AN ANALYSIS OF 24-SEVEN’S RETAIL STRATEGY FOR NORTH AMERICA

by

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ABSTRACT

24-Seven is the largest convenience store operator in North America. This analysis will determine if the current strategy is the best choice for the company. Key characteristics of the current strategy include a decentralized structure, highly autonomous store operators, and a focus on fresh food. A review of the strategy reveals a number of weaknesses. As a result, the company is struggling to increase profitability and maximize operational efficiency.

The convenience store industry is very competitive. Low profitability and intense rivalry are characteristic of the industry. A low operating cost strategy is recommended for 24-Seven. The conversion of corporate stores to franchise operations is a key element of this strategic alternative. Increased centralization and tighter operational controls are also essential. Successful implementation will require a variety of strategic adjustments. However, this strategy will enable the company to leverage its large network of stores to become more profitable and efficient.

Key words: convenience store; strategy; 24-Seven; operating cost
DEDICATION

I would like to dedicate this effort to my wife Leanne. Her support and patience during my time in the program has helped make this possible.
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1 INTRODUCTION

The purpose of this paper is to determine if the current strategy for 24-Seven Inc. is appropriate for the North American marketplace. An overview of the company and a review of the current strategy will be provided. The external environment will be analyzed to determine the nature of the North American Convenience store industry. Potential opportunities and threats will be identified as part of the external analysis. An appropriate strategic alternative for 24-Seven will be identified and evaluated. An internal analysis of the company will be performed to insure that the strategies and tactics ultimately recommended for 24-Seven are obtainable considering the current organizational capabilities, resources, and management preferences.

This analysis will use information for the North American industry as a whole. Company information is consolidated and includes operational results from Canada and the United States. It should be noted that the data is heavily influenced by the large size of the United States market. The strategic recommendations are intended to apply to operations in both countries. The author is confident that the analysis and recommendations are appropriate for operations in both countries. Additional research is possible to determine if consumer preferences, regulations, and competitive conditions require specific adjustments for Canadian operations. This additional analysis is outside the scope of this paper.

1.1 Company Overview

24-Seven Inc. is the largest convenience store operator in North America, ranking first in total store count and second in total revenue\(^1\). The company operates or franchises a network of

5,806 stores across the United States and Canada. A total of 5,318 24-Seven stores are located in the United States and 488 are located in Canada.

A wide variety of products and services are sold by 24-Seven. Two broad categories that encompass the entire assortment are merchandise sales and gasoline sales. All stores sell merchandise and approximately 40 percent of stores have the facilities to sell gasoline. Merchandise includes a broad assortment of packaged foods, beverages, fresh foods, and non-food products. Total company sales consisted of $7.9 billion in merchandise sales and $4.2 billion in gasoline sales in 2004.

1.2 Company History

24-Seven was a pioneer of the convenience store industry. The company has had a long and interesting history and it continues to evolve to this day. Knowing the history of the company helps in understanding how and why the strategies have changed over time.

1.2.1 The Early Years

In 1927 the Southland Ice Company was formed with the first store in Oak Cliff, Texas. Joseph Thompson was one of the original founders of the company and he played a significant role in shaping the company throughout its history. The main business was selling blocks of ice for refrigeration but within the first couple of years the product mix had expanded to include milk, bread, eggs, and gasoline. In 1931, during the Great Depression, the company experienced financial trouble and declared bankruptcy. The subsequent reorganization put Joseph Thompson in the role of company president. The repurchase of all outstanding Southland bonds put the ownership and control of the company with the board of directors.

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2 24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc.
World War II brought increased demand for ice and the company benefited financially, becoming the largest ice operator in Dallas. Refrigerators were still not available after the war and public demand for ice increased further. In response to the increasing demand, Southland bought Texas Public Utilities in order to acquire another 20 ice plants. The 24-Seven name was introduced in 1946 to reflect the hours of operation, with stores open from 7:00 am until 11:00 pm. Joseph Thompson’s oldest son John was appointed to the board of directors in 1948.

1.2.2 The 1960’s and 1970’s

By 1961 John Thompson had become the second president of Southland and his brother Jere became vice president. Southland incorporated in 1961 and continued aggressive store expansion and dairy acquisitions. A pivotal point for the company was the acquisition of 100 SpeeDee Mart stores in California in 1963. It was this purchase that introduced Southland to the concept of franchising. The company discovered that franchising could enable faster growth and greater decentralization. In 1965 there were 1,519 24-Seven stores and that number grew to 3,537 by 1969.

A popular frozen drink was launched under the brand name Slurpee in 1965. Over the years the Slurpee brand has developed strong recognition and acceptance by customers. It has become the name that most people use when referring to a carbonated frozen beverage, even when purchasing it at competitive locations. At this time in the company history Southland began to explore the 24 hour concept, hoping to better serve customer demands. The 24 hour concept resulted in increased employee turnover and the company struggled with its inventory systems due to the number of stores and wide product assortment. The first computer inventory systems were introduced in an attempt to better manage the goods coming into the stores. A regional

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distribution centre was opened in Florida in 1971 and several more were added in subsequent years.

During the 1970’s 24-Seven began to focus on international expansion. The first Canadian store opened in 1969 in Calgary, Alberta. It was company owned and operated. A 50 percent equity interest was taken in Cavenham Ltd in order to gain access to 840 retail outlets in Great Britain. 24-Seven Mexico started as a joint venture with Grupo Chapa SA de CV, a Mexican grocery distributor. Mexican operations started as four Super 7 stores and now consists of over 350 24-Seven locations. The most important international expansion to the future of the company was the entry into the Japanese market. In 1973 an area license was granted to one of Japan’s largest retail companies, Ito-Yokado Co.

1.2.3 The 1980’s and 1990’s

The 80’s and early 90’s were a tumultuous time for the company and it was a period that would ultimately shape the future of the company. In 1983 the largest acquisition to date occurred with the purchase of Citgo Petroleum Corporation. The goal of the acquisition was to guarantee consistent supply of gasoline to the convenience stores\(^6\). However, slowing demand for gasoline resulted in a loss of $50 million in the first year from Citgo. A profit was made the following year but the company decided to sell a 50 percent interest in Citgo to a subsidiary of Petroleos de Venezuela, a state owned Oil Company, in 1986. At that time Southland signed a 20 year supply agreement with Citgo and committed to purchasing minimum volumes of gasoline at market prices.

Threats of a hostile takeover of Southland by Samuel Belzberg, a Canadian raider, led the Thompson brothers to initiate a leveraged buyout of the company in 1987. The Thompson family sold off a number of the company assets following the buyout in order to increase efficiency and

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reduce the company debt of approximately 4.9 billion dollars. Part of the divesture included the sale of the remaining 50 percent share in Citgo to Petroleos de Venezuela in 1990. Increasing competition in the industry, the 1987 stock market crash, and the 1989 junk bond market crash created a great financial strain on Southland. Southland was left with interest rates as high as 18 percent on the approximately 3 billion dollars of debt remaining\(^7\). Late in 1989 Southland sold the Hawaii operations to 24-Seven Japan. Despite the sale of assets, the company continued to struggle with the high debt load and filed for bankruptcy protection in late 1990 after defaulting on loan payments.

The next year Southland emerged from bankruptcy after restructuring the company. As part of the deal Ito Yokado Holding Company purchased a 70 percent equity stake in Southland for $430 million and assumed management control of the North American operations. The Ito Yokado Holding Company was owned by Ito Yokado, the Japanese licensee and 24-Seven Japan, a subsidiary of Ito Yokado. In 1992 the company dropped the distribution and food processing businesses to focus on 24-Seven. Some of these assets were sold to McLane, a U.S. distributor and a subsidiary of Wal-Mart. Southland signed a service agreement with McLane and they continue to use McLane as their national distributor in the United States to this day.

A major investment was made to update and remodel stores in the mid 1990s. Further significant investment was made to implement a scanning system and proprietary information system with installation beginning in the United States in 1994 and Canada in 2002. In 1999 Southland officially changed its name to 24-Seven Inc.

1.2.4 2000 to 2006

In late 2005 the Japanese investors completed their acquisition of 24-Seven Inc. The remaining shares of 24-Seven Inc. were purchased by 24-Seven Japan and the company was de-listed from the New York Stock Exchange. There were senior level management changes and a number of executives including the Chief Executive Officer, the Chief Operations Officer, the Chief Financial Officer and the Vice President of Merchandising left the company. 24-Seven now exists as an indirect subsidiary of Seven & I Holdings, a large Japanese based multinational enterprise. Senior management has been replaced and a direct representative of 24-Seven Japan has been promoted to Chief Operating Officer. Key strategic decisions are made in Japan and the North American executives are largely responsible for communicating and implementing the business strategies.

In August of 2006 24-Seven made its largest acquisition in 20 years with the purchase of White Hen Pantry Inc. White Hen represents 261 small format grocery stores that also sell fresh foods. The retail stores are located in the Chicago area, Northwest Indiana, and Boston.

1.3 Current Strategy

There has been a strategic shift in the North American operations since the restructuring of the company in 1991. The Japanese investors have attempted to bring elements of their successful retail strategies to the one time licensor. Now that 24-Seven Japan has full control of the North American operations, these changes are being accelerated.

Senior management has been very specific about the strategic direction of the company over the past several years. A major effort has been made to change the culture of the company in support of the new business strategies. A great deal of internal communication and change to current business practices are underway. The following strategic goals have been set for 24-Seven Inc.
1. Grow fresh food sales from 8 percent to 15 percent of total merchandise sales by the end of 2008.
2. Increase company net profit margin dramatically from 0.79 percent to 1.5 percent by the end of 2008.
3. Achieve an ongoing same store merchandise sales increase of 6 percent.

1.3.1 Retailer Initiative – Store Level Autonomy

There is one element of 24-Seven’s strategy that gets particular attention from senior management. The concept is termed Retailer Initiative. It is explained in a number of ways such as, “item by item management of the product assortment on a store-by-store basis”. Another description that is commonly used is that Retailer Initiative is “giving the customers what they want, when they want it, in the quantities that they want”.

Store managers and staff have been given the autonomy to make an increasing number of decisions about the product assortment and merchandising in their particular location. There is a strong belief within the senior levels of the company that each store has unique requirements based on local customer demographics. They also believe that the store personnel are in the best position to understand the customer requirements and to act on them.

Store staff is encouraged to bring new product ideas forward to the merchandising departments to be added to the national product list. They are also encouraged to test new items and to share that information with their Field Consultant and others in the corporate offices. Individual stores may also decide to put a particular focus on certain items they believe to be high potential. Often this product focus will result in large orders and the building of displays in the store. Retailer Initiative is essentially a store-by-store focus strategy. The additional costs of customization are supposed to be offset with higher sales. However, this is generally not the case. A more detailed description of the weaknesses of the current strategy is provided in section 1.4.
1.3.2 Store Operations – Franchise System Preference

There are 4 different ways in which 24-Seven stores may be operated. There are company operated stores, individual store franchises, business conversion franchises, and stores operated under area licensing agreements. Each method of operation assigns different responsibilities and has different financial implications. The 2 predominant methods of operation are corporate and individual franchise agreements. The scope of the paper will be limited to a discussion of these two options.

1.3.2.1 Corporate Store Operations

In a company operated store, 24-Seven controls every aspect of the business. The company owns or leases the land and building and owns the equipment. The store is managed and staffed by employees of the company. Corporate stores are expected to follow the directions of the company and have somewhat less autonomy than a franchisee might. All stores in Canada and approximately 30 percent of the stores in the United States are company operated.

1.3.2.2 Individual Store Franchise

The individual store franchise provides an individual investor with an opportunity to run a nationally recognized convenience store. The average up-front investment required to obtain a 24-Seven franchise is approximately $150,000. This investment covers the opening inventory, supplies, business licenses, permits, cash register fund and the franchise fee. The franchisee leases or subleases the land, building, and equipment from the company.

Franchisees are independent contractors and are responsible for the day-to-day operational decisions in the store. In addition to the up front investment, the franchisee must also

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8 24-Seven Inc. (2006). *Press release: Franchise system overview*. 24-Seven Inc.
9 24-Seven Inc. (2006). *Press release: Franchise system overview*. 24-Seven Inc.
pay the company 50 percent of the gross profits from the store. A list of the responsibilities of both parties is provided in table 1.1.

Table 1.1 Responsibilities of Franchisee and the Company

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As of August 2006, 4,199 out of a total of 5,806 24-Seven stores in North America were operated under a franchise or area licence agreement. An area license agreement grants the exclusive rights to use the 24-Seven trademark and the 24-Seven system in a defined geographic area. The franchise agreement applies to individual stores only. The remaining 1,607 stores were company operated. Senior management has developed a strong preference for a franchise structure over corporate store operations. A concerted effort is underway to convert existing corporate stores into individual franchise locations. Progress has been made resulting in a net decrease of 792 in the number of corporate stores since the end of 2004.

