MJG Gas Station Institute
24828 N. 56th Dr.
Glendale AZ 85310
Ph.: (623) 931-5086 / Email: Mike@MJGSpecialistsAZ.com

August 2013

Blue Paper

GAS STATIONS & C-STORES

The Connection Between C-store Earnings & Property Values

A recent article appeared in CS News dtd 2-25-13. It's written by Robert E. Bainbridge, an author, instructor and expert witness in the appraisal and valuation of convenience stores and gas stations. It's included in this *Blue Paper* because of its relevance in pointing out the relationship between business earnings and property values. The quantitative measures illustrated deserve a fairly wide range of latitude. However, if you haven't read Mr. Bainbridge's analysis & opinion of the subject, please do.

> *For convenience store real estate, value is related to earnings. Because they are income producing properties, the market value of c-stores is directly proportional to their capacity to generate sales and profits -- stores that earn more are worth more. Property prices for c-stores today are down about 20 percent as a result of the Great Recession. Commercial real estate prices across the nation dropped about 40 percent during that recession, which began in 2007, but are now recovering. Based on the past relationship between earnings and real estate prices, we can project real estate price levels at full recovery.*
>
> *To illustrate this relationship, we can use gross profit as a measure of earnings. The table below shows various levels of gross profit alongside the corresponding current real estate value today and the projected recovery value. It can easily be seen that stores with higher gross profits typically have higher real estate values. For example, a store earning a stabilized gross profit of $400,000 per year would have real estate assets worth about $1,040,000 today, and an expected recovery value of $1,320,000. The real estate values in this table include the site, store building, canopy, underground storage tanks and dispensers. They do not include foodservice equipment, personal property or business value. The reported real estate value assumes typical management and is not based on any specific branding. Per-store gross profit has been steadily increasing over the last decade, rising by about 4 percent per year, unadjusted for inflation. So, the decline in c-store property prices during the recession most likely reflected general economic conditions outside the convenience industry. According to CoStar's latest CCRSI Commercial Property Sale Index, commercial real estate prices are recovering and pricing growth is accelerating across the nation. We expect convenience store real estate prices to follow this trend.*

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If you'd like discussion about this, and a more localized opinion of values as a function of operating metrics, call MJG at your convenience.

Fuels Market Changing Fast

The following comments and opinion come courtesy of the NACS Leadership Forum held last February in Miami. Remarks were given by John Eichberger, Vice President of Government Relations for NACS.

Fuels represent 71 percent of the convenience store industry's total sales, and convenience stores sell 80 percent of the fuel sold in this country. 2007 was the peak year for fuel consumption in America. "We will never sell more (fossil) fuel than we did in 2007", per Eichberger, "due to a combination of slower economic growth during the recession, as well as government policies that are forcing the nation's auto makers to increase the fuel efficiency of their fleets."

Mr. Eichberger continued, "The federal government's push for ever-higher fuel efficiency, as well as a Renewable Fuel Standard that sets the goal that 27 percent of all gasoline sold must be biofuels by 2020 …"

When forecasting the future, I'm reminded of one of my favorite Yogi-isms:

"It's tough making predictions, especially about the future."

Yogi Berra

Mr. Eichberger also noted that the industry's interests are blunted by the different goals of other stakeholders in the nation's fuel economy. "Auto makers, refiners and the biofuels industry all have very different goals" when it comes to the future of fuels," he said. "How do we educate policy makers so they don't make decisions in a vacuum without looking at the total ramifications of what changes they mandate through regulation and legislation?" To that end, Eichberger announced the formation of a new organization, **The Fuels Institute**, to serve as an independent think tank on fuel issues, founded and funded by NACS. The hope, according to Eichberger, is that The Fuels Institute will foster collaboration among all the different stakeholders and assist in answering questions facing market and policy makers.

What's it all mean?? Take a minute and think about it. (You may want to read the last paragraph another time or two.)

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Are Drugstores the New Convenience Stores?

New research by The Hartman Group suggests this retail channel is making greater strides in the area of convenience, especially in regards to food and beverage purchases. Shoppers visiting drugstores exhibited both behavior modes, with 58 percent saying they browse and buy, which includes an element of surprise and discovery. Another 38 percent said they search and retrieve, which shows these customers want to get in and out of the store quickly.

These results were the lowest and highest of each shopping style across other primary retail channels including grocery (g), dollar ($), club (c) and mass discount (m) – drugstore data below is in the (d) column. This indicates shoppers have little interest in discovering new products within drugstores and are more interested in getting the job done quickly and efficiently.

In addition, drugstores are now seen as a highly convenient shopping channel with 24 percent of shopping trips described as immediate consumption occasions, in which food and beverages purchased are consumed within one hour of purchase.

Trip Mission	g	$	c	m	d
Stock-up	47%	23%	50%	42%	29%
Fill-in	25%	23%	23%	21%	21%
Occasion-based	12%	8%	8%	14%	6%
Immediate Consumption	11%	21%	8%	7%	24%

Knowing your competition is among the first steps to developing a competitive strategy.

COMMERCIAL REAL ESTATE

Reminder: Gas stations are a sub-segment of the retail segment of commercial real estate.

Commercial Real Estate (CRE) Fundamentals Improving – Lending Tight for Small Business

With vacancy rates modestly falling and rents moderately rising in commercial real estate sectors, market fundamentals have improved … BUT, financing remains a challenge for small business, according to the National Association of Realtors® quarterly commercial real estate forecast.

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Lawrence Yun, NAR chief economist, said the market is showing an uneven recovery. "The wheels appear to be greased for the big players, but not so much for small business," he said. "Overall, the commercial sectors are firming nicely, with multifamily continuing to show the best performance." National vacancy rates over the coming year are expected to decline 0.1 percentage point in the office market, 0.5 point in industrial, <u>and 0.3 point for retail</u>; however, the average multifamily vacancy rate is forecast to rise 0.2 percentage point, with that sector still showing the tightest availability and biggest rent increases.

