

Formula for GROWTH

DOLLAR GENERAL

INCREASED PAY, A NEW FORMAT, DIGITAL INITIATIVES, EXPANDED FRESH DEPARTMENTS AND A LOT MORE STORES IS DOLLAR GENERAL CEO TODD VASOS' FORMULA FOR GROWTH. > By Mike Troy



▲ Dollar General CEO Todd Vasos leads an army of more than 120,000 employees tasked with executing the company's strategy of serving others at a network of stores that will surpass 14,000 locations in 2017.

It's not easy being Dollar General. Its core customers tend to be on fixed incomes or low wage earners. Their real incomes haven't risen in more than a decade even as expenses for such things as health care and rental housing have risen steadily. Meanwhile, recent years have seen the federal government reduce nutrition assistance funding from a peak of about \$76 billion in 2013 to \$66.6 billion last year.

Dollar General serves a customer that even in favorable economic conditions tends to be under duress, which is why more than 80 percent of the approximately 11,000 items found in its stores sell for less than \$5. Attempting to grow sales by selling more stuff to people of limited means is a challenging proposition made even more so several years of flat to declining prices in the

food and consumables category, which accounts for three fourths of Dollar General's sales. Then there is the issue of competition. Walmart has been on a two-year roll of reporting traffic increases to its stores as cash-strapped shoppers benefitting from low gas prices have been willing to drive a bit further to shop at their local Walmart. Catering to the same lower income shopper are Aldi and Family Dollar and Dollar Tree, which merged two years ago.

No wonder then that 2016 was a challenging year for Dollar General and the company has offered a restrained view of the current year performance due to some self-imposed expense pressures. Sales last year increased 7.9 percent to nearly \$22 billion and net income rose 7.4 percent to \$1.25 billion but those figures were aided by the inclusion of a 53rd week in the fiscal year and driven almost entirely by the addition of 900 stores. A meager same store increase of 0.9 percent helped the company keep alive its streak of 27 consecutive years of comp store growth. The repurchase of nearly \$1 billion worth of stock contributed

20 cents a share to full year earnings of \$4.43 cents, a 12.2 percent increase from prior year earnings per share of \$3.95.

During the current year, a forecast of four percent to six percent sales growth will be driven largely by the addition of selling space with Dollar General continuing to raise the bar on what is possible with new store openings. The company plans to add an astonishing 1,000 units but put the upper limit of same store sales growth at two percent. Earnings per share may actually decline from last year's \$4.43 based on the \$4.25 to \$4.50 range of possibilities the company envisions.

One of the key reasons Dollar General the potential for a profit decline exists this year involves a \$70 million investment in store manager training and compensation that will create an earnings per share headwind of 16 cents.

"Being an old operator as I am, the store manager is the key linchpin to everything that happens at retail; always has been and at least probably in my lifetime as a retailer always will be," Vasos said during the company's fourth quarter earnings call in March.

The store manager role is especially critical at Dollar General given that store managers perform a wider range of operational tasks than their peers at larger retail operations due to the structure of the Dollar General store operations team. The typical Dollar General is staffed by a store manager, one or more assistant store managers and three or more sales associates.

Dollar General places a great reliance on the small army of managers who operate its network of more than 14,000 locations, which is why increased pay and training is expected to yield better customer experience scores, increase sales, reduce inventory shrinkage and further reduce turnover, which the company says is already at a four-year low. The pay hike comes as Dollar General is in the midst of its most aggressive hiring effort in the company's 78 year history with 10,000 new position to be filled this year. Dollar General needs higher caliber employees because of the direction the company appears to be taking with merchandising, introducing new complexities to store operations as it looks to become a bigger play in fresh categories and traditional drug store categories.

