

Chapter 2: MARKET ANALYSIS

This chapter discusses marketplace trends and their effect on WSLCB retail and wholesale operations. Proposals and ideas presented in subsequent chapters have been evaluated against, and are consistent with, the historical and projected trends and customer demographics summarized in this chapter.

Topics covered include:

- Sales Forecast
- Consumption Trends
- Product Trends
- Drinking Age Population Increases While Number of Liquor Stores Decline
- Distribution Strategy
- How WSLCB's Performance Ranks With Others
- Profits and Tax Collections Increase
- What Are the WSLCB's Opportunities?
- What Are the WSLCB's Challenges?
- The Future

Important conclusions regarding this information:

- Sales increases are being driven by growth in the drinking-age population.
- Insufficient agency resources exist to keep up with the growth in demand.
- A more discerning customer base wants improved product choice and increasing numbers of up-scale products.

Sales Forecast

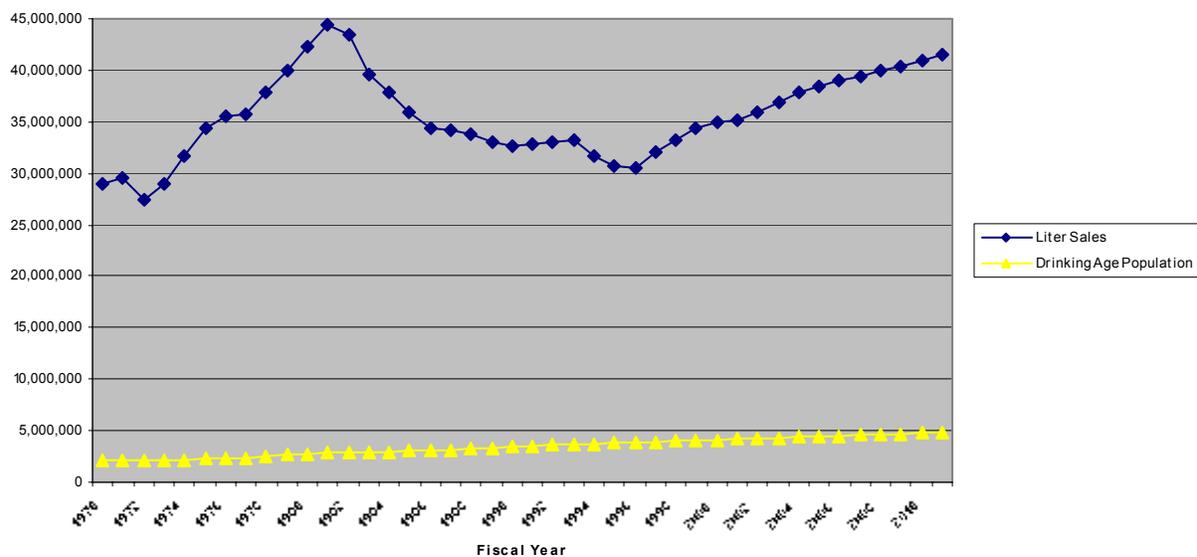
The forecast of demand for liquor (spirits, wine, malt beverages and industrial alcohol) through state and contract stores is affected by the price of liquor, the economic situation, social trends, and the drinking-age population. Through the years these variables have changed their degree of influence on liquor sales.

The chart on the next page depicts an increase in liter sales between 1996 and 2004 from 30,000 to 37,000, a growth of over 23 percent. The projections for 2011 show a growth of 40 percent compared with 1996. In contrast, the number of Retail and Distribution Center employees has decreased by about 2 percent.

- **Price of liquor:** This played a larger role in the 1980's when the price of liquor increased sharply due to large increases in the federal excise tax and in Washington State spirit taxes. Recently, liquor prices have played a minor role due to relative small price increases and the fact that spirits are inelastic.

