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## **RETAIL BUSINESS TREND REPORT**

BRINGING RESEARCH TO RETAIL
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### **DECEMBER 2003:**

The indicators continue to point to an improving economy, with businesses finally catching up with consumers. Business profits are improving, resulting in inventory investments being made and capital spending is increasing. Industrial production rose by a solid 0.9% in November. Capacity utilization jumped 0.6% in November as well. Further, the ISM manufacturing index hit a 20 year high of 62.8% in November, indicating a strong pace of activity in the manufacturing sector. The unemployment rate fell to 5.9% in November. Job growth is still less than anticipated, but continues to show modest improvement. Interest rates were again left unchanged, and the Fed indicated that rates will continue to remain low. The leading economic indicators rose for a second month, pointing to growth into next year. Also noteworthy, total construction spending increased 0.9% in October.

November retail sales, excluding autos, rose 0.4%, even with the 0.4% rise in October. On an annualized rate, retail sales, excluding autos, rose 3.6% for the trailing three months and 6.5% for the trailing twelve months. Consumer Electronics and Building Materials, Garden and Supply stores had strong gains during the month; department stores, sporting goods, hobby, and book and music retailers were lagging.

Retail sales for the first week of December were negatively impacted by adverse weather. By the following week, sales recovered somewhat. Overall, December should show stable, but not the hoped for spectacular gains. Consumer spending in the fourth quarter of 2003 will not match the 6.4% pace of the third quarter.

The outlook for retailers for 2004 is encouraging. Interest rates are and should continue to remain low. Inflation remains tame and employment should recover. Washington's fiscal-stimulus, rising consumer incomes, a surging stock market, a slowing- yet still strong rate- of mortgage refinancing and tax cuts will prime the economy. Personal income rose 0.5% in November, after rising 0.2% in October, and personal spending rose 0.4% in November following a 0.1% rise in October, indicating that the consumer is alive and well. And businesses are now investing in capital equipment and inventories as well.

In this issue, our research note examines the fundamental shift in consumer preference to value retailers from other merchants, and advances some suggestions for competing with these retailers in the future.

STEVEN KEITH PLATT  
DIRECTOR

# **I. ECONOMIC OVERVIEW**

## **MACRO ECONOMIC INDICATORS-BUSINESS:**

(% change )	2000	2001	2002	2003-1 <sup>st</sup> Qtr.	2003-2nd Qtr.	2003-3rd Qtr.	2003-4th Qtr.
Real GDP	3.8%	.3%	2.4%	1.4%	3.3%	8.2%	
Capital Spending	7.8%	-5.2%	-5.7%	-4.4%	7.3%	14.0%	
Corporate Profits	----	-7.2%	7.6%	+\$20.4B	+\$80.6B	+105.5B	
Labor Productivity	3.0%	1.9%	5.4%	2.1%	7.0%	8.1%	

(% change)	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Durable Goods Orders	1.6	-0.5	1.5	-2.6	0.3	1.9	2.0	-0.3	1.4	2.2		
Durable Goods Shipments	2.5	-1.9	0.4	-1.1	0.1	1.5	2.6	-1.7	1.4	0.6		
Leading Index	0.0	-0.5	-0.2	0.1	1.1	0.4	0.6	0.4	-0.2	0.5	0.3	
ISM Manuf. Survey (absolute)	53.9	50.5	46.2	45.4	49.4	49.8	51.8	54.7	53.7	57.0	62.8	
Industrial Capacity Utilization	----	----	----	----	----	----	----	74.6	74.9	75.1	75.7	

## **MACRO ECONOMIC INDICATORS-CONSUMER:**

(% change)	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Personal Consumption Expenditures	----	0.0	0.8	0.0	0.5	0.7	0.9	0.9	0.0	0.1	0.4	
Change in Payroll Employ. (000)	158	-121	-151	-22	-76	-83	-57	35	99	137	57	
Unemploy. Rate	5.7	5.8	5.8	6.0	6.1	6.4	6.2	6.1	6.1	6.0	5.9	
Personal Income	0.1	0.2	0.2	0.2	0.4	0.4	0.4	0.2	0.3	0.2	0.5	

**MACRO ECONOMIC INDICATORS- RETAIL:**

	2000	2001	2002	2003-1 <sup>st</sup> Qtr.	2003- 2nd Qtr.	2003-3 <sup>rd</sup> Qtr.	2003-4th Qtr.
Large Retailer After-Tax Profit Ratio	----	1.82%	2.6%	2.4%	2.5%		
Large Retailer Profits	\$73.4B	\$79.1B	\$81.2B	\$8.57B	\$9.08B		
Large Retailer Return on Equity (net Income)	----	----	----	12.44%	12.96%		
Large Retailer Return on Assets (net Income)	----	----	----	4.80%	5.07%		

(% change)	2000	2001	2002	E. 2003	E. 2004
Retail GDP	7.5%	4.6%	5.9%		
Retail Construction	----	----	-8.0%	2.0%	3.0%

	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Retail Sales (% change; x auto)	----	----	1.5	-0.9	0.3	1.2	1.2	1.1	0.1	0.4	0.4	
Retail Sales (\$ in millions; x auto; adj.)	235	233	236	234	235	238	240	243	243	244	245	
Retail Inventories (% change; x auto)	----	----	----	----	----	----	----	----	01.1	0.6		

## **II. MAJOR RETAIL SECTOR TRENDS:**

### **BUILDING MATERIALS, GARDEN AND SUPPLY STORES**

Sales growth slowed in November to 0.3%, versus 1.5% in October and 0.9% in September. On an annualized rate, revenue is up 11.7% for the trailing 3-months and 11.0% for the trailing 12 months. The outlook for these retailers remains strong.

