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IMPACT ON PRODUCT PROFITABILITY OF ENERGY AND CAPITAL REQUIREMENTS

by

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Objectives of the Study

Convenience store operators, like most businessmen, are painfully aware of the realities of our present economic climate. Inflation has reached unprecedented levels, interest costs are likewise at record levels, while capital availability is scarce. In addition, they face shortages in energy, as was brought to everyone's attention by the oil crisis last winter. Convenience stores depend heavily on both capital and energy. Capital is needed in the form of land, buildings, equipment and inventory. Energy is required to provide refrigeration for products, as well as heat and lighting for the store.

To gain insight into ways of overcoming these shortages, the Executive Committee of the National Association of Convenience Stores commissioned a study with the following objectives:

1. Determine the energy required to service each product line of merchandise in convenience stores.
2. Determine the cost of capital required for each product line of merchandise.
3. Determine the impact on product-line profitability of energy and capital costs.

Commissioning the Study

Sam Jacobsen, President of PDQ, headed up this program and engaged Arthur Andersen & Co., Chicago, Illinois, an

international firm of public accountants, to conduct the study. Easton & Associates, Madison, Wisconsin, an engineering firm was also engaged to provide technical assistance with respect to the energy requirements of the study. Four convenience store companies were selected to provide the necessary input data. Each company selected a typical store for its operations and, in this manner, the study represents a cross-section of convenience stores from various areas of the country operating under various types of management policies. Pilot stores were selected from Kwik Shop in Hutchinson, Kansas; Stop 'N Go in Madison, Wisconsin; Time Saver in New Orleans, Louisiana; and Wawa Foods in Wawa, Pennsylvania.

In each of the stores, electric meters were installed to monitor the power consumption for each fixture, compressor, lighting, etc., for a one-month period. This data was analyzed by Easton & Associates, Inc., to determine the energy requirements as set forth in this study.

The participating companies provided data concerning the stores' product sales, gross margins, operating expenses, square footage, inventory requirements, equipment costs, etc. This data was supplied to Arthur Andersen & Co., who compiled the information on product-line profitability. This data was not subject to audit procedures or independent verification but was accepted as reported by the participating companies. In this report, the figures presented represent the composite average of the four stores

surveyed. The reader is cautioned that the figures presented may not be representative of his own operations.

Composite Store Profile

Exhibit 1 shows the statement of operations for the composite store. While the figures used from each of the four stores may be typical for the companies selected, the overall composite varies somewhat from overall industry averages. For example, the annual sales of the composite store was \$288,512 compared to \$223,800 as reported in the 1974 State of the Convenience Store Industry Report. Likewise, the profit (before income tax) as a percentage of sales was 5.6 percent, compared to 2.9 percent for the overall industry average.

Product Line Costs

Typically, costs such as rent, depreciation, interest and utilities are considered to be fixed costs and receive relatively little attention in day-to-day operations. However, as building costs, equipment costs and interest and utilities escalate, operators must utilize these resources in the most productive way. The major resource required by convenience stores is the capital which has been invested in the store. A convenience store is limited in size and the space within that store becomes a very precious commodity. Astute merchandising judgment must be used in allocating that space to various competing products and product lines to achieve the best overall profitability.

The income statement shown on Exhibit 2 illustrates the composite convenience stores figures when product line costs are deducted from gross margin to arrive at net margin.

Occupancy

For purposes of this study, the occupancy costs were allocated to each

product line based upon the square footage of floor space used by each product line. It was interesting to note that, while the composite convenience store had 2,433 overall square feet, only 842 square feet, or 35 percent, of the total were actually available for merchandise display and cooler space. The remaining square footage was comprised of the aisles, backroom, rest rooms, etc. Occupancy costs included building rent, property taxes, insurance, and utilities used for heating and lighting, etc. The cost of capital or interest applicable to the land and building investment is included in the rental figure. On this basis, the overall annual occupancy cost per square foot was \$5.58. Since those costs must be borne by the products carried in the store, the cost per square foot allocated to actual display and cooler space is \$16.12.

