Bain Retail Holiday Newsletter #2

November 18, 2009

To: US Retail Partners
From: Darrell Rigby, Kris Miller and Josh Chernoff

GAFS growth turned positive in October after 13 consecutive months of downward movement. Furthermore, recently released reports of third-quarter earnings tell us that margins and balance sheets are healthier than they were last year. A number of retailers exceeded their own projections for the quarter and raised guidance for the rest of the year. Still, as we enter the heart of the holiday shopping season, many consumers remain cautious. Some are delaying their holiday shopping, hoping to see a repeat of last season's deep discounts. Retailers need to be creative to get these shoppers spending both in stores and online.

Results are stabilizing, and a slight momentum is building

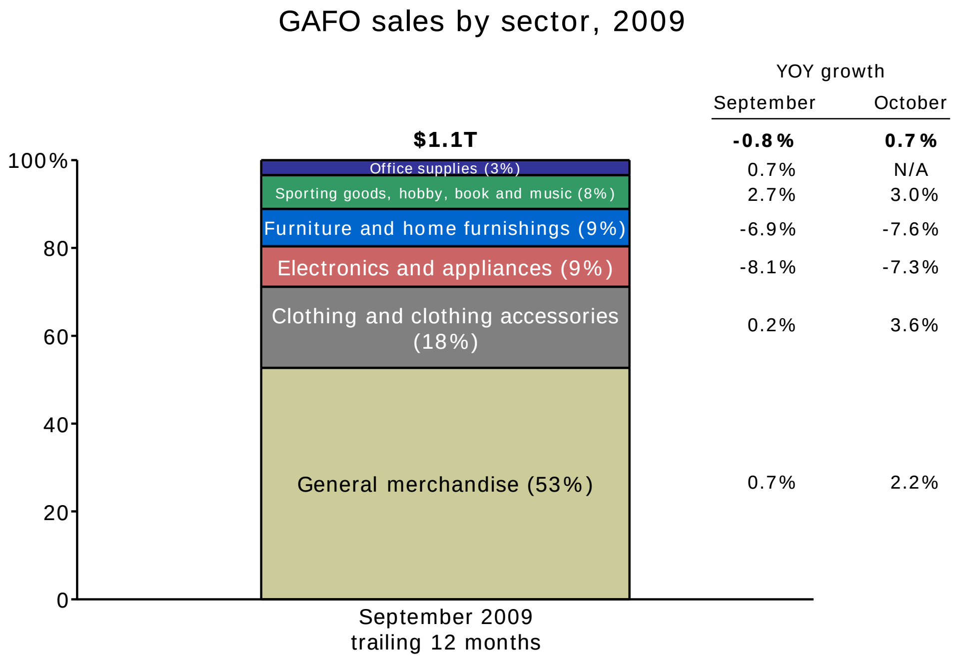
GAFS sales were up 0.7% in October, an encouraging sign when measured against last October's drop in GAFS sales of 1.2%.[1] However, segment-level growth varied significantly ***(Chart 1)***. Clothing and clothing accessories grew 3.6%, while the largest segment, general merchandise, rose 2.2%. These positive figures were offset in part by negative growth in furniture and home furnishings (down 7.6%) and in electronics and appliances (down 7.3%).

Total GAFS sales for the 12 months ended October 31, 2009, fell $27 billion compared to the same period two years ago, before the start of the recession. But top-line numbers tell only part of the story: There are now fewer retailers competing for sales. Many companies caught off guard by the sudden and severe downturn were forced into bankruptcy. In total, 27 retailers went bankrupt in 2008, and 18 more have done so to date in 2009. Together, these companies had sales of approximately $25 billion to $30 billion, which were quickly divvied up among their competitors. Surviving retailers combined those incremental sales with savvy strategies to restore their financial health. To demonstrate the effect of this Darwinian shakeout, we examined a sample of 12 US

[1] Preliminary September 2009 GAFO growth was −0.8%. September 2009 GAFS growth has been updated to −0.9%. See Chart A in the Appendix for definitions of GAFS, GAFO and other sales measures.

retailers that recently reported third-quarter results.[2] On average these companies managed to hold third-quarter sales roughly flat compared to 2008—which was already well above 2007—and increase both their earnings and cash reserves versus both 2007 and 2008 ***(Chart 2)***.