A companion report, the *Commercial Real Estate 2013 Lending Survey*, shows widely varying availability of lending capital depending on property size, with a significant disadvantage for buyers of smaller properties. Commercial sales volume of major properties valued at $2.5 million and above increased 24 percent in 2012 to $294 billion. The uptrend continued during the first quarter of 2013, with a $72.8 billion volume that is 35 percent above the first quarter of 2012. Sixteen markets in the first quarter experienced triple digit gains. Commercial mortgage-backed securities regained market share in 2012, accounting for 22 percent of lending for major commercial properties. A comparable source was government agencies, followed by national banks, insurance companies and regional banks. Realtor® (members of the NAR) commercial members report 85 percent of their clients' transactions are for purchases under $2 million – generally small businesses. These transactions are financed largely by private investors, along with local and regional banks, marking a bifurcation in capital availability based on property value. "Despite the improvement for major commercial properties, 52 percent of Realtors® report they had a commercial transaction fail in the past year due to a lack of financing," Yun said. "In addition, 42 percent of respondents said clients failed to complete a refinancing. <u>Credit for small business remains unnecessarily tight."</u>

Commercial members report that new and proposed U.S. legislative and regulatory initiatives, and regulatory uncertainty for financial institutions, account for the lack of capital in commercial lending for smaller properties.

<u>CRE Prices Rising to Old Peaks</u>

Prices for U.S. commercial property are expected to climb in the next six months, extending a rebound that has sent values close to levels reached at the market's peak in 2007, according to Green Street Advisors Inc., the Newport Beach, California-based research firm. There is an 80 percent likelihood that commercial real estate prices will rise by Sept. Prices climbed 1 percent in February and are within 1 percentage point of their August 2007 high, according to the company, <u>which tracks real estate investment trusts</u> (REITs). "We're effectively back to peak pricing," Mike Kirby, Green Street's director of research. "We're fairly confident that the rebound will continue." A "renaissance" in the issuance of commercial mortgage- backed securities (CMBSs) will help boost prices, particularly for lower-quality properties, because financing will be more available, according to the report.

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Green Street's CRE price index is based on its estimate of the value of portfolios of REITs (BBREIT), which tend to own high quality properties. Another measure of national values, the Moody's/RCA Commercial Property Price Index, is 20 percent below its peak in November 2007. REITs are trading at "moderate" premiums to net asset values, which historically has been a positive sign for prices of apartments, industrial and office properties, malls and strip shopping centers, according to the report. The spread between real estate returns and yields on investment-grade corporate bonds is also wider than usual, which is also a signal for climbing prices, Green Street said. "Values of high-quality (i.e., REIT-owned) properties have recovered virtually all of their lost value, while prices of lower-quality assets remain mired in the doldrums," according to the report, written by Kirby and Peter Rothemund. "A recent renaissance in the CMBS market –- issuance is back to '04 levels -– bodes well for a narrowing of the gap."

Shopping Center Rents Continue to Rise (This by way of CCIM News.)

U.S. shopping centers posted their fourth consecutive net operating income (NOI) gain in 1Q13, rising 5.5 percent since 1Q12, according to the International Council of Shopping Centers and the National Council of Real Estate Investment Fiduciaries. After years of sluggish growth, Midwestern shopping centers posted an 8.6 percent NOI gain year over year, followed by the West with a 7.3 percent YOY increase. Power centers surged 7.7 percent YOY in 1Q13, followed by neighborhood centers (typically grocery-anchored) with a 6.8 percent gain. Super-regional malls produced the highest NOI of all retail property types ($5.54 psf) but recorded only 2.0 percent NOI growth last quarter. "Retail continues to be the best performing sector," says Jeffrey R. Havsy, director of research for NCREIF. "The continued improvement in NOI is driving income returns and pushing up values."

Take-Aways & Qualifiers from the CRE Section

The value of CRE is directly linked to the ability of the property to make money.

Gas station properties are generally NOT part of the landscape when analysts discuss CRE.

Properties included in the discussion of CRE are landlord/investor-tenant properties. The investors (landlords) typically see CRE as an alternative to other fixed income (bond) investments.

The CRE universe for institutional investors (including REITS) are traditional multi-tenant, sometimes single-tenant, class A, sometimes class B, properties in MSAs, sometimes 2nd tier, markets. REITS that are followed by the Green Streets of the world are publicly traded companies – you can buy and sell them like stocks – that make their financial information public. They tend to trade on their yield, much like utilities. Investors typically shop the yield (which is why the spreads are important), and let the fundamentals be implied.

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There is a direct linkage between the value of CRE and the amount of debt capital available to finance it. Lack of capital makes an illiquid (dead) market … no transactions. Money is mobile! Liquidity loosening up in the high end ultimately filters down to smaller, less traditional markets, e.g., gas stations.

CRE markets, rents and values are directly affected by changes in the traditional investment markets, e.g., stocks & bonds. Both the U.S. stock and bond markets have been engineered into bubbles (some say) by the continuous QE programs conducted by the Fed. We've had a glimpse of the markets reactions to the proposal floated a few weeks ago by Bernanke hinting that the Fed may begin to rein in the current $85b/mo QE program – long term rates will be most negatively impacted by this when (not if) it begins. There are similar risks in the other G-20 countries for the same reason. What will be the impact on CRE when the bubbles pop, as some say? Re-read the above then connect the dots. But then again, "some" may be wrong.

CREDIT & BANKING

If nobody's mentioned it to you lately, we're still in a credit crisis!

What Happened to the Fed's Non-Performing Data Series?