Equipment

Equipment is another significant capital requirement for convenience store operators. The companies provided data related to the cost of equipment used in the stores, depreciation methods and the amount of display space used by each product line. The annual depreciation costs were allocated to each product line accordingly. In addition, the interest cost associated with the investment in equipment was determined, using an imputed interest rate of 13 percent and one half of the equipment's original cost (represents average net book value over the life of the equipment).

Capital

There also is a cost of capital associated with the investment required to carry the inventories for each product line. The participating companies provided data relating to the average inventory and corresponding accounts payable balance for each product line. The portion of the inventory not covered by accounts payable was considered to be the

net cash investment in inventory and imputed interest was computed on this investment at 13 percent. Likewise, in those cases where the merchandise was sold before it was paid for (accounts payable exceeded inventory), an interest credit was determined using 13 percent on the net accounts payable balance. Exhibit 3 shows the components of the capital required by product line.

The cost of capital as shown on Exhibit 4 was based on the net working capital required, one half of the original cost of equipment (represents net undepreciated amount over life of the equipment) and a 13 percent interest factor. The cost of capital for the land and building is included in the rent which is part of occupancy costs.

Energy

Based upon the meter readings, the energy costs associated with each product line were calculated by Easton & Associates. It was determined that 55.7 percent of the total monthly utility bill was applicable to the overall store heating, lighting, air conditioning, etc., and was included in occupancy costs for allocation to product lines. The remaining 44.3 percent of the electric costs were allocated to specific product lines that are cooled, frozen, etc.

Profit Determination

The scope of this study did not include a detailed study of labor, administrative costs, maintenance and repairs, and other variable costs to allocate these to product lines. Therefore, the net margin by product line represents gross margin, less shrinkage (based on a percentage of sales), occupancy costs, cost of capital, equipment costs and energy costs. For the total store, the product line costs accounted for 6.9 percent of the sales dollar, which left a net margin of 19.9 percent.

Product Line Profitability

As shown on Exhibit 4, tobacco accounts for 20.8 percent of the composite store's net margin. The annual tobacco sales were \$47,284, with a 26.0 percent gross margin, and contributed \$12,309 gross margin dollars, and \$11,965 of net margin dollars. Against the gross margin, there are very few allocated costs since cigarettes require relatively little space, a small net cash investment in inventory, little cost, if any, in display fixtures and no direct cost of energy.

Conversely, based upon the results of this study, the frozen food product line was the least profitable and, in fact, produced a loss at the net margin level. While the gross margin percent is relatively high, the annual sales per square foot (\$104) and inventory turnover (4.8 times) is relatively low. The energy costs and equipment costs are high for the frozen food department, which results in a low net margin on these items. Other studies have shown frozen foods to be a very profitable item for supermarkets. The results of this study indicate that further analysis and an in-depth study of convenience store frozen food sales, merchandising and profitability are warranted.

Low Cost Product Lines

The study showed that the product line costs basically have no relationship or correlation to their gross margin percentages. While the product line costs average 6.9 percent of sales, they range from .7 percent to 40.2 percent of the sales when viewed on a product line basis.

As Exhibit 4 shows, from a convenience store standpoint, the tobacco department appears to be an ideal item. It requires little space, no refrigeration, very little display fixture cost, and a

relatively small cash investment in inventory due to the high inventory turnover. As a result, the product line costs applicable to tobacco were only .7 percent of sales, leaving a net margin of 25.3 percent. Bear in mind that, out of the net margin, the store will have to cover its labor costs, fringe benefits, repairs and maintenance, administrative and certain other costs.

Bread and pastries was another department with low product line costs. Only 2.3 percent of the bread and pastries sales was required to cover product line costs. The average inventory in the store represented approximately four days' purchases of bread and pastries, while the average accounts payable balance represented about 30 days' purchases. On this basis, the bread and pastries department actually provided \$1,300 of working capital to the store. The magazine and newspaper product line also had a relatively low cost of 3.7 percent since there are no direct utility costs, and, in many instances, vendors supply the display racks.

It was surprising to note that the dairy department, which does require refrigeration, had a relatively low product line cost of 4.3 percent. While this department does require utilities and refrigerated display equipment, the turnover is high enough that, on a per sales dollar basis, the product line costs are about average for the store. The dairy product line also provides cash working capital dollars to the composite convenience store. The inventory balance in the composite store represented approximately five days' purchases, while the unpaid liability to the vendors represented 23 days' purchases. This provides approximately \$1,600 of working capital to the convenience store.

