

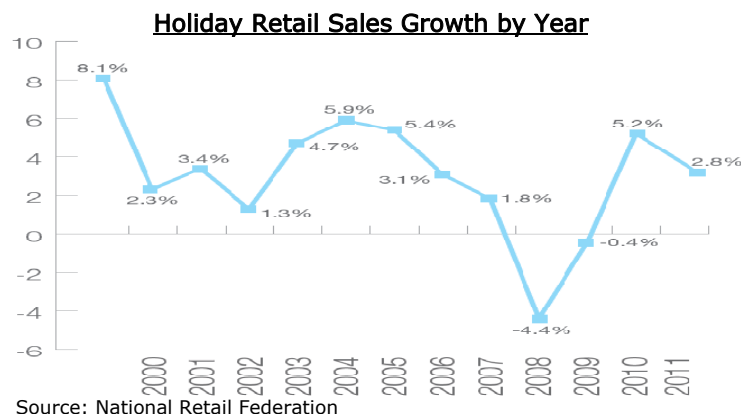
**Todd Jones, CFA**  
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As consumers recover from their tryptophan-induced slumbers, retailers have already shifted their focus to the all-important holiday selling season, which can account for as much as 40% of annual sales. However, with an economy challenged by stubbornly high unemployment, modest income growth and weak consumer confidence, it remains to be seen whether consumers will bring holiday cheer to retailers' cash registers again this year.

Encouragingly, consumers have shown an incredible resilience in their recent spending habits, with the Census Bureau reporting year-on-year increases in U.S. retail and food service sales in each month this year. Not surprisingly, middle to higher-end consumers have exhibited stronger and more consistent spending trends over this time frame. Furthermore, sales results have generally been strongest around specific occasions and/or holidays, suggesting most consumers are buying for particular needs, rather than discretionary "wants". No doubt retailers still need to be both competitive and creative to drive traffic to their stores and websites this holiday season. However, based on recent history, consumers' spending patterns are likely to remain healthy, resulting in a favorable holiday sales performance for the industry.

## Holiday Sales Outlook

The National Retail Federation (NRF), the industry's largest trade association, recently summed up its 2011 holiday sales outlook in one word: "average". Their forecast calls for an increase of 2.8%. If this estimate proves correct, it will register just above the 10-year average increase of 2.6%. However, the 2011 forecast suffers somewhat from the difficult comparison to last year's very strong 5.2% increase. As shown in the chart below, the robust increase in 2010 holiday sales followed two successive years of declines as consumers retrenched in the wake of the financial crisis. Taking a closer look at the data, if the NRF's forecast is correct, the combined increase for 2010 and 2011 would be roughly 4%, aligning closely with the 10-year, pre-recession average increase of 4.2%. This would imply a healthier underlying sales trend than what is reflected in the current forecast.

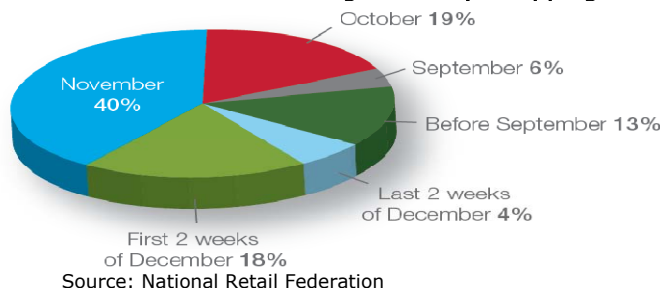


Early indications suggest the season got off to an encouraging start. Based on NRF survey data, consumers spent a record \$52 billion over the Black Friday weekend, an increase of 9.1%, surpassing most industry expectations. This momentum continued into Cyber Monday, the online kick-off to the holiday season. IBM Benchmark reported a 33% increase in total online sales, with the average order value up 2.6% year-over-year. While Black Friday and Cyber Monday sales cannot necessarily be extrapolated across the entire holiday season, these solid early results provide a strong tailwind for the industry.

## Evolving Consumer Behaviors

Consumers' spending behaviors and preferences around the holidays are constantly evolving. Although Black Friday has traditionally marked the beginning of the holiday selling season and continues to be the busiest shopping day of the year, the chart below shows that roughly 40% of consumers surveyed now start their shopping before Halloween, nearly as many as those who begin in November. In all likelihood, this is due to consumers' desires to spread their holiday purchases over a longer time period to avoid the "cash crunch" associated with this time of year.

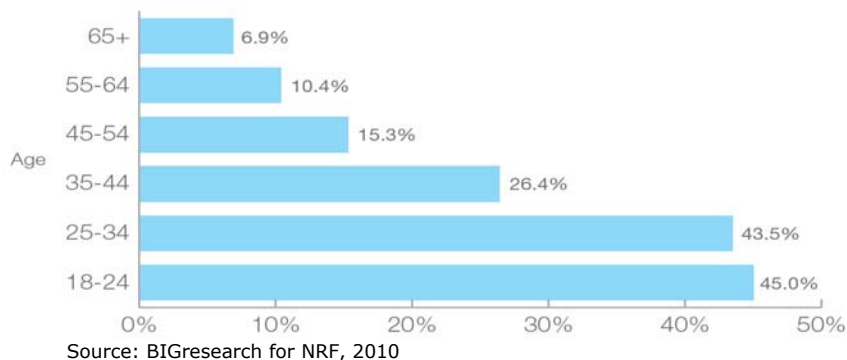
### When Consumers Begin Holiday Shopping



Furthermore, to help minimize debt burdens, consumers have altered how they pay for their holiday purchases. According to an annual NRF survey on payment methods, 70% of holiday shoppers in 2010 preferred the use of debit cards or cash for their purchases, while just 30% favored credit cards. This marked the lowest level of credit card transactions since 2002. Given ongoing economic uncertainty, these payment trends are likely to persist over the 2011 holiday shopping season.

