
Morgan Business Address

The Next Business Cycle

A View from the Premium End

Consumer behaviourist Ross Honeywill takes a hard look at the prevailing economic conditions in Australia, using the lens of consumer economics to set the business compass for the future

September 2005

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A View from the Premium End

The current business cycle has taken a serious downturn...

- Consumer confidence has taken a hit
- Manufacturing is slowing
- Retail sales have slowed
- Economic growth has slowed

So...What are the big questions for business in Australia?

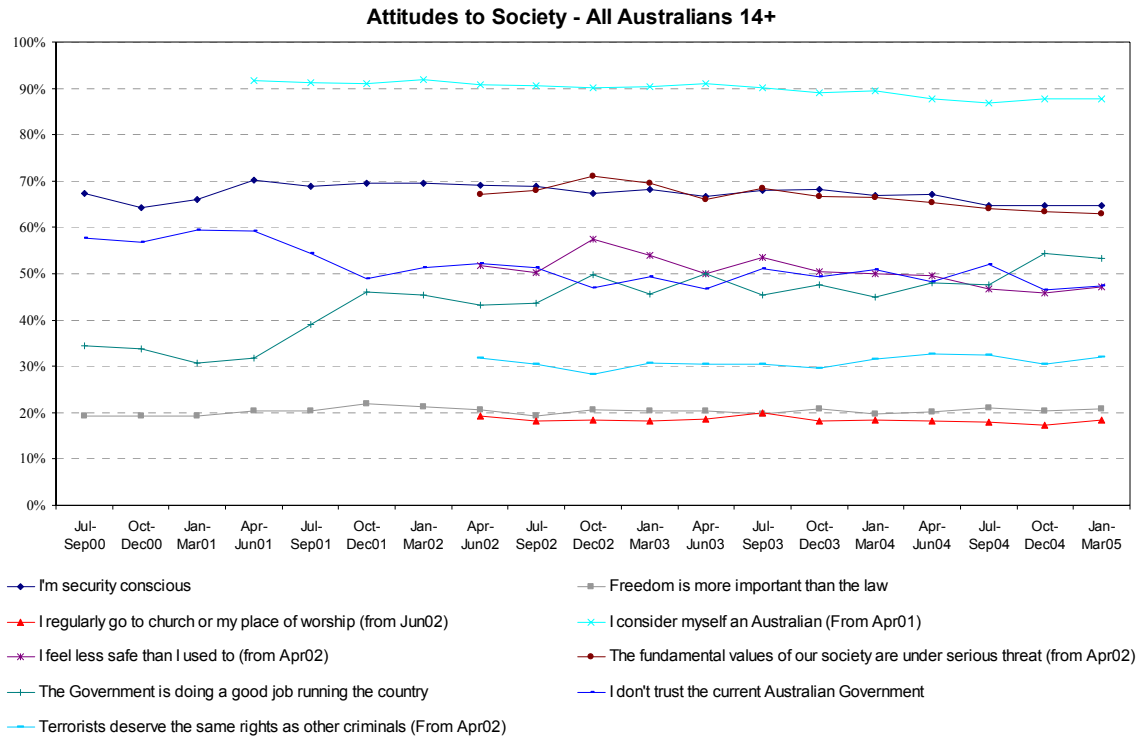
- Are there serious downward trends?
- Are we in some kind of business or economic bubble? And is it about to burst?
- Or has the business downturn already bottomed out?
- And...what are the big societal shifts that will impact the downturn or recovery?

Let's start this analysis by taking a look at some of the over-arching influences on our business cycle here in Australia in an attempt to answer the question those questions.

One potential influence on our business cycle is globalisation...and the future of a globalised world is looking significantly less certain than it did at the turn of the millennium. The shift to economic unions and the dream of a shared prosperity were wounded this year when EU members voted against issues that threatened their sovereignty, the Soviet Union reorganised into nation states and nationalism became increasingly entrenched around the world.

Canadian philosopher and historian, John Ralston Saul said during a recent visit to Australia, *'Globalisation is dead. Since 1995, we've seen a very serious return of nationalism. Of the nation state. In the Soviet Union, you have the creation of about 25 new nation states, and they are extremely eager to embrace their full existence as nation states in the 19th Century sense'*.

But is this shift to an entrenched nationalism happening in Australia? Or are the stable economic conditions of the past five years moderating political activism, religious revivalism and nationalistic fervour?



Source: Roy Morgan Research

The answer is simple – Australians are not about to mount the barricades.

We are more relaxed and less security conscious now than we were both before and immediately after 'September 11'.

