



platt | retail | institute

**P.O. Box 158
Hinsdale, IL 60522
Phone: 630-920-1844
Email: skp@plattretailinstitute.org
www.plattretailinstitute.org**

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PRI QUARTELY RETAIL ANALYTICS

“BRINGING RESEARCH TO RETAIL”

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By Steven Keith Platt, Director and Research Fellow, Platt Retail Institute, and
Peter VanSickle, BMO Bank of Montreal

PRI's mission is to initiate and secure the funding of studies on specific retail business issues. PRI functions as a conduit, bringing together retail executives with leading researchers. The genesis of the Retail Institute is the recognition of the wealth of knowledge being produced at the University level, on the one hand, and the need for more advanced yet practical business research and insight at the retail level, on the other. It is, therefore, the Retail Institute's main objective to serve as a knowledge bridge between the University and retail industry and its related vendors. It will achieve this objective through the commercialization of the resources of its Research Fellows and University relationships.

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I. BUSINESS OUTLOOK

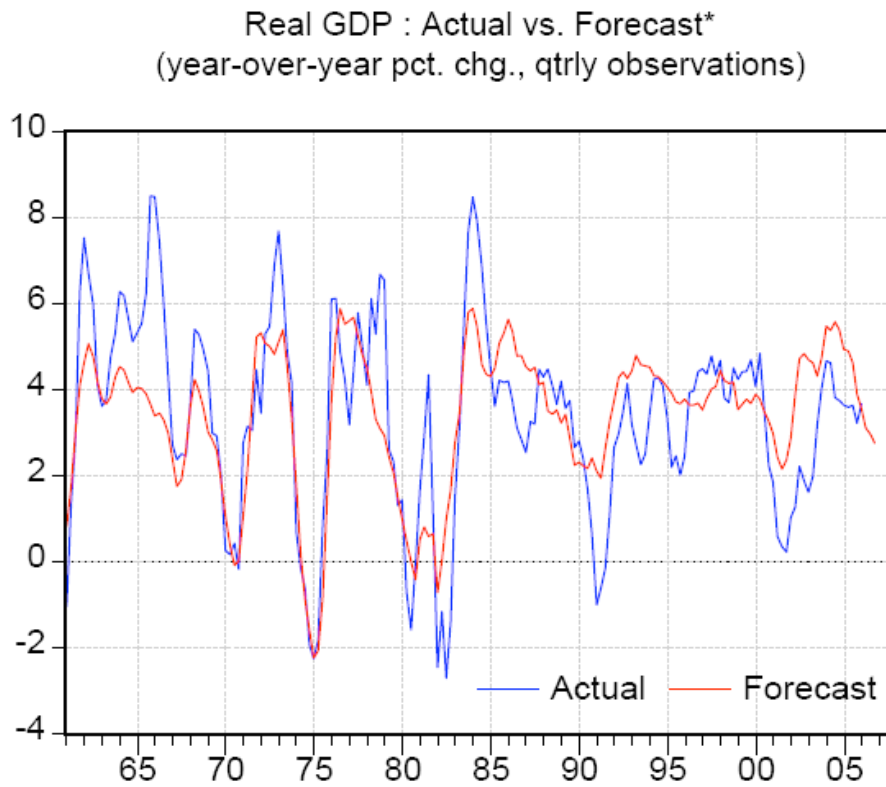
BUSINESS INDICATORS

Look for a gradual easing in overall U.S. economic activity. Inflation and its impact on consumer spending continues to raise major concerns. Rising interest rates, a slowing housing market, and increased energy costs are important considerations. Various other indicators of economic activity are generally more favorable, and will provide a reasonable support level. Corporate earnings are good, employment gains are reasonable, manufacturing activity is sound, and business investment remains healthy.

First quarter Gross Domestic Product grew at an annual rate of 5.6%. Lehman Brothers estimates second quarter growth, due out this Friday, in the range of 3.2%. Recall that for 2005, GDP grew by 3.5%, following a strong 4.2% gain in 2004. Lehman Brothers outlook for 2006 is 3.5%. Chart 1 is a model that forecasts the direction for GDP, and supports this view. A recent comment by the Federal Reserve enforces the view that the pace of economic activity is slowing. In a recent release, the Fed suggested it expects an average rate of growth of significantly less than 3% (annualized) in the last three quarters of 2006.

