

A roadmap to success: Convenience stores on the fast track





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Introduction

As Americans have become more time-constrained, convenience stores (C-stores) have become a beacon in the retail sector. Part grocery store, part food-service outlet and frequently part gas station, C-stores — whether local mini-marts or interstate drive-throughs — offer something for everyone. And consumers are taking notice. An increasing number are turning to C-stores for their purchases, growing the C-store business to a projected \$52.8 billion in 2010¹. Moreover, the industry appears to be poised for continued growth. In the next five years, C-store revenues in the United States are projected to increase by an average annual rate of 3.9 percent and reach \$63.9 billion by 2015².

But the C-store business is complex, fast-moving and rife with challenges such as shifting consumer preferences; intensifying competition from mass retailers; volatile gas prices; multiple legal and regulatory compliance obligations; around-the-clock staffing and operations; and growing consolidation of stores and chains. Consumer demands and tastes change frequently, calling for innovation across an extensive range of products and services. New products and operational changes can be expensive to implement and — if new products, processes or systems are implemented poorly — can undermine the very profitability and growth that they are intended to deliver. C-stores must also be able to maintain strong communication between employees at the point of sale (POS) and upper management personnel, who must disseminate insights and implement best practices throughout the network of stores. It's a tall order, and not all C-stores fare equally well in the face of these challenges.

In the following sections, we draw upon our experience with C-stores to highlight a number of trends affecting the C-store industry as well as ideas for management personnel to consider as they evaluate what's right for their organization. We touch on both big-picture trends, such as M&A activities, and trends in technical areas that may get overlooked as executives grapple with strategic issues.



Mark Wuller
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¹ IBISWorld Industry Report, May 8, 2010. (This statistic excludes gas stations with convenience stores.)

² IBISWorld Industry Report, May 8, 2010. (This statistic excludes gas stations with convenience stores.)

Mapping the road to success

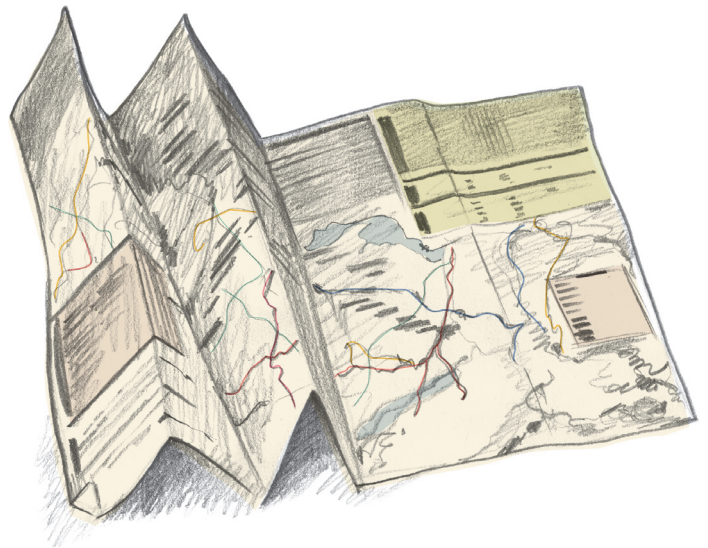
Since its inception in 1927, the C-store industry has succeeded based on its chameleon-like ability to adapt to changing customer preferences and an evolving business environment. Now more than ever, C-store executives recognize that both survival and prosperity depend on this ability. The challenge is to execute change quickly and consistently across large numbers — in many cases hundreds — of individual stores. This is no easy task, given that each store has a unique marketplace and that, particularly with franchises, each store is a business in its own right. Executing change successfully requires strong discipline and close attention to detail. It also requires a roadmap that gives directions for achieving consistency across all stores while catering to consumer preferences specific to local markets.

This roadmap is a formalized set of guidelines and best practices delineating how to run a C-store at the level of the individual store unit. Effectively a how-to guide, the roadmap serves as a means of standardizing operations for an organization comprising multiple geographically dispersed units that deliver essentially the same product or service nationwide — while meeting changing customer expectations and addressing issues within local markets.

An effective roadmap will help the organization achieve operational efficiencies and consistency of service, from store formats to merchandising to regulatory compliance and training of employees. But the roadmap should be flexible enough to accommodate customization at the local level. A one-size-fits-all approach can lead to underperformance if individual stores are not able to adapt their product mix, marketing programs or employment strategies to reflect the expectations and idiosyncrasies of their local markets.

An operational roadmap can help C-store businesses:

- delineate responsibilities across headquarters, central functions and individual stores;
- create and drive operational efficiency;
- benchmark and implement best practices across the chain;
- evaluate and respond to operational risks at the store level;
- perform due diligence for acquisitions of new stores;
- quickly integrate newly built or acquired stores;
- comply with laws and regulations; and
- execute strategic and operational changes quickly and consistently across the organization.



