

Value Focus

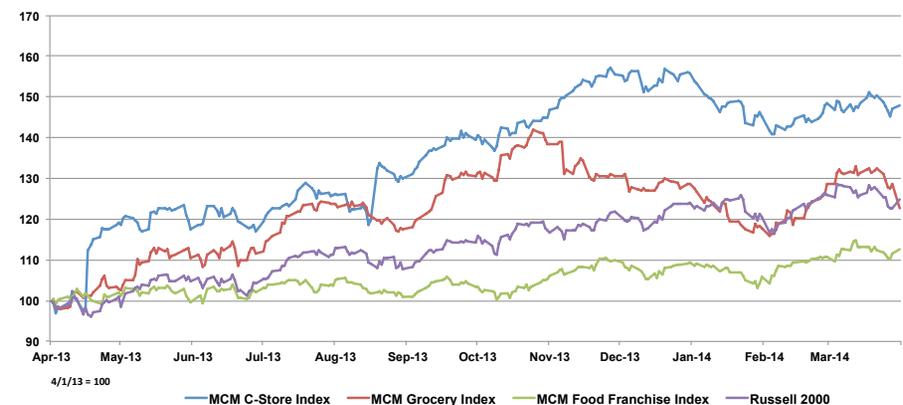
Convenience Store Industry

Convenience Stores | Grocery Stores | QSR (Fast Food)

Second Quarter 2014

Equity Market Overview. Over the three months ending March 2014, median stock market pricing for the convenience store and retail grocery indexes was down 5.0% and 4.7%, respectively, underperforming the Russell 2000 index's increase of 0.8%. The Mercer Capital fast food index posted a 3.0% increase in the first quarter.