Chart 1:



Note: Data are not seasonally adjusted; October overall growth rate is for GAFS; office supplies data have not yet been reported for October; September data are based on preliminary numbers, and October data are based on advanced data published November 16, 2009
Source: US Census Bureau

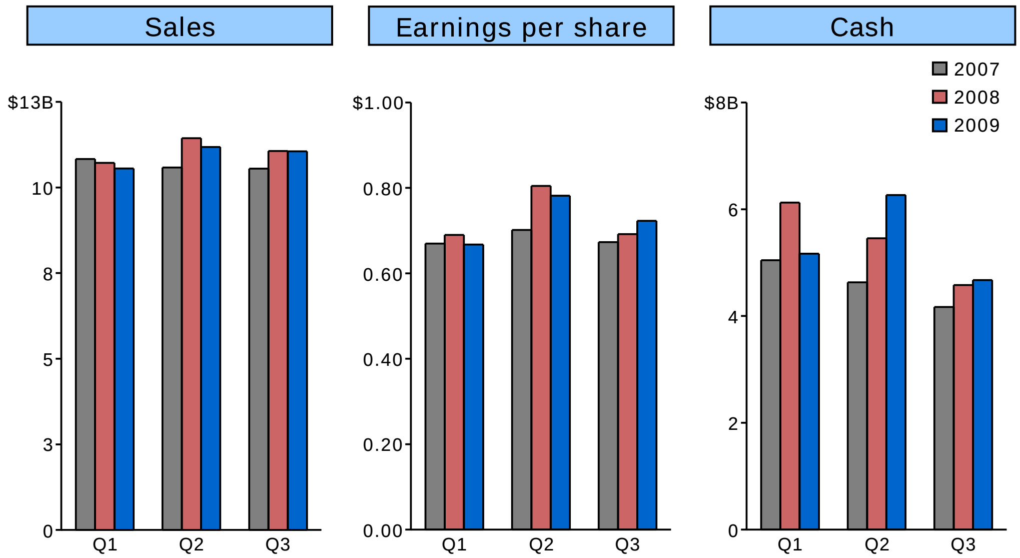
Over the last year, retailers have focused on lowering inventory levels in order to minimize discounting, improve margins and reduce debt required to fund working capital. Industry inventory-to-sales ratios for July through September are now at their lowest point since the Census Bureau began tracking comparable inventory data in 1992.[3] Data from our 12-company sample over the last three years are in line with this finding ***(Chart 3)***. For example, Wal-Mart cited better inventory management as one of the main reasons for its improved financial performance. In each of the last 10 quarters, the company has cut its inventory-to-sales ratio by an average of 1.7 percentage points compared to the previous year, ending at 39% in the most recent quarter. Similarly, Kohl's chairman Kevin Mansell attributed the company's 20% year-over-year increase in earnings per share (EPS) in the third quarter (from $0.52 to $0.63) largely to increases in same-store sales and improvements in inventory management.

[2] Our sample includes GAFO retailers that recently reported Q3 results: Abercrombie & Fitch, American Apparel, hhgregg, JCPenney, Kohl's, Macy's, Nordstrom, RadioShack, Saks, Target, Urban Outfitters and Wal-Mart.

[3] The Census Bureau began tracking inventory data in December 1980. They changed classification systems in 1992, making direct comparison to pre-1992 data impossible.

Chart 2:

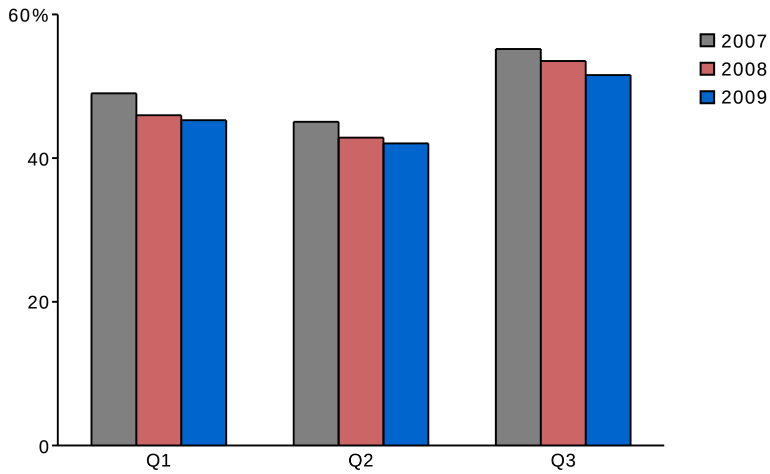
Quarterly financial metrics, 2007-2009



Note: Data represents average sales, sales-weighted average EPS and sales-weighted cash for a 12-company sample (Abercrombie & Fitch, American Apparel, hhgregg, JCPenney, Kohl's, Macy's, Nordstrom, RadioShack, Saks, Target, Urban Outfitters, Wal-Mart)
Source: Bloomberg; company reports

