

ECONOMY 2005 FORECAST

A new year is upon us and it's time to look into our crystal ball for a view of the next 12 months. How will the economy affect consumer spending and what will the impact be on traditional retailers and RTO dealers? Several factors come into consideration when trying to determine whether future economic conditions will positively impact RTO transactions and/or traditional sales. And when one thrives, will the other suffer? While there are no economists who traditionally evaluate the RTO market, what we can do is take a snapshot of the retail forecast in order to determine how those industry predictions could impact the RTO market in the coming year. ✦ To find the answer, we spoke with a number of experts around the country. Their comments share one common characteristic: a more subdued outlook than the hopeful optimism of 12 months back when many were predicting a robust 2004. For most parts of the country, the past year has simply not brought a rebound in cash register activity to the extent anticipated. When evaluating the performance of RTO industry over the past nine years, however, the business has witnessed revenue growth at a compounded rate of 6 percent without a single down year.

**WHAT LIES AHEAD
FOR RENTAL DEALERS
AND RETAILERS?
BY PHILLIP M. PERRY
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ost forecasters believe that the more subdued sales environment for retailers will continue well into 2005. There is an important bright spot, however. Consumer confidence continues

to stay relatively high. Nimble retailers and RTO dealers can capitalize by learning more about their customers and meeting their needs through new offerings of merchandise and services. On the flip side, according to a recent industry analysis report on RTO by Legg Mason Wood Walker Inc., "The RTO industry is healthy, growing, very profitable and, we believe, relatively impervious to swings in the economic cycle. For example, industry revenue grew 5.7 percent in 2001 despite a recession."

SALES GROWTH SLIPS

"The beginning of 2004 was very strong, but retail sales started to ease off in the summer," says Rosalind Wells, chief economist for the National Retail Federation in Washington, D.C. That softening trend is expected to continue as most organizations join the NRF in forecasting a moderation in the growth of spending. "It's very clear we had a boom in retail sales in the first five months of the year," says Scott Hoyt, director of consumer economics at Economy.com, an independent research organization based in West Chester, PA. "We are looking at a 2005 retail sales growth that is somewhat slower than the past 12 months."

The RTO public companies also performed well in 2004, posting gains for the past three quarters ranging from 3.6 percent to 23 percent.

Independents will continue to face special challenges. "The past 12 months have been a rocky ride for smaller business owners," says Jim Dion, president of Dionco Inc., a Chicago-based retail consulting firm. "The power of the major chains continues to increase as the big get bigger and stronger. That puts tremendous pressure on independents."

That is also true for RTO. While thousands of "mom-and-pop" RTO operators still exist, there is a dearth of meaningfully sized RTO companies that remain independent, resulting in increased competition and rising acquisition valuations, reports Legg Mason.


SOFT EMPLOYMENT

Jobs—and the lack of enough good ones—is the No. 1 restraint on consumers. Employment growth began to taper off in the summer of 2004

after a strong start earlier in the year. Stubbornly low employment not only dampens consumer confidence, but also reduces spending power. "Retail sales are really driven by income growth," says Wells. "And income growth depends on employment growth. That's been disappointing."

In a robust economy, Legg Mason expects a slight lift to the RTO industry. Likewise, in a recession with high blue-collar unemployment, there would be some dampening demand. So while the RTO industry is not counter-cyclical, it is recession resistant.

Furthermore, forecasters are concerned about the quality of the jobs being created. "My concern is that even if the employment rate picks up, are the new jobs the ones people need for their required income and benefits?" says Deborah Fowler, director of the Center for Retailing, a research and educational resource at the University of South Carolina, Columbia, SC. "I am hearing about a lot of people losing well-paying jobs only to discover there are no new jobs similar to the ones they left. People who have lost \$100,000 jobs are taking \$30,000 ones. As companies and families downsize, they lose discretionary income and so they cannot buy the things they want." This argument would tend to fuel the potential for attracting new and existing RTO customers to stores. Unfortunately, the RTO industry has been unsuccessful for several years in boosting its customer count.



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Is there hope for a turnaround? Some observers are still waiting for the hiring pickup that most were anticipating a year ago. One enthusiast is Scott of Economy.com. "We are expecting a gradual pickup in employment growth. Businesses seem well positioned and demand is strong enough that we expect some hiring." A long-overdue rebound in hiring would certainly be a welcome phenomenon and might turn the coming year into a major win for business owners.