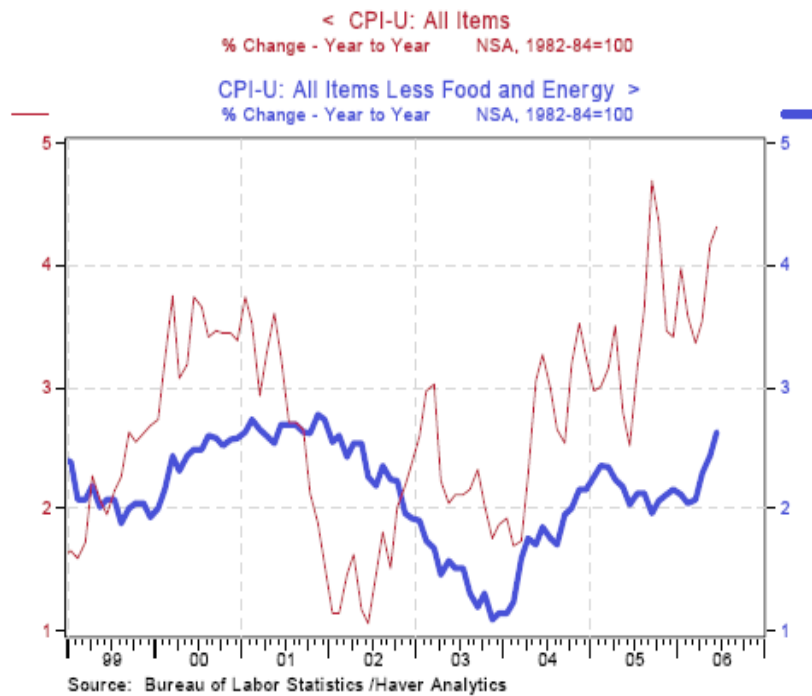
The Consumer Price Index for the first six months of 2006 increased by 4.7%, versus 3.4% for all of 2005. Energy prices alone grew at annualized rate of 22.8% during the first six months of the year. These trends are illustrated in Chart 2.

Chart 1.



Source: Northern Trust

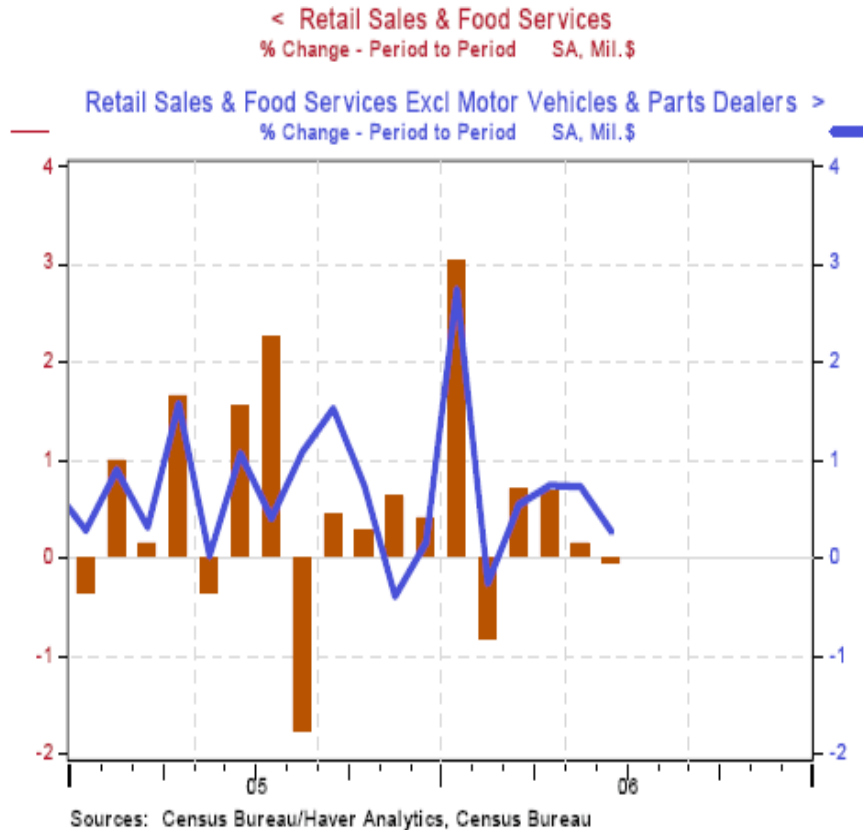
Chart 2.



