# Chapter 2: Analyzing a Gas Station's Financial Statements & Operations

**To analyze a gas station's operations a close look must be taken at the day to day operations as well as examining the gas station's financial history. Usually more emphasis is placed on financial ratio analysis. However, financial statements offer only figures. Many times more insight can be gained by simply walking through the gas station.**

## Overview

Competition acts to drive profit margins and the returns on investment down to a free market minimum level. In other words, competition translates into lower prices. Therefore, in the long run, the analysis of profit margins (which is a component of return on equity) will depend upon the analysis of a firm's competitive position as well as the competitive position of the industry in which it operates.

Two factors determine the choice of a competitive strategy:

**(1)** The long-term profit outlook for the gas station industry.

**(2)** A firm's competitive position within the gas station industry.

Both are important. A firm can be in a profitable industry and still do poorly because of a bad competitive strategy, or it may have a good competitive strategy and do poorly because the industry is mature.

In order to forecast the profit margin of a company, and its return on equity, one needs to review the basic competitive forces that exist in an industry and assess the strength of each. There are five basic competitive forces as put forward by Michael Porter in his book *Competitive strategy: Techniques for Analyzing industries and competitors*:[1]

**(1)** Ease of entry and exit

**(2)** Rivalry between existing competitors

**(3)** Pressure from substitute products

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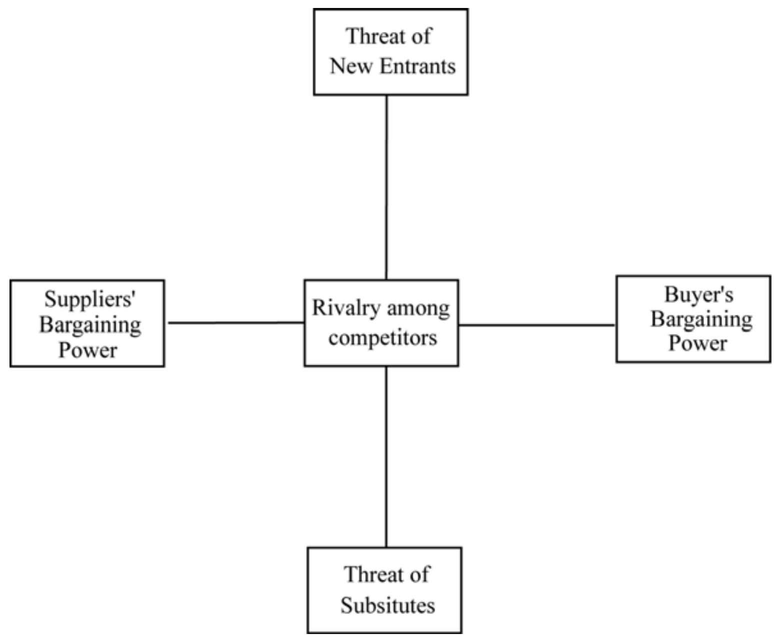
1. Porter, Michael E. 1980. *Competitive strategy: Techniques for analyzing industries and competitors*. New York: Free Press.

(4) Bargaining power of buyers
(5) Bargaining power of suppliers

These pressures are presented in Figure 2-1.

**Figure 2-1: Five Basic Competitive Forces Facing a Gas Station**




First, with respect to ease of entry, the following factors affect the decision of a gas station to enter a given market: capital requirements, economies of scale, secure distribution channels, strong brand identification, government policy, technologically differences, expected retaliation, and absolute cost advantages.

Second, rivalry between existing competitors involves such variables as the number of competitors, the relative strength of the competitors, the strength of their competitor's relationship with wholesalers, the industry growth potential, the amount of fixed costs needed, convenience product differences, and gasoline quality.

Third, pressure from competitors through pricing forms narrow margins for the gas station industry. Consumers are more fickle with regard to gas than other products and tend to be fixated on price alone. The brand of gasoline helps slightly, but the greatest discerning factor is only seen among branded versus unbranded gasoline; the consumers do not see as much of a difference among competing brands though.

Finally, the bargaining power of suppliers (gasoline wholesalers/refineries) can reduce a firm's profit margins by raising costs or reducing quality. The conditions that give bargaining power to suppliers are: the relative size of suppliers versus buyers, the importance of the buyer to the seller, the switching costs, whether the supplier can penetrate the buyer's market, the degree of organization of the supplier, the supply of the supplier's product, and whether the government can control the supplies of certain products.

If economic forces are strong enough to create a competitive market, then they will place downward pressure on rates of return so as to equal the return to assets used plus a business risk premium. If an industry is earning above average returns, then capital will flow into it causing an expansion of supply and therefore placing downward pressure upon margins. If the industry is earning below average returns, then capital will exit and there will be upward pressure upon margins.