- There appears to have been no increase in nationalism since June 2000.
- The fundamentalist religious fervour reported by the Australian media and the re-mergence of God in US politics do not appear to have gained traction beyond small pockets within Australia. Interest in religion is at historical lows with the general population slightly decreasing its attendance at places of worship since the turn of the millennium.
- Australians appear very happy that the current government is doing a good job running the country with a significant lift in support from 34.5% in 2000 to 54% in 2005.
- Addressing terrorism head-on, 32% of Australians believe terrorists deserve the same rights as other criminals. However that level has not changed even as terrorism swept the world over the past five years.

It would appear therefore that the benefits of economic certainty over those five years have immunised Australians from social activism or nationalism. Comfort is however different from apathy in that comfort can morph into discomfort very quickly. But it appears that Australians generally are comfortable with their lot and that comfort has quarantined Australia from the tectonic shifts occurring in Europe and the former Soviet Union.

But are Australian consumers so socially and politically comfortable that they have been de-sensitised to economic influences? To examine that question we need to look at indicators from both Australia and around the world to explore where we are in the business cycle and what the prognosis is for Australian business.

First, let's fast forward and take a look at where we really are in the current business cycle:

- Consumer confidence is high in those who spend the most
- The property landing has been soft and is in recovery in vital areas
- The sharemarket is booming and does not look like a bubble at all let alone a bubble about to burst
- Discretionary choice retailers like David Jones are reporting record profits
- The national output is continuing to rise, albeit at a slower pace
- Unemployment is continuing to fall

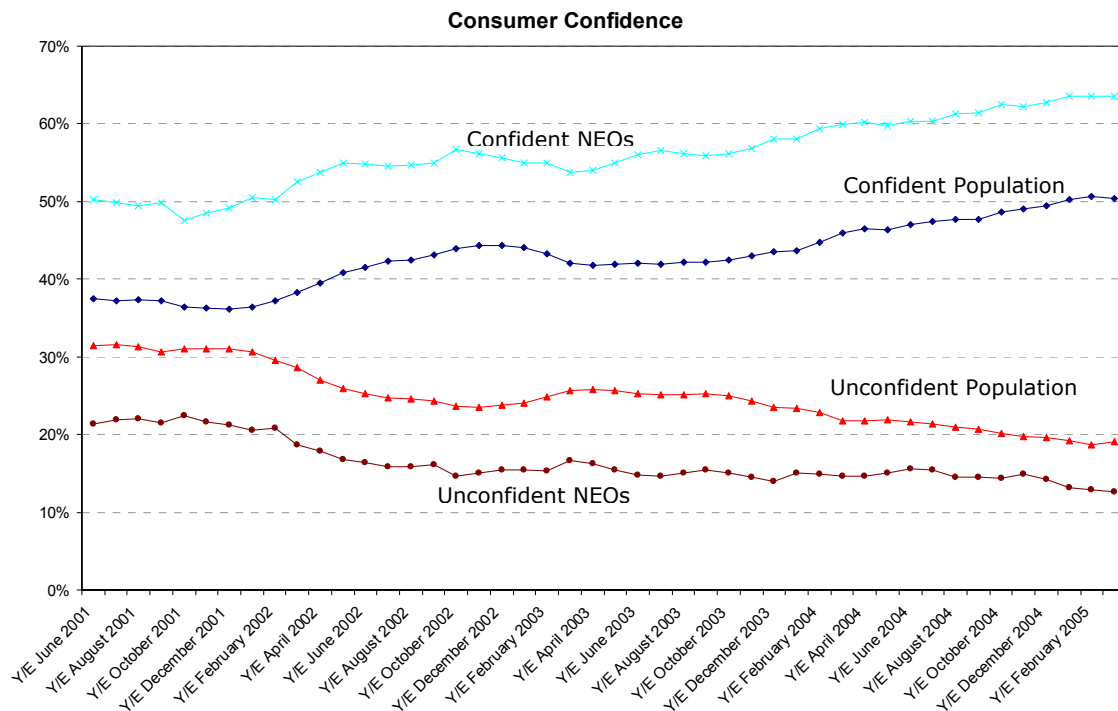
But before we explore the consumer economics that underpin our assessment, I need to let you into a secret. There are two Australias. The first is an Australia that political, media and business leaders characterise as Joe Average with average earning capacity, average spending behaviour and average attitudes and values. There is of course no such animal, but it is a necessary construct for economists to map and measure where the country has come from and where it is going. I have already shown you the attitudes of that average Australian and will continue to examine his or her behaviour.

The secret is however that the population breaks into significant subsets. I also intend to show you the most economically significant of those subsets...a group we identified over the past five years known as the *new economic order*. This group is behaving quite differently to the average Australian.