Chart 3:

Quarterly inventory, 2007-2009



Note: Data represent sales-weighted inventory for a 12-company sample (Abercrombie & Fitch, American Apparel, hhgregg, JCPenney, Kohl's, Macy's, Nordstrom, RadioShack, Saks, Target, Urban Outfitters, Wal-Mart)
Source: Bloomberg; company reports

Retailers' efforts to increase earnings and cash reserves and reduce inventories raised analysts' expectations, which in turn drove retail stock prices up: The S&P Retail Index rose by approximately 15% in the last three months. Although most of the retailers in our sample posted earnings per share that exceeded their own forecasts and adjusted their full-year earnings guidance upward, guidance numbers by and large fell short of analysts' even higher expectations. Following their announcements, many of these retailers saw their stock price fall. Looking ahead, analysts expect EPS to grow by approximately 20% a year on average between 2010 and 2012 for our 12-company sample. With average EPS already approaching prerecession levels, these forward-looking estimates impose aggressive targets on many retailers.

Whether or not analysts' expectations are reasonable, more than "business as usual" is going to be needed to meet them. Many retailers who pulled back on capital expenditures throughout the downturn, are beginning to test the investment waters:

- ***Opening new stores:*** This year Kohl's is adding 56 new stores to its base of 1,000, largely by acquiring former Mervyns locations. Smaller players are also taking advantage of growth opportunities in the current market: In an effort to capture a disproportionate share of Circuit City's business, regional electronics retailer hhgregg has added 15 new stores over the last 12 months, increasing its store count by roughly 10%. The company is planning to use its "ample liquidity and internally generated capital" to open another 40 stores in 2010.

- ***Expanding internationally:*** Abercrombie & Fitch is increasing its focus on international markets with new stores opening in Italy and the United Kingdom. More than half of Apple's planned 40 to 50 store openings in 2010 are expected to be outside the United States. And Wal-Mart plans on adding 550 to 600 international stores in fiscal 2010, compared to just 165 to 185 stores in the United States.

- ***Experimenting with product adjacencies:*** Earlier this year Barnes & Noble acquired Fictionwise, one of the largest e-booksellers in North America, an important step in the company's launch of its e-book store. Amazon.com acquired online retailer Zappos.com this past summer to expand its footwear and clothing offerings. And apparel retailer Aéropostale is looking to expand into the children's market with the introduction of P.S. in June. The company plans to open as many as 500 new stores under the P.S. brand.

- ***Upgrading systems:*** Canadian sports apparel retailer lululemon athletica expanded its product offering and invested in new inventory management systems during the downturn. The new technology has helped lululemon avoid stock-outs on popular items. The company claims that has had a positive impact on sales, which led it to raise profit targets for the rest of this year.

As we emerge from this recession, retailers that have reduced costs, boosted margins and stockpiled cash stand better prepared to pursue opportunities to grow sales and profits. Key will be determining the right time to act. Following most recessions of the last 40 years, corporate profits have risen steeply. In fact our analysis shows that in the first two years following a recession, half of total profit growth has come in the first two quarters.

There's still time to influence holiday shoppers

Last season consumers saw just how low retailers would go to earn their business. This year many shoppers may delay buying until the last minute in hopes of getting the best possible deal. But will these consumers end up missing out on what they want because retailers are keeping inventories down? Maybe, but that doesn't seem to worry most of the people with whom we spoke.