Fresh ideas brewing

As budget-conscious consumers have scaled back on restaurant dining, the C-store industry has adapted to the demand for fast, affordable food by increasingly stocking private-label and fresh foods as well as premium coffees. In fact, C-stores are seeing a growing percentage of their revenue generated from the sale of fresh food, including food prepared on-site; packaged sandwiches; and hot, cold or frozen dispensed beverages. In 2009, approximately 9.2 percent of sales were derived from food service, an increase from only 5.9 percent in 2005³. This trend reflects evolving consumer tastes and preferences, as well as a changing competitive landscape exemplified by Starbucks introducing more food options and fast-food chains offering salads and other healthy menu options.



“Ultimately, convenience stores — as their name suggests — are about convenience. If they can offer a broad selection of food options, they can up-sell the customer or at least provide the opportunity for the customer to get the food they want without having to visit a quick-service restaurant (QSR). It’s all about getting the customer’s attention and persuading them to spend their allocated dollars with you rather than with someone else,” says Dexter Manning, Audit partner and National Food and Beverage Practice Leader.

In order to cash in on this trend, C-stores have increasingly turned to co-branding with QSRs such as McDonald’s, Taco Bell or Subway, as Manning explains. Pilot Travel Centers, a large C-store chain, is a major franchisee of both Wendy’s and Subway in the United States. “Every C-store is looking to maximize its sales per square foot, and adding another brand concept is a great way to bring in new sales without cannibalizing existing ones,” notes Manning.

However, making the shift to providing food service affects the C-store business from top to bottom. Before they begin, C-stores need to make a careful assessment of how adding these offerings fits with the demographic profile of their current customer base. Are their customers looking for these kinds of products? Will introducing these options attract a new customer demographic to C-stores — for example, will more women be drawn to C-stores because of healthier fresh-food options?

Chains will need to evaluate whether there is a business case for introducing fresh foods or premium coffees within all — or just a small subset — of their stores. If it makes sense only in certain stores, the chain needs to determine its willingness to live with that level of variation. Leadership will also need to develop, implement and update store procedures to minimize the risks and manage the costs of establishing and maintaining food service.

³ IBISWorld industry report, Jan. 29, 2010.

Assuming a chain decides to move ahead with offering these new products, the hard work of implementing them begins. This will require changes in many areas:

- Alteration of store layout, including the addition of food and beverage preparation areas
- Establishment of new procurement processes regarding increased numbers of store deliveries
- Compliance with relevant health and safety rules and regulations
- Training or hiring of new employees to provide new product offerings
- Updating of POS systems
- Execution of marketing and promotional campaigns

C-stores also need to consider the potential downsides and liabilities. “Expanding into food service can expose an organization to significant new costs and risks,” cautions Audit Partner Doug Townsden. “A health and safety issue arising from the sale of food — for example, freshly prepared sandwiches — could cause major commercial and reputational damage going far beyond the individual product range or the individual store where the incident occurred.”



Certainly, as our food sources have become more global, the number of food contamination cases has increased, reaching 76 million cases of food-borne illnesses reported each year in the United States. Under pending federal regulations, food processors and distributors may soon have to track more food sourcing information than ever before. Consequently, it is important to know the reputation of the supplier, the source of its ingredients, and its processes for managing food contamination risks. One high-profile case of a food-borne illness contracted from food sold at one C-store could sully the reputation of the whole chain, causing irreparable damage to the brand.

Understanding — and managing — these risks is essential not only for management, but also for the board. For this reason, management may want to emulate one major C-store chain that has a former CEO of a fast-food chain on its board and audit committee. By tapping into the expertise of such seasoned professionals, C-store businesses will be better-positioned to manage the incorporation of food-service offerings and any accompanying risks.

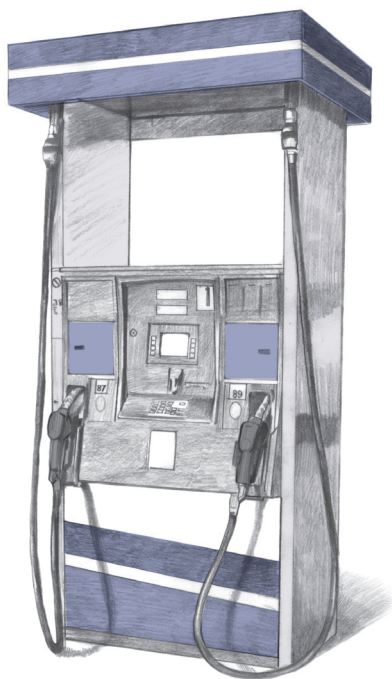
Food-service considerations

- Have we evaluated consumer demand and preferences for these products in each of our target markets? Is there a potential to attract new customers?
- Are we up to speed on the relevant health and safety issues associated with offering perishable products? How confident are we in our suppliers' risk management related to food safety?
- Do we have the product and customer service expertise to manage these offerings effectively?
- What new staff recruitment and training will we need to provide?
- Are our procurement, supply chain, and in-store receiving and inventory processes capable of handling these new offerings? If not, what changes will be required?
- How will we measure success and respond if these offerings underperform?
- How will we share insights and expertise across the C-store chain to enhance these offerings?