High Cost Product Lines

On the opposite end of the product line costs spectrum is frozen foods. In

the composite convenience store, the gross margin on frozen foods was 33.7 percent. However, the cost of occupancy, power, equipment and capital amounted to 40.2 percent of the frozen foods sales dollars, which resulted in a net loss of 6.5 percent. Remember that this loss is before deduction for labor, fringe benefits and administrative costs. Several factors have contributed to this problem with frozen foods. Probably the most significant is the low inventory turnover of 4.3 percent times per year in this department. This means that the average frozen food item is in the frozen food case for almost three months before it is sold. The frozen foods sales of \$5,100 represents only 1.8 percent of the total store sales. With this low sales level, it was not possible, even with a 33.7 percent gross, for this department to be profitable.

This is a prime example of the pitfall that convenience store operators can find themselves in when they rely too heavily on the gross margin percent and not enough on the net margin dollars actually contributed by each product line. The occupancy cost for the frozen foods was 14.7 percent of sales. The direct cost of the power used was 12.7 percent. Equipment depreciation was 7.3 percent and cost of capital 5.5 percent. These are relatively fixed costs as long as the store has the same type and size of frozen food freezers. Therefore, the primary way to make this department profitable is to increase the inventory turnover.

Produce was another department with high product line costs. The produce gross margin of 21.5 percent was almost wiped out by 19.7 percent of product line costs. The remaining 1.8 percent of net margin for the produce department only amounted to \$54 for the entire year in the composite convenience store.

As might be expected, the ice product line was also a high-cost department.

The product line costs in this department were 17 percent of sales. However, the ice product line had a 41 percent gross margin and, therefore, still had a very high net margin of 24 percent. A major factor in determining the cost of the ice product line is whether the ice merchandiser is inside or outside the store. For purposes of this study, the occupancy costs were allocated on a square footage basis in those cases where the ice merchandiser was inside the store. If the merchandiser was outside the store, no occupancy costs were charged against the ice department. With the cost per square foot of usable display space being \$16 per year, the occupancy cost of a 4 x 4 foot merchandiser would be \$258 per year or about 12 percent of the ice sales dollars.

Groceries is another high-cost department. This results primarily from two factors. The grocery department takes up a substantial amount of space and, therefore, its occupancy costs are 11.2 percent of its sales. Furthermore, the grocery department has a relatively slow inventory turnover. The composite store grocery inventory of approximately \$6,000 represented 85 days' purchases or only 4.3 turns per year. Although the grocery inventory turns relatively slowly, the bills get paid quickly. The accounts payable balance for groceries represented only 12.5 days' purchases. Therefore, this single department required \$5,100 of net working capital for inventory, which was somewhat surprising, especially in view of the fact that all the other departments, on a net basis, required only an additional \$1,000 of net working capital for inventory. The net margin in the grocery department was only 15.2 percent of sales, which is less than the store average of 19.9 percent.

Gross Margin Percentage Versus Net Margin Dollars

To avoid the misleading nature of gross margin percent, it is helpful to examine product lines in terms of net margin percent and, more importantly, in terms of net margin dollars. Exhibits 5 and 6 rank the product lines in terms of net margin percent and net margin dollars.

The number one dollar contributor at the net margin level was the tobacco department, which contributed \$11,965 of net margin. This one department contributed 20.8 percent of the total store net margin dollars. Note that there is a significant difference between the tobacco department at \$11,965 and the number two item, the dairy department, contributing \$6,617.

Other Operating Statistics

The information gathered during this study provided other interesting statistics on the composite convenience store, as shown on Exhibit 7. The sales, gross margin and net margin per square foot of display floor space show significant ranges. The allocation of space to product lines and products is a complex matter and must balance many factors, including a proper product assortment, store image, customer demands, etc. One of the factors which must be considered is the net margin dollars produced per square foot of display space.

Conclusion

This study has provided very interesting and useful information in reviewing the cost of capital and energy required to support the sales of various products in convenience stores. Ultimately, these products must generate enough gross

margin dollars to cover their costs and provide a reasonable profit return to convenience store operators.