Bain continues to work with Communispace, a market research company that builds and runs online consumer communities to better understand how consumers are feeling and what they are thinking about shopping this holiday season.[4] We asked some 250 consumers if they are buying gifts as soon as they find what they want, or if they are holding out for the best deals. Most consumers fell into one of three segments: sale stalkers, holiday sentimentalists or checklist shoppers.[5]

Sale stalkers are professional deal-seekers. They represent about 40% of our community members. James is a sales stalker. Like most consumers in this segment, he waits until prices on the items on his list reach rock bottom and then pounces: "I usually research pretty thoroughly and try to find the best price. I then put off the purchase and watch the sales." This season James is particularly intrigued by the price wars among Wal-Mart, Amazon.com and Target. He says that watching them go back and forth on the price of books and DVDs is like watching a tennis match. Black Friday is a holiday in and of itself for James. He enjoys camping outside a store, scooping up that store's deals, and then heading to the next store on his carefully planned route (you had better stay out of his way!). What can retailers do to attract him? Communicate. James loves ads that keep him informed about prices and product availability. Retailers might be able to convince him to shop early: Key is letting him know when prices are as low as they are going to get, to tactfully signal that he might end up empty-handed if he waits too long. This is especially true if hot toys like Zhu Zhu Pets toy hamsters or Mattel's Mindflex are on James's list, in which case he has already learned that waiting has its own cost. Retailers may also be able to convince James to shop now by touting their price-matching policies.

Jill is a sale stalker too, but she's not waiting for holiday discounts. In fact Jill has finished much of her holiday shopping because she started buying on December 26 last year, seeking out the best deals as they came up: "If the funds are there, I will usually buy it right now. However, I will make

[4] A Communispace community is a private online site where up to 400 invited prospects and customers regularly spend time brainstorming, sharing feelings and experiences, and discussing trends to help a company figure out its marketing and business strategies. These private communities are facilitated by Communispace to keep the "conversation" relevant and insightful.

[5] These three groups accounted for about 80% of our community members. The rest were uncertain about their strategies or intended to combine them.

sure I am updated on their policy of honoring sales deadlines; [then] I watch sales and keep my receipts." Retailers can still convince Jill to buy a few more items, but they have to inspire her. For example, liberal return policies may convince her to buy more today without worrying about overspending. She also may be attracted to offers like Kohl's Cash—every $50 spent earns $10 toward future purchases—that give her extra savings to look forward to when she shops the after-holiday sales.

Then there are the **holiday sentimentalists**, who make up about 20%of our community members. Suzie, like many holiday sentimentalists, doesn't wait for discounts when she comes across the perfect holiday gift: "There's nothing better than finding a gift that you are excited about giving because you know they will love it. If I see something that fits the recipient, I buy it!" Retailers need to act early to get Suzie into their store because once she's spent what she budgeted, she's through for the season. Suzie responds to advertising that evokes family and holiday traditions. She enjoys shopping in well-decorated stores and feels the earlier the holidays arrive, the better. She applauded Macy's decision to start selling ornaments and other decorations displayed on trimmed holiday trees in mid-September. And for sentimentalists who hold out for discounts—typically on higher-priced or lower-priority items—holiday ads that speak to savings are likely to catch their eye. For example, one JCPenney campaign focuses on the joy of giving . . . at a discount: "Merry Christmas to all, and to all a great price" reads one of the ads. The underlying theme of the campaign: Celebrating the holidays is even more important when times are tough.

Finally there are the **checklist shoppers**, representing another 20% of our community members. Anna, like more than half of our checklist shoppers, doesn't wait for discounts, fearful that retailers will run out of "the good stuff," especially this year: "I almost always buy right away. I'm an impatient person, and I'm always afraid that if I don't buy right away it'll be gone the next time I'm there." The challenge for Anna is coming up with gift ideas. She shops until something catches her eye; and when it does, she buys it. Anna is easily influenced. In addition to playing to her concerns about availability, retailers that help Anna find good gifts are likely to capture a large share of her shopping budget. That's the thinking behind J.Crew's holiday gift guide, a "selection of gifts to surprise and delight." An added bonus for the retailer: Gift guide items are not necessarily the most heavily discounted.

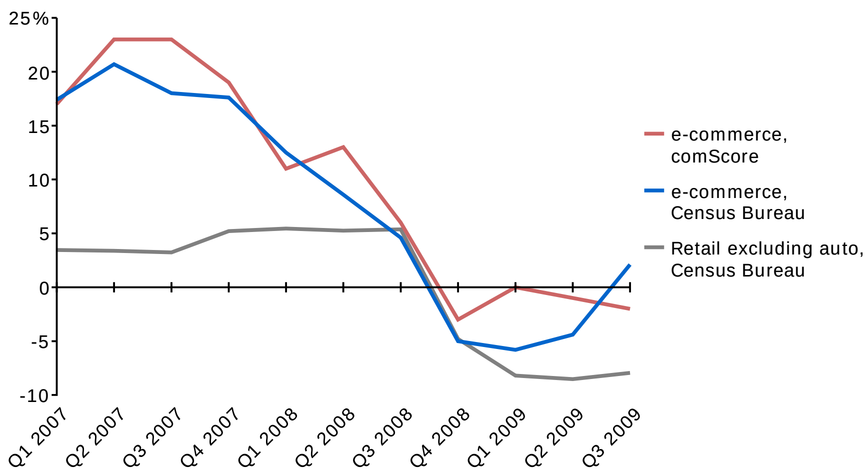
Whatever their shopping strategies, consumers are heading into this holiday season well aware of the economy. As is the case in times of uncertainty, they appreciate communication that helps put them at ease, particularly information that reassures them they will be able to find what they want at the right price. And the communication should continue in the store: The savviest retailers train their salespeople to recognize different shopper types and fine-tune customer service to best match their behaviors.

