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PRI QUARTELY RETAIL ANALYTICS

“BRINGING RESEARCH TO RETAIL”

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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

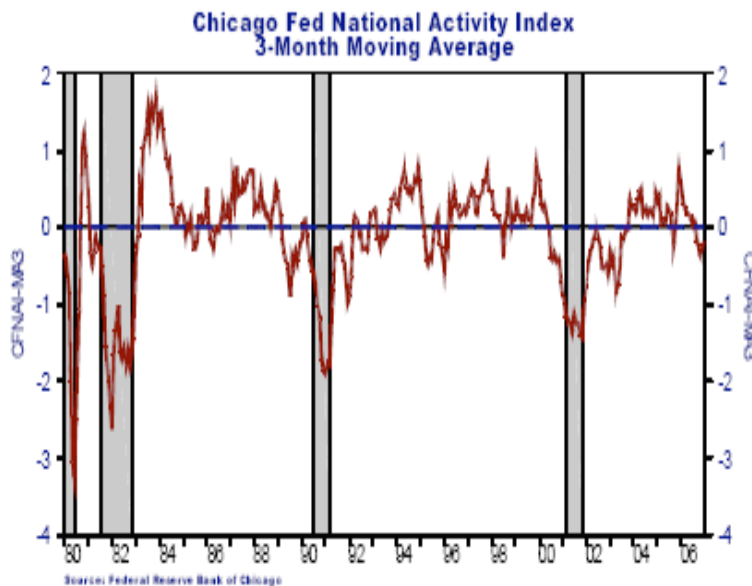
BUSINESS INDICATORS

Most economists expect the U.S. economy to grow 2.3% in 2007, versus a consensus forecast of 3.3% in 2006. This compares to 3.2% in 2005 and 3.9% in 2004. We think 2.1% is more likely. The economy is expected to remain subdued during the first half of 2007, and improve for the balance of the year.

The Federal Reserve Board's Beige Book noted on January 17, 2006 that economic activity had been expanding at "a modest pace." They went on to note "modest increases in retail sales," positive service sector and manufacturing growth, and a "softening in housing markets." Labor markets are tight, but wages and price increases were generally moderate.

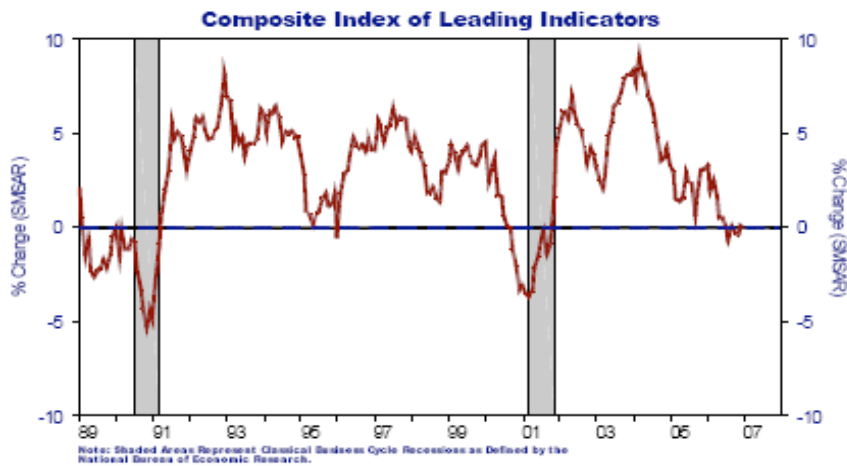
The Chicago Federal National Activity Index, which is a weighted average of 85 monthly indicators of national economic activity supports this near-term view, with a negative three-month moving average (see Chart 1). A negative index reading corresponds to below trend growth.

Chart 1.



Looking further out into 2007, the Index of Leading Economic Indicators increased 0.3% in December (see Chart 2). The Index has been trending down for most of 2006, so this may indicate an improvement in economic activity during the second half of 2007.

Chart 2.

