Convenience Stores Expand Their Role and Global Footprint

Convenience stores (C-stores) have seen dramatic growth across the globe, and more is set to come, both in terms of store counts and revenue. Although the layout and selection of goods offered in C-stores can differ greatly region to region, some of the major trends driving C-store proliferation—such as expansion of food categories, additional conveniences, and private label products—are shared across geographies. This theme report examines these key trends and explores why Southeast Asia, North America, and China appear poised for the most significant growth. It also provides a list of global equity ideas we’re watching in the space. Calls on individual equities will be made—as they develop—in subsequent reports.

Expanding Food Categories
The food category has become an essential component of C-store sales and profitability. In the U.S.—which has the world’s highest C-store count at 151,000—food services sales accounted for 18% of total in-store sales of $204 billion in 2013, up from 15% of $199 billion in 2012, according to Convenience Store News. While that’s less than 20% of total sales, food service accounted for 30% of total gross profit. At the company level, CST Brands (CST), a fuel and convenience retailer in North America, confirms this trend. In its
legacy stores, food service made up only 9% of merchandise sales in 2013, but for its new-to-industry stores, it made up 19%. Moreover, the Company attributed its Q4 2013 gross margin gain of 8% to improvement in packaged food and beverage margins. CST noted that it expects food to continue to grow its margins.

This trend holds in other regions. In Japan, where C-stores number 42,000 (still high by world standards), food service items, including processed foods, fast food, and daily delivered food, made up 90% of fiscal 2014 convenience store business net sales for Lawson (LAWS.JP; 2651:JP)—the second-largest C-store chain in the country. In China, more than 30% of revenue for both Japan-based 7-Eleven (SEVI.JP; 3382:JP) and FamilyMart (FAMA.JP; 8028:JP) C-stores came from boxed lunches. And for Greencore Group (GNCL.GB, GNC:LN), a dominant supplier of processed food to C-stores in the U.K., saw 17% growth in its U.K. Food-to-Go category in 1H FY14.

Recent snacking statistics support the idea that C-store food consumption should continue to climb. According to a study by the Hartman Group, eating habits are shifting from the standard three meals a day to more frequent snacking, with snacking accounting for half of all eating occasions in the U.S. The study also found that when purchasing food for immediate consumption, consumers are four times more likely to visit a C-store than when food shopping for non-immediate consumption. In response, C-stores are expanding their grab-and-go food options. Because many consumers also end up purchasing a drink to complement snacks, marketing efforts often pair specific foods with drinks to maximize purchases made by snackers. In early July, 7-Eleven and PepsiCo Inc. (PEP) began a marketing campaign pairing Doritos Loaded with an exclusive Big Gulp fountain drink in a new flavor, Mountain Dew Solar Flare.

Emerging markets are also seeing more snacking as consumer trends become more westernized. In China, as the country progresses economically, there is evidence that middle-class workers snack more, as they have less time for traditional meals. In Vietnam, the growing economy coupled with a young population—the majority is under age 30—has led to growth in packaged foods, which are often purchased in modern retail channels, such as C-stores.

But the importance of the food category in C-stores goes beyond packaged and processed food. According to Euromonitor, the
global consumption of fresh food grew 2% in 2013 versus 2012. And according to IndustryARC, the global “functional food” market—defined as foods that have a potentially positive effect on health beyond basic nutrition—is estimated to have generated revenues of approximately $175 billion in 2013. With its annual average growth rate of 15%, that puts it on track to reach $230 billion by 2015. C-stores recognize that meeting this new demand for fresh or more nutritious food is essential to growing revenue. Everything from nutritional bars to kid-friendly drinks with less sugar is becoming more visible in C-stores worldwide. Sainsbury (SBRY:GB, SBRY:LN), a U.K.-based operator of C-stores and supermarkets, reduced the sugar in its own-brand chilled juice drinks, and it plans to reduce salt, fat, and sugar in many of its other own-brand products as well. In the U.S., Columbia Marketing International tested out a mini package of fresh cherries in select U.S. markets in July, and Casey’s General Stores (CASY), an operator of convenience stores in the Midwestern U.S., offers made-from-scratch pizza and donuts prepared on-site in many of its stores.