In examining this new economic order – or NEO – group we should see if the future of the business cycle is dependant on Joe Average

or on the NEOs who appear to be changing the rules of engagement for anyone dealing with consumers.

Let's look first at consumer confidence since June 2001:

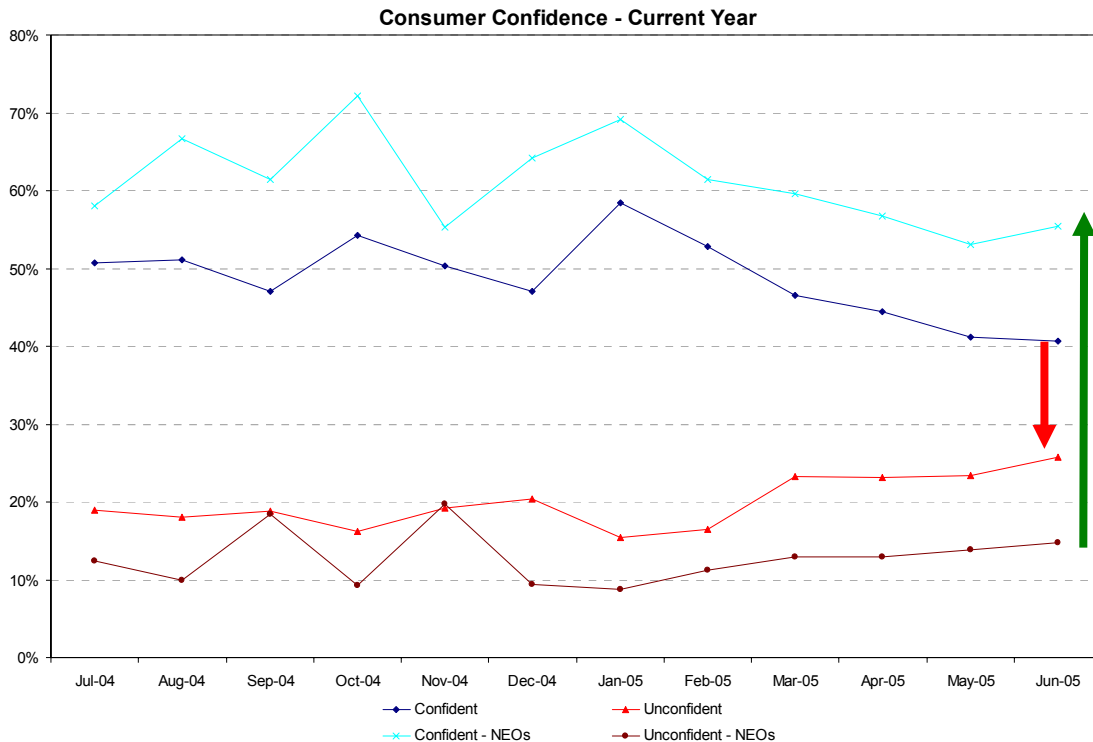


Source: Roy Morgan Research

The two key observations from this graph are that even in the general population, consumer confidence in Australia has steadily risen since before the terrorist attack on New York City and Washington DC. And seems largely unaffected by that act of terrorism. The second is that the gap between Confident NEOs and Unconfident NEOs is far greater than for the general population with NEOs who number 4 million in Australia (24% of the adult population) more confident than anyone else.

Consumer confidence and behaviour accounts for as much as two-thirds of the economist's diagnosis of prevailing conditions.

And given that the chart (above) of *moving average totals* ends in February this year, anyone involved with business will know it's really since Christmas that the business cycle appears to have turned. The pattern of consumer confidence since Christmas is indeed quite different – it provides the first real insight into the future of the business cycle:



Source: Roy Morgan Research

Everyone's confidence has dipped since Christmas last year – particularly the general population or the economists' Joe Average. And alarmingly the gap between the confident and unconfident in the population has shrunk from more than 30% in June last year to less than 15% in June this year.

When we look at NEOs, who account for 54% of all discretionary spending in the economy however, we see a significant recovery in May/June this year to a point only 2.6% lower than June last year. And the gap between Confident and Unconfident for NEOs is more than 40% compared to the 15% gap for the general population.

