-minded consumers. And the competition will only stiffen. For one thing, segment rivals are encroaching on c-stores' playing field. For example, some grocery chains and mass-merchant competitors are expanding their convenience and prepared-food offerings, and some are moving to a small-box format. Moreover, some dollar stores are giving grocery and foodservice products greater shares of shelf space in an attempt to steal share from c-stores.[5]

Even more alarming for c-store operators, new entrants are muscling their way into the competitive arena, armed with new business models. Amazon, for example, is looking at several retail models. One potential plan is to open brick-and-mortar c-stores backed by grocery home delivery and drive-through grocery pickup, whereby customers order food products online and have them delivered to their vehicles outside the store. E-commerce entrants are seeking to satisfy consumers' hunger for convenience by delivering straight to customers' doorsteps various kinds of meal kits complete with premeasured ingredients and recipes.

To outmaneuver rivals, some forward-thinking operators are venturing into alternative distribution channels. Sheetz, for example, recently announced a partnership with restaurant food delivery service OrderUp and has plans to pilot delivery at two stores for Sheetz's signature, made-to-order products.[6] 7-Eleven has partnered with Flirtey to test drone delivery of food products.[7] And QuikTrip opened a drive-through test location to evaluate the viability of a broader rollout.

IMPROVING THE CUSTOMER EXPERIENCE

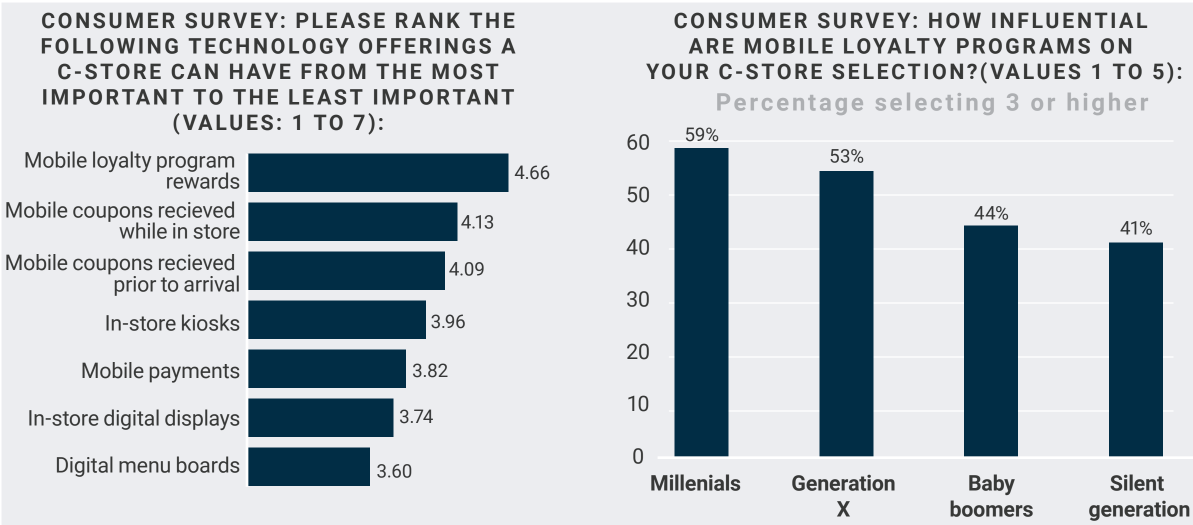
Offering unparalleled convenience and ease of delivery goes a long way toward enhancing customers' experiences with food products as well as in-store merchandise. Capitalizing on digital technologies such as mobile loyalty programs and mobile payments can further help operators attract and retain c-store customers.

Mobile loyalty programs

Our study participants named mobile loyalty programs the most important technology offerings that c-stores can provide (figure 4). When asked how influential loyalty programs are in their choices of stores to frequent, 59% of millennial respondents and 53% of Gen X respondents in our sample cited a rating of 3 or

[5] "Dollar General Unveils New 'DGX' Concept," *CSP Daily News*, November 9, 2016.
[6] "Sheetz, OrderUp Team Up On Delivery," *NACS Online*, October 21, 2016.
[7] 7-Eleven press release issued July 22, 2016.