Fueling profits: Aligning with suppliers

It is widely acknowledged that while gasoline sales represent the lion's share of revenues for C-stores with gas pumps, they offer much smaller margins than other in-store products and services. After credit card fees are subtracted, C-stores' profit margins for gas are razor-thin. Fluctuating wholesale prices for gas, which are affected by volatile crude oil prices, can also cut sharply into C-stores' profits, since C-stores are limited by competition and customer price sensitivity in their ability to raise prices at the pump to cover these higher costs. Given these narrow margins, as well as the volatility of wholesale gas prices and the cutthroat competition in retail gas pricing, more and more C-stores are re-evaluating their risk management policies.

There are a number of considerations for C-store owners, depending on their business model and risk management strategy. For example, some chains buy gasoline in bulk, hold it at terminals and deliver it as needed to the pump. These chains need to consider a hedging strategy to protect the value of the inventory bulk purchases against price swings.



If C-stores buy inventory as it is delivered to the C-store location, the best strategy may be to forge strong partnerships with fuel suppliers in order to ensure a stable supply of gasoline and obtain lower wholesale prices. However, C-stores should keep in mind that if supply agreements fluctuate with the market, there may not be a need to hedge for price movement. If purchases are made at a fixed price, those C-store chains may want to explore a hedging strategy to protect against price swings.

C-store owners should keep in mind that exclusive supply agreements limit flexibility and, as such, they can impact the value of a business.

C-store owners should also be prepared for “price stickiness” at the pump. When gasoline prices are increasing, margins will decline; when gasoline prices are dropping margins will increase. While it is not advisable for C-store operators to try to predict the direction that the cost of a barrel of oil will move, they need to understand the dynamics of what these price changes will do to their margins over the short term.

“Achieving the lowest wholesale cost is critical for C-stores,” asserts Audit Senior Manager Barry Cooper, “especially given the growing trend for grocery stores, mass merchandisers and warehouse clubs to add gas pumps to their locations. In the long term, the C-stores that have managed this aspect of their business most effectively are those that will maximize profits.”

Building the best margins and risk management policies to protect against price volatility and to forge beneficial relationships can be tricky. Therefore, getting the right legal and financial advice is essential.

Fuel pricing and volatility considerations

- Are we monitoring retail and wholesale gas pricing forecasts?
- Are we tapping into appropriate expertise when employing hedges to help manage gas price risks?
- Are we monitoring the performance of long-term supply contracts? Have these contracts served us well during periods of high volatility?
- Do we need to reassess our strategies for managing gas supply and pricing?

Safeguarding profits from shrinkage and fraud

C-stores have always been susceptible to theft and fraud because of their high-traffic locations, high-volume and low-value products, and relatively low-wage employees. Minimizing shoplifting is an essential focus, especially at stores that stay open around the clock.

“There is a growing awareness that store design and physical security — aided by devices such as security cameras — are fundamental to minimizing the risk of loss from theft,” says Mark Sullivan, a principal in the Forensics, Litigation and Investigation Services practice. “So too are employee training and awareness programs, which can help optimize loss prevention and lower the rate of inventory shrinkage.”

Sullivan emphasizes the need for C-stores to give executives and store management real-time access to shrinkage data. Detailed analysis of transaction data can reveal not only shrinkage, but other forms of loss, such as deliveries of goods that fall short of the quantities requested. “If management can see where shrinkage is happening, they can identify opportunities to reduce it through changes in store layout or product placement. Managers could also be provided with meaningful incentives to help reduce shrinkage,” he suggests.

Although employees can help reduce shrinkage, they can also help cause it. For example, drive-offs or gasoline theft can be costly prospects. However, while drive-offs are certainly a real concern, some of these incidents may in fact be employee theft, as Sullivan explains. Employees may be pocketing cash payments for gas sales from customers and recording those payments as drive-offs.

A simple way to identify such activity is to look for drive-off payments in round dollar amounts such as \$10 or \$20. Such amounts are consistent with a cash sale, but inconsistent with the uneven sales amounts commonly associated with drive-offs, in which customers typically stop pumping when they see that the salesclerk’s attention has been diverted. A review of these anomalies may reveal a pattern attributable to an individual employee.

Having a large number of similar stores works to the organization’s advantage in identifying instances of potential fraud. Corporate managers can compare store performance, revealing variances that may be indicators of operating weaknesses or fraud at specific stores. Other fraud indicators can include questionable credit card returns or missing or delayed bank deposits of store cash receipts.

Hiring policies are also important, notes Cooper. “By adopting hiring policies that include background and credit checks, businesses can minimize their exposure to the types of employees that are most likely to commit fraud. It is more cost-effective to prevent the wrong people from joining the entity than it is to control the risk of fraud after they have been hired,” he says.

Paying close attention to issues of theft and shrinkage — and addressing concerns promptly when they arise — is vital. When small, isolated incidents are either ignored or not dealt with quickly, significant shrinkage and related issues can result. Failing to address employee fraud can foster a belief among employees that they can get away with such behaviors — and hence can encourage additional incidents.