C-Store, Grocery Store, & QSR Stock Indices

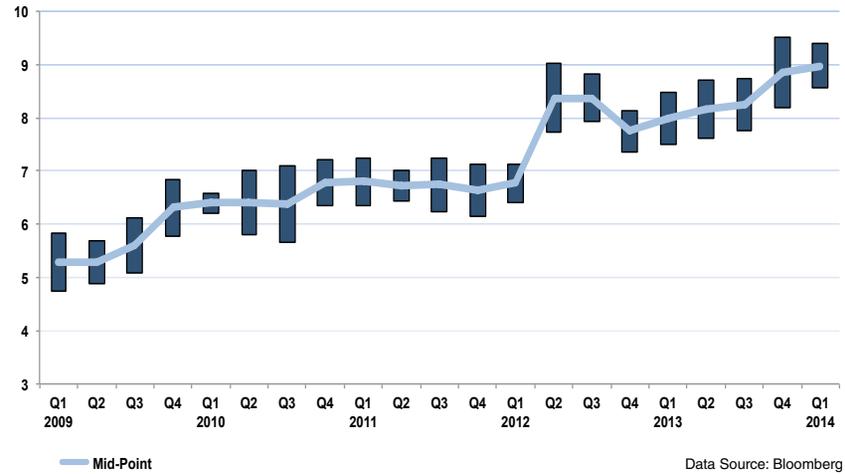


Data Source: Capital IQ / Bloomberg

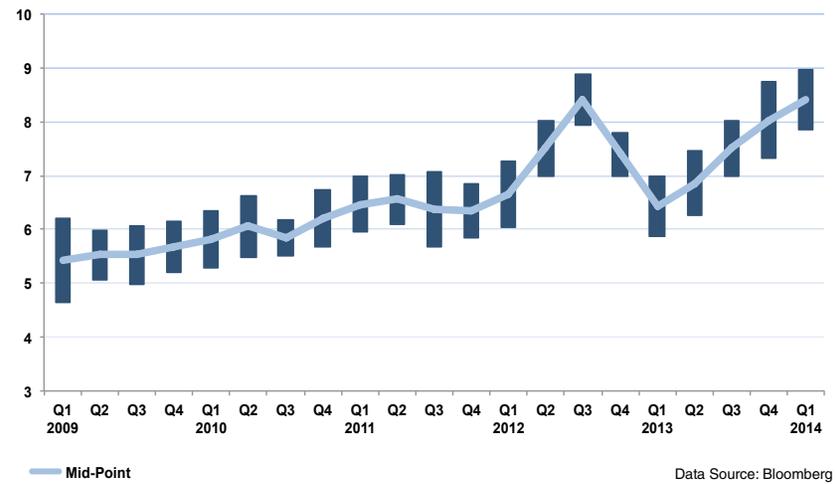
Valuations Drift Higher, Ranges Tighten. EBITDA multiples were up across the board. Multiples for public c-store operators increased from 8.8x EBITDA at the end of the fourth quarter of 2013 to 9.0x at the end of the first quarter of 2014. EBITDA multiples were at their highest levels for the five-year period ended Q1-2014. Grocery store and fast food publics posted larger gains, as shown in the following charts. During 2013, comparable EBITDA multiples for our c-store index ranged from 8.0x to 8.8x EBITDA. At year-end 2012, the median c-store multiple was 7.8x EBITDA.

¹ As measured by the average of (1) end-of-quarter high EBITDA measures of all the companies in the Mercer Capital index and (2) the end-of-quarter low EBITDA measures of all the companies in the Mercer Capital index. Travel Centers of America is currently excluded due to underperformance.

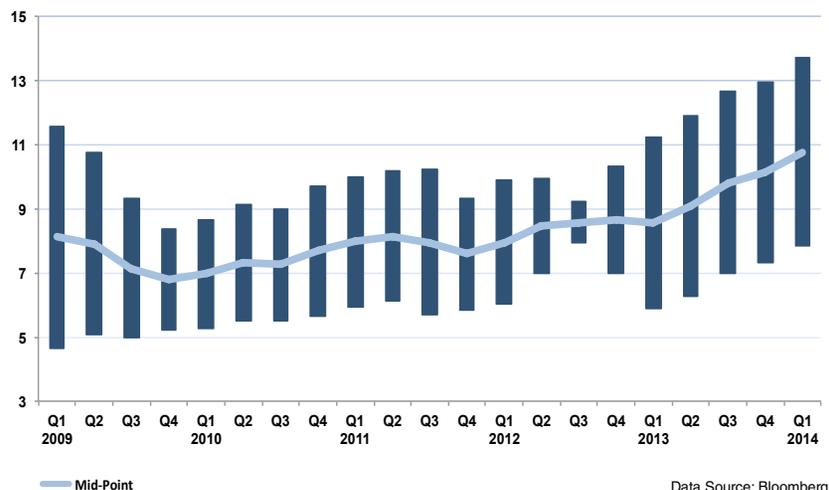
C-Store EBITDA Valuations // Quarterly Range of Mean Highs & Lows



Grocery Store EBITDA Valuations // Quarterly Range of Mean Highs & Lows



Fast Food (QSR) EBITDA Valuations // Quarterly Range of Mean Highs & Lows



Margins. Nationwide retail gasoline margins ended the quarter at 15.4 cents per gallon, down from 19.3 cents per gallon in the first week of the first quarter, but in line with the historical five-year average. According to OPIS, gasoline prices are currently supported by a low supply, especially in the Southeastern United States, while gasoline demand is on the rise. Diesel margins have rallied, ending the quarter at 30.9 cents per gallon. Diesel margins during the first week of the first quarter were 26.3 cents per gallon. A wide separation between gasoline and diesel profits exists across many regions of the country. Many U.S. refineries will complete annual maintenance in the second quarter, and the increase in gasoline supply should push pricing down and support strong margins.

Generally, over 70% of a c-store's sales are motor fuels; however, fuel contributes only one-third of total convenience store gross margin dollars. Fuel margins have been consistent on an annual basis, averaging 16.9 cents per gallon for 2008 through 2012.² There is a delay between the time crude prices increase and the time that pump prices rise. This lag also occurs when wholesale prices drop. Retailers tend to reduce their markups when costs are escalating. Conversely, when costs are declining, retailers tend to leave their pump prices elevated – leading to increased fuel margins – until competition forces pump pricing downward. The time lag between cost changes and retail price adjustments as well as the duration of cost trends is a significant influencer of the operator's margin. On average, it costs retailers approximately 12 to 16 cents to dispense a gallon of fuel. Given that the average five-year markup on gasoline was 16.9 cents, this translates to a typical two to three cents per gallon of bottom line profit.

