Bain Retail Holiday Newsletter #1

October 23, 2010

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

With cautious optimism, Bain is forecasting GAFO sales growth of 3% for the holidays.[1] *Although signals are mixed, we are heading into the season with relatively strong momentum versus last year. Among the positive signs: Retailers are stocking slightly more inventory and are planning to increase holiday hiring over last year, some consumers are excited about shopping (or at least about jumping on bargains), and the economy is on a gradual albeit bumpy road to recovery. Underlying our forecast, which is at the high end of publicized estimates, are results that will vary widely by GAFO segment and consumer tier. The purpose of this newsletter is to highlight holiday sales trends and to clarify conflicting signals. We plan to distribute updates every two to three weeks throughout the holiday season to keep you informed as new data emerge.*

It's going to be a good season . . . at least compared to the last few

Bain is forecasting holiday GAFO sales growth of 3% for the November–December period, a marked improvement over last year's lackluster holiday performance and slightly above the 10-year average growth ***(Chart 1)***.[2] This forecast reflects a renewed if cautious optimism following a comparatively strong year to date in which GAFO sales have increased over 2009 every month since February ***(Chart 2)***. In addition, seasonally adjusted GAFO sales have gone up almost every month since July 2009 ***(Chart 3)***.

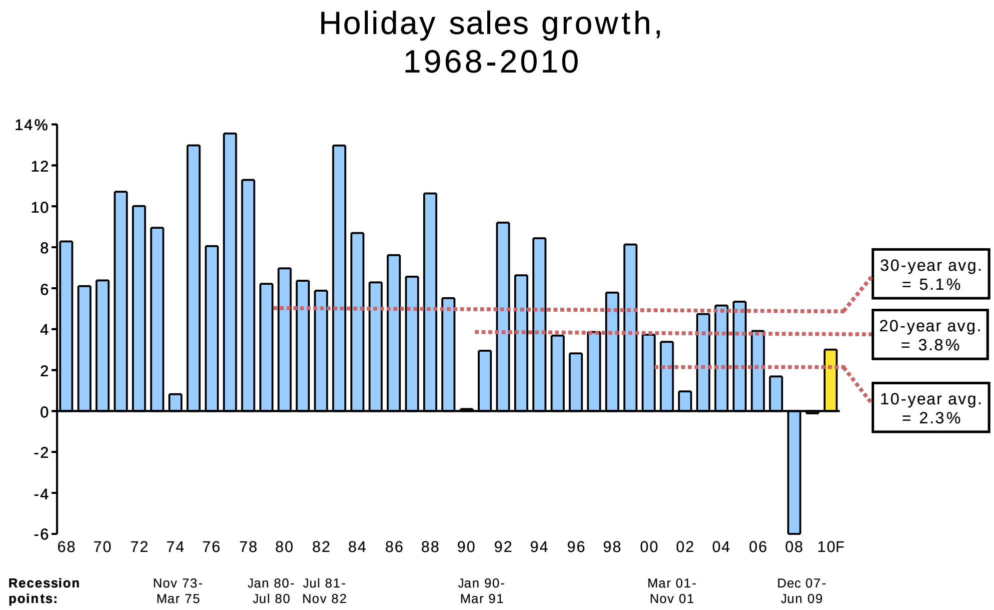
A longer-term view helps put performance figures into perspective. With 3% holiday sales growth, total GAFO sales will reach an estimated $1,147 billion in 2010, in line with 2008 sales but still 0.6% below their prerecession peak of $1,154 billion in 2007 ***(Chart 4)***. Several other metrics add further context:

- *Inventories are above 2009 levels.* Retail inventories were below 2009 levels through June, but were 1.2% higher in July and 3.2% higher in August. Still, absolute inventories in August were 7% below the same month in 2008. While more recent

[1] See Chart A in the Appendix for definitions of GAFO and other sales measures.