Senior management believes that franchise stores will enable the company to increase the return on assets and improve profitability. Franchise stores are less costly to run because the company is not responsible for store labour, the cost of inventory, or cash and inventory shortages. In addition, franchise stores are generally more profitable than 24-Seven’s corporate stores. The difference in annual profitability between a franchise store and a corporate store is estimated by the author to average roughly $140,000. More information about these profitability estimates is provided in section 3.4.2 Financial Scenarios.

An analysis of the franchise structure in section 2.5 reveals that a franchising strategy has the potential to reduce operating costs for the stores and the entire corporation. Improved operational efficiency and lower monitoring costs from franchising could lead to increased company profitability. While the company has been involved in franchising for a long time, this sole strategic focus on franchise operations is relatively new. The company has become less focused on operating convenience stores and more interested in providing the services, technology and expertise to independent operators.

1.3.3 Product Offerings – Fresh Food Focus

Fresh Food has become the focus category of the store. This includes the sale of hot foods like hot dogs and Taquitos. It also includes the sale of refrigerated products such as sandwiches, salads, wraps, and fresh fruit. These foods are prepared in commissaries and are then shipped daily to the stores. In Japan, the company has had a great deal of success selling rice-based prepared meals and they are attempting to recreate a similar fresh food model in North America. It is believed that implementing this fresh food model in North America will result in increased customer visits, product differentiation, and a diversification of revenue.

An integral part of the fresh food strategy is the daily delivery of products to the stores. The Japanese stores receive up to three deliveries of fresh foods per day. The frequent deliveries
reduce stock-outs and improve the quality of perishable products. The North American operations are well behind the Japanese in terms of delivery frequency. Lower fresh food sales and a larger geographic area have made similar delivery frequencies uneconomical in North America. However, investments continue to be made to develop Combined Distribution Centres that will provide stores with daily delivery. There are a total of 42 Combined Distribution Centres across Canada and the United States. These distribution centres provide daily delivery of fresh food items to almost 5,000 stores.\footnote{24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc.}

24-Seven has chosen to invest in a proprietary fresh food program. Corporate employees work with vendors to develop products and programs exclusively for 24-Seven. The company seeks to gain a competitive advantage through the development and introduction of fresh food items because these programs are difficult and expensive to replicate. Recently there has been an emphasis placed on developing products and programs at the regional level. Several individuals within each division office have been charged with this responsibility.

1.3.4 New Store Strategy- Merchandise Only

24-Seven has reduced the focus on gasoline operations. The vast majority of stores built after 2004 do not sell gasoline. Low gross margins and the high costs of the gasoline infrastructure are key reasons for making this strategic adjustment. Gasoline stores require larger lots and regulations limit the potential sites. Small format merchandise-only stores are being built in key urban centres. Gasoline stores and rural locations are not considered to be a good use of the company’s resources. Management has determined that is not possible to gain a competitive advantage over the large, vertically integrated oil companies that operate other gasoline outlets. It is also believed that rural locations cannot be adequately supported by the company’s daily distribution system.
1.3.5 The Field Consultant Role

Corporate Field Consultants are the key link between the company and the stores. Each Field Consultant is assigned a group of eight locations to supervise. Field Consultants are present in corporate planning meetings and are expected to convey important company information to the stores.

The Field Consultants work with the stores to resolve operational issues and implement business plans. The role is considered to be that of a business consultant. However, a key part of the role is acting as an advocate for the company and its programs. Field Consultants spend time dealing with operational concerns and they also spend an equal amount of time persuading franchisees of the benefits of corporate programs.

1.4 Weaknesses of Current Strategy

Michael Porter suggests that there are three potentially successful strategies for outperforming other firms in an industry\(^\text{13}\). These three strategies are: low cost leadership, differentiation, and focus. Sometimes elements of these strategies can be combined. However, the likelihood of failure increases significantly when management is unclear about which of the three strategies it is pursuing. 24-Seven appears to be pursuing elements of all three strategies. The proprietary fresh food program is an attempt to differentiate from the competition. Retailer Initiative is a store-by-store focus strategy. Franchise store operations are an attempt at a low cost operating structure.

The current strategy is pulling the company in many different directions. Conflicting strategies have created or contributed to some of the problems facing the company that were mentioned above. The investment into the Fresh Food category has resulted in revenue growth.

but it has failed to increase customer counts. The costs of the daily delivery system have added to the relatively high cost structure of the company. Margin in the Fresh Food category runs five percentage points lower than the average margin for in-store sales. 24-Seven’s fresh food margin also runs ten percentage points below the industry average. Low sales volumes, high delivery costs, excessive product development costs, and promotional expenses pull down 24-Seven’s fresh food margin. The low margin suggests that the attempts at differentiation have largely failed because customers are not paying the premium required to maintain profitability.

The Retailer Initiative philosophy weakens the company’s buying power and reduces efficiency of the distribution systems. Store standardization is also negatively impacted by increased store level autonomy and there is considerable duplication of work at store level. A franchise structure has potential to lower operating costs through increased operational efficiency and lower monitoring costs. However, limited participation in corporate programs and poor cleanliness scores are evidence of weak operational controls.

A large and expensive operating structure has been created to support the company’s strategy. High operating and administration expenses negatively impact company profits. Corporate stores have proven to be expensive to run due mainly due to labour and inventory costs. The administrative infrastructure to support the stores is also costly. 24-Seven is burdened with high operating costs that put it at a disadvantage to competitors in the industry. A comparison of 24-Seven versus key competitors is provided in chapter 2.

1.5 Problems Facing the Company

24-Seven will have to face a number of challenges as management continues to implement the current strategic plan. This section will outline some of the key challenges that the company must overcome in order to maintain its position as the number one convenience store retailer in North America.
1.5.1 Declining Transaction Counts

24-Seven has experienced a negative long term trend in average daily transaction counts. Transactions counts are used by the company to measure the average number of daily customer visits per store. The transaction count trend between 1994 and 2006 is shown in figure 1.1. Transaction counts peaked in 1997 but declined each subsequent year until 2003. Transaction counts bottomed in 2002, which represented a decline of 9.5 percent from the 1997 high. The increases in 2003 and 2004 were followed by relatively modest declines over the next two years. The transaction count in 2006 still represented a 6.7 percent decrease from 1997 high. This long term decline is particularly troubling because the volume of customer traffic has a direct impact on store sales and profitability.

![Average Daily Store Transaction Counts (1994-2006)](image)

Figure 1.1 Average Daily Store Transaction Counts (1994-2006)

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14 Data obtained from the 24-Seven Merchandising department. Actual values removed for confidentiality.
1.5.2 Weak Company Profitability

Net earnings have been somewhat volatile over the recent past, dropping to $11.6 million in 2002. The trend has improved since 2002; however, the company still operates on slim net profit margins. The net operating profit margin was a mere 0.79 percent in 2004. The 3-year average net profit margin, between 2001 and 2004, was even lower at 0.52 percent. A review of the earnings trend is provided in section 1.6 of chapter one. The average operating profit margin of convenience stores in the industry is 2.3 percent\(^\text{15}\). In chapter 2, it will be shown that the corporations running chain stores tend to have lower operating profit margins. The weaker profitability of 24-Seven and other chain stores suggests that operating costs are too high.

24-Seven’s cost structure has ultimately put pressure on profits. In 2004, the company spent $3.0 billion on operating, selling, and general administration expenses\(^\text{16}\). This represented an expense equal to 24.9 percent of the total annual revenue for the year. The three-year average between 2001 and 2004 was even higher with administrative expenses representing 25.8 percent of total annual revenue. Interest expenses, income tax expenses, occupancy costs, franchise fees, and labour are some of the key areas represented in this category. 24-Seven does not disclose the actual breakdown of costs. However, we know from the industry that labour is the largest portion of direct store operating expenses. Thirty five percent of gross profit goes towards labour costs. 24-Seven’s operating, selling, and general administration expenses would include store labour for corporate stores and all of the expenses associated with the company’s administrative personnel and infrastructure.

A significant portion of revenues are coming from gasoline and tobacco sales. These two categories tend to have much lower margins than the store average. The relative size of these

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\(^{16}\) 24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc.
categories tends to negatively impact gross margin and profit margin measurements. The current sales mix is described in more detail later in section 1.6 of chapter one.

1.5.3 Franchisee Compliance

Franchise stores tend to lag behind corporate stores in fresh food performance and cleanliness. The top three divisions for fresh food sales over the past several years have consistently been Canada, Florida, and Chesapeake. These three divisions are either exclusively or predominately made up of corporate stores. There has been some degree of resistance to the fresh foods plans of the company from the franchise operators. Poor sales performance, the complexity of the programs, and high write-offs are commonly cited by franchisees as reasons for their limited support. The number and variety of duties puts pressure on human resources at store level. Employees have to forecast and order all products in the store, deal with customer service issues, stock the shelves, run the cash register, clean the store, implement promotions, and perform many other tasks. The low profitability of the stores may also contribute to the pressure on the store operators to cut costs.

Surveys performed by the company show that divisions with a high percentage of corporate stores tend to score higher on overall cleanliness. The top three divisions for cleanliness scores in 2005 were are Canada, Florida, and Chesapeake. These are the same three top performing fresh food divisions. Since franchise locations are responsible for employee staffing and payroll, there is speculation that many locations attempt to minimize labour expenses in order to boost profits. This can result in deteriorating store conditions.

1.5.4 Product Proliferation

24-Seven’s Retailer Initiative strategy has resulted in an expanding product assortment. The ultimate goal of this strategy is to customize the product assortment and merchandising for each and every store. However, pressure to fulfil individual store and regional product requests
has resulted in the addition some of items that have limited potential in the majority of stores. Furthermore, store personnel have been given the autonomy to add items from outside the company’s regular supply channel. Stores can add Non Recommended Items if these products are not currently available through the ordering system. Senior management has actively encouraged store staff to even go out and purchase items from other wholesalers and retailers in order to test them in-store. The store employees are charged with the responsibility to properly account for these items and to set them up on the store computer for scanning. There are currently many thousands of Non Recommended Items set up across North America.

The expanding product assortment creates a number of serious problems for the company. One problem with an excessive assortment is that it weakens the company’s buying power by spreading purchases of similar items across multiple products and vendors. Another concern is that having a large product assortment increases the complexity of ordering and inventory management at store level. Finally, the efficiency of the distribution channel is negatively impacted. Wholesale partners sometimes struggle to meet minimum order requirements on individual items due to the breadth of the assortment. There are also incremental warehousing and labour costs caused by having more items than necessary. Expenses for corporate administration, warehousing, delivery, inventory management, and ordering all increase if the assortment grows past an efficient level.

1.6 Financial Performance

The financial performance of the company has improved since the restructuring in 1990. The management stake bought by 24-Seven Japan brought with it access to significant financial resources. In addition, the approach to the business changed with the new stakeholder’s involvement managing the company. The Japanese influence increased over the years leading up to 2005, when the remaining shares of the company were purchased. 24-Seven Japan has since
accelerated the implementation of their strategic plans for the North American business as outlined in section 1.3 of chapter one.

1.6.1 Revenues and Earnings

2004 was the last year that detailed financial information for the North American operations of 24-Seven was made available to the public. Therefore, the majority of the analysis and comparison will be made up until that time. 24-Seven experienced revenue growth over each of the years between 2000 and 200417. The most significant increases occurred in 2004 and 2005. During those two years, total revenue increased by 10 percent and 13 percent respectively. Revenue results are shown in figure 1.2.

Company net earnings were not as consistent as revenues during the period between 2000 and 2004. Earnings decreased during 2001 and 2002. There was a $12 million charge in 2002 for discontinued operations as the company closed a number of underperforming locations. In the same year, there was a $28 million charge due to an accounting change in how certain liabilities are reported. Although earnings improved significantly in 2003 and 2004, the annual results were still below the year 2000 net earnings of 107.8 million dollars. By comparing the revenues and net earnings it becomes obvious that the company net profit margin is slim. The net profit margin in 2004 was 0.79 percent. Over the three year period between 2001 and 2004 the profit margin was a mere 0.52 percent. Company net earnings results are shown in figure 1.3.

Revenue and profit growth exceeded five percent in 2005 and 2006. Gasoline boosted company performance due to significant increases in the market price of oil. Gross profit margin increased slightly for in-store sales over this two year period. In-store sales grew at a slower pace than total company revenue growth. The Fresh Food category performed well in 2005, growing

17 Financial information obtained from: 24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc.
at over ten percent. However, the growth rate for Fresh Food was cut in half in 2006 and the category gross margin remains ten percentage points lower than the industry average.

