Protecting the Backbar

With the right assortment, convenience stores can continue to win the battle for tobacco dollars By Melissa Kress

IN APRIL, CONVENIENCE STORE INDUSTRY INSIDERS gathering at the 2018 NACS State of the Industry Summit heard 7-Eleven Inc.'s Alan Beach caution them not to turn their backs on cigarettes.

That may seem like a no-brainer. However, as the convenience channel moves away from its traditional cokes-and-smokes reputation and toward fresh and healthier offerings, it is easy to overlook the cigarettes category — with its diminishing volumes and tight margins.

"You can't ignore this. We need to protect this; it is what got us here," Beach urged.

Yes, it is true cigarettes have struggled historically. The category was relatively flat in both average sales per store and total industry sales in 2017, according to the latest *Convenience Store News Industry Report*. Still, it ranks No. 1 among in-store merchandise by a long shot, capturing 29.82 percent of all in-store sales in 2017 (down from 30.11 percent the prior year).

That alone should make c-store operators sit up and pay attention.

While Beach was talking specifically about cigarettes, his advice can apply to tobacco as a whole. According to the *CSNews Industry Report*, other tobacco products (OTP) ranks fourth among merchandise, at 5.62 percent of in-store sales last year — and growing.

"Tobacco continues to be really important, particularly to the convenience retailer, by far," echoed Don Burke, senior vice president of Management Science Associates Inc.

Looking at total nicotine consumption, Management Science Associates found declines of 0.2 percent and 0.3 percent, on average, over the past few years. Recently, total nicotine experienced a greater decline, by about 0.8 percent, driven not by consumer activity but by higher state excise taxes in California and Pennsylvania, Tobacco 21 ordinances and flavor bans, Burke explained.

"We are seeing a little bit greater decline; however, that decline is still less than 1 percent," he noted. "Tobacco continues to be a very important category, and we project that it will be for many more years."

Cigarette consumption, according to Burke, remains consistent, at typical declines of about 3.5 percent a year over the past 10 years.

"Because cigarettes account for about 70 percent of all tobacco sales in the U.S., most people look at that decline rate and expect that overall tobacco is declining and not becoming as important. But that is not the full picture," he clarified.

The full picture is being shaped by changing consumer preferences.

"When you look across total nicotine, and what's happening in the other tobacco categories and vapor, you see there are definitely categories that are increasing," Burke said.

"Consumer preferences for the tobacco items they use are changing and because of that, the category is continuing to be very strong. The decline in cigarettes shouldn't be applied to the entire category," he added.

Sizing Up the Competition

Even with the shift toward other items on the backbar, though, many consumers are still picking up that pack of smokes. Management Science Associates does not survey consumers, but it does track volume-metric data, and the point-of-sale data shows that when someone purchases a tobacco item, the next most-likely item to be in that basket is another type of tobacco item.

"So, dual usage of tobacco items is very strong," Burke pointed out.

The convenience channel is performing very well particularly in the OTP segments, and experiencing growth in almost all the other segments on the backbar.

"As consumers shift from a combustible item to other items — typically not combustibles — they are starting to increase their usage. Convenience is doing very well in all the other categories," according to Burke.

Right now, the next largest category after cigarettes is large cigars. In 2017, cigarettes held about 69 percent of the category, large cigars followed at 18.3 percent and moist smokeless was about 8.8 percent, according to data from Management Science Associates.

As for vapor products, e-liquid sales in the convenience channel have dropped off tremendously and are continuing to decline. However, the vapor category overall in convenience is increasing, driven primarily by the sale of closed-system vaporizers and their cartridges.

Looking at the competitive landscape, convenience stores have traditionally been the king of tobacco — and that is still true today.

Pressure began to heat up a few years ago when vape shops burst onto the scene, leading some to question what effect they would have on the c-store market. But to date, such worries have been unfounded. Vape shops typically do not compete with convenience, noted Burke.

"[Vape shops] provide a far greater selection of vape items than can be found in convenience. And while some dual users — consumers who use the vape product along with tobacco — will purchase it in convenience because it is easier to do, most of the vape shop consumers don't typically shop convenience," he explained. "They are dedicated to a particular vape shop, the type of flavors they offer at that vape shop, or the brands they offer."

The consumer who buys vapor products in convenience stores is typically the consumer who uses vapor occasionally in addition to other tobacco items.

