



Critical thinking at the critical time™

FTI CONSULTING 2011 RETAIL REPORT

...FEAR ITSELF



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TO OUR CLIENTS AND FRIENDS

We are now three years removed from the worst financial crisis of our lifetimes but nobody seems convinced that the fallout it is completely behind us. After two years of recovery and relative tranquility in global financial markets, volatility reappeared around mid-year to remind us of the fragility of the financial system and the ability of far off events to ricochet around the globe in short order. More than ever we are an interconnected planet in just about every way—a positive development that's not without some risks as well.

As we marvel at how far the U.S. economy has come from the brink of disaster in late 2008 we must also face the reality that tens of millions of Americans still don't see it this way at all. For them, the state of our economy and its prospects seem nearly as grim today as they did during that fateful episode. By nearly every statistical measure the U.S. economy, as uninspired as its performance has been in 2011, is miles away from that ditch it fell into three years ago. But too many don't believe it and that perception is too widespread to dismiss or minimize. This rising tide has clearly failed to lift all boats—and has capsized quite a few as well. The challenge for policymakers and business leaders in 2012 is to make this recovery more inclusive. It's hard to imagine a sustainable economy recovery with vigorous growth that continues to exclude such a large portion of Americans. If that isn't achieved to some degree there is an ever growing risk that we could sink back into recession.

The U.S. retail sector continues to perform admirably amid a challenging environment for most shoppers. Nominal sales growth is positive across all sectors—more for some than others—and operating profits continue to grow at a faster clip than sales for most large chains thanks to ongoing efficiency efforts. By now these measures have mostly run their course and ongoing growth in profitability will require solid top-line gains. But it is becoming increasingly difficult to speak of retail as if it were a monolithic industry; sector-level and company performance largely reflects the financial health of its core customers, and we know how widely that can vary these days.

The theme of our 2011 Retail Report is fear and the impact that fears and anxieties of a financial nature are having on us as consumers and humans. The noticeable anger that is ratcheting up here and around the globe emanates from a place of fear. It is a theme we suspect will be with us throughout 2012.

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The views expressed in the following report are those of the authors and not necessarily those of FTI Consulting Inc., or its other professionals.



EXECUTIVE SUMMARY

- Slowing economic growth in most of the developed world since mid-year combined with the increasing prospect of a European sovereign debt default has rattled global financial markets since June and ushered in a mood of anxiety among investors after two years of relative tranquility and low market volatility.
- This weakness is expected to continue into 2012, with most economists calling for negligible growth (possibly a minor recession) in Western Europe and about 2.0% real GDP growth in the U.S.
- The persistence of the housing slump, high unemployment and weak growth in the U.S. has eroded the confidence and finances of most households—a large majority of whom believe we are in recession. Current consumer confidence readings are consistent with past recessions. Most consumers are bleak in their assessment of economic conditions over the next several months and few expect meaningful improvement in their financial situations over the next year. The mood of U.S. consumers has soured since mid-year.
- Frustrations over the economy combined with lingering resentment over Wall Street bailouts of 2008 and the inability of Congress to address our nation’s fiscal imbalances have ratcheted up the anger level among many Americans in a palpable way. Polling data consistently points to growing dissatisfaction among respondents with the direction of our country and the performance of our elected officials. Most recently, this anger has manifested itself in the Occupy Wall Street movement, which has gained considerable traction and media attention since it began in mid-September.
- Growing dissatisfaction levels among Americans may seem like a relatively recent development but actually originated in mid-2004 when the proportion of dissatisfied respondents began to drift noticeably higher. We believe a contributing factor to this dissatisfaction has been weak real wage growth relative to large productivity gains since 2003 and especially since the recession of 2008. Corporate profits remain at record-levels and large companies are opting to return cash to shareholders or retain it rather than hire, expand or reinvest at anywhere near pre-recession levels.
- The U.S. retail sector has performed admirably throughout the recession and in its aftermath. Nominal sales growth has been consistently positive across most sectors in 2011—in the range of 4%-6% on a year-over-year basis. All things considered, this is a fairly impressive showing. But nominal sales in several highly discretionary categories have yet to top pre-recession levels.
- Large retailers have managed costs extremely well and operating metrics are better than pre-recession levels for many chains even in the absence of robust sales growth.
- However, capital expenditures and new store openings remain well below pre-recession levels, as retailers recognize the precarious tone of this recovery.
- The growth of the online channel continues to far outpace store-based sales growth and is giving strong brands the opportunity to become global brands without the burden of extensive store rollouts in international markets. The use of social media by retailers is also paving the way for such growth.
- Our 2011 holiday forecast expects a modest improvement of 3% over last year’s surprisingly strong season. Most variables in our forecast model are reading slightly weaker today than a year ago.

INTRODUCTION: CONTEMPLATING THE UNTHINKABLE

Particle physicists at the Large Hadron Collider in Cern, Switzerland stunned the scientific community in September when they announced that a beam of neutrinos fired from a particle accelerator in Cern to the Gran Sasso underground laboratory in Italy—a distance of 453 miles—had traveled faster than the speed of light. Needless to say, the announcement was met with skepticism bordering on disbelief by esteemed colleagues throughout the fields of physics and cosmology...and understandably so. These findings, if confirmed, would violate Einstein's Special Theory of Relativity, which posits the equivalence of mass and energy, the constancy of light speed and concludes that nothing in the universe can travel faster than the speed of light. Einstein's special theory of relativity has held up to experimental scrutiny for over a century and is part of the bedrock of modern physics. A lot of settled science is at stake if this recent finding is confirmed—a process that will likely take years to verify but only months to refute.

These neutrinos, subatomic particles with almost no mass and no charge, arrived at their destination in Italy 60 nanoseconds faster than the speed of light, which should have taken 2.4 milliseconds. A nanosecond is one billionth of a second. To give this some perspective, consider this analogy from Wikipedia: a nanosecond is to one second as one second is to 31.7 years. So these neutrinos fired from Cern arrived 0.00000006 seconds faster than light would have. Many experts in the field assume that measurement errors must have been made and scientists are already reviewing the results for accuracy. Others are suggesting possibilities that would allow for such a phenomenon without violating Einstein's relativity laws—such as the possibility that the neutrinos traveled through dimensions outside our universe. (Don't ask, but apparently it's a shortcut.) As impossibly small as it may sound to lay people, 60 nanoseconds is not so infinitesimal in the realm of particle physics. The average person is challenged to appreciate how this tiny time increment could have such earthshaking implications. But scientists around the world fully recognize the profoundly unsettling potential of this event if confirmed (don't bet on it) and will be monitoring its resolution closely.

GLOBAL INVESTORS ALSO PONDER THE UNTHINKABLE

Anxious investors also seem to appreciate the potentially large impact of small things these days. On September 21, within minutes of a press release of the Federal Open Market Committee's (FOMC) recent meeting, U.S. equity markets began a sharp sell off, with the Dow Jones Industrial Average falling nearly 300 points, most of it coming in the last two hours of trading. The apparent culprit was a single word contained in the press release that caught traders by surprise. That Wednesday afternoon sell-off triggered a relentless market pullback that soon took global equity markets into bear market territory.

The paragraph in the FOMC's 552 word press release that caused the ruckus read as follows:

*"The Committee expects some pickup in the pace of recovery over coming quarters but anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, there are **significant** (our emphasis) downside risks to the economic outlook, including strains in global financial markets."*

In its previous release on August 9, the FOMC memo merely stated, *"Moreover, downside risks to the economic outlook have increased."*

How significant is *"significant"*? Quite. The 35 points surrendered by the S&P 500 Index that afternoon represent lost market value of about \$300 billion. That's one painfully expensive adjective.

The memo went on to introduce Operation Twist, the Fed's latest effort to stimulate the economy by lengthening the duration of its Treasury security holdings over the next ten months, thereby lowering interest rates at the long end of the yield curve. Given how weakly the U.S. economy has thus far responded to near record low interest rates, investors held out little hope that lowering rates further would do the trick. There is

a growing sense within the global investment community that the Federal Reserve's remaining policy options at this point are rather feckless with respect to spurring economic growth.

But maybe we're reading too much into this one word. Perhaps markets were looking for any excuse to sell-off again after a brief run-up—that has certainly been the pattern since summer—and this curt expression of caution by the FOMC provided such an excuse. What we've all come to realize in the last few months is that the specter of September 2008 has not been exorcised for most investors despite a broad recovery in financial markets and strong corporate performance since March 2009. Nobody believes that it couldn't happen again despite the many bold measures taken by financial institutions and regulatory bodies to safeguard against such events since late 2008. After more than two years of near tranquility and fairly easy returns, anxiety has returned to financial markets and the bad memories of 2008 suddenly don't seem so distant.

We can't recall another time when investor sentiment has been this negative without extremely persuasive justification. (The 2008 financial crisis was, after all, a reaction to specific events that had transpired.) There are good reasons to be apprehensive about 2012 but global investors are behaving as if something calamitous is waiting in plain sight despite the persistence of strong corporate earnings and copious amounts of liquidity. So far it's been mostly dark shadows and noises in the distance. It's true that the likelihood of a European sovereign default can no longer be considered remote though its impact on the financial system remains an unknown quantity. We know that the capitalization of some large European banks may not be sufficient to withstand a large credit shock but specific risk exposures of these institutions remain somewhat opaque. We also know that global economic growth has slowed since mid-year and recession talk has increased but this is not the base case expectation among prominent economists. Financial markets generally seem to be girding for a bad outcome. Attempts to rally are typically unsustainable. Encouraging economic data points are often marginalized. Highly improbable events or scenarios are given too much credence. Wild rumors spread across trading floors and often have market impact. (Recall the unsubstantiated rumors about Morgan Stanley's derivatives exposure back in early October that drove down its stock price 15% in two days.) Market strategists and economists now tend to see more near-term risk than opportunity in most places on the global investing scene though few have offered up a likely scenario that will take us to a really bad place. It's unusual to see such pessimism take hold. Equity markets may have rallied in recent weeks on news of solid third quarter earnings but investors remain very much on edge, as evidenced by wild daily swings prompted by swirling speculation and shifting sentiment regarding global macro events.

Market commentators today speak of a "fear-driven market" and often refer to the "fear trade" when describing the investing climate, that is, flight-to-safety trades such as gold and other precious metals, U.S. treasuries, safe haven currencies, like the Swiss franc, and some commodities. The surging VIX index of market volatility is commonly called the fear index. Fear is a popular theme these days though, ironically, not in the context of physical safety or national security. One decade after a hostile attack came to our shores, polling data tells us that most Americans are less concerned with terrorism these days. It is more mundane matters that are keeping them fearful.

The theme of our 2011 Retail Report is fear and the role this emotion and its close cousins, anxiety and anger, can play in formulating our worldviews and influencing our economic and financial decision making.

FEAR FACTOR

Fear is a primal emotional response to a perceived threat, danger or obstacle. It is considered an innate emotion that serves as a survival mechanism. It is our brain signaling that danger is near. In evolved animals it triggers a “fight or flight” response to a fear inducing stimulus. Moreover, in humans, fear is strongly associated with feelings of vulnerability, insecurity or loss of control over events. Fear is our emotional reaction to a specific threat and the way we process a fear stimulus and formulate a response depends on whether a threat is perceived consciously or unconsciously. When a fear stimulus is consciously perceived we have greater emotional control over our response. This difference in response has a neurobiological basis according to a Columbia University Medical Center study, where researchers using fMRI scanning of brain activity concluded that our brains process unconscious and conscious fear in different ways.⁽¹⁾ Our evaluation of the nature and severity of a threat and our response to it depend primarily on whether it's consciously perceived.

Many millennia after we emerged from caves and learned to tame our environment, the primal emotion of fear still affects our lives on a daily basis whether we acknowledge it or not. It may not be the thought of a woolly mammoth making a meal of us but something is usually terrorizing us.

Franklin Delano Roosevelt (FDR) appreciated the power of fear, expressing it succinctly, if simplistically almost 80 years ago. Nearly everyone who managed to stay awake through their American history classes in high school remembers FDR's famous quote, “...*the only thing we have to fear is fear itself...*” We can sympathize with millions of students over the years who have undoubtedly asked the same question: What exactly does it mean to *fear* fear? It takes some adult wisdom to get it.

Few recall the setting and context of that memorable speech. The quote is from FDR's inaugural speech given in March 1933. He had defeated the incumbent Herbert Hoover in a rout in the 1932 presidential election as America was suffering through the worst months of the Great Depression, which began in late 1929. Bank runs began in January 1933 and by his inauguration day a banking holiday was in effect in 32 states. Unemployment was nearly 25% and GDP had fallen by 30% since 1930. Prices for farm crops and manufactured goods had plunged as never before in the midst of a deflationary spiral. Poverty and homelessness were soaring and a frightened nation tuned in to hear its new leader speak for the first time as president.

“I am certain that my fellow Americans expect that on my induction into the Presidency I will address them with a candor and a decision which the present situation of our people impels. This is preeminently the time to speak the truth, the whole truth, frankly and boldly. Nor need we shrink from honestly facing conditions in our country today. This great Nation will endure as it has endured, will revive and will prosper. So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance. In every dark hour of our national life a leadership of frankness and vigor has met with that understanding and support of the people themselves which is essential to victory. I am convinced that you will again give that support to leadership in these critical days.”

“In such a spirit on my part and on yours we face our common difficulties. They concern, thank God, only material things. Values have shrunken to fantastic levels; taxes have risen; our ability to pay has fallen; government of all kinds is faced by serious curtailment of income; the means of exchange are frozen in the currents of trade; the withered leaves of industrial enterprise lie on every side; farmers find no markets for their produce; the savings of many years in thousands of families are gone. More important, a host of unemployed citizens face the grim problem of existence and an equally great number toil with little return. Only a foolish optimist can deny the dark realities of the moment.”

The entirety of his speech, less than 2,000 words, was a candid, if not blunt, assessment of the daunting challenges facing the nation at that moment and had a solemn, almost religious aspect to it. He didn't mince his words either, referring to activities of Wall Street financiers as, “*Practices of the unscrupulous money*

1. *Medical News Today*, October 2, 2006

changers...indicted in the court of public opinion, rejected by the hearts and minds of men." Politicians just don't speak publicly like that any more. President Obama got ripped by the Wall Street crowd for calling them fat cats in the aftermath of the 2008 financial crisis.

The speech was also a call to action. He broadly outlined how he envisioned putting Americans back to work and urged Congress to work with him in this endeavor. He also warned that if Congress were obstructive he would attempt to invoke broad executive powers for his office as would be befitting of a national emergency.

He cautioned that, *"...there must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing. Small wonder that confidence languishes, for it thrives only on honesty, on honor, on the sacredness of obligations, on faithful protection, on unselfish performance; without them it cannot live."*

Is this admonishment not relevant to modern times, especially considering some of the unsavory business practices, willful blindness and regulatory enabling that preceded the financial crisis of 2008? One can't read FDR's entire speech without noting many broad similarities to our current economic malaise and political divisiveness. FDR's detractors (apparently there are many these days) take exception to his harsh criticism of the capitalist system and his attribution of blame on a largely unregulated Wall Street for the maladies of the Great Depression. The Pecora Commission was established by a Republican controlled Senate in 1932 to investigate the causes of the stock market crash and it had the full support of FDR upon his inauguration to continue its inquiry. Its final report was a scathing indictment of many business practices on Wall Street. It swayed public sentiment and paved the way for major legislative reform that was to follow which would regulate and curtail many of these activities for decades to come. Many business leaders of the time were hostile to Roosevelt's aggressive efforts to regulate commerce and finance and painted him as a socialist despite his patrician pedigree. The Banking Act of 1933 and Securities Act of 1933 made the Dodd-Frank Act look like a parking ticket. It took decades for economic historians to finally agree that while Black Monday and the stock market crash of 1929 were doubtless the catalysts for the Great Depression, its length and severity was largely attributable to monetary policy blunders that ensued in the first years of that epoch downturn as well as global trade wars.

Today as we watch the financial industry continue its intense behind the scenes efforts to defang the Dodd-Frank Act even after acknowledging the need for reform in the wake of the 2008 credit crisis, as we hear accusations hurled by some partisan critics that President Obama is a jobs-killing socialist, it all sounds too familiar.