"What is this", you ask, "and why should I care?" The answer will lead you to understand why most banks aren't lending (except SBA loans), and those that are have raised the bar so high on underwriting standards.

Businesses try to predict, on an ongoing basis, the amount of loss in their accounts. They take periodic charges to earnings to better match losses to periods when they occurred. Banks do this as well. They use current income, through the provision for loan and lease losses, to create and build a reserve to absorb losses.

The Allowances for Loan Lease Losses (ALLL) can be increased another way. When the bank collects on previously charged-off loans, the amount recovered goes into the ALLL. Charged-off loans decrease the ALLL. If a bank decides it has overestimated its potential loss exposure, it can choose to reduce its ALLL and add the amount to its income. This is known as making "reverse provisions" for loan and lease losses, because the bank decreases the allowance, or reserve amount, rather than increasing the provision. It is rare for a bank to make a reverse provision, however, because of the imprecise nature of determining an appropriate reserve. One last point to remember with respect to the reserve is that the ALLL is a general reserve. Therefore, even if a bank analyzes and estimates the loss on each loan, the allowance is there to absorb all losses in the loan portfolio and is not specific to a particular loan.

The original Fed data series showed how banks had 80-90% allowance for loan and lease losses from the mid-90s (post dot-com recovery) until the 2008 financial crisis. (See chart below.) It

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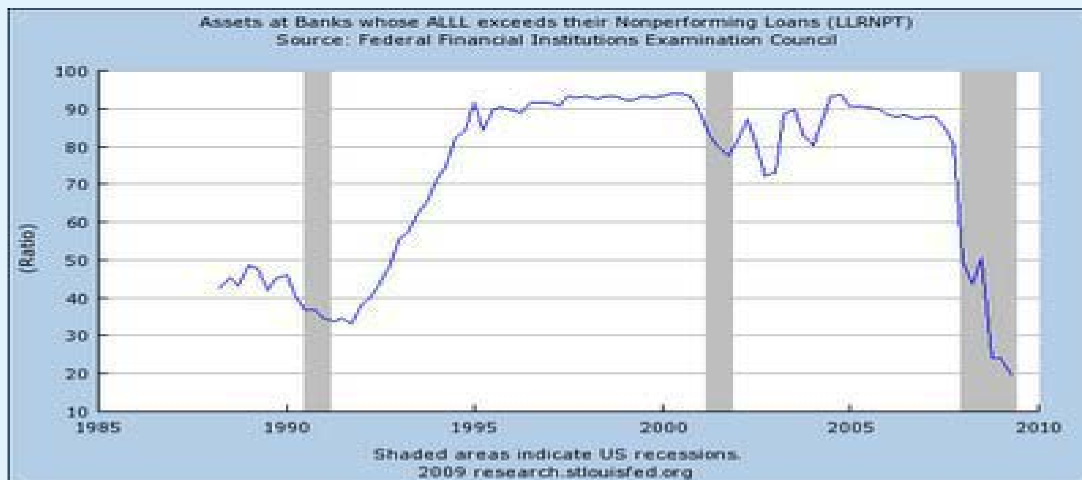
then dropped like a stone to 15% (chart stops at 20% about '09). It has been gradually struggling up since then and is now 35% (not charted). The old data series showed how pathetically inadequate the reserves are and how slow the recovery has been - actually, the non-recovery since about 2/3 of loan and lease losses are not covered!).



The re-building of ALLLs to even 35% has taken about 3 years. While attempting to rebuild these reserves banks certainly don't want to add to the problem, i.e., make more loans that can go bad. Meanwhile, the Fed keeps increasing reserves which the member banks in turn deposit back at the Fed, effectively arbitraging Government debt financing. You and I could be bankers doing this … borrow money from the Fed at ¼ point and invest in, say 2 yr. Treasuries at 1.5%, making a handy 1.25% with no risk (by definition). Given this alternative, why would a banker want to make a risky loan to you or me? And, they don't!

<u>But Bank Examiners Insist, so … Banks are Posturing for Loans</u>

You can tell the pressure's on for bankers. I've been getting cold calls from BDOs (loan officers) wanting me to direct gas station borrowers to them for SBA loans. (These can be structured such that, after the Government insurance, the bank has little money left in the deal … if it should happen to go south.)

Example of an email received:

"Now is a great time to refinance commercial debt!

- Improve current cash flow
- Restructure Debt
- Up to 90% LTV
- Up to 25 years fully amortized
- Variable and Fixed Options available

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- Many loans have no pre-pay penalties
- Loans up to **$5,000,000**

We do turnarounds!

The last 4 years have been a challenge for everyone. At ████ Bank we realize this and are eager to help businesses that can demonstrate that they have (past tense!) indeed turned the corner."

WHAT THEY MEAN… they are eager to help businesses that have already turned around, not that are still trying. No "blue sky" deals.

The Fed's Interest Rate Madness

Lenders trade the present value of cash for a future stream of payments. This includes remuneration for doing without the use of the money for the period of the loan. In a free market, rates would be dictated by what the overall time preference of society is. In other words, how much people value the present over the future determines the rate of interest.

What we have today is anything but a free market. The Federal Reserve is buying the vast majority of the government's new treasury bonds in an attempt to keep interest rates at or near zero, subverting the market signal that rates might communicate about society's time preference. Taken at face value, rates tell us that the average person has very little value for the present vis-a-vis the future.

In (Ben) Bernanke's world, it's as if we are all immortal. Time, as anyone over a certain age comes to realize, is in short supply, yet central bank policy attempts to quash this scarcity.