Heavy reliance on gross margin percentages can be misleading. Net margins are a better basis for evaluating each product line's profitability. This information is essential in determining the productivity of space devoted to each item and in allocating space from product line to product line. It can also be helpful in pricing and studying the gross margins that are necessary to cover the product line costs. As was shown to be the case in the frozen foods department in the composite store, the use of the net margin can identify problem departments.

Convenience store operators should know what their product line costs are. This represents the cost for occupancy or space used in the store, the cost of utilities used for refrigeration, the cost of display equipment depreciation, and, finally, the cost of capital. To determine product line costs, it is suggested that studies be conducted periodically of the store's cost structure. This need not be a part of the monthly accounting procedure but should be done on a special-project basis.

By working with the local electric company service representatives and equipment manufacturers, it is possible to estimate the energy requirements and cost of alternative types of refrigeration equipment. At a minimum, a record should be maintained of the actual kilowatts billed by the electric company to each store. By comparing kilowatt consumption from one store to another and from one period to another, it will be possible to spot problem stores which require further study. Problems may not be as apparent if only utility costs are reviewed since rates are continually

changing and stores in different areas may be served by different utilities with different rate structures.

FOOTNOTE

This study was the basis for the presentation of James Doyle and James Marpe on the topic "Research to Improve Capital Efficiency of Facilities and Equipment" at the Fall, 1978 FDRS meeting. It should be noted that the initial study was performed in 1974. However, the approach, concepts and conclusions remain valid.

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James Marpe is a manager in the firm's Administrative Services Division. He is a member of Arthur Andersen & Co.'s food distribution specialty team with specific responsibility for its supermarket store labor scheduling system developed in conjunction with the Food Marketing Institute.

Exhibit 1. Composite Convenience Store
Statement of Operations
(Typical Format) 1974

	Amount	% of Sales
Sales	\$288,512	100.0%
Cost of Goods Sold	<u>211,148</u>	<u>73.2</u>
Gross Margin	\$ 77,364	26.8%
Other Income	901	.3
Salaries and Fringe Benefits	(26,344)	(9.1)
Other Store Expenses	<u>(24,907)</u>	<u>(8.6)</u>
Store Operating Profit	\$ 27,014	9.4%
Administrative Expense	(9,987)	(3.5)
Interest Expense	<u>(858)</u>	<u>(.3)</u>
Profit Before Income Taxes	\$ 16,169	5.6%

Exhibit 2. Composite Convenience Store
Statement of Operations
(Product Cost Format) 1974

	Amount	% of Sales
Sales	\$288,512	100.0%
Cost of Goods Sold	<u>211,148</u>	<u>73.2</u>
Gross Margin	\$ 77,364	26.8%
Less - Allocated Product-line Costs:		
Occupancy	13,576	4.7%
Equipment utilities	2,287	.8
Equipment depreciation	2,069	.7
Cost of capital	<u>1,896</u>	<u>.7</u>
	\$ 19,828	6.9%
Net Margin	<u>57,536</u>	<u>19.9%</u>
Less - Nonallocated Costs:		
Salaries and fringe benefits	26,344	9.1%
Supplies	1,978	.7
Advertising	1,354	.5
Maintenance and repairs	1,501	.5
Administrative and other costs, net	<u>11,091</u>	<u>3.8</u>
	\$ 42,268	14.6%
Add - Other Income (lottery income, money orders and miscellaneous)	\$ 901	.3%
Profit Before Income Taxes	\$ 16,169	5.6%