- **Economic situation:** Since 1960, only twice has there been a decrease in sales during an economic downturn. This occurred in 1970 and again in 1982.
- **Social preferences.** These played a major role from 1983 to 1996. During this period the drinking population consumed less liquor because of health concerns and stronger DUI laws.
- **Drinking-age population.** Except for the period 1983 to 1996, growth in the drinking-age population has been the primary driver in liquor sales growth. The drinking-age population is expected to increase 11 percent over the period 2004 to 2011, from 4,376,123 to 4,868,568.

Liter Sales & Population Growth 1970-2011



Consumption Trends

Nationally, consumer demand for products with flavor and style drove U.S. spirits and wine case-sales in 2003 to heights not seen in more than a decade.¹ Despite a slight dip in beer consumption, all three segments of the business posted record retail dollar sales. "Growth in beverage alcohol sales continues to be driven by flavorful and high-end spirit products, continued interest in varietal wines and the ongoing popularity of imported brews," according to the Adams Handbook. Spirit sales climbed 3.8 percent in 2003 reaching more than 159 million 9-liter cases. Wine consumption climbed 4.9 percent to the highest levels since the 1980s. And despite a slight dip in beer case sales overall, imports, lights and domestic super premium offerings continued their upward climb. Total beer consumption fell 0.6 percent to 2.8 billion 2.25-gallon cases last year.

"Consumers spent \$8 billion more on spirits, wine and beer products last year compared with the previous 12 months," Adams reported. Total beverage alcohol retail dollars

¹ Adams Handbook Advance, published by Adams Beverage Group

grew at a faster pace than case sales in 2003. Retail dollars climbed 6 percent to \$145.4 billion, whereas overall industry case sales were essentially unchanged. "Imported products in all three segments of the beverage alcohol market grew at twice the clip compared with domestics. As with virtually every other consumer goods category, beverage alcohol continues to benefit from the trading up trend."

Many beverage analysts believe the trend toward higher-end, flavored spirits will continue in the next decade, adding to revenue growth for the state. Washington State mirrors these beverage alcohol consumption trends. In FY 2003:

- Spirit sales rose \$24.5 million or 5 percent.
- Spirit case sales rose 3.1 percent.
- Spirit liter sales rose 2.7 percent.
- Wine sales rose \$800,000 or 2.1 percent.
- Wine case sales rose 2.1 percent.
- Wine liter sales rose 2.5 percent.
- Case sales in the flavored vodka and rum categories growing at 26.5 and 12.3 percent, respectively.
- Consumers were "trading up," or making purchases in the higher price ranges of almost every beverage alcohol category.

Product Trends

Some products are experiencing growth while others are flat or declining in market share. For example, although beer is the most popular alcohol beverage in the country, it is losing market share to wine. On the other hand, consumption of hard liquor, which had been flat (except for some premium brands), is now enjoying growth driven by innovative new product introductions and an increase in the drinking-age population.