Some critics deride the naivety of FDR's memorable quote. Americans, after all, were (and are) fearful of some very specific things—like losing a home or a job. But long before behavioral economists arrived on the scene, FDR understood that our reaction to fearful impulses has real consequences beyond its proximate cause. Once again:

"...let me assert my firm belief that the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance."

Fear can be terrorizing. From an economic perspective this can have a destructive effect on business activity that becomes self-fulfilling and self-reinforcing. The two decade long economic malaise in Japan stems largely from households and businesses that are still fearful of spending vigorously some 20 years after that nation's asset bubble burst.

Persistently high unemployment today has made a growing number of Americans fearful—and we're not just referring to the jobless. As regrettably high as that figure is, 14 million unemployed Americans cannot alone account for such weak economic performance in a workforce of 132 million. Rather, it is the knock-on effect that has inflicted the worst collateral damage on consumption. Many millions more working households have opted to count their blessings, curb their spending and avoid financial risk for fear of job loss or other economic setback. Eighty percent of Americans today think we are in a recession according to a September

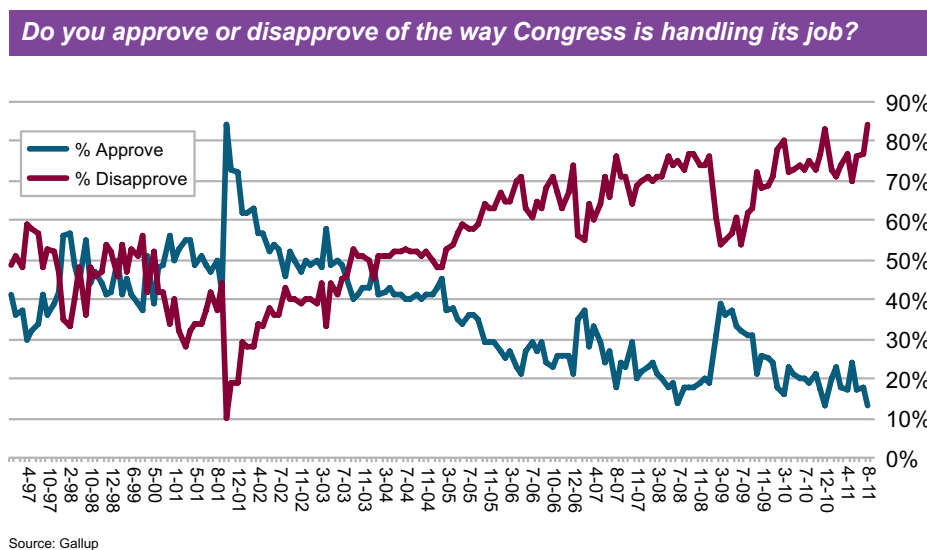
USA Today/Gallup poll—roughly the same percentage that responded affirmatively to the same question in the two prior years. This collective mindset is like a millstone around the neck of our economy and has real financial consequences. Big ticket spending decisions are frequently postponed and ambitious plans are scaled down to a more manageable size. Dreams are deferred. Consider the housing market, where the lowest mortgage rates ever and most affordable home prices in a decade cannot jumpstart home buying activity. Some prospective buyers are apprehensive about making such a large financial commitment amid such economic uncertainty. Others wait for prices to fall further. In the aggregate these kinds of economic decisions—often fear-influenced ones—will continue to depress spending and investment, which indeed leads to further job losses and slower growth. And so it goes. That is the feedback loop we are trapped in today and the challenge for politicians and other policy makers is to break this pernicious cycle.

LEADERSHIP IN FEARFUL TIMES

Roosevelt understood that leadership could restore the public confidence that was essential to breaking the entrenched cycle of business decline and mass pessimism. In psychological terms, the projection of leadership conveys a sense of vigilance or protection—that someone is looking out for you—that can mitigate the sensation of vulnerability that is at the heart of fear. Leadership can infuse a people with hope where hopelessness or fatalism had prevailed. It can alter our perception of events (“*things are going to get better soon...*”), which in turn modifies our behaviors (“*...so let’s take that vacation.*”) This attribute of leadership is evident in a time of war but it is no less true during any mass crisis or period of tribulation. Former Mayor Rudy Giuliani was a polarizing political figure whose popularity with New Yorkers had waned prior to the 9-11 attacks but his tireless display of leadership in the aftermath that tragedy won him plaudits all around, gave comfort and strength to millions of New Yorkers and toughened their resolve to endure the crisis and rebuild their city. It made a difference.

Leadership is in short supply these days in Washington according to public opinion and this void is impacting the public’s perception of events that affect their lives. It is making people cynical and bitter. Congress has never been held in lower esteem by the public, with approval ratings consistently polling at less than 20%. Approval ratings of Congress have fallen into the low teens since the debt ceiling spectacle in July (**Exhibit 1**). Americans see the constant partisan bickering and gridlock as impediments to economic progress and blame Congress more than the White House for the hostile climate and political impasses in Washington. The common refrain one hears is that Congress no longer represents the will or interests of its constituents. Others believe that a deeply divided Congress is only the reflection of a deeply divided nation. Recent public opinion polls consistently show that a plurality or majority of respondents would change the entire constituency on Capitol Hill, including their state and local representatives, if they could. Enough said.

Exhibit 1



President Obama doesn't escape unscathed—far from it. His overall approval ratings are at the nadir of his presidency and the inability of Washington to make meaningful progress on the deficit or jobs front ultimately becomes his burden and possibly his legacy. Polls show that most Americans don't blame him for the lousy economy but give him poor grades for his handling of it. Moreover, his measured responses to political confrontation, his detached coolness in the midst of these tough times and his inability to elicit empathy in a Bill Clinton sort of way ("*I feel your pain.*") has come across to many Americans as a lack of leadership during this crucible.

Washington's repeated failures to find common ground on the policy front is troubling not only to Americans but to global observers too. This was never more evident than the July showdown over the statutory federal debt ceiling—a very damaging episode for our elected officials in Washington and our current political system and a blow to our government's credibility in the eyes of the world. It demonstrated a lack of political will and commitment on both sides of the aisle to meaningfully address our nation's serious fiscal woes if it meant compromising ideological positions to any degree. President Obama didn't seriously engage Congress to come up with a "Grand Bargain" until early July, a practical impossibility given the intransigence of both parties and the tedious, time consuming process of drafting legislation. Congressional Republicans were more concerned with their tax cutting obsession than a compromise solution that served the interests of the nation. Democrats were equally resistant to take on the sacred cow of entitlements to any material degree. It was an ugly spectacle to watch and the last second agreement that skirted a technical debt default satisfied nobody. It was a political black eye for Washington.

Standard & Poor's specifically cited the contentious political climate in Washington as a factor in its August 5th credit downgrade of our nation's debt stating, "*...the downgrade reflects our view that the effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 8th, 2011.*" It went on to state its pessimism "*...about the capacity of Congress and the Administration to be able to leverage their agreement this week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon.*" The episode led to a rare rebuke from China, our largest creditor, urging the United States to get more serious about getting its fiscal house in order.

The American public might not have followed every chapter of this story but the message was not lost on them: too few in Congress were willing to meet in the middle to get a real deal done. The grandstanding and political calculation on both sides was more than obvious; it was naked. If the appointed Super Committee of Congress is unable to bridge this ideological divide in a consensual way by the end of November it will only reinforce these legitimate concerns (despite the automatic spending cuts that will supposedly be triggered) and ratchet up the rhetoric that our nation has become ungovernable. Early indications about the progress of the Super Committee in reaching a consensual agreement of deficit reduction are not encouraging. Thirteen months ahead of a presidential election we see a president who is finally trying to assert bold leadership in a very public way and a Republican-controlled House that is determined to deny him that mantle. This isn't business as usual in Washington and the prospect of chronic political paralysis has left many, well, fearful of what may come of it. The July debt ceiling showdown should cause a reasonable person to question the long standing presumption that divided government produces the best results because it coerces compromise solutions. That didn't happen. Americans fully understand that there are no easy answers to the fiscal and economic problems our nation faces but they are not unreasonable in expecting leadership from our leaders in pivotal moments.

HIGH ANXIETY

Anxiety is an emotional state or reaction similar to fear with one notable distinction: fear is an emotional response to a real and specific threat or danger; anxiety is a response to an anticipated and often non-specific threat—one which may not materialize or exist. The two are related, of course, and they can be

interrelated. Fear can cause anxiety and vice versa. Someone who is mugged walking down a dark street in a bad neighborhood has had a fearful experience but suffers from anxiety if thereafter he is scared to walk down any street at night.

The difference between fear and anxiety isn't necessarily obvious. Somebody who is highly agitated because his company has announced there will be a mass layoff by year-end is fearful because the threat is specific and imminent. But someone who is worried about job loss because he has heard terrible stories of unemployed friends or neighbors is anxious. The threat he anticipates may be remote or nonexistent. Fear is a healthier emotion in the sense that the threat will be resolved or dispatched, either through confrontation or avoidance, and the emotion subsides. One way or the other that first worker will no longer be fearful about losing his job come January. Not so for the second guy—that thought may be stuck in his head for quite awhile. Anxiety can be paralyzing because the perceived threat is amorphous. There are many kinds of anxiety disorders and people who suffer from them often endure a chronic state of agitation or unease. For some, the ghosts are always there.

The financial crisis of 2008 was a fearful episode for those who understood how perilously close the global financial system came to failing that year, and its legacy for many of us today is financial anxiety. Recall that business confidence and trust in our largest financial institutions disappeared. Banks virtually stopped lending to each other even on a short-term basis following the failure of Lehman Brothers. Massive interventions by central banks around the world were needed to restore some degree of trust and prevent the system from collapsing. Metaphorically, we were at the edge of the cliff staring down. What has been learned from various firsthand accounts in the three years since that episode is that the severity of that crisis was hardly exaggerated. Unlike other close calls that perhaps don't seem as bad in retrospect, this had the potential to be ruinous on a global scale. Most people were genuinely frightened, if only momentarily. Whatever toll the financial crisis exacted on the global economy—and it was severe—it could have been much worse.

Today we live with the vivid memory of that intense experience and it is anxiety inducing. Like the man who can't walk down any street at night after being mugged, some recall the terror of that episode and perhaps hear footsteps when there are none. There are valid reasons to be nervous about the global economy going into 2012 but the cooler talking heads out there keep reminding us that the current backdrop bears little resemblance to 2008. That may be so but a large cohort of investors isn't willing to chance it following a two year period of market tranquility and financial healing. They are tempted to run for cover with every howl of wind and may be contributing to the volatility that has returned to financial markets. Nobody is prepared to return to that precipice. There are murmurings that, more than ever, the very affluent have moved a greater portion of their wealth entirely outside the global financial system, into art and collectibles and precious metals. They too caught a scare in 2008 and are determined not to be so exposed again to a financial system they don't entirely trust.

This is also a time of high anxiety for millions of other struggling Americans with little or no attachment to financial markets. They live with anxieties borne of financial insecurity. It could be the anxiety that a neglected car will break down or an unexpected medical expense. Unlike fear, which passes, these kinds of anxieties can be lingering and overwhelming. If you travel much through depressed parts of the country you can practically see it etched on people's faces. It will take more than a couple of decent jobs reports to get these folks out of their funk. For many middle class Americans, falling home prices and diminished personal wealth are constant sources of anxiety. College tuition loans are causing angst for those just beginning their working careers. For others, it's the sacrifices that will almost certainly be asked of us whenever Washington gets serious about addressing our deficits. Many middle aged folks are anxious they will be unable to retire as planned and this anxiety influences economic decisions they make today. Financial anxiety abounds today no matter what side of the tracks you come from.

ANGER MANAGEMENT

Anger is another emotion closely related to fear. Some psychologists consider anger a secondary emotion, that is, it is preceded by other emotions, such as fear, pain or grief⁽²⁾. The intense grief following the 9/11 attacks soon gave way to anger over the injustice of such a heinous act. In interpersonal relations, the experience of anger is linked to notions of fairness, justice and equity⁽³⁾. People may experience anger in the context of a social situation when they perceive that there was an injustice and the expression of that anger serves the role to repair, at a psychological level, the perceived harm⁽⁴⁾. Anger is an assertion of power in a situation in which an individual is experiencing a loss of control or an obstacle. It serves the function of protecting or affirming the needs and interests of the individual⁽⁵⁾.

The expression of feelings of anger can be beneficial for health while the repression of anger can be unhealthy. However, anger as a temperamental trait rather than an experience or mood is often destructive.

There is no shortage of anger these days coming from all sides of the political and class divide and what should be understood is that this anger has its origins in fear. An overwhelming majority of Americans believe that members of Congress aren't serving the public interest and that special interests and their money are unduly influencing our political system. They see this as an affront to representative government. Millions of disenfranchised Americans are fearful that they're losing control of their financial security and are at the mercy of harsh elements beyond their ability to change. Anger was evident in elements of the Tea Party's earliest days and, more recently, the Occupy Wall Street protesters. Disaffected people aren't just frightened these days, they're indignant and the combination of the two has manifested itself as anger over the growing perception that prevailing economic and political systems are failing them while producing highly inequitable outcomes that benefit very few. The primary distinction between the two groups is where they choose to place blame.

The Occupy Wall Street movement has become an unexpected litmus test of one's political leanings, empathetic tendencies and tolerance of dissent. It would seem that Occupy Wall Street is the progressive movement's analogue to the Tea Party but it has been telling to hear certain politicians and business commentators trying to draw distinctions between the two groups in ways other than ideology. Protestors at Occupy Wall Street rallies are often described as "angry mobs" inciting class warfare, a label never put on the early Tea Party movement even when it was clear these self-proclaimed patriots were quite ticked off too and often radical in their views of government. Maybe it's the difference in the age demographic between the two groups, as the Occupy Wall Street cohort skews younger and this may come across as more threatening. Some protesters have engaged in acts of civil disobedience. Many conservatives who embraced the Tea Party movement from the get-go have been quick to denounce the Occupy Wall Street protest as a menacing, potentially destructive force rather than the same healthy exercise of non-violent free speech. Others have said it encourages social unrest and have called the movement un-American. But much of the harshest criticism, especially from politicians, has softened in recent weeks as it has become clear through polling data that the Occupy Wall Street movement has touched a nerve with many Americans, a plurality of whom support or sympathize with it.

The galvanizing event of the Tea Party movement was the 2008 bailout of banks with taxpayer money. The TARP program still rankles the Tea Party crowd today despite the fact that these bailouts likely saved the U.S. financial system from failure and have mostly been repaid. Little of their resentment is directed at the recipients of bailout money; it is the politicians who signed off on TARP that are the target of their ire. Many were voted out of office in the 2010 mid-term elections as the Tea Party became a political force to be reckoned with. They view TARP and other financial rescues of private enterprises as government intrusion in the private sector—a development they see at the heart of mostly all that ails our economy.

2. Schiraldi, Glenn, PhD and Kerr, Melissa Hallmark PhD., *The Anger Management Sourcebook*, 2002

3. Dumitru, Catalina Zaborila, PhD., *Occupational Health Psychology*

4. Op. Cit., Dumitru

5. Op. Cit., Dumitru

The Occupy Wall Street protesters have lost patience with an economy that isn't working for them at all but continues to hugely benefit a financial services industry that has been surprisingly resistant to change its business practices (some of which contributed to the 2008 crisis) or pay grade despite receiving all sorts of government subsidies and guaranties to this day. The protesters believe that much of the outsized prosperity that accrues to this sector would not be possible without this government support and that distinction should justify more restraint than the industry has shown it is willing to accept. For the Occupy Wall Street marchers and sympathizers, the banking and securities sector and their lobbyists in Washington are the mustachioed villains. More broadly they rail against a prevailing economic system that is increasingly producing extreme outcomes for winners and losers.

The demographics, ideology and tactics of these two grass roots movements couldn't differ any more starkly but scratch beneath the surface of either and what you'll find they have in common is impassioned supporters motivated by lingering resentment over corporate bailouts, fears and anxieties triggered by personal financial insecurity and the collective determination to take on these issues directly after years of merely grumbling about it. We're shocked that people are shocked it is happening here.

With financial markets still very unsettled, 25 million Americans either unemployed or underemployed, the housing picture still in disarray and another year of anemic economic growth on tap in the midst of a presidential race, there's little reason to expect that any of this drama will subside in 2012. There is a sense out there that it will be a momentous year.