Exhibit 3. Composite Convenience Store - Capital Requirements

Product Line	Inventory		Accounts Payable		Net Working Capital Required (Provided)	Display and Refrigeration Equipment (Original Cost)	Land and Building(1)	Total Capital Required
	Amount	Days	Amount	Days				
Bread & Pastries	\$ 212	4.3%	\$ 1,489	29.9%	\$(1,277)	\$ 536	\$ 2,164	\$ 1,423
Cookies & Crackers	244	33.4	261	35.8	(17)	116	1,424	1,523
Snacks & Chips	221	13.1	603	35.8	(382)	134	1,766	1,518
Dairy	491	5.3	2,122	22.7	(1,631)	2,154	5,069	5,592
Ice Cream	365	16.2	558	24.7	(193)	1,978	2,221	4,006
Beer, wine & Liquor	1,360	32.8	242	5.8	1,118	1,067	3,588	5,773
Soft Drinks	1,190	27.7	1,741	40.5	(551)	1,401	5,639	6,489
Lunch Meat-Delicatessen	609	15.6	537	13.7	72	2,031	2,677	4,780
Produce	115	17.4	50	7.6	65	910	1,196	2,171
Groceries	5,989	84.7	886	12.5	5,103	2,575	17,430	25,108
Frozen foods	777	84.0	192	20.8	585	3,164	3,304	7,053
Tobacco	1,854	19.3	1,097	11.4	757	116	968	1,841
Candy	742	36.1	312	15.2	430	102	1,994	2,526
Magazines & Newspapers	822	34.6	800	33.7	22	--	1,766	1,788
Health & Beauty Aids	1,224	68.7	487	27.3	737	188	1,823	2,748
Ice	55	15.6	148	42.0	(93)	460	627	994
Other Nonfood	1,654	97.4	300	17.7	1,354	37	3,304	4,695
	\$17,924	31.0%	\$11,825	20.4%	\$6,099	\$16,969	\$56,960	\$80,028

(1) Land and building costs were allocated based on the square footage of inside display space used in the composite store for each product line. The cost of capital for land and buildings is included in rent which is part of occupancy costs.

Exhibit 4. Composite Convenience Store - Net Margin by Product Line 1974

Product Line	Sales	% of Total	Gross Margin	% of Sales	Product-Line Costs										Net Margin (Loss)	% of Sales Total
					Occupancy	Equipment Utilities	Equipment Depreciation	Cost of Capital	Net Margin							
	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales
Bread & Pastries	\$ 23,620	8.2%	\$ 5,425	23.0%	\$ 548	2.3%	\$ 13	.1%	\$ 71	.3%	\$ (131)	(.5%)	\$ 4,924	20.8%	\$ 8.6%	
Cookies & Crackers	3,783	1.3	1,119	29.6	348	9.2	--	--	14	.4	5	.1	752	19.9	1.3	
Chips & Snacks	8,427	2.9	2,284	27.1	435	5.2	--	--	18	.2	(41)	(.5)	1,872	22.2	3.3	
Dairy	42,540	14.7	8,429	19.8	1,304	3.1	326	.8	254	.6	(72)	(.2)	6,617	15.5	11.5	
Ice Cream	11,219	3.9	2,983	26.6	515	4.6	419	3.7	210	1.9	103	.9	1,736	15.5	3.0	
Beer, Wine & Liquor	20,152	7.0	5,038	25.0	804	4.0	183	.9	149	.7	215	1.1	3,687	18.3	6.4	
Soft Drinks	22,563	7.8	6,874	30.5	1,267	5.6	252	1.1	180	.8	19	.1	5,156	22.9	9.0	
Lunch Meat - Delicatessen	20,531	7.1	6,268	30.5	721	3.5	221	1.1	211	1.0	141	.7	4,974	24.2	8.6	
Produce	3,069	1.1	661	21.5	331	10.8	111	3.6	97	3.2	68	2.2	54	1.8	.1	
Groceries	36,741	12.7	10,938	29.8	4,107	11.2	52	.1	360	1.0	831	2.3	5,588	15.2	9.7	
Frozen Foods	5,098	1.8	1,720	33.7	750	14.7	649	12.7	371	7.3	282	5.5	(332)	(6.5)	(.6)	
Tobacco	47,284	16.4	12,309	26.0	221	.5	--	--	17	--	106	.2	11,965	25.3	20.8	
Candy	10,999	3.8	3,487	31.7	489	4.5	--	--	16	.1	63	.6	2,919	26.5	5.1	
Magazines & Newspapers	11,148	3.9	2,482	22.3	406	3.6	--	--	--	--	3	--	2,073	18.6	3.6	
Health & Beauty	9,916	3.4	3,412	34.4	409	4.1	--	--	28	.3	108	1.1	2,867	28.9	5.0	
Aids	2,181	.8	897	41.1	224	10.3	61	2.8	69	3.2	18	.8	525	24.1	.9	
Ice	9,241	3.2	3,038	32.9	697	7.5	--	--	4	--	178	1.9	2,159	29.4	3.7	
Other Nonfood	\$288,512	100.0%	\$77,364	26.8%	\$13,576	4.7%	\$2,287	.8%	\$2,069	.7%	\$1,896	.7%	\$57,536	19.9%	100.0%	
Total																