**Figure 1.2 Revenue Trend 2000 – 2004**

24-Seven Total Revenue in Billions of Dollars

1.6.2 Source of Revenues and Earnings

In 2004, 2,423 stores out of a total of 5,799 sold gasoline. The revenue potential from gasoline is high but the gross margin tends to be low. The gasoline gross profit margin was 8.1 percent for the year as compared to a merchandise margin of 35.6 percent. Gasoline contributed 34.7 percent of the company’s net sales as illustrated in figure 1.4. However, it only contributed 12.5 percent of total gross profit dollars.

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18 Data source: 24-Seven Inc. (2005) *Think 24-Seven: 24-Seven Inc. 2004 annual report*. 24-Seven Inc.
19 24-Seven Inc. (2005) *Think 24-Seven: 24-Seven Inc. 2004 annual report*. 24-Seven Inc. 36.
The relative share of sales from gasoline and merchandise has a great deal of influence over the company’s financial results. The sales mix within the merchandise category is another important factor for the financial success of 24-Seven. The largest segment within the merchandise sales category is tobacco. This single category represents 29.1 percent of total merchandise sales (figure 1.5). The gross margin on tobacco products is lower than the average for total merchandise sales. Margins typically run between 15 to 20 percent for the tobacco category.20 Product categories that tend to have significantly higher than average gross margins include confectionary, snacks, beverages, and fresh foods.

Figure 1.3 Earnings Trend 2000 - 200421

24-Seven Net Earnings in Millions of Dollars

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20 Estimate from 24-Seven Merchandising department.
21 Data source: 24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc.
1.7 Method

The author has worked at 24-Seven for over seven years. As a manager in the Canadian Merchandising department he makes product assortment, merchandising, pricing, and promotional decisions for the Canadian operations. The author attends planning and strategy meetings for Canadian and American operations several times a month. The information for this paper has been collected from a number of sources including: internal interviews, industry journals, annual reports, financial statements, and business reports.

Chapter one of the paper was intended to give an overview of the company. The current strategy and the shortfalls of that strategy were described. Financial information was included to provide an indication of the past and current performance of the company. Chapter two will bring a greater depth of industry information into the analysis. The characteristics of the industry and a comparison of 24-Seven against two key competitors will be used to identify the best strategic alternative for 24-Seven. In chapter three an internal analysis of 24-Seven will be used to determine how the recommended strategic alternative can be implemented given the current management preferences, capabilities, and resources. Gaps that could cause implementation problems will be identified and solutions will be recommended. In addition, the financial impact of the recommended changes will be forecast. Chapter four is the final chapter and it will provide final recommendations and strategic adjustments.
Figure 1.4 Total Sales 2004

Share of 24-Seven Sales from Gasoline and Merchandise

- Merchandise Sales 65.3%
- Gasoline Sales 34.7%

Figure 1.5 Merchandise Sales 2004

Merchandise Sales Mix 2004

- Tobacco 29.1%
- Beverages 23.5%
- Beer/Wine 11.2%
- Candy/Snacks 10.0%
- Fresh Foods 7.7%
- Non-Foods 6.9%
- Dairy 4.4%
- Services 3.7%
- Other 3.5%

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22 Data source: 24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc. 8.

23 Data source: 24-Seven Inc. (2005) Think 24-Seven: 24-Seven Inc. 2004 annual report. 24-Seven Inc. 8.
2 EXTERNAL ANALYSIS OF THE CONVENIENCE STORE INDUSTRY

Total sales in the North American Convenience store industry reached an all time high of $467.4 billion in 2005. Industry sales growth has been impressive over the past several years. Sales increased over the years of 2003, 2004, and 2005 by 13.9 percent, 18.2 percent, and 18.0 percent respectively. The industry is represented by over 140,000 convenience stores. A large proportion of these stores are independent operators. Of the chain stores, 24-Seven is the largest with over 5,800 stores. BP North America is second in size with almost 5,200 locations and Alimentation Couche-Tard is third with just under 5,000. A better understanding of the characteristics of the convenience store industry will revealed through an industry analysis. In addition, two of the top ten competitors in the industry have been chosen for a direct comparison against 24-Seven. These two competitors are Alimentation Couche-Tard and The Pantry Inc.

2.1 Five Force Industry Analysis

The Five Forces Model, developed by Michael Porter, will be used to analyze the North American convenience store industry. There are five forces that impact company profitability and determine the overall attractiveness of the industry. These forces are Barriers to Entry, Threat of Substitutes, Buyer Power, Supplier Power, and Degree of Rivalry. The potential for profit increases for firms in the industry when the forces are weak.

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2.1.1 Threat of Entry – High

2.1.1.1 Low Entry and Exit Costs

The convenience store industry is made up of a relatively small number of large chains, a moderate number of medium size regional chains, and a large number of single store operators. The number of single store operators increased by 2 percent, over three years, to reach 60 percent by the end of 2005\(^{26}\). The relatively high proportion of independent convenience store operators suggests that the barriers to entry are low. The building and real estate represent some of the largest capital costs of start up. However, these assets may already be owned by a potential operator or can be leased, thereby lowering the up-front costs.

Independent store operators have relatively low start-up costs. This is often complemented with low operational costs as well. These convenience store operators do not have the high overhead costs that the chain stores have. A much flatter and leaner organization is characteristic of this type of operator. There will be no network of offices or legions of corporate staff. The store owner and family members commonly work in the store resulting in reduced labour costs, in addition to lower administrative expenses. Independents often do not have the resources to get the best locations or build a brand through advertising. These can both be key success factors in the industry. As an alternative, smaller operators will sometimes take advantage of the lower operating costs and set prices below that of the chain stores. A lower price has value to the customer but not as much as some of the other factors. Forms of rivalry are discussed in more detail later in the chapter.

Chains like 24-Seven must take advantage of economies of scale and larger buying power to offset some of the higher administrative costs. Chains must be constantly managing administrative costs to insure that independent store operators are not able to achieve significant

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and sustainable operating cost advantages. A low operating cost structure is an important key success factor. Alternatively, chain stores can attempt to differentiate their product offerings and store sites. In order for this to be successful, customers must recognize the added value and be willing to pay for it.

2.1.1.2 Available Management Expertise and Knowledge

Management expertise and business systems might prove to be a barrier for less experienced operators. However, the industry has provided a solution to that potential problem with franchise agreements. 24-Seven, for example, will grant a franchise to a qualified candidate for an up front cost of approximately $150,000. The initial investment and a share of sales or profit will secure a store, inventory, and access to the company systems and expertise. Certain other large chain stores like AM/PM and Couche-Tard have similar franchise options. More detail on the Couche-Tard franchise option is provided later in the chapter.

24-Seven ranks fourth on the 2007 Top 500 Franchises list by Entrepreneur.com27. The only other convenience store ranking in the top 500 is AM/PM at number 51. Brand recognition and a relatively low start-up fee are likely reasons for 24-Seven’s top ranking. The 24-Seven franchise system is a well recognized opportunity for potential operators to run their own store.

2.1.1.3 Easily Accessible and Efficient Product Supply

Warehousing and distribution does not prove to be a significant barrier to entry as it might in other retail channels. There are a number of large independent distributors in the United States and Canada that service convenience store retailers. These distributors consolidate the relatively small volumes of individual stores in order to create an efficient distribution system. All operators, from the largest chain stores to single store operators, have access to the same

distribution systems. This enables the small operators to benefit from the economies of scale created by the large operators.

Some manufacturers use a direct to store delivery model rather than putting their products through a distributor. Coke, Pepsi, and Frito Lay are companies that deliver their own products to stores in an attempt to gain a competitive advantage. Again these companies service the chain stores and the independent operators using the same system. The delivery frequency and the costs may differ but the independent operators have access to the products they want to sell.

**Key Success Factors for Entry Threats:** Firms in the convenience store industry require a number of key success factors in order to effectively deal with the high threat of entry. Low operating costs will help firms to survive and compete in an industry with many new entrants. Strong brand recognition helps to differentiate chain stores from the independent store operators. This helps to create loyal customers who are less likely to go elsewhere. Brand recognition can also encourage investment in franchise stores for new entrants. 24-Seven hopes to benefit from this by bringing some of these new entrants into the company system. Location is another way to compete against new entrants. Securing highly productive real estate is often very expensive. This can provide an advantage to firms with the financial capital to secure these sites. Finally, price is another key success factor that is sometimes used in an attempt to pull customers from other locations.

### 2.1.2 Threat of Substitute Products/Services – High

#### 2.1.2.1 A Low Level of Product Differentiation

Convenience stores sell a wide range of products and services. Packaged foods, fresh foods, cigarettes, beverages, and many other products are common offerings. The majority of the products are standardized and are essentially identical regardless of where they are purchased. A package of Player's Light or a Mars bar, for example, are not differentiated between different
retail locations. A low level of product differentiation provides little incentive for consumers to seek out specific locations for their shopping needs. They are likely to go to the location that is most convenient. Product standardization supports a low operating cost strategy because it makes differentiation difficult or impossible to achieve. In this case low operating cost is a key success factor.

Successful differentiation is a key success factor for the industry. Companies attempt to differentiate product offerings by creating private label products and offering a wider assortment. Some of these attempts at differentiation are successful, such as the development of the Slurpee brand by 24-Seven. However, competitors are becoming increasingly adept at replicating successful products and brands. The competitive advantages achieved through product differentiation strategies are becoming much shorter lived than in the past.

2.1.2.2 Many Available Substitute Products

Consumers choose from a variety of products to satisfy their hunger and thirst. They may substitute the food or beverage offerings available in a convenience store for those found in a quick serve restaurant like Subway or MacDonald’s. As these restaurants become more convenient, it is easier for consumers to choose these substitutes. Restaurants with drive through windows, good locations, and extended hours encourage the substitution of food and beverage purchases. Quick serve restaurants often use a low operating cost strategy and that puts further pressure on convenience stores to lower costs.

The grocery store channel now has extended hours of operation and better locations than in the past. This provides easier access to a wide range of products to consumers. Grocery stores have also expanded the available product assortment to try and meet the needs of convenience oriented consumers. Washed and bagged salads and ready-to-eat meals are examples of products
that may appeal to convenience store customers. Many other substitute food and beverage products are available in a wide variety of retail channels.

2.1.2.3 Changing Consumer Trends and Perceptions

An increasing interest in health and wellness in the general population may encourage substitution. Convenience stores are well known as a destination for unhealthy products. Potato chips, chocolate bars, carbonated beverages, and frozen beverages are popular products in this channel. Health conscious consumers may decide to substitute some of these traditional snack items with healthier products such as fruits, vegetables, or a proper meal.

Some manufacturers have attempted to keep up with this trend by modifying their products. Snack products with reduced fat and salt content and no trans-fat are becoming more common. Some convenience store retailers have tried to keep up with changing consumer trends by expanding the limited product assortment of healthy items like fruit and water. However, the convenience store channel has struggled to keep up with the healthy lifestyle trends that seem to be gaining momentum.

Key Success Factors for Substitution Threats: There is a high threat from substitution in the convenience store industry. Firms must work harder to differentiate their product assortment from what can be found in other retailers. This could take the form of unique items or convenient packaging formats. Fresh food offerings could help to differentiate and pull consumers from other channels. Many fresh foods items like salads and sandwiches have the added benefit of being perceived as healthy products. Convenient location is another key success factor that would enable firms to compete against the price and assortment offers in other channels. Firms need to be able to survive in an industry when many substitute products are available. A low cost operating structure is important key success factor if attempts at differentiation fail. This strategy would enable companies to make a profit on less volume.
2.1.3 Bargaining Power of Suppliers – Moderate

The suppliers in the convenience store industry consist of the product manufacturers and the distributors. The level of supplier power varies greatly across the different product categories and services. Two key factors in determining the level of supplier power are the degree of consolidation of suppliers and the relative importance of the category to the retailer.

2.1.3.1 Level of Supplier Consolidation

The level of supplier consolidation depends on the business segment. Some industry segments such as salty snacks, beverages, and tobacco have a small number of highly powerful suppliers. Frito Lay claims a 60 percent market share of the salty snack category in Canada and is even more dominant in the United States. PepsiCo and Coca-Cola are very powerful suppliers of beverages. Together these two suppliers have a 50 percent market share in the United States beverage category. PepsiCo owns Frito Lay and therefore has a 22 percent share of the larger Convenient Food and Beverage category in the United States. Companies like PepsiCo and Coca-Cola are constantly striving to increase their respective market shares in numerous business segments. One tactic employed by large suppliers is buying smaller competitors. Another tactic is to secure merchandising agreements with retailers that guarantee premium product placement in exchange for rebate payments.

In Canada, three companies control almost 100 percent of the tobacco industry. Imperial Tobacco Limited is the largest with approximately 57 percent market share. Rothmans Incorporated is the second largest with a 33 percent market share and Japan Tobacco International holds a 10 percent share. A similar structure is found in the United States with three companies

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controlling 92 percent of the market. Phillip Morris has a 50 percent market share, Reynolds America Inc. has 33 percent of the market and Lorillard has 9 percent.