It is the degree of competition produced by these competitive forces that determines the ability of gas stations within the industry to generate attractive rates of return. If these five factors are favorable, then many gas stations can earn attractive returns; if they are unfavorable and lead to intense competition, then few gas stations can do well despite good management. The gas service station industry profitability is directly related to the industry structure and not the product which the industry sells.

## A Gas Station Operator's Business Strategy

For most gas station operators growth has been primarily through consolidation of gas stations with a primary focus of increasing gallonage.

Most operators have built facilities with services such as a convenience store, car wash, or auto-repair shop in under-served mid-sized U.S. markets as well as in major U.S. metropolitan areas. In such markets an operator typically faces competition from an immediate competitor, leading to price ceilings and floors (gasoline distributors rarely allow price competition), usually dictated by the company who supplies the gasoline.

Some operators continue to maintain discount gas station niches in the United States by offering unbranded gasoline. These operators maintain their discount operations (per gallon cost typically 10% lower than branded gasoline) in the U.S. to serve patrons who do not have a strong preference towards major gasoline brands and care primarily about cost per gallon.

The industry is moving more towards closing many smaller, older and/or stand-alone gas stations, and focusing on the selective construction of larger service stations with offerings including car washes, convenience stores, and automotive repairs. Multi-offering gas stations enable an operator to compete more effectively on price per gallon while creating larger margins through the side operations. Frequently, an operator with a convenience store or other services will sell gasoline at a profit margin of less than $0.05 per gallon, sometimes even break even in order to attract customers to their location over that of competitors.

**Location**

An operator relies upon location as the primary driving force of demand. Locations in high traffic areas as well as near freeways help drive demand and ensure visibility. Other important factors include the brand of the gasoline carried, such as Mobil, Shell, BP, and so on, as well as the price of the gasoline relative to competitors in the immediate area.

## Gasoline Revenue

Revenues are directly related to:

**(1)** Location, proximity to a freeway entrance or other high traffic area.
**(2)** Brand of gasoline carried,
**(3)** The gasoline price,
**(4)** Other services provided such as car washes, propane filling, convenience store and so forth, and
**(5)** Overall cleanliness of the facility.

**Location**

Each input has a different effect on revenue depending on consumer behavior within the target market. The most important factor, however, is location, which is the main determining factor of traffic flow.

In determining location, the idea of "the trail of ants" is important to take into consideration. In marketing, the "trail of ants" represents traffic flows during rush hours to and from work. For a company such as Starbucks, it is important to be on the side of the road which receives the "trail of ants" in the morning; that is, the side of the road potential patrons travel on the way to work, as that is when they see a significant portion of sales.

A similar approach can be taken for gas stations close to neighborhoods. Gas stations close to neighborhoods should be placed on the side of the road going away from the neighborhoods, as many patrons prefer to fill up in the beginning of their journey, as they travel away from home.

The same can be said for gas stations near industrial/commercial zones or areas of high concentrations of workers. Workers will be more prone to fill up their cars near work, on their way back to their homes. Because of this, gas stations should place their operations on roads leading away from work, towards freeways or suburban areas.

**Gasoline Brand**

Gasoline brand also has a significant impact on revenues, as branded gasoline has a greater impact on consumers than non-branded gasoline. The relationship between revenues and gross margins are inversely proportional, however, when comparing branded and non-branded gas stations. According to Michael Fox, executive director of **Gasoline & Automotive Service Dealers of America**, non-branded gas stations have gross margins ranging from 30 cents to 40 cents per gallon while branded stations have margins of 8 and 10 cents for each gallon[1].

To explain the difference in gross margins, Fox goes on to explain that non-branded gas stations have the ability to shop around from a wide array of distributors and get the lowest possible price. Furthermore, with most branded gas stations, the brand company controls the price of the gasoline and will not let the franchisee reduce prices in areas of competition.

In addition to branded gasoline, Top Tier Gasoline designation has been created to distinguish distributors with higher standards of gasoline. Top Tier Gas was created jointly between BMW, GM, Honda, Toyota, Volkswagen and Audi as "their brand choice and standard." Currently gasoline retailers with Top Tier designations include:

- QuikTrip
- Chevron
- Conoco
- Phillips
- 76
- Shell
- Entec Stations
- MFA Oil Company
- Krik Trip/Kwi Star
- The Somerset Refinery, Inc.
- Chevron-Canada
- Tri-Par Oil Company
- Shell-Canada
- Texaco
- Petro-Canada
- Sunoco-Canada

For those consumers that are conscientious of the gasoline they put in their cars (typically owners of higher end model cars), Top Tier branding is another marketing tool operators can have at their disposal to lure customers to their facilities over other branded and non-branded facilities.

1. The Denver Post - "Gas Woes Deflate Brand Loyalty." 2007