

## Economic Trends

### **Business leaders bullish on Bay Area**

Local business executives believe the Bay Area economy will chug ahead at a brisk pace in the coming months, according to a recent survey. And the regional economy is strong enough that nearly five times as many company managers are gearing up to hire more employees in the next six months than those who are planning to reduce their staffing levels, the latest Bay Area Business Confidence Survey shows.

“It looks like we are rocking and rolling,” said Jim Wunderman, president of the Bay Area Council, which commissioned the survey. “The CEOs we surveyed are telling us they are very much bullish about the Bay Area economy.” About 37 percent of the executives surveyed said they intended to increase the size of their Bay Area workforce. Eight percent said they planned to reduce employees. “Things look pretty solid right now,” Wunderman said. And if the experience of Livermore-based Heritage Paper is any indication, business should continue to pick up. The company makes corrugated boxes, stretch film tape, and other materials that are needed for shipping items.

John Tatum, chief executive officer of Heritage Paper, said demand for shipping materials is a good leading indicator of the economy’s strength. “We have found that things have improved lately,” Tatum said. “For this time of year, things are pretty good. We think that things will be solid next year.” Heritage Paper has about 150 employees between its principal operations in Livermore and Lathrop. Even the battered technology sector seems to be doing better, which would be a welcome reversal of its misfortune in the dot-com implosion. “About 50 percent of the tech executives we surveyed say their industry is better, and about 75 percent say things will get better in the next six months,” Wunderman said. “The traffic between the East Bay and San Jose is increasing on a daily basis. Welcome back, Sunol Grade.

“If anything, our issues are that it’s hard to find good people,” paper executive Tatum said. “And our customers are having trouble finding qualified people for certain jobs.” “Hiring plans are pretty strong across sectors and throughout the region,” Wunderman said. “It’s not just one area being strong and another lagging. It is all pretty solid right now.”

### **California losing its innovative edge**

California is home to one-fourth of the nation’s billionaires, many of them software engineers who made it big in the tech boom. The state has the sixth-largest economy in the world – bigger than all other far Western states combined. And Californians have higher incomes than people nationwide. Yet California spends less on educating its students than two-third of the states, ranking 33rd in spending per pupil. Its classrooms are more crowded than those in all but two states. And, not surprisingly given these other statistics, academic achievement among California students ranks among the lowest in the 50 states based on standardized tests.

So why does the richest state and the technology capital of the world invest so much less in education? More important, what will be the consequences.” Nothing short of California fading as the technology leader of the world, business groups warn. “California has a window of opportunity to prepare the highly educated workforce we need to maintain our position as economic leaders,” said Bill Hauck, president of the California Business Roundtable. “If

California fails to provide this workforce in time, we are likely to lose the edge we now have over other states and international competitors.”

The problem has captured the attention of numerous business groups from the roundtable to TechNet to the Silicon Valley Leadership Group, which have made education reform and spending a top issue this year. They are lobbying for more money for education, particularly for math and science, and for reforms and more teacher training. In a year, California claims three Nobel Prizes in science – won by Bay Area professors at Stanford University and UC Berkeley – they worry whether this legacy will continue.

California’s slide compared with the nation is happening even as U.S. students fall behind peers in China, India, Korea, Japan and Europe in their mastery of math and other academic subjects. “Maintaining a culture of innovation in the United States will require a larger homegrown pool of energized and creative mathematicians and scientists,” warns the National Venture Capital Association which puts education on the very top of its 2006 innovation initiative. The AeA, formerly the American Electronics Association, has pushed Congress to hold hearings on the education achievement of U.S. students. Sixty industry executives and academic leaders sent a letter to California’s gubernatorial candidates, urging them to adopt the coalition’s agenda, which calls for the state to spend more on hiring math and science teachers for California’s K-12 schools and to help enroll more math and science students in California’s public universities.

California has revised its curriculum standards in recent years – adding more stringent requirements in math and laboratory sciences, and a more hands-on approach to learning science - and the federal government has upped its requirements through No Child Left Behind. But the requirements have not been matched with significant increases in funding. The American Competitiveness Initiative started by the Bush administration this year recognizes the need for more math and science education, but assigns only \$412 million to its education effort for all of the United States. Also, it expands the college loan program by about \$800 million per year.

In California, education organizations have long sought more state funding. This year, the state education budget increased, but it does not restore money cut early this decade when education funding dropped precipitously. Why does this matter? The most immediate consequence is a shortage of sufficiently trained workers. “Homegrown talent is becoming a scarce resource,” warns the Silicon Valley Leadership Group in a 2006 study. Noting “an alarming decline in the number of American students training to be scientists,” it says that “Silicon Valley and the state are at a crossroads in how we prepare our children and train our workers.”