Perhaps the most compelling evidence of fresh food’s significance to C-store growth is that several of Japan’s large C-store operators have been investing in cropland to meet the demand for fresh fruits and vegetables. Not only does fresh food attract new customers, but it draws them in more frequently. According to Lawson, C-store visitors who buy perishables visit stores twice as often and spend about 20% more than customers who don’t buy perishable items. These fresh and healthy food offerings are also attracting more women and elderly customers, who are becoming more significant consumers in C-stores, which historically have catered more to working-age males. In countries where C-store counts are highest, like Japan and the U.S., elderly populations are becoming disproportionately large and two-income families need convenient, healthy snacks and evening meals. President Chain Store Corp (PCS.TW, 2912:TT), the operator of 7-Eleven stores in Taiwan, introduced in 2013 its Homeal series, a line of refrigerated complete meals that only need to be warmed up prior to consumption.

As more C-stores offer more food service options to consumers, the line between convenience stores and quick-service restaurants is becoming increasingly blurred. In Japan, 7-Eleven doesn’t see itself as only competing in the ¥9 trillion ($88 billion) convenience store market; instead, it sees itself as a competitor in the ¥70 trillion...
A third common trend is the use of private label brands to help C-stores grow their margins. Private-label brands generally tend to be of comparable quality to national brands, but more attractively priced. According to a survey conducted by Euromonitor, 89% of the respondents worldwide indicated that they had purchased a private-label product in 2013. The Co-operative, which operates C-stores in the U.K., was able to double sales of its own-label brand bread, following a revamping of the line. The Company plans further pushes of its own-brand products by re-launching 3,800 lines by the end of 2014.
This trend is not new but its huge potential is still evolving worldwide. 7-Eleven’s private labels, including 7-Select, Seven Premium, and Seven Gold brands now provide a wide range of quality-levels in goods across regions, with various licensees adapting the brands to their needs. President Chain Store Corp (PCS.TW; 2112:TT), the operator of 7-Eleven convenience stores in Taiwan, launched its version of “7-SELECT” in 2009, which today covers roughly 300 items. A similar evolution has spread throughout the FamilyMart through its FamilyMart Collection brand. In Taiwan last month, the FamilyMart licensee, Taiwan FamilyMart (FMC.TW, 5903:TT) announced several new additions—including alcohol, finger food, and snacks—aiming to increase the ratio of its private label brand to other brands. Near the end of 2013 the Company announced that own-brand products had a market value of approximately U.S. $337 million in Taiwan, based on its own research.

Key Geographies
The three key geographies of Southeast Asia, North America, and China are proving to be the regions of greatest potential for convenience stores. In these key areas, C-store counts have been growing by impressive numbers, through the construction of new stores or the acquisition of smaller chains.

Southeast Asia
Urban economies now account for an estimated 80% of GDP in the ASEAN region, and the proportion of urban population to total population has grown from slightly less than 30% in 1980 to 45% in 2012. This increasing urbanization and the resulting growth of a middle class with more purchasing power have heightened demand for C-stores, and developers are responding with ambitious C-store expansion plans throughout Southeast Asia.

In Thailand, for example, three prominent C-store operators have announced plans to increase store counts:

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<td>FamilyMart</td>
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<td>7-Eleven</td>
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This expected growth is reflected in numbers released by the Thai Retailers Association, which shows C-store numbers growing from 12,246 at year-end 2012 to 30,000 over the next five to 10 years. Indonesia’s local operator of 7-Eleven stores, Modern Internasional (MOD.ID; MDRN:IJ), plans to increase store counts in Jakarta from the current 119 to more than 2,000 over a similar time period, as well as increase store counts nationwide.

In the Philippines, too, C-store counts are climbing. In 2013, FamilyMart entered into an agreement with local property company, Ayala Land (ALI.PH; ALI:PM), to begin opening stores. It opened 40 in 2013 with plans to open 300 over five years. Philippine Seven (PSC.PH; SEVN:M) (in which President Chain Store Corp. owns a 52% stake) announced in January that it would add 300 stores to its 1,012 stores in 2014 (it currently has 1,127). Finally, Puregold Price Club Inc (PUR.PH; PGOLD:PM), a supermarket operator, recently announced plans to enter the C-store industry through a joint venture with Lawson. According to estimates from ACNielsen the Philippines market could support about 2,500 convenience stores. This number is expected to grow to 15,000 in over 10 years, as the national income per capita doubles from $2,500 to $5,000. In Malaysia, 7-Eleven Malaysian Holdings (SEVE.MY; SEM:MK), which recently listed on the Kuala Lumpur stock exchange, also has ambitious growth plans to open 600 stores in the next two years, adding to its current total of 1,583 stores.

In Vietnam no single convenience store operator dominates, leaving tremendous opportunity for a leader to emerge. In Ho Chi Minh City, one of Vietnam’s largest cities with 10 million people, there are only about 500 C-stores. Nationwide, Shop&Go leads store counts with 103 outlets, followed by Alimentation Couche-Tard with 73 Circle K stores, B’s Mart with 47 stores, and FamilyMart with 40 stores. All these operators have plans for major expansions. Shop&Go plans for 30 more outlets to open by year-end; FamilyMart plans for 70 by year-end; and B’s Mart plans for 300 by end of 2015.