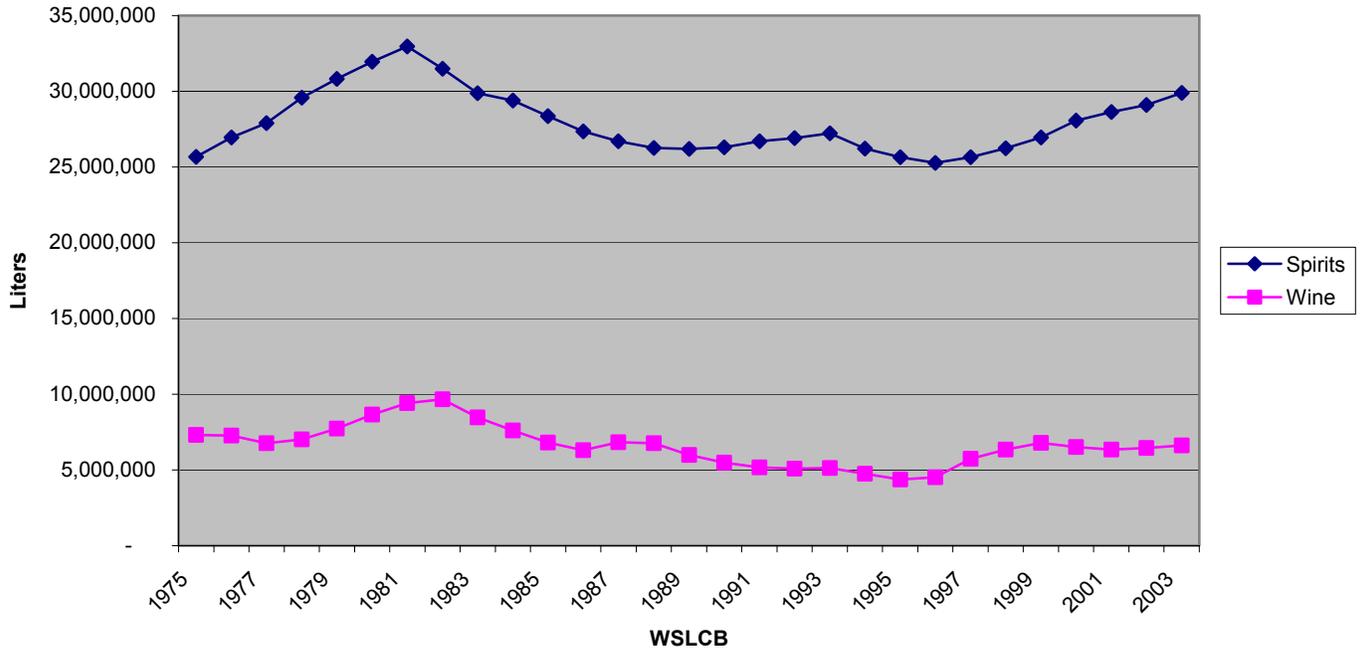
Washington State liquor store trends are fairly consistent with national trends. However, Washington consumers' preference for wine tends to be higher than it is nationally, while it tends to be somewhat lower for beer.

Nearly 40 percent of drinking-age adults purchase wine. Continued reports of the health benefits of red wine have helped to make it the most popular type (purchased by 24 percent of adults), closely followed by white wine (purchased by 22 percent). About 20 percent of U.S. wine buyers will spend \$5 to \$9 for a bottle of wine and another 20 percent will pay from \$10 to \$14. Washington consumers are more likely to spend \$5 to \$9; Seattle wine buyers are more likely than average to pay \$10 to \$14.²

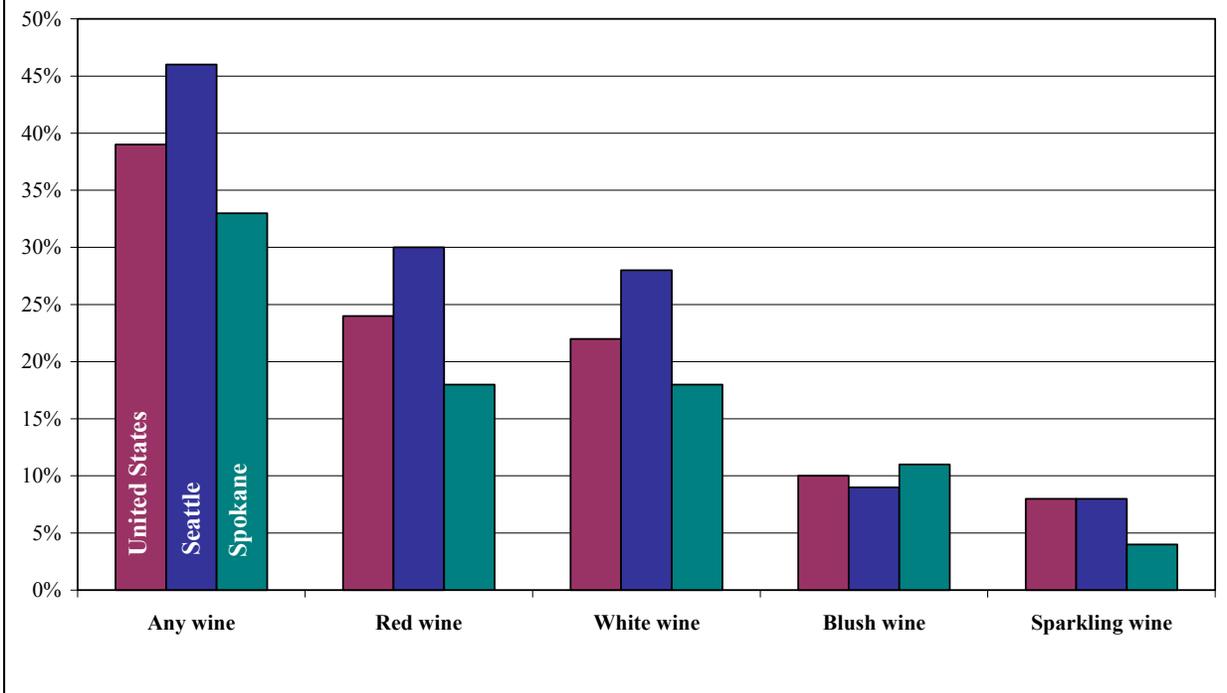
The state's product line includes spirits, wines, malt beverages and industrial alcohol. For fiscal year 2003, spirit sales were \$517 million, wine sales were \$39 million, malt beverages were \$814,000 and industrial alcohol was \$350,000. In equivalent liter units, spirits are 81 percent of our business, wine is 17 percent of our business, and malt beverages and industrial alcohol are 2 percent.