² 2013 margin average is forthcoming but not yet available at the time of this publication.

Tobacco Products. Tobacco products comprised 37% of in-store sales during 2013 and accounted for only 18.7% of gross margin, according to the NACS. Dollar sales dipped 3.5% in 2013, and unit sales dropped 2.1%. Tobacco sales are the largest inside product category for c-stores. Many industry insiders are predicting the OTP (other tobacco products) category to overtake cigarettes in the next few years. The OTP category includes e-cigarettes, vapor tobacco products, cigars, and smokeless tobacco. It will take some time for this to occur, as OTP sales averaged \$6,479 per month per store as compared to sales of \$44,751 for cigarettes. However, e-cigarettes posted the strongest growth as a percentage of dollar sales among all c-store product categories, a nearly 177% increase during 2013.

Taxation remains the biggest challenge to selling cigarettes, and there is a large degree of regulatory uncertainty where the OTP category is concerned. The FDA is focused on new regulations (or even a ban) on menthol in tobacco products, the decision to increase the legal age of tobacco purchase to 21 or 25, and new regulations for cigars, pipe tobacco, electronic cigarettes and/or hookah tobacco.

CVS drug stores are expected to give up \$2 billion in tobacco sales as the company exited the category during the quarter. Military exchanges are considering a ban on tobacco sales as well.

Highway Trust Fund. The Highway Trust Fund ("HTF") was created by the federal government in 1956 to pay for highway construction and maintenance. It is funded by an 18.3 cent per gallon federal tax on gasoline and a 24.4 cent per gallon tax on diesel. These levels have not changed since 1993. Since then, the cost of road construction and maintenance has gone up, and these taxes have lost more than 40% of their purchasing power, according to the Institute on Taxation and Economic Policy. Over that same time, vehicles have become more fuel efficient, reducing the total number of gallons purchased and taxes collected per vehicle. A \$100 million shortfall is anticipated for the HTF in the third quarter of 2014. Several proposed remedies include:

- » An increase in the cents per gallon tax rate, or indexing the tax to inflation;
- » A mileage-based user fee whereby a recorder would be installed in a vehicle to log miles traveled and report them back to the appropriate taxing authority;
- » A tax on alternative fuel vehicles;
- » Raising U.S. taxes on companies' overseas earnings; or
- » Rescinding the restriction on tolling federal interstates.

The U.S. Transportation Secretary estimates 700,000 jobs are at risk if the HTF is allowed to become insolvent. This could represent a concern for c-store operators as construction workers are often a key customer segment. However, an increase in the gasoline tax could negatively impact the volume of c-store gallons sold.

Recent M&A Activity

Given that terms were not disclosed relating to these transactions, we are not able to derive valuation multiples. However, industry insiders are noticing a trend of improving multiples and increased activity. This is expected to continue in 2014.