Among California’s 18 to 24-year-olds, only 40 percent are enrolled in college, according to the National Report Card on Higher Education, and only 25 percent of that age group graduates from college. Those are the people expected to replace a good part of California’s current workforce as baby boomers begin to retire. But only 42.6 percent of today’s workforce consists of college graduates, according to Census Bureau statistics.

The California Business Roundtable and Campaign for College Opportunity see a severe shortage of knowledge workers hitting California in the next 16 years, as demand for college-educated workers grows 48 percent at the same time fewer Californians are graduating from college and more than 1 million baby boomers are expected to retire. Already technology companies have a hard time finding skilled workers. Job postings from such Bay Area tech companies as Intel Corp., Sybase Inc., Juniper Networks Inc. and Oracle Corp. show dozens of unfilled job openings for software engineers, computer scientists and the like. Companies are going to creative means to find them. Dublin-based Sybase identified and mentors college students studying computer

science, keeping them up to date on technologies Sybase uses while they are in school; so they will be ready for hire when they graduate.

Some companies find recruitment such a sensitive business competition topic that they refused to talk about it for publication.

### Auto Trends

#### **This year, Californians drawn to Japanese cars**

Californians will buy more Japanese cars and trucks than domestic models in 2006, something that has never happened before, despite the state's long-held reputation for loving Toyotas and Hondas. By the time the year ends, state residents will have bought 938,839 Japanese brand vehicles and 859,206 from the traditional Big Three nameplates, including Ford, Chevrolet and Dodge, according to a forecast by the state's auto dealers.

That would give Japanese automakers a 44.8 percent share of the California market, compared with 41.0 percent for the Big Three. Nationally, through November according to Automotive News, domestic brands have a 53.9 percent share of the U.S. market, while Japanese brands have a 34.8 percent share.

The state numbers come from a forecast prepared for the California Motor Car Dealers Association by Auto Outlook, a Pennsylvania researcher. It includes retail and fleet sales. The 2006 numbers, based on vehicle registrations, reflect a 2.7 percent gain from 2005 by Japanese brands, and a 9.2 percent loss by the Big Three. "It's not a big surprise. This is a very import-oriented marketplace," said Jesse Toprak, executive director for industry analysis with Edmunds.com in Santa Monica. But, from a marketing standpoint, it gives the domestics a harder challenge in the California market."

"It's no surprise in Santa Clara County, where Toyota is the dominant brand, and just five Japanese nameplates – Toyota, Scion, Lexus, Honda and Acura – garner 51.4 percent of sales. "In Toyota's case, it seems like we have what customers want," said Art Wicker, president of Piercey Toyota in San Jose. "We have hybrids. We just have the cars that are in demand."

For years, domestic makers such as Ford and General Motors retained their advantage in California because of their full lines of vehicles, the number of trucks they sold to businesses and their heavy fleet sales, said George Peterson, president of the AutoPacific consultancy in Tustin. This year Peterson said, "We finally found the tipping point." In 2003, when Micheline Maynard wrote "The End of Detroit: How The Big Three Lost Their Grip On The American Car Market," she predicted that the Big Three's share of the U.S. market would fall below 50 percent by 2010. Through the first 11 months of 2006, it's at 53.9 percent, down from 57.1 percent in the same period a year ago. "In the hearts and minds of many Americans consumers, Detroit's traditional Big Three auto companies have lost their grip on the car market," wrote Maynard in her book.

Despite having design studios in Southern California and regional offices in the state, the domestic automakers for too long considered California to be "way on the periphery," Peterson said. Today, they're trying to fight back with California-specific marketing programs, such as Ford Motor's effort to push its hybrid and lower-emission PZEV, a partial zero emission vehicle, but it remains a challenge. There remains a perception in California, Toprak said, that domestic vehicles have inferior quality to the Japanese, even though it's not true statistically.

**Toyota aims at truck country**

Toyota Motor Corp's latest assault on the U.S. automotive industry is considered its most important, and what a place for it: deep in the heart of Texas, where American pickups have crowded backroads and highways for decades. Japan's top automaker is set to begin building its revamped, full-size Tundra pickup at a 2.2 million-square-foot plant in San Antonio, a move aimed at grabbing a larger share of a lucrative market long dominated by Chevrolet's Silverado, Ford's F-150 and Dodge's Ram. On a broader sale, the \$850 million investment affirms Toyota's aggressive plans to expand its' business as the company poises itself to unseat General Motors Corp. as the world's No. 1 automaker.