² Scarborough Research, 2003

Spirits & Wine Liter Sales



**Wine Buyers
Share of Adults 21+**



WSLCB Distilled Spirits Sales Trends

The trend of “buying up” to more expensive brands is represented in Washington liquor stores. Over the last twelve months, the highest growth category for spirit case sales is in premium products, as the table below illustrates.

	2002	2003	% Increase
Flavored Vodka	5,551	7,023	26.5
Single Malt Scotch	1,922	2,202	14.6
Flavored Rum	8,358	9,383	12.3
Liqueurs	26,837	30,002	11.8
Flavored Schnapps	5,188	5,771	11.2

Stores Decline/Drinking Population Rises

The number of LCB retail stores has not kept pace with the growth in the drinking-age population. In 1988 there were 180 state stores and 188 contract stores to serve population of 3.38 million drinking-age adults. By 2000, only 159 state stores and 157 contract stores served a drinking-age population of 4.2 million. By 2011, the number of drinking-age adults is expected to grow to nearly 4.9 million.

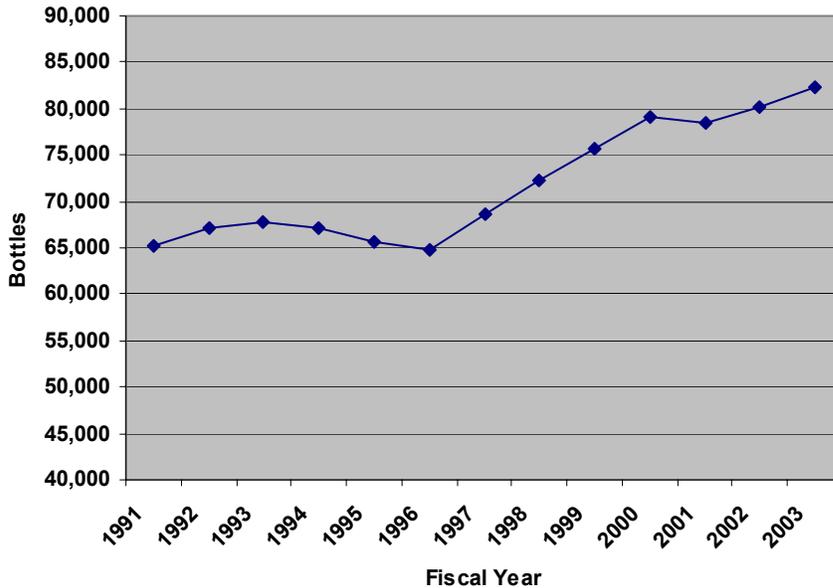
Additional stores were added in 2004-2005, bringing the total number of state stores to 164. The following chart also demonstrates the annual increase in the number of private licensees served by state-run and contract liquor stores.