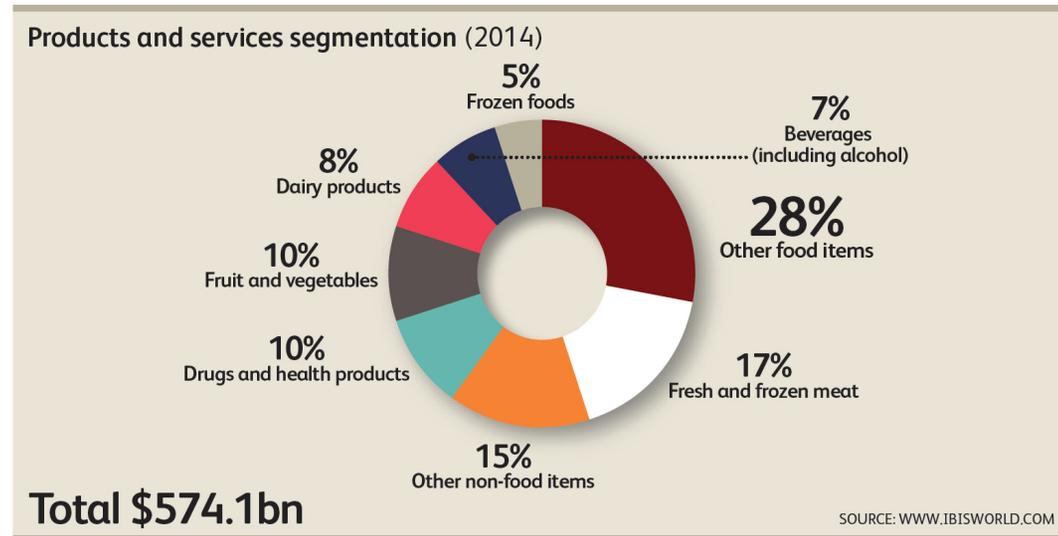
Factors contributing to higher multiples include the increase of willing lenders to finance transactions at relatively low rates, the increase of tax-advantaged MLPs and spinoffs, and higher demand for properties in urban centers and smaller format stores. Experts indicate that while multiples a few years ago were in the 5x - 6x EBITDA range, recent deals have been in the 7x - 8x range.

- » **Pantry's** group of dissident shareholders was ultimately successful in placing their chosen nominees to the board of directors. This may have an influence on the direction of the company in the near term.
- » Several major brands announced significant divestiture programs during the first three months of the year after conducting analyses of their real estate portfolios. **CST Brands, Inc.** plans to sell approximately 100 stores, **7-Eleven, Inc.** is divesting 72 stores, and **Getty Realty Corporation** is selling 50 stores.
- » **Hess Retail Corp.** gained approval for a spinoff in early 2014, which is expected to be completed by the middle of the year. Immediately prior to the release of this publication (May 22, 2014), Hess announced its intention to sell the recently spun-off retail operations to **Marathon Petroleum** for \$2.6 billion, ending months of speculation regarding the future of the Hess c-stores. The Hess c-store chain consists of over 1,300 locations and will make Marathon one of the largest owners and operators of c-stores in the U.S. with locations in 23 states.
- » **Casey's General Stores** signed an asset purchase agreement to acquire 24 **Stop-n-Go** locations in North Dakota and Minnesota, as it looks to expand in the Upper Midwest. The stores are expected to be rebranded upon repurchase.
- » The spin-off trend continues as **Western Refining Inc.** and **Northern Tier Energy LP** discussed the possibility of combining and spinning off their respective gas station and convenience store networks into a standalone company. This conversation took place in the first joint earnings call following Western Refining's purchase of 38.7% of Northern Tier Energy LP from ACON Investments and TPG, two private equity firms. While this transaction was primarily a refining play, it includes the SuperAmerica retail chain consisting of 163 company-operated c-stores and 74 franchised locations. Western Refining has 229 gas stations and c-stores.

