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# Dollar Days

## HOW DOLLAR STORES ARE GROWING IN A WEAK ECONOMY

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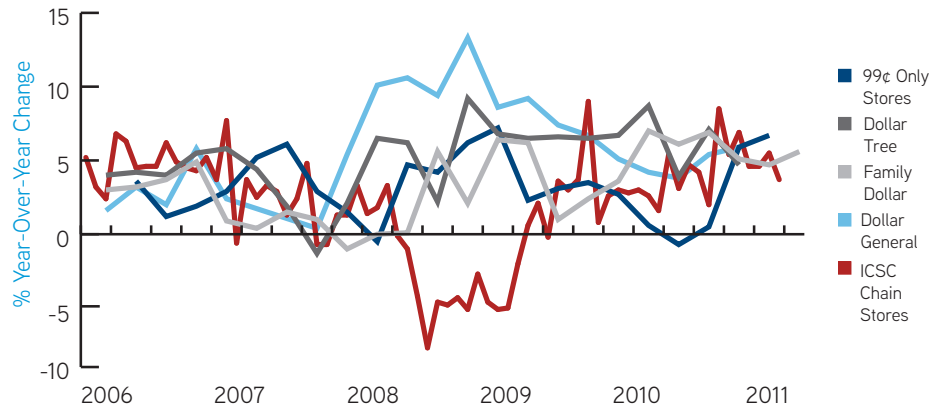
It's the single lesson retailers took away from the recent recession: they're dealing with a transformed consumer. The rapid evaporation of wealth, both real and perceived, has profoundly changed the way Americans shop, how they think about the buying experience, and how they define value.

As dollars migrate away from some discretionary spending, retailers' mission to provide value has intensified competition in need-based product categories. Food is one of them. Traditional grocers, drive-up grocers, supercenters, organic markets, warehouse clubs, drugstores, and dollar stores now jostle each other in an extremely crowded food-at-home marketplace. Developers, owners, and investors have taken notice, realigning their growth strategies to embrace the lower-risk prospects of either retailers or properties that derive significant profits from food sales.

Dollar stores have been one of the clear winners. Long known for value they provide with convenience positioning, edited assortments, and low prices, the four leading national chains have emerged recently as viable, rapidly expanding players in the niche food market. Unlike other retail categories with clear leaders and laggards, each dollar store chain is a strong operator. All four have remained bullish in their 2012 outlooks, reiterating earnings guidance and the scope of their real estate programs.

This white paper will explore the combined expansion programs of the four major chains with an eye toward the sustainability of their future growth. An aggressive suppliers' rush into any category, even food, carries a risk of saturation, and historically newer entrants are more vulnerable when consumer sentiment changes. A combination of dollar stores' real estate

