INDUSTRY TIMELINESS: 17 (of 97)

The U.S. economy has had a different effect on two segments of the Retail Store Industry this year. That is, comparable-store sales and profits at most leading department store chains have been hurt by weak consumer demand for high-end apparel and home furnishings. On the other hand, some major discount chains, which offer wide selections of household goods and casual apparel at relatively low prices, have seen their same-store sales rebound to levels near the peaks achieved in the late Nineties. The apparent delay of a robust economic recovery has been played out in consumer spending patterns. It has also taken a toll on the stock market averages. Many equities in this group have certainly felt the effects of both factors during this period.

A Spotty Economic Recovery

The consumer Confidence Index fell to 97.1 in July, its lowest level since February. The drop from June's level of 106.3 was particularly sharp. Fears of a "double-dip recession", which appear to be unwarranted at this juncture, in our view, were largely triggered by a recent report on U.S. job creation, which indicated a far lower number than expected. Indeed, new service-related jobs offset a decline in manufacturing (particularly managerial) positions.

We figure that Gross Domestic Product will increase by 2%-2.5% in the second half of this year and by possibly 4% next year. Moreover, thanks to easy sales and margin comparisons during the upcoming September to January period, profits at most department store chains ought to show some improvement. Meanwhile, the current economic scenario is working to the advantage of discounters, and we look for solid top- and bottom-line momentum at the two leading players, *Wal-Mart* and *Target*.

Mixed Results At Department Store Chains

Most top-tier (featuring high-quality apparel and home furnishings) department store companies reported either modest declines or little change in same-store sales during the first half of fiscal 2002. (Years generally end around January 31st.) Competitive pressures from more moderately priced retailers, such as *Kohl's*, and concerns about sharp declines in stock prices and uncertain job prospects offset benefits from new merchandising measures, including the recent launch of numerous private-label brands. They declined by 2.9% and 3.6% at *Federated Department Stores* and *May Department Stores*, respectively, and increased by 0.3% at *Nordstrom*. Over the coming 3 to 5 years, we don't expect their sales-per-square foot to meaningfully improve, and annual selling-space expansion will likely be in the low-single digits. Profits and net profit margins, though, ought to be aided by the use of free cash flow to repay debt and possibly repurchase stock. Moreover, depreciation charges as a percentage of sales should decline.

An Altered Discounting Segment

Wal-Mart's recent decision to group items selling for a dollar or less in some of its stores hurt the stocks of *Family Dollar* and *Dollar General*. We think their sales and profits in the coming years will be minimally affected by this move. Both companies intend to continue expanding their store counts by at least 10% in each of the coming 3 to 5 years. The keys to their success are the convenient locations of their relatively small stores and their ability to provide most basic nonfood merchandise to their low-income customers at very attractive prices.

Meanwhile, *Wal-Mart* and *Target's* near-term earnings prospects have been enhanced by *Kmart*'s bankruptcy filing earlier this year. Several other discounters should also reap some benefit from that competitor's closure of nearly 300 (15%) of its stores and the easing of price competition in certain geographic markets. The bankruptcy filing has allowed the company to curtail lease payments on its empty facilities. Nevertheless, *Kmart*'s future is precarious, given aggressive expansion programs by major discounters and the renowned operating efficiency of *Wal-Mart*. Despite the negative impact of groceries on margins, *Wal-Mart* plans to increase the number of its supercenters in the U.S. by 70%, to around 1,800, by the close of fiscal 2005.

Investment Advice

This group's P/E ratio has declined considerably in the past three months. Earnings will generally best last year's depressed results at department store companies, and discounters should fare well. With share prices near the bottom of 12-month price ranges, the long-term appreciation potential of many stocks in this group is decent.

David R. Cohen

Composite Statistics: RETAIL STORE INDUSTRY

1998	1999	2000	2001	2002	2003		05-07
374759	420881	460517	503130	***552000***	***601700***	**Sales ($mill)**	***715000***
26.5%	26.6%	26.3%	26.2%	***26.3%***	***26.3%***	**Gross Margin**	***26.5%***
8.0%	8.0%	7.4%	7.2%	***7.3%***	***7.5%***	**Operating Margin**	***8.0%***
26195	28116	28934	29755	***31000***	***32400***	**Number of Stores**	***36500***
11526	13552	13185	14112	***16000***	***18000***	**Net Profit ($mill)**	***24300***
37.9%	37.5%	37.3%	37.5%	***37.5%***	***37.5%***	**Income Tax Rate**	***37.5%***
3.1%	3.2%	2.9%	2.8%	***2.9%***	***3.0%***	**Net Profit Margin**	***3.4%***
44594	38138	34407	37489	***38000***	***39300***	**Working Cap'l ($mill)**	***44000***
53911	59395	59270	60535	***61500***	***62200***	**Long-Term Debt ($mill)**	***63500***
72788	82492	87386	95810	***106500***	***118200***	**Shr. Equity ($mill)**	***157000***
10.7%	11.1%	10.6%	10.2%	***10.5%***	***10.5%***	**Return on Total Cap'l**	***10.5%***
15.8%	16.4%	15.1%	14.7%	***15.0%***	***15.5%***	**Return on Shr. Equity**	***15.5%***
13.0%	13.6%	12.6%	12.2%	***12.5%***	***13.0%***	**Retained to Com Eq**	***13.0%***
20%	19%	18%	17%	***16%***	***15%***	**All Div'ds to Net Prof**	***15%***
22.3	21.8	22.6	22.5	***Bold figures are Value Line estimates***		**Relative P/E Ratio**	***20.0***
1.17	1.25	1.47	1.14			**Avg Ann'l Div'd Yield**	***1.35***
1.1%	1.0%	.9%	.9%			**Avg Annual Div'd Yield**	***.8%***