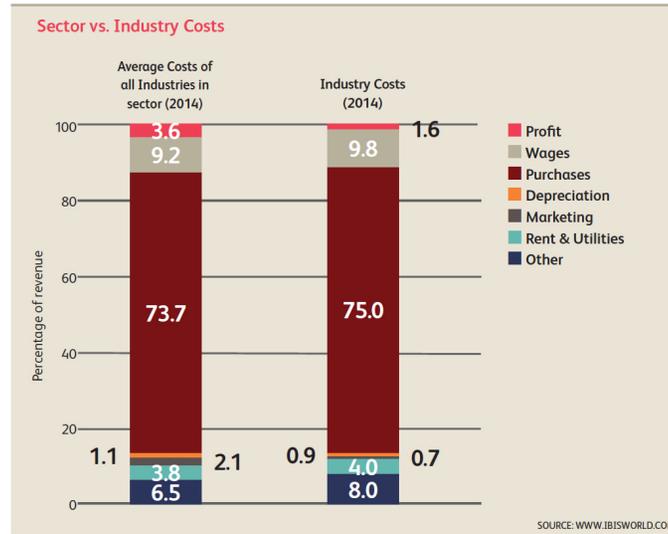
Segment Focus

Grocery Stores

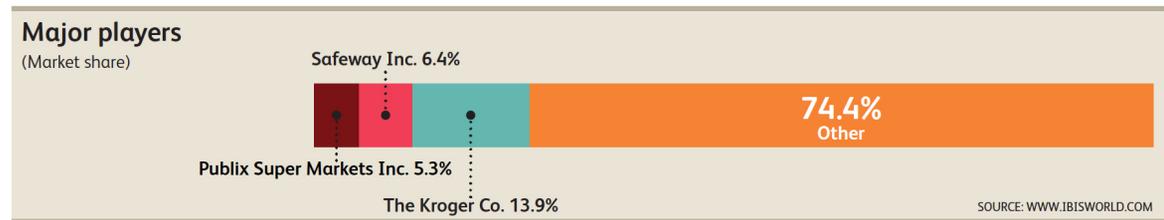
The Supermarkets and Grocery Stores industry makes up the largest food retail channel in the United States. Industry revenue totaled approximately \$574.1 billion in 2013, and profit was \$9.2 billion. The following chart presents the products and services segmentation for the industry as estimated for 2014 by IBISWORLD.



This industry has grown over the past five years, benefitting from a strengthening economy and the trend toward organic and all-natural brands. However, the industry is mature, and revenue is expected to grow at a rate below national GDP over the next five years (1.5%, annualized). The top four operators account for roughly 30% of industry revenue. Competition from superstores and warehouse clubs intensified during the recent recession, and remains high. As shown below, other sector operators enjoy modestly lower costs than grocery store retailers.



The industry continues to consolidate, and merger and acquisition activity has been high in recent quarters.



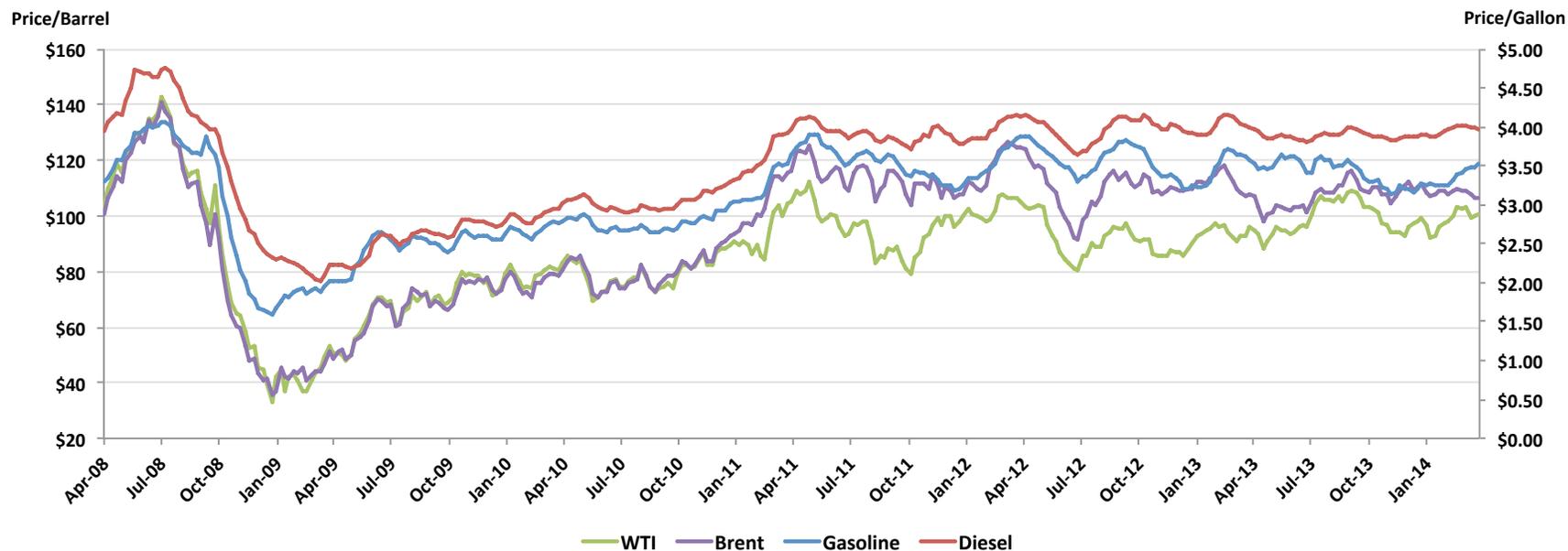
The Kroger Co., the largest pure player in the industry, merged with Harris Teeter Supermarkets in a cash transaction valued at \$2.5 billion in order to boost its market share. This represents a multiple of 7.9x EBITDA. Safeway, with a 6.4% market share, announced a definitive merger agreement in March 2014 with Albertsons LLC. Albertsons is expected to purchase the struggling Safeway for \$9.2 billion, a multiple of 5.5x EBITDA. Such transactions allow for retailers to lower per-unit costs through economies of scale.