Gasoline distributors also have a high level of supplier power due to consolidation. In addition, many oil companies are vertically integrated and compete in the convenience store industry. Buying your product supply from a competitor puts a company in a disadvantaged position. While oil companies want to make profits from the retail sale of gasoline, they could survive on the profits from other company operations such as exploration, drilling, and refining. Going forward, 24-Seven has chosen to open merchandise only stores and avoid this unattractive part of the industry.

2.1.3.2 Relative Category Importance

Some categories are more important to convenience store operators than others. The revenue and profit contributions from tobacco and gasoline make them strategically important to the success of the company. Gasoline sales account for 70 percent of total industry sales and 36 percent of industry gross profits. Cigarette sales represent 33 percent of in-store sales and 20 percent of in-store gross margin dollars. Wine & Liquor, Ice Cream, Health and Beauty Care, and Publications each represent less than 2 percent of in-store sales and may be considered less strategic. Suppliers have less bargaining power in categories that are considered less strategic.

Key Success Factors for Supplier Power: There are four key success factors which help firms to deal with the moderate supplier power in the industry: a low cost operating structure, product differentiation, diversification of revenues, and size. A low cost structure enables firms

to deal with cost pressures more effectively than the competition. Firms with a low cost operating structure will maintain an advantage over others if premium prices cannot be charged.

It can be difficult for a store operator to charge higher prices on standardized products. However, successful product differentiation through private label products and branding might provide some premium pricing options. Companies with more diversified revenue streams are less reliant on one or two categories and therefore face a lower level of supplier power. When convenience stores enter into new areas of business like fresh food it can help to diversify revenue and reduce supplier power.

Another way to mitigate supplier power is through consolidated buying. Buying in large quantities gives the retailer considerable leverage over suppliers. Consolidated buying can occur through centralized purchasing within a large firm. It may also occur through trade groups or associations that bring together large groups of independent operators. Attempts to deal with supplier power through associations are likely to be more complicated due to diverse interests of members and coordination problems. Since 24-Seven is the largest convenience store operator in North America, the company should be in a unique position to leverage its size and potential buying power through consolidated purchasing.

2.1.4 Bargaining Power of Customers – Moderate

The average transaction size for convenience store customers is relatively low but it has increased over the past several years. Today, the majority of customers purchase less than ten dollars worth of merchandise, excluding gasoline, at any one time. In addition, consumers that shop in convenience stores act independently and not in coordination with other consumers. Small purchases and little coordination between consumers act to weaken buyer power. However, low switching costs tend to strengthen buyer power.
2.1.4.1 Low Switching Costs

Convenience store customers are easily able to switch to alternative products or retail channels, or to forego consumption all together. The nature of the products and services sold in the industry do not create a strong relationship with the consumer. If customers are unsatisfied with any aspect of their local store, most can find an alternative. Individuals that are time starved get the greatest value from the convenience store format. They are willing to pay higher prices and accept a limited assortment in exchange for a convenient location and extended store hours. For these individuals the switching costs are somewhat higher. However, a growing number of options are becoming available for even the time starved customer.

Successful differentiation creates a brand that has value for the customer. This value can come in the form of quality expectations or familiarity with the product assortment and hours of operation. A strong brand can lower search costs for customers and reduce the rate of switching. Differentiation that leads to a strong brand is therefore a key success factor.

**Key Success Factors for Buyer Power:** Firms with the most convenient locations are in the best position to deal with the moderate level of buyer power. A strong brand is another key success factor that reduces the likelihood of customers shopping elsewhere.

2.1.5 Competitive Rivalry – Intense

This is a large industry with room for many operators. However, there is evidence of intense rivalry among the competitors. This section will identify and describe some of the factors that contribute to this intense rivalry.

2.1.5.1 Industry Growth May be Unsustainable

Industry sales growth has been impressive over the past several years. Sales increased over the years of 2003, 2004, and 2005 by 13.9 percent, 18.2 percent, and 18.0 percent
respectively. Double digit gasoline price increases occurred over this three year period, caused by changes in the underlying price of oil. Changes in this category have a major impact on total revenue since gasoline represents 70 percent of the total industry sales.

In-store sales, excluding gasoline, increased at a more moderate pace. In-store sales grew by 4.6 percent, 11.8 percent, and 9.3 percent in 2003, 2004, and 2005 respectively. Price inflation on cigarettes and the ability of the channel to capture a larger share of this declining category helped to boost merchandise sales. A summary of same-store sales increases for the top performing categories in 2005 is shown in table 2.1. Other lower performing categories pull down the total in-store sales increase.

Gasoline and tobacco are two of the fastest growing categories. It is unlikely that these categories will continue to grow at this rate over the long term. Slowing sales growth would further increase rivalry in the future. Existing operators and new entrants would have to compete more aggressively to achieve sales increases. Instead of sharing in the industry growth there would be a greater emphasis on taking market share from others. 24-Seven will have to decide how to compete for survival if conditions become more difficult. Having a low cost operating structure would put 24-Seven in a better position to deal with slower industry growth.

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2.1.5.2 Low Industry Profitability

Average in-store sales per store reached $1,025,075 in 2005, breaking the one million dollar mark. Average annual pre-tax profit, after operating expenses and franchise fees, was $35,714 per store in 2005. The sales levels seem impressive but clearly this is an industry that operates on slim margins. The average operating profit margin in 2005 was only 2.3 percent for all convenience stores. This is still significantly higher than the aggressive internal target of 1.5 percent set by 24-Seven. Low operating profit margin is not the only concern. Gross margin in the industry has trended down for many years. Industry gross margin continued its decline in 2005 dropping 50 basis points to 28.2 percent for in-store sales. Gasoline gross margin dropped 70 basis points to 6.9 percent over the same time period. Weak profitability and negative margin

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trends again raise the key success factor of low operating costs. If the market will not bear higher prices, then the only solution is to cut costs.

Food Service is one area that stands out as having relatively high gross margins. Food Service currently only accounts for 12 percent of total in-store sales. A margin comparison for Food Service segments is shown in figure 2.2. The segment consists of Fresh Food, Hot Dispensed Beverages, and Cold/ Frozen Dispensed Beverages. Companies like 24-Seven are hoping to develop high margin categories in order to improve company profitability. 24-Seven has traditionally been dominant in areas like hot and cold dispensed beverages but competitors have managed to close the gap over the past several years by investing into these areas of the business. Fresh food appears to be a good opportunity to increase overall profitability but 24-Seven’s differentiation approach has resulted in a gross margin that is significantly below the industry average.

2.1.5.3 Increasing Competition

The store count increased by 1.8 percent in 2005 following a 5.8 percent increase in 2004. Low entry barriers encourage new companies to enter the market. The new entrants are not limited to independent operators. Domestic companies such as Canadian Tire and Home Depot have recently started to open up their own convenience stores. Large international chains are also showing interest in the North American Market. 24-Seven Japan’s investment in 24-Seven Inc. is one example of this. The British retailer Tesco has announced that it will soon be entering the United States market, competing with small format grocery stores and convenience stores. Competition is intensifying as the number of convenience stores increases. Additional pressure on the convenience channel is being caused by “channel blurring” as the drug and grocery channels attempt to attract more convenience oriented consumers.

2.1.5.4 Competitive Tactics

There are a number of tactics used by competing convenience store operators. The types of tactics employed tend to vary according to the size of the company. Independent operators usually have a limited number of options while competing against national and regional chains. For that reason independent operators often resort to competing on price. The cigarette category is a key traffic driver and cigarette prices are often lower in independent convenience stores.

Chain stores rarely compete on price. The chain stores maintain premium pricing over other retail channels in order to stay profitable. Temporary promotion and multiple purchase programs are commonplace but are used more to drive volume with existing customers rather than...
than to lure customers away from other locations. Chain stores use other strategies to stay competitive and increase market share.

Store location is one of the most important ways that the chain store operators seek to achieve a competitive advantage. The number of new store openings and the location of those new stores are strategically important. Some companies have taken an aggressive approach over the past several years to secure high potential locations. Alimentation Couche-Tard has taken an aggressive stance towards opening new stores and acquiring existing stores. Couche-Tard has become a key competitor of 24-Seven as a result.

Several chain stores have also invested in store renovation. Oil companies like Shell, Chevron, and Petro Canada have allocated significant resources to remodel existing stores. In general the renovated stores are larger, more well lit, and have an improved overall image. New coffee and frozen beverage equipment, and increased refrigeration space for packaged beverages are often key components of the renovation.

Some chains have turned their focus to the fresh food category as a way to differentiate themselves from other locations. An increasing assortment of cold and hot foods like sandwiches, chicken and hot dogs is becoming more prevalent in the industry. The Fresh Food category is now being recognized as an opportunity to increase gross margins and provide a level of differentiation. Competitors have approached this category by either developing proprietary offerings or by partnering with branded offerings such as Subway and Quiznos.

**Key Success Factors for Rivalry:** Companies in the convenience store industry must find ways to thrive in the face of intense rivalry. Independent operators use price as a key success factor due to their lower operating costs. A low cost operating structure enables a firm to stay profitable in a competitive environment with a high degree of product standardization. A low cost structure will be increasingly important for chain stores in the future if the industry does
experience a reduction in revenue growth. Good location, image, and product differentiation are all important factors in determining the success of firms. Success with these factors helps to create new customers and to capture customers from other retail outlets.

2.2 Summary of Key Success Factors

An analysis of the convenience store industry using the Five Forces Model has identified a variety of key success factors. These key success factors have been compiled and categorized in order of importance in table 2.1 below. These factors play a role in the level of success achieved in the industry by convenience store operators. However, individual firms must choose the particular factors they will use to develop a competitive advantage.

Table 2.1 Key Success Factors

<table>
<thead>
<tr>
<th>Relative Level of Importance</th>
<th>High</th>
<th>Medium</th>
<th>Low</th>
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<tbody>
<tr>
<td>Low Operating Costs</td>
<td>Financial Capital</td>
<td>Company Size</td>
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<tr>
<td>Store Location</td>
<td>Consolidated Buying</td>
<td>Price</td>
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<tr>
<td>Product Differentiation</td>
<td></td>
<td>Diversification of Revenues</td>
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<tr>
<td>Store Image</td>
<td></td>
<td>Hours of Operation</td>
<td></td>
</tr>
<tr>
<td>Brand Strength</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2.3 Analysis of 24-Seven Inc. vs. Key Competitors

In this section the performance of two key competitors will be analyzed. Alimentation Couche-Tard was chosen due to its top position in the industry and the fast growth of the company. Couche-Tard provides a view of a large, national chain store with both franchise and corporate operations. The Pantry was chosen because it is a top ten company in the industry. The Pantry is a regional chain of convenience stores that is growing more modestly than Couche-

39 Rating by the author
Tard. A review of The Pantry allows the analysis of a company that uses a purely corporate model for store operations.

2.3.1 Alimentation Couche-Tard (Mac’s, Circle-K, Couche-Tard)

Couche-Tard is a large Canadian based convenience store operator. The company is the third largest in North America based on total store count\(^{40}\). It is second only to 24-Seven among chains that are not integrated with an oil company. Couche-Tard operates 4,983 stores across North America under key brands such as Mac’s, Circle K, and Couche-Tard. Approximately 3,600 of the stores are corporate and 1,400 are operated under franchise or licensing agreements.

2.3.1.1 Financial Comparison

There are some interesting facts that stand out when comparing the results of Couche-Tard and 24-Seven. Average revenue per store is significantly higher for 24-Seven. Couche-Tard is showing a very high growth rate in revenue due to their acquisition strategy. The operating profit margin is significantly higher at Couche-Tard. Expense control appears to be an important reason behind the difference in operating margins. 24-Seven runs a higher expense for operating, selling, and administration expenses as a percentage of total revenue. Couche-Tard outperforms 24-Seven in the return on assets but lags behind in the return on equity.

24-Seven’s high return on equity is caused by the company’s capital structure. High levels of debt had been maintained during this time. Much of the debt is held by 24-Seven Japan. Some of the debt is convertible to common shares in the company. As a result of conversions and repayments, debt levels have started to decline and shareholder equity has begun to increase. Return on equity measurements are expected to decline in the future as a result. A summary of selected financial information is shown in table 2.3.