Housing and remodeling continue to show strength, which is a strong indicator of the outlook for these retailers. Sales of existing and new homes continue to show growth. October existing home sales declined 4.9%, indicating an easing from historically high sales levels. Building permits for new homes fell -5.4% in November following an October rise of 5.7%. Yet permits for November of 2003 are 6.2% ahead of November 2002. Housing starts rose 4.5% in November, passing the two million unit level, versus 2.5% in October and are up 17.6% versus November 2002. Mortgage rates are still at attractive levels and an improving job picture indicates continued strength in this sector.

Monthly % Change	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Sales	----	----	7.2	0.2	0.1	2.6	2.2	0.6	0.9	1.5	0.3	

### **FOOD AND BEVERAGE STORES**

Sales again declined in November by -0.3%, the same as in October. On an annualized rate, revenue is down -1.3% for the trailing 3-months and is up 2.2% for the trailing 12 months. The ongoing West Coast strike is having a negative impact upon some of the major retailers. Settlement talks collapsed on 12/20/03, shortly after they resumed, in the 10-week-old dispute that has idled 70,000 California workers. The Food Marketing Institute indicated that the percent of after-tax profit for food retailers in 2003 was \$.95, the lowest rate since 1990 and 30% below 2002's rate of \$1.36. Look for more consolidation as competition continues to exert pressure on the industry.

Monthly % Change	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Sales	----	----	0.5	-0.1	-.04	1.0	0.9	0.3	0.4	-0.3	-0.3	

## **HEALTH AND PERSONAL CARE (DRUG) STORES**

Sales grew 1.3% in November, versus 0.7% in October and 0.7% in September. For the ten-months through October, sales grew 8.6%. Longer-term, more competition will challenge the drug chains, as has occurred in the food segment, as these chains traditional reliance on H&BA items and convenience may be challenged.

Monthly % Change	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Sales	----	----	0.8	0.1	0.3	1.3	1.4	0.6	0.7	0.7	1.3	

## **CLOTHING AND ACCESSORY (APPAREL) STORES**

Sales grew 1.1% in November, versus 0.0% in October and 0.5% in September. On an annualized rate, revenue is up 6.6% for the trailing 3 months and is 5.7% for the trailing 12 months.

Monthly % Change	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Sales	----	----	1.5	-1.4	1.7	1.2	1.3	0.0	0.5	0.0	1.1	

## **GENERAL MERCHANDISE STORES**

Sales grew 0.1% in November, versus -0.1% decline in October and -0.3% decline in September. On an annualized rate, revenue is down -1.0% for the trailing 3 months and is up 4.9% for the trailing 12 months. Warehouse clubs, small-format value retailers and select discount department stores performed well.

Monthly % Change	JN-03	FB-03	MR-03	AP-03	MY-03	JN-03	JL-03	AG-03	SP-03	OT-03	NV-03	DC-03
Sales	----	----	0.2	-0.8	1.2	0.8	1.6	0.9	-0.3	-0.1	0.1	

### **III. RESEARCH NOTE**

#### “Competing in a Value-Driven World”

By Robert J. Frank, Elizabeth A. Mihas, Laxman Narasimhan and Stacey Rauch, with McKinsey & Company’s North American Retail Practice

This white-paper details the fundamental shift in consumer preference to value retailers from other merchants and suggests how traditional retailers may seek to respond to the growth in market share that these retailers are winning. The rationale presented for this shift in preference is attributable to several key trends, to wit: consumer acceptance of a lower price/value merchandise proposition and the improvements in assortment, convenience and customer experience now being offered by these value retailers<sup>1</sup>. Such value retailers’ market share has almost doubled in the past decade, from 10.2% of total U.S. retail sales to 17.4% by 2001. Further, value retailers have lots of room to grow, with smaller, undifferentiated regional chains being seen as the most vulnerable.

To survive, the authors advance five retail business imperatives:

1. Traditional retailers must reinvent their brand and move beyond a commodity proposition.
2. Retailers should adopt a “lean” cost structure.
3. Merchants should reevaluate their pricing strategies; that is, their value proposition.
4. In-store execution should be simplified in areas such as in-stocks, merchandise assortment, service, etc. to improve performance.
5. Customer relationships should be leveraged to identify new retail categories and/or formats.

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<sup>1</sup> Value retailers are defined to include mass merchandisers, warehouse, dollar, and big box stores.