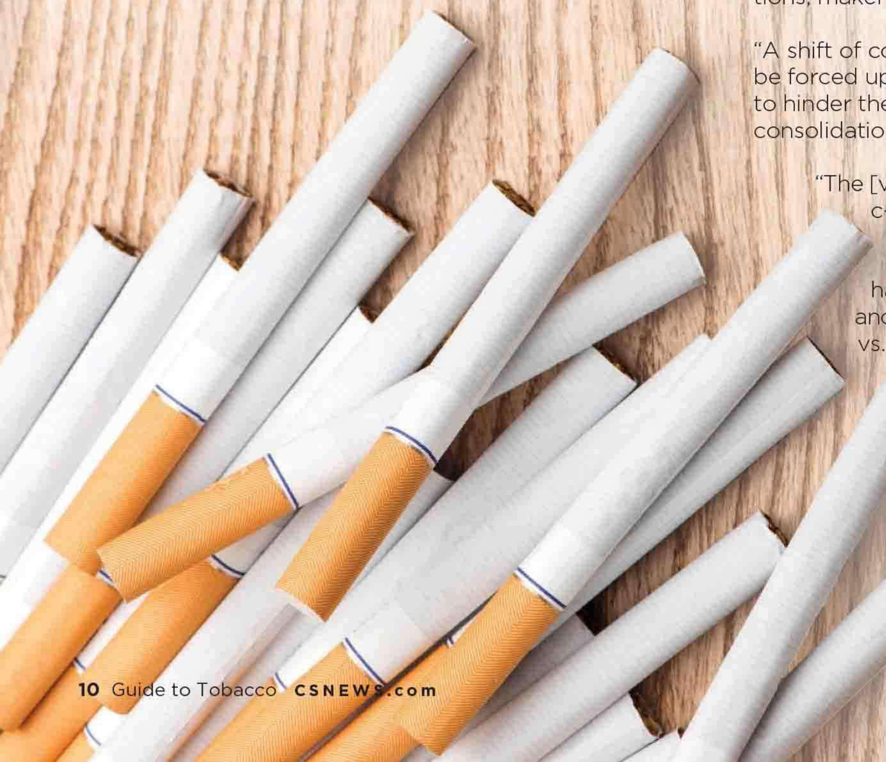
With the Food and Drug Administration's (FDA) deeming rule putting pressure on vape shops, convenience stores are in a place to pick up the slack, according to Jacopo D'Alessandris, president and CEO of E-Alternative Solutions, maker of the Cue Vapor System.

"A shift of consumer buying habits in the e-category will be forced upon adults as the FDA regulations continue to hinder the vape shop channel, leading to an expedited consolidation in this channel," D'Alessandris predicts.

"The [vapor] category will grow in importance in the c-store and tobacco outlet channels as this scenario plays out in the next few years," he continued, adding that many discount tobacco outlets have already expanded into the vapor category and are competing head-to-head with vape shops vs. the traditional convenience channel.

Dollar stores are really the retailers to watch, Burke cautioned.

"The dollar channel really is the greatest threat to convenience because one, they have the greatest number of stores of any other class of trade as compared to convenience. They are the next most popular type



of store in the U.S. They have more locations than drug, mass merchandisers or grocery. Just from that angle, they are a threat," he explained.

And two, dollar stores are starting to carry tobacco items.

"In fact, the dollar channel is experiencing quite a growth in most of the tobacco categories, but they still haven't quite figured out the right product mix," Burke said, noting that dollar stores have made a lot of changes in the types of products, brands and items they carry.

"They are not as big a threat yet as they will become, but once they figure out the right tobacco items to be carrying in their stores, they likely will be a fairly big threat to the convenience channel," he said.

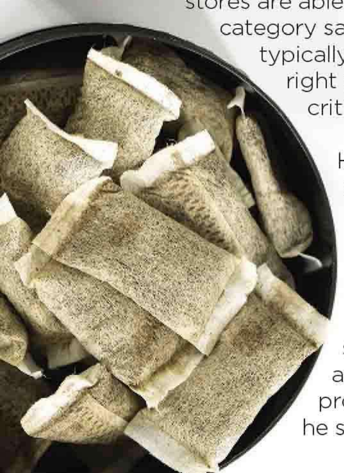
Across all OTP segments, the only one in which dollar stores have declined is roll-your-own; in every other area, dollar has been growing quite considerably, Burke cited.

In the convenience channel, roll-your-own and little cigars join cigarettes in showing declines on the backbar. Other than that, every other segment is growing well.

Not Without a Fight

Therein lies the reality that convenience store operators need to protect their tobacco category, and the strategy to do that is twofold: assortment and OTP.

"In a study we did in the past several years, we found that about 30 percent of convenience stores are able to increase their tobacco category sales each year. They typically do it by carrying the right products. That's actually critical," Burke said.