### QUARTERLY SAME-STORE SALES (SSS) GROWTH

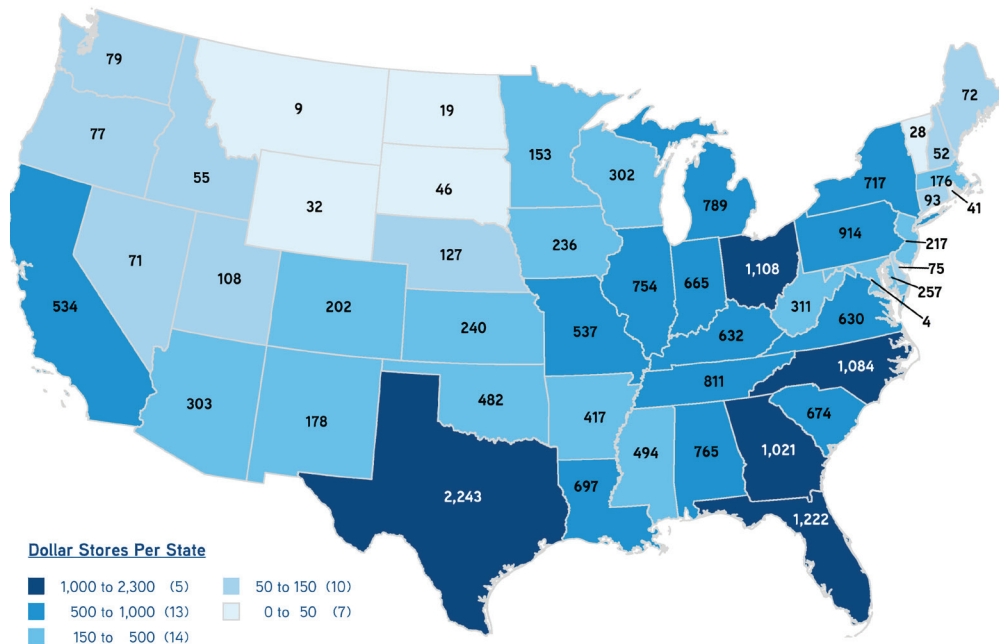


Sources: Company reports, ICSC

decisions, merchandising assortments, and deal structures, however, suggests their future will continue to be bright even as the overall retail market struggles to regain momentum.

### CARVING OUT THEIR NICHE

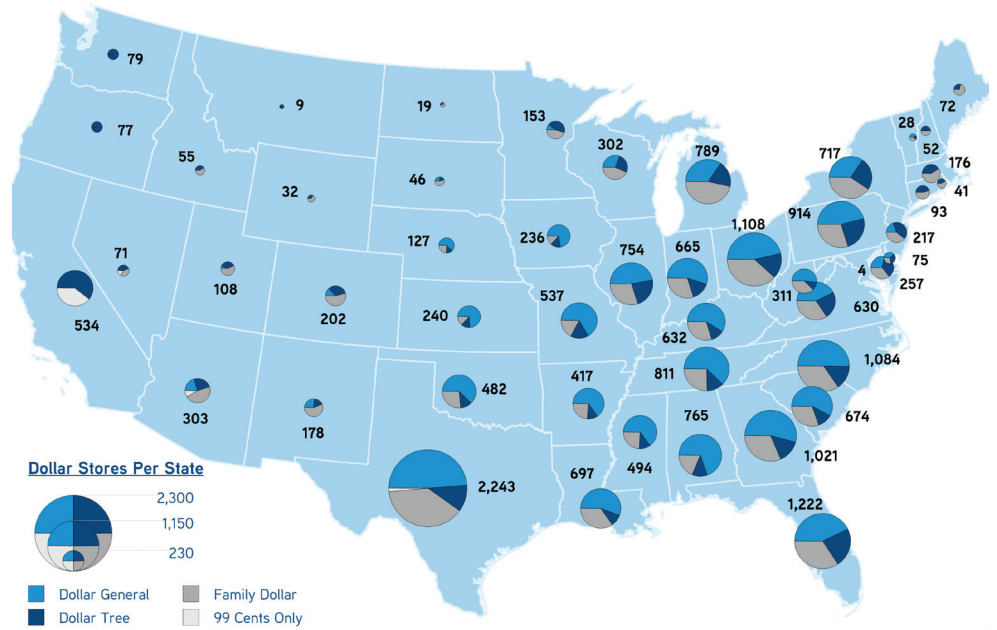
Dollar stores can trace their market opportunity back to the disappearance of Woolworth's and other five-and-dime retailers in the 1970s and 1980s, which left a huge hole in the convenience retail niche. Numerous stores stepped in to fill it. Drugstores added product categories to capture additional spend from customers coming in for prescriptions. Gas stations did the same for those stopping in to fill their tanks, offering grocery and toiletry items at higher



\*Store counts are as of January 2011

Sources: Company annual reports, 10-K filings

The combined store count of the four dollar store chains—21,500—now exceeds the combined store count of the three national drug-store chains (19,700).



prices that customers were willing to pay. In the 1990s, superstores Walmart and Target accelerated their real estate expansion, offering a value proposition based on price and “one-stop” shopping. Their onerous real estate requirements—anywhere from 120,000 to 250,000 square feet—kept them out of smaller markets and infill locations, though.