THE U.S. CONSUMER SECTOR

NO SATISFACTION

The popular discontent that's been bubbling up here since late 2008 shouldn't convey the impression that this is a recent phenomenon; most Americans have been dissatisfied for considerably longer than three years—it's been eight years, to be precise. Two identical public opinion polls taken by Pew Research and Gallup for the last 16 years provide a fascinating glimpse into the origins of this discontent, and their results are nearly identical too.

Exhibits 2 and 3 show that Americans were about evenly divided between being satisfied and dissatisfied with the state of things in the U.S. from 1997 through 2003. But in early-to-mid 2004 the proportion of dissatisfied Americans suddenly jumped and the divide between the two groups of respondents has been widening ever since. Today some 80-90% of respondents are dissatisfied with the way things are going here. It's hard to get that percentage of people to agree on the weather. Both surveys point to May 2011 as the start of the latest leg down in satisfaction levels—a point in time that coincides with the sudden slowing of domestic economic growth and a topping out of U.S. equity markets.

Exhibit 2

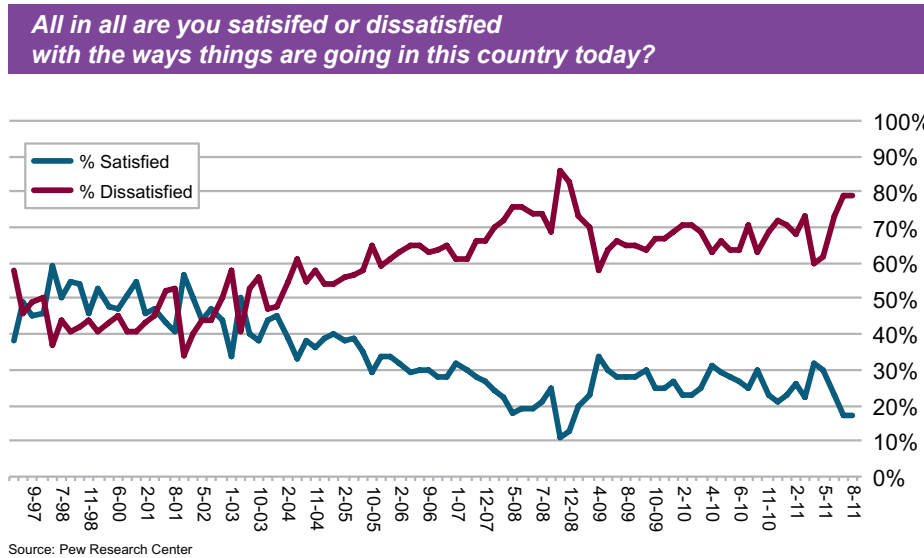
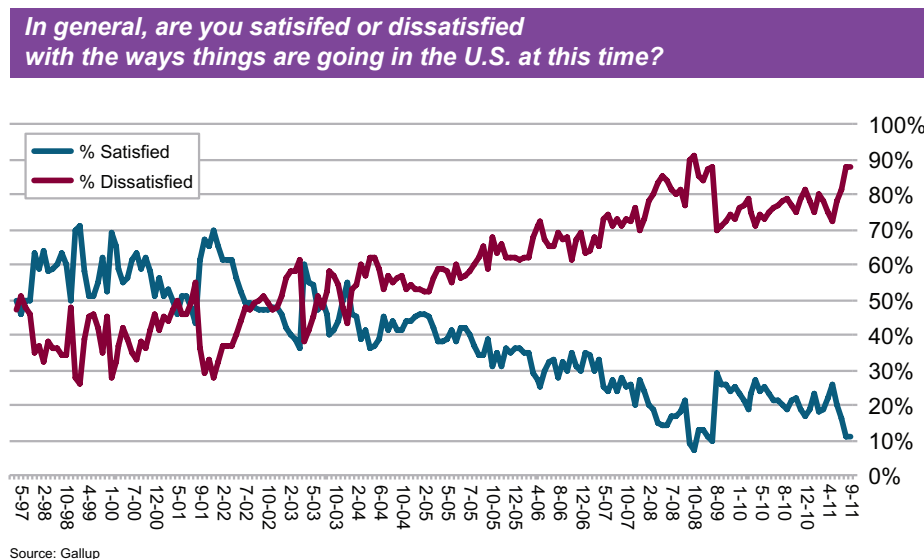
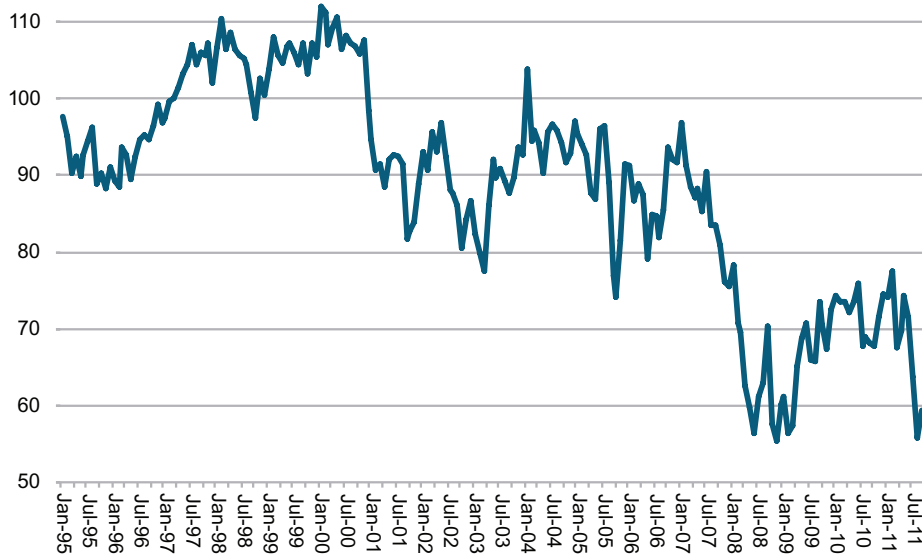


Exhibit 3



Consumer confidence, which measures responses to personal and general economic questions, follows a similar pattern, showing strength from the late nineties until the recession of 2001 then rallying briefly until early 2004 when it began a broad descent that continues to this day—with current readings close to the lows of the late 2008 financial crisis (**Exhibit 4**). The Conference Board’s Index of Consumer Confidence is also at extremely depressed levels currently. It’s important to note that consumer sentiment began falling sharply well in advance of the 2008 crisis and subsequent recession.

Exhibit 4: University of Michigan’s Index of Consumer Sentiment



Source: University of Michigan Survey of Consumers

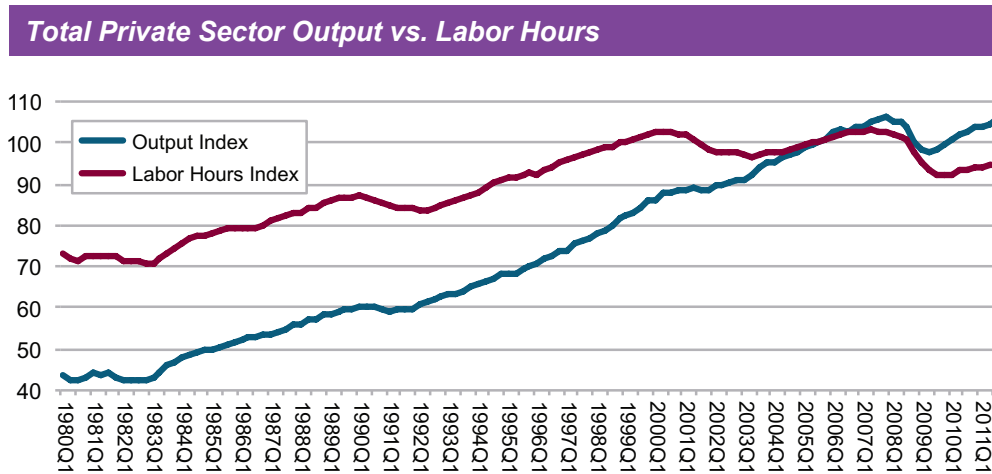
It’s uncanny that this torrent of dissatisfaction seems to have begun at a fairly precise moment in time—the middle of 2004. This got us to thinking about what might have been the catalyst to propel this amazing deterioration in satisfaction among Americans. There is no single standout event that might explain this phenomenon. By mid-2004 U.S. economic growth was fairly robust after two years of weak growth following the 2001 recession. The unemployment rate was 5.5% and falling, and the S&P 500 had rallied more than 35% off its cyclical lows of late 2002. Oil was \$40-45 per barrel and gasoline prices were under \$2.00 per gallon. Interest rates were low and the housing boom was just starting to kick into overdrive. The war in Iraq was a year old, large budget deficits had become chronic and President George W. Bush was kicking off his re-election campaign against Senator John Kerry. Judging by these headline events it wasn’t a troubling moment in time. Quite the contrary, it almost makes us wistful for such a benign economic backdrop. We suspect the answer had to be more subtle.

Since people are more apt to be unhappy or dissatisfied when their personal financial situation is tenuous or insecure, we decided to examine what was happening with personal income and wages around that time. One explanation nearly jumped out of the data. The Bureau of Labor Statistics (BLS) compiles labor productivity and labor cost data for the private sector. Productivity of labor is defined as output per labor hour worked. All productivity and labor data produced by BLS are expressed as index numbers. Productivity is measured by BLS across all industry sectors, not just manufacturing.

The productivity marvel of the last decade or so is hardly a secret. Its genesis dates back to the IT revolution in the mid-nineties and what it means is that businesses can create more output with the same amount of labor or the same amount of output with less labor. This is manifest in **Exhibit 5**, where we plot total private sector output versus total labor hours worked. In early 2008, just prior to the start of the recession, BLS’s labor hours index was practically unchanged from a decade earlier while its total output index rose by one-third in that same time. Then the recession hit and labor hours contracted sharply. Today output is nearly back to

pre-recession levels while the labor hours index is 7% below its pre-recession mark. Most people are familiar with the sweeping theme of this story; huge productivity gains have blunted net job creation and contributed to job displacement and unemployment for about a decade. But that's only half of the story.

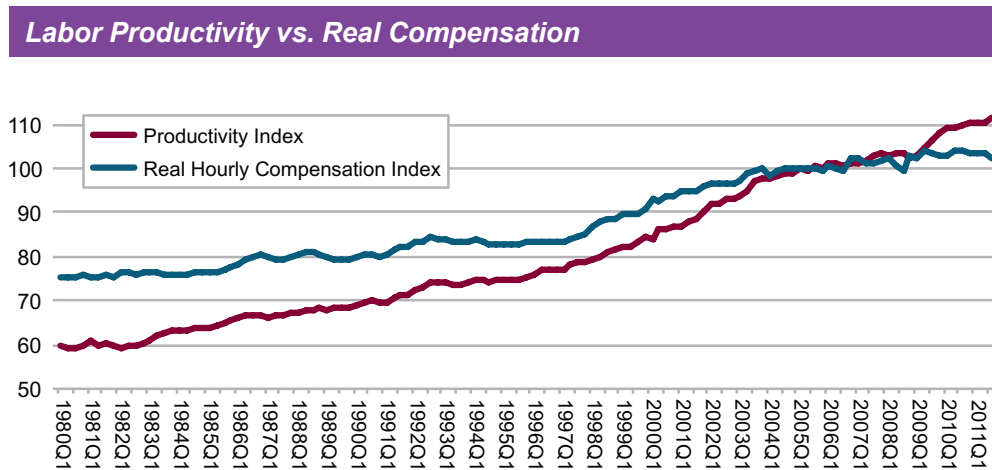
Exhibit 5



Source: Bureau of Labor Statistics; Index 2005=100

The other half of the story involves the impact of productivity gains on the employed. **Exhibit 6** shows labor productivity (i.e. output per labor hour worked) versus real labor costs per hour plotted over the last 30 years. Two observations are quickly apparent. Private sector labor productivity accelerated notably beginning in the late nineties—1997 to be exact. Labor shared generously in the prosperity brought about by this productivity surge for about five years, as we see that the real hourly compensation index also accelerated sharply from 1997 through 2003. But this shared prosperity came to an abrupt end sometime in late 2003 and ushered in a five-year period of nearly stagnant real wage growth while productivity continued to rise—albeit more slowly. Then the recession came and this relationship became entirely disjointed. Labor productivity surged in 2009-2010 as companies responded aggressively to the exigencies of the downturn. But real hourly compensation growth has remained negligible. Between 2004 and 2011 BLS's labor productivity index increased by nearly 15% while its real hourly compensation index grew by merely 3%. The change in this relationship over time is more evident in **Exhibit 7** where we show year-over-year percentage changes in each index since 1997. Labor has had little to cheer about for the better part of six years.

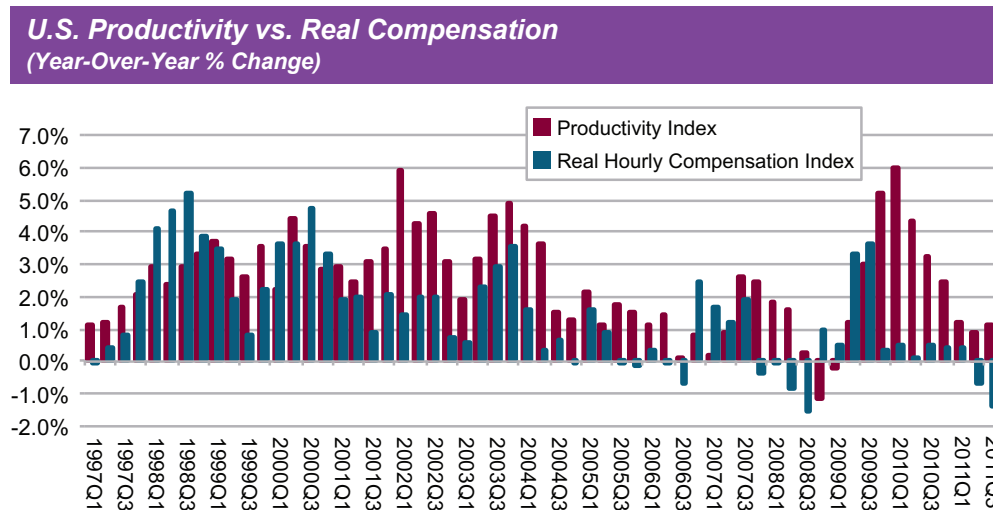
Exhibit 6



Source: Bureau of Labor Statistics; Index 2005=100

The timing of these developments coincides so closely with the erosion of public satisfaction and consumer confidence that it would be difficult to believe they are unrelated. At a minimum, negligible real growth in private sector hourly compensation has doubtless contributed to rising dissatisfaction levels among Americans. This frustration is compounded by a general understanding that large productivity gains of the last few years have accrued almost entirely to employers and shareholders. Little wonder that public dissatisfaction levels today are very nearly as high as they were at the worst moments of the 2008 financial crisis.