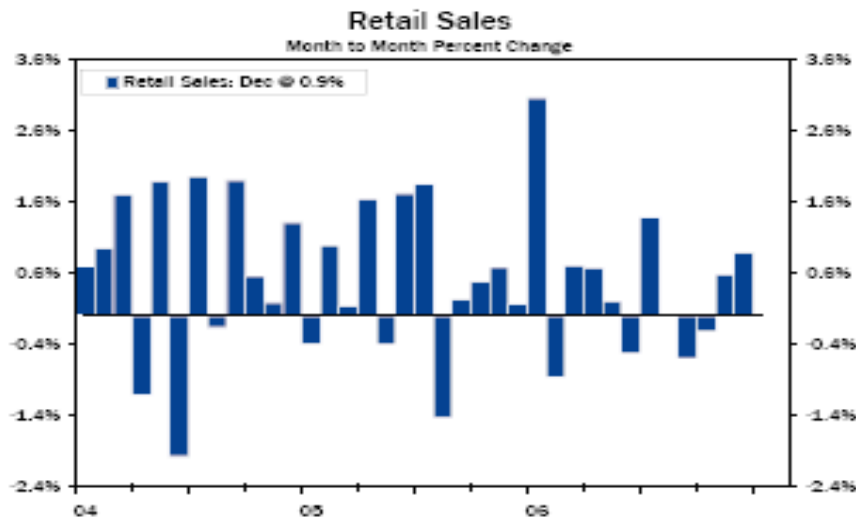


RETAIL INDICATORS

Unlike most who guess into the future, we are willing to benchmark our past forecasts versus reality, in an attempt to keep us reasonably grounded. Last quarter we noted some economic weakness, which caused us pull back on our holiday and full year forecast. Retail sales results were, in fact, better than anticipated.

Holiday sales rose 5.3% versus a strong 8.1% gain in 2005. Retail sales for 2006 rose 5.4% (see Chart 3). Excluding autos and gasoline sales, retail sales rose by 5.6%. The average annual rate of increase for the past 10 years, according to the NRF, is 4.6%. So one can reasonable conclude that 2006 retail sales were above trend, and better than anticipated.

Chart 3.



Source: Wachovia

Being stubborn, however, we advance that a portion of these sales came as a result of heavy discounting, at the expense of retail profit margins. Further retail sales gains will be modest in the first half of 2007 due to such discounting accelerating demand (and sales) into 2006, as well as the overall impact of a moderating economy.

Chart 4 illustrates that consumer prices have been falling. Such discounting leads to stimulating sales, but is neither sustainable nor profitable. Consider that large U.S. retailers' sales rose by 8.5% in the third quarter of 2006 versus the third quarter of 2005. Yet after-tax income rose to a modest 3.0% of sales versus 2.9% of sales in 2005 (see Chart 5).

Chart 4.

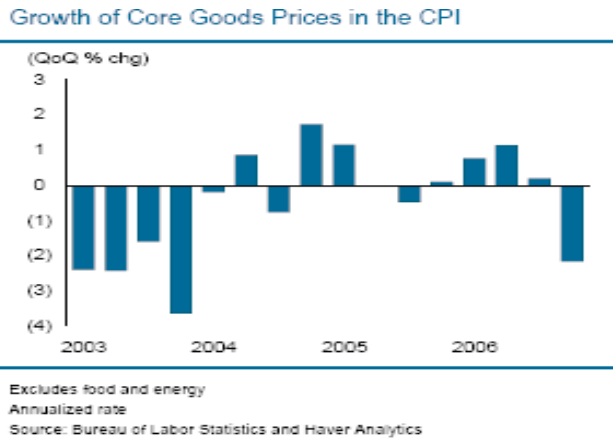
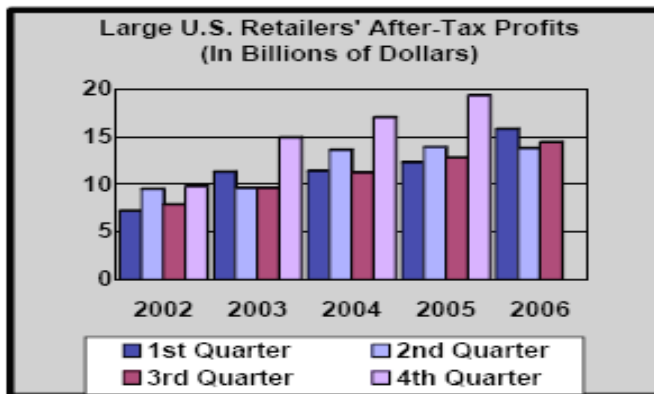


