The Consumer Emphasis on Value

In the late 1990s **The Consumer Emphasis on Value** was identified as an attractive investment theme. Several trends were considered as those that would shape consumption patterns of goods and services for the foreseeable future. The weak economic environment over the last couple of years and reactions to the events of 9/11 have only served to reinforce these trends.

For a variety of reasons consumers at all income levels have become more value conscious. While affluent consumers may purchase more upscale goods and services in booming economic periods, generally they are more affected by the fortunes of the stock market. The recent stock market malaise has caused even the most affluent consumers to become more value conscious. In fact, it has become fashionable and part of cocktail parlance to brag about the bargains obtained at Costco or nearby “Tar-zhay” (Target) or Wal-Mart. Further, even in good times the affluent are finding the need to balance a number of different financial considerations. These include the desire for gracious living today, the need to have sufficient funds for lengthening retirement years, and for many, the wish to have a second home. The latter generally reflects either a desire to avoid inclement weather or to diversify one’s investment portfolio, particularly in view of the recent vagaries of the stock market. As a result, companies that are able to deliver quality products and services at desirable price points should be beneficiaries of this upscale value conscious consumer.

For the inflationary two and half decades through the mid nineties, the middle class consumer was continuously pinched by declining real wages. It was only in recent years, as unemployment levels came down and inflation subsided, that the middle class consumer began to have the wherewithal to participate in the growth of the economy. It was not surprising, however, that the frugal habits developed over very lean decades would be reflected in value conscious consumer expenditure patterns. Of course, the recession and coincident rising unemployment levels over the last two years have made the middle class consumer even more cautious. The advent of the web has served to enhance this trend. Sellers on the web have used price as a draw in many cases. More importantly, the web has provided the consumer a multitude of new shopping outlets and the ability to comparison shop, forcing providers of goods and services to hold down prices. These trends augur well for those providers with the best value propositions enabling them to take market share from competitors.

This has been a winning formula for two segments of two different consumer industries. The retail discounters have been gaining market share mainly from the department store chains. Similarly, casual dining style restaurants have been growing at the expense of more upscale white tablecloth type restaurants. Further, the home improvement chains have been garnering market share from their less efficient “ma and pa” store competitors, which cannot price their goods as aggressively.

Within each industry, specific companies may have achieved competitive advantages. For instance, those companies with a size advantage are able to benefit from the ability to leverage their distribution investment. As an example, advertising dollars per store in a market where a company has 50 stores will be a lot lower than the cost for a competitor with only 5 stores. Also, such companies are able to obtain better pricing from suppliers because of larger order volume. Further, those providers that have invested in cost-cutting technology and boosted productivity have created a competitive advantage. For instance, investments in information technology have helped many chains obtain better information about the demographics of the customer, customer preferences, and inventory turnover of specific products. Such companies can carry the most preferred products and those that turnover the most often. This lowers inventory costs and allows the company to offer the lowest prices. In addition, those companies that provide the most sophisticated infrastructure to identify consumer preferences and to efficiently complete order processing and fulfillment should be at a distinct advantage. Finally, those companies that are able to develop loyalty among their customer base will have a long term, powerful competitive advantage. Today's consumer is smart and busy. He/she generally know what they are looking for and want to spend as little time as possible shopping. Those companies with a loyal customer base that are also able to demonstrate continued attention to their needs will distance themselves from competitors.

Sigma Investment Selections

All **Sigma** portfolios may not contain all of Sigma's selections due to the unique and individualized attributes of each client's portfolio. Nonetheless, investment in some of the following companies provides exposure in client portfolios to **The Consumer's Emphasis on Value** theme: discount retailers Costco, Kohl's and Wal-Mart; home improvement chain Home Depot; and casual dining restaurant chain Outback Steakhouse.

Costco

Costco leads the wholesale club industry with $34 billion in sales versus Sam's $29 billion and BJ's $5.2 billion. In general, we find the wholesale club format attractive. This industry generally carries fewer items than found in other retail formats. By limiting specific items in each product category to fast selling models, sizes and colors, the number of stockkeeping items per warehouse is minimized. The resulting high sales volume and rapid inventory turnover, combined with efficient distribution and reduced handling of merchandise in no-frills, self service warehouse facilities enables companies in this industry to operate profitably at significantly lower prices than other retailers. Costco, in our opinion, has built the most defined image in the wholesale club industry by differentiating its real estate positioning and merchandise offering. By locating stores in dense, urban locations, the company generated sales per square foot at $801 in 2001, which was significantly higher than Sam's Club at $493 and BJ's at $392. Also, the merchandise mix at Costco is regarded as the most upscale in the club industry, which attracts a desirable demographic clientele. Finally, the Company is attempting to increase its appeal to a wider audience and increase visitor frequency by offering many ancillary services. These include pharmacy counters, gas stations, one-hour photo centers, hearing aid centers, food courts, and even travel planning services. Growth will also continue to be propelled by an ongoing store expansion program.

Kohl's

Kohl's operates family oriented, specialty department stores that feature quality apparel, shoes, accessories, soft home goods and housewares. Kohl's primary competitive advantage is that it sells the same brand name merchandise found in traditional department stores but often at discount prices up to 30%. The company has been able to offer such values since its stores are smaller resulting in lower overhead per store and by focusing on faster moving products leading to more rapid inventory turnover. Both of these measures allow the Company to operate profitably at lower prices than its competitors. The Company also employs a number of methods of minimizing store labor, while maintaining a high level of perceived service. An example is deep-capacity fixtures designed to maximize the amount of goods on the retail floor versus in the back storage room, ensuring high in-stock levels with minimal filling-in required. The Company's future growth will continue to be propelled by taking market share from its traditional department store rivals and an aggressive square footage expansion program in high population growth areas.