Shrinkage and fraud considerations

- How can we effectively monitor shrinkage at the store level and determine the underlying causes?
- What preventive measures can we take to minimize fraud risks?
- How do we enforce policies regarding employee fraud in such a way that we prevent future occurrences?
- Do we provide proper incentives so that our employees will protect our assets? Do we give employees the tools necessary to do so?
- Are we using data analytics effectively as a means of detecting anomalies that suggest potential fraud? For instance, if a particular employee has a much higher percentage of voided transactions than all others in his or her peer group, do we initiate an investigation?
- Do we have a robust training and awareness program that drives our loss prevention strategy?
- Do our hiring processes include mandatory background and credit checks?

Employee engagement

As C-store businesses have upgraded their stores and product offerings, customer-facing employees have come to play an increasingly influential role in their stores' growth and performance. Every C-store employee must be able to greet customers with a smile, serve them quickly, and handle their problems discreetly and efficiently. Employees must also be familiar with a growing array of technology applications that are integral to both the customer experience and management's ability to monitor a wide variety of operational activities. A well-trained, motivated, and engaged workforce delivers real performance benefits, as many chains have come to realize.

These benefits may justify a level of compensation that defies the near-minimum-wage amount generally paid to employees. Some privately held chains such as QuikTrip offer bonus plans and employee ownership — incentives to perform up to and beyond expectations. Further, QuikTrip pays well above minimum wage. A starting full-time employee at a QuikTrip store can expect to earn roughly \$40,000 per year in wages and incentive bonuses.

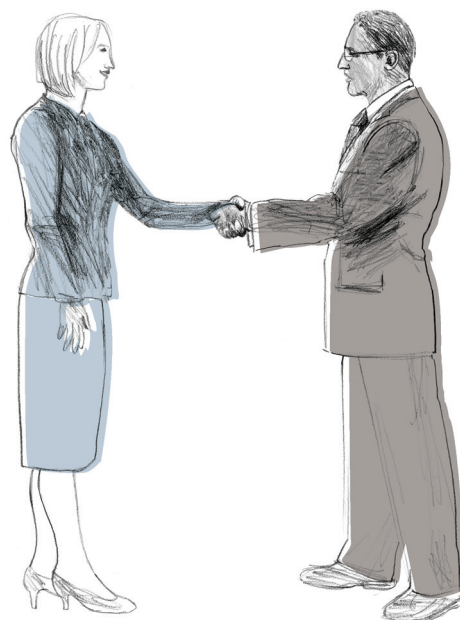
Chet Cadieux, CEO of QuikTrip, explains why: "Our store employees are our marketing plan. They conduct almost two million transactions every day. That represents two million opportunities for them to get it right or wrong. If they get it wrong, the negative impressions that they would create with our customers would quickly overwhelm any advertising that we might do."

The benefits of such programs are manifest not just in employees' heightened skills and motivation, but also in the increased retention of experienced employees. Retaining experienced employees helps the organization respond quickly to marketplace changes, since these valuable staff members have the experience to know what is and isn't working. Increased retention also reduces the high recruiting and training costs associated with rapid workforce turnover.

Help from Uncle Sam

C-stores may be able to capitalize on recently enacted federal tax incentives for hiring new workers who have not been employed for more than 40 hours in the 60-day period before hiring. Because the incentives are available for replacing a previous employee who leaves voluntarily, they have the potential to provide a welcome boost for employers such as C-stores that typically experience regular employee turnover. The Hiring Incentives to Restore Employment (HIRE) Act includes two incentives: An exemption from the 6.2 percent employer share of Social Security taxes on qualified employee wages paid from March 19 through the end of 2010; and a \$1,000 tax credit for each qualified individual who is retained for 52 consecutive weeks.

"C-stores considering this incentive should evaluate whether it is more or less attractive than the Work Opportunity Tax Credit, or WOTC, since a company generally cannot claim the benefits of both," explains Corporate Tax Partner Rob Byrd. The WOTC is a federal tax credit for private sector businesses that hire individuals from 12 target groups whose members have consistently faced significant barriers to employment. The credit is worth up to \$2,400 for most adult hires and \$4,800 for disabled veterans.



Another piece of the puzzle is offering employees opportunities to advance their careers or to enhance their skills. If C-stores do not offer attractive career development opportunities, they risk losing those skilled employees, thus returning the business to the costly and disruptive cycle of recruiting and training. For this reason, C-store chains need to determine the extent to which they can offer attractive career development paths. They also need to establish appropriate performance criteria and evaluation processes for managing career development.

In areas of the business that have less potential for career development, C-stores must examine ways to make potentially complex activities less difficult. For example, deploying POS systems with touch-screen interfaces and images of products can be an effective way to simplify and accelerate sales transaction processing. Matt Podowitz, Business Advisory Services executive director, offers an illustration: When one C-store computerized its POS system, order accuracy fell; because of high turnover, the cost of training new employees became increasingly prohibitive. But when the company replaced dozens of buttons on the POS terminal with photos of the items and graphical representations of size, the system required very little sophistication or training to master, and the store ultimately realized the benefits of automation.