Tiny interest rates allow less-than-talented and inefficient businesses to stall and run out the clock, just as the Pistons did in 1950. The old Fort Wayne (the frontier fort prior to being named Detroit) bunch couldn't match up well against Hall of Famer George Mikan and the Lakers. They employed a "delay game" strategy from the opening tip. We can't begrudge the Pistons for their successful strategy, but the point is that an inferior team won because there was no mechanism to force the teams to attempt to score.

Likewise, absent the 'ticking' (accrual) of a proper real rate of interest, poor investments can survive and even appear to be the equal of alternatives that could generate superior returns. No shot clock, fewer shots; no interest accrual, less monetary velocity.

Indeed, the demand for money, as measured by the velocity of MZM Money Stock (MZM/GDP) peaked at nearly 3.5 in the early 1980s. Today it has sunk to less than 1.4. For all the Fed's

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attempts to ignite an animal-spirited lending spree, the cash just keeps piling up (result of all the QEs) and doing nothing. (The Fed can lead it to water but they can't make it drink.)

Last November, *The Economist* weighed-in on the cash issue with a piece entitled "Dead money". Companies have been supplying cash rather than using it since 2008. Firms in the S&P 500 are holding close to a trillion dollars in cash on their collective balance sheets, an increase of 40% from the dark days of 2008. (What isn't talked about is that much of this cash is offset by bonds (debt) – borrowing money now that they don't immediately need since rates are low. Stocking the war chest for the anticipated recovery.)

Cash is sloshing around in banks around the globe. In fact banks themselves are swimming in liquidity. The loan-to-deposit ratio of America's banks is a decades-low 70%. Plus, banks still have nearly $1.5 trillion parked at the central bank in excess reserves.

> (Have you noticed how banks for the last few years have been posting record earnings? How do they do this without making loans? Investments, and delaying write-offs for ALLLs. The more money the Fed feeds them, the more investments they can make. NOTE: banks can't make loans as a function of their reserves, but only as a function of their equity capital, and reserves don't count as capital. Current tier 1 capital requirement is 4 % - highly leveraged!!!! Leverage works both ways. It doesn't take much of a loss (increased ALLLs) before your shareholder capital is gone – they call that bankrupted! What banks can do with their reserves, however, is make investments. Nice how that fits together.

As *The Economist* points out, this cash hoarding is a worldwide phenomenon. Companies (non-banks) in Japan have increased their liquid assets 75% since 2007 to $2.8 trillion. Canadian firms have $300 billion sitting on their balance sheets. That's a 25% increase from 2008. When he was a governor for the Bank of Canada, Mark Carney told those companies to "put money to work and if they can't think of what to do with it, they should give it back to their shareholders."

Of course it's not high rates that are enticing companies to leave money in demand deposit accounts, money market funds, or treasuries. In fact, rates have never been lower. As hungry as banks were for money during the boom, many are doing all they can to get rid of deposits. The central bank's zero interest rate policy has compressed interest rate margins at banks. Banks can't pay less than zero for demand deposits, so as lending rates and treasury rates have decreased, interest rate margins have been flattened. (Soon you'll be offered toasters and microwave ovens instead of an interest rate!)

The Fed's Zero Interest Rate Policy has trickled down to gamier borrowers. Junk bond rates are way down. This allows inefficient businesses to compete against more productive competitors that have the wherewithal to service much higher market rates. Dicier operators living on Bernanke's low rate largess now crowd out more capable borrowers.

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At the same time, low rates allow lenders to sit on foreclosed housing units indefinitely, keeping markets from clearing and sending faulty signals about supply to the market. Also, the intrusions of government go unimpeded since government is paying little or nothing to the Fed. The central bank then turns around and disgorges its profits back to where they came from — the Treasury.

So despite all of the monetary stimulus, this all adds up to lower economic growth. And so, as colorfully explained in *Grant's*, "Malinvestment persists, and the 'beer goggles' of too-low rates (a couple of Budweisers, and everything looks better) continually clouds the a priori investment analysis of any thinking capitalist."

Reportedly, the Fed is desperate for businesses to make investments and hire people. The stated plan is to lower borrowing costs for businesses so that borrowers will seek and be granted loans to do projects that require increased hiring. (The Fed can lower borrowing costs – interest rates – all day long, but if banks are "risk-encumbered" by latent write-offs, inadequate capital, and alternative risk-free investments, loans won't be made … and the Fed can't make 'em!)

Thus far, the results have been terrible. The headline unemployment rate still hovers 7-8%. Three million fewer Americans are employed now than in January 2008. Median household income has dropped 9% since the end of 2007. GDP growth since 2007 has been just over half a percent annually.

Expect more of the same until the Fed gets out of the way. If and when interest rates finally rise, bloated and inefficient businesses and governments will be forced out of the game leaving the court for the most skilled operators to drive economic growth and employment. (This will take time to run its course, and it won't be fun!)

In fiscal 2010, according to numbers published by the Census Bureau and the Office of Management and Budget (OMB), net spending by all levels of government in the United States was $5,942,988,401,000. That equaled $50,074 for each one of the 118,682,000 households in the country. In that same year, according to the Census Bureau, the median household income was $49,445. That means total net government spending per household ($50,074) exceeded median household income (49,445) by $629 ... As recently as 2000, the relationship between government spending and household income was dramatically different. Data from the Census Bureau and the OMB show that in that year net spending by all levels of government was 3,239,913,876,000. That equaled $29,941 for each of the nation's then 108,209,000 households. In 2000, the median household income was $41,990.

Why Fed Tapering Won't Go Smoothly

If you buy the party line that Wall Street and the Federal Reserve are pushing, that the process of "tapering" back on Quantitative Easing (QE) will be relatively painless … that all the Fed has to

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do is gradually, slowly, predictably, and gently ease back on its bond purchases and, they say, it will have minimal market impact, then I have a bridge to sell you. My take … it will be anything but smooth.
But before we take a look at the Fed's predicament, let's first see how we get here and what we can learn from others, e.g., Japan, who have gone before.