The grocery store industry has been facing increasing competition from superstores and discount warehouse clubs, such as Wal-Mart. According to Wal-Mart's 10-K for the fiscal year ended January 31, 2014, grocery segment revenues were 56% of total company revenues. This translates to roughly \$264 billion in grocery-related company revenue, making Wal-Mart the nation's largest grocery retailer.¹ It is estimated that 25% of America's grocery budget is spent at Wal-Mart.

¹ Grocery is defined as "grocery items, including meat, produce, deli, bakery, dairy, frozen foods, alcoholic and nonalcoholic beverages, floral and dry grocery, as well as consumables such as health and beauty aids, baby products, household chemicals, paper goods, and pet supplies."

Fuel Pricing and Supply Charts

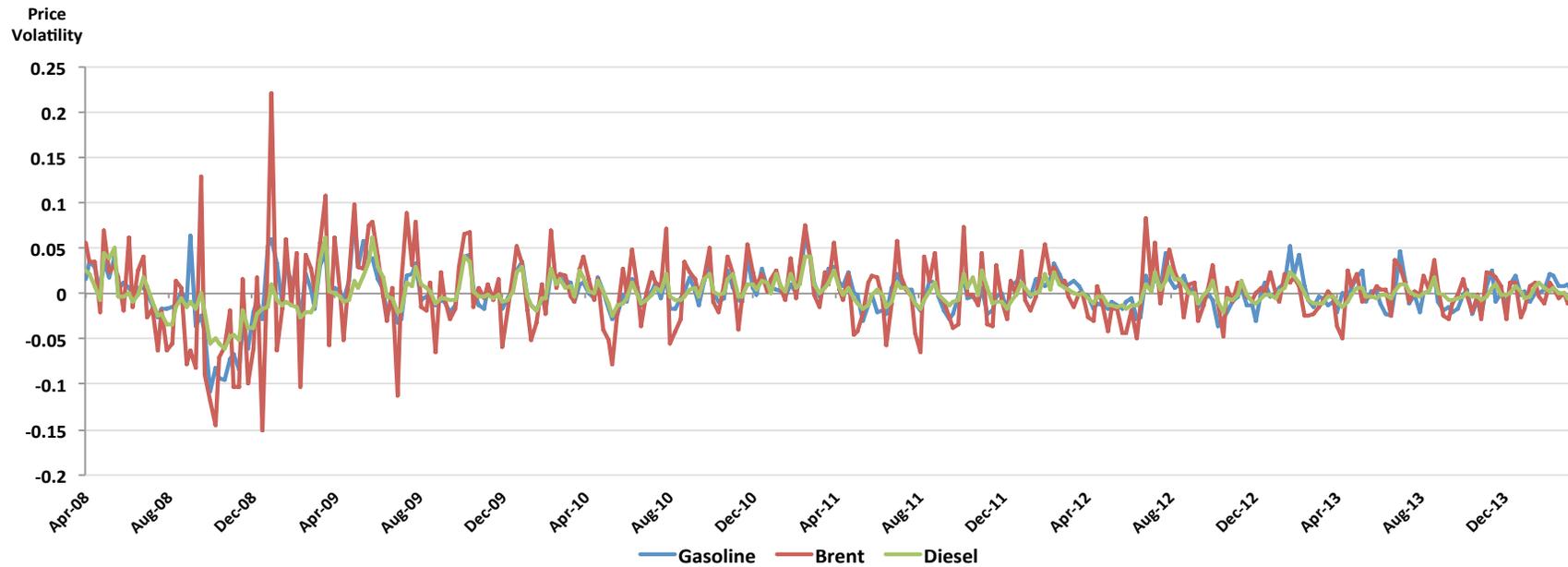
Fuel Prices & Supply



Data Source: Calculated by Mercer Capital based on raw data obtained from the US Energy Information Administration (EIA.gov)

Fuel Pricing and Supply Charts

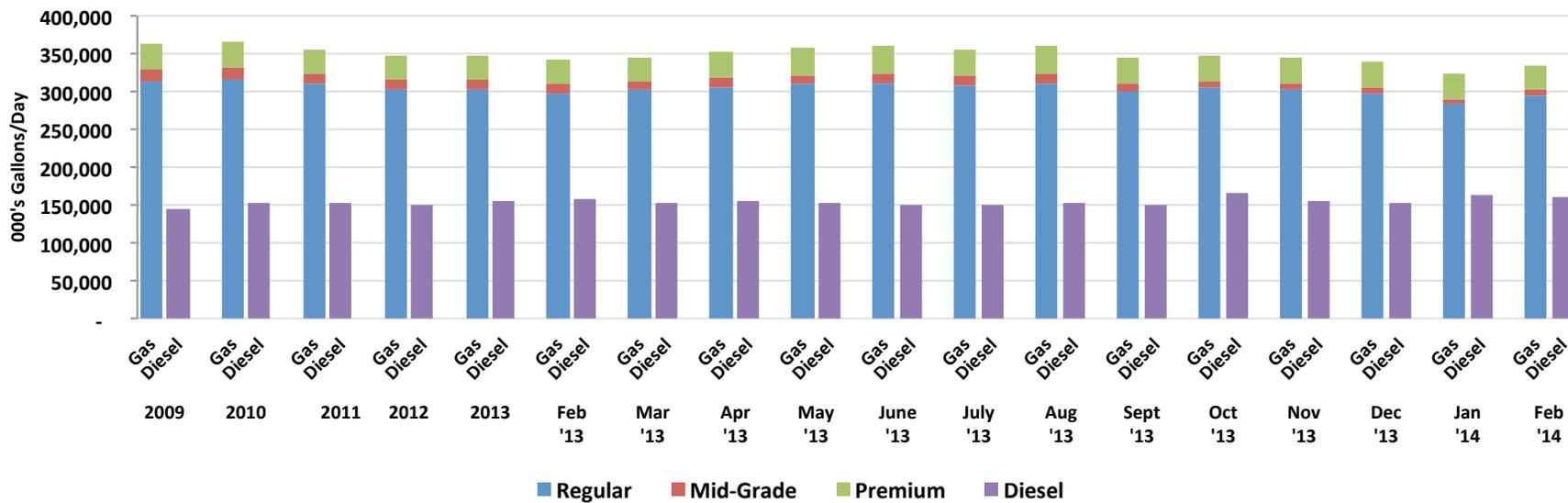
Motor Fuel and Brent Crude Price Fluctuation



Data Source: Calculated by Mercer Capital based on raw data obtained from the US Energy Information Administration (EIA.gov)