	1980	1990	2005	2006	2007	2008	2009	2010	2011
Eligible Drinking Age Population	2,759,552	3,387,546	4,439,465	4,507,827	4,577,979	4,647,076	4,718,589	4,791,975	4,868,568
Licensees Served by LCB	2,279	2,673	4,146	4,212	4,280	4,348	4,418	4,488	4,560
State Stores	173	171	161	163	165	167	169	171	173
Contract Stores	182	176	156	156	156	156	156	156	156

As our population continues to mature, customer accessibility and convenience will become even larger factors in the operation’s ability to be responsive to customer expectations. These trends, combined with the state’s continued population growth, mean that careful selection of new outlet locations and models will also be important to maintain market penetration levels and maximize revenue generating opportunities.

There has been no increase in the number of retail FTEs in the last 10 years. During this period, bottle sales per retail FTE have increased 23 percent, from 67,000 per year to 82,000 per year. To achieve this result, retail operations have had to severely reduce training opportunities for employees. Formal and informal training programs have been cut to allow employees time to perform the basic store tasks such as stocking shelves and ringing sales. Similarly there is no time to talk with customers about new products and wine selections.

Bottle Sales Per Retail FTE



Population growth provides an opportunity for revenue growth and a responsibility to meet un-stimulated demand. The 1999 Deloitte & Touche Retail Business Plan reported that the number of Washington State liquor outlets per 100,000 people was significantly lower than the U.S. average, and lower than the average in most other control states. Population growth is particularly problematic in the higher-growth counties. The following table displays some areas that appear to be under-served.

Projected Population Growth --Top Ten Counties in Washington State

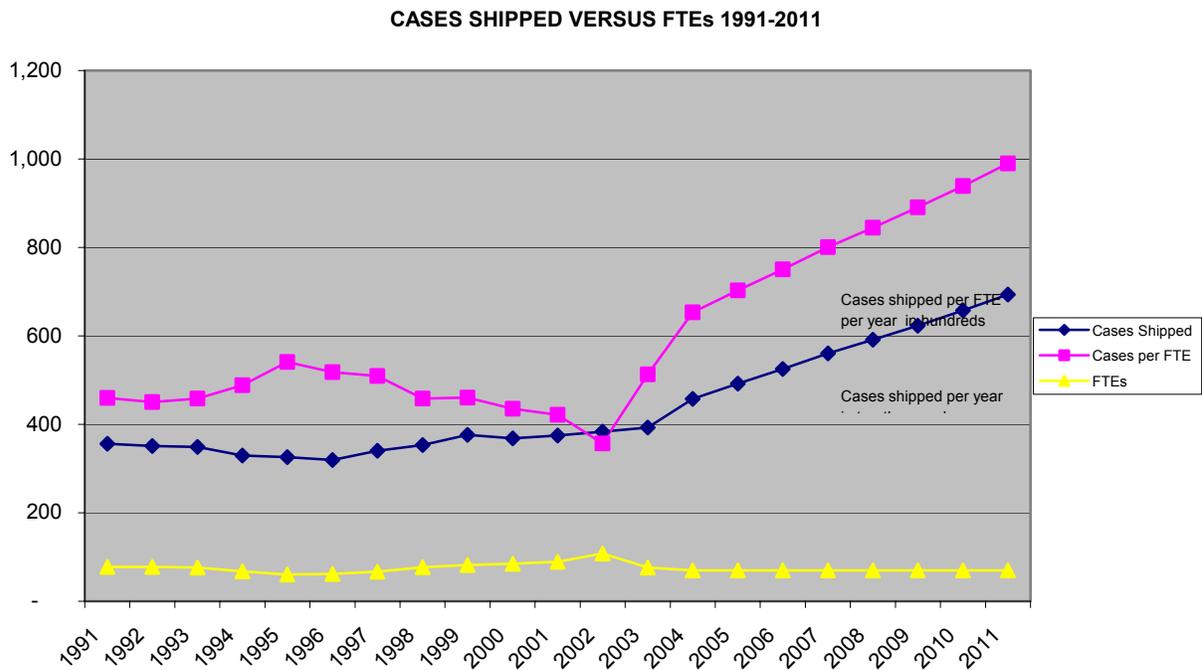
	State Stores	Contract Stores	Total Liquor Stores 2004	2005 Population	Population per Store 2005	2010 Population	Population per Store 2010 (if no new stores)	Persons per Sq. Mile(2000)
King	58	7	65	1,851,128	28,479	1,961,538	30,178	817
Snohomish	16	4	20	699,238	34,962	781,806	39,090	290
Pierce	19	10	29	791,400	27,290	856,004	29,517	418
Clark	5	6	11	413,273	37,570	465,996	42,363	550
Spokane	9	12	21	469,958	22,379	509,327	24,254	237
Thurston	4	4	8	255,703	31,963	287,919	35,990	285
Kitsap	6	2	8	277,242	34,655	306,960	38,370	586
Whatcom	5	6	11	194,449	17,677	217,009	19,728	79
Yakima	3	7	10	237,411	23,741	255,599	25,560	52
Benton	3	2	5	164,553	32,911	180,423	36,085	84
Skagit	4	4	8	121,451	15,181	137,054	17,132	59
Cowlitz	3	3	6	108,369	18,062	122,416	20,403	82