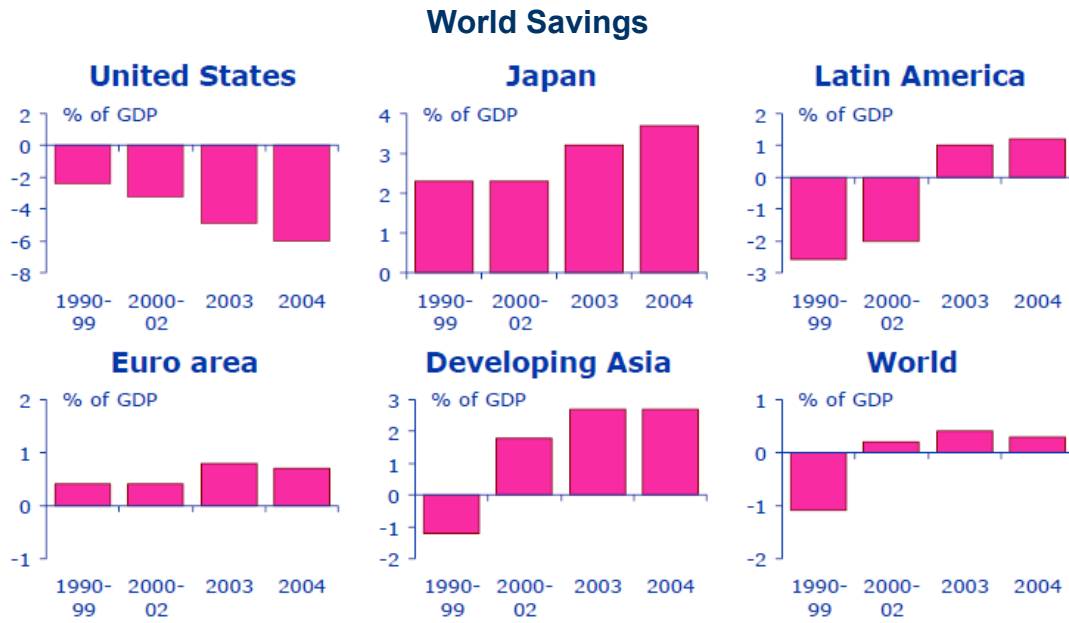
If this trend continues, it is good news for retailers operating at the discretionary end of the market, and for banks and telcos with what are known as premium platforms (a higher level of service quality for a higher price to consumers).

We are undoubtedly in a business downturn, but for managers targeting the new economic order, the downturn has, at worst, bottomed and, at best, already commenced a gradual recovery that may well span the next 12 months.

Conversely it looks like bad news for businesses with a value proposition based on commodities, a deal or a discount. They may not yet have bottomed and their recovery looks like taking longer.

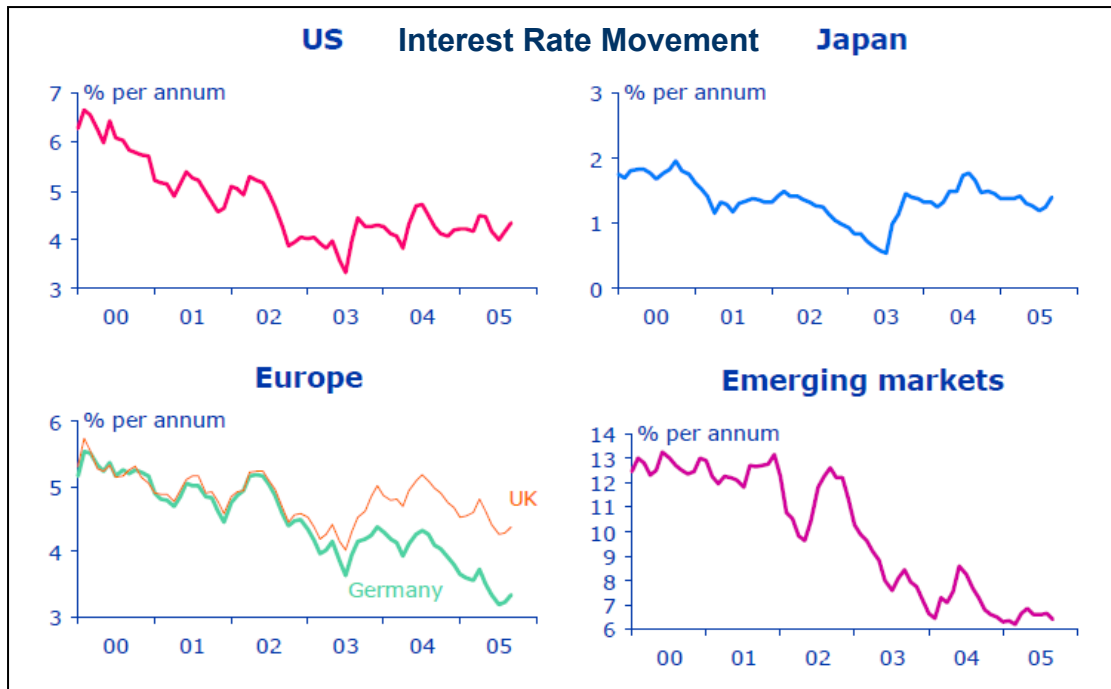
Economic statistics and indicators from around the world also point to, not only a soft landing, but to a positive view of the future of the business cycle in Australia.