Enter the dollar stores. The four chains—Dollar General, Dollar Tree, Family Dollar, and 99¢ Only Stores—currently operate approximately 21,500 locations in the United States. They occupy an average footprint of 7,000 to 10,000 square feet, although some newer prototypes exceed 20,000 square feet.

Each chain caters to a different customer, which drives both merchandising strategies and store opening programs. The “dollar” moniker can be misleading: Dollar General and Family Dollar operate as general merchandisers selling goods at “everyday low prices,” most at less than \$10.00 and a percentage—one-quarter to one-third priced—under \$1.00. Dollar Tree and 99¢ Only Stores function as variety stores, with more SKUs in discretionary categories sold at a \$1.00 price point.

Dollar General, with 9,600 stores, positions itself as rural America’s convenience store. More than 70% of its stores serve communities with fewer than 20,000 residents. These are markets unlikely to land even a small-format Walmart. Dollar General may compete with a local grocer but it’s often the only game in town. Without competitors, Dollar General doesn’t need to seek out the best real estate in its markets. The typical store stocks between 10,000 and 12,000 items in 9,100 square feet. Shoppers make frequent trips; average length of stay is fewer than 10 minutes.



In contrast, Family Dollar locates in urban, suburban, and rural areas, but less desirable areas of large markets, a.k.a. “food deserts,” are its sweet spot. Urban areas force convenience retailers to focus more on price to combat competition. There, Family Dollar is very comfortable locating close to grocery stores and supercenters: it believes that its compact store layout will win over customers who don’t want to deal with the hassles of shopping a larger store. Family Dollar ramped up its new store program in 2011 after focusing more CapEx on remodels in recent years. It now operates 6,800 stores, offering an assortment in a number of core categories: health and beauty aids, packaged food and refrigerated products, home cleaning supplies, housewares, stationery, seasonal goods, apparel, and home fashions.

Dollar Tree and 99¢ Only Stores, with more discretionary product mixes, follow the old-time variety store model more closely. Of the two, Dollar Tree has a more suburban footprint: its consumables, toys, housewares, party goods, greeting cards, and seasonal products attract shoppers on longer-than-average duration trips. Like Dollar General and Family Dollar, Dollar Tree is broadening its food offerings and, as of mid-year 2011, had installed freezer cases in approximately one-half of its stores. Subsequent commentary from Dollar Tree executives, however, reiterated a long-term commitment to a variety-focused product mix even as the chain responds to current consumer demand.

99¢ Only Stores, with 285 locations in Texas, California, Nevada, and Arizona, holds the category’s smallest real estate portfolio but, at \$291/per square foot (2010), by far the most productive. It prefers to locate in larger centers, either urban or suburban, that can accommodate its new 21,000-square-foot prototype. Merchandise includes many closeout products and foreign brands across consumables, health and beauty, and household items. Although it appears to have begun with the smallest percentage of food among the four chains, 99¢ Only Stores’ recent shift to an expanded food offering has resulted in the category’s most supermarket-like store layout.

### WHAT MAKES A GOOD LOCATION?

Dollar stores’ site selection criteria mirror their customer strategies, with a primary focus on convenience. All four chains track automobile counts on adjacent roadways; even in a small market, customers need good access. For chains locating in more competitive markets, success relies strongly on storefront visibility and the impulse shopping it generates. The priority of car counts in initial site selection criteria differentiates dollar stores from enclosed malls (which focus more on area demographics), making them more like drugstores in the small markets they serve.

Dollar chains differ in their preference for freestanding or strip mall locations. CoStar tallies that 58% of Dollar General’s 9,600 locations are freestanding versus only 35% of Family Dollar’s. This allocation makes sense given Dollar General’s rural-skewed portfolio, although Family Dollar is likely to increase its percentage of freestanding stores. As dollar stores upgrade and expand their offering, they compete with a broader set of retailers. Proximity and co-tenancy are now much larger issues in site selection. Grocer and supercenter leases

**“Family Dollar’s net retail sales increased 15% from 2007–2010, with consumables rising from 58.8% of net sales to 65.1%. Dollar General’s net sales increased 37% from 2007–2010, and consumables sales went from 66.5% to 71.6%.”**

frequently include restrictions on dollar stores opening within a center. This trend is pushing dollar stores, even those that have historically preferred the cross-traffic benefits of locating in a larger project, to build new ground-up locations.