“In the C-store industry, technology can do great things to improve efficiency and increase accuracy, but sophisticated technology can very quickly exceed the capabilities of users with less education and experience,” says Podowitz. “To realize the potential value, it is critical to factor the needs and capabilities of the user into decisions about implementing new technology.”

Healthy employees

As C-stores consider their options for updating their employee compensation strategies and programs, they will need to evaluate their obligations under the new health care reform laws. Under the Patient Protection and Affordable Care Act, businesses with 50 or more employees must offer adequate health coverage to employees by 2014 or face penalties.

This legislation will have widespread implications for the C-store sector. Franchise owners will likely be affected if they own multiple stores or businesses. Planning ahead for this reality is critical.

“C-store chains should weigh their options for setting up captive plans and opening them to franchisees and independent C-stores,” says Eddie Adkins, Washington National Tax Office partner. “Providing health coverage in bulk to more employees could result in significant cost savings.”

Adkins emphasizes that C-stores must understand and evaluate the compliance obligations and commercial risks associated with administering health plans. Now, he stresses, is the time for C-stores to begin determining the best way forward.

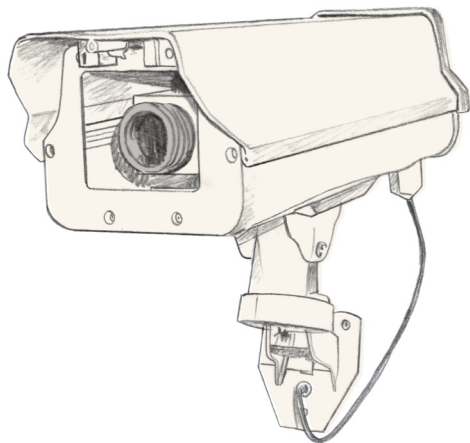
Employee engagement considerations

- Have we explored enhancing compensation in order to attract and retain better-qualified staff?
- How do we motivate and train staff members to increase productivity and lower shrinkage?
- Do we offer career opportunities that will allow us to retain higher numbers of skilled employees?
- Can we link employee compensation to store performance?
- Can we provide store managers with information and technological tools to measure and understand what drives performance at their stores?
- How far are we willing to go in empowering employees to make decisions at the local level without negatively affecting the policies and financial needs of the overall organization?
- How do we identify and share what's working — and what isn't — across stores?

Achieving compliance

State and local taxes, environmental obligations related to fuel tanks, and laws regarding the sale of cigarettes and alcohol to underage customers are just a few of the myriad compliance issues facing C-stores. Revenue-hungry state and local governments have been devising new ways to generate tax revenues, as well as increasing their efforts to collect existing taxes.

Complying with federal and state laws and regulations is nothing new, but successful C-stores have come to realize that they need a clear structure for managing these multiple obligations. Such a structure should go beyond monitoring and evaluating all relevant state and local tax pronouncements. A C-store needs to have processes and operating systems that enable new or changed rules to be reflected quickly and accurately in the company's transaction processing and financial reporting systems. Having a compliance structure in place is particularly important because different jurisdictions frequently apply very different tax rules and regulations to identical products and services.



The growing operational role of the tax department

In recent years, tax departments have gained increasing visibility within corporate America for a number of reasons: The Sarbanes-Oxley (SOX) Section 404 compliance process has highlighted the complex processes that tax departments manage, while FIN 48 has brought to light the various and often volatile risks handled by tax departments. Moreover, there is growing recognition that tax efficiency is directly related to competitiveness.

However, explains State and Local Tax Partner Giles Sutton, "often there is not a great deal of transparency on financial statements as to what drives state and local tax expense differences between one competitor and another. Further, the lack of symmetry in the amount of state and local taxes paid by different C-store chains results largely from differences in geographical footprints and operating models."

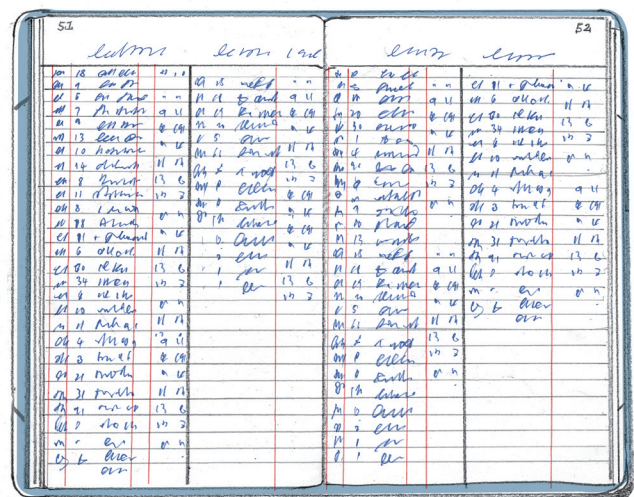
Sutton asserts that it is essential to pay close attention to state and local taxation and to build relationships with professional advisers who are committed to keeping you informed of changes, trends and best practices in the field. "Because of the volatility and velocity of change in the state and local tax area, the most important realization for C-level executives as well as for tax professionals who are directly, or indirectly, responsible for managing the tax function is that you don't know what you don't know," says Sutton. Sutton also notes that there are some recommended best practices when trying to achieve competitive tax efficiency:

- Ascertain that documentation of the tax processes supporting the state and local tax function meets SOX standards. This area of the SOX compliance process is often overlooked, and inattention to it can lead to unpleasant surprises.
- Review sales tax systems, processes and reporting at least once every two years in order to ensure that compliance requirements are met and resources within the sales tax function are deployed efficiently.
- Be sure to make state and local taxes a focus of due diligence pertaining to any acquisition or expansion.
- Conduct periodic compliance and process reviews of the fuel tax collection and remittance function.
- Request the involvement of the state and local tax function in the tax provision review process to avert potentially costly consequences.