QE is unlike anything the Fed has previously done in the last century. It was an untested, fly-by-the-seat-of-the-pants policy when policymakers rolled it out in the midst of 2008's full-scale credit market emergency. No one at the Fed — or anywhere else — had any idea what the long-term consequences would be. But they did it anyway because they had nothing else up their sleeve. That made it inherently risky from the start. Things went okay for a while, which encouraged the Fed to keep at it ... despite the fact the "real" economy didn't respond all that much. But beginning last spring everything started to change. In fact, the last few QE and QE-like moves that overseas central banks have tried have utterly backfired.

Take Japan for instance.

An initial pop in Japanese stocks due to that country's massive QE effort has now resulted in some of the worst declines — and crazy volatility — in several years. In just two recent weeks, for instance, Nikkei 225 futures plunged more than 3,300 points. That was a whopping 21 percent move! (For perspective, 21% down puts it in line with the U.S. market crashes in '29 and '87.) Swings of several hundred points have become the norm rather than the exception since then. Another move this week by the Bank of England is also backfiring. New BOE Governor Mark Carney pledged to keep monetary policy easy until unemployment there drops below 7 percent, a form of "forward guidance" that was designed to mimic Fed moves here. (Forward Guidance is central bank talk for hinting to the market what that central banks short term interest rate policy will be.) He also said the BOE could ramp up its $574 billion QE program. But rather than drive the British currency down and bond prices up, the announcement had the exact opposite effect. That marked the second time in the past few months that monetary policy not only failed completely ... it actually hurt the very markets it was supposed to help. So to recap: You have an untested, emergency program that wasn't allowed to die after the emergency faded, despite the possibility of significant long-term consequences. And you have key evidence over the past few months that QE overseas is backfiring.

From Dallas Fed President Richard Fisher … He noted in a speech in early August that the Fed is now basically buying every mortgage backed security the industry is issuing ... as well as others being sold by third parties. Not only that, the Fed has jettisoned virtually all of its highly liquid, easy-to-sell short-term Treasuries ... and "hoovered-up" more than one-fifth of all the long-term Treasuries on the market. His conclusion:

> "The point is: We own a significant slice of these critical markets. This is, indeed, something of a Gordian Knot."

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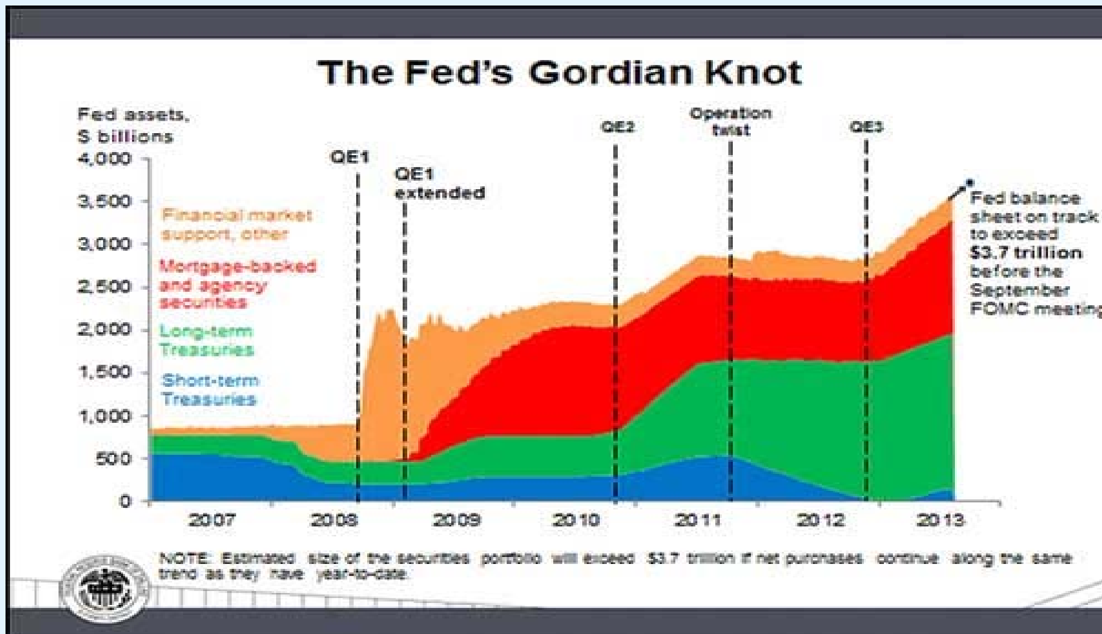
Suffice it to say, Fisher's reference is shorthand for an intractable situation that's virtually impossible to get out of.

This clarifying chart below - from the very same presentation - makes it clear what kind of trap the Fed has created for itself. It shows that the Fed's balance sheet is nearing a whopping $3.7 trillion — by far the greatest as a percentage of GDP in the history of the country. That compares to about $880 billion back in 2008 before the credit crisis.



Even the mere mention of a possible future tapering of QE caused key parts of the bond market to suffer their worst declines since the credit market collapse of 2008. So when the actual tapering begins — possibly as early as Sept., maybe Oct. — look out!

ECONOMY

First, last Friday's jobs report was a disappointment as mentioned above. Payrolls did expand by 162,000 last month, but it was below expectations. More disturbingly, the details of this report clearly show that the underlying employment trends in the job market leave a lot to be desired. Consider the following:

* The number of Americans forced to work part-time jumped another 19,000 to a staggering 8.25 million workers — stuck at the same high level as this time last year.

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* Those unable to find work and dropped out of the labor force last month climbed by 240,000, to nearly 90 million Americans - the second-highest reading ever recorded.