In either strips or freestanding buildings, dollar stores are very comfortable taking second, third, or even fourth generation space. They generally do inexpensive buildouts and request limited tenant allowance; the landlord may paint the façade or make parking lot improvements. Looking ahead, dollar stores’ willingness to take vacant space in that 10,000-square-foot category—provided they aren’t blocked by usage restrictions—will likely result in increased absorption, particularly of freestanding units.

**RISKS AND REWARDS OF ENTERING THE CONSUMABLES MARKETPLACE**

Since early 2008, all four dollar chains have moved to stock a higher percentage of consumable products. Definitions differ between retailers, but consumables generally include household chemicals, paper products, food (including candy and snacks), health and beauty aids, hardware/auto, and pet food/supplies. Dollar General and Family Dollar, which started adding food earlier, have experienced sales growth that justified the strategy. Family Dollar’s net retail sales increased 15% from 2007–2010, with consumables rising from 58.8% of net sales to 65.1%. Dollar General’s net sales increased 37% from 2007–2010, and consumables sales went from 66.5% to 71.6%. (Dollar Tree and 99¢ Only Stores do not break out sales by category.)

While sales have increased, dollar stores make the trade-off in margins. Shifting to a more consumable-based model can negatively impact margins, especially in an inflationary environment. Dollar stores attempt to manage rising costs by increasing both the breadth of their private label lines and the number of imported goods, which, even with the high cost of transporting them, are still less expensive than products sourced domestically. Keeping prices low doesn’t guarantee success, though. Dollar store customers proved over the summer that they still have room to trade down, shifting purchases even further to essential goods within the

**COMPARISON OF DOLLAR STORE REAL ESTATE PROGRAMS**

	# of U. S. Stores*	Prototype (SF)	Target Market	New Stores	
				FY 2011	FY 2012
Dollar General	9,600	9,100	small town	625	n/a
Dollar Tree	4,200	8,400	suburban	275	n/a
Family Dollar	6,800	7,500–9,500	secondary urban location	300	450–500
99¢ Only Stores	285	21,000	urban, suburban	10	17

\* Estimated as of November 2011  
Sources: Company reports

## RENT COMPARISON

Average asking rents for centers anchored by each of the four chains

Store	Rent per SF in Strip Centers Less than 145,000 SF
Dollar General	\$8.32–\$8.60
Family Dollar	\$9.29–\$9.43
Dollar Tree	\$11.47–14.49
99¢ Only Stores	\$15.00–\$17.30

Source: CoStar

**“The predominant trend is the increasing ability of dollar stores—depending on their market focus—to open in better-quality real estate. Many of these new locations, either freestanding or within an existing strip center, are submarkets or sites neither tenant nor landlord would have envisioned several years ago.”**

low-margin staples categories. To stay competitive with a continually strained consumer base, dollar stores (and all of their competitors in the food convenience space), must continue searching for ways to improve their profit structure.

## OPPORTUNITIES TO TAKE BETTER LOCATIONS

Dollar stores’ strong earnings and aggressive store expansion/remodel programs have made them extremely popular with landlords and property investors. In reviewing transactions brokered by Colliers’ retail professionals, we have uncovered several meaningful trends.

The predominant trend is the increasing ability of dollar stores—depending on their market focus—to open in better-quality real estate.\* Many of these new locations, either freestanding or within an existing strip center, are submarkets or sites neither tenant nor landlord would have envisioned several years ago. These days, though, dollar store sales projections are so high that they make the decision a no-brainer. Elevated vacancy rates no doubt accelerated this shift. Credit tenants, especially those targeting rural or lower-income areas, have plenty of options when seeking space even when the majority of sites won’t work for them. It’s unlikely we’ll see many dollar stores on High Streets or in “A”-quality regional malls, but elsewhere dollar stores are becoming a more accepted tenant.