**North America**

C-stores in North America should continue to grow, as small-format stores are projected to see a 5.3% CAGR from 2013 to 2016 versus 3.3% for big-box stores. According to RetailNet Group, 39% of current retail sales growth is coming from stores of 35,000 square feet and smaller, and over one-third of that portion is coming from stores 5,000 square feet or smaller.
North America’s convenience store growth is largely being propelled by acquisitions and consolidation, as the small-format store is one of the retail formats that still has a significant number of smaller chains and single-store operations. In the U.S., C-stores have grown by over 85% from 1984 to 2013, to approximately 151,000 stores. However, the top 100 convenience store operators only account for 40% of the stores and the top 10 account for 24%. As this market’s saturation has reached a relatively high level, the re-branding of smaller chains to larger chains as they are acquired has been—and will likely continue to be—the preferred strategy to grow store networks. By rebranding, the acquired stores typically enjoy more brand recognition and access to new products and services that the smaller operators were unable or unlikely to support.

In May, Casey’s General Stores Inc acquired the Stop-n-Go chain of 24 convenience stores, with most of them slated to switch to the Casey’s brand. With the rebranding comes the added service of prepared food operations that includes pizzas, sub sandwiches, and doughnuts. 7-Eleven, the largest U.S. chain, currently has over 8,000 stores in North America, with 662 stores acquired in fiscal 2013. In 2013, it acquired 17 stores owned by Lehigh Gas Corp in the Cleveland area and 143 Speedy Stop and Tigermarket stores in Texas, with many of them converted to the 7-Eleven brand. Alimentation Couche-Tard Inc. (ATD/B.CA; ATD/B:CN), an operator of C-stores in North America and Europe, has also increased its network largely through acquisitions. In fiscal 2013, it acquired 2,506 stores and opened 225 new stores, growing its total store count by 36%. In July 2014 it announced that it would acquire 55 stores under the Super Pantry brand, with all of them to be switched over to the Company’s Circle K brand.

**China**

China’s C-store market is underdeveloped, but some leading companies are set to change that. Lawson, which operated 384 C-stores in China at the end of 2013, has ambitious long-term plans to grow that number by 10,000 by 2025. FamilyMart’s target is even more ambitious: 20,000 stores by 2019, up from its current count of 1,100 stores. Ministop (MINS.JP; 9946:JP), a smaller chain with 48 stores in China, is projecting to open 5,000 stores by 2020.

The China Chain Store & Franchise Association reported that there was one convenience store per 5,000 people in 2013. In both Taiwan and Japan, markets that have reached maturity, the ratio is
one store per 2,000 people. China’s population of 1.4 billion people could potentially support over 400,000 new stores before reaching a saturation level similar to Japan’s and Taiwan’s.

With the influx of Japanese-style convenience stores, already well-versed in the operations of food service, the Chinese middle-class are welcoming prepared foods, especially the growing number of young professionals and students seeking food that is relatively affordable, convenient, and high quality. This is posing a challenge to China’s small, local C-stores that lack access to large distributors and can only support small inventories. The smaller chains are also being squeezed by the rising rent costs in large cities, and the investments needed to fund food service operations. Major operators, such as Lawson and FamilyMart, have stronger balance sheets and better access to growth capital.

**Risks**

C-stores and quick service restaurants are now considered competitors for foodservice dollars, which may lead to margin erosion as competition heats up for cost-conscious consumers. Competition also looks to be heating up between C-stores and dollar stores, where an increasing proportion of consumers are shopping. Large retailers, including Wal-Mart (WMT) and Target (TGT), are also testing out smaller store formats. If these new experimental formats become more widespread, competition may further intensify. Another challenge that C-stores face is the availability and costs associated with opening or acquiring new and/or existing stores. Some markets are already at saturation levels and, as real estate prices rise, store network growth may be adversely affected.

**Looking Forward**

Potential upside should remain strong for C-stores, as favorable trends continue to run their course. These include the continued growth of store networks (with overseas markets showing more dramatic growth), consolidation of the C-store industry in the North American market, food sales growth, and the ramping up of product innovation to expand revenues.

As the C-store landscape develops across Southeast Asia, North America, and China, we will be issuing subsequent reports on the names that begin to lead the markets. The list of stocks on the following page features names we believe offer the best investment opportunities.
## Equities in Our Convenience Store Theme

(as of August 13, 2014)

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