Wal-Mart

Wal-Mart has established itself as the premier low-cost domestic retailer of general merchandise and food and is expanding its everyday-low price concept globally. The largest retailer in the world, Wal-Mart operates three separate discount store models. The Wal-Mart segment includes the company's domestic discount stores, Supercenters(combination discount and food store) and Neighborhood Markets(urban supermarkets). The Sam's Club segment represents the domestic warehouse membership clubs. The International segment includes Wal-Marts and Sam's Clubs in many foreign countries. The Company has three long-term major competitive advantages: sheer scale, superior technology, and one of the few retailers, perhaps the only one in the world, that has successfully expanded its operations in many countries by understanding and paying careful attention to cultural idiosyncrasies.

Sheer scale allows Wal-Mart to command enormous purchasing power. Even more effective in keeping operating costs low has been the Company's substantial investment in technology. In the last decade, Wal-Mart has spent over $10 billion on system upgrades and enhancements, more than the accumulated spending on technology of all of its competitors. Its commitment and spending have helped it maintain a vast and technologically advanced distribution and logistics network. Innovations in technology have enabled the company to significantly improve inventory turns and its payables ratio to the point where its inventory is almost fully financed by its vendors.

Wal-Mart still has a meaningful opportunity to expand domestically particularly with its Supercenter format and its relatively new Neighborhood Market concept. However, we expect that it will be the Company's international expansion strategy that will help sustain the Company's organic growth profile at near-historical rates. The International division represented just 12% of total operating profit in 2001. This division may account for one-third of the Company's earnings over the next 3-5 years. In our view, this retail giant continues to have the ability to leverage its enormous scale to seize market share across many retail channels and to increase square footage for many years to come.

Home Depot

Home Depot operates more than 1,300 retail stores (home improvement and EXPO design centers) in the U.S., Canada, Puerto Rico, and Mexico. Historically, the company's growth was mainly a function of increasing the number of stores and using its scale and purchasing power to price competitively against the many "ma and pa" purveyors of similar goods and other home improvement chains. In recent years, over expansion among the chains has led to the demise of several chains and the emergence of two very strong competitors, Home Depot and Lowes. While each serves similar markets, we believe they can coexist because of some major differences. Lowes caters more to the consumer interested in decorating, with large displays of carpeting, bathroom and kitchen items and far less square footage devoted to the remodeling function such as lumber, carpentry, electrical, and plumbing items. Home Depot has taken the reverse tact and has focused increasing attention on the do-itself-yourself market, including providing a tool rental center, and on the professional builder market. Along these lines, the Company is rolling out a new Pro Supply format that caters solely to the professional customer. These stores appear to have a good chance of being successful since they have a targeted market with a high degree of credibility already established. They also have a high inventory turn model and are less capital and labor intensive than the traditional Home Depot store, which itself produces a very attractive return on capital.

Probably with an eye to lessening the risk of competing directly with Lowes and also with an eye toward identifying other large markets to sustain their historical above-average growth rate, the Company has identified the higher margin service area. Last year, the Company completed an agreement with Service Master to provide many different services to home owners including lawn care, plumbing, kitchen installation, among many others. Recently, the Company opened three free-standing lawn and garden nursery stores, another effort to penetrate another commercial market (the commercial landscaper market) similar to the Pro Supply stores, although these stores also will be available to the do-it-yourself consumer.

In addition to focusing on its revenue growth, which will include the continued expansion of square footage, albeit at a slower rate than historically, the Company is also streamlining operations significantly. A centralized purchasing program should lead to lower prices on goods purchased as well as much improved inventory turnover and costs and reduction in administrative costs. Also, the exclusive partnerships that Home Depot is entering such as its expanded arrangement with Stanley Works suggests that profitability should increase in the future as the consolidation of vendors improves efficiency throughout the entire supply chain channel.

It is clear that Home Depot has numerous initiatives in place for protracted growth for some time to come. The Company has demonstrated considerable success already, giving us confidence that many of the new endeavors will also be successful.

Outback Steakhouse

There are a number of favorable long-term secular trends facing the restaurant industry or at least the casual dining segment. These include the large baby boomer segment of the population getting older and eating out more, the echo-boomers providing a large source of labor supply-easing wage pressures, and restaurants taking share from supermarkets. Simultaneously, a number of restaurant chains have come of age in terms of providing more consistent financial results and recognizing the need to develop multiple concepts to sustain growth.

The Outback Steakhouse concept has the best returns in the business. This is in large part due to management's prudent site selection, attractive menu, and their ability to attract high quality personnel. The latter is a function of only being open for dinner reducing the working hours of restaurant managers and employees and offering managers the ability to purchase ownership positions in individual stores. Currently, the Company owns, franchises, and operates via joint venture 707 Outback Steakhouses. As the largest steakhouse chain in the U.S., the Company has an inherent cost advantage with regard to purchasing power and marketing expenses compared to its competitors.

Outback's other concepts also continue to perform well. Carraba's Italian Grills opened its 100th restaurant last November and are demonstrating strong identical store growth. With this new concept combined with three other concepts in their infancy showing strong performance (Fleming's Prime Steakhouse and Wine Bar, Roy's Hawaiian Fusion Cuisine, and Ley Roy Selmon's Southern comfort cooking), the Company has positioned itself for sustainable growth.

The Consumer Emphasis on Value is expected to be a trend for the foreseeable future. The companies reviewed above are among those well-positioned to capitalize on this investment theme. They all offer quality products and services at attractive prices, have well thought out growth plans, and have demonstrated an excellent ability to execute their strategies. As a result, some or all of these companies belong in portfolios, in our opinion.