The second major trend is dollar stores’ continued ability to drive extremely aggressive deals. This is occurring even in markets where landlords, especially those with better-performing centers, are beginning to see some pricing power return to them. Depending on the chain, base rents can run as low as the high single digits for a 10-year term. Rent step-ups are rare during the first five years; tenants will consider a 10% bump (2% per year), beginning in Year six, for the balance of the term. According to CoStar’s third-quarter data, strip centers less than 145,000 square feet that contained a Dollar General commanded the lowest average asking rent: \$8.32 to \$8.60 per square foot. Family Dollar centers were the next-highest at \$9.29 to \$9.43 per square foot. Compare this with Dollar Tree centers, at \$11.47 to \$14.49, and 99¢ Only Stores at \$15.00 to \$17.30. Some of these rent trends are attributable to Dollar General’s preference for rural markets. Small-town centers have experienced higher vacancy rates during the recession because their tenant mix is predominantly local; merchants are less able to withstand long periods of lower sales and traffic and are capturing an ever smaller market share. Dollar Tree’s more suburban portfolio and discretionary product mix suggest it’s locating in better quality centers with higher rents.

Despite the aggressive terms, landlords take dollar store deals for several reasons. First, they recognize that so long as trading down and pinching pennies stays fashionable (likely a long time), any and all merchants offering “value” have more cachet. Second, dollar stores have

\*In some markets, we’ve seen a small trend somewhat at odds with the first. When a lease comes up for renewal, and landlords aren’t willing to reduce rent, a handful of dollar stores have relocated to a slightly inferior location, at the same intersection. Conventional wisdom suggests that retailers are unlikely to close a profitable store, even short-term, for \$1 or \$2 PSF less rent, though, so these deals are more the exception than the norm. They do, however, illustrate the dollar stores’ power in a still largely tenant-driven market.

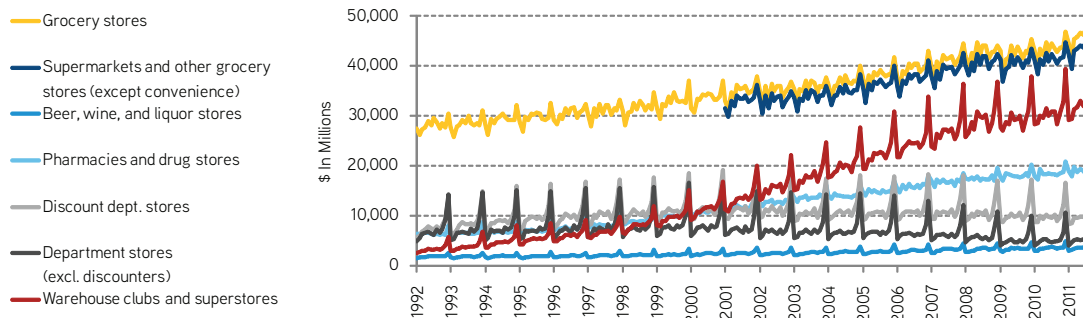
upgraded both the look of their stores and their merchandise presentation, increasing their appeal to a better demographic (and which relates back to dollar stores showing up in better locations). Third, dollar stores' expanded food offering increases customer trip frequency, which can generate positive spillover effects for the rest of the property. Lastly, as mentioned above, landlords in smaller markets often lease to a predominantly local tenant mix. Adding a large, national credit tenant can re-energize a leasing effort and reassure lenders of a property's viability. Sacrificing a couple of dollars in rent is well worth the uptick in occupancy, especially in centers below 100,000 square feet, as the landlord's upside comes from the resulting lower valuation multiple.

Centers occupied by a dollar store exhibit markedly different patterns in vacancy rates, depending on center size. For each of the chains, we compared four years (Q4 2007–Q3 2011) of CoStar vacancy data for centers they anchored against a benchmark group without a dollar store. For Dollar General and Family Dollar, shopping centers less than 45,000 square feet recorded vacancy rates up to 200–300 basis points below the benchmark value. The spread for Dollar Tree centers and the benchmark was narrower: 50–100 basis points lower. On the other side, small centers anchored by 99¢ Only Stores recorded extremely low vacancy rates, averaging 10% below the benchmark in recent quarters.