Levels of credit and savings are seen by economists as indicators of the health of an economy and while the US is borrowing more, savings are lifting everywhere else around the world.



Source: BIS; ANZ Economics

And the positive news for our economy is that this global savings 'glut' is putting downward pressure on interest rates. Many believe the next move of interest rates in Australia may well be down rather than up. If this proves to be true, it will hasten the recovery for the vulnerable commodity end of the market so sensitised to bad economic perceptions.

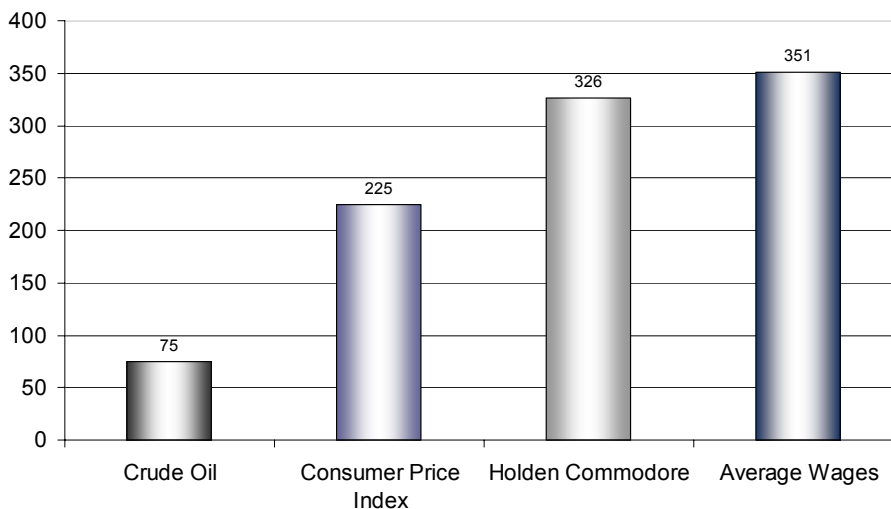


Source: Datastream; Lehman Brothers

Much has been written about the impact of higher petrol prices on the economy and on consumer confidence. We have already seen that it has not impacted negatively on the robust NEOs, but the evidence is strong that it is affecting more traditional consumers.

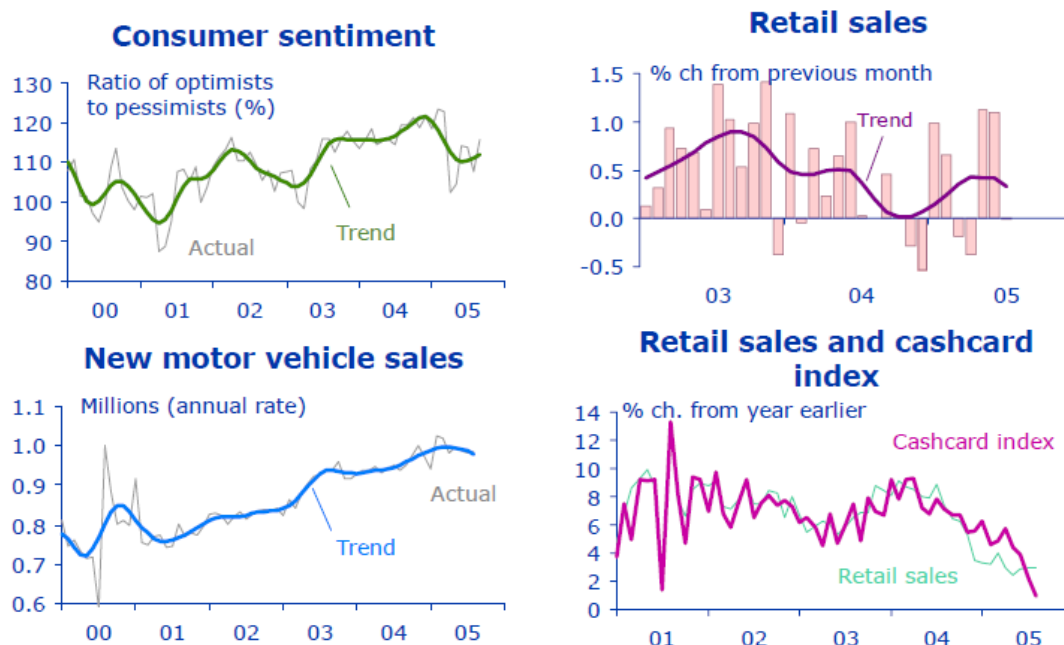
Economically savvy NEOs appear to grasp that the increase in oil (petrol) costs has not kept pace with other price increases, and that high petrol costs are here to stay.