Exhibit 7

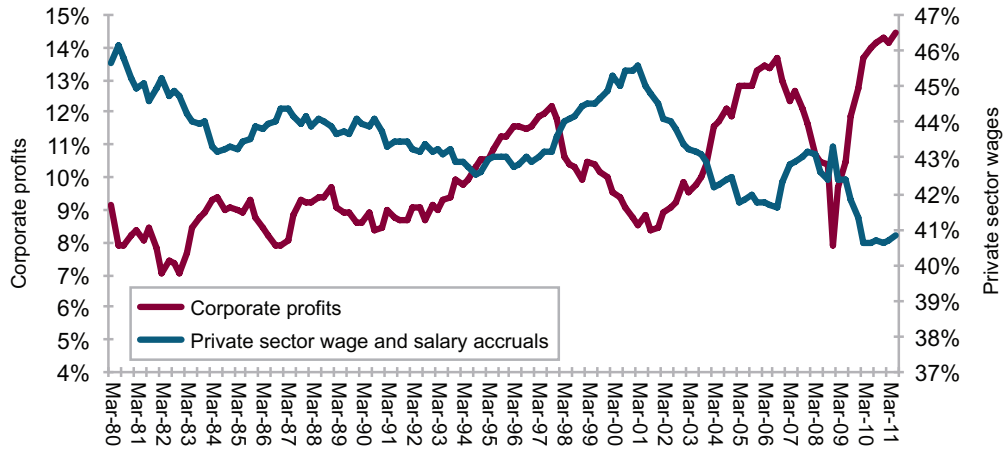


Source: Bureau of Labor Statistics

Economic data from another source supports this premise—specifically data from the Bureau of Economic Analysis (BEA), a division of the Commerce Department. BEA compiles U.S. GDP statistics and the National Income accounts. National income is approximately the equivalent of GDP expressed as the sum of income components, such as wages, rents, interest, profits, etc. In **Exhibit 8** we see private sector wages as a percentage of national income climbing from the mid-1990’s until the 2001 recession. Thereafter it assumed a declining trajectory (with a brief exception of late-2006 and 2007) and today accounts for less than 41% of national income compared to nearly 46% in 2001—a significant change in barely a decade and the lowest absolute level in over 50 years. Conversely, corporate profits’ share of national income began its steep ascent in 2002, interrupted momentarily by the 2008-2009 recession, and today stands at close to 15% of national income—an all-time high and far above its long-term average of 10.5%. In each succeeding period of economic expansion over the last 30 years, corporate profits (as a % of national income) have exceeded their previous cyclical peak. The three recessions since 1980 have only interrupted this sweeping trend, which then resumes when the downturns pass. Corporate profits will reach \$2 trillion in 2011, about one-third more than pre-recession profit levels. Much has been written in the business media this year about record-level corporate profits and all that cash they don’t know what to do with. It’s no exaggeration.

Exhibit 8

Components of U.S. National Income
(as a % of National Income)



Source: BEA

To sum it up, significant gains in labor productivity over nearly a decade have contributed in no small part to soaring growth in corporate profits but have likely had a deleterious effect on net job creation and real wages, which has likely stirred up growing dissatisfaction among Americans in recent years. The Great Recession and subsequent weak recovery have certainly prolonged and exacerbated this issue but make no mistake about it; the trend was well underway before the recession began. This dynamic is unlikely to change in the near-term as large businesses have signaled they have little need or incentive to step up hiring, compensation or new investment in a meaningful way at the moment.

THE U.S. RETAIL SECTOR

IT'S A SMALL WORLD AFTER ALL

Recent events remind just us how dynamic and unpredictable a mature industry like retailing can still be. One day after The Gap announced it would be closing an additional 200 Gap Stores by 2013 and reducing its total U.S. square footage by 10% compared to 2007, Uniqlo, the Japanese retail powerhouse opened an 89,000 square foot flagship store on New York's Fifth Avenue that signaled the start of its American invasion. Uniqlo intends to have 200 stores here by decade's end and possibly \$10 billion of sales. It sees the potential for well over 1,000 stores in the states eventually. Gap has struggled for years to excite customers as it once did and, though still popular and profitable today, its recent decision can only be viewed as a partial retreat from a hostile environment. By 2013 its Gap brand store base in the states will have shrunk by about 35% compared to 2007. Uniqlo apparently doesn't see the U.S. market quite the same way—its founder, Tadashi Yanai, speaks enthusiastically of the opportunities he sees on our shores and international markets generally. The chain intends to open 200-300 stores a year outside of Japan for the next decade, primarily in Asia. Its "Made For All" tagline and clever marketing blitz that mixes celebrities and ordinary folks has certainly created an early buzz here. Uniqlo's cheap chic aesthetic and focus on basics appeals to much of the same demographic as Gap does...or did. Much of Uniqlo's product line looks like it could be sold in a Gap or Banana Republic store—maybe it's just a bit more stylish. It's only natural to wonder how these two competing chains can see the same market so differently.

To add to the irony, Gap also announced it would be opening 45 stores in China next year while introducing the Old Navy brand in Japan, markets already tapped or targeted by Uniqlo. Gap is eyeing other new Asian markets too, such as South Korea and Singapore. It will also franchise some 400 new stores internationally over the next couple of years. This international push might sound counterintuitive; a Gap chain that has lacked pizzazz with Americans for years choosing to go east with its predictable fashion sensibility and compete against established rivals more attuned to local market tastes and cultures. But in a world where the biggest growth opportunities are in developing nations with huge middle class potential and high spending aspirations, the temptation to develop and exploit a global brand is understandably irresistible.

There was a time when only luxury brands could become truly global brands without encountering daunting obstacles. The affluent covet the same baubles, more or less, irrespective of nationality and this makes the transition to the global stage considerably less complicated. A Louis Vuitton bag is a universally recognized icon and LVMH doesn't need worry too much about adapting its merchandise and marketing to local tastes and sensibilities. Those who can afford their products want them just the way they are. Wal-Mart China, on the other hand, cannot escape these very same issues pertaining to local market adaptation and tastes. It continues its struggle to be successful in China after some 15 years in the country.

What has changed notably in the last decade is the aspiration of non-luxury brands to go global. H&M, the Swedish retailer, European stalwart, and a pioneer of cheap chic came to the states in 2000 and now has over 200 stores nationally. Many U.S. retailers with strong national brands have also moved beyond our shores in recent years. Abercrombie & Fitch has pinned much of its growth strategy on international expansion and hopes to derive about one-quarter of its sales from international sources over the next few years, as does True Religion, a smaller high-end jeans company. Amazon.com gets about 45% of its sales from international customers while Texas-based accessory seller Fossil sells more than half its merchandise internationally.

Two developments of the last decade have greatly facilitated the transition from national to global retailing; online commerce and social networking. The latter has been critical in brand building and creating awareness on a mass scale to international audiences, especially for the under 30 crowd. It also helps homogenize tastes and trends across a global audience. Again, this is truer of a younger demographic. Last year we noted that Hollywood's movie industry was a great example of the enormous financial benefits bestowed by a global audience built with aggressive marketing campaigns that include social media. Tent pole films

now open simultaneously across continents, and are occasionally released in select foreign markets ahead of their American debut. Foreign box office receipts often top domestic receipts by a wide margin for many blockbuster releases. In many countries, audiences opt for American fare over domestic films—a clear sign that common tastes are shared in a culturally diverse world. Hollywood’s prosperity, indeed its very future, is dependent on foreign markets. This summer’s release of the last installment of the Pirates of the Caribbean franchise grossed a disappointing \$250 million domestically but generated over \$1 billion in its worldwide theatrical run. The final Harry Potter installment, Cars 2 and even The Smurfs were all huge international hits—with the latter grossing an incredible \$500 million worldwide. This is no happy accident and the marketing blitzes for blockbuster films these days often incorporate a social media component applied on a global scale.

As much as ever, teens and young adults in developed countries share many of the same consumption desires and priorities—a phenomenon that social media is greatly influencing by obliterating geographic barriers and diluting culture based preferences. Social media is indispensable to this Generation Y cohort across the globe and they are increasingly accessing it through their mobile devices. Many large retail chains have already rolled out mobile web sites even if they are not yet engaged in mobile commerce.

Social media serve as both marketing and monitoring tools. Most large retailers have a Facebook page on which events can be promoted and visits or activity can be measured. Many can also be followed on Twitter. Targeting a specific region or audience via social media allows a retailer to soften the ground and create brand awareness ahead of an expansion push while monitoring social media outlets lets a retailer know what resonates with those audiences and whether its marketing efforts are creating a perceptible buzz.

Gap’s Asian push exemplifies how these developments are influencing international expansion in ways that weren’t possible at the turn of the century. Its store footprint in the region will be very light, at least initially, and this greatly reduces the capital commitment required to establish a meaningful market presence without compromising its potential. It will open a handful of flagship stores in critical markets, supported by a limited number of core stores and outlets. A paramount purpose of these stores will be to promote the brand and generate mass awareness in these countries. Ringing up huge sales is almost secondary to this purpose. Gap will largely depend on its online channel to accommodate customers too far from store locations. It will also rely on franchised stores with local operators. Most importantly its Asian strategy calls for a beefed up local online presence, including dedicated websites and social media outreach in these new markets and strong direct distribution capabilities in the region. If successful this strategy will generate huge direct sales volumes in these countries relative to store-based sales right from the outset. Should this be sustainable it will confirm the viability of these markets and likely justify additional store openings.

The brilliance of this approach, especially on a new continent, is that it allows a large retailer to tread lightly, greatly reducing the costly store blitz and extensive support structure that has traditionally been required, without necessarily sacrificing the scale or ambition of the undertaking. By materially reducing these sizeable upfront commitments, such an approach mitigates the financial risk of the venture and increases potential returns. Of course, as with any bold plan its success largely depends on execution risk and there is plenty of it in a “store lite” strategy. But there is little doubt that the inexorable growth of the online channel as a shopping and transacting medium on a global scale combined with the far reaching marketing potential of social media and the data riches it provides gives established national brands a shot at global scale like never before. But it’s a two way street and this will similarly encourage some new entrants to our retail markets. However, large retailers with global aspirations will put most of their money and energy where the growth potential is, and that ain’t here.

THE STATE OF U.S. RETAILING IN 2011

Ever since the onset of the Great Recession the U.S. retail sector has reminded us of the children’s story *The Little Engine That Could*, chugging up that steep hill pulling a heavy load and steadfastly determined to make it to the other side. Along the way it has lightened that load considerably by jettisoning some weight—

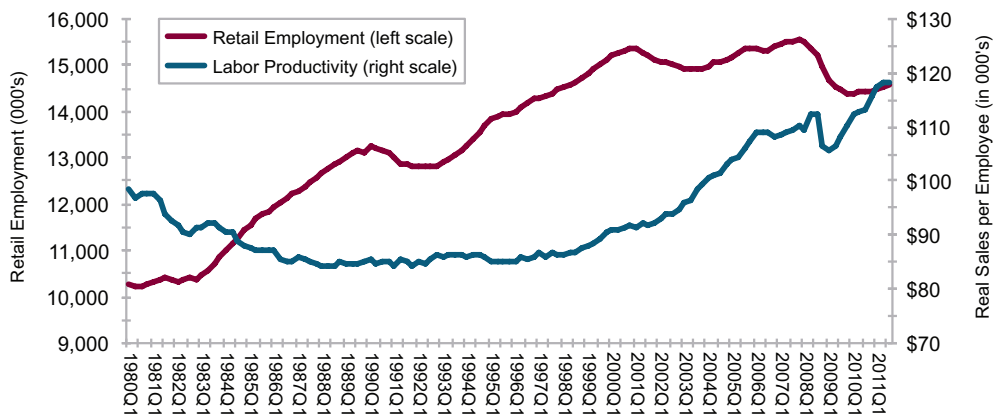
namely employees. Like other industry sectors, U.S. retailers have shed jobs in a big way. Historically such deep cuts are uncharacteristic of the retail industry. Between 4Q07 and 4Q09 some 1.2 million net jobs were lost in retailing, or 7.7% of its pre-recession workforce of 15.5 million. Such a large percentage decline for the retail sector is without precedent. Today, some two years after the recession officially ended, employment in the industry has increased by only 220,000 net jobs compared to the recession low of 4Q09. Retailers learned to do more with less during the recession, as we see in **Exhibit 9**. Today's retail workforce of 14.6 million is about the same size it was in 1998.

Incidentally, one reason why the national unemployment rate has remained so high to date is that traditional fallback careers in industries such as retail and consumer services are still not hiring enough to absorb displaced workers from other ravaged sectors, such as construction. Teens and young adults looking to start their working careers have also been hurt badly by this trend.

Getting back to the topic of labor productivity, it has soared for the U.S. retail sector since the recession. Labor productivity in the retail sector, which we define below as real (i.e. inflation adjusted) sales (excluding autos) per average employee, increased steadily from 2000 through 2007 on a relatively stable employment base but has surged some 12% since 2009, as employment levels have dropped while sales have begun to recover. Large chains have shown little inclination to boost hiring from current levels with the exception of seasonal help. The prospect of another recession, however improbable, will likely keep retailers running lean in 2012. Most large retailers have managed their businesses aggressively throughout this historic downturn and stunted recovery. Such measures extend beyond layoffs and include marked improvements in supply chain management and working capital investments. **The Appendix** to this report provides persuasive evidence that such measures have been fruitful for the sector. But they have come at a cost for retail workers.

Exhibit 9

Retail Sector Employment vs. Labor Productivity



Source: Moody's Economy.com

Some retailers have also fallen victim to the technology boom. We said goodbye to Borders Group in 2011, another casualty of the online revolution. Borders was late to that game with its e-reader and e-store and never had a realistic chance to play catch-up. The forty year old chain was once the big gorilla of bookselling back in the eighties and nineties when it embraced the superstore format that isn't quite as super today as it once was. The predator became the prey. Its failure was foreseeable (perhaps not its complete liquidation) and is another stark reminder of the vulnerability of established retailers to the onslaught of the online channel, which gradually continues to take market share in a growing number of product categories.

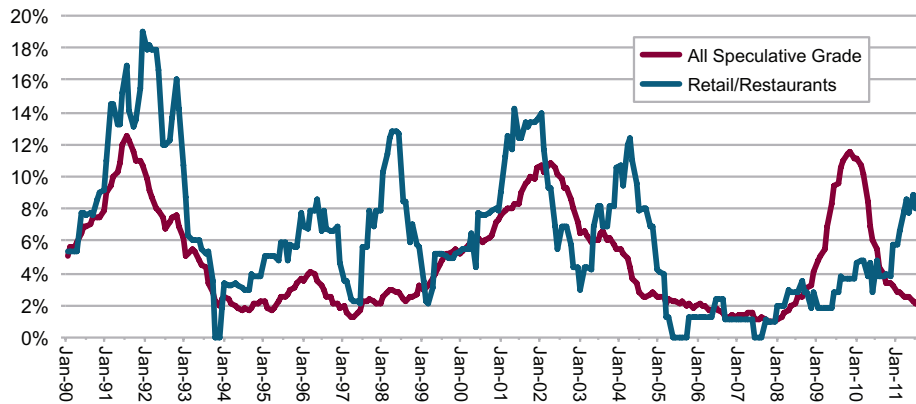
This post-recession period has been a humbling one for other big gorillas in retail that have been unable to make any real traction despite their advantages of scale. Wal-Mart still struggles to hold on to its core shoppers and hadn't posted positive domestic comps at its namesake stores for nearly two years. In food & drug retailing, some of the sector's giants, like Kroger, Safeway and CVS, also struggle with weak comps and gross margins despite dominant market shares in many regions of the country. Sears Holding is an unfocused mess. Other erstwhile stars like Target and Kohl's are producing mostly middling results without the exposure to distinctly down-market shoppers. Their ability to be more price competitive than rivals has not insulated them from the effects of a sluggish recovery nor has it allowed them to grab much new market share. It's better than it was in 2009 but few retail executives would call today's shopping environment normal in any remote sense.

U.S. retail sales have held up decently in 2011 despite weakening economic vigor and consumer confidence since mid-year. Aggregate sales excluding autos and gasoline have been growing at a 5%-6% clip on a nominal year-over-year basis for much of 2011 and about 3%-4% for more discretionary GAFO categories (**Exhibit 11**). Gasoline sales are up nearly 20% so far this year but this has hardly inhibited overall retail spending growth. Auto sales remain quite strong and we keep wondering who the heck is buying all these cars. These growth rates seem fairly impressive, and in many respects they are, but they tend to make us forget how far we remain from normal. For instance, despite near double-digit growth in auto sales for much of this year, the current pace of sales is just 13 million light vehicles compared to 16.5 million units prior to the downturn. This general observation is similarly true in other discretionary categories, such as home improvement, where sales have still not topped pre-recession levels.

Another sign that these are not yet normal times for U.S. retailers is rated debt defaults in the sector, which remained uncharacteristically subdued throughout the entirety of the recession but have spiked higher in 2011 and now exceed the overall speculative-grade default rate of just 2% by a considerable margin (**Exhibit 10**). Several bankruptcy filings by restaurant chains have contributed in no small part to this uptick, as many mid-sized chains are finding they cannot pass through sharply rising food costs to value conscious patrons. The popularity of value priced menus by the largest chains is keeping the pressure on smaller operators and has squeezed margins for some smaller to the breaking point. There are a few other popular restaurant chains that remain on the ropes at this juncture. Apparel retailers face a similar dilemma in dealing with an operating environment of rising product costs and tepid customer demand.