He suggests retailers scout their competition, particularly dollar stores. "If dollar stores are going to be stealing share from convenience, go look at what products they are selling and make sure you are carrying at least those products within your store," he said.

How Cumberland Farms Stays the Victor

Protecting the tobacco category is something convenience store retailer Cumberland Farms Inc.'s category managers Anne Flint and Stephanie Martone take seriously.

Tobacco accounts for a large portion of the revenue at Cumberland Farms — 40 percent, according to Flint, director of category management, tobacco.

"It's nothing to sneeze at. You make more money on foodservice, but tobacco is not something that we ignore. But you are also dealing with a declining customer base because less people are smoking combustibles," she said. "Will non-combustibles pick up the slack? To some extent, it does. We can make a lot of money on the non-combustible side of the business as taxes have not affected that part of the business."

However, the Westborough, Mass.-based convenience store chain faces an ever-growing web of tobacco legislation on a daily basis. For instance, cigar legislation is one of the big issues currently with the boards of health in Massachusetts.

"There are single bans and minimum pricing. The flavor bans are expanding. Those affect not just cigars, but e-cigarettes and smokeless as well," explained Martone, category manager, OTP. "That is a big fight for us as far as legislation, which also has overrun into Rhode Island now. We are seeing a lot of that in Rhode Island as well."

The lack of guidance as to what is a flavor and what is not is making the job harder.

"There is a lot of debate about what is flavored and what is not flavored. There is a guidance list, but not a guidance list from the state. It is a guidance list of many hundreds of items that the Massachusetts Association of Health Boards developed," Flint said. "There is no clear definition how you get on the list or how you get off the list."

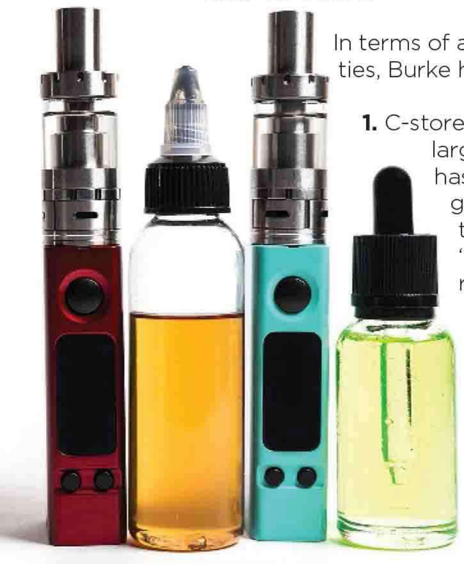
Massachusetts also has restrictions on what you can and cannot do in the category.

"You can't do a lot of things, like cigarette coupons, so you have to have some kind of edge to level the playing field. You can't take advantage of a lot of the new programs tobacco companies are coming out with as far as app integration or coupons online," Flint explained. "That's a third of our stores that get left out of a lot, so you have to be creative."

Still, in the end, Cumberland Farms is finding a way to win in tobacco.

"We are surviving today in the combustibles category. We are beating the national trends, which are down 3 percent to 4 percent. We are still on the plus side of those trends," Flint reported. "I think one of the strongest factors in that is our very strong exclusive brand, First Class, manufactured by U.S. Flue Cured Tobacco, Premier Tobacco. That is our lowest-priced brand. It is helping us maintain, or exceed, our competition."

"Make sure you are carrying the right number of SKUs, the right number of products and the right amount of selection. When consumers shop convenience, they are looking for selection," he added.



In terms of assortment opportunities, Burke highlighted a few:

1. C-stores need to embrace the large cigar segment, which has one of the greatest growth rates of all the tobacco segments. "One of things we found recently is that pre-priced items, which most convenience stores don't like, have helped this category considerably," he noted. If a retailer does not want pre-priced items, then it needs to offer a range of price points within the large cigar segment to meet consumer demand.

2. Moist smokeless is another tobacco segment that convenience stores need to be in because it continues to grow by about 2 percent a year.

3. The third way to build the category is to take advantage of consumer interest in the vapor category, particularly in the vaporizers that typically retail for $20-plus, Burke explained. "That's a high cash-register ring for the tobacco category and contributes considerably to revenue growth in convenience," he said.

There is a lot of potential for the less-thought-of tobacco segments to be merchandised and featured within convenience. "There are opportunities there," he advised.

He also specifically called out super-premium cigarettes, such as Reynolds American Inc.'s Natural American Spirit and Altria Group Inc.'s Nat Sherman.

"[Super-premium cigarettes] is a small category, but even that is growing, so any convenience retailer should be carrying at least one super-premium," he said. **CSN**