Exhibit 5. Composite Store - Net Margin Percentages

Rank	Percent
1. Health and Beauty Aids	28.9
2. Candy	26.5
3. Tobacco	25.3
4. Luncheon Meat - Delicatessen	24.2
5. Ice	24.1
6. Nonfoods	23.4
7. Soft Drinks	22.9
8. Chips and Snacks	22.2
9. Bread and Pastries	20.8
10. Cookies and Crackers	19.9
Store Average	<u>19.9</u>
11. Magazines - Newspapers	18.6
12. Beer, Wine and Liquor	18.3
13. Dairy	15.5
14. Ice Cream	15.5
15. Groceries	15.2
16. Produce	1.8
17. Frozen Foods	(6.5)

Exhibit 6. Composite Store - Net Margin Dollars

Rank	Dollars
1. Tobacco	\$11,965
2. Dairy	6,617
3. Groceries	5,588
4. Soft Drinks	5,156
5. Luncheon Meat - Delicatessen	4,974
6. Bread and Pastries	4,924
7. Beer, Wine and Liquor	3,687
8. Candy	2,919
9. Health and Beauty Aids	2,867
10. Nonfoods	2,159
11. Magazines - Newspapers	2,073
12. Chips and Snacks	1,872
13. Ice Cream	1,736
14. Ice	1,736
15. Cookies and Crackers	752
16. Produce	54
17. Frozen Foods (Loss)	(332)

Exhibit 7. Composite Convenience Store - Statistical Data

Product Line	Per Square Foot of Display Space (Annual)		Percentage of Total										Rank		
	Sales	Margin	Occupancy	Utilities	Equipment Depreciation	Capital	Cost of Net Margin	Sales Dollars	Gross Margin Dollars	Net Margin Dollars	Gross Margin Dollars	Net Margin Dollars	Sales Dollars	Gross Margin Dollars	Net Margin Dollars
Bread & Pastries	738	169	154	7.0%	4.0%	.6%	3.4%	(6.9%)	8.6%	4	6	6	6	2	
Cookies & Crackers	180	53	36	1.4	2.6	-	.7	.3	1.3	15	15	15	14	14	
Snacks & Chips	324	88	72	3.0	3.2	-	.9	(2.2)	3.3	13	13	13	12	8	
Dairy	567	112	88	10.9	9.6	14.3	12.3	(3.8)	11.5	2	3	2	2	6	
Ice Cream	345	92	53	3.9	3.8	18.3	10.1	5.4	3.0	8	11	13	13	12	
Beer, Wine & Liquor	380	95	70	6.5	5.9	8.0	7.2	11.3	6.4	7	7	7	7	9	
Soft Drinks	270	82	62	8.9	9.3	11.0	8.7	1.0	9.0	5	4	4	4	10	
Lunch Meat - Delicatessen	513	157	124	8.1	5.3	9.6	10.2	7.4	8.6	6	5	5	5	3	
Produce	171	37	3	.9	2.5	4.8	4.7	3.6	.1	16	17	16	16	16	
Groceries	143	43	22	14.1	30.3	2.3	17.4	43.8	9.7	3	2	3	3	15	
Frozen Foods	104	35	(7)	2.2	5.5	28.4	17.9	14.9	(.6)	14	14	14	17	17	
Tobacco	3,377	879	855	15.9	1.6	-	.8	5.6	20.8	1	1	1	1	1	
Candy	373	118	99	4.5	3.6	-	.8	3.3	5.1	10	8	8	8	5	
Magazines & Newspapers	429	95	80	3.2	3.0	-	-	.2	3.6	9	12	11	11	7	
Health & Beauty Aids	367	126	106	4.4	3.0	-	1.4	5.7	5.0	11	9	9	9	4	
Ice	230	94	55	1.2	1.7	2.7	3.3	1.0	.9	17	16	15	15	11	
Other Nonfood	188	62	44	3.9	5.1	-	.2	9.4	3.7	12	10	10	10	13	
Average	343	92	68	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	