Exhibit 10

U.S. Speculative-Grade Debt Default Rates

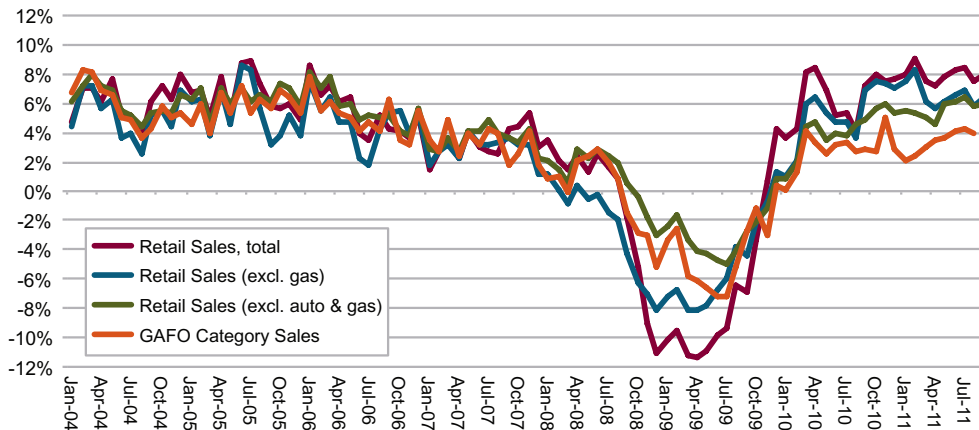


Source: S&P

Our data in the Appendix to this report seems to suggest that most retailers have just about squeezed all the juice from the lemon with respect to operating improvements and other efficiencies. Various operating adjustments and other such measures have had a beneficial impact on margins and returns amid a challenging sales environment but cannot be expected to drive performance much further in the absence of better top-line growth. Expense reduction initiatives have mostly run their course and many large chains cannot afford to run much leaner without risk of harming the business. Operating margins have met or surpassed pre-recession levels in several sectors but such margin improvement appears to be topping out. Inventory levels have been rising in recent quarters but are mostly commensurate with sales growth or just a bit higher. If one metric captures the cautious mood of large retailers these days it's relative capital expenditures, which remain exceedingly low by conventional standards. Consequently, free cash flow generated remains strong and large retailers, not unlike other public companies, are opting to return cash to shareholders in some form rather than reinvest it.

Exhibit 11

U.S. Monthly Retail Sales (YOY % Nominal Growth)



Source: U.S. Census Bureau

The cumulative toll of the Great Recession and the impact of online selling on new store openings and closings have finally begun to take a noticeable toll on retail real estate. Reis recently reported that the average vacancy rate at regional malls was at an 11-year high of 9.4% while strip center vacancies were up to 11%--with this development coming two years into an economic recovery. Reis also noted that asking rents were close to 2006 levels. We caution against making any broad generalizations about retail real estate, as "Class A" properties in major urban markets are hardly facing such challenges. But in many suburban markets in depressed regions of the country, the vacancies are hard not to notice and once they reach a certain threshold the commercial viability of the property becomes questionable. Strip centers are in worse shape than enclosed shopping malls or power centers, as many of the retail chains that have failed or closed stores in recent years tended to inhabit strip malls. The few really hot retail chains that are embarking on expansion, like Lululemon, are niche players that don't have the potential for national scale or a large store base. S&P's Retail REIT Sub-Index is nearly 50% below its pre-recession levels and has underperformed the broader S&P REIT Industry Index since the recession. With new store openings and capital expenditures by large retail chains remaining depressed and far below pre-recession norms, there is little reason to expect this weakness to abate in 2012.

SECTOR SPOTLIGHT: OFFICE SUPPLY

We expect office supplies to be the next retail sector to experience some form of consolidation activity, not necessarily in a restructuring context but perhaps via a combination of accelerated store closings among the top chains, the capitulation of small chains or, perhaps, a large acquisition. Like books and music, office supply is a product category that's well suited for the online channel and the category is arguably over-stored in North America. Online sales of office supplies now account for over 20% of retail sales in the sector according to the U.S. Census Bureau (**Exhibit 12**), making it one of the most popular online product categories among consumers. For the "Big Three" chains in the office supply sector, direct sales (online, catalog and sales force) account for between 40-50% of their total sales—mostly due to the growth of their business delivery segments in recent years. So, we ask, why all the stores?

Exhibit 12: U.S. E-Commerce Retail Sales: Market Share of Product Categories

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--------------------------------------|-------------|-------------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Books and magazines | 9.6% | 8.8% | 9.3% | 10.5% | 12.8% | 12.6% | 15.6% | 19.4% | 21.0% | 22.8% |
| Clothing, footwear, and accessories | 1.6% | 2.3% | 3.1% | 3.9% | 4.7% | 5.9% | 7.2% | 8.6% | 9.5% | 11.1% |
| Computer hardware | 13.8% | 15.4% | 18.2% | 21.4% | 24.2% | 26.9% | 29.6% | 30.7% | 29.8% | 29.2% |
| Computer software | 14.3% | 16.9% | 19.7% | 19.1% | 22.1% | 23.1% | 23.8% | 27.7% | 28.4% | 32.4% |
| Drugs, health and beauty aids | 0.4% | 0.6% | 0.9% | 1.1% | 1.4% | 1.5% | 1.7% | 1.8% | 1.9% | 1.9% |
| Electronics and appliances | 2.3% | 3.1% | 3.9% | 5.9% | 6.4% | 9.5% | 10.4% | 11.2% | 13.7% | 15.9% |
| Food, beer and wine | 0.1% | 0.1% | 0.2% | 0.2% | 0.3% | 0.5% | 0.6% | 0.7% | 0.6% | 0.6% |
| Furniture and home furnishings | 1.0% | 1.7% | 2.3% | 3.1% | 3.9% | 5.1% | 6.8% | 7.3% | 8.7% | 9.9% |
| Music and videos | 9.5% | 10.6% | 13.6% | 13.7% | 20.9% | 19.9% | 30.1% | 41.3% | 52.5% | 58.8% |
| Office supplies and equipment | 4.7% | 7.0% | 9.2% | 10.6% | 13.4% | 13.3% | 15.9% | 18.6% | 20.7% | 20.3% |
| Sporting goods | 2.9% | 3.2% | 4.7% | 5.4% | 6.7% | 8.6% | 10.2% | 12.3% | 13.4% | 15.1% |
| Toys, hobby goods, and games | 3.9% | 4.6% | 5.4% | 7.5% | 8.2% | 10.4% | 11.3% | 14.0% | 15.1% | 16.6% |

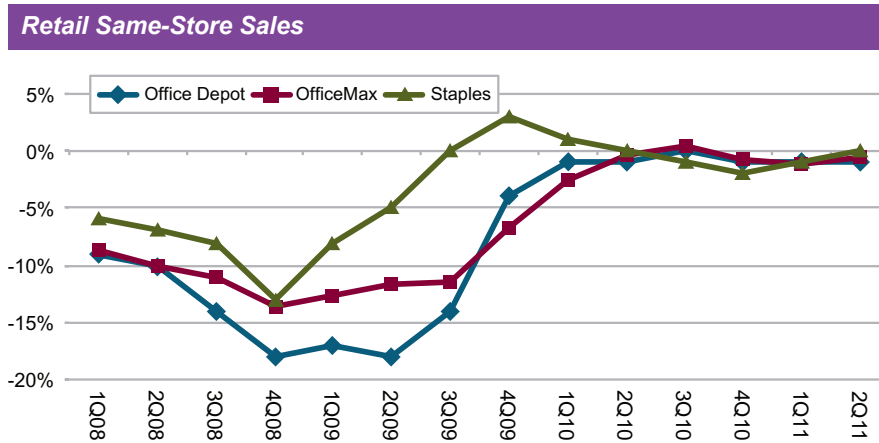
Source: U.S. Census Bureau

There might not be a more challenging sector in retail these days than office supplies. The impediments to success are long established and well known. It is a business selling mostly commodity products to highly price sensitive customers that have little loyalty or attachment to any particular seller. More than any other retail segment, office supply is a price driven business because most products are viewed as fungible by shoppers. Brand names matter little except in hardware categories and some peripherals. Gross margins are slightly better than those of supermarkets but without the benefit of such high inventory turnover. Worse still, other retailing channels compete to sell many of the products carried by office supply stores, including general merchandisers and consumer electronic stores, and this encroachment has only intensified in recent years. Office supply chains have tried to counter the commoditization of its basic business with service offerings, such as professional printing, but there is no shortage of competition in this arena either.

A potential game changer was the entry Amazon.com into the office products category in 2008. Amazon's product offerings in the category aren't as extensive as those of the Top Three but it has been aggressive in trying to win market share. Two pricing comparison surveys done by Deutsche Bank in 2011 indicated that Amazon was, on average, about 25% cheaper than the three top chains in the sector on a basket of items. Amazon's entry into the category is certain to take market share from others established in the space, mainly Office Depot and OfficeMax, both of whom have struggled to stay price competitive with the larger Staples.

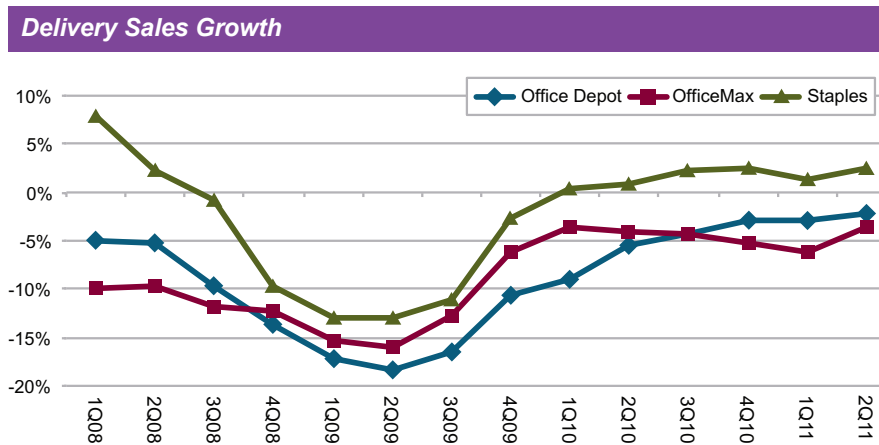
The recession hit the office supply sector hard and it has yet to recover as expected (**Exhibits 13A and 13B**). For much of the past year there has been a wide expectation on Wall Street that business spending on office supplies would snap back in 2011, much as it has coming out of prior recessions, but this scenario has failed to materialize. There are a couple of forces at play and the dominant reason for the stilted recovery in office supplies is still unclear. This is perturbing because one culprit is cyclical in nature and will eventually reverse itself as the economy strengthens but the other is long-term secular trend that may be indicative of a changing landscape that is irreversible.

Exhibit 13A



Source: Goldman Sachs Investment Research

Exhibit 13B

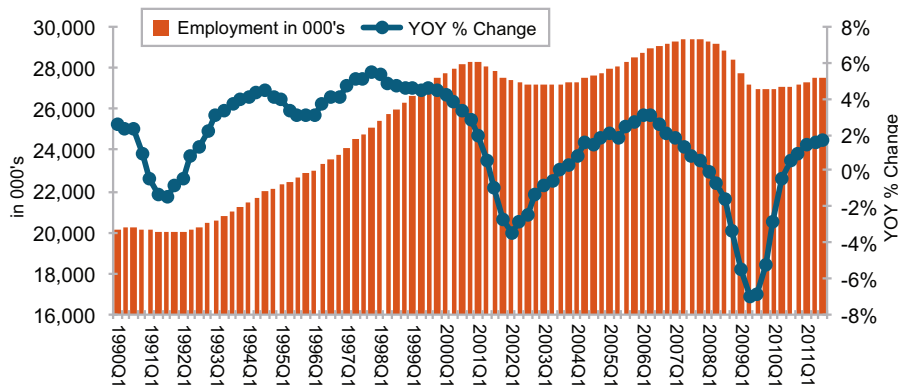


Source: Goldman Sachs Investment Research

Business spending on office supplies cratered during the recession due to extensive layoffs in back office and support functions. Today weak job creation and high unemployment remain a cyclical problem that won't go away. Office-based employment, which would be a reasonable proxy of the business demand for office supplies, remains unusually weak at this stage of recovery (**Exhibit 14**). White collar jobs were hit harder by this recession than previous downturns and most of these jobs have yet to return. More than two years into this recovery, only 600,000 of the nearly 2.5 million office-based jobs lost during the recession have been restored. This ongoing slow recovery has undoubtedly dampened the demand for office supplies, as has the stagnation of new business formation since the downturn.

Exhibit 14

Office-Using Employment



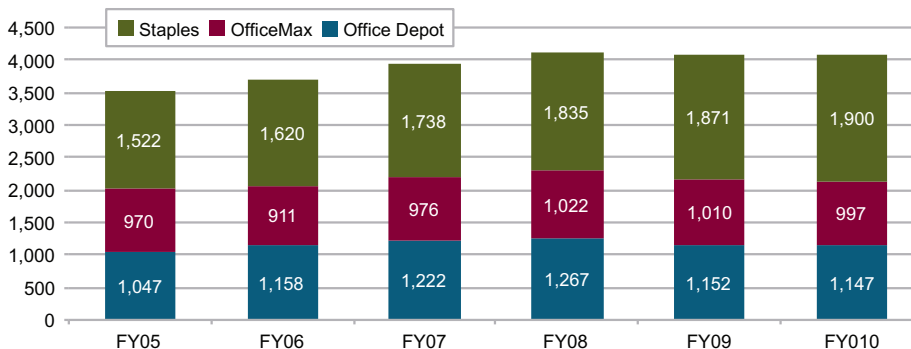
Source: Bureau of Labor Statistics

The other major factor suppressing the demand recovery for office supplies is the emergence of mobile computing and its impact on peripherals and related supplies. The waning popularity of desktop PCs and the ubiquity of notebook computers and now tablet computers have revolutionized computing in the office and home office environments and reduced demand for paper and printing products that office suppliers largely depend on. This is a more troubling trend for office supply retailers as it seems unlikely to reverse even in a stronger business environment. The surging popularity of tablets may only worsen this trend. Office supply retailers will get some of these hardware sales but likely stand to lose more in the way declining demand for paper products and all else that entails.

For all the challenges the sector has faced over the last several years, there have been surprisingly few net store closings by the large office supply chains. Today there are about 4,100 stores in North America among the Big Three, roughly the same as in 2008, with new openings by Staples exceeding some pruning by Office Depot and OfficeMax (**Exhibit 15**). All three chains spent much of the recession wringing costs out of their supply chains, mainly by consolidating distribution and fulfillment centers, but store closings were relatively minor. Today it's acknowledged that the North American market is getting close to saturation and new store openings are fairly minimal. Prototype stores have also gotten somewhat smaller, moving away from the 20,000-25,000 square foot superstore model that has prevailed for three decades.

Exhibit 15

Office Supply Segment North American Store Count

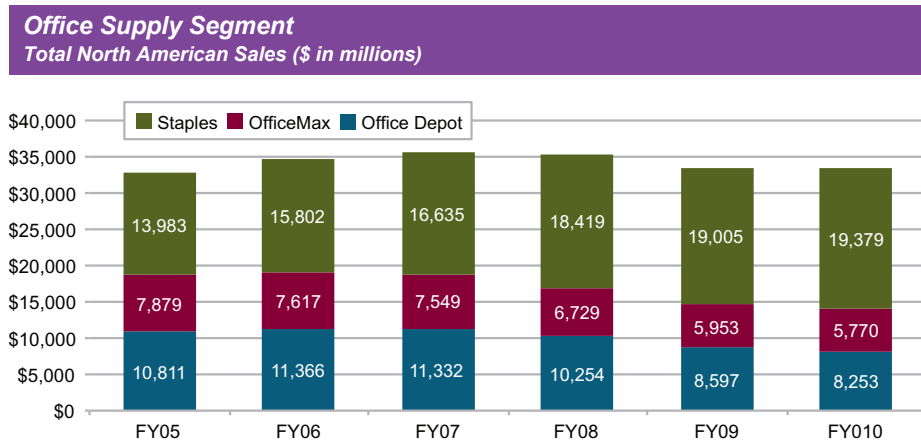


Source: Capital IQ and SEC filings

Staples endured the downturn much better than its two rivals (**Exhibit 16**) by remaining aggressive on pricing and taking market share from these competitors. Its scale advantage over the other two allowed it

to do so without hurting operating profitability. The impact of retail sales erosion at OfficeMax and Office Depot in North America has caused operating margins to drop into the low single digits today compared to mid-single digits prior to the downturn. Furthermore, Staples' purchase of Corporate Express in 2008 was a notable acquisition that boosted sales and efficiencies in its North American business delivery segment.