% Change Between 1980 & 2005



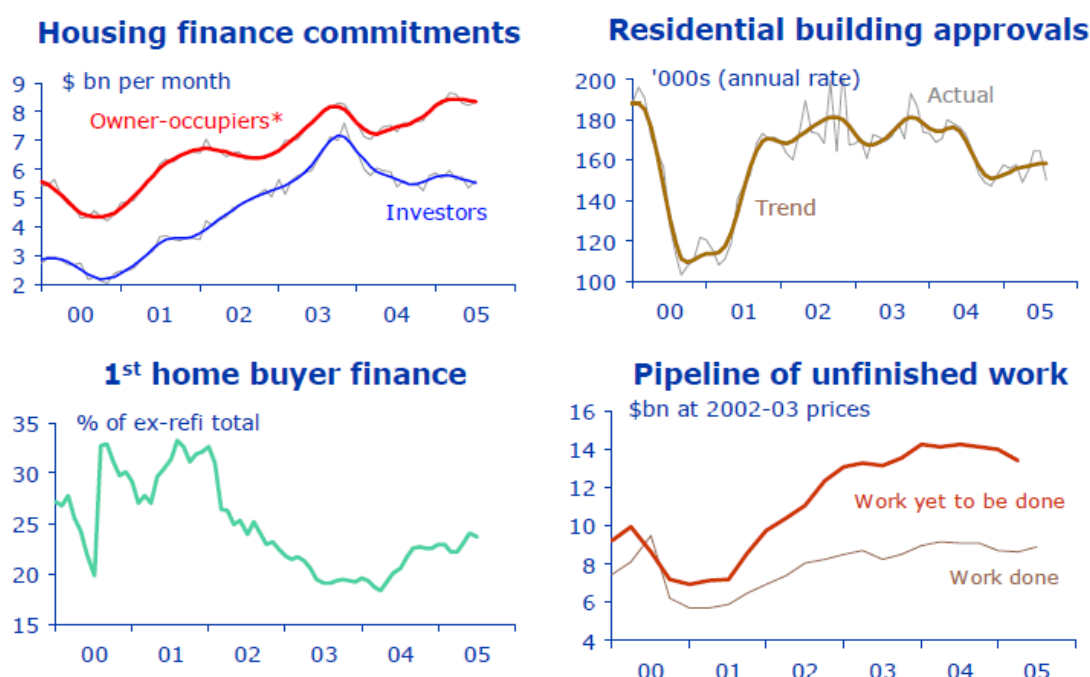
Source: Shane Oliver, AMP

Overall, while there is undoubtedly a short term dampening of basic-needs spending, impact of lower housing prices and increasing petrol prices has not been as severe as some pundits predicted.



Source: Westpac/Melbourne Institute; ABS; First Data International Australia

Critically, the slowdown in housing triggered by interest rate increases in late 2003 appears to have bottomed.



Source: ABS; ANZ Economics

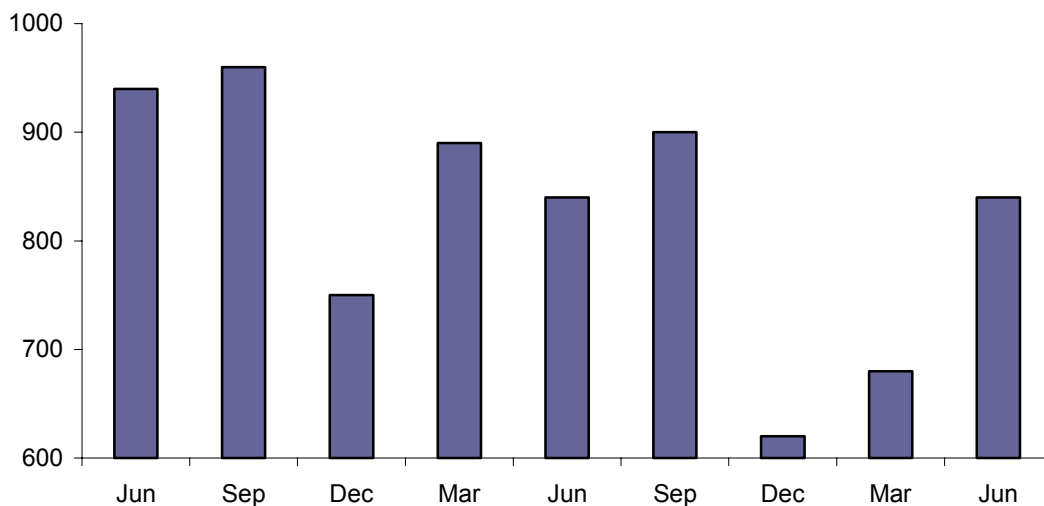
In solid evidence of a soft landing, between Dec 2003 and June 2005 the sentiment about a property bubble in Australia reversed.