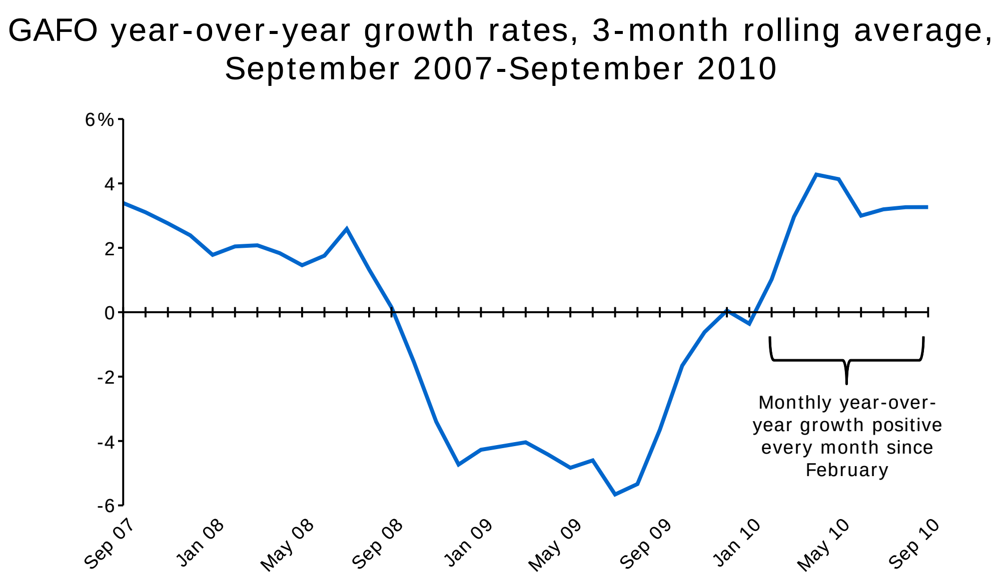
[2] In January 2010, advance Census Bureau figures pointed to holiday sales growth in 2009 of 1.2%. As more data became available, growth was restated at −0.1%.

Chart 1:



Note: *Holiday* is defined as November and December; growth rates are based on most comparable data available by time; 1968-1978 growth rates are for GAF excluding miscellaneous shopping goods; 1979-1992 growth rates are for GAF; 1993-2009 growth rates are for GAFO; 2010 is the Bain growth rate forecast
Source: US Census Bureau; Bain analysis

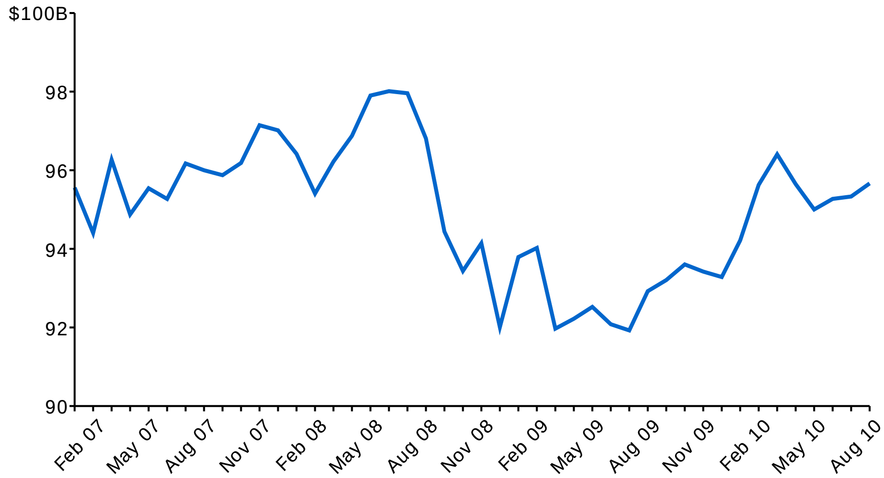
Chart 2:



Note: September 2010 data are based on advance GAFS
Source: US Census Bureau

<u>Chart 3:</u>

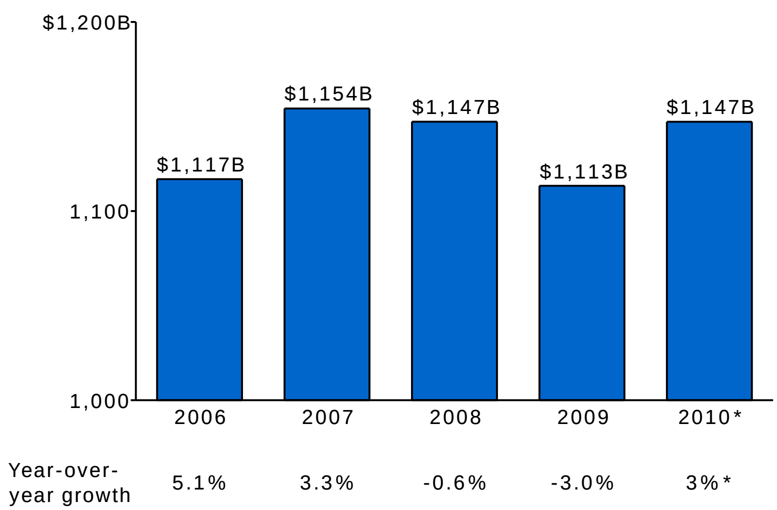
Seasonally adjusted GAFO sales, 2007-2010



Source: US Census Bureau

<u>Chart 4:</u>

Annual GAFO sales, 2006-2010



*Fourth-quarter 2010 GAFO sales have been estimated using Bain's forecast of 3% year-over-year growth
Note: September 2010 office supplies data have been estimated using the August trailing 3-month average growth rate
Source: US Census Bureau; Bain analysis

inventory data are not yet available, retail container traffic continued to trend well above last year in September and is forecast to do the same in October.[3]

- *Holiday hiring will be up.* Outsourcing firm Challenger, Gray & Christmas expects holiday hiring to go up 10% to 30% over 2009, an increase of 550,000 to 650,000 jobs. But these figures will still lag the estimated 720,000 jobs added in 2007 by 10% to 25%. Total retail employment also remains 7% below its 2007 peak.

- *Store productivity is well above 2007 levels.* Average store productivity, measured by sales per square foot, is the silver lining of store closures. It is up 7.9% from 2007 to 2010, a function of the sharp drop (8.1%) in retail selling space over the period, which buffered declining sales.[4]

Online sales continue to be a bright spot for retailers and are rapidly increasing in importance. E-commerce sales increased at a healthy 10% through the first two quarters of 2010, and Forrester expects them to continue to grow at the same rate through 2013. E-commerce penetration has almost doubled—from 4% in 2004 to 7% year-to-date in 2010—according to comScore. But these are just averages; some traditional retailers are driving 15% or more of their business through digital channels. The most innovative retailers are looking beyond traditional multichannel tactics to what we call an omni-channel approach. This means that all channels need to work in concert to provide a seamless, cohesive and integrated customer experience, one that grows both digital and brick-and-mortar sales. It also means offering solutions to meet consumers' needs through their websites, mobile platforms, links to social media pages, gaming options, and in-store technology. We will cover this topic in more depth in our third newsletter, after third-quarter e-commerce results are released.

The recession may be over, but where's the bounce-back?

Although the recession officially ended 16 months ago, it's clear that the recovery is going to be long and bumpy. After falling 2.6% in 2009, GDP increased 3.7% in the first quarter of 2010 and 1.7% in the second quarter. But those increases were funded largely by government spending, which went up 5% and 12.8% in the same quarters.[5]

Some economic indicators are showing improvement. Equity markets have risen almost 75% from their recession low in May 2009, down only about 25% from their all-time high in October 2007.[6] Federal Reserve data indicate that the average consumer credit interest rate has eased to 14.2%, its lowest level in the last eight quarters. And decreases in mortgage rates may expand consumers' spending capacity, if they are able to refinance.

[3] The Census Bureau reports inventory data with a two-month lag.