Chart 5.



Source: U.S. Census Bureau

And while most retailers will not be releasing their financial results until the end of February, the recent stock price performance of various retailers segments versus the Benchmark S&P 500 may indicate some earnings surprises are coming (see Chart 6, comparing the price performance of the S&P 500 in red, versus discount stores, in blue; Chart 7, comparing the price performance of the S&P 500 in red, versus department stores, in blue; Chart 8, comparing the price performance of the S&P 500 in red, versus

electronic stores, in blue; and Chart 9, comparing the price performance of the S&P 500 in red, versus home improvement stores, in blue).

Chart 6.



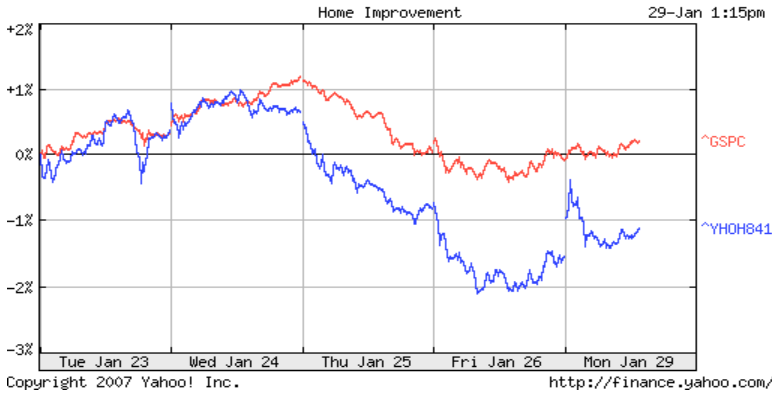
Chart 7.



Chart 8.

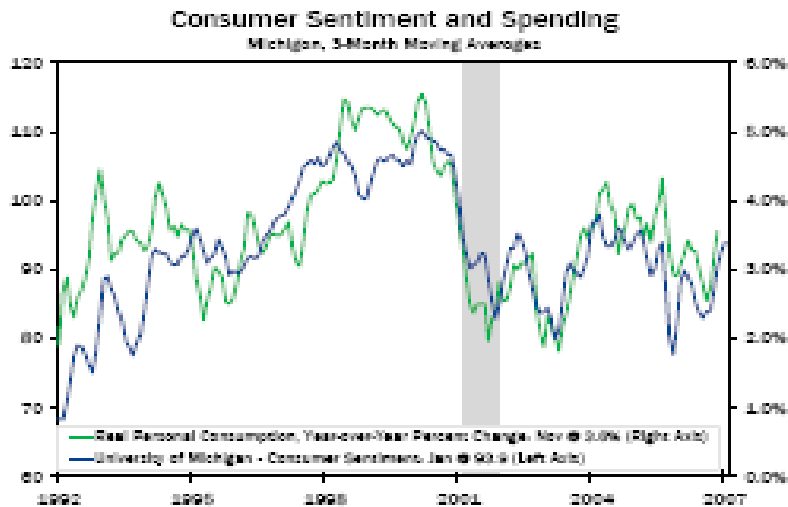


Chart 9.



The good news for retailers is falling oil prices, healthy employment levels, and wage gains (including the potential for an increase in the minimum wage) are translating into strong consumer sentiment, which can be an indicator of retail spending trends (see chart 10). The bad news is housing weakness and higher interest rates are exerting downward pressure on consumers.