A well-spun Web catches more customers

For years e-commerce was the star of the holiday season, posting double-digit growth and accounting for a small but ever-increasing share of sales. But online sales slowed throughout 2008, and growth ultimately turned negative in the fourth quarter. Through the first two quarters of 2009, online sales growth exceeded overall sales growth, though it remained slightly negative ***(Chart 4)***. Third-quarter figures, however, show signs of improvement. The Census Bureau estimates that online sales increased 2.1%, and monthly detail from comScore shows that online sales growth went up from −5% in July to flat in September.

Chart 4:

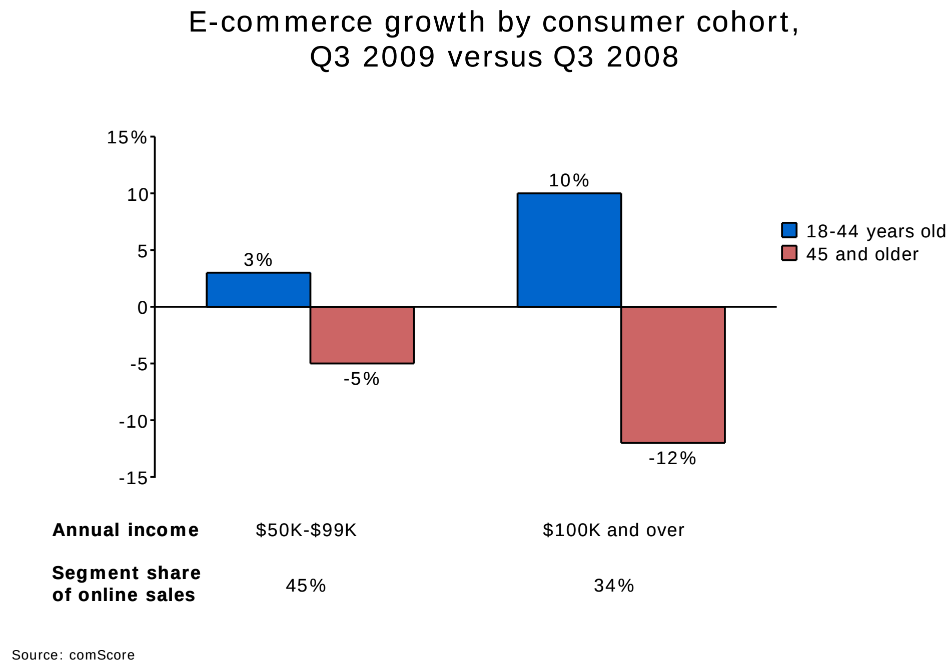
Quarterly retail sales growth online versus overall, 2007-2009



Note: comScore data exclude travel, auctions, autos and large corporate purchases and include data for pure-play and multichannel retailers; Census Bureau data include goods and services where an order is placed by the buyer or price and terms of sale are negotiated over an Internet, extranet, Electronic Data Interchange network, electronic mail, or other online system (payment may or may not be made online)
Source: comScore; US Census Bureau

The number of online buyers in the third quarter was up significantly—19.6% over last year—as value-conscious consumers increasingly turned to the Web for easy comparison shopping and the best deals. This growth was not enough, however, to offset the average number and size of transactions: 16.4% fewer transactions per buyer and 2.4% smaller transactions than last year. These overall figures also mask more significant pockets of growth and decline. For high-income consumers between the ages of 18 and 44, third-quarter spending was up by 10% over last year, while spending for older consumers in the same income bracket dropped by 12% ***(Chart 5)***.