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Table 2.2 Comparison of Selected Financial Information

<table>
<thead>
<tr>
<th>Year Ending Dec 31, 2004</th>
<th>24-Seven Inc.</th>
<th>Couche-Tard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Store Count</td>
<td>5,799</td>
<td>4,881</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$12.2 billion</td>
<td>$4.6 billion</td>
</tr>
<tr>
<td>Total Revenue Growth</td>
<td>13.1%</td>
<td>77.1%</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>$96.5 million</td>
<td>$62.0 million</td>
</tr>
<tr>
<td>Annual Profit Margin</td>
<td>0.79%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Total OSG &amp; A Expense</td>
<td>$3.0 billion</td>
<td>$769 million</td>
</tr>
<tr>
<td>OSG &amp; A Expense (% of Total Revenue)</td>
<td>24.9%</td>
<td>16.8%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>20.8%</td>
<td>10.6%</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>0.4%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Share of Total Revenue from Gasoline</td>
<td>34.7%</td>
<td>33.3%</td>
</tr>
<tr>
<td>Merchandise Gross Profit Margin</td>
<td>35.6%</td>
<td>32.62%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3-Year Period Ending Dec 31, 2004</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Operating Profit Margin</td>
<td>0.52%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>17.9%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>1.7%</td>
<td>4.7%</td>
</tr>
<tr>
<td>OSG &amp; A Expenses (% of Total Revenue)</td>
<td>25.8%</td>
<td>17.6%</td>
</tr>
</tbody>
</table>

2.3.1.2 Store Image Improvements

In an effort to boost productivity, Couche-Tard has put a major emphasis on store image through its IMPACT program. This is a store renovation program that upgrades store design and equipment. Food service is one of the focus areas of the IMPACT program. Approximately half of the corporate locations have been renovated at a cost of between $100,000 and $200,000 each. The remaining stores will be renovated as well and the program will continue so that each store is revisited every eight years.

24-Seven reduced the investment into store image improvements for several years. A program known as RESTORE was active in the 1990’s. The goal of the program was to improve the store image through the complete remodel of every store. Prior to the completion of the program it was shelved due to cost concerns. The company has lost some ground to its competitors on the overall store image as a result. However, a more modest store improvement

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41 Selected financial information compiled from each respective company’s 2004 annual reports. Couche-Tard information has been converted to US currency at a rate of 1 Canadian dollar = 78 cents US.
program is now underway with 800 stores completed in 2006 and another 900 planned for 2007. Despite a limited investment in store improvement, 24-Seven continues to have one of the strongest brand names around. The historical dominance of the company, past advertising campaigns, and a global presence has created a well recognized brand.

2.3.1.3 Product Differentiation

Product differentiation at Couche-Tard is attempted through private label brands such as Sloche, Froster, and Sunshine Joe Coffee. This is similar in nature to 24-Seven’s private label programs like Slurpee, Big Gulp, and Exclusive Blends Coffee. The companies take a different approach when it comes to food service. Quick serve restaurants have become an important part of Couche-Tard’s food service program. The company has signed franchise agreements with well known banners including Subway, Dunkin Doughnuts, and Quiznos. The proper facilities are installed as part of the IMPACT program. The restaurant is operated inside the convenience store by the company under a franchise agreement. This approach brings well recognized products and proven food service systems to the convenience store channel.

24-Seven has chosen to focus on proprietary fresh food offerings. This is represented mainly by refrigerated sandwiches, salads, and fruit which are delivered daily to the stores. Fast food offerings like hot dogs from the roller grill are also an important part of the program. Branded hot or cold food offerings are not a core part of the 24-Seven strategy. Branded quick serve restaurants will not be found in the vast majority of stores. 24-Seven has decided to create its own fresh food brands and its own fresh food delivery system. Both The Pantry and Couche-Tard are developing fresh food offerings for their customers. 24-Seven does not stand alone in this respect. 24-Seven will face competition on this front as they do on all parts of the business. In fact, the quick serve restaurant concept enables the competition to get up to speed quickly and
reduces some advantages that 24-Seven has gained through its early entry into the fresh food segment.

2.3.1.4 Organizational Structure and Costs

Low cost appears to be one of the key success factors that Couche-Tard has acquired. Higher operating profit margins and lower administration expenses are evidence of this. The company’s objective is to become the largest and most profitable convenience store operator in North America. The company follows a similar organizational structure for operations as 24-Seven. There is a combination of Division Vice presidents, Regional Managers, Market Co-ordinators, and Store Operators. Instead of having one Field Consultant for every eight stores, Couche-Tard has one Market Coordinator for every 10 to 12 stores. A flat and lean organizational structure across all areas of the business is an important objective for Couche-Tard. This lean structure is one way that Couche-Tard maintains a competitive advantage over 24-Seven. 24-Seven clearly has a higher cost structure than Couche-Tard. This reduces profitability and therefore fewer financial resources are available to reinvest in the company.

2.3.1.5 Franchise Model

Couche-Tard has a different compensation model for its franchise agreements. There is an up front fee of between $500,000 and $1,200,000 for a gas location. This secures a store, inventory, equipment and use of the business systems. Real estate is not included but the franchisee owns the store. An ongoing royalty of 4 percent of sales is paid to the company on a monthly basis. This option is significantly more capital intensive than a 24-Seven Franchise. In

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addition, based on approximate industry averages of $1,000,000 in annual revenue per store and $35,000 in pre-tax profit per year, the ongoing fees for a Couche-Tard franchisee are higher. A 24-Seven franchise seems like a compelling offer for individual investors with limited resources.

2.3.1.6 Store Location

The annual merchandise sales for 2004 averaged just under $500,000 per store for Couche-Tard. This is much lower than the $1,400,000 average for 24-Seven stores. Daily customer visits are estimated to be roughly 30 percent less on average in Couche-Tard locations. Couche-Tard’s current locations are less productive but the company is growing fast. High potential new store sites are being acquired and developed at a rapid pace.

An acquisition strategy is being used to increase economies of scale and to gain a more dominant position in the marketplace. Couche-Tard has shown exponential growth in total store count, growing from 310 stores in 1996 to almost 5,000 by the end of 2006. This fast rate of growth in revenue and store count should be of concern to 24-Seven.

2.3.2 The Pantry Inc.

The Pantry Inc. operates almost 1,500 convenience stores across the South Eastern United States. All stores are operated by the company and most are under the Kangaroo Express banner. The Pantry ranks number ten in total store count for North America. The company is headquartered in Sanford, North Carolina.

2.3.2.1 Financial Comparison

A comparison of some selected financial data from table 2.4 reveals that revenue growth at The Pantry is greater than at 24-Seven over the same period. Merchandise gross margin is the

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45 Daily customer visits are calculated from annual customer visit information found in the company annual reports.
highest of the three companies we have looked at. However, operating profit margin is very weak at only 0.35 percent over a three year period. Profitability measurements are negatively impacted by the high proportion of gasoline sales. Over a three year period The Pantry underperforms 24-Seven in return on assets and return on equity.

Table 2.3  Comparison of Selected Financial Information

<table>
<thead>
<tr>
<th>Fiscal Year Ending 2004</th>
<th>24-Seven Inc.</th>
<th>The Pantry Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Store Count</td>
<td>5,799</td>
<td>1,361</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$12.2 billion</td>
<td>$3.5 billion</td>
</tr>
<tr>
<td>Total Revenue Growth</td>
<td>13.1%</td>
<td>27.0%</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>$96.5 million</td>
<td>$17.6 million</td>
</tr>
<tr>
<td>Annual Profit Margin</td>
<td>0.79%</td>
<td>0.50%</td>
</tr>
<tr>
<td>Total OSG &amp; A Expense</td>
<td>$3.0 billion</td>
<td>$438 million</td>
</tr>
<tr>
<td>OSG &amp; A Expense ( % of Total Revenue)</td>
<td>24.9%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>20.8%</td>
<td>11.6%</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>0.4%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Share of Total Revenue from Gasoline</td>
<td>34.7 %</td>
<td>65.7%</td>
</tr>
<tr>
<td>Merchandise Gross Profit Margin</td>
<td>35.6%</td>
<td>36.3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3-Year Period Ending 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Operating Profit Margin</td>
</tr>
<tr>
<td>Return on Equity</td>
</tr>
<tr>
<td>Return on Assets</td>
</tr>
<tr>
<td>OSG &amp; A Expenses ( % of Total Revenue)</td>
</tr>
</tbody>
</table>

2.3.2.2  Store Image Improvements

Store image improvement is an important part of the company strategy for The Pantry. They strive for a clean and modern look through store remodels and re-branding efforts. A total of 1,100 stores were remodelled and re-branded as the Kangaroo Express over the three year period of 2003 and 2005.48

2.3.2.3  Product Differentiation

Private label branding is being used by the company to differentiate its products. The portfolio of private label products includes Chill Zone fountain and frozen drinks, Celeste brand

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47 Selected financial information compiled from each respective company’s 2004 annual reports.
packaged beverages, and Bean Street Coffee. The Pantry has started to expand the assortment of fresh food items and food service options. A total of 197 quick serve restaurants have been integrated into the convenience store operations. A number of proprietary quick serve restaurants were recently closed in favour of more well recognized franchises such as Subway and Quiznos.

2.3.2.4 Organizational Structure & Costs

The Pantry has an average selling and general administrative expense of $322,000 per store. This is lower than 24-Seven’s average annual expense of $517,000. Having corporate store operations facilitates centralization and consolidated buying. Despite the lower operating costs and potential for consolidated buying, The Pantry falls behind in profitability. A high proportion of sales from the gasoline category negatively influences profitability. Also, the regional nature of the company limits the ability to gain a buying power advantage over 24-Seven.

2.3.2.5 Store Location

Annual merchandise sales are approximately $860,000 per store for The Pantry. The sites are more productive than Couche-Tard but less productive than 24-Seven. The Pantry is securing new store sites but at a rather slow pace. A strategy of acquiring small, regional convenience store chains is being used. Two hundred and nine locations have been added to the network over the last two years due to acquisition.

2.3.3 Comparison of Key Success Factors

A matrix has been developed to summarize the ability of 24-Seven and the two selected competitors to deliver against the five most important key success factors identified in table 2.1. An estimated percentile score has been assigned based on each company’s capability to deliver

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against the key success factors. The final overall score will serve as a measure of the companies’ relative competitive position.

Table 2.4 Comparison of Key Success Factors

<table>
<thead>
<tr>
<th>Key Success Factor</th>
<th>24-Seven</th>
<th>Couche-Tard</th>
<th>The Pantry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Operating Costs</td>
<td>50</td>
<td>80</td>
<td>40</td>
</tr>
<tr>
<td>Store Location</td>
<td>70</td>
<td>80</td>
<td>60</td>
</tr>
<tr>
<td>Product Differentiation</td>
<td>75</td>
<td>70</td>
<td>65</td>
</tr>
<tr>
<td>Store Image</td>
<td>70</td>
<td>90</td>
<td>80</td>
</tr>
<tr>
<td>Brand Strength</td>
<td>80</td>
<td>70</td>
<td>80</td>
</tr>
<tr>
<td>Total Capability (Total Possible 500)</td>
<td>345</td>
<td>390</td>
<td>285</td>
</tr>
</tbody>
</table>

2.4 Opportunities and Threats

Opportunities and threats have been identified based on the analysis of the industry and the capabilities of key competitors. 24-Seven is losing the competitive advantage it has gained through its historically dominant position in the market place. Couche-Tard and other competitors continue to increase in size and revenue. As competitors grow larger they are able to achieve greater economies of scale and greater efficiency.

The biggest threat for 24-Seven is the low cost operating structures in the industry. In this intensely competitive industry a cost disadvantage is dangerous for 24-Seven. Companies that generate higher returns are able to reinvest in the business. If sales growth weakens and industry rivalry increases as anticipated, cost control will be essential to survival. Independent convenience stores have low overhead but lack the buying power of the large chain stores. If 24-Seven can maintain a dominant position in the market it is possible to exercise considerable buying power through consolidated purchasing. In order to compete with other large chains, 24-

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50 Rating by the author
Seven must get administrative costs under control. The current franchise model appears to be an excellent opportunity to achieve growth and cost control.

24-Seven has highly productive locations. However, the store count for 24-Seven has been relatively flat over the last ten years. One danger with a lower rate of growth is the selection of new sites. It is important to plan ahead as new neighbourhoods are created and demographics change. Securing locations early on can result in productive stores for many years to come. 24-Seven needs to balance the requirements for short term profitability with the investment required for future growth. The key competitors do not generate the same revenues as 24-Seven but they continue to acquire sites with future potential. 24-Seven must find a way to grow profitably so that it does not fall behind the competition. Corporate stores are an expensive option for the company but franchise stores would enable faster growth and better returns.

24-Seven has a better store image than the independent store operators but the company has fallen behind key regional and national chains. Key competitors continue to invest in renovations and remodels at higher levels than 24-Seven. Image improvements include redesigns and equipment upgrades. The one-time quality gap in frozen beverage and coffee offerings is all but gone as a result. Couche-Tard and The Pantry are investing in fresh food programs by building quick serve restaurants as part of the image upgrade programs. 24-Seven has started to invest in store upgrades once again. In addition, some of the image issues can be dealt with through the enforcement of higher cleanliness standards and other operational controls.