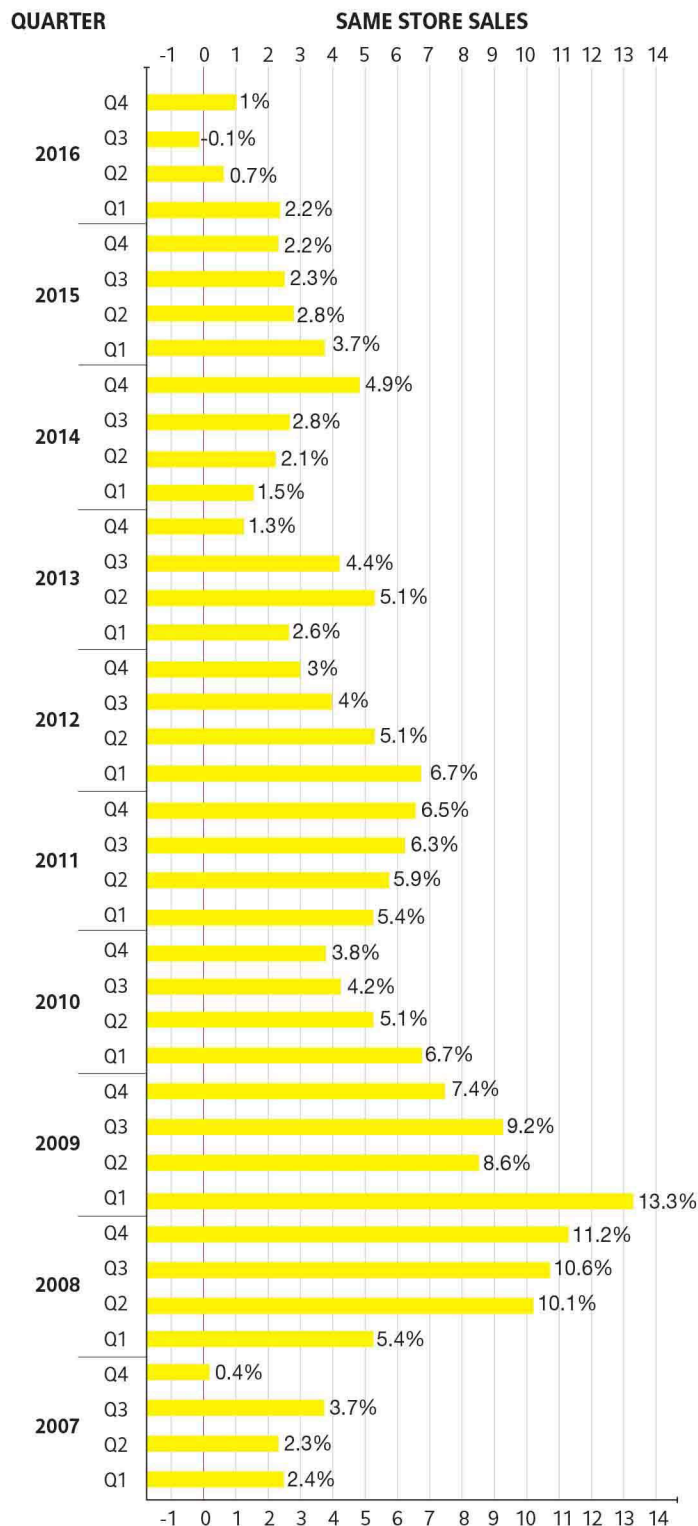
"Based on the lessons learned from the conversions of our recently-acquired Walmart Express locations to our Dollar General Plus format that include fresh meat and produce, we're remodeling about 300 traditional stores to include 34 cooler doors, an increase of about 160% from the existing cooler footprint in these locations," according to Vasos. "This allows for a much greater perishable assortment which helps drive trips and basket size. Additionally, across about one-third of these locations, we're testing an assortment of fresh produce."

In Dollar General's oldest stores the company is also adding more refrigerated space which requires adherence to cold chain compliance procedures vastly different than replenishing dry grocery or household chemicals.

"We have a focus on stores that have fewer than 10 cooler doors which in relative terms are expected to drive the highest returns. By the end of 2017, we anticipate that across our store base we will have an average of 17 cooler doors, up from 10 in 2012," Vasos said.

THE DG DECADE AT-A-GLANCE:

Same store sales have deteriorated as Dollar General store openings have accelerated.



SOURCE: Company Reports



▲ Dollar General's value message is communicated extensively to shoppers throughout stores.

Another key merchandising initiative relates to expansion of the health and beauty area. Much of Vasos' career was spent in the chain drug industry and several members of the retailer's board have extensive drug store experience so the move seems overdue.