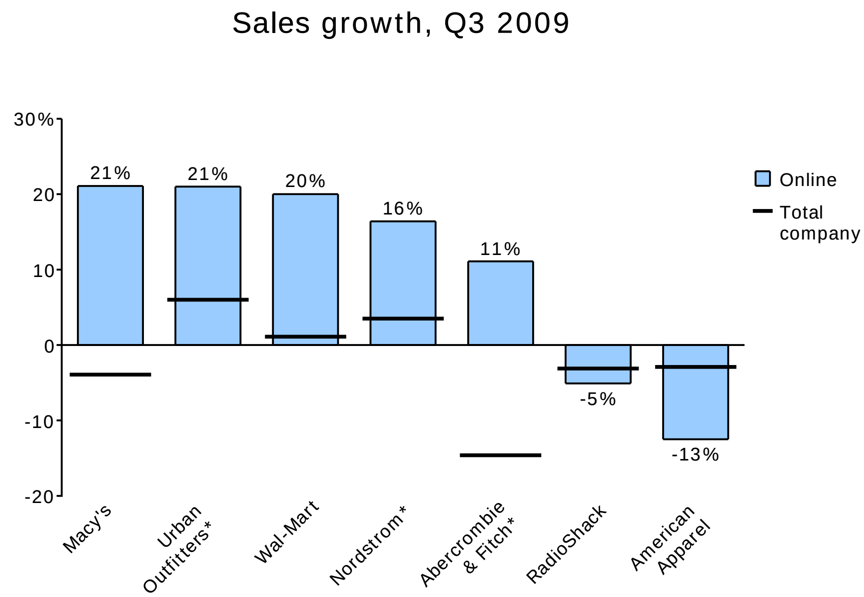
Chart 5:



We also see wide differences among retailers. Of those that have reported third-quarter results, only a few break out online sales. But these few offer evidence both of large differences and of the fact that online sales are still an important source of growth for some retailers ***(Chart 6)***. Take Macy's, for example, whose online sales jumped 21% in the third quarter. The company continues to consider multichannel integration a priority, and is adding and testing new functionality. Conversely, American Apparel's online sales dropped by almost 13%, which the company blamed on less online ad spend and cannibalization from a larger retail footprint than last year. Online pure-play companies continue to outsell multichannel retailers overall, ending the third quarter with a 58% share of online sales, up 2 points over 2008. Pure-plays also continue to earn high marks for customer service: According to BIGresearch, 7 of the top 11 highest-rated retailers do not have physical stores.

Retailers continue to invest in online capabilities, and some are building completely new platforms. Zara recently announced it is going to make its fashion products available online for the first time in what the CEO called "an important strategic step." Target, which has been selling its products online through Amazon.com for years, announced in August that it is going to build and manage its own platform, which the company plans to have in place by the 2011 holiday season.

Chart 6:



*Online figure includes all direct-to-consumer sales
Source: Company reports

This season we expect to see notable winners and losers online—in contrast to just a few years ago, when online sales growth was almost a given. In addition to having the products consumers want at the right price, winners will:

- Help consumers find the perfect product
- Create a sense of urgency to make the sale
- Make the purchase easy

Helping consumers find the perfect product

Effective search and product recommendations are functions that retailers have been working on for years. But recommendations can easily miss the mark. Online movie retailer Netflix took a unique approach to this problem, offering a $1 million prize to anybody who could improve the accuracy of the company's current recommendation system by 10%. It took three years, but a consortium of teams finally achieved the goal in September. Immediately after announcing the winners, Netflix announced a second $1 million contest to keep the improvements coming.

One way to help consumers choose products is to help them visualize those products. Although the technology may not be cutting-edge, retailers are beginning to apply online tools to the benefit of consumers. JCPenney, for example, helps its customers put together outfits by dragging and dropping images of clothing and accessories into a My Look window. In addition to keeping a running total of the cost, the tool also allows customers to save and even publish their looks.

Creating a sense of urgency to make the sale

A number of retailers are using timed events to generate excitement. New members-only sites like RueLaLa and Gilt Groupe run one- to two-day sales on designer products. Customers are forced to act fast to take advantage of low prices on limited-quantity items. Some of these sites feature product counters so that consumers can watch stock dwindle before their eyes.

In a similar approach, Saks recently held a 36-hour invitation-only sale online exclusively for consumers on the company's e-mail list. And as we discussed in our special edition, Neiman Marcus periodically sends a "Fashion Flash" to customers on Facebook or on their e-mail list, alerting them to deep discounts on select items that are only available online for two to three hours.