One clear area of opportunity for the industry is in fresh food. This segment is highly profitable and it is growing quickly in the marketplace. Fresh food programs could help to reverse the negative trend in customer counts by appealing to multiple meal occasions. The same customer could visit the store breakfast, lunch, dinner, or just a snack. Increasing the sales in
new areas like fresh food will ultimately help to reduce the reliance on less attractive categories like gasoline and tobacco.

24-Seven has taken a differentiation approach to fresh food. The revenue growth has been decent but it has not met with the expectations of management. The differentiation approach has had limited success so far in increasing customer counts. In addition, the gross margin is running a full ten percentage points behind the industry average. It appears that customers have not been willing to pay extra for the level of differentiation provided. Better in-store implementation of existing programs and a focus on efficiency may help the company to lower costs and grow fresh food sales at the same time.

2.5 Analysis of the Franchise Structure

A key decision made by many retail companies is whether the stores should be run by the company or by independent contractors. Some industry research exists on this topic. This research is useful in determining the best organizational structure for 24-Seven.

2.5.1 Lower Operating Inefficiency

Corporate employees generally receive fixed salaries. These employees may receive an additional incentive for meeting financial targets as part of their compensation. Franchisees, however, have made a personal financial investment and share directly in store profits. These factors create a stronger incentive for the franchisee to maximize operational efficiency. Industry research suggests that since corporate managers do not bear the full cost of shirking and perquisite-taking, they will have more incentive to engage in this behaviour than franchisees51.

Weaker incentives for corporate managers to maximize efficiency can result in higher costs. For example, corporate managers may choose higher labour costs over longer hours and increased job stress for themselves. A less aggressive approach may also be taken to address theft if the financial impact is less significant to the corporate operator. A higher level of operating efficiency in franchise outlets is consistent with the lower operating costs of sole proprietorships in the convenience store industry. It is also consistent with the lower operating costs observed in 24-Seven's franchise stores. Franchising is a potential method to reduce operational inefficiency since it internalizes most of the wealth effects of shirking and perquisite-taking to the store operator\textsuperscript{52}.

### 2.5.2 Reduced Incentive for Free-Riding

There is a tendency for operators to under invest in certain parts of the business. Store operators may be tempted to free-ride on the brand investments of the corporation and other operators. Evidence of free-riding in the convenience store industry may appear as poor store conditions and low quality prepared foods.

Brickley makes the following comments about the free-rider problem, "A major problem facing companies with valuable brand names is controlling the actions of agents throughout the organization to assure the continued value of the trademark. Not all individuals within the firm can be expected to have a strong interest in expending the effort to maintain the quality and reputation of the product"\textsuperscript{53}. Control mechanisms and monitoring are commonly used to minimize this problem in company operated sites. A franchise model reduces some of the incentive for free-riding due to the residual ownership in the business. However, "an externality


problem among units within the organization implies that some central control is likely to be beneficial in maintaining the trademark value."54.

Clear contractual obligations, financial penalties, and financial incentives can help to achieve a sufficient level of centralized control over franchise stores. The lower cleanliness scores and fresh food sales observed in 24-Seven's franchise markets is likely the result of weak controls rather than a strong incentive to free-ride.

2.5.3 Lower Monitoring Costs

A reduced incentive for free-riding generally leads to lower monitoring costs within a franchise structure. "The operation of all stores by a central company can be very costly because it is expensive to develop systems for controlling employee behavior. Monitoring costs are even higher when stores are dispersed over a wide geographic area."55. A wide dispersion of store locations is characteristic of many convenience store chains. Furthermore, expense control is essential in this competitive environment. Relatively high monitoring costs can create an additional burden for organizations that have a high proportion of company operated sites.

2.5.4 Summary of Findings

Industry research suggests that a franchise structure can result in lower store operating costs. In addition, the incentive for free-riding on the brand investment of the company tends to be lower among franchisees. However, the incentive to free-ride is not completely eliminated. Some operational controls are still necessary within a franchise operation. Measures taken to control franchisees are often less costly than more stringent control mechanisms required of corporate operations. A franchise model seems consistent with a low operating cost strategy due

to the lower operational inefficiency and lower monitoring costs characteristic of this organizational structure.

2.6 Strategic Alternatives

Based on the analysis of the industry and the key success factors, the author suggests that 24-Seven follows a low operating cost strategy. The company’s dominant position in the industry is being challenged by fast growing competitors and intense rivalry. 24-Seven’s attempts at product differentiation have failed to maintain a competitive advantage over the long term. Competitors have created their own proprietary brands and have successfully replicated many of the company’s successful programs. The relatively low gross margin of the 24-Seven fresh food categories indicates that consumers are unwilling to pay the premium required for a differentiation strategy.

A low cost operating strategy for 24-Seven should be centred on converting the remaining corporate stores to franchise operations. A review of the corporate infrastructure should be undertaken to find areas of opportunity to lower costs and increase efficiency. A greater level of centralization must be implemented to reduce the duplication of work and significantly increase the company’s buying power. Tighter operational controls will be necessary to improve efficiency, improve the store image, and strengthen the brand under a franchise model.

A merchandise-only store model for new locations is consistent with maximizing profitability reducing costs. Fresh food should continue to be an area of focus for 24-Seven due to the high potential of the category. Withdrawing from this segment now would put the company at a disadvantage to the competition. However management must make a concerted effort to maximize the efficiency of the program so that it does not negatively influence company profitability.
An internal analysis of the company will be completed in chapter three. This analysis will help to determine how a low operating cost strategy fits with the company’s management preferences organizational capabilities, and resources. Recommendations will be provided where gaps exist between this strategic alternative and the characteristics of the company.
3 ANALYSIS OF INTERNAL ENVIRONMENT AND CAPABILITIES

24-Seven must have the necessary internal capabilities and resources to successfully implement a low operating cost strategy. This chapter will examine the company in terms of its management preferences, organizational capabilities, and resources.

3.1 Analysis of Management Preferences

Strong management preferences exist within the company. The company has been pushed in a different direction since the initial investment that brought 24-Seven Inc. out of bankruptcy protection in 1990. It is very clear that the Japanese investors believe the previous strategies and management practices led to the financial failure of the company. As a result, they developed a new corporate strategy. This strategy is a combination of low cost, differentiation, and focus tactics that have been successful in Japan. These same tactics have met with only limited success in North America.

24-Seven Japan uses a franchise model exclusively and has an intensive focus on fresh foods. The Retailer Initiative philosophy originated in Japan and it is still practiced today. Store operators are given a considerable amount of autonomy to make product assortment and merchandising decisions as a result. The company has been successful in Japan and is now looking to diversify abroad. It is not surprising that the 24-Seven Japan would attempt to follow a similar business model in foreign countries. Past success and a familiarity with the business processes reinforce the notion that the Japanese strategy is best for all geographic areas.
A similar business model in Japan and North America is seen as one way to simplify the business. However, the author feels strongly that strategic decisions should be made based on an analysis of the external environment and key competitors. Management has a bias towards strategies used in Japan and that influences decision making in the North American operations. Despite the bias there is a very clear desire for improved performance and profitability in the North American operations.

3.1.1 Management Preference Gap Analysis

There is considerable common ground between the recommended strategic alternative and current management preferences. A franchise structure is strongly supported by management. In fact, efforts are now underway to convert a number of corporate stores to franchise stores in the United States. Continued participation in the fresh food category would also be supported by management since it is a key part of the Japanese strategy. Finally, the company has recently made decisions to modestly reduce corporate staff and the cut costs. There would be little resistance to further cost cutting and staff reductions as long as it did not negatively impact day-to-day operations or company performance.

3.1.1.1 Potential Areas of Conflict

Areas of conflict do exist between current management preferences and the low operating cost strategy. The conflict revolves around the recommendations for tighter operational controls and centralized decision making. These two recommendations take a very different approach from what is currently being practiced under the company’s Retailer Initiative philosophy. Management believes that store employees are in the best position to understand the needs of customers. Enabling the individual stores to make assortment and merchandising decisions creates in a high level of customization.
There is another reason for the high level of autonomy and the low level of forced compliance. 24-Seven attempts to appease franchisees and appeal to potential franchisees by using this operator friendly approach. A strong case must be made before management will reconsider the Retailer Initiative model. Management ultimately must understand that these changes will enable the company to achieve its financial targets and that these changes are essential to maintain a competitive position in the industry.

3.1.1.2 Bridging the Gap

Japanese operations significantly outperform North America in the key financial metrics of operating profit margin and return on assets. The three year average operating profit margin for 24-Seven Japan is 3.2 percent versus 0.52 percent for 24-Seven Inc. Japanese operations have a three year average return on assets of 10.4 percent versus 1.7 percent for North America. Any opportunities to significantly improve the performance of North America on these fronts would be well received by the company. The efficiencies, cost savings, and greater buying power resulting from centralizing key functions will enable the company to make significant improvements in these areas. In the author’s opinion, management’s desire to achieve aggressive financial targets will outweigh the desire to follow the Retailer Initiative philosophy. Change is necessary to achieve the current financial objectives. Illustrating the poor historical results and forecasting future company performance will help convince management of the merits of a low operating cost strategy.

3.2 Analysis of Organizational Capabilities

3.2.1 Information and Ordering Systems

Information collected from the company’s Retail Information System is available to the stores. Each store can review product sales over the most recent 28 day period. In addition, they

56 Based on financial data included in each company’s respective 2004 annual report.
can review sales results for the Market in which they reside. This helps to provide an understanding of the sales trends in the surrounding area. Store computers provide information about local demographics from what has been collected in previous surveys. Weather forecasts are also accessible through the store computer to help with forecasting product requirements.

The 24-Seven ordering system requires that the stores place their own orders on a daily and weekly basis, depending on the products. The stores select items from what is made available by the merchandising departments in the United States and Canadian head offices. Every week the stores receive a package that includes details about new products. Any type of automatic product distribution by the corporate merchandising department to the stores is strongly discouraged. Replenishment orders are also placed by the stores on an ongoing basis for products that they want to keep in the assortment. This means that each product in the store is re-ordered and forecasted by store staff within the weekly cycle.

3.2.2 Information and Ordering Systems Gap Analysis

24-Seven’s information system provides a great deal of information to the stores and offices. This information is useful for analyzing performance and identifying areas of opportunity. Individual store results can be accessed at the office level. In addition, the data can be rearranged and manipulated at almost any level. This information is valuable for corporate employees when making decisions on behalf of store operators. The information system supports a higher degree of centralization and good decision making.

3.2.2.1 Potential Areas of Conflict

The current ordering system is designed around the need for a high level of customization. The system supports a store-by-store focus strategy but not a low operating cost strategy. The current system encourages store operators to make their own decisions about new items, replenishment orders, and the overall product assortment. The ability to set up Non-
Recommended items also encourages operators to source products from outside the company distribution system. A more centralized approach to ordering is required for the successful implementation of a low operating cost strategy.

The current order system is very labour intensive for store personnel. Currently individuals in thousands of different stores order thousands of products every week. This results in a great deal of duplication of work and inconsistent results at store level. The 24-Seven ordering system is a major barrier to achieving greater buying power, improved efficiency, and lower operating costs.

3.2.2.2 Bridging the Gap

Automated replenishment systems would fit well with a greater level of centralized decision making. This type of system would also be much less labour intensive for the stores. An automated replenishment system uses a computer model to generate store orders based on sales history and other relevant factors. Information such as seasonality and weather forecasts can be taken into account to improve the accuracy orders. This technological solution has excellent potential to reduce the complexity of the job for store employees, therefore reducing labour requirements. Reduced labour directly translates into higher profitability for franchise operators.

A change to computer generated ordering would not be difficult for 24-Seven. Much of the technological infrastructure is already in place. Every store has a scanning system, store computer, and communication links to office systems. A software package can be purchased by the company and customized to its particular needs. Many other retailers use these systems so they are tested and proven successful. Wal-Mart is well known for its support of computerized inventory management systems. The European grocery retailer Tesco is also using an automated system to maximize efficiency.
Over 90 percent of the products and services in 24-Seven are standardized and shelf stable. These products would be well suited for an automatic replenishment system. Item by item management may still be necessary for highly perishable fresh food products. Accurate forecasting and adjustments to local consumer demands are important in preventing stock outs and write-offs. A hands-on approach to this area is also important to insure that a high level of cleanliness and food safe conditions are maintained. Some of the labour savings could be directed towards managing fresh food programs and excess staff could be cut to reduce costs.

3.2.3 Organizational Control Systems

Certain operational requirements are already written into the existing franchise agreement. Stores must purchase at least 85 percent of products from the company. There are also minimum standards for store cleanliness and participation in proprietary programs. Currently the company can only take action for a serious breach of contract. The actions are limited to providing a warning to the store operator and subsequently terminating the franchise agreement.

The company has not demonstrated the will to hold franchisees accountable to these operational standards in the past. Very few franchise agreements have been terminated for failure to meet specified standards for purchasing, program implementation, or cleanliness.

