L.E.K.

EXECUTIVE INSIGHTS

VOLUME X, ISSUE 4

Consumers Change Their Stripes: Dealing with Consumer Recession

In the midst of almost unprecedented economic turmoil, retailers and brand managers are eager to get their fingers on the true pulse of the consumer today. What's the consumer's confidence level – and what are the implications for stores and brands?

L.E.K.'s most recent research – based on a proprietary study of a demographically balanced set of 2,000 households – confirms that people:

- Feel that their personal financial situation has worsened dramatically
- Are determined to get their financial house back in order
- Have made specific plans to alter their buying habits to achieve that goal

First, the backdrop: History tells us that **1)** households move to build their nest eggs in response to perceived opportunities in the marketplace, and **2)** these moves tend to follow a dominant wealth-creating strategy. History also tells us that whenever there's a shock to that dominant strategy, households collectively readjust. They start building their nest eggs in new ways.

Until the recent disruptions, consumers believed that they were accumulating wealth in real estate and the market – and this persuaded them to save very little and spend a lot. Figure 1 tracks the personal savings and personal consumption expenditure rates over the past six decades:

Our most recent consumer research suggests strongly that at least in the near term, both of these trend lines will reverse direction, perhaps dramatically. An end to "easy credit" will certainly have an impact, but there appears to be an even broader psychological shift at work. Savings will increase and consumption will decline commensurately.

This represents a startling reversal, with huge implications for the economy. If consumers do indeed move the savings rate back to the average over the past 20 years – around 7% – that will take between $115 billion and $120 billion out of the consumer economy on a quarterly basis. In the short term, our research suggests, they'll probably do more than that. For example: If they save at a rate of 10%, which has historic precedent, it could take as much as $200 billion out of the economy each quarter.

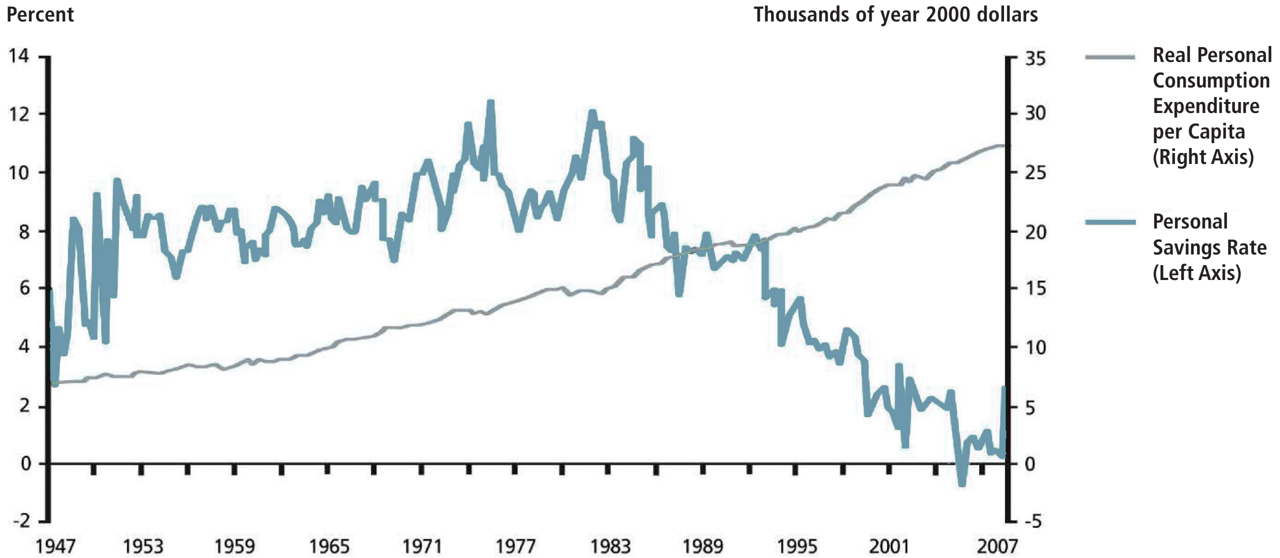
To put that huge number in perspective, remember that the entire consumer-stimulus tax package enacted last spring totaled less than $150 billion.

What does this mean for businesses that sell products and services to consumers? If consumers plan to spend less, what are they likely to cut back on? The answers are not always obvious.

Consumers Change Their Stripes: Dealing with the Consumer Recession was written by **Daniel McKone,** Vice President and Retail and Consumer Products Practice Leader in L.E.K.'s Boston office. Please contact L.E.K. at consumerproducts@lek.com for additional information.

Figure 1

U.S. Household Personal Savings Rate vs. Real Personal Consumer Expenditure per Capita (Q1 1947 – Q2 2008)



Source: Bureau of Economic Analysis, L.E.K. Consulting analysis.

Figure 2 – taken from our most recent consumer research – depicts how consumers rate various categories of expenditures, from "least discretionary" to "most discretionary."

Not too many surprises here for most retailers and brand managers. But digging down deeper, our research reveals a host of interesting choices that consumers are now making about their purchases on a going-forward basis. For example, although "Cosmetics" and "Intimates" rank fairly close together in Figure 2 – that is, on the lower end of the discretionary-spending scale – it turns out that consumers intend to cut their spending on cosmetics by less than 10% but are prepared to cut their spending on intimates by between 10% and 20%, i.e., twice as much. Consumers may define cosmetics as "discretionary," but they're not yet prepared to give them up.