"Health and beauty represents large and growing department at Dollar General. These products remain a significant opportunity for us to increase our share of wallet with our customers as we have only about half of the share with our customers in these areas as compared to other consumables like paper and cleaning," according to Vasos.

UNBRIDLED EXPANSION

Dollar General plans to open 1,000 stores this year, which is simply astonishing in the broader context of the retail industry. Store closings are at record levels due in large part to department stores and specialty retailers rationalizing their operations but other successful retailers are still moderating their physical aspirations to allocate greater resources to bolster technology and supply chain capabilities to better serve consumers' desires for a seamless physical and digital experience.

Dollar General has enjoyed some digital success, most notably with digital coupons that were launched about three years ago. The company said its digital coupon enrollment increased by 200 percent last year and that the average transaction that involves digital coupons runs twice the company average. The company also offers a subscription service branded as DG AutoDeliver.

Despite such digital initiatives, Dollar General is all about stores. The 1,000 new stores it plans to open this year are on top of 900 last year. In addition, Dollar General is expanding with acquisitions. It bought 42 former Walmart Express small format stores last year and more recently the Federal Trade Commission approved Sycamore Partners' application to sell to Dollar General 323 former Family Dollar stores it acquired from Dollar Tree two years ago as a condition of Dollar Tree's acquisition of Family Dollar. Between openings and the acquisitions, Dollar General's store count will swell by roughly 1,300 units this year. That makes the company an extreme outlier in the retail industry, but its physical obsession is rooted in some solid fundamentals. It costs Dollar General only about \$250,000 to open a store. This year, about 45 percent of capital spending expected to range from \$650 million to \$700 million will go toward new stores, relocations and remodel-

ing activity. The company's average store does about \$1.6 million in annual volume and generates sales per square foot of about \$226.

"We continue to be pleased with the return on investment and performance of our real estate program, as our new stores overall are yielding returns of approximately 20%, according to Vasos.

Why wouldn't Dollar General open more stores? The company's value proposition embodied by the slogan, "Save time. Save money. Every day!" has at its heart proximity to the customer along with low prices. Historically that has meant targeting smaller more rural communities, which is why roughly 70 percent of the company's stores are located in towns with fewer than 20,000 people. While expansion opportunities continue to exist in those areas, Dollar General is more aggressively probing urban areas with a smaller format store that measures less than 6,000-sq.-ft. compared to the standard store size of 7,400-sq.-ft.

"Given our success over the last two years with the results of our smaller box that is less than 6,000 square feet used in certain metro and rural locations, we anticipate opening an additional 160 locations this year, bringing the total smaller box store count to about 250 by the end of 2017," Vasos said.

SUPPLY CHAIN EXPANSION

The rapid expansion of Dollar General's store network is made possible by equally aggressive investments to add supply chain capacity. The company opened a new distribution in San Antonio last year and then in January its 14th distribution center came online in Janesville, Wis., strategically located 100 miles northwest of Chicago. By this fall, Dollar General's 15th distribution facility is set to open about an hour south of Atlanta in the town of Jackson.

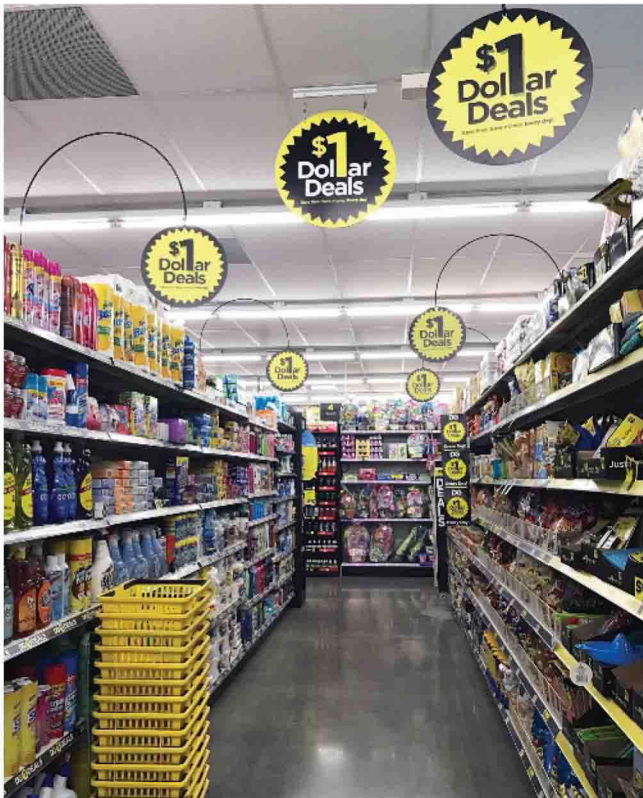


▲ The addition of refrigerated space to many stores has made fresh food an increasingly important part of the Dollar General value proposition.