3.2.4 Organizational Control Systems Gap Analysis

Enforcing tighter control on store operators is essential under a franchise model. A large network of stores run by independent operators can be difficult to manage. Ineffective control systems reduce the efficiency of the company. Program implementation worsens when company direction is not followed. Standardization and consistency are not possible when store operators are not held accountable for achieving operational standards.
Tighter control is an important part of increasing fresh food sales. Store operators must be held more accountable for the level of participation in fresh food programs and for store cleanliness. 24-Seven can get the benefit of lower operating costs from franchise stores while running a successful fresh food program if proper operational controls are in place.

### 3.2.4.1 Bridging the Gap

The first step to the successful implementation of a low operating cost strategy is to communicate what the company deems acceptable under the current agreement. A greater level of clarity is required for store operators to take notice. Operational standards should be communicated on a regular basis. However, communication alone is not enough. Management must also begin to measure compliance and enforce the standards that they have communicated.

Franchise agreements for new operators and renewals should be updated with tighter operational controls. This is an opportunity to further support the low operating cost strategy. More aggressive standards should be set for cleanliness and purchasing. It is reasonable for management to expect franchise operators to purchase greater than 90 percent of merchandise through the company system.

Financial penalties for non-compliance should also be written into new franchise agreements. This would give management the ability to enforce standards without resorting to more serious methods such as termination of the business relationship due to breach of contract. Financial rewards for superior operational performance are also worth consideration. Financial rewards could serve as a strong incentive for operators to achieve management’s operational standards. These types of incentives could be structured in a way that does not create a large financial burden for the company. The expectation is that improved compliance by store operators will lead to sales and profit increases for the company. Therefore, some investment into incentive programs seems logical.
3.2.5 Organizational Structure

24-Seven already has some centralized business functions. However, the evolution of the company has led to a somewhat decentralized structure overall. There is one North American office in Dallas Texas. This office houses support functions for stores in the United States. There are corporate departments for Marketing, Finance, Accounting, Merchandising, Information Systems, Legal, Construction & Development and other functions. These departments provide direction and support to operations in the field, division offices, and regional offices. Despite the support provided by the Dallas office, regional personnel have some responsibility and autonomy to react to local requests and needs.

A Canadian head office exists in Burnaby, British Columbia. This office provides the support and direction to the Canadian group of approximately 500 stores. The Canadian office does not have the same breadth or depth of support services that exist in the Dallas office. Certain services are provided directly from the North American office. The Information Technology department in Dallas, for example, is responsible for the technology infrastructure in the United States and Canada. The following functions are performed almost exclusively by Canadian staff in the Burnaby office: Merchandising, Marketing, Accounting, Data Processing, Construction & Development, and Purchasing.

The company groups stores together based on geography. Markets are formed from a collection of anywhere from fifty to one hundred and fifty stores. These Markets are then allocated to a Division for management purposes. There are 7 Divisions across the United States and Canada is a separate division. There is a Senior Vice President of Operations in the Dallas Office. Each Division has a dedicated office and a Division Vice President. A group of Market Managers report directly to each of the Division Vice Presidents. Field Consultants are assigned a group of approximately eight stores and are expected to act as a business consultant to those stores. The current structure for the Field Operations group is shown in figure 3.1.
3.2.6 Organizational Structure Gap Analysis

3.2.6.1 Potential Areas of Conflict

The conflict between 24-Seven's current organizational structure and the implementation of a low operating cost relates to the high administrative costs. Operating, selling, and general administration costs represent almost 25 percent of total revenues. These are some of the highest administration costs in the industry and it does not bode well for the 24-Seven's competitive position. A decentralized structure has contributed to the high administrative costs and weak buying power. Efficiencies must be found in order to have success with a low operating cost strategy.

24-Seven must provide the proper management support and supervision to franchise stores. An efficient structure that facilitates some regional flexibility is essential to the low cost strategy. Centralization of some functions is required to maximize efficiency. For example, centralized buying would be required in order to obtain the lowest possible cost of goods. Some local representation is still necessary to accommodate any specific needs of each region. This local representation is currently available in the form of Field Merchandising staff in the division.
Merchandise managers can make assortment and merchandising adjustments for the stores within a division. These changes can be made for individual stores or for all stores in the division.

Management has recently taken a confusing approach in its centralization strategy. Moves have been made to centralize some functions and to decentralize others. Decision making for Fresh Food programs has been pushed down to the division level. Resources are no longer being added in the Dallas office and individuals in the division offices have been charged with the responsibility for their own programs. At the same time the company has attempted to transfer some of the marketing and merchandising functions from the Canadian office into the Dallas office. Little success has been made in this attempt due to a lack of local knowledge, differing product regulations between the two countries, and a refusal to add staff in the Dallas office.

3.2.6.2 Bridging the Gap

A consistent strategic approach and a role change and staff reductions for Field Consultants would help bring the structure inline with a low operating cost strategy. These changes would be relatively easy to implement. Once implemented, the structure of the company would be well suited to provide franchise stores with the products, support, and supervision required of a low operating cost strategy. The corporate infrastructure is in place to make decisions about product assortment and merchandising for the stores. Merchandise managers are available in each division to make necessary regional adjustments.

Field Consultants would no longer have to persuade reluctant franchisees to follow company programs if tighter operational controls and penalties were written into franchise agreements. This would make a change in responsibilities possible for this position. Field Consultants would still be required to provide some operational assistance for new operators and underperforming stores. However, the new position would require only periodic visits in other
locations to measure compliance against the standards of the agreement. A Field Consultant could manage a much larger group of stores after this change in responsibilities. A group of twenty stores should still allow monthly visits to all locations and weekly visits to new and problem stores. The head count for Field Consultants could be reduced from 725 to 290 under this model. Expense reductions of over $30 million per year would be achieved from this reduction in staff.

The offices in Dallas and Burnaby are the recommended locations for the centralized functions of the company. The departments exist and experienced employees are already in position. Some opportunity exists to centralize a limited number of functions like Information Technology and Marketing into the Dallas office for all of North America. Past experience suggests that functions such as Accounting, Data Processing, Purchasing, Merchandising, and Store Development are best centralized at the country level. Differences in regulation, suppliers, product assortment, and consumer preferences are significant enough that centralizing at the country level provides the best balance of efficiency and performance.

3.2.7 Decision Making Process

There are two key elements of the decision making process at 24-Seven. These elements are a scientific approach to decision making and a desire to build consensus within the organization.

The company encourages the use of a four-step scientific decision making process. The four-step method consists of the following steps:

1. Current Situation
   - This step is intended to be a summary of the current environment. The reason for change and a review of the opportunity would be included in this step.
2. Hypothesis
   - The hypothesis is simply a statement of the intended action and the anticipated business consequences of the action.

3. Verification
   - This step is intended to prove the validity of the business proposal, or hypothesis. Frequently, information from the company’s scanning system is used to show the impact of a change in a test store or group of stores.

4. Conclusion
   - The conclusion confirms or refutes the hypothesis. It is also used to show how the lessons can be applied to a wider business context.

   The importance of mutual acceptance and support of business decisions is emphasized throughout the organization. Information is passed up and across the organization. Business plans and case studies are presented and discussed in public forums. Individuals, especially in Operations, are encouraged to raise issues and concerns. It is expected that the decision maker will address any concerns before proceeding with the proposed plan.

3.2.8 Decision Making Process Gap Analysis

3.2.8.1 Potential Areas of Conflict

The current decision making process at 24-Seven could cause issues with the successful implementation of a low operating cost strategy. The system does not clearly define who has the authority to make decisions. Consensus-based decision making puts the burden on corporate staff to try and please all parties before implementing programs. In many cases this can lead to slow decision making and less than optimal solutions for the company. The recommended strategic alternative requires good decision making as well as quick and effective implementation of programs by store operators. The corporate decisions may not please everyone. However, the more important factor is that the decisions lead to lower costs and improved profitability for the company as a whole.
3.2.8.2 Bridging the Gap

Management needs to start treating franchisees less like customers and more like business partners. Management must exercise its authority and set the expectations that store operators will implement programs as directed. This can be accomplished through clear communication with the store operators, enforcement of the existing franchise agreement, stricter controls in new agreements, and supervision by the remaining Field Consultants. Franchisees and the company will benefit directly once the changes lead to increased store profitability.

3.3 Analysis of Organization Resources

3.3.1 Financial Resources

24-Seven Inc. has faced significant financial issues in the past. The company has gone into bankruptcy protection twice since it began in 1927. Assets have been sold off and the company has been reorganized on a number of occasions in order to deal with financial shortfalls and poor performance. It is obvious that the availability of financial resources has been a major issue in the past. During the most recent reorganization in 1990, Ito Yokado Holding Company purchased a 70 percent equity stake in Southland for $430 million and assumed management control of the North American operations.

This infusion of cash relieved some of the financial pressure on the company. An even more important part of the Japanese investment was that it provided ongoing access to large amounts of capital at relatively low costs. The company took advantage of this by securing long term debt from 24-Seven Japan and Ito Yokado Holding Company. A number of different debt instruments were used including long term low interest loans, and convertible debt securities. In addition to direct loans, Ito Yokado also guaranteed loans to 24-Seven Inc. which allowed for lower interest rates.
While access to financial resources may have been a problem in the past, that is certainly not the case today. 24-Seven is financially strong and has access to funds if significant investment in the business is required.

3.3.2 Financial Resources Gap Analysis

A low operating cost strategy is less capital intensive than other alternatives such as a differentiation strategy. Less financial resources are required for the low cost approach versus the combination of strategies currently used by the company. Considering the management preferences for improved profitability and higher return on assets, a reduction in capital investment should appeal to the company.

There does not appear to be any financial constraints that would prevent the implementation of a low cost strategy. One of the most capital intensive parts of the business is new store development. The cost to develop a new store is estimated to be between two and three million dollars per location\(^5\). The cost of building and equipping a store is essentially the same for corporate and franchise locations. However, a franchisee pays an initial $150,000 fee at the start of the agreement. Company operating expenses are lower for franchise locations because labour and inventory costs are assumed by the franchisee. The franchise system, therefore, provides the company with a way of achieving relatively quick and profitable growth.

Store growth could play an important role in a low operating cost strategy. 24-Seven must defend its dominant position in the marketplace against fast growing competitors. A large and efficient network of stores strengthens the company’s position in the industry. Furthermore, store development in areas serviced by the company’s Combined Distribution Centres will create economies of scale within the fresh food distribution system.

\(^5\) Estimate from the Construction and Development department of 24-Seven Canada.
3.3.3 Human Resources

One of the biggest challenges in a convenience store operation is dealing effectively with human resources. Employees face low pay, little prestige, and sometimes risks to personal safety. The employer faces challenges acquiring and retaining a motivated workforce. 24-Seven experiences an annual turnover of store level staff of 70 percent in Canada and 100 percent in the United States58. Employees are expected to perform a wide range of tasks for little over minimum wage. Running the register, installing promotional signage, ordering products, merchandising the shelves, and cleaning the store are only some of the tasks that a typical 24-Seven employee would be expected to perform.

As mentioned in the previous section, the current ordering system places a significant burden on store level staff. The company philosophy is that products should be ordered item by item, store-by-store. Additional expenses are created by corporate training programs that have been put in place to teach the fundamentals of ordering. Each store now has a number of certified order writers that have been trained by the company. The high level of employee turnover means that training must be continual.

3.3.4 Human Resources Gap Analysis

3.3.4.1 Potential Areas of Conflict

A low operating cost strategy requires a lean and efficient infrastructure. In contrast, 24-Seven’s current strategy has created complicated, labour intensive practices at store level. Greater efficiency and simplification must be attained in order to ease the burden on store operators and reduce labour costs.

58 An estimate from the 24-Seven Human Resources department.
3.3.4.2 Bridging the Gap

Two changes already recommended will help lower labour requirements and increase efficiency. Increased centralization will take the majority of product assortment and merchandising decisions out of the hands of the store operators. Corporate staff in the Canadian and American head offices will perform these functions. Furthermore, an automatic replenishment system will greatly reduce the work required for store ordering. Labour reductions will be made possible through these initiatives.

3.4 Financial Rationale

This section will outline the financial rationale for this proposal. Estimates of the financial impact of recommended changes will be developed. Elements of the plan to be considered in this analysis include: a conversion of corporate stores to franchise operations, increased buying power resulting from centralized purchasing, a reduction in the number of Field Consultants, a reduction in the number of store staff, and the introduction of an automated replenishment system.

Two financial scenarios have been developed in the Financial Scenarios section. The first scenario approximates the current financial state of the company. It will enable an analysis of the relative operating performance of corporate and franchise stores. Changes to this scenario will be made according to the recommendations for a low operating cost strategy. This second scenario will forecast the financial impact of the specified changes.