Analysts say it also emphasizes the company's confidence to take on the industry leaders at any level of the business. Toyota already has distinguished itself in North America with its bread-and-butter Camry sedan, always one of the best-selling cars annually, and its luxury Lexus brand, which has topped J.D. Power and Associates' vehicle dependability study for the past dozen years. "This is one of the most important launches for Toyota in the U.S. market," said To Libby, J.D. Power's senior director of industry analysis. "It shows they're serious enough to attack the heart of the pickup market."

Analysts and others estimate that as many as one in five pickups sold in the United States is bought in Texas. But it won't be easy for Toyota to grab a bigger share of the truck business, only because demand for full-size pickups has been shrinking as drivers shift to more fuel-efficient rides. For the first 10 months of 2006, sales of full-size pickups were off 9.8 percent from a year ago, according to Autodata Corp., which tracks industry sales.

Another challenge for Toyota is persuading pickup owners to give up their domestic models for a nameplate that's been on the market since 1999 but has lagged GM, Ford and Dodge in size and power. Toyota hopes to change that with the redesigned Tundra, which offers a more powerful stance and a 5.7 liter V8 engine that will help it compete head on with Detroit automakers. Toyota spokesman Mike Goss said engineers who designed the truck visited farms and ranches across the country to see how people were using their pickups. "We feel like we've got a truck that can truly compete in a brand-loyal segment," Goss said.

Kevin Worfe, general manager of Universal Toyota in San Antonio, said he expects an additional level of interest from Texas truck drivers because the Tundra will be "born, bred and driven in Texas." The highly automated Texas plant has the capacity to build 200,000 Tundras a year. The trucks also are made at Toyota's Princeton, Indiana, plant.

A glance at U.S. pickup sales for 2006 shows the huge gap Toyota faces in the full-size pickup market. GM, with its Chevy and GMC brands, sold 935,469 full-size pickups last year, and Ford sold 911,737, according to Autodata. Daimler-Chrysler AG's Chrysler Group was in the middle of the pack with 400,543 sales, and Toyota and Nissan posted 126,529 and 86,945 sales, respectively. Nissan began selling its first full-size pickup, the Titan in 2003.

**2006 Auto Sales: As bad as expected**

Normally, the first few weeks of January are festive ones in Detroit. That's when the U.S. auto industry throws itself its biggest party of the year at the North American International Auto Show and debuts 2007 models. The 700,000-square-foot Cobo Convention Center is filled with shiny new cars from all over the world, well-fed dealers, back-slapping executives, excited enthusiasts, and dozens of pretty girls in skimpy clothes.

But this year, behind all the razzle-dazzle and forced smiles, Detroit doesn't have too much to celebrate. The reason is that on Jan. 3, General Motors, Ford and Chrysler all released their December 2006 sales figures, and they were just as grim as everyone had known they would be. That fact was made even harder to swallow as Toyota enjoyed another banner year and is now poised to pass longtime industry leader GM this year as the world's biggest automaker by sales.

How bad was it? GM, Ford and Chrysler declined by 8.7%, 8%, and 7%, respectively this year. Toyota was up 12.5%, and Honda increased sales by 3.2%, even while a few products like its Ridgeline pickup and Acura RL Sedan continued to disappoint. Nissan's sales declined, but the Japanese company's profits are so good, despite a sales drop, that it can weather a soft year.

### **GM: Top spot in jeopardy**

The sales results capped what could arguably be one of the worst years ever weathered by Detroit. On top of declining sales, GM had to fend off a forced marriage with Renault-Nissan; Ford brought on a new chief executive, announced two separate restructurings and mortgaged its plants and real estate to raise a survival cash fund, and Chrysler stumbled so badly that there are now rumors that German parent company DaimlerChrysler may be forced to sell all or part of it.

GM will likely give up its No. 1 status to Toyota in 2007 as the Japanese automaker has set a worldwide production goal of 9.34 million vehicles. That would exceed the 9.2 million vehicles that GM expects to sell. GM's production for this year isn't set, but its decreased production for North America is enough to offset any upticks around the world. And Toyota tends to sell everything it makes.

Ford finished 2006 with a 17.5% market share, down from 18.6% the year before. But that's nothing. Its share for Ford, Lincoln, and Mercury was down to 14.7% in December. And Ford executives say it expects its share to settle in at between 14% and 15% for the next two to three years. Ford, despite its financial travails, had some bright spots. The Ford Fusion, Mercury Milan, and Lincoln MKZ sold more than 200,000 units. That pales against the 417,000 efficient sales Toyota made last year with just one model, the popular Camry. But it helped Ford post a year-over-year gain in passenger-car sales for the first time since 1993, when its now-retired Taurus was the best selling car.