Chart 10.



Source: Wachovia

Finally, the National Retail Federation shares our view with its forecast for 2007 retail sales expected to grow at 4.8%, with “subdued first half economic growth to give way to accelerated sales in the second half.”

II. MAJOR RETAIL SECTOR TRENDS

BUILDING MATERIALS, GARDEN AND SUPPLY STORES

Sales fell -1.1% in December. On an annualized rate, sales are down -9.5% for the trailing 3-months and are down -0.8% for the trailing 12 months.

FOOD AND BEVERAGE STORES

Sales rose 0.8% in December. On an annualized rate, sales are up 9.1% for the trailing 3-months and are up 4.9% for the trailing 12 months.

HEALTH AND PERSONAL CARE (DRUG) STORES

Sales rose 1.2% in December. On an annualized rate, sales are up 15.5% for the trailing 3-months and are up 10.2% for the trailing 12 months.

CLOTHING AND ACCESSORY (APPAREL) STORES

Sales rose 0.6% in December. On an annualized rate, sales are down -7.2% for the trailing 3-months and are up 5.5% for the trailing 12 months.

GENERAL MERCHANDISE STORES

Sales rose 0.9% in December. On an annualized rate, sales are up 4.2% for the trailing 3-months and are up 5.4% for the trailing 12 months.

DEPARTMENT STORES

Sales rose 0.2% in December. On an annualized rate, sales are up -0.6% for the trailing 3-months and are down -0.5% for the trailing 12 months.

III. RESEARCH NOTES

BUILDING STORE LOYALTY THROUGH STORE BRANDS

By Marcel Corstjens, Insead, France, and Rajiv Lal, Harvard Business School
Journal of Marketing Research, August 2000

The growth in the importance of private label store brands has been well documented. In the UK, for example, grocery store brands have a market share in excess of 39%. The authors note the importance of selling quality private label brands, and that these private label products are not always more profitable than national brands, when factors such as allowances, warehousing, transportation, and in-store labor are considered. Notwithstanding, the researchers advance that even if a store brand does not have a cost advantage versus a national brand (due to its high quality and related indirect costs), that retailers will increase store loyalty and increase overall profits by selling quality store brands due to the complimentary relationship between store brands, which create store differentiation and loyalty, and national brands, by enabling the retailer to raise prices and increase store profitability.

UNDERSTANDING RETAIL BRANDING: CONCEPTUAL INSIGHTS AND RESEARCH PRIORITIES

By Kusum L. Ailawadi, Dartmouth College, and Kevin Lane Keller, Dartmouth College
Journal of Retailing, Volume 80, 2004

Retail brand equity broadly refers to the image of a retailer in the mind of a consumer. Building brand equity is beneficial, as it serves to distinguish a retailer from the competition, on the one hand, and increase its leverage with brand manufactures, on the other. Understanding the attributes of retail brand equity is useful for a retailer seeking to improve its competitive positioning. According to the researchers, these attributes include:

1. Access-location no longer comprises a major input into consumer store choice, but it is still important.
2. Store Atmosphere-store atmosphere includes physical features like design and layout, ambient features such as music and smell, and social features including the type of clientele, employee availability and friendliness. A positive atmosphere provides utility to consumers and encourages them to visit more, stay longer, and buy more. An appealing store atmosphere is important in creating a unique store image and establishing differentiation.
3. Price and Promotion: a retailer's price image is influenced by the average level of prices, price variation over time, the frequency and depth of promotions, and overall price strategy.
4. Cross-Category Product/Service Assortment: a wide assortment is generally beneficial, as the broader the assortment, the more often the retailer is considered by a consumer, as a broad assortment tends to be convenient for the customer, and to capture unplanned store purchases.

5. Within Brand/Item Assortment: greater perceived assortment influences store image, store choice, and store satisfaction, but that does not necessarily mean a greater number of SKUs. Private label products are also an important component of assortment.

(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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