3.4.1 Financial Cost and Benefit Analysis

The cost and benefit of proposed strategic changes are summarized in table 3.1.
Table 3.1 Estimated Financial Costs and Benefits

24-Seven Inc.

<table>
<thead>
<tr>
<th>Cost</th>
<th>Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Store Operating Cost Savings</td>
<td>328,663,000</td>
</tr>
<tr>
<td>Field Consultant Reduction</td>
<td>30,450,000</td>
</tr>
<tr>
<td>Automated Replenishment System</td>
<td>10,900,000</td>
</tr>
<tr>
<td>Increased Buying Power</td>
<td>19,750,000</td>
</tr>
<tr>
<td>Total</td>
<td>10,900,000</td>
</tr>
<tr>
<td></td>
<td>378,863,000</td>
</tr>
</tbody>
</table>

Franchise Operators

<table>
<thead>
<tr>
<th>Cost</th>
<th>Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Store Staff Reduction</td>
<td>96,495,360</td>
</tr>
<tr>
<td>Increased Buying Power</td>
<td>19,750,000</td>
</tr>
<tr>
<td>Total</td>
<td>116,245,360</td>
</tr>
</tbody>
</table>

3.4.1.1 Financial Costs and Benefits for 24-Seven

Converting the remaining corporate stores to franchise locations will create the largest financial benefit of all of the recommendations. Franchise stores are more profitable for the company due to lower costs of operation. The difference in the annual profitability between corporate and franchise stores is estimated to be $137,000 per location (see Appendix A).

Therefore, the anticipated benefit to the company totals almost $330 million per year. Income from the initial franchise fee for converted stores is not included in this analysis. It is likely that this initial franchise fee would need to be temporarily reduced. This would facilitate the conversion of a large number of corporate stores over a short time period. The more important factor here is the increased profitability of future operations for the company.

A reduction in the number of Field Consultants employed by the company will result in annual savings of over $30 million in administrative costs. The average annual salary is estimated to be $70,000 and it is recommended that the number of positions be decreased by 435.

Centralization of the buying function is anticipated to generate a gross margin increase of half a percentage point. This is roughly equivalent to $40 million dollars which will be shared equally by 24-Seven Inc. and the franchise operators. This margin increase will be achievable due to
increased buying power resulting in lower cost of goods. Corporate managers will be able to negotiate better deals and the company will be able to collect a larger share of volume rebates.

The one area where the company is required to invest additional funds is in the purchase and development of an automated replenishment system. Third party software is available and can be purchased by 24-Seven. Significant customization would be required so that the program works within the existing hardware and software infrastructure. The initial purchase price is estimated to be $4 million with another $3 million in software customization. Five hundred dollars per store have been budgeted to update store equipment in the event that an additional terminal or scanner is required to electronically verify delivery quantities. The $2.9 million for store hardware upgrades and $1 million for system testing brings the total company investment to $10.9 million.

3.4.1.2 Financial Costs and Benefits for Franchise Operators

Franchise operators will also directly benefit from the recommended strategic adjustments. This is important because the profitability of the franchise stores plays an important role in attracting additional franchisees to the 24-Seven system. A franchise store network stands to gain an additional $116 million dollars with the successful implementation of a low operating cost strategy. The stores will gain almost $20 million with the anticipated margin increase of half a percentage point. The company gets the other $20 million due the equal sharing of franchisee gross profits. A staff reduction at store level is made possible by the centralization of purchasing, assortment, and merchandising functions. The automated replenishment system will further simplify store operations. It is anticipated that one full time position may be eliminated due to these changes. This provides a savings of approximately $16,600 per store or a total of $96 million across the entire network. This labour reduction benefits the franchise operators directly since the franchise fee is calculated before labour costs.
3.4.2 Financial Scenarios

Financial scenarios have been developed by the author in order to better understand differences in the operating profitability between corporate and franchise stores (see Appendix). Profitability for the company and for the franchise operator will be reviewed. These scenarios will focus on merchandise sales only since the majority of existing stores and all new stores will fall under this category. The first scenario is intended to replicate the most recent company results (Appendix A). The forecast scenario (Appendix B) is used to show the anticipated financial impacts of making the recommended strategic changes specified in the Financial Cost and Benefit Analysis section.

3.4.2.1 Financial Scenario – Before Implementation

While franchise stores generate slightly less merchandise sales, they are less expensive for the company to run. The fact that the company does not pay franchise store labour or inventory costs leads to a lower operating expense of $164,000. As a result, franchise stores are profitable for the company. Franchise stores generate an estimated $15,000 per year in company profit from merchandise sales. Corporate stores are not profitable before the profit contribution from gasoline. Corporate stores on average lose $122,000 in profit per year after all company expenses are factored in. This is very concerning considering the significant number of corporate stores. Furthermore, the huge profits currently generated by gasoline are not expected to be sustainable or consistent.

The franchise operator brings in an after tax profit of $21,000 after all operating expenses. The franchise operator must pay the company royalty which is 50 percent of gross profits. Store labour and other operating expenses are also paid directly by the franchisee. This profit level is very much in line with the industry average.
3.4.2.2 Financial Scenario – Forecast after Implementation

The profitability for both franchise and corporate stores is expected to improve after the implementation of the recommended changes. The loss from a corporate store declines to $110,000 due to reduced company overhead. The company will generate an increased annual profit of $27,000 per year from each franchise store. Franchise operators will also see an increase in their profits. The after tax profit for operators increases from $21,000 previously to $34,000 after the changes.

A dramatic reduction in the number of corporate stores, reduced overhead, and increased profitability will significantly enhance company net earnings. Annual company net earnings are anticipated to reach $455 million. This is a dramatic increase from the $97 million made in 2004. The end result is a net operating profit margin of 3.7 percent, far in excess of the 1.5 percent goal set by management.
4 FINAL RECOMMENDATIONS

A low operating cost strategy has been recommended for 24-Seven Inc. This strategic alternative includes the following elements:

- A minimum 95 percent franchise structure for store operations.
- A review and reduction of administrative expenses.
- Greater centralization of product assortment, merchandising, and replenishment functions.
- Tighter operational controls for store operators.

A low cost operating strategy will increase the chances of success in the competitive convenience store industry. The company will be able to leverage its size and operate the current network of stores more efficiently. The end result will be greater profitability for the company and for franchise operators.

The internal analysis in chapter three identified a number of additional strategic adjustments that are necessary to insure the successful implementation of the strategy. In some areas the strategy conflicts with the current management preferences, organizational capabilities, or available resources. However, any conflicts or shortcoming can be overcome by making the strategic adjustments identified in chapter three.

Management must be convinced that the strategy will enable the company to meet or exceed the current financial targets. The analysis completed in chapter three shows that implementing the new strategy will allow the company to significantly exceed its profitability target. Furthermore, the improved profitability and low capital requirements will lead to increased return on assets.
The strategy calls for tighter operational controls for franchise operators. Management must make efforts to enforce purchasing and image conditions in the current franchise agreement. Operational control can be further strengthened with the introduction of additional conditions and financial penalties for non-compliance in new agreements and renewals.

The current structure is expensive and cumbersome. Administrative costs must be reduced in order to successfully implement a low operating cost strategy. Tighter controls and clear authority will make it possible to transform the role of the Field Consultant. This change in job description makes it possible to reduce the number of Field Consultants required by the company.

The introduction of an automated replenishment system is another recommended strategic adjustment. This system will facilitate the centralization of decision making. It will also reduce the burden on the human resources in the stores. The reduced labour requirements will lead to better implementation of fresh food programs and cost savings for store operators. A staff reduction will lead to greater franchisee profitability. Franchisee profitability is an important factor in attracting new operators to the 24-Seven system.

4.1 Prioritizing Strategic Elements

There are three key elements of the recommended strategy that are pivotal to the ultimate success of the company. Management must prioritize these key elements and monitor implementation carefully. The most important element of the low operating cost strategy is the transition to franchise operations. This results in the largest financial benefit to the company. This is so important to future profitability that the company should treat this as the top priority. A large number of stores would need to be converted in a short period of time. It may be wise to reduce the initial franchise fee during the conversion to create an additional incentive for
operators to join the system. Obviously this would only be necessary if enough qualified candidates were not already available.

Enforcing tighter controls on store operators is essential under a franchise model. A large network of stores run by independent operators can be difficult to manage. The franchise agreement and penalties for non-compliance will become very important tools for the company. The current system of individually coaching, persuading, and communicating company programs to store operators is just not viable under a low operating cost strategy.

The third most important element of the strategy is centralization. 24-Seven is a large company that has fragmented some of its key functions. It operates like a much smaller company when it comes to exercising buying power and making merchandising commitments on behalf of the store operators. Efficiency, lower cost of goods, and standardized merchandising will only result when decisions are made effectively at the corporate level.

4.2 Timeframe for Implementation

Time is an important factor for 24-Seven. Key competitors continue to gain ground on many fronts. The company has lost many of its historical advantages. The quality of programs and the overall store image has improved significantly in the industry. Large competitors are growing store counts and revenues aggressively. Domestic and international companies are poised to enter the North American Convenience store industry. 24-Seven must respond to these challenges by quickly implementing the low operating cost strategy. Fortunately there are no major barriers preventing the implementation of the strategy. In addition, the capital requirements are modest. What is required of management is a change in the way that they view the business and an understanding of the urgency of the situation. It is recommended that the company moves quickly to implement this strategic plan.
APPENDICES

Appendix A – Financial Model Base Case

Current Company Profitability by Store Type

<table>
<thead>
<tr>
<th></th>
<th>Corporate Store</th>
<th>Franchise Store</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise Revenue</td>
<td>1,400,000</td>
<td>1,325,000</td>
</tr>
<tr>
<td>Merchandise Gross Profit</td>
<td>498,400</td>
<td>471,700</td>
</tr>
<tr>
<td>Total Store Operating Expenses</td>
<td>621,018</td>
<td>456,964</td>
</tr>
<tr>
<td>Net Profit</td>
<td>-122,618</td>
<td>14,736</td>
</tr>
</tbody>
</table>

Current Franchise Store Profitability

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise Revenue</td>
<td>1,325,000</td>
</tr>
<tr>
<td>Merchandise Gross Profit</td>
<td>471,700</td>
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<tr>
<td>Company Royalty</td>
<td>235,850</td>
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<tr>
<td>Direct Store Labour</td>
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<tr>
<td>Other Direct Store Operating Expenses</td>
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<td>Total Store Operating Expenses</td>
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<td>Net Profit</td>
<td>33,019</td>
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<tr>
<td>After Tax Profit</td>
<td>21,462</td>
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</table>

Total Net Income 97,941,600
Net Operating Profit Margin 0.80%

Assumptions

- Merchandise Gross Margin 35.6%
- Direct Store Labour % Profit (Franchisee) 33.0%
- Other Direct Store Operation Expenses % Profit (Franchisee) 10.0%
- Tax Rate 35.0%
- Corporate Store Count 2399
- Franchise Store Count 3400
- Total Company OSG & A 3,043,500,000
- Total Company Revenue 12,246,100,000
- Gasoline Gross Profit 342,000,000
## Appendix B – Financial Model Forecast

### Forecast of Company Profitability by Store Type

<table>
<thead>
<tr>
<th></th>
<th>Corporate Store</th>
<th>Franchise Store</th>
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<tbody>
<tr>
<td>Merchandise Revenue</td>
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<td>1,325,000</td>
</tr>
<tr>
<td>Merchandise Gross Profit</td>
<td>505,400</td>
<td>478,325</td>
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<tr>
<td>Total Store Operating Expenses</td>
<td>615,767</td>
<td>451,713</td>
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<tr>
<td>Net Profit</td>
<td>-110,367</td>
<td>26,612</td>
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### Forecast of Franchise Store Profitability

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<thead>
<tr>
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<th>Corporate Store</th>
<th>Franchise Store</th>
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<tbody>
<tr>
<td>Merchandise Revenue</td>
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<tr>
<td>Merchandise Gross Profit</td>
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<td>Company Royalty</td>
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<td>Direct Store Labour</td>
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<td>Other Direct Store Operating Expenses</td>
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<td>Total Store Operating Expenses</td>
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<td>Net Profit</td>
<td>52,972</td>
<td>34,431</td>
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<tr>
<td>After Tax Profit</td>
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<td></td>
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</table>

Total Net Income 455,255,359
Operating Profit Margin 3.7%

**Assumptions**

- Merchandise Gross Margin 36.1%
- Direct Store Labour % Profit (Franchisee) 33.0%
- Other Direct Store Operation Expenses % Profit (Franchisee) 10.0%
- Tax Rate 35.0%
- Corporate Store Count 300
- Franchise Store Count 5500
- Total Company OSG & A 3,043,500,000
- Ave Store labour savings 16,640
- Ave FC Labour Savings 5,251
- Total Company Revenue 12,246,100,000
- Gasoline GP 342,000,000
REFERENCE LIST

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