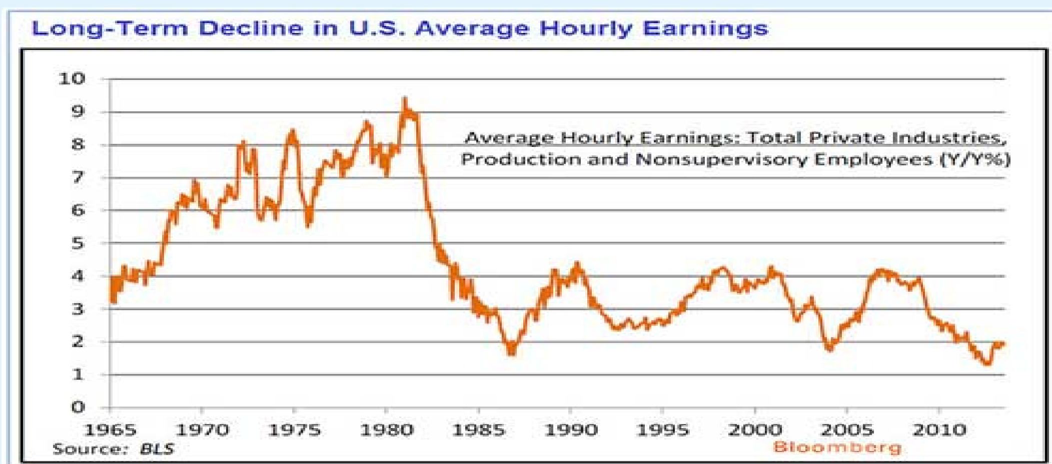
* And out of the 162,000 new jobs that were created last month ... nearly 60 percent of them were low-paying positions in retail, restaurants or temp-jobs.

In other words, the employment trend remains dysfunctional at best, and won't do much to promote stronger economic growth, not when two-thirds of U.S. Gross Domestic Product (GDP) growth is driven by consumption. People without well paying, full-time jobs don't have the ability to boost their spending.

Second, last July the Bureau of Economic Analysis reported that the U.S. economy expanded 1.7 percent in the second quarter ending June 2013. That beat expectations of just 1.1 percent growth, a positive surprise, and helped the aforementioned indexes tick slightly higher. Ah-ha, but once again the devil was in the details. The main reason for surprisingly strong second quarter GDP was because first quarter growth was revised substantially lower. In fact, we now find that GDP advanced just 1.1 percent during the first three months of 2013, far below the 1.8 percent growth previously reported. In other words, this particular "positive surprise" in the data wasn't real. It's pretty much a wash with our economy growing at an average pace of just 1.4 percent over the past 12-months. (These results in spite of the Fed's QE activity.)

Historically, such a slow growth rate has been associated with the start of recessions in the past. Going all the way back to 1948, any time annual GDP growth has been this anemic the "economy has entered recession within three quarters," according to analysis from Bloomberg.

The reason: Stagnant income growth is zapping consumer spending, the life-blood of our economy (See chart below.)



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* Average hourly earnings for U.S. workers declined in July and expanded just 1.9 percent year-over-year.

* When adjusted for taxes and inflation, American's disposable personal incomes are up just 0.6 percent since this time last year.

* As a result, consumption is getting squeezed, with inflation-adjusted consumer spending up just 2 percent over the past year as shown below.

<u>The Case for Declining GDP</u>

Before the argument, let's clarify what we're talking about … Gross Domestic Product: the value of all goods & services produced in the country. This comes with 2 descriptors: nominal and real. To get from nominal GDP to real GDP simply subtract inflation. The inflation correction factor is called the GDP Deflator. The Bureau of Economic Analysis has it's own deflator for this purpose … but there are others! (Not a perfect science.) The BEA put the 2012 compounded annual percentage change in the GDP deflator (i.e., the inflation rate) at 0.60%. (Does anyone believe inflation last year was .6%?) With this deflator, GDP calculates to be -.14%. However, other deflator measures produce other GDP results:

Using PCE (Personal Consumption Expenditure) deflator, GDP becomes -.77%,
Using CPI (Consumer Price index) deflator, GDP becomes -1.56%

Clearly modifying the measure of inflation affects the results of economic growth … what we might call "gaming the system". With that in mind, a couple of structural changes have quietly been made … the price of food and fuel have been eliminated from the deflator. On the GDP side, corporate expenses for R&D have been added to goods and services. These 2 changes alone should certainly have helped the economy come out of the slump (jobless recovery!).

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In very simplistic terms, there are only 2 ways to grow an economy: increase the number of workers, or make the same number of workers more productive through technology. That's it … that's all there is. With this in mind, let's consider the reasons why our economy might not grow, or grow as fast as we might like.

1. Changing social attitudes towards consumption and debt in all age groups (consumers are deleveraging, and have been for several years),
2. Demographics of an aging workforce,
3. A severe lack of high-paying jobs for college graduates,
4. Kids fresh out of college have delayed marriage, family formation, and home purchases,
5. Many coming out of college are effectively debt slaves having no way to pay back student loans (the amount of student loans now exceeds credit card balances),
6. Debt overhang from the housing bust,
7. Boomers headed into retirement have insufficient savings,
8. Shrinking middle-class plagued by declining real wages,
9. Rapidly changing technology negates skills (called structural unemployment),
10. Technology, especially robots, currently eliminates more jobs than it creates.

Changing the quantitative results of economic measurement may be politically satisfying, but in reality doesn't change the economic or financial condition of the participants, i.e., you and me.