For the time being, though, employers are holding their ground because of an ability to wring more revenue out of the same investment in workers and assets. "Productivity is still growing strongly, if not as fast as before," says Scott. "That's good for the long run, but in the short term businesses can get by with fewer employees." And taking on new hires is costly: "Employers are cautious because of high benefits costs."

STIMULI DISAPPEAR

Retailers are affected by more than a weak employment picture. "We are seeing the disappearance of a number of economic stimuli that were important factors supporting sales in 2004," says Wells. Perhaps the most effective of these were the tax cuts of late 2003 and the ongoing rounds of mortgage refinancing. Consumers have mostly spent the cash gained from both phenomena, neither of which is expected to play a role on the economic stage in 2005.

Indeed, with interest rates gradually rising, some market observers are worried about the prevalence of adjustable rate mortgages. "We have not yet seen the effect of adjustable rate mortgages. But I have started hearing people say their rates are about to go up and that causes some negative anticipation. If you have to spend more money on a house, that affects your discretionary spending," says Fowler. This can also have a negative impact on RTO dealers across the country.

Dion also sees a potential danger. "There are a record number of adjustable rate mortgages," says Dion. "And they are ticking time bombs. If any of the regional housing markets burst, there will be a couple of million people with houses worth less than their mortgages."

CONSUMER DEBT

Historically, when consumer debt tightens, the number of RTO agreements increase. And while some mortgage refinancing money has gone toward paying down charge cards, consumer credit still continues at record levels. "A lot of people have been delving into the lines of credit on their equity," says Dion, speaking of individuals who have refinanced their mortgages.

At the very least, high leverage is a risk for big-ticket sales. "Clearly, consumers are leveraged and debt burdens are high," says Scott. "As interest rates creep up, it will be difficult for consumers to borrow and spend. So we are back to a key conclusion: Labor income will be the most important

HOW TO KEEP TABS ON THE ECONOMY

Major economic trends have a profound impact on your cash registers. How do you keep tabs on the vital factors spotlighted in the accompanying article?

Check out these relevant Internet sites:

- The Dismal Scientist, sponsored by Economy.com, is an Internet site that reports trends in the national and international economy. Analysis is presented in terms understandable by non-specialists. www.economy.com/dismal.
- The White House maintains an economic statistics briefing room for easy access to current Federal economic indicators. www.whitehouse.gov/fsbr/esbr.html.
- The U.S. Department of Labor capsulizes many vital economic statistics maintained by the Bureau of Labor Statistics. www.bls.gov.
- The Conference Board tracks consumer confidence. www.conference-board.org.

determinant of spending growth next year."

Speaking of debt, many observers are leery about the national deficit. "Consumers have to start getting concerned about the deficit we are building," says Dion. "They read about it in the paper, but it has not yet hit home. We have had a tax cut in a time of war—that is the first time the nation has done that." Knowing that the deficit will lead to either higher taxes or increased interest rates is bound to have a depressing effect on shoppers. "At some point, people will start looking at the numbers and saying, 'Whoa! I have to start watching my pennies more.'"

Add to this litany of misery a number of other factors such as higher energy and gasoline costs, the continuing threat of terrorism and bad news from Iraq. No wonder people call economics "the dismal science."

WHAT YOU CAN DO NOW

Perhaps these aren't the best times for retailers, but the RTO industry appears to be holding its own. The good news so far is that both inflation and interest rates seem to be largely under control. Most important of all, consumer confidence remains high despite a modest dip early in the fall. That provides retailers and RTO dealers with an important opening wedge: Thanks to the public's willingness to spend, smaller organizations can finesse the larger economic issues by smart maneuvering.

Fowler advises sharpening marketing skills by redefining your own customers and taking special pains to meet their needs. "Talk with shoppers and your associates to get a sense of who your customer is. Then base your policies and pricing and customer service upon the answer."

There are now two distinct consumer groups in the United States, says Fowler. One seeks good value; the other efficiency. "If your customer is price oriented, then discounted or everyday low prices are positive attractions. Time conscious customers are looking for shopping convenience, customer service and quality merchandise." Know which group you serve.

Success, then, is customer driven—far more so in 2005 than ever before in recent history. "In 2005, there will be some great independents who continue to do good business because they understand fundamentals and treat their customers well," says Dion. "No retailer or RTO dealer can control the global stage. But everyone can manage their businesses as best they can and be what they should be for their customers." ■

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