RETAIL INDICATORS

During June, retail sales fell by -0.1% (see Chart 3). This weak headline number, while indicative of an overall economic slowdown, is not as dire as it may first appear. Retail sales excluding the volatile auto, gas and building materials sectors, in fact, rose by 0.3% in June; sales were up 9.5% for the first quarter, and are trending down, up 5.2% during the second quarter. By way of comparison, during 2005, overall retail sales grew by 6.1%, following a strong 7.0% gain in 2004. The National Retail Federation looks for retail sales growth to slow during 2006 to 4.7%. Due to trends in consume spending; we think the NRF is probably pretty close.

Chart 3.



Consumer spending has slowed markedly in the second quarter (see Chart 4). Consumer spending rose a strong 5.1% during the first quarter, and is estimated to grow at around a 2.5% annualized rate in the second quarter. Short-term, energy prices are impacting spending (gasoline prices surged roughly 30% from early March through May). Longer-term, increased levels of consumer debt (hitting a high of 13.93% in the first quarter, see Chart 5), a reduction of cash-out mortgages (on the rise since 2000, again see Chart 5), and falling equity prices will impact spending.

Chart 4.

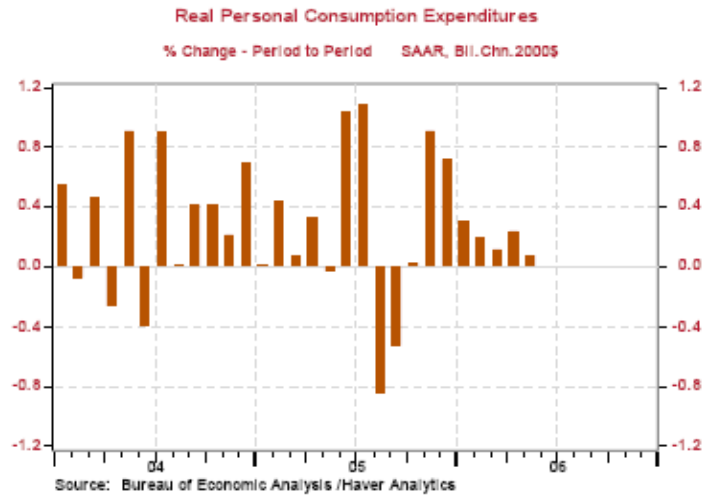
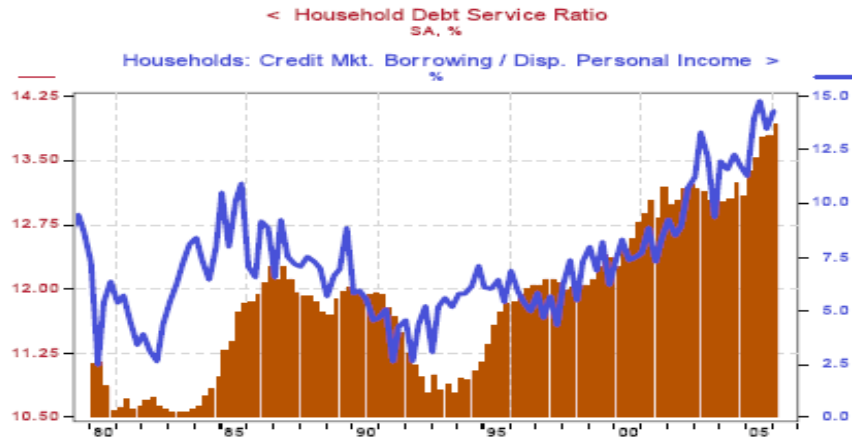


Chart 5.



Source: Northern Trust

We believe that retailers are already adjusting to this expected slowdown. For example, year-over-year retail employment for the first six months of 2006 fell by -0.2%, versus an increase of 1.3% during 2005 (versus overall U.S. employment growth of 1.4%). In addition, McGraw-Hill Construction estimates that store construction starts will ease to 2% in 2006 versus 3% in 2005, the first decline since 2002.