Source: NAB

And the view that the worst is behind us is borne out by the rejuvenation of renovation. The HIA last week reported a 24.2% pick-up in major renovation activity during the June quarter to \$832m.

**Spending on Major Renovations - \$m
June 2003 - June 2005**



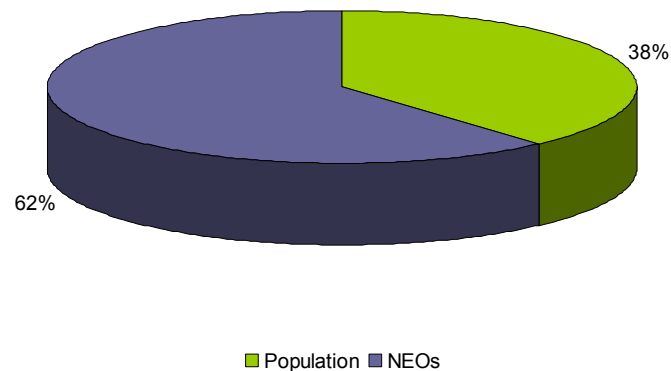
Source: HIA

While historical data is useful, it is a rear-vision view. Consumers' intention to renovate however gives us a much better read on how the future looks.

The same percentage of the population intends to renovate over the next 12 months as did so in the past 12 months, but the intention

to renovate in the coming year is dominated by NEOs. This is positive news for building and homewares suppliers operating at the discretionary or premium end of the market.

**Split of Consumers Intending to Renovate
in Next 12 Months**



When it comes to the share market as an indicator of the future, according to Alan Kohler in his Eureka Report, the price of Australian shares has increased by approximately 60% in the past 2 years...BUT...company profits, on which share prices are always based, have gone up by about the same amount.

SUMMARY

- Consumer confidence is high in those who spend the most
- The property landing has been soft and is in recovery in vital areas
- The sharemarket is booming and does not look like a bubble at all let alone a bubble about to burst
- Discretionary choice retailers like David Jones are reporting record profits
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CONCLUSION

We have reached the bottom of the downturn and the next cycle has already begun. Some sectors are bouncing along the bottom; some are rebounding and others are dragging along the bottom and will take longer to bounce back. But one thing is certain...the bottom is not far down and the dip will not be deep.

The new business cycle will favour the discretionary end with lessons to be learned by all businesses from the premium end of the economy.

The next business cycle will be defined by the *discretionary divide*.

The online world exemplified by Yahoo! is a major expression of the high-yield, commercially bountiful discretionary market. Similarly, David Jones on the discretionary or NEO side of the *divide* will continue to power on and will help shape the new business cycle.

But on the other side – the Traditional or non-discretionary side, Kmart will continue to thrive as long as it understands where it sits in the consumer economy.

The biggest risk will be to companies that attempt to straddle the discretionary divide or adopt a brand position in the, so-called, middle market. Unless they reinvent themselves they will be consigned to the commercial scrapheap.

In conclusion, the new economic order will pull us out of the current slump. Resilient NEOs will be first back into the market and will pull NEO businesses along with them.

IMMEDIATE EVIDENCE?

On Wednesday 28 September 2005, David Jones announced its biggest profit in a decade (NEOs account for 70% of the David Jones customer base)

On the same day, Qantas announced a 2.3% in lift passenger numbers for August 2005 over the same time last year (61% of Qantas Frequent Flyers are NEOs)

INDUSTRY SNAPSHOTS

Media Sector

Over the past five years, in the *heavy media* consumption category, radio, cinema, newspapers and magazines have all declined, while commercial television remained unchanged.

Internet was the only medium that enjoyed an increase – and in fact it doubled while other media declined.

Examining heavy media consumption by NEOs, we find that, while all traditional media declined over the same period, the Internet boomed. NEOs were first into the new medium. By 2005, the 98% of NEOs who are already connected to the Internet doubled their *heavy* online usage (more than 8 times per week) to 58% - compared to 28% for the general population.

The Internet, that vehicle of the Information Age, is now the dominant medium for reaching and motivating high-spending NEOs.

The Information Age had been born in 1991, the year in which, for the first time in history, more was spent (\$US112b) on machines to gather, process and distribute information than on machines to make and move physical objects (\$US107b).