### **Chrysler cracks up**

Chrysler had a 1% sales gain in December "carried by 10 new product introductions in 2006. " Final sales results for the year showed a 7% decline. With 10 new products introduced, sales should have been up, not down, and certainly up more than an anemic 1% in December. Chrysler's sales performance was made worse by the fact that it actually posted tens of thousands of sales it never made – vehicles it produced, booked on sales, but sent to airport parking lots to sit until dealers ordered them. If Chrysler had a true bright spot, it's hard to see what it was, except that competitors still point to the company's minivans as the industry standard and consider the 300 sedan, finishing its third year on sale, as the benchmark for full-size car design.

The auto industry finished 2006 with 16.5 million light vehicles sold, down 2.5%. GM Executive Director of Market and Industry Analysis Paul Bellew says he is confident that the industry will do about the same in 2007, though, he says, the second half of the year will be better for sales than the first half. He says that both the housing decline that sapped sales in mid-2006 and higher fuel prices have bottomed out. He may be overly optimistic. Merrill Lynch, for example, sees

another 2% to 3% drop, to 16.2 million cars sold. The strongest companies will be those with new products in the small-car and crossover segments, as consumers increasingly ditch truck-based sport-utility vehicles. Last year, crossovers surpassed traditional SUVs for the first time. On the luxury front, Lexus was the leading brand last year, with 322,000 sales, up 6.5%. BMW was next with 314,000 (including Mini sales), up 2.2%. Mercedes-Benz posted sales of 248,000 up 10.6%.

### Holiday Retail Sales

#### **Holiday sales lagging, so far**

Christmas has passed and retailers are still hoping more gifts will land under their trees. Holiday shopping season was not as strong as analysts expected and will not match last year's 6.1 percent growth, early reports suggest. U.S. holiday retail sales rose a disappointing 3 percent from 2005 as a slowing housing market and higher energy costs cut into spending, according to a survey conducted by MasterCard. The gain is less than the increase in 2005 and the smallest growth since the survey started in 2003, MasterCard Advisors said in a statement. But, the season's not over yet. Post-Christmas shopping is becoming a more crucial part of the shopping season thanks to the growing use of gift cards. Instead of hitting stores for discounted gift wrap, consumers are looking for fresh goods on which to spend their gift cards. A survey by accounting firm Deloitte and Touche found that about 35 percent of shoppers planned to buy gifts from Tuesday until the end of the year. "There is quite a bit of shopping still to come: said Dale Lottig, the regional managing partner of Deloitte's Consumer Business practice. Merchants "are going to use all 31 days in December" and the month of January, said Marshal Cohen, chief analyst at NPD Group Inc., a market research company in Port Washington, N.Y.

Deloitte's survey also found that shoppers have been turned off by long lines, poor customer service and not finding specific merchandise in stock. "Retailers may be losing opportunities to turn shoppers into buyers." Lottig said.

Another analyst, Britt Beemer of America's Research Group, said retailers were lax in decorating their stores and creating a warm shopping environment. "If it weren't for the mall decorations, you wouldn't know it was Christmas," Beemer said. "It's just atrocious the way retailers have downplayed Christmas." Retailers also failed to offer shoppers significant discounts to entice them to spend before the holiday. "Last year, retailers did give 50 percent off that last week," Beemer said. "I think this year they felt consumers were going to spend the money anyway, and the consumer said, "Wrong answer."

The season got off to a good start the day after Thanksgiving, but then tapered off during December. Industry experts and retailers expected a last-minute rush this past weekend would serve a home-run ending for the season. "These were big days but they came up short in terms of traffic and sales," Bill Martin, co-founder of ShopperTrak RCT Corp., a research firm, referring to the Friday and Saturday before Christmas. ShopperTrak monitors total retail sales at more than 45,000 outlets.

Based on data released late Dec.24th by ShopperTrak, sales for both the 23rd and the 24th generated a combined \$16.2 billion, with the 23rd business generating \$8.72 billion. But Martin expected the 23<sup>rd</sup>'s sales volume to surpass Black Friday's sales, which posted \$8.96 billion. Average weekly sales for December compared with 2005 are up 4.3 percent, short of ShopperTrak's 5 percent holiday sales forecast.

“We still have the week after Christmas,” said Martin. “We are going to need a lot of gift card redemptions.” Gift cards are recorded on a retailer’s balance sheet only when the cards are redeemed. The question will be whether shoppers will purchase goods they want. “Consumers don’t look at those gift cards as free money anymore” Beemer said. “They look at them as their money and they are more cautious about how they spend it.”

### **Holidays boost Web sales growth**

ComScore Networks Inc. boosted its online holiday spending growth forecast to 25 percent as many internet shoppers took advantage of shipping guarantees to catch up on Christmas shopping last weekend. Online sales for the 48 days through Dec. 18 increased 25 percent to \$20.7 billion, the Reston, VA. based research company said in a recent statement. The firm boosted its overall holiday spending forecast by \$300 million to \$24.6 billion. ComScore modified its previous estimate of 24 percent growth for November and December as more retailers guaranteed that items would be shipped in time for Christmas. Purchases for Dec. 16-17 increased 34 percent from the corresponding weekend a year earlier, ComScore said.

“Every year, we see the season get pushed out a little more because shoppers are making guarantees,” said Heather Dougherty, senior commerce analyst with New York-based research firm Nielsen/NetRatings. Online spending has climbed while overall U.S. retail sales have trailed some forecasts because consumers delayed their shopping until closer to the holiday. Retail sales for the week through December 16 rose 3.2 percent, trailing a forecast of 5 percent for November and December. Chicago-based ShopperTrak RCT Corp. said foot traffic fell 6.1 percent from a year earlier, ShopperTrak said.

Guarantees that products purchased as late as Dec. 18 would be delivered in time for Christmas helped to push online sales higher, said ComScore Chairman Gian Fulgoni. Online shoppers spent \$52.5 million that day, 28 percent more than the corresponding year earlier. Sales at stores open at least a year rose 2.4 percent in the week through December 16 from a year earlier, New York-based trade group International Council of Shopping Centers and UBS Securities LLC said December 19. This was the slowest pace in a month as consumers put off their holiday shopping and mild weather limited sales of hats and coats.

Retailers’ Web traffic is growing faster than online-only stores. While eBay Inc., the world’s largest online auctioneer and Amazon.com Inc., the world’s largest Internet retailer received the most visits last week, their gains were 12 percent and 2 percent, respectively, according to Nielsen/NetRatings. Wal-Mart Stores Inc. and Target Corp., the two largest U.S. discount chains, each had more than a 20 percent increase in customer traffic, Nielsen/NetRatings said.

### **Amazon calls ’06 holidays ‘best ever’**

Amazon.com Inc.’s 2006 holiday season peaked with more than 4 million orders placed on Dec. 11, the Web retailer said. In its 12<sup>th</sup> holiday season, Amazon.com said it again had its ‘best ever’ sales and that it shipped more than 99 percent of orders in time to meet holiday deadlines around the globe. As many as 3.4 million units went out in a single day. The company said it sold 1,000 Xbox 360 game consoles in 29 seconds as part of a promotion that slashed two-thirds off the regular retail price.

Demand for the Microsoft Corp. machines was so high that Amazon.com’s site bogged down briefly on Thanksgiving Day, generating bitter complaints from shoppers and forcing the retailer

to change procedures for subsequent promotions. Amazon.com also said customers ordered enough orange-flavored Airborne cold-fighting supplements to supply every passenger on 192 Boeing 747 planes.

Apple Computer Inc.'s iPods, Canon Inc.'s Powershot Digital Elph cameras and Garmin Ltd.'s navigational devices using Global Positioning System technology were among the best-selling consumer electronics items.

### Retail Sales November

#### **Big retailers report mixed results**

Wal-Mart Stores Inc. issued a sobering warning for the holiday shopping season, predicting its December same-store sales gain would be no better than 1 percent. The news, coupled with Wal-Mart's expected announcement that it suffered its first same-store decline in more than 10 years during November, came as the nation's retailers reported an overall mixed sales performance for the month. Same-store sales reflect business at stores open at least a year and are the industry standard for measuring a retailer's strength.

Wal-Mart's disappointment was a sharp contrast with results from Target Corp., which beat Wall Street forecasts, and Federated Department Stores Inc., which far exceeded expectations. Other retailers had mixed sales. J.C. Penney Co. and Costco Wholesale Corp. both fell short of Wall Street projections. Industry analysts generally believe that Wal-Mart's problems weren't a sign that other retailers would have a disappointing holiday season. But a Labor Department report showed a jump in claims for jobless benefits did add some uncertainty to the outlook for holiday sales.

The timing of Wal-Mart's news couldn't have been worse for the world's largest retailer, coming just after most consumers started holiday shopping. While many retailers had a strong Thanksgiving weekend, Wal-Mart had warned that its November sales would be weaker than expected. Wal-Mart reported a 0.1 percent dip in same-store sales for November. That's in line with the reduced forecast from analysts surveyed by Thomson Financial, which forecast unchanged growth. Including a drop in gasoline revenues from its Sam's Club division, which Wal-Mart did not include in its calculation, same store-sales fell 0.3 percent.

Wal-Mart has struggled in recent months on a mix of problems, including the fact that its lower-income customers were hurt by soaring gas prices. But the company's lackluster sales have persisted even as the cost of gas eased an indication that there are other factors that are dragging down Wal-Mart's results. "This is pretty discouraging," said Ken Perkins, president of RetailMetrics LLC, a research company in Swampscott, Mass. But he added that Wal-Mart's weak sales "will not be a harbinger of a broad based weakness across the retail sector." Wal-Mart's discount stores suffered a 0.5 percent decline; while Sam's Clubs had a 2 percent increase.

One of Wal-Mart's main problems is that its strategy to broaden its appeal to higher-income shoppers with upscale merchandise was poorly executed. It filled its fall clothing racks with too many trendy items like skinny jeans that shoppers just didn't want. The company said in October that it was cutting back on distribution of the clothing line Metro7, but the move was too late for the holiday season. Despite Wal-Mart's problems, many other retailers do have hopes for a strong season. Sales during the Thanksgiving week-end rose a respectable 2.8 percent, according to the research firm ShopperTrak RCT Corp.

The International Council of Shopping Centers-UBS tally of November same-store rose 2.1 percent, less than the forecast for a 3 percent gain. Excluding Wal-Mart, the tally rose 4.0 percent. Still, there are concerns about how confident consumers are going into the season. The latest measure of confidence by the Conference Board fell during November, and reports of job cuts and buyouts at companies including Pfizer Inc. and Ford Motor Co. could make consumers even more uneasy. October figures on consumer income and spending showed that consumers had reason to be upbeat, at least during that month. The Commerce Department said incomes rose a healthy 0.4 percent, while spending rose 0.2 percent after a decline in September. The data was encouraging but does not guarantee that consumers shopping for the holidays will feel like spending freely – something that was clear the day after Thanksgiving, when shoppers focused on getting the best bargain, gravitating toward early bird specials and then leaving stores when the deals disappeared.

“This tells me that the customer is very savvy about shopping for markdowns,” said John Morris, a managing director at Wachovia Securities “It takes promotions to stimulate demand in this early part of the season.”

### Retail Trends

#### **Mervyns opening stores again**

Middle-aged discount department chain Mervyns, founded in 1949, is unveiling a modern look at its first new stores to open since the struggling retailer was sold to private owners two years ago. Four locations – including one in San Jose on North Capitol Avenue – held their grand opening Thursday. The new stores have wider aisles, brighter lighting and a bigger selection of clothing than before said Vanessa Castagna, executive chairwoman of the Hayward-based chain’s board of directors. “We are just settling in to becoming more important again, to turn this company around,” said Castagna, who joined Mervyns from J.C. Penny.

Mervyns became Target’s crown jewel in 1978, the year Target bought the California chain for \$300 million. Soon afterward, Mervyns encountered trouble after finding that offering bargains alone wasn’t a strong enough draw to set it apart in the competitive retail industry. Conventional department-store rivals also have perpetual markdowns, and no-frills discounters steadily attracted shoppers. Even the flashy and successful Target discount chain, Mervyn’s parent at the time, lured some of Mervyn’s customers away. After being sold to private investors in 2004, Mervyn’s new owners closed 62 struggling locations – one-quarter of all its stores – and laid off 4,800 workers in an effort to focus on its stronger stores in California and elsewhere in the West.

Soon after the sale, the new owners revised Mervyn’s merchandise lineup, axing low-volume “dollar store” departments and using the space to display children’s apparel. The new stores opened recently are the first the chain has opened since adding a store in Las Vegas in 2003. “They have certainly changed significantly,” said retail analyst George Whalin of Retail Management Consultants in San Marcos, who said the stores are less cluttered. “They cleaned them up, brought in more products and a better selection of products. They are doing a lot of the right things.”

Mervyn’s new stores have 9-foot-wide aisles, up to 50 percent wider than at older stores, and have central checkout lanes near the front entrances. Not all of the rest of Mervyn’s stores will get those same renovations, but they all have been stocked during the past year with a wider selection of merchandise than before, including men’s suit jackets and matching dress slacks and

teen brands South Pole and Seven Jeans. The new San Jose store expanded the shoe department by 45 percent, adding such popular items as Heelys roller shoes.

The chain now has 189 stores in 10 states, including 125 in California and 22 in the Bay Area. At the time of the sale by Target, Mervyns had 257 stores in 13 states. More store openings are planned for next year, said Castagna, who added that the trimmed-down chain has been profitable since 2005. Mervyn's lost money for each of the past three years under Target's ownership, and some industry observers said the chain foundered because rapidly growing Target invested too little money and attention in the Mervyns chain. Founded in 1949 by Delano native Mervin Morris in San Lorenzo, Mervyns excelled at selling brand-name clothing at discount prices.

The stores frequently passed up enclosed shopping malls for spots in freestanding, less-expensive sites, a strategy that enabled Mervyns to price its merchandise for less, said William Cody, a lecturer in the marketing department at the Wharton School of Business at the University of Pennsylvania. Then, in the 1980s, the chain went on an expansion binge in Texas, an effort that backfired after oil prices plummeted and consumers in the region cut their spending.

Other discounters, including Target, gained steam in the apparel segment, and department stores also sliced their prices to compete. Apparel-focused Mervyns had few signature clothing lines to reel shoppers in. All those developments blunted Mervyns' edge, leading to three years of losses and setting the state for Mervyns' sale to a private consortium including Sun Capital Partners of Boca Raton, Fla., in 2004.

### **Full shelves a shopper's delight**

Stores looking to attract shoppers can forget about the newspaper inserts and all those coupons and e-mail solicitations. The best way to win them over is by having a well-stocked store and a simple return policy, according to a recent survey conducted by KPMG LLP. The survey, which polled 1,200 shoppers from Dec. 11 to 21, found that 81 percent of consumers said they shopped at the store that had their desired item in stock, and 75 percent said a simple return policy helped them decide which retailers to patronize. "The hustle and bustle of the holiday season wears thin on shoppers, who tell us that those retailers that provide immediate gratification get wallet share in this extremely competitive retail market," said John Rittenhouse, KPMG's national service leader for operations risk management. "Meanwhile, in case a finicky relative doesn't like their gift, consumers say they want retailers to have an easy gift-return policy."

Price, shoppers said, was secondary, cited by just 19 percent of respondents as influential in picking a retailer, KPMG found. By contrast, respondents to last year's poll said price, selection and convenience were most important. The study found that about 39 percent of consumers this holiday shopping season reported shifting to retailers based on which one best met their needs, underscoring the importance of having the right amount of desired merchandise in stock at the right time.

The study also found that low prices were considered most critical when purchasing electronics. And 64 percent of respondents said they would prefer to shop at a strip mall or free-standing store, because they were less crowded, contained more stores and restaurants, better parking and were easier to get in and out of compared with enclosed malls. "Shoppers want their experience to be easy," said Rittenhouse.

**Unused gift cards are boon for stores**

Shoppers across America have millions of gift cards tucked away in envelopes, drawers and wallets. And some of the nation's largest retailers are profiting as a result. "It can be fun to get them, but then I forget about them," said Deborah Cabaret, 46, who has hundreds of dollars' worth of unused cards. "Or I walk into the store, I look around, I don't know what I want, and I leave."

Last winter, Best Buy Co. reported a \$43 million gain in fiscal 2006 from cards that hadn't been used in two or more years. Limited Brands Inc. recorded \$30 million in 2005 revenue because of unredeemed cards. Even so, this holiday season is likely to see record sales of gift cards. The National Retail Federation, a trade group, estimates that shoppers will buy \$24.8 billion worth of cards, up 34 percent from last year. More places offer gift cards these days, including drugstores, jewelers, spas and even supermarkets. Shoppers are buying cards with higher dollar values, and more stores are packaging the cards with accessories to make them less like plastic money.

About 6 percent, or \$4.8 billion, of this year's gift cards will go unused, estimated Laura Lane, vice president of unclaimed property services for Keane Co., a compliance and risk management consulting firm. Consumer Reports put the figure even higher, estimating that 19 percent of those who received cards last year had not used them because the cards were lost or expired.

"It can add up to significant dollars," Lane said. "I think the message to consumers is: use it or regift it." Some gift cards get spent faster than others. Supermarkets and gas stations have close to 100 percent redemption rates, said Bob Skiba, who runs the gift card division of Ceridian Corp.'s Comdata gift card division, based in Louisville, Ky. "You don't have to buy a sweater every day, but you do have to eat and fill up your car," Skiba said. Retailers say they would rather see customers use the cards. "They have money in their pockets that's pointed to our store," said John Fleming, Wal-Mart Stores Inc.'s marketing chief and a former Target Corp. executive.

In addition, a retailer can't report revenue from a gift card when it is sold. The revenue is recognized as the card is used or after it has gone a long time without being used. Research shows that most consumers will spend more than the card is worth, using their own money to make up the difference.

**Manufacturing****Manufacturing activity falls to lowest level since June 2003**

Manufacturing expanded at the slowest pace in more than three years, and construction spending declined as housing continued to suffer through its longest stretch of weakness since 1995. Two reports released recently depicted an economy beginning to feel the impact of the sharp slump in the once-booming housing sector.

The Institute for Supply Management said its gauge of manufacturing activity fell to 51.2 in October. That compares with 52.9 in September and is the lowest since June 2003. October's decline reflected weakness at companies that supply the beleaguered auto and housing industries. The Commerce Department said that spending on construction projects dropped by 0.3 percent to a seasonally adjusted annual rate of \$1.196 trillion in September. Housing activity fell for a sixth straight month, the longest stretch of declines since 1995.

“It now seems clear that the U.S. factory sector is straining under the weight of declining auto production and a deteriorating housing market,” said Bart Melek, an economist at BMO Capital Markets. Analysts said that manufacturing, which had strong growth in recent years after the 2001 recession, probably would slow sharply in the coming months, reflecting the overall sluggish economy. “The manufacturing malaise is gathering steam, and the troubles in the vehicle sector point to further problems ahead,” said Joel Naroff, chief economist at Naroff Economic Advisors. But there was some good news for automakers on Wednesday with General Motors, Ford and Toyota reporting increased sales in October compared with a year earlier. The gains were led by trucks and sport utility vehicles where falling gasoline prices revived demand.

### [UCLA Anderson School Economic Forecast](#)

#### **Recession not inevitable, report says**

Despite the woozy housing market, California should be able to avoid a recession thanks to a diverse economy that is showing strength in other sectors, according to a recent report. The housing sector has staggered. Sales have taken a dive. Prices have flattened. Yet though homeowners might have to endure further beatings, the latest UCLA Anderson Forecast offers hope that the residential realty market’s woes can be counteracted by other industries.

“Will there be savior sectors?” said Ryan Ratcliff, an economist with the Anderson Forecast. “The two that are most likely are professional and business services, and leisure and hospitality.” During the past year, California’s two largest private-sector job producers were professional and business services, leisure and hospitality, and education and health services. Together, these three industries accounted for 112,000 new jobs the state added in the 12 months that ended in October. Reflecting the fading housing market, California lost 4,000 construction jobs during the year.

The East Bay had some similarities in its job growth during the past year, with a big exception: construction still added the most jobs, with education and health services, and professional and business services rounding out the top three. Ratcliff, however warned that even the “savior sectors” could have some problems. He warned that a stubborn slowdown in the technology industry could hold back continued growth in professional and business services. “High-tech, high-knowledge jobs are showing slower growth in 2006 than they did in 2005,” Ratcliff said.

Leisure and hospitality could be a question mark because, he said, much of the growth of that category has been focused in the restaurant industry, particularly in fast-food restaurants. Other obstacles could materialize. Ratcliff said the slowdown in housing could chill consumer appetites for spending money. Studies have shown that homeowners often tap the equity in their homes to bolster consumer spending. State budget problem could provide other uncertainties.

Bottom line from UCLA: A significant slowdown looms for the California economy. But the various trends are unlikely to coalesce into a full-scale recession for the Golden State, which saw its most recent economic downturn in 2001 along with the rest of the nation. Other economists see a slow-down. But most do not believe the slump will be nearly as bad as UCLA Anderson envisions. “We don’t see a recession in our forecast period, through 2008, anyway,” said Howard Roth, chief economist with the state’s Department of Finance.

Sean Snaith, a consultant for the University of the Pacific’s Business Forecasting Center, said he does not believe the slowdown will be that severe in part because he never believed the housing market would evaporate in a bubble style. “We have always been the anti-bubble, pro-soufflé

proponents all along,” Snaith said. And he said he still believes the East Bay job market will continue to outperform California as it has done so during the past couple of years. “The East Bay will fare better than most places in the state,” Snaith said. “We’re looking for the East Bay to have employment growth in excess of the rate the state will add jobs.”

Snaith’s current forecast calls for California to expand its job base by about 1.4 percent a year in 2007. “The East Bay will be right there, maybe slightly higher,” Snaith said. One reason why analysts say the East Bay could have staying power is that it did not recover quite as quickly after the recent recession as the rest of California. Plus, the region’s economy is more diversified. “The East Bay came late to the party, so it hasn’t gotten tired and doesn’t want to go home yet,” Roth said.

Dan Hamilton, Director of Economics at the UC Santa Barbara Economic Forecast Project, identified several industries that could prop up the housing market. And he said he believes that California will have solid growth in the 3 percent range that should keep the state well out of the recession danger zone. “Commercial real estate, in contrast with residential, is very strong,” Hamilton said. “The entire financial sector, banking and insurance, are all doing fine. The California economy is doing just fine.”

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