II. MAJOR RETAIL SECTOR TRENDS

BUILDING MATERIALS, GARDEN AND SUPPLY STORES

Sales fell -1.0% in June. On an annualized rate, sales are off -15.2% for the trailing 3-months and are up 8.8% for the trailing 12 months.

FOOD AND BEVERAGE STORES

Sales rose 0.4% in June. On an annualized rate, sales are up 6.5% for the trailing 3-months and are up 4.5% for the trailing 12 months. Traditional grocers continue to reposition themselves as high quality, lifestyle stores or as high-value chains to differentiate themselves from those who have stolen the middle. More prepared foods and quality produce are replacing traditional center-aisle products that can be found in non-traditional food retailers. Additional features include: self-checkout; quality private-label products; nutritionists and health clinics in-store; coffee shops, banks and name-brand restaurants; self-serve kiosks for refilling a prescription and placing a deli order; and in-store assembly of pre-washed, pre-cooked ingredients for cooking at home.

HEALTH AND PERSONAL CARE (DRUG) STORES

Sales rose 0.7% in June. On an annualized rate, sales are up 9.4% for the trailing 3-months and are up 8.1% for the trailing 12 months. The segment benefits from strength in the pharmacy business (65% of sales and growing at 5-6% per annum); gaining market share from the independents; and convenient locations.

CLOTHING AND ACCESSORY (APPAREL) STORES

Sales rose 0.3% in June. On an annualized rate, sales are up 4.8% for the trailing 3-months and are up 4.9% for the trailing 12 months. The overall category will remain highly competitive, and continues to suffer from deflationary pricing pressures. Sourcing efficiencies, broadening merchandise offerings, and finding unfilled niches (such as Women's Athletic Boutiques) will define success for the specialty retailer.

GENERAL MERCHANDISE STORES

Sales rose 0.3% in June. On an annualized rate, sales are up 4.8% for the trailing 3-months and are up 4.6% for the trailing 12 months.

DEPARTMENT STORES

Sales fell -0.3% in June. On an annualized rate, sales are down -1.9% for the trailing 3-months and are down -2.2% for the trailing 12 months.

III. RETAIL NOTES

NEAR-TERM OUTLOOK FOR THE DIGITAL COMMUNICATIONS NETWORK INDUSTRY

Our outlook for the Digital Communications Network market (“DCN”) is generally positive. Many new programs are being considered in various markets and industries. Yet activity does not necessarily lead to revenue, and we remain conservative in terms of making market-growth predictions.

In the U.K., for example, the apparent failure to generate significant advertising revenue streams has blunted new retail deployments. We believe that our British friends could benefit from proposing non-ad supported business models to their clients. Notwithstanding, inroads in some ad supported verticals in the U.K., such as hair salons, pharmacies, non-governmental managed post offices, malls, and pubs, for example, are being made. We see this same pattern in ad-supported businesses developing in the U.S., where broad-based ad programs are not materializing, but specific verticals with a more localized focus appear to be gaining traction.

Retail deployments in the U.S. in general, while active, appear to still be moving slowly. We believe that this situation will reverse itself, but not necessarily before 2008. This opinion is being driven, in part, by the fact that we see a slowing in the U.S. economy, and believe that DCN’s will be the short-term losers in the retail quest for budget allocations.

Other markets, however, are more robust and beginning to open. South Africa, China and India present interesting opportunities. Industries beyond retail, such as governmental, financial services, and out-of-home, also have promise. In addition, many large, well-capitalized multi-nationals, with lots of clients’ in-tow, are starting to get serious about DCN’s. For now, we generally suggest avoiding putting all of one’s energies into the U.S. market, and in traditional retail markets, specifically.

THE VANISHING MIDDLE-CLASS

The high-end premium, and no-frills low-end, are squeezing the middle-market. A 2005 McKinsey study of 25 industries in Europe, North America, and globally found that “from 1999 to 2004, revenue growth for mid-tier products and services trailed the market average by nearly 6 percent (6%) per year.” In the U.S., the middle class has shrunk from 51.9% of households in 1980 to 44.9% in 2003. The result: more people are wealthy; many more are impoverished. For retailers, the ramifications are that high-end and lower-end stores tend to do well, while those focused upon the middle are serving a shrinking market. The following details some of the retail implications from this demographic trend.