Making the purchase easy

Multichannel retailers increasingly are using their Web sites to improve the in-store shopping experience. Both Macy's and The Container Store, for example, have added "find in store" capability to their Web sites, enabling customers to verify store stock before making the trip in. Best Buy's "buy online, pick up in store" functionality includes e-mail notification when stock has been pulled and is ready for pickup. And when customers who use this service arrive at the store, they find dedicated parking spaces and a clearly marked pickup line.

Retailers also are developing tools to help consumers make purchases on the go with mobile applications. Although mobile commerce is still in its infancy in the United States, a number of retailers have launched iPhone (and other smartphone) applications, and some offer unique functionality. Amazon.com's application features a barcode reader that enables quick online price comparisons of items being considered at a store. Wal-Mart's application allows users to take a picture of a room and determine what size television would work best. Moreover, companies are beginning to see benefits: eBay recently announced that shoppers have already spent $400 million on the site using the company's iPhone application. Items that have been purchased with the application include a Lamborghini, a Bentley and a $150,000 boat.

Finally, retailers continue to make changes to help online shoppers get over the shipping hurdle. One way is with free shipping: In the third quarter of 2009, 42% of online purchases shipped for free, up from 31% in the first quarter of 2008. Another way is with fast shipping. Amazon.com, for example, recently added local express delivery: Items ordered weekdays by the cutoff time in certain cities can be delivered the same day.[6] The company is also expanding its Saturday delivery options.

[6] The cities are Baltimore, Boston, Las Vegas, New York City, Philadelphia, Seattle and Washington DC.

Black Friday is fast approaching

As we write this newsletter, Black Friday, the day on which retailers historically have gone from “being in the red” to “being in the black,” is just over a week away. For most retailers, preparations for the big day are largely complete, and the focus now is on executing carefully made plans.

Several important questions are about to be answered: Will shoppers come out in force for the sales? If they do, will they be tempted to spend their cash and use their credit cards? And will they buy only sale items, or will they get caught up in the holiday spirit and let loose a bit?

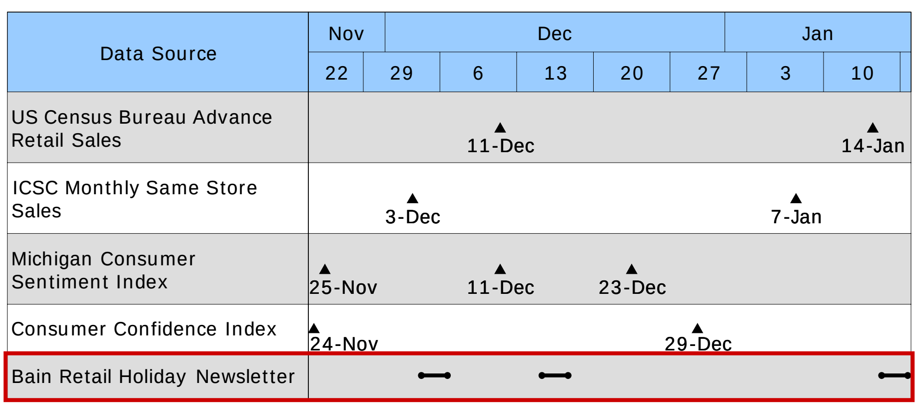
In our next newsletter, we will report estimates of Black Friday results, the first concrete indicator of where holiday sales are heading.

Newsletter schedule

Our next newsletter will be released in early December, with a new issue roughly every two to three weeks after that through the holiday season ***(Chart 7)***. This schedule allows us to incorporate newly released holiday forecasts and performance data in a timely manner. Please let us know if you have any questions or need additional analysis.

Chart 7:

Indicator update schedule



Appendix

Chart A:

Definitions

	GAFO	GAFS	GAF	General merchandise	Retail excluding auto
• General merchandise stores	✓	✓	✓	✓	✓
• Clothing and clothing accessories stores	✓	✓	✓		✓
• Furniture and home furnishing stores	✓	✓	✓		✓
• Electronics and appliances stores	✓	✓			✓
• Sporting goods, hobby, book and music stores	✓	✓			✓
• Office supplies, stationery and gift stores	✓				✓
• All other retail trade sales not included in GAFO (excluding auto and auto parts)					✓
• Auto and auto parts sales					

Source: US Census Bureau; analyst reports

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