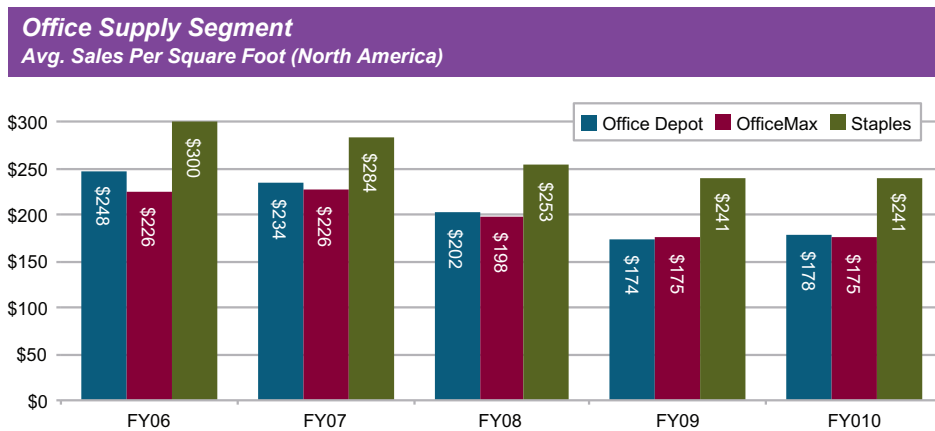
Exhibit 16



Source: Capital IQ and SEC filings

But none has been able to escape the reality of declining store-level productivity—not even Staples. Sales per average square foot—the best metric of store level productivity—has declined by about 20%-25% since the recession (**Exhibit 17**). Sales per square foot at Office Depot and OfficeMax are particularly dismal. This decline is explained by the continuing weak sales environment as well as the ongoing migration of retail customers to the online channel—a sales channel that these three chains know how to execute proficiently.

Exhibit 17



Source: Capital IQ and SEC filings

This brings us back to our original question: Why all the office supply stores? Given their demonstrated abilities to do online well, it's a logical question. With office supply chains paying about \$20 per square foot in rent and employing dozens of employees for a typical box that's now too large and unproductive in many instances, we would expect a noticeable acceleration in store closings over the next few years. Should the economy remain so weak in 2012 or lapse back into recession this will almost certainly be the case. The online model now provides a more profitable platform to makes these sales. We're just not sure who exactly will get them.

Today the aggregate equity market value of the Big Three office supply chains is one-third of its pre-recession value. Investors clearly have their doubts too.

OUR 2011 HOLIDAY SEASON FORECAST

Last year's holiday season was considerably stronger than most expectations, including ours. Our measurement of the season, which includes total GAFO⁽⁶⁾ category sales plus online and mail order sales for the three months of November through January, was up an impressive 5.7% in the 2010 season compared to our forecast of a 3.5% increase. All in all, 2010 holiday sales totaled \$408 billion compared to \$386 billion in 2009. Worth noting was the standout performance of the direct-to-consumer channel (this includes online and catalog sales), which arguably saved the season for retailers and accounted for 20% of total holiday season sales, or \$83 billion. Store-based sales increased only 3.2% during the 2010 holiday season while direct-to-consumer sales were up about 16% (**Exhibit 18**). Millions of Americans have realized that strolling crowded malls during the mad holiday rush isn't quite the fun they remembered it to be, while the convenience and savings of online shopping has proven to be just too alluring. While some malls hit up shoppers with \$5 parking fees, online retailers counter with free shipping through early Christmas week. We can't come up with a single reason why the popularity of online shopping won't continue to grow at low double-digit rates this holiday season.

Overall the 2010 holiday season was a strong one by any historical standard, diminished slightly by the easy comparison to a weak 2009 season. November was the standout month of last season on a year-over-year comparison. Spending proved to be fairly robust despite the tepid economic backdrop and various financial woes of consumers—a trend which persists to this day. For all their persistent financial anxieties and cautious choices, consumers are managing to move the needle with their spending.

What was likely the biggest factor that contributed to the surprising strength of the season last year was the extension of the Bush tax cuts through 2012 and a two-year reduction in employee payroll tax contributions that offset other expiring provisions that were helping lower and middle income families. This extension came after another big partisan showdown in Congress last autumn that pitted Republicans who wanted to extend all the Bush tax cuts against Democrats who wanted them extended only for households with income under \$250,000. Ultimately, it was "tax cuts for all" that won out and this was a serendipitous outcome mostly for high income households, many of whom were girding for the possibility of a rollback. The impasse was finally resolved shortly after the 2010 holiday season kicked off and undoubtedly resulted in some extra splurging by households who gained the most from these extensions.

Exhibit 18: YOY Percentage Change in Nominal Sales

| | Nov-10 | Dec-10 | Jan-11 | Holiday 2010 |
|---|--------------|--------------|--------------|--------------|
| GAFO | 5.4% | 3.2% | 0.8% | 3.2% |
| Furniture and home furnishings stores | 3.9% | 1.2% | -1.9% | 1.2% |
| Electronics and appliance stores | 0.3% | 1.0% | -1.5% | 0.2% |
| Clothing and clothing access. stores | 9.0% | 5.1% | 2.6% | 5.8% |
| Sporting goods, hobby, book, and music stores | 11.8% | 4.8% | 0.9% | 5.6% |
| General merchandise stores | 4.3% | 2.8% | 1.3% | 2.9% |
| Department stores (incl. L.D.) | 0.7% | 0.1% | -3.5% | -0.5% |
| Discount dept. stores | 0.1% | -3.5% | -5.3% | -2.7% |
| Conventional & national chain dept stores | 1.7% | 6.2% | 0.3% | 3.6% |
| Warehouse clubs & superstores | 5.7% | 4.4% | 2.8% | 4.4% |
| All other gen. merchandise stores | 8.9% | 5.1% | 4.5% | 6.2% |
| Electronic shopping and mail-order houses | 19.6% | 14.7% | 15.1% | 16.3% |
| GAFO Categories + Electronic Shopping & Mail Order | 7.9% | 5.2% | 3.7% | 5.7% |

Source: Census Bureau

6. GAFO categories include general merchandise stores, apparel & accessories, consumer electronics and appliances, furniture and home furnishings and other miscellaneous categories, including sporting goods, books, music and office supply.

Earlier this year there were various reports and articles cautioning about rising product costs for most retail businesses, particularly apparel related. Material costs, energy prices, labor and shipping costs were all moving higher through mid-year and it was believed that most retailers would have little choice but to pass through some or all of these increases to consumers in the second-half of 2011. Several months later these concerns appear to have dissipated. The economic slowdown since May and renewed financial anxieties for many households seems to have dissuaded most retailers from boosting prices. To the contrary, promotional pricing and heavy discounting seem as prevalent today as any time within the last year or so. It appears that most retailers would rather sacrifice gross margins than lose sales in this unsettled environment. This is especially true now that some of these cost pressures have eased in recent months and won't likely get imbedded in product costs. The only retailers with the clout to raise prices and get away with it this season are the strong brand names and purveyors of luxury goods. Their customers are still feeling pretty good these days despite recent volatility in financial markets and can handle the markups. Otherwise, concerns of inflation for consumer goods have largely faded out and it is shaping up to be a very promotional holiday season despite tightly managed inventory levels for most large chains. Wal-Mart's recent announcement of a price matching guarantee for the entirety of the holiday season, a move intended to fight the perception it is losing its edge on low prices, has certainly set the tone for the season. They have also joined the growing ranks of down market retailers offering a layaway plan—a practice that had all but disappeared from the scene until the economy went south and low end shoppers found their credit lines slashed. Many Wal-Mart shoppers can sure use the break, as stubbornly high energy and food prices continue to take a big bite of their disposable income. If anyone doubts that most consumers are price sensitive these days, consider the fierce backlash from Netflix customers to a price increase that would cost them an extra \$72 a year—this after not having raised prices for several years. Nearly a million Netflix subscribers cancelled their subscriptions within weeks of the announcement.

Most forecasts we have seen to date for the 2011 holiday season are anticipating a modest bump in sales, mostly in the range of 2.0-3.5% over 2010—a range that would imply slowing sales momentum compared to recent months. As we stated previously, retail sales so far in 2011, though less than stellar, have been resilient in the face of continuing weak consumer metrics and generally dour economic headlines. What might explain this pattern and why shouldn't it be expected to continue?

In last year's holiday report we noted that disproportionate spending by high income households often results in retail sales growth that defies low expectations derived from weak readings of consumer level data. In proportion to their numbers, higher income households (the top 20%) account for more than double their share of discretionary spending while lower income households (the bottom 40%) account for about one-half their proportionate share by number. In total, the top 20% of households by income spend more than twice as much on discretionary purchases as the bottom 40% do. What this means is that, in the aggregate, spending cutbacks by many financially challenged households can easily be offset by spending increases of far fewer high income earners. This bifurcation of spending by income groups is certainly nothing new but it has become more pronounced in recent years.

Consequently, forecasting models that use economic data or survey data without explicitly recognizing this effect will tend to produce forecasts that are biased to underestimate growth. For instance, consumer surveys of holiday spending intentions that count all respondents' replies equally will likely produce a low forecast because lower income earners, who account for a disproportionately small percentage of sales, would be overrepresented in number while higher income households that do most of the spending would be underrepresented in the survey. Weighting these survey results by respondents' incomes would likely produce a better forecast. With that intention in mind, this year we have applied such a weighting to a key variable in our forecast model, consumer sentiment.

Our forecast model calls for a 3% increase in 2011 holiday sales. One variable in the model, consumer sentiment, is 10% lower than it was a year ago. Worse still, sentiment of the higher income cohort has contracted sharply since mid-year and was only marginally higher than the overall sentiment index in September after having exceeded it comfortably for about a year. (That may have changed with the October

rally in financial markets.) It is the expectations component of this index that has led the decline in 2011. There's little question that the economic mood of the country has soured compared to last holiday season—and this downcast feeling encompasses most income cohorts at the moment. The deceleration of online sales in recent months, from the mid-teens to very low double-digits, may be one sign that higher income groups have been slowing their spending a bit since summer. Lastly, there is no "must have" gift item this year aside from tablets and e-readers, and it remains to be seen whether their price points remain too high for many Americans to exchange as presents.

Add to this the tough comparison against a strong 2010 season and it's hard to be upbeat about the prospects for this holiday season. Lastly, the November 23 deadline of the Congressional Super Committee to agree on a plan that substantially reduces our nation's chronic budget deficits will again remind most Americans that some form of financial austerity is coming our way fairly soon—not exactly the best news for shoppers to hear as the holiday season gets underway. But U.S. consumers are famous for defying low expectations and succumbing to the temptation of a bargain. Let's see if they can pleasantly surprise retailers as they did last year—but don't bet on it.

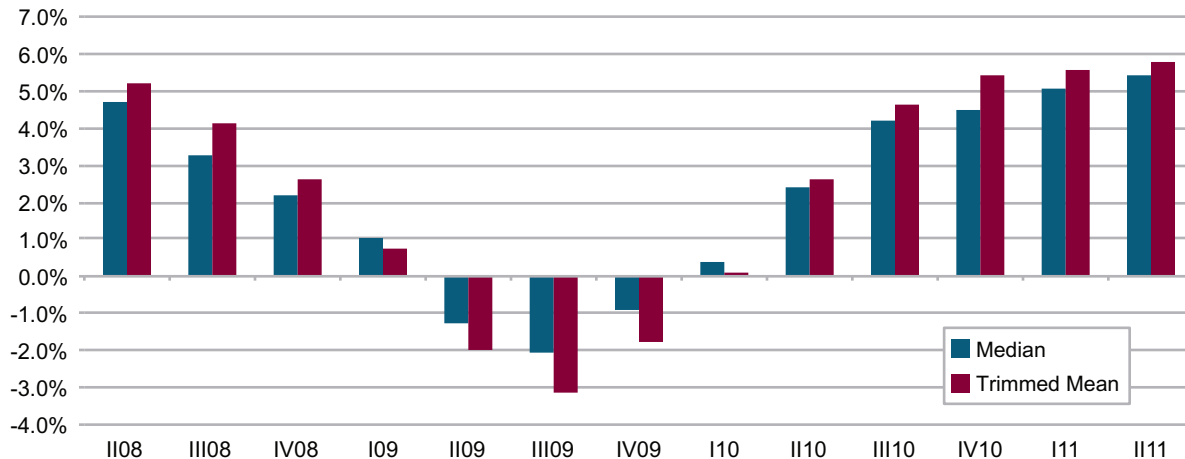
We would only hope that everyone is feeling confident enough to spend a bit more this holiday season but even those who cannot will be getting more bang for their buck.

Happy Holidays to All!

APPENDIX

YOY PERCENTAGE CHANGE IN TOTAL SALES

U.S. Retail Sector YOY % Change in Total Sales (LTM)



Source: S&P's Compustat

YOY % Change in LTM Sales

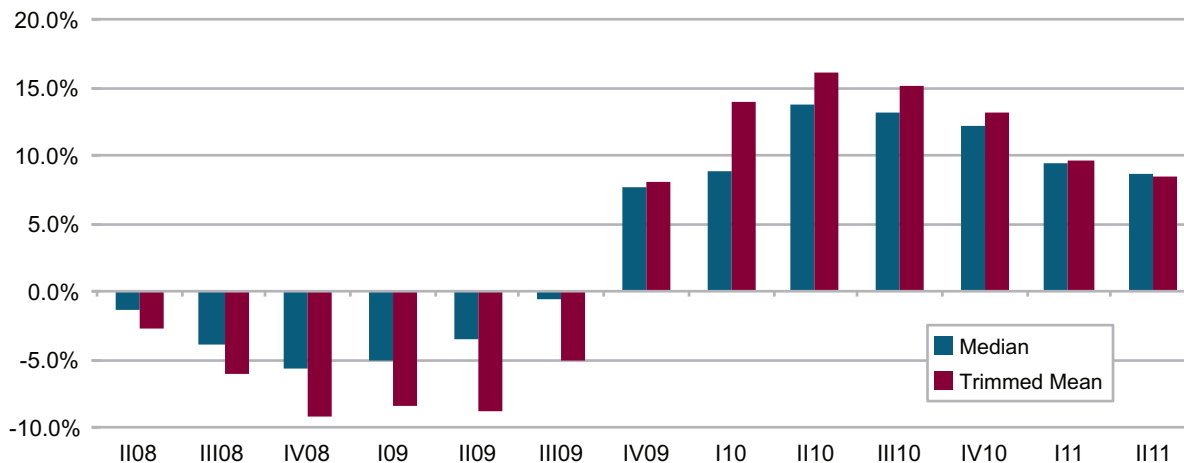
| Median Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|-------------------------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Home Improvement | 11.3% | 12.3% | 11.3% | 5.8% | -2.2% | -3.3% | -2.1% | -0.6% | 1.9% | 8.7% | 13.5% | 9.9% | 6.4% |
| General Merchandise | 2.5% | 1.3% | 1.0% | -0.6% | -1.4% | -1.3% | 0.6% | 1.8% | 3.1% | 3.9% | 4.8% | 5.0% | 4.7% |
| Supermarkets | 5.6% | 5.9% | 5.8% | 4.0% | 1.7% | 0.7% | 0.6% | 1.6% | 1.8% | 2.5% | 3.8% | 3.6% | 4.3% |
| Auto Dealers & Parts | 2.0% | 1.7% | -1.7% | -5.5% | -14.7% | -22.5% | -13.6% | -6.5% | 4.8% | 11.3% | 12.6% | 14.7% | 13.9% |
| Specialty Apparel | 0.1% | -1.2% | -1.9% | -2.9% | -4.5% | -4.9% | -0.6% | 1.1% | 4.6% | 4.9% | 5.4% | 5.7% | 4.2% |
| Furniture, Home Furnish. & CE | 0.7% | -1.3% | -1.6% | -3.5% | -5.0% | -3.9% | -1.6% | 0.4% | 2.4% | 2.9% | 5.4% | 5.4% | 4.1% |
| Away From Home Dining | 6.8% | 4.7% | 3.4% | 2.9% | -0.6% | -1.1% | -1.4% | -1.4% | 0.2% | 1.8% | 2.8% | 4.0% | 4.0% |
| Miscellaneous Specialty | 7.7% | 6.1% | -0.5% | -2.0% | -1.8% | -1.1% | 2.3% | 3.7% | 3.2% | 4.3% | 2.2% | 4.3% | 7.0% |
| All Retailers | 4.7% | 3.3% | 2.2% | 1.0% | -1.2% | -2.1% | -0.9% | 0.4% | 2.4% | 4.2% | 4.5% | 5.1% | 5.4% |
| Mean Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
| Home Improvement | 9.6% | 9.6% | 7.2% | 4.9% | 1.3% | -1.9% | -1.5% | 1.0% | 4.8% | 7.9% | 10.3% | 10.1% | 9.3% |
| General Merchandise | 2.0% | 1.1% | 0.6% | 0.0% | -1.7% | -1.8% | -0.2% | 1.3% | 3.4% | 4.4% | 4.8% | 4.6% | 5.1% |
| Supermarkets | 7.4% | 6.9% | 5.8% | 4.1% | 2.6% | 1.1% | -0.4% | -0.5% | 0.2% | 1.4% | 2.1% | 2.9% | 3.8% |
| Auto Dealers & Parts | 5.2% | 5.4% | 0.6% | -6.4% | -12.6% | -15.9% | -10.8% | -3.2% | 4.7% | 12.5% | 14.2% | 14.1% | 13.8% |
| Specialty Apparel | 1.5% | 1.3% | 1.2% | 0.0% | -3.3% | -3.4% | -1.0% | 1.6% | 4.2% | 5.8% | 6.4% | 6.2% | 6.5% |
| Furniture, Home Furnish. & CE | 1.6% | -0.3% | -2.4% | -3.9% | -5.9% | -4.9% | -2.9% | -1.5% | 1.4% | 3.5% | 5.1% | 5.1% | 3.8% |
| Away From Home Dining | 9.1% | 7.2% | 5.6% | 4.0% | 1.1% | -1.5% | -1.9% | -1.4% | 0.0% | 1.6% | 2.4% | 3.2% | 3.7% |
| Miscellaneous Specialty | 7.7% | 6.1% | 2.0% | -0.7% | -2.3% | -3.5% | -0.7% | 1.8% | 3.4% | 5.2% | 5.3% | 5.2% | 5.9% |
| All Retailers | 5.2% | 4.2% | 2.6% | 0.7% | -2.0% | -3.1% | -1.8% | 0.1% | 2.6% | 4.6% | 5.4% | 5.6% | 5.8% |