“C-store chains are collectors and remitters of a variety of taxes including sales, fuel excise, as well as payers of income and franchise taxes. These all require detailed attention and coordination to ensure C-stores are in compliance,” explains State and Local Tax Partner Giles Sutton. “This also can pose IT systems challenges, in that the sales tax system, in particular, needs to speak to the POS system.”

“State and local income and gross receipts tax laws are another area that can create compliance challenges for C-stores,” notes Sutton. “Given the geographic spread of C-stores chains, they are inherently exposed to a number of state and local tax regimes and need to keep track of multijurisdictional issues. Moreover, these rules change frequently. But the real challenge is that many C-store chains tend to have lean back-office functions that may lack the skills and resources to track these shifting compliance obligations effectively.”

Failing to charge and collect and remit the correct taxes on certain goods and services with high transaction volumes can quickly turn into a major headache and an expensive financial mistake, particularly when penalties and interest are added.



Compliance considerations

- Who is responsible for tracking and identifying relevant legal and regulatory developments?
- How do we monitor compliance with new and changed tax laws?
- How do we communicate and implement changes to our policies and procedures in response to changing tax laws?
- What are our procedures for updating systems and processes to ensure that tax is correctly calculated and recorded?
- How do we identify changes in state and local tax obligations?
- How do we determine new state and local tax obligations when entering new markets?
- Are we prepared for state and local tax issues associated with expansion?
- Have we done due diligence on latent tax exposures related to potential acquisitions?
- Have we explored credits or negotiated incentives related to greenfield expansion?

Growth and consolidation

While most C-stores have felt the effects of the recession to some extent, the industry — unlike many others — is not scaling back. In fact, the C-store sector has continued to see chains acquiring independent stores and smaller chains, as well as adjusting and realigning their store portfolios. The number of M&A transactions in the C-store sector has continued to increase, with 2009 showing more transactions than the prior peak in 2007. In stark contrast, 2009 was far from a banner year for U.S. M&A activity as a whole. Most analysts believe that the C-store sector will continue to consolidate in the coming months.

Most C-store buyers over the past 18 months have been strategic buyers, with operators of existing C-stores comprising more than one-half of buyers. Petroleum distributors and real estate companies have also been actively acquiring C-stores.

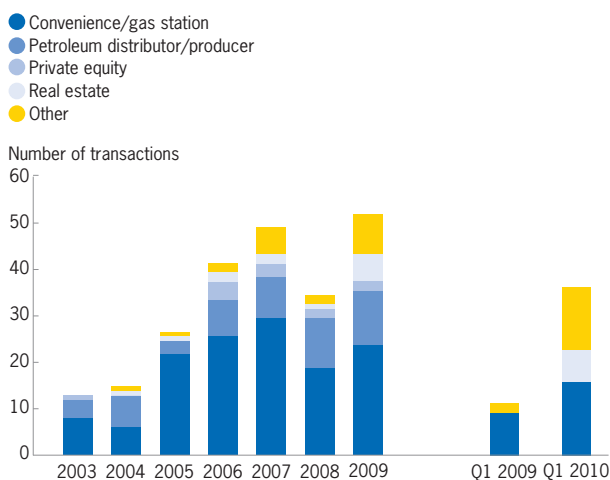
For instance, C-store chain Casey's General Stores (Casey's) received a hostile takeover bid from Alimentation Couche-Tard (Couche-Tard). With public companies in the sector trading at median enterprise multiples of around 7x corporate-level EBITDA (down from around 9x in 2007), Casey's dismissed the offer as opportunistic. Couche-Tard and Casey's, despite their minimal financial leverage, have continued to show strong earnings growth, while other public sector companies have struggled under heavy debt loads.

Grant Thornton represents unsecured creditors in Flying J bankruptcy

Citing falling oil prices and the freeze in credit markets, Flying J, an \$18 billion operator of travel plazas that include C-stores, restaurants, refueling operations and other services for the trucking industry, filed for Chapter 11 bankruptcy protection in December 2008. Grant Thornton represents the unsecured creditors in the bankruptcy proceedings. During this process, Grant Thornton has overseen transactions related to refineries, pipelines, an exploration and production company, and the travel plaza business.