1. *Both high-end and low-end retailers will face more competition, as those stuck in the middle look for growth.*

For example, Wal-Mart, the largest mass market retailer in the world, is looking at going up-market by testing new store designs that feature dramatically different store design, layout, merchandise selection, and range of services. Enhancements include new signage and graphics to create eight principal shopping areas, a redesigned apparel area, etc. They have also added expensive electronics, such as large screen TVs, and are improving their apparel offering.

Wal-Mart itself faces competition from dirt-cheap dollar stores.

Looking to go up-market can also be challenging. Ten years ago JC Penney, the mid-market retailer ran into problems when it introduced pricier designer cloths and home furnishings. It has since regained its footing as the retailer of fashion forward clothing to the mid-market mall shopper within its price point.

2. *Those retailers positioned in either the upper or lower segment will need to find growth within their market, or look for growth elsewhere.*

For example, Home Depot, the large do-it-yourself store, has acquired several pro distribution companies, has experimented with high-end stores, and is again looking at overseas expansion (Home Depot attempted to expand and met with mixed results in Chile and Argentina, they are rumored to be buying a 49% stake in China retailer Orient Home).

3. *Those at the low-end will continue to drive out system costs and frills.*

Self-checkouts are an example of this.

4. *Strong retailers, in either camp, will look to extend their range services.*

For example, Best Buy, the large electronics retailer created the Geek Squad, a large service and install group that will go to the consumer's home to install a large screen TV or set-up a wireless network. Home Depot will design your kitchen and/or repair your roof. Walgreens, the largest chain-drug retailer in the U.S. with 5,300 stores, is providing clinics in-store for routine medical exams, with the result of keeping consumer's in the store longer and buying more. In the third and fourth quarters of 2006, Wal-Mart will add SmartCare family medical clinics in select Supercenters. The clinics will offer treatment for common ailments including sore throats, ear infections, and seasonal allergies.

IV. RESEARCH NOTE

IMPACTING THE CUSTOMER EXPERIENCE AT A RETAIL BANK BRANCH THROUGH A DIGITAL COMMUNICATIONS NETWORK

PRI Working Paper No. 5, 2006

By Steven Keith Platt, Director and Research Fellow, Platt Retail Institute, and Peter VanSickle, BMO Bank of Montreal

The retail banking business is extremely competitive. Compounding this, consumers consider banking products and services to be commoditized offerings, essentially all being viewed as somewhat the same. Due to the competitive nature of the industry on the one hand, and the homogenized view of its product and service offerings on the other, retail banks are challenged to develop meaningful marketing activities to ensure new customer acquisition and to sell additional, higher margin products and services to current clients.

This is leading many banks to invest in their branch marketing and communications by means of a digital communications network (“DCN”). By way of example, Citizens Financial Group-Charter One, Providence, Rhode Island, a subsidiary of the Royal Bank of Scotland Group plc, has a DCN installed in over 760 branches. TCF Bank, Minneapolis, Minnesota, has announced that it will be extending its DCN to over 430 branches. Also in the U.S., Synovus Financial Corporation, Columbus, Georgia, has a DCN installed in over 220 branches, and Commerce Bank, Cherry Hill, New Jersey, has a DCN in over 200 branches. Many other banks, both in the United States and around the world have or are in the process of deploying such networks. Illustrations of international bank deployments include the following: Bank Hapoalim, Tel Aviv, Israel; BRD-Societe Generale, Bucharest, Romania; HSBC, Dubai, UAE; Nedbank, Johannesburg, South Africa; and Rabobank, Utrecht, The Netherlands.

In this Working Paper, the authors detail the attributes of a branch DCN. The significance of the branch and the importance of enhancing the customer experience therein are also addressed. In addition, the major benefits to be derived from a branch DCN are delineated. Finally, concepts relative to measuring the effectiveness of a bank DCN are advanced.

This Working Paper contributes to the study of implementing a DCN in a bank branch in the following ways:

1. The positive impact on the customer branch experience resulting from a DCN is detailed.
2. It demonstrates that banks tend to under-invest in consumer facing information technologies. Further, it illustrates that banks overspend on traditional forms of mass advertising. As a result, it is advanced that banks should redirect capital into branch DCNs.
3. It details the significant benefits that can be realized by a bank from the deployment of a DCN.

(Our research notes are published monthly, and can be found on the National Retail Federation's website at: <http://www.nrf.com/RetailResearch/View.aspx>).

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