Additionally, the ongoing trend toward online shopping continues to build momentum, with the NRF reporting that last year 44% of shoppers conducted at least a portion of their holiday spending online. Taking this trend a step further, the rapid penetration of Smartphone technology has led to a surge in mobile purchasing activity, with more than 25% of all Smartphone users having planned to make a holiday purchase with their phone in 2010. As seen in the chart below, this trend is most prevalent among younger consumers. This paradigm shift has been driven not only by the added convenience of making purchases anywhere and at any time but also by consumers' demands to research product information, compare prices, and check in-store availability, all in real time. While these dynamics pose an additional challenge for retailers, the trade-off is a positive one, as shoppers who conduct at least a portion of their holiday spending online tend to buy an average of 25% more than in-store-only consumers.

### Smartphone Users Who Made Holiday Purchases w/ Mobile Devices



As retailers are well aware, the one constant in the industry is change. Regardless of whether these evolving behavioral patterns are temporary or permanent, the industry has become quite adept at dealing with this change, and the best operators have built business models that are flexible enough to respond accordingly.

## Retailers Stay Nimble

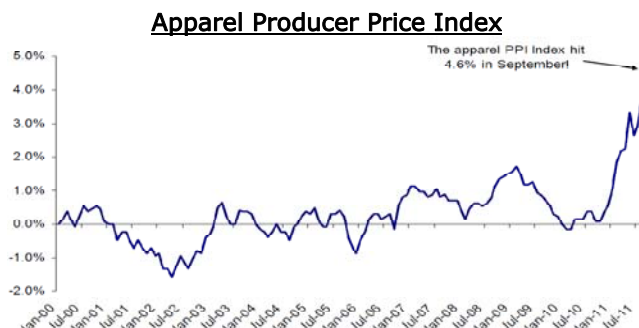
While the challenging economy remains a significant hurdle for the industry in 2011, retailers have been operating in this environment for several years now and have adapted quite well to meet consumers' changing preferences. Examples of strategies used by retailers to drive more traffic into their stores include: setting up seasonal displays and offering holiday merchandise as early as September, providing exclusive

pre-holiday “deals” to their most loyal customers, hiring additional seasonal employees and extending operating hours. For the first time, most large chain stores opened their doors by midnight on Black Friday. What was once a leisurely, promotion-driven kickoff to the holiday shopping season has transformed into an all-out campaign to pull consumers into stores ahead of the competition.

To stay competitive online, retailers are increasing their social networking presence, broadening online-only product offerings, expanding free shipping options and drawing shoppers’ attention to their promotional offerings for Cyber Monday. Above all, retailers must offer differentiated merchandise across multiple channels at compelling values to successfully vie for consumers’ discerning holiday dollars.

### The Mounting Inflation Challenge

Retailers’ ability to offer compelling values has become more challenging due to the high level of product cost inflation experienced this year, particularly within the apparel category. The sharp spike has been driven primarily by three factors: significant increases in the price of cotton and other synthetic fabrics, rising labor rates in China and higher transportation costs. As the following chart shows, the Apparel Producer Price Index has risen more than 4% this year, the highest level in more than a decade.



Source: Bureau of Labor Statistics, Citi Investment Research & Analysis

To offset this inflation and protect profit margins, retailers are employing a host of strategies across their businesses. They have purchased holiday merchandise conservatively to better control inventories in the hopes of selling more products at full price. They are utilizing sophisticated merchandise planning and markdown technologies that analyze historical sales data to help place the proper product assortments in the right stores and guide the timing and level of promotional markdowns. These programs effectively introduce science into the decision-making process with the goal of maximizing both sales and profit margins.

Perhaps the most noticeable of the retailers’ strategies, from the consumers’ perspective, will be the price increases implemented across the industry. Numbers vary widely depending on the product category, but price increases have averaged 5-10% this year, with higher increases for more specialized items and lower increases for more commoditized products. While retailers will remain highly promotional throughout the holiday season, their need to offset product cost inflation is likely to result in higher net prices for consumers.

### Conclusion

Despite a challenging economic environment, recent consumer spending resilience suggests 2011 holiday sales results generally should be favorable. Sales expectations for the season are modest and appear achievable, thus limiting downside risk for retailers. While consumers continue to be demanding and market forces remain volatile, retailers are as well-positioned as ever to deliver. At Legg Mason Investment Counsel, our fundamental analysis is focused on understanding the changing dynamics of the retail industry and identifying those companies whose differentiated merchandise and superior management execution drive strong and sustainable earnings growth.



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Todd joined Legg Mason Investment Counsel in July 2006 as a Principal and Equity Research Analyst. His research coverage responsibilities include the following industries: retail; textiles, apparel & luxury goods manufacturers; automobiles and auto components; aerospace & defense; industrial conglomerate; and most industries in the consumer staples sector.

Todd entered the Financial Services Industry in 1990. Prior to joining the firm, he had been with PNC Advisors, as Vice President from April 2004 until July 2006. Todd also held the position of Equity Research Analyst with Morgan Stanley Investment Management from April 1998 until September 2003, and held various positions with Dean Witter Inter Capital from September 1990 until April 1998.

Todd earned his B.A. in Economics from S.U.N.Y. Albany in 1990 and his M.B.A. from Pace University in 1998. Todd is a CFA Charterholder.