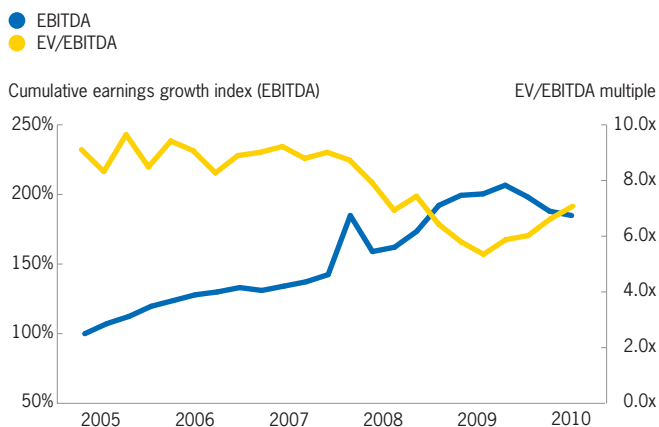
Through its use of the bankruptcy process, Flying J has been able to stabilize its business, continue to employ more than 11,000 workers, and generate the positive cash flow that made the restructuring possible. As a result, it is anticipated that all creditors will be paid in full and that more than \$820 million will be returned to the company's equity holders. Flying J is also close to completing the merger of its network of 240 travel centers and fuel stops with those of competitor Pilot Travel Centers.

C-store transactions - number by year and buyer type



Sources: GTCF research; certain information provided by Capital IQ

C-store average earnings growth and EV/EBITDA multiples of public companies



Cumulative earnings growth and EV/EBITDA multiples comprise average figures for Susser Holdings, Pantry Inc., Alimentation Couche-Tard Inc., and Casey's General Stores Inc.

Sources: GTCF research; certain information provided by Capital IQ

“In recent months, much of the acquisition activity has been driven by buyers looking at troubled stores or stores exiting from bankruptcy. In many cases, consolidation makes sense, particularly if chains are set up with the appropriate infrastructure and methodology for assimilating acquisitions,” explains Cooper. “C-stores must be able to integrate functions such as purchasing, marketing, and accounting and finance. Simply put, those companies that can integrate quickly can operate effectively.”

With any new store or acquisition, it is important to develop a clear decision-making framework. This should include a checklist for evaluating whether a proposed new location has the market and operational characteristics that will fit with the chain’s strategies and operating practices. It also helps to determine which aspects of the acquired stores, such as store interiors or employment practices, will require changes. Evaluating these factors will give an indication of total acquisition costs and integration timing. It’s also essential to perform appropriate due diligence in order to identify significant risks, such as environmental, compliance, IT and accounting risks.

Other essential considerations are the target company’s purchasing arrangements — such as gross pricing, discounts and rebates — regarding fuel and merchandise. It is critical for the acquirer to understand and assess these arrangements and how they may affect valuation. Purchasing arrangements may lead to potential advantages for the acquirer such as economies of scale, which may not be fully reflected in the purchase price.

In order to facilitate integration and help new stores deliver results quickly, many chains move experienced employees from existing stores to the new locations. This has the added benefit of offering career development opportunities for these employees.

Some of the most successful C-store chains have turned the process of investing in new or acquired stores into a core competency that encompasses not only selecting the right stores, but also aligning them with the organization’s strategy quickly and cost-effectively.

Environmental issues and asset retirement obligations

When C-stores are looking at acquisition targets, environmental issues and asset retirement obligations (AROs) are sometimes afterthoughts. But aside from revenues and margins, environmental issues may be the most important thing to understand when performing acquisition-related due diligence. Regardless of whether the transaction is an acquisition of stock or assets, the acquirer is usually saddled with the costs of environmental cleanup. Uncovering these issues after the acquisition could turn what was an attractive acquisition into a costly misstep. Therefore, it is essential to understand not only the outstanding environmental issues, but also the potential recoveries under state programs and insurance policies. AROs should reflect long-range assumptions about the projected life cycle of gas station outlets and their fuel tanks; these assumptions may have changed in light of the recent economic turmoil. AROs can affect business earnings and valuation — crucial considerations given the expectation of increased consolidation across the C-store sector.

Lease-versus-buy decisions can also make a difference. If a C-store owns its real estate, it manages the AROs. But if the property is leased, the AROs associated with it are sometimes left with the lessor, depending on the provisions of the lease.

Acquisition considerations

- What financial and economic considerations need to be factored into our acquisition decisions?
- When we assess the value of stores or chains as potential targets, are we rigorously reviewing their environmental obligations?
- Are we consistently evaluating our store portfolio with regard to potential acquisitions and divestitures?
- Are we plugged into opportunities for and ways to communicate about potential acquisitions?
- Do we have sufficient capital to finance our plans for an acquisition or a divestiture?

Getting real about real estate

C-store chains have historically pursued a variety of strategies with respect to lease-versus-buy real estate decisions. Many factors — such as site availability, lease provisions, environmental obligations and the company's overall financing situation — typically play into these decisions. However, the economic crisis and turmoil in commercial real estate markets have led many C-stores to reconsider their real estate strategies. The reduced price points for properties and the willingness of lessors to make deals may be fundamentally changing the calculus of real estate decision-making.

Many C-stores are finding significant opportunities to convert leased sites to owned sites, or vice versa, and to take advantage of new and better-located store sites. The recession has made many desirable retail spaces available, often at much lower prices than they would have garnered in the recent past.