Note: Contract Stores generally serve rural populations.

Distribution Strategy

The WSLCB distributes spirits and wine to its more than 310 state and contract stores from a central warehouse in Seattle, Washington. Designed for a maximum daily shipping volume of 17,500 cases, the warehouse is nearing its capacity during peak shipping periods. Shipping volumes are expected to exceed capacity by FY 2005, outstripping both equipment and labor resources. The chart below shows the trend in cases shipped with projections to 2011.

It is important to note in viewing the chart below that the number of FTEs for Fiscal Years 1998-2002 are higher than the other years because during this period the new Distribution Center was being constructed and the agency was actually operating two separate warehouses. If these years are not included, the number of FTEs have either declined or remained constant while the number of cases shipped has continued to increase.



How WSLCB's Performance Ranks

Other LCB results favorably compare to the private liquor industry and other private retail operations in a number of categories, as the following chart indicates.

SAME OR BETTER	INDUSTRY COMPARISONS
✓	Washington ranked third among all control states in FY 2003 in sales and revenue contributions.
✓	Average per-store net income was 8.8 percent in FY 2002. Private liquor stores report averages of between 2.1 to 2.8 percent. ¹
✓	Sales per FTE of \$664,000 (2002) were higher than other control states and much greater than many retail businesses. Private liquor stores report sales of \$174,000 per person. ²
✓	LCB's inventory turns were 10.4 in FY 2004 compared to industry averages of 6.3 to 7.7 for private liquor stores. ³
✓	Order fill rates match the industry average of 95 percent. ⁴
✓	Average per-square-foot sales in state stores of \$606 (2002) exceed many retail businesses. For example, Wal-Mart is \$422, Costco is \$771, and Safeway is \$443. ⁵

Retail Services management continues to develop ways to improve profitability and create efficiencies while providing high-quality customer service. The Washington State University Customer Survey completed in 1999 showed this goal is being met, as overall customer satisfaction with state liquor stores ranked high. Specific questions about customer service, product availability, location, convenience, and safety all scored consistently high.

Rising Profits/Tax Collections

Consistent with sales growth, there also has been growth in the amount of taxes collected and profits generated and distributed to the state general fund, local governments, and health care funds. Between 1994 and 2003, there was a 37 percent increase in distribution. The chart below shows the taxes and revenue distribution for Fiscal Years 1994 through 2003.

¹ Bizstats.com/liquor.htm

² Ibid.

³ Ibid.