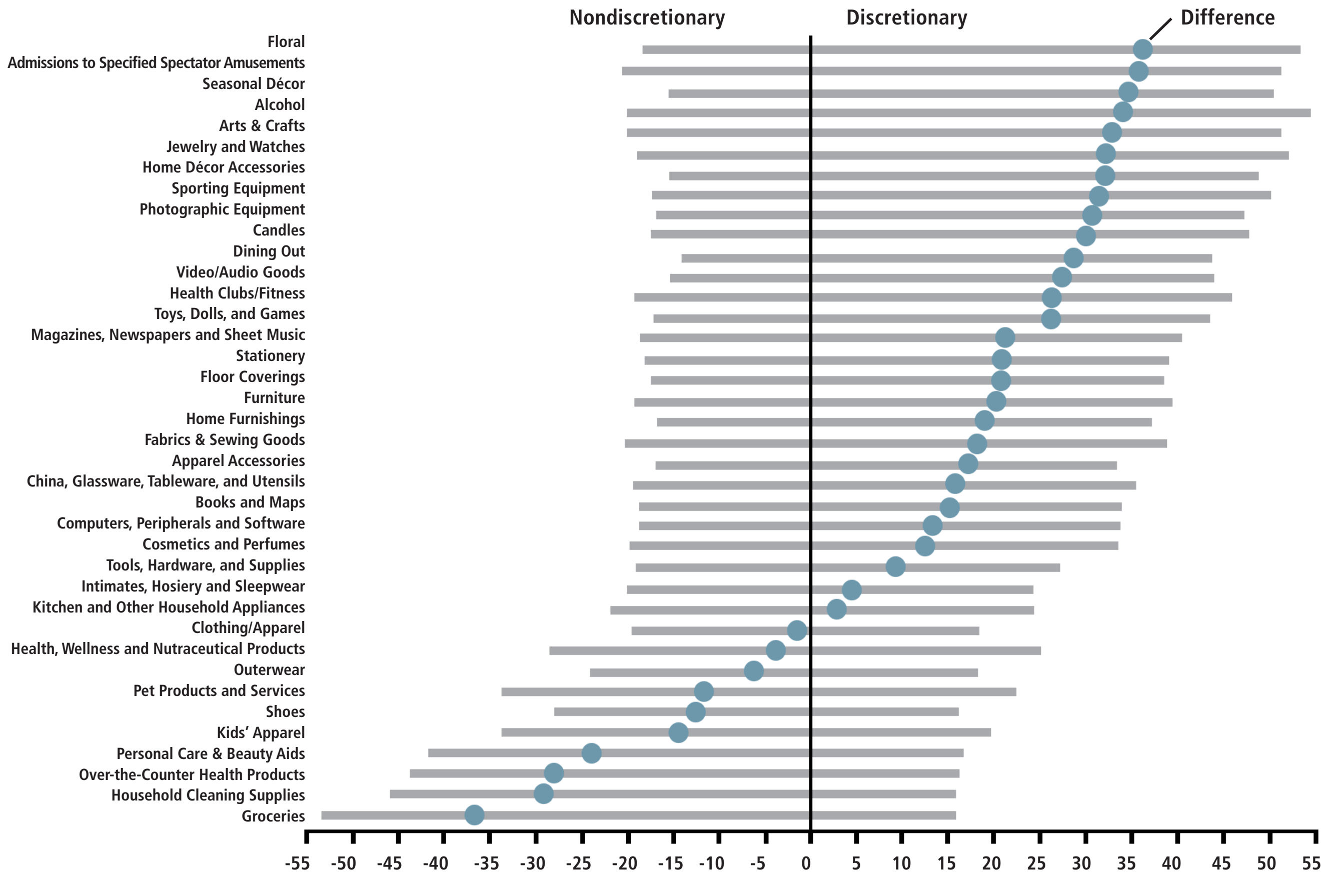
Some retailers and brand managers are simply hoping for the best – i.e., adopting short-term tactical measures and praying for a quick recovery. But all indications are that this recession will be longer and deeper than those in recent memory.

And as our readers know all too well, confidence drives their sector – and consumer confidence has fallen to levels not seen in decades.

The punch line: To succeed in a difficult new environment, retailers and brand managers have to look long and hard at their businesses, understand how consumers are viewing them, reset their cost base to reflect their new revenue realities, and – in many cases – retool strategically.

Figure 2

Consumer Categories Ranked by Net Respondent Rating (Discretionary vs. Nondiscretionary)



Source: L.E.K. Consulting Consumer Sentiment Study 2008.

These are hard times for retailers, but there are solutions. L.E.K. can help.

L.E.K. has worked with a broad spectrum of retailers on their most important strategic and financial challenges, including:

- **Declining revenues.** We help our clients pinpoint the key drivers of revenue loss. At the same time, we explore the growth potential of new opportunities, including, for example, e-commerce and alternative formats.
- **Shrinking gross margin.** We work with our clients to refine their pricing strategies, enhance the effectiveness of their promotional and clearance strategies, and reduce COGS.
- **Deleveraging operating costs.** Drawing on our extensive experience in the retail sector, we help our clients perform SG&A benchmarking and reduction – while protecting the company's ability to grow as the economy recovers.
- **Lack of cash flow.** We help our clients "find cash" by prioritizing their capital expenditures, devising inventory-liquidation strategies, and reducing working capital without reducing sales potential.

For more information, including an in-depth look at our extensive research findings, please contact Steve Krekorian at 617.951.9550 or at s.krekorian@lek.com.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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