FIGURE 4: Integrated mobile loyalty programs are a crucial c-store offering



Sources: AlixPartners; company websites and press releases

higher on a scale of 1 to 5, where 1 indicated loyalty programs are "not at all influential" and 5 indicated they're "very influential."

As fast casuals and QSRs have already discovered, those two age cohorts want "mobile everything." They also want unlimited options. When it comes to food, that means getting exactly what they want as well as when they want it, where they want it, and how they want it.

Clearly, mobile loyalty programs shape consumers' decisions about which c-stores to patronize. But such programs can also generate valuable consumer data to inform operators' strategic decision making. Take RaceTrac, which recently launched a 100% in-app loyalty program. The program comprises several tiers, and as customers move up the tiers, the list of items for which they can redeem rewards expands, as does the number of free items available to them. An enhanced store locator shows customers the locations of the nearest stores, as well as their prices and amenities. The app scored 250,000 downloads in just four weeks following its launch.[8]

Some of the smaller convenience store chains are partnering with GasBuddy—an app for finding cheap gas—in an effort to develop proprietary loyalty apps. Those apps might offer customers games and coupons while providing data that yields insights into customer buying patterns. Beacon technology is also available to push notifications to customers' mobile devices as they fuel up outside convenience stores.[9]

Mobile payments

Mobile payments using near-field communication have continued to gain traction. Many millennial and Gen X respondents in our study said they had used a mobile device to pay for products at a convenience store in the previous 12 months. Indeed, the total value of mobile payment transactions in the US is expected to reach $62.5 billion during 2017. At the same time, c-stores are also currently focusing on the costly effort of converting their systems for Europay, MasterCard, and Visa chip-card compliance.[10]

BUILDING SCALE

Consolidation may be the watchword for the North American c-store industry, which is highly fragmented and oversaturated. As much as 63% of industry locations are still considered independent despite years of aggressive M&A activity. But given rising healthcare and labor costs, it's difficult for independents to compete. Meanwhile, same-store sales growth and overall unit growth are lackluster.[11]

To drive growth and achieve cost efficiencies, operators must build scale. The continued favorability of capital markets and the low cost of capital may provide tailwinds for those efforts. Some operators have scaled by inking M&A deals, with an eye toward achieving revenue and cost synergies. Given the saturated domestic market, operators may also look to acquisitions in international markets for new growth opportunities. Asia Pacific—particularly Japan and

[8] "RaceTrac Press Release" dated April 1, 2016.
[9] "6 New C-Store Apps Hit Market," *CSP Daily News*, April 7, 2016.
[10] "Mobile Payments in the US Growing Fast, but Still Far From Mass Adoption," *eMarketer*, November 7, 2016.
[11] "Convenience Store News Industry Report", June 2016.

South Korea—represents particularly attractive markets for such deals. According to our global consumer survey, consumers in Japan eat meals at convenience stores 70.3 times a year representing 61% of total dining occasions. In South Korea the figures are 85.6 times a year and 50% of all dining occasions.[12]

SUPERCHARGING ENTERPRISE PERFORMANCE

To boost productivity and profitability, convenience store operators should consider executing comprehensive enterprise-improvement strategies aimed at offsetting increases in operating expenses and protecting profitability. They have several levers available for meeting these objectives.

For example, to control costs, enhancing labor productivity and garnering procurement synergies would likely prove vital, along with optimizing general and administrative expenses. Cost-management strategies should take into account not only direct-cost categories such as foodservice, merchandise, and fuel but also indirect categories such as facilities, construction and equipment, and consumables. As for stimulating fresh growth, c-stores can differentiate themselves through savvier marketing and more-effective product mixes such as expanding their foodservice offerings to increase in-store guest counts and average check size.

[12] AlixPartners 2016 global consumer survey.

SUMMING UP

C-stores have expanded their foodservice offerings with an eye toward boosting profitability. They've gone head-to-head with traditional restaurant players, triggering aggressive countermoves, even as new rivals enter the foodservice space. Trends in such areas as operating costs, fuel prices, and technology have further complicated c-stores' environment.

To succeed in this landscape, convenience stores will have to keep striving for next-generation improvements by enhancing their execution of foodservice programs, improving the customer experience, building scale, and boosting overall enterprise performance. Hard work? Yes. But if they hope to sustain and sharpen their competitive edge in the long run, c-stores can't afford to shy away from the effort. **A**

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