Note: Color coded cells represent declines from the preceding quarter.
Financial statement data obtained for 200 U.S. retail chains with sales exceeding \$100 million.
Source: Standard & Poor's Compustat

APPENDIX

YOY PERCENTAGE CHANGE IN EBITDA

U.S. Retail Sector YOY % Change in EBITDA (LTM)



Source: S&P's Compustat

YOY % Change in LTM EBITDA

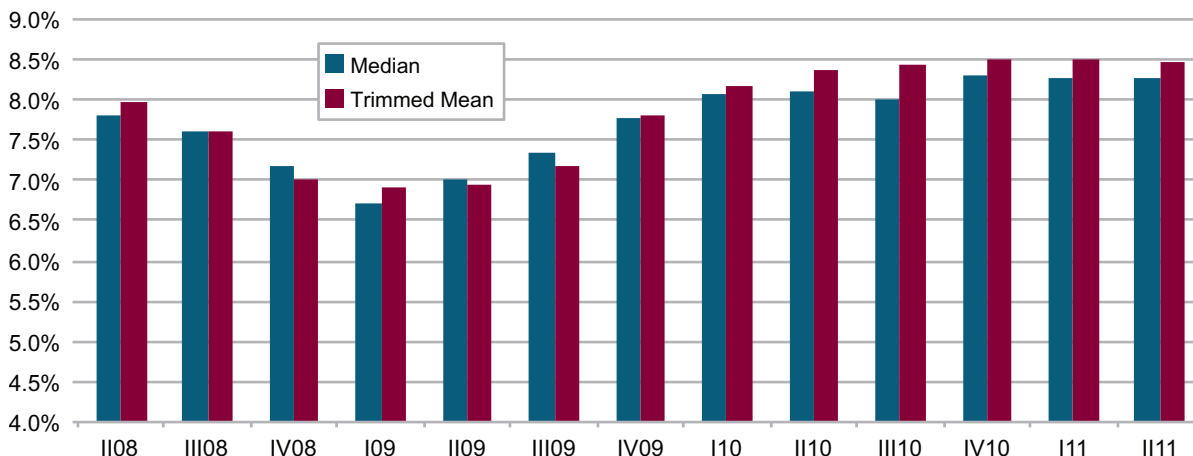
| Median Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|-------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|-------------|-------------|
| Home Improvement | -3.7% | -5.6% | -7.0% | -0.5% | -10.3% | -15.2% | -6.2% | -0.9% | 5.0% | 8.5% | 12.1% | 10.4% | 11.2% |
| General Merchandise | -6.9% | -12.2% | -9.1% | -4.0% | -4.7% | -4.0% | 14.0% | 13.4% | 17.4% | 19.5% | 16.5% | 12.8% | 13.4% |
| Supermarkets | 10.2% | 4.7% | 4.2% | 3.5% | 4.2% | 6.7% | 6.0% | 1.0% | -4.3% | -3.0% | 0.4% | 4.1% | 4.0% |
| Auto Dealers & Parts | -15.6% | -12.9% | -25.4% | -30.0% | 0.0% | 6.6% | -0.1% | 7.4% | 19.9% | 20.3% | 20.0% | 16.7% | 16.2% |
| Specialty Apparel | -8.6% | -10.8% | -12.4% | -11.4% | -11.7% | -16.5% | 12.4% | 27.9% | 31.9% | 28.2% | 20.0% | 14.7% | 12.4% |
| Furniture, Home Furnish. & CE | -5.4% | -18.4% | -14.0% | -9.6% | -9.9% | -0.9% | 3.6% | -0.3% | 5.9% | 8.0% | 4.7% | 6.5% | 16.0% |
| Away From Home Dining | -0.8% | -5.0% | -6.6% | -1.9% | -1.5% | 0.9% | 7.5% | 4.0% | 5.7% | 7.9% | 10.3% | 8.7% | 3.8% |
| Miscellaneous Specialty | 6.8% | 3.1% | -3.7% | -11.9% | -16.7% | -5.6% | 6.3% | 8.1% | 11.8% | 9.4% | 7.4% | 2.1% | 7.3% |
| All Retailers | -1.3% | -4.0% | -5.7% | -5.1% | -3.6% | -0.6% | 7.6% | 8.7% | 13.8% | 13.1% | 12.1% | 9.4% | 8.6% |
| Mean Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
| Home Improvement | -0.1% | -0.4% | 12.8% | 6.0% | -0.6% | -1.9% | -1.0% | 4.4% | 12.4% | 15.5% | 19.0% | 17.2% | 10.9% |
| General Merchandise | -9.1% | -12.7% | -15.1% | -5.8% | -5.7% | -2.3% | 27.2% | 20.6% | 22.0% | 18.6% | 18.8% | 14.2% | 12.9% |
| Supermarkets | 11.7% | 10.1% | 8.2% | 8.2% | 9.2% | 8.8% | 4.9% | 2.6% | 0.5% | -0.9% | -1.0% | 1.9% | 1.6% |
| Auto Dealers & Parts | -17.6% | -25.6% | -22.8% | -12.3% | -6.2% | 6.9% | 3.7% | 12.2% | 23.1% | 19.3% | 19.8% | 15.6% | 14.1% |
| Specialty Apparel | -8.6% | -9.0% | -12.8% | -12.8% | -20.1% | -24.0% | 10.8% | 35.1% | 35.7% | 37.0% | 21.9% | 12.0% | 8.6% |
| Furniture, Home Furnish. & CE | -4.1% | -14.0% | -16.7% | -20.6% | -22.9% | -12.5% | 8.7% | 10.3% | 31.1% | 23.9% | 16.4% | 12.0% | 12.6% |
| Away From Home Dining | -0.7% | -4.7% | -4.5% | -4.6% | -2.0% | 1.3% | 6.9% | 5.6% | 8.5% | 8.7% | 9.6% | 8.6% | 5.8% |
| Miscellaneous Specialty | 4.1% | 0.0% | -13.8% | -17.2% | -21.8% | -15.8% | 1.3% | 13.3% | 13.7% | 11.5% | 9.2% | 2.8% | 7.0% |
| All Retailers | -2.8% | -6.1% | -9.1% | -8.5% | -8.8% | -5.0% | 8.0% | 14.0% | 16.1% | 15.1% | 13.2% | 9.5% | 8.3% |

Note: Color coded cells represent declines from the preceding quarter.
Financial statement data obtained for 200 U.S. retail chains with sales exceeding \$100 million.
Source: Standard & Poor's Compustat

APPENDIX

EBITDA MARGIN

U.S. Retail Sector EBITDA Margin (LTM)



Source: S&P's Compustat

EBITDA Margin (LTM)

| Median Results: | II08 | III08 | IV08 | IO9 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Home Improvement | 10.9% | 10.5% | 9.9% | 10.0% | 9.9% | 9.9% | 10.0% | 9.9% | 10.1% | 10.3% | 10.5% | 10.5% | 10.3% |
| General Merchandise | 6.8% | 5.9% | 5.6% | 5.8% | 5.8% | 6.5% | 6.9% | 7.8% | 7.8% | 7.8% | 8.0% | 8.4% | 8.7% |
| Supermarkets | 6.2% | 6.0% | 5.9% | 5.8% | 5.8% | 5.9% | 5.8% | 5.7% | 5.8% | 5.8% | 5.7% | 5.7% | 5.6% |
| Auto Dealers & Parts | 3.4% | 3.1% | 3.1% | 2.9% | 3.3% | 3.9% | 4.0% | 4.1% | 4.2% | 4.1% | 3.9% | 3.9% | 4.1% |
| Specialty Apparel | 9.2% | 9.0% | 7.6% | 7.5% | 7.2% | 7.7% | 8.0% | 9.3% | 9.9% | 10.7% | 10.2% | 10.5% | 10.6% |
| Furniture, Home Furnish. & CE | 8.2% | 6.3% | 6.0% | 6.4% | 6.2% | 6.3% | 6.4% | 6.0% | 6.4% | 7.0% | 6.9% | 7.1% | 7.3% |
| Away From Home Dining | 10.7% | 10.2% | 10.0% | 10.2% | 10.5% | 10.4% | 10.7% | 10.6% | 10.8% | 10.7% | 11.1% | 11.3% | 10.9% |
| Miscellaneous Specialty | 7.1% | 7.1% | 6.6% | 6.2% | 6.1% | 6.0% | 6.6% | 6.7% | 6.7% | 6.4% | 6.1% | 5.0% | 5.4% |
| All Retailers | 7.8% | 7.6% | 7.2% | 6.7% | 7.0% | 7.3% | 7.8% | 8.1% | 8.1% | 8.0% | 8.3% | 8.3% | 8.3% |
| Mean Results: | II08 | III08 | IV08 | IO9 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
| Home Improvement | 11.6% | 11.5% | 11.5% | 11.3% | 11.1% | 10.9% | 10.9% | 11.0% | 11.5% | 11.7% | 11.9% | 11.9% | 11.9% |
| General Merchandise | 6.6% | 6.3% | 5.8% | 5.9% | 6.0% | 6.4% | 7.0% | 7.4% | 7.7% | 7.8% | 8.1% | 8.1% | 8.2% |
| Supermarkets | 5.9% | 5.7% | 6.0% | 6.0% | 6.1% | 6.3% | 6.2% | 6.2% | 6.2% | 6.3% | 6.2% | 6.2% | 6.2% |
| Auto Dealers & Parts | 4.5% | 4.0% | 3.9% | 4.0% | 4.3% | 4.8% | 5.0% | 5.2% | 5.4% | 5.4% | 5.4% | 5.4% | 5.5% |
| Specialty Apparel | 10.1% | 9.5% | 7.9% | 7.5% | 7.0% | 7.1% | 8.7% | 9.6% | 9.8% | 9.9% | 9.9% | 9.8% | 9.7% |
| Furniture, Home Furnish. & CE | 6.9% | 6.1% | 5.0% | 4.5% | 4.9% | 5.2% | 5.9% | 6.6% | 7.1% | 7.5% | 7.7% | 7.7% | 7.6% |
| Away From Home Dining | 10.9% | 10.4% | 9.9% | 10.0% | 10.3% | 10.6% | 11.1% | 11.2% | 11.3% | 11.3% | 11.6% | 11.8% | 11.7% |
| Miscellaneous Specialty | 6.7% | 6.4% | 5.9% | 5.6% | 5.5% | 5.6% | 6.1% | 6.3% | 6.2% | 6.1% | 6.2% | 6.1% | 6.0% |
| All Retailers | 8.0% | 7.6% | 7.0% | 6.9% | 6.9% | 7.2% | 7.8% | 8.2% | 8.4% | 8.4% | 8.5% | 8.5% | 8.5% |

Note: Color coded cells represent declines from the preceding quarter.

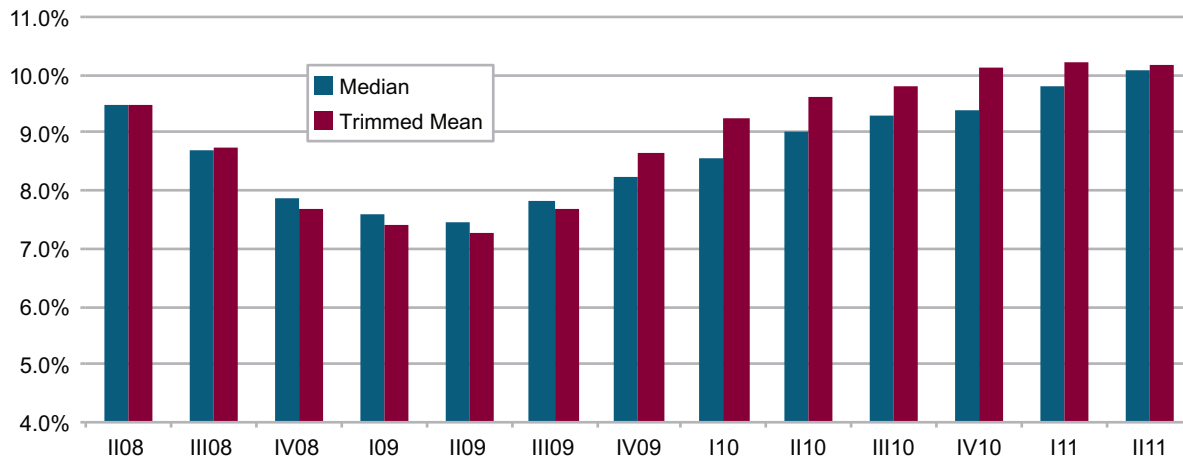
Financial statement data obtained for 200 U.S. retail chains with sales exceeding \$100 million.