Both facilities illustrate how the company is optimizing its supply chain infrastructure to shorten the distance trucks travel to more efficiently replenish stores and potentially support greater growth in urban areas. For example, at the end of last year Dollar General operated 481 stores in Illinois and 133 in Wisconsin, but relatively few of those units were located in Chicago or nearby Milwaukee, both of which are easily serviceable from the new Janesville facility. The same is true of the new facility coming online this fall near Atlanta. Dollar General's 758 stores in Georgia are currently served by distribution centers in the contiguous states of Florida, South Carolina and Alabama, so the new facility will make it easier to support Atlanta area growth.

Dollar General is also adding capacity to support its expansion in underpenetrated markets in the Northeast. After the Jackson facility opens the retailer's next big supply chain project is in the town of Amsterdam in upstate New York. Dollar General ended last year with 358 locations in New York, which isn't a lot considering the state has nearly 20 million residents. Expected to open in 2018, the new facility will support existing New York stores and presumably a bunch more as well as expansion in nearby Vermont, New Hampshire and Maine, where Dollar General operated 84 stores at the end of last year. The Amsterdam facility will relieve pressure on a distribution center in the eastern Pennsylvania town of Bethel that opened in 2014.

Dollar General has not announced any additional supply chain projects, however it is apparent that additional capacity will eventually be needed in the Western U.S. if Dollar General hopes to



▲ Every day low prices are key to Dollar General's success, but true to its name an offering of single price point items are key to the assortment.

► Striking black endcaps loaded with value priced impulse items serve as a gateway to expanded beauty departments.



realize penetration rates closer to what it enjoys in some of its more mature Southeastern markets. For example, Dollar General serves the nearly 4.9 million resident of Alabama with 688 stores. By comparison, there are only 185 stores in California supported by a 600,000-sq.-ft. distribution center — Dollar General's smallest

— which opened in 2012 when the company entered the state. If Dollar General were to apply an Alabama-like penetration rate to California the state would have 5,500 stores.

SERVING OTHERS

As unlikely as that seems it also seemed unlikely that Dollar General would be in its current position a decade ago. The company mustered a profit of \$138 million on sales of \$9.2 billion the year before Kohlberg Kravis Roberts & Co. acquired the company for \$22 a share deal in a deal valued at \$6.9 billion.

Private equity was good for Dollar General as the new owners brought in new management, did away with outdated practices such as packing away unsold seasonal inventory to resell the following year. KKR also hit the reset button on store growth, closing 400 stores and establishing new site selection processes that would fuel the company's subsequent expansion.

Vasos joined Dollar General as chief merchandising officer shortly after the company was acquired by KKR. He had spent the prior seven years with Longs Drug Stores, an operator of larger format stores along the West Coast and prior to that held leadership roles at Phar-Mor, a deep discount drug store concept and Eckerd Corp, a drug chain that was sold to CVS and Canada's Jean Coutu Group. Dollar General went public again in the fall of 2009, Vasos was named COO in November 2013 and by the following month KKR had sold its stake in the company.

Elevated to the role of CEO about two years ago, Vasos leads a company whose growth is rooted in the longstanding mission of "serving others" that is one of the key variables in the company growth formula. Visitors to the company's home office are reminded of this mission in the Hall of Values adjacent to reception area and employees are reminded of the mission also in a code of conduct they sign annually.

"Serving Others means providing our customers convenience, quality, and great prices, our employees respect and opportunity, our shareholders a superior return and our communities a better life. As CEO, I pledge to uphold both the letter and the spirit of our code. As a fellow team member, I expect you to do the same," Vasos explains in the code. **RL**