Fuel Pricing and Supply Charts

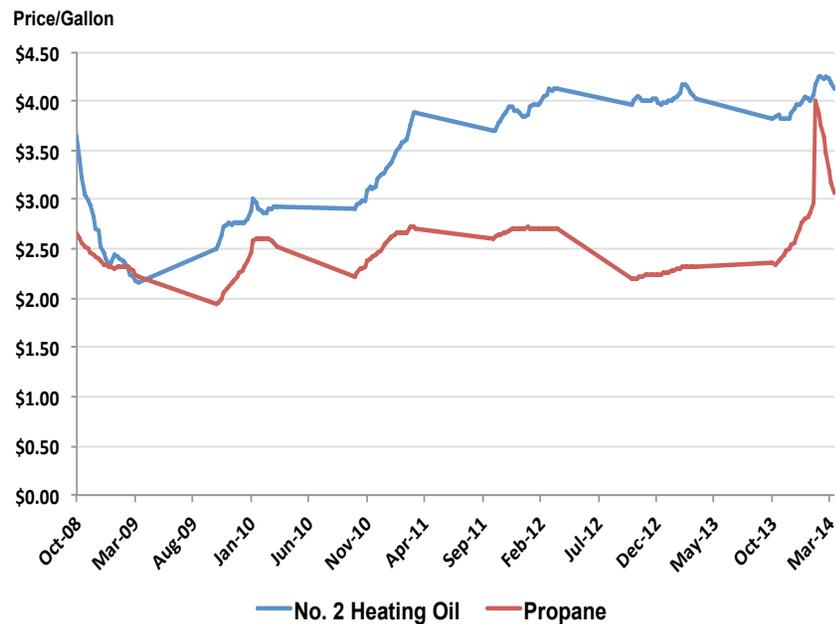
Prime Supplier Sales Volumes



Data Source: US Energy Information Administration (EIA.gov)

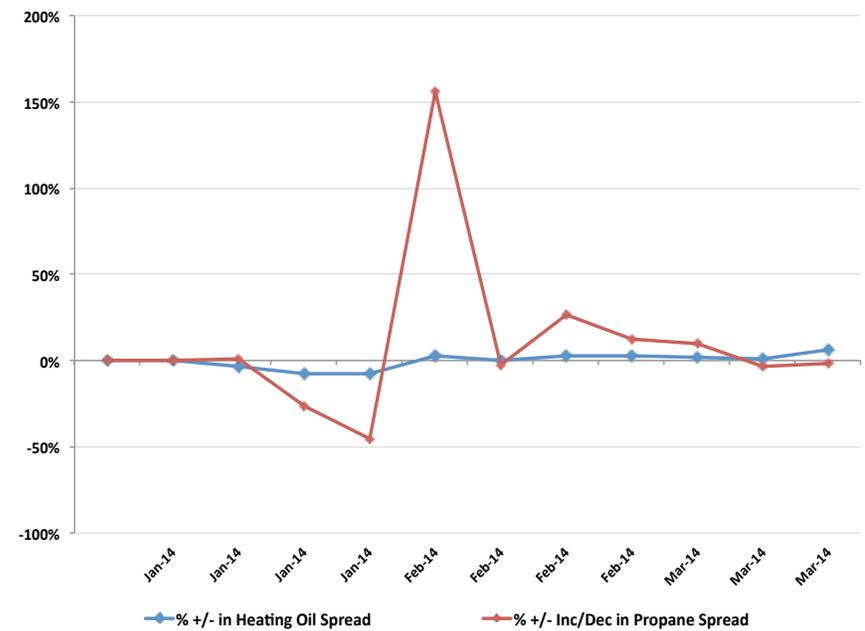
Fuel Pricing and Supply Charts

Non-Motor Fuel Prices



Data Source: US Energy Information Administration (EIA.gov)

Percentage Change in Non-Motor Fuel Spread by Month



Data Source: Calculated by Mercer Capital based on raw data obtained from the US Energy Information Administration (EIA.gov)

Mercer Capital

Convenience Store
Industry Services

Mercer Capital provides the multi-unit retailing and QSR industries with corporate valuation, financial reporting, transaction advisory, and related services.

Industry Segments

Mercer Capital serves the following industry segments:

- Convenience stores
- Grocery stores
- Fast food (QSR)
- Travel Centers

Mercer Capital Experience

- Family and management succession planning
- Buy-side and sell-side transaction advisory assistance
- Conflict resolution and litigation support
- Trust and estate planning
- Buy-sell agreement valuation, design, and funding advisory

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