International Investors Dump U.S. Government Bonds

Foreign holders dumped a whopping $40.8 billion in long-term Treasuries, the biggest exodus from bonds in the history of the U.S. Worse, June was actually the third month of mass dumping in the past four, for a total of $79 billion. China, the biggest holder of our bonds, unloaded $21.5 billion, while Japan, the second-largest holder, dumped $20.3 billion. (Do you think China and Japan will be standing in line again at our next auction?)

It wasn't just government bonds, either. Foreigners dumped $116 million of bonds made up of packaged U.S. mortgages. They sold $5.2 billion of Fannie Mae, Freddie Mac and Ginnie Mae bonds, and $5 billion in corporate bonds. And they unloaded $26.8 billion of U.S. stocks. All told, more international capital flowed out of U.S. markets than at any time in history, worse even than at the depths of the 2008 credit crisis. Indeed, the Federal Reserve was inflating its third massive bubble in the past 15 years (after dot-coms and housing), and that it was going to blow up in our face.

Source: www.moneyandmarkets.com – free subscriptions available.

We don't have to guess what this selling and the implications behind it does to interest rates. The 10-Year Treasury note (something of a benchmark), traded as low as 1.55% last Sept., almost a year ago. In the middle of August during this sell off the rate rose to 2.6% (that I know

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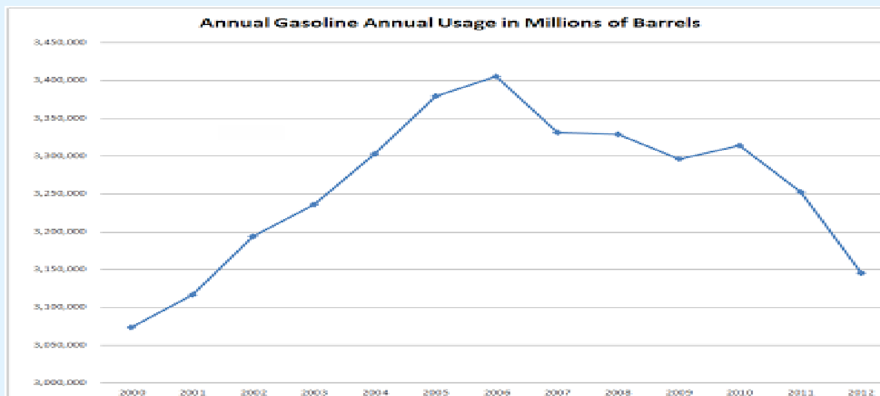
of … extreme volatility). That approximately 1% rise in rate was a 65% rise in the rate of the rate, or said from the price side, as 65% drop in the price of the bond, i.e., a $1,000 bond issued with a 1.55% coupon traded at $350 when the rate was 2.6%. (How's that for safety in Government bonds!)

The implications for real estate financing are not good. The Government can protect the rate somewhat for SBA loans which tend to be the primary source for financing individual gas stations, but as we've seen, they can't make the banks lend.

ENERGY

<u>Annual Fuel Usage Down</u>

The decline in gas usage continues as seen in the chart below.



The current downturn happened back in 2007 in gasoline, roughly coincidental with the credit crisis and subsequent recession. I can't see an improved economy from this chart. The continuing decline also cannot be explained by "higher mileage" vehicles - the impact would be some, but not as major as we see here with usage numbers now back to 2001 levels. For you operators and jobbers reading this, it merely clarifies the obvious.

<u>Increased Transportation Tax "Coming Soon"</u>

At least one downstream effect of the reduced mileage being driven as described above is the reduction in fuel tax collected by the Feds. With higher fuel efficiency and less miles driven, not to mention alternative energy used, the gas tax not being collected has declined commensurately. The $.184 per gallon Federal tax last set by Clinton in1993 has failed to pay for everything that Congress has legislated that it should pay for.

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The Highway Trust Fund, which includes the Mass Transit Account, has received several infusions of money from the "general revenue fund" to the tune of over $60 billion. But a new report from the Government Accountability Office (GAO), the congressional think tank focused on financing, past, present, and future, has made the country take a giant step forward in considering a switch to a fee that more accurately charges usage. The report, like all GAO studies, was commissioned by the House Transportation Appropriations Subcommittee. The gas tax charges drivers based on their use of petroleum, different vehicles can go different distances on the same amount of petroleum: essentially, some pay less than others for the same use of the road. Additionally, the counts of how much people drive has decreased (called vehicle miles traveled, or VMT), yet our demand for funds to maintain and build new infrastructure outpaces the incoming revenues from the gas tax. Lastly, the federal gas tax hasn't changed at all, sticking to the 18.4 cents per gallon (for non-diesel drivers). "While the gas tax was equal to 17 percent of the cost of a gallon of gas when it was set at its current level in 1993, it is now only 5 percent" (per *Streetsblog*). The Simpson-Bowles Commission, convened by President Obama to find strategies to improve the country's fiscal situation in 2010, "called for an immediate 15 cent-per-gallon increase in the gas tax". An alternative to the gas tax is to charge people based on how much they drive, a mileage fee. This can be calculated in more than one way, and doesn't require the use of a GPS system (initially thought) to track where people are going: pay-at-the-pump (or electric vehicle charging station), and prepaid, self reporting system based on odometer readings.

Governors Push for Tier 3 Gas Standards

Despite opposition from groups such as the *Society of Independent Gasoline Marketers of America* (SIGMA) and the *Petroleum Marketers Association of America* (PMAA), six governors and the Washington, D.C., mayor jointly sent a letter to Pres. Barack Obama in an effort to reduce smog-forming sulfur emissions. The letter asked the president to support a proposal to cut sulfur emissions from 30 parts per million to 10 parts per million. The EPA has contemplated the Tier 3 rule since 2008. According to the letter, the politicians believe Tier 3 standards are necessary as "emissions from vehicles must continue to be significantly reduced in order to attain and maintain the ozone air quality throughout the nation. Failure to meet the ozone standard results in approximately 200 additional deaths and $2 billion in health related economic impacts annually in the Northeast alone." More specifically, cutting sulfur emissions would allow catalytic converters to work more effectively, allowing cars to emit fewer smog-forming compounds, reported *FuelFix*.