For larger retail projects, though, dollar-store anchored centers had significantly more vacancy. Looking at those between 100,000–145,000 square feet, dollar-store-anchored projects exceeded the vacancy benchmark for every chain except those anchored by 99¢ Only Stores. The trend is especially pronounced for Dollar General: in centers between 125,000–145,000 square feet, Dollar General-anchored centers experience vacancy rates more than 7% higher than the benchmark.

What might explain these differences? Do dollar stores have less impact on adjacent small shop space, or are shopping center vacancy rates strictly a function of the underlying real estate quality? The answer: a little bit of both. Many dollar stores, especially Dollar General and Family Dollar, have become destinations and don't need the cross-traffic generated by co-tenants. As a result, they're comfortable locating in challenged real estate that already had higher vacancy rates. 99¢ Only Stores, whose small centers have the lowest vacancy rates, may be helping

### ESTIMATES OF MONTHLY RETAIL AND FOOD SERVICES SALES



Note: Supermarket data were not available before 2001  
 Source: U.S. Census of Monthly Retail Trade

## 512 offices in 61 countries on 6 continents

United States: 125  
Canada: 38  
Latin America: 18  
Asia Pacific: 214  
EMEA: 117

- \$1.5 billion in annual revenue
- 979 million square feet under management
- Over 12,500 professionals and staff
- 348 retail professionals in 63 U.S. Offices

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with its larger 21,000-SF prototype, which absorbs more square footage. Also, 99¢ Only Stores' and Dollar Tree's willingness to pay higher rents gets them into better centers with lower vacancy rates.

### WHOSE SHARE ARE DOLLAR STORES STEALING?

Retailers are expanding their food offerings in the face of two worrying trends: 1) Inflation-adjusted food expenditures by U.S. households decreased 5% during the Great Recession and have yet to recover; and 2) Food-related retail square footage is being added far more quickly than the population can absorb at a current growth rate of 1%. Retail expansion and convergence into food then becomes a zero sum game.

Determining which chains and which locations survive is tough to quantify. As currently reported, retail sales data—both by product category and by channel—can't be broken out to the degree necessary to allocate share among individual chains' converging assortments. The accompanying graph of sales trends by channel, for example, doesn't break out dollar store sales, and NAICS lumps dollar stores in with general merchandisers. The graph does, however, demonstrate that sales growth in grocery stores and drugstores has decelerated in the past couple of years.

In smaller markets, it will be the local grocers who can't compete with the economies of scale made possible by dollar stores' national distribution networks and marketing programs. In larger markets, dollar stores are likely taking marginal sales from larger box retailers as some customers seek to avoid the endless parking fields and crowded stores. Walmart (Express) and Target (CityTarget) have already acknowledged this risk and responded with their rollout of smaller stores in urban and infill areas. In the next 12–18 months, we'll be watching the pace of expansion of these two retail formats and how their layouts and assortments adapt, to determine how well they're competing against dollar stores.

There's also some anecdotal evidence that dollar stores' rapid expansion is curtailing the real estate programs of existing retailers. Colliers knows of at least one national chain that sought to test out a new smaller-format grocery concept in the Southeast earlier this year, only to pull back when it couldn't find enough viable sites that weren't surrounded by drugstores, dollar stores, and supercenters.

### CONCLUSION

In an extended period of muted retail sales growth, it's hard to argue against dollar stores' strategy. The convenience they provide, bringing better products at lower prices closer to the consumer, helps them better serve existing customers and attract new ones. When the recession began, nearly everyone traded down either out of necessity or a desire to spend more prudently. Many consumers may have expected to resume their pre-recession shopping habits when the economy improved, but the slow recovery has kept them in a cautious mode. Retail is habit-forming, though, and the longer shoppers patronize a particular store or category, the more likely it is to become a permanent shopping destination. Regardless of the pace of recovery, dollar stores are hoping their real estate and merchandising expansions will keep them top-of-mind with consumers for years to come.