⁴ Deloitte & Touche, LLP, *Washington State Liquor Control Board, Retail Business Plan Final Report*, December 1999

⁵ Ibid.

DISTRIBUTION OF REVENUE (Millions of \$)

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Cities	27.0	25.7	25.5	26.2	30.3	31.0	29.6	33.0	34.0	35.7
Counties	6.8	6.4	6.4	6.6	7.2	7.4	7.1	8.2	8.5	9.0
State	99.9	96.8	95.9	98.5	100.7	101.7	107.9	113.9	117.1	121.6
Border Cities and Counties	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.3
DSHS	4.7	5.2	5.4	5.4	5.2	5.3	5.3	5.6	5.8	6.1
SPI	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Drug Enforcement	11.4	9.9	9.7	9.6	10.1	11.8	10.4	10.2	10.7	11.0
Health Care	11.8	11.6	20.3	20.7	29.2	37.6	35.8	35.3	37.6	38.7
Universities	0.7	0.8	0.8	0.9	0.8	0.9	0.7	0.6	0.8	0.8
Rapid Transit	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3
Wine Commission	0.3	0.3	0.3	0.3	0.3	0.3	0.5	0.5	0.5	0.4
Youth Tobacco Prevention									0.1	0.1
WSP Toxicology									0.2	0.2
Total	163.0	157.1	164.7	168.5	184.2	196.5	197.9	207.9	215.9	224.4

Note: For Tax Distribution for Cities and Counties, see Appendix.

The Opportunities

Changes in the liquor industry and in market trends provide Retail Services number of opportunities.

- The LCB's new Strategic Plan and Retail Services Business Plan will provide solid direction for the agency's retail operations.
- Partnering with key stakeholders, as was done with the shelf reset program, can yield additional revenue with minimal cost.
- The LCB buys the majority of its product as bailment inventory, which means the product is not paid for until it is shipped from the Distribution Center.
- The Bailment system allows expansion of inventory in the distribution center to support store growth without additional investment in inventory.

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- Newly installed point-of-sale equipment will provide a strong foundation to improve customer service and sales.
- Improvements in employee safety, employee recognition, and inventory management are planned.
- Growth in the drinking-age population provides opportunities for additional revenue.
- The LCB has a monopoly on spirit sales in the state.
- The new LCB management team is focused on making the Retail Services operation a leader in the industry, and to continually evaluate and review opportunities for new improvements. Areas being focused on include:
 - Developing performance standards for stores;
 - Using transaction data to develop, purchase, merchandise, monitor and ship product more efficiently;
 - Developing store location and leasing strategies using best business practices;
 - Hiring people with the skills needed to implement the business plan; and
 - Creating management tools, reporting mechanisms and risk management processes.

The Challenges

While the LCB has many opportunities to build on, there are also significant constraints that limit the potential of the Retail Services operations. These include, but are not limited to, the following:

- Increased sales volumes coupled with no store employee FTE increases have left the WSLCB unable to spare the time needed for store employee training.
- Training store employees carries a double cost in salaries and benefits as additional staffing must be provided to continue operations uninterrupted.
- The management ratio in the Retail Division is 12 WMS positions for 700 people. Consequently, management resources are stretched.
- There is not a funding process permitting reinvestment of revenue into the business, as would take place in an enterprise organization or private business.
- The agency is operating with outdated technology.
- Store employees frequently work alone in stores, increasing risk to their personal safety.
- A change in organizational culture must occur before best business practices can be fully integrated.
- The LCB has marketing and advertising limitations unlike other businesses.

- The Legislative appropriation process impedes the agency's ability to make needed investments and respond to changing market conditions in a timely manner.
- The Distribution Center is operating at or near peak capacity during high-volume sales periods. In two years, the DC will not be able to handle peak loads. The cost of labor to maintain the material management system is increasing.

The Future

The LCB's Retail Services is looking forward to continuing to create systems, efficiencies, and programs as a standard bearer in the industry. Specific plans for how this will be accomplished are outlined in this business plan. This plan will be reviewed and, as appropriate, revised as more information is available or as environmental conditions change.