However, there is another side to the story as indicated in an exclusive column written by Dan Gilligan, president of the PMAA, for *Convenience Store News*. He noted that the industry trade group is opposed to Tier 3 gasoline and "will be participating with other industry and consumer groups opposed to the rule."The new specifications will result in significantly higher gasoline prices with very little environmental benefit," Gilligan continued.

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The White House could bring the U.S. Environmental Protection Agency's (EPA) automobile pollution regulations to fruition this year (2013). The Office of Management and Budget conducted a review of Tier 3 emissions and fuel standards last January, and was expected to complete the review last March. (No word on the completion against these timeframes.) "The pollution reductions achieved by the standard result in huge health benefits, estimated at over $5 billion per year by 2020 and $10 billion per year by 2030," said Luke Tonachel, a vehicle analyst for the Natural Resources Defense Council. "It's time to move quickly to adopt 'common sense' Tier 3 standards and make breathing easier for us and for future generations." (I have no doubt that Obamacare has language somewhere in it that opens the door for the EPA to pass whatever rules it likes in defense of our health, and as a direct link to keeping health care costs down. I also doubt that whatever the rules propose will in fact succeed in materially accomplishing either of the proposed benefits.)

ROUNDING OUT – POINTS OF PERSPECTIVE

* **FIVE TRILLION IN 4 YEARS** - The nation's debt ceiling was $11.315 trillion when President Obama was inaugurated initially on 1/20/09. During his first 4 years in the White House, the debt ceiling was raised 5 times to $16.394 trillion as of 1/20/13, the date of Obama's 2nd inauguration (source: Treasury Department).

* **CASE-SHILLER INDICES RISE AT FASTEST PACE SINCE 2006** - Home prices rose at their fastest pace since July 2006, according to the Case-Shiller 10- and 20-city Home Price Indices, Standard & Poor's reported Tuesday. At the same time, the Case-Shiller national index, reported quarterly, registered its strongest gain since Q2 2006. The 10- and 20-city index each rose 0.2 percent in December, reversing declines in November. Year-over-year, the 10-city index was up 5.9 percent and the 20-city index rose 6.8 percent. The national index was up 7.3 percent year-over-year.

* **BEST OF THE REST** - The yield on the 10-year Treasury note was 2.57% on 8/05/11, the day that S&P announced a downgrade of the USA from AAA to AA+. Now 21 months later, the yield on the 10-year Treasury note closed last Friday (5/17/13) at 1.95% as global bond investors continue to buy US debt (source: Treasury Department).

* **BUT WHAT IF?** - The average interest rate that Uncle Sam is paying on its interest bearing debt is 2.464% as of 4/30/13, approximately half the cost the government was paying (4.838%) as of 12/31/07 (source: Treasury Department).

* **LONG TIME, NO CHANGE** - The Federal Open Market Committee voted 10-2 last Wednesday (6/19/13) to keep short-term interest rates unchanged for a 36th consecutive meeting. It has now been 4 ½ years since the Fed made any change to short-term rates (source: Federal Reserve).

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* **SEVEN PERCENT** - Ben Bernanke announced on 12/12/12 that is would keep interest rates unchanged until the unemployment rate reached 6.5% or lower. Following last Wednesday's meeting (6/19/13), Bernanke raised the bar to initiate a change in rates to a 7% unemployment rate (source: Federal Reserve).

* ***MORE RED INK*** - With just 4 months to go in fiscal year 2013 (i.e., the 12 months ending 9/30/13), the White House is estimating tax revenues of $2.712 trillion and outlays of $3.685 trillion for the entire year, resulting in a deficit of $973 billion, equal to $2.67 billion of debt created per day (source: OMB).

* ***NO CHANGE*** **-** The cover story of Time Magazine on 1/10/83 (more than 30 years ago) was "The Debt Bomb - The Worldwide Peril of Go-Go Lending" (source: Time).

* ***30 YEARS*** **-** have gone by since the labor force participation rate was as low as it is today. Despite supposed improvements in the unemployment rate, only 63.46% participated in the job market in the latest quarter

* **147%** - is how much private equity fundraising volume jumped this past quarter (Q2). That's the highest level since March 2009.

* **NEW PHASE 1 ESA STANDARDS** - Effective 9-13-13 there are new ASTM standards for environmental Phase 1s. Expected impact: expect the cost to go up, and time to complete take longer. *(Thanks to Judd Bowers, J. Bowers & Assoc. environmental consultants for this heads-up. You can contact Judd at 480-898-1068 for discussion and details.)*

* **CHEVRON-SAFEWAY LINK UP** - Five months after the initial rollout of their joint Reward Points loyalty program, Chevron Corp. and the Vons division of Safeway Inc. announced earlier this year that they are expanding the program's reach. The companies brought the Reward Points program to consumers in Las Vegas and northern California, including the Richmond, Sacramento and San Jose areas, on March 20, according to Chevron. Under the program, consumers who earn gas rewards by shopping with their Vons Club Card or Safeway Club Card at Vons or Safeway stores can use their Rewards to get a gas discount up to 20 cents off per gallon at participating Chevron- and Texaco-branded locations in the new markets. Chevron and Safeway launched the loyalty program in southern and central California in October, as *CSNews Online* previously reported. Safeway, which has an existing loyalty rewards card, had been in talks with Chevron for approximately a year before introducing the joint rewards program. The loyalty program is Chevron's first in the United States. It has a program in Canada and in some of its Asian markets.

Thank You for Your Attention,

MJG

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