Source: Standard & Poor's Compustat

APPENDIX

RETURN ON AVERAGE TOTAL ASSETS

U.S. Retail Sector Return on Average Total Assets



Source: S&P's Compustat

Return on Total Assets (EBIT / Avg. Total Assets)

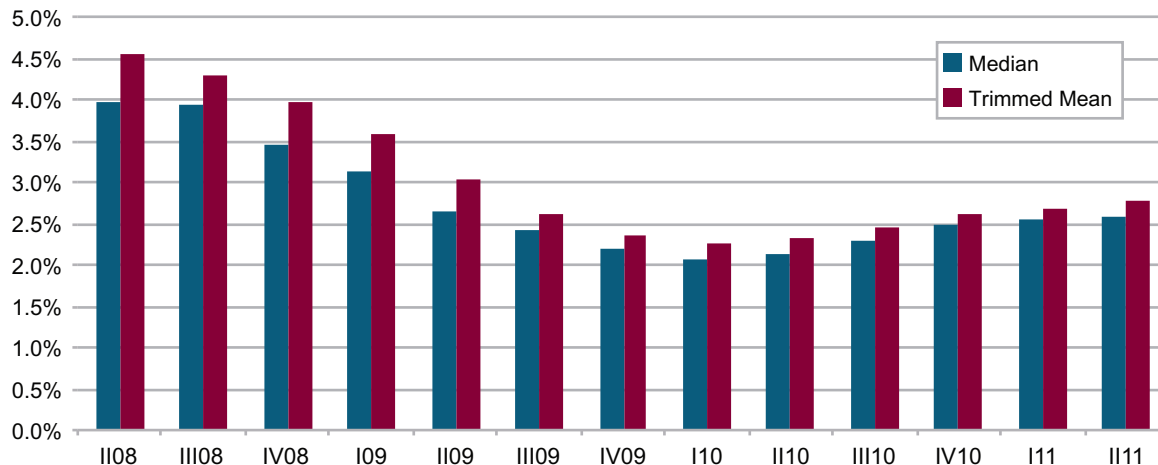
| Median Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Home Improvement | 14.3% | 13.4% | 12.1% | 12.1% | 13.6% | 14.1% | 15.3% | 16.1% | 18.2% | 18.6% | 18.4% | 16.8% | 14.9% |
| General Merchandise | 6.7% | 6.6% | 6.9% | 7.5% | 7.3% | 8.3% | 8.5% | 8.6% | 8.8% | 8.9% | 9.6% | 10.0% | 10.8% |
| Supermarkets | 9.3% | 9.1% | 8.7% | 8.8% | 9.4% | 8.9% | 9.1% | 8.6% | 9.0% | 9.2% | 9.0% | 9.8% | 9.7% |
| Auto Dealers & Parts | 6.9% | 6.5% | 5.8% | 5.2% | 5.4% | 6.1% | 6.1% | 6.5% | 6.8% | 7.0% | 7.7% | 8.3% | 8.9% |
| Specialty Apparel | 9.7% | 8.6% | 7.5% | 5.9% | 6.4% | 6.5% | 8.4% | 10.2% | 11.0% | 11.9% | 12.4% | 12.4% | 12.8% |
| Furniture, Home Furnish. & CE | 13.4% | 9.5% | 8.2% | 3.2% | 2.0% | 2.0% | 6.2% | 5.1% | 9.7% | 11.7% | 12.0% | 12.1% | 11.9% |
| Away From Home Dining | 10.7% | 9.6% | 8.1% | 8.9% | 8.1% | 8.9% | 9.6% | 9.5% | 9.5% | 9.9% | 10.2% | 10.3% | 10.4% |
| Miscellaneous Specialty | 9.3% | 7.4% | 7.4% | 6.8% | 6.3% | 7.1% | 7.7% | 7.6% | 7.8% | 7.5% | 7.3% | 6.9% | 7.0% |
| All Retailers | 9.5% | 8.7% | 7.9% | 7.6% | 7.5% | 7.8% | 8.2% | 8.6% | 9.0% | 9.3% | 9.4% | 9.8% | 10.1% |
| Mean Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
| Home Improvement | 19.5% | 19.3% | 19.2% | 18.3% | 17.4% | 16.7% | 16.3% | 16.7% | 17.8% | 17.9% | 18.3% | 18.4% | 18.4% |
| General Merchandise | 8.2% | 7.8% | 6.9% | 7.4% | 7.6% | 8.0% | 8.8% | 9.4% | 9.9% | 10.1% | 10.8% | 11.0% | 11.1% |
| Supermarkets | 9.0% | 8.8% | 9.1% | 9.2% | 9.5% | 9.6% | 9.4% | 9.3% | 9.4% | 9.6% | 9.5% | 9.9% | 9.9% |
| Auto Dealers & Parts | 6.4% | 5.6% | 5.4% | 5.5% | 6.1% | 6.7% | 6.9% | 7.1% | 7.5% | 7.8% | 8.0% | 8.2% | 8.5% |
| Specialty Apparel | 10.6% | 9.9% | 7.1% | 6.1% | 5.1% | 5.5% | 8.4% | 10.1% | 10.6% | 11.1% | 11.2% | 11.1% | 11.3% |
| Furniture, Home Furnish. & CE | 9.4% | 7.2% | 5.0% | 4.0% | 3.1% | 3.8% | 5.5% | 6.4% | 7.5% | 8.4% | 9.2% | 9.7% | 9.3% |
| Away From Home Dining | 10.4% | 9.6% | 8.7% | 8.8% | 8.9% | 9.5% | 9.8% | 9.9% | 10.1% | 10.1% | 10.6% | 10.7% | 10.5% |
| Miscellaneous Specialty | 8.7% | 8.1% | 7.1% | 6.5% | 6.3% | 6.4% | 7.3% | 7.7% | 7.6% | 7.5% | 7.8% | 7.5% | 7.3% |
| All Retailers | 9.5% | 8.8% | 7.7% | 7.4% | 7.3% | 7.7% | 8.6% | 9.3% | 9.6% | 9.8% | 10.1% | 10.2% | 10.2% |

Note: Color coded cells represent declines from the preceding quarter.
Financial statement data obtained for 200 U.S. retail chains with sales exceeding \$100 million.
Source: Standard & Poor's Compustat

APPENDIX

CAPITAL EXPENDITURES AS A PERCENTAGE OF SALES

U.S. Retail Sector Capital Expenditures to Sales



Source: S&P's Compustat

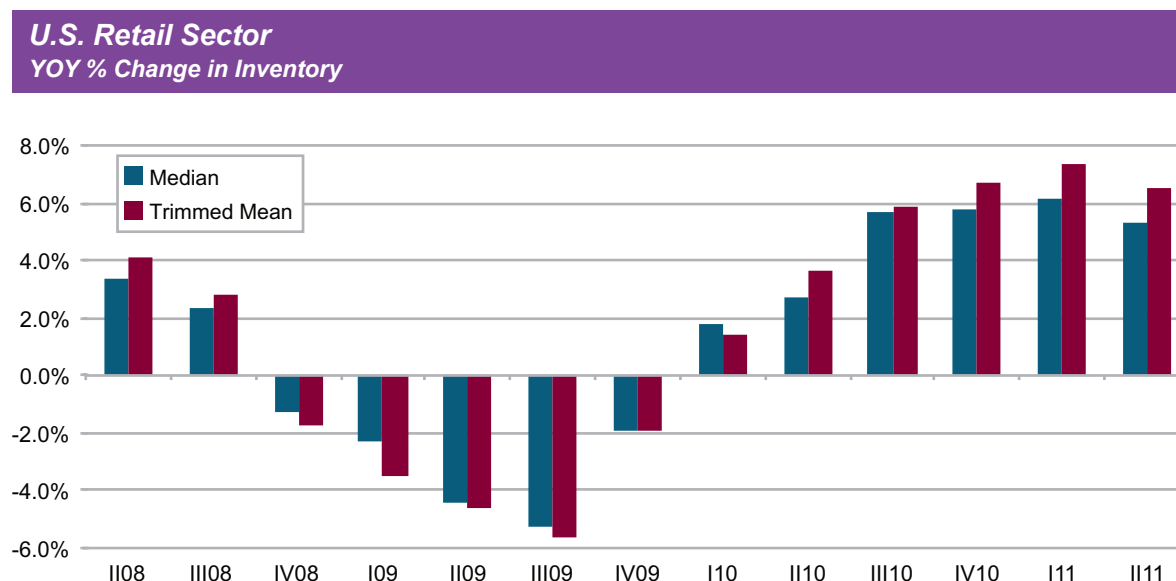
Capital Expenditures to Sales

| Median Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Home Improvement | 3.8% | 3.3% | 3.1% | 2.7% | 2.3% | 2.3% | 2.3% | 2.1% | 2.5% | 2.6% | 2.7% | 3.0% | 3.2% |
| General Merchandise | 3.3% | 3.0% | 2.7% | 2.5% | 2.1% | 2.0% | 1.7% | 1.9% | 1.9% | 2.1% | 2.3% | 2.6% | 2.5% |
| Supermarkets | 3.0% | 2.9% | 3.0% | 2.7% | 2.9% | 2.8% | 2.3% | 2.0% | 1.9% | 2.0% | 2.0% | 1.9% | 1.9% |
| Auto Dealers & Parts | 2.5% | 2.2% | 2.5% | 1.8% | 1.3% | 1.5% | 1.3% | 1.4% | 1.4% | 1.2% | 1.5% | 1.6% | 1.6% |
| Specialty Apparel | 5.5% | 4.8% | 4.4% | 3.8% | 3.2% | 2.7% | 2.4% | 2.4% | 2.6% | 2.8% | 2.9% | 3.0% | 3.1% |
| Furniture, Home Furnish. & CE | 2.3% | 2.6% | 2.1% | 2.3% | 2.3% | 1.9% | 1.8% | 1.6% | 1.5% | 1.5% | 1.8% | 1.9% | 2.1% |
| Away From Home Dining | 7.1% | 7.4% | 7.4% | 6.0% | 5.2% | 4.6% | 3.7% | 3.8% | 3.6% | 3.5% | 3.7% | 3.7% | 3.7% |
| Miscellaneous Specialty | 2.8% | 2.8% | 2.6% | 2.5% | 2.0% | 1.5% | 1.4% | 1.5% | 1.6% | 1.9% | 1.9% | 1.8% | 1.8% |
| All Retailers | 4.0% | 3.9% | 3.5% | 3.1% | 2.6% | 2.4% | 2.2% | 2.1% | 2.1% | 2.3% | 2.5% | 2.6% | 2.6% |
| Mean Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
| Home Improvement | 4.7% | 3.8% | 3.6% | 3.2% | 2.9% | 2.6% | 2.5% | 2.2% | 2.4% | 2.5% | 2.7% | 2.9% | 3.1% |
| General Merchandise | 3.2% | 2.9% | 2.8% | 2.6% | 2.4% | 2.2% | 2.1% | 2.0% | 2.1% | 2.2% | 2.3% | 2.4% | 2.6% |
| Supermarkets | 3.3% | 3.3% | 3.3% | 3.2% | 3.1% | 2.8% | 2.4% | 2.1% | 2.0% | 2.0% | 2.0% | 2.0% | 2.0% |
| Auto Dealers & Parts | 3.0% | 2.8% | 2.7% | 2.6% | 1.7% | 1.7% | 1.7% | 1.6% | 1.6% | 1.7% | 1.9% | 2.2% | 2.2% |
| Specialty Apparel | 5.4% | 4.9% | 4.5% | 4.1% | 3.5% | 3.0% | 2.7% | 2.6% | 2.7% | 2.9% | 3.1% | 3.2% | 3.3% |
| Furniture, Home Furnish. & CE | 2.8% | 2.8% | 2.7% | 2.4% | 2.1% | 1.7% | 1.5% | 1.4% | 1.4% | 1.5% | 1.7% | 1.7% | 1.9% |
| Away From Home Dining | 8.2% | 7.9% | 7.4% | 6.5% | 5.6% | 4.7% | 4.1% | 3.8% | 3.7% | 3.7% | 3.9% | 3.9% | 4.0% |
| Miscellaneous Specialty | 3.1% | 3.0% | 2.7% | 2.5% | 2.0% | 1.7% | 1.5% | 1.5% | 1.7% | 1.8% | 1.9% | 2.0% | 2.0% |
| All Retailers | 4.5% | 4.3% | 4.0% | 3.6% | 3.0% | 2.6% | 2.3% | 2.3% | 2.3% | 2.4% | 2.6% | 2.7% | 2.8% |

Note: Color coded cells represent declines from the preceding quarter.
Financial statement data obtained for 200 U.S. retail chains with sales exceeding \$100 million.
Source: Standard & Poor's Compustat

APPENDIX

YOY PERCENTAGE CHANGE IN INVENTORY



Source: S&P's Compustat

YOY % Change in Inventory

| Median Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|----------------------------------|-------------|-------------|--------------|--------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Home Improvement | -0.3% | 7.1% | 7.9% | 6.8% | 2.2% | 0.1% | -0.4% | 3.5% | 5.7% | 7.8% | 9.6% | 13.6% | 16.6% |
| General Merchandise | -3.0% | -2.7% | -2.0% | -0.9% | -3.9% | -4.2% | -1.0% | 0.4% | 3.4% | 6.2% | 6.3% | 6.2% | 6.8% |
| Supermarkets | 4.6% | 6.0% | 4.4% | 2.0% | 1.7% | -2.3% | -1.2% | 1.6% | 0.4% | 0.3% | 2.3% | 2.7% | 3.6% |
| Auto-Related | 5.4% | -1.3% | -11.6% | -18.6% | -18.8% | -12.5% | -0.4% | 2.6% | 8.9% | 10.2% | 13.9% | 15.2% | 12.2% |
| Specialty Apparel | -2.7% | -3.5% | -5.7% | -8.0% | -8.8% | -7.7% | -2.0% | 2.4% | 6.6% | 8.4% | 9.0% | 10.3% | 9.2% |
| Furniture, Home Furnishings & CE | 2.4% | 5.4% | 1.0% | -8.1% | -8.3% | -11.7% | -2.1% | -0.8% | 2.7% | 7.6% | 7.5% | 1.4% | 1.1% |
| Away From Home Dining | 11.6% | 9.2% | 4.7% | 2.0% | 2.0% | -1.7% | -3.6% | -0.5% | -0.9% | 4.1% | 2.6% | 4.1% | 1.9% |
| Miscellaneous Specialty Retail | 3.4% | 0.0% | -3.7% | -6.0% | -5.0% | -6.0% | -2.5% | 5.1% | 4.6% | 5.3% | 4.7% | 6.2% | 2.5% |
| Total | 3.3% | 2.4% | -1.3% | -2.3% | -4.4% | -5.3% | -1.9% | 1.8% | 2.7% | 5.7% | 5.8% | 6.2% | 5.3% |

| Mean Results: | II08 | III08 | IV08 | I09 | II09 | III09 | IV09 | I10 | II10 | III10 | IV10 | I11 | II11 |
|----------------------------------|-------------|-------------|--------------|--------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Home Improvement | 0.9% | 8.1% | 5.7% | 3.7% | -0.3% | -1.4% | 7.2% | 5.6% | 9.8% | 14.3% | 10.7% | 12.4% | 14.1% |
| General Merchandise | -1.4% | -1.5% | -2.5% | -1.3% | -2.7% | -3.7% | -0.9% | 0.7% | 4.0% | 6.9% | 8.0% | 7.9% | 7.4% |
| Supermarkets | 6.3% | 5.9% | 2.4% | 1.7% | 0.6% | -1.9% | -0.8% | 0.8% | 0.6% | 0.4% | 1.2% | 1.1% | 3.4% |
| Auto-Related | 5.1% | 4.1% | -9.7% | -16.3% | -18.3% | -15.3% | -3.0% | 4.5% | 10.0% | 18.1% | 14.1% | 15.8% | 13.5% |
| Specialty Apparel | -0.9% | -2.3% | -7.4% | -8.1% | -9.2% | -8.6% | -2.3% | 2.4% | 6.4% | 8.8% | 9.2% | 10.5% | 9.5% |
| Furniture, Home Furnishings & CE | 9.9% | 2.4% | -4.1% | -8.0% | -9.5% | -8.3% | -6.9% | 0.6% | 2.1% | 5.4% | 7.5% | 1.6% | -0.3% |
| Away From Home Dining | 10.3% | 9.7% | 5.1% | 3.9% | 0.8% | -3.5% | -1.7% | -1.8% | -2.3% | 1.3% | 3.0% | 4.9% | 5.1% |
| Miscellaneous Specialty Retail | 4.2% | 3.1% | 0.1% | -3.1% | -2.7% | -3.1% | -1.1% | 3.1% | 5.7% | 5.4% | 5.1% | 5.6% | 3.8% |
| Total | 4.1% | 2.8% | -1.7% | -3.5% | -4.6% | -5.6% | -1.9% | 1.4% | 3.6% | 5.8% | 6.7% | 7.4% | 6.5% |

Note: Color coded cells represent declines from the preceding quarter.
 Financial statement data obtained for 200 U.S. retail chains with sales exceeding \$100 million.
 Source: Standard & Poor's Compustat



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