“Weighing the factors involved in leasing, buying or building stores feeds directly into projected profitability for store locations,” says Cooper. “Long-term leasing is not always the best path, because leases often include environmental obligations and AROs, which can impose financial requirements beyond the lease payments.”

Regardless of whether C-store chains lease or refurbish stores — or build new ones — one thing is certain: Controlling costs is vital. Development and refit costs can easily spiral out of control, and weak contracts can be abused, particularly with respect to labor costs.

“In order to protect your construction project, it's very important to negotiate a firm-fixed-price construction contract,” says Jim Schmid, Economic Advisory Services partner. “If a cost-based contract — for example, a guaranteed-maximum-price, time-and-materials, cost-plus, fast-track, or hybrid contract — is used instead of a fixed-price contract, it is a recommended practice to have the internal audit or accounting department participate in the contract development process to ensure that the contract has the necessary tools to facilitate financial oversight of the project.”

This contract should clearly define a number of items:

- The allowable cost of work
- The pay application process and required proof of cost
- The change-order process and allowable markups
- What is acceptable to charge to contingency
- The bidding process and how contractors and subcontractors are selected
- The rights to audit

Careful attention to costs is equally important when it comes to store refits that are not expansions. Refreshing stores may qualify the company for tax relief. “If a planned store redesign won't change the store's physical structure but instead involves painting and other interior changes, costs that are capitalized from an accounting perspective can be treated as current expenses for purposes of income tax filings,” explains Byrd. “From a tax perspective, this accelerates the tax deduction and delivers cash flow advantages.”



Lease accounting

In a discussion paper titled *Leases: Preliminary Views*, the Financial Accounting Standards Board has agreed to eliminate off-balance sheet accounting for operating leases. If that agreement is finalized, all current and future leases will be recorded on the balance sheet as assets and liabilities. This has major implications for C-stores that lease property.

The following table lists some of the ways that a change in lease accounting could affect business practices and suggests some stress tests that can be used today to determine whether an arrangement will meet a business's needs in the future. The table includes some items to consider when evaluating current and future leasing contracts.

| Agreement | Implications | Stress test |
|-------------------------------|--|---|
| Loan agreements | Lease obligations coming onto the balance sheet two or three years out could trip loan covenants. | Test proposed covenants against a pro forma balance sheet that includes current leases, likely lease renewals and likely additional leases. |
| New or extended leases | Changes could affect the outcome of current lease-versus-buy evaluations and the tailoring of terms to achieve operating lease classification. | Revise lease-versus-buy tests to incorporate the possibility of new accounting for leases. Calculate costs/benefits assuming leases will be on the balance sheet. |
| Sale and leaseback | Changes could affect the desirability of terms tailored to achieve sales recognition or operating lease classification. | Evaluate the decision with and without sales recognition and with and without operating lease classification. |
| Other agreements | Changes may alter the impact of provisions based on measures such as EBITDA. | Evaluate the impact on covenants or agreements that refer to EBITDA or similar measures by recasting rent expense as interest and depreciation. |

Real estate considerations

- How have the economic crisis and turmoil in commercial real estate affected our chain's portfolio?
 - Have they changed our lease-versus-buy outlook?
 - Have they changed the attractiveness of certain store locations such that we should be considering disposals?
 - Are previously rejected locations now more compelling?
- Are our internal audit or accounting professionals adequately involved in contract development and financial oversight of construction projects?

Conclusion

As a one-stop shop for time-constrained, busy customers, C-stores must stock the right mix of a limited number of products and continually evaluate and add new products and services, whether fresh foods, lottery tickets or premium coffees. Management must constantly be on the lookout for evidence that the market is changing and evaluate the need to adjust strategy or business focus in all aspects of the business. Management must also be alert to declining operational performance and seek ways to improve processes across the organization's network.

Based on our work with many C-store chains, we have learned what separates the thriving, growing operations on the fast track from those that are sputtering to a halt. Ultimately, the goal should be to identify and detail the key risks stores or chains face, and draw upon relevant skills and expertise to manage these risks effectively. Management needs to communicate effectively with its store personnel and arrive at informed answers to a number of critical questions:

- Are new product and service introductions exceeding expectations or failing to get traction in the market?
- Is sales performance in particular product or service lines declining?
- Is sales performance in particular stores declining?
- How are retail and wholesale gas pricing affecting our gas sales and margins?
- Are we succeeding in reducing shrinkage levels across our stores?
- Are we up to speed and in compliance with new legal and regulatory requirements?
- How is employee retention affecting store performance?
- How effectively have we selected and aligned our stores with the organization's business strategy?
- What are the benefits and costs associated with buying versus leasing store locations?

"In this fast-moving and complex business, it is altogether too easy to become distracted and make a costly wrong turn. While management is rolling out new products and services, is its attention being diverted from essential operating processes and controls?" asks Townsdin. "If C-store leaders are not applying appropriate discipline and strong internal controls, they may be putting their whole enterprise at risk." But by exercising that discipline, C-stores can journey confidently on the road to success.

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