The Information Age delivered to individuals *la connaissance sans frontières* or 'knowledge without borders'. It is one of the great historical paradoxes that while corporations and governments may have failed to create a borderless world of institutionalised economics and politics, the Information Age and its World Wide Web created an anarchic world of knowledge for individuals out of reach of the institutions.

The lessons: The online advertising market is exploding. Advertisers, agencies and publishers are increasingly optimistic about the role of the Internet as part of the overall media mix, with the majority of advertisers (73%, up fourteen percentage points from 59% in December 2004) agreeing that "*the internet will be a vital component of my company's marketing strategy over the next three years*".

Prominent advertisers allocated an average 5% of their advertising spend to online advertising in 2004-2005. This level of online advertising spend is slightly ahead of predictions made in June 2004, according to the latest emitch/Roy Morgan *Internet*

Advertising Intentions and Attitudes Survey conducted in July. This strong trend is forecast to continue, with prominent advertisers reporting that they will invest 6% of their advertising dollars online in 2005-2006.

Media companies making major investments in online businesses (eg. News Corp), online publishers themselves (eg. Yahoo!), dedicated online classified ad vehicles (Seek), online advertising agencies (eg. emitch) and IT services (eg. Melbourne IT) will be best placed to thrive and to lead the recovery in Australia. In fact they will not have felt any ill effects of the downturn in the business cycle and will continue to be counter-cyclical.

Retail Sector

All major retail brands have been impacted by the slowing business cycle, however those with a very clear value proposition – Kmart at the discount department store end and David Jones at the discretionary end – are showing the least impact in 2005.

So, what is the retail lesson here? Because NEOs (a) spend more, more frequently; and (b) dominate discretionary spending: the higher the discretionary nature of the purchase the stronger the NEO attraction and the faster the recovery from the economic downturn.

David Jones is suffering less and recovering faster than Myer. Millers Retail will continue struggling. Harvey Norman will bounce back when traditional consumers get good news, like interest rates falling. Similarly, Bunnings Hardware (Wesfarmers) will continue with difficult trading conditions into 2006 until the traditional market picks up.

Motor Vehicle Sector

The **intention** to purchase either a new or a used vehicle in the coming 12 months is healthier in the first half of 2005 than it was in late 2004. This is, again, a positive indicator for the coming 12 months.

A growing appetite for luxury vehicles reinforces the proposition that the premium end of the market is providing a lead indicator for early recovery.

And when the population is compared to NEOs intending to buy a luxury vehicle in the next 12 months, NEOs are more than twice as likely to make a purchase – with luxury SUVs popular.

The petrol challenge is merely an irritation to NEOs who continue consuming what they want, when they wish. Price-sensitive 'commodity' car brands will struggle in the medium term as traditional consumers take their wallets to the barricades.

Conversely quality brands and brands with a specialist value proposition should notice little impact from the business cycle downturn. SAAB, Renault, Mini, Lexus are all examples of brands that will not only survive but also have the opportunity to thrive.

The Beverage Barometer

Premium and imported beers are discretionary products that attract a premium price and retail margin. Since June 2001, the consumption of premium and imported beer has grown steadily and that growth shows no sign of slowing – despite the softer economic conditions.

This is further evidence of the resilience of the premium market – particularly given that the market is dominated by NEOs who drink more wine and premium & imported beer than anyone else in the economy – and their consumption continues on an upward trajectory.

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Unless otherwise noted, all data has been drawn from Roy Morgan Single Source.

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What business needs to do to be AHEAD OF THE GAME

Critical success drivers for the next business cycle:

- Understanding how 'premium' behaviour drives 'general' behaviour
- Learning which are the 'right' consumers to acquire as new-value customers
- Acquiring the 'right' customers
- Having relevant platforms for different customer types
- Moving the 'right' customers to premium platforms or brands
- Treating your premium customers as individuals
- Personalising every premium customer interaction
- Capitalising on the online explosion and the NEO obsession with the Internet
- Retaining the 'right' customers
- Unlocking new value from premium customers
- Driving the premium knowledge down into the general market

Specific strategies will deliver that success:

- Develop a premium (NEO) value proposition
- Identify individual NEOs for personal targeting – either on your customer database or on an external mailing list
- Develop product 'options' so NEOs can design their own 'solutions'
- Design a direct-channel strategy to individually reach & motivate NEOs (both online & direct mail)
- Identify, capture & manage individual customer lifestage events and personal preferences
- Reward loyalty with personally relevant feedback and useful information to enhance customers' lives
- Prevent NEO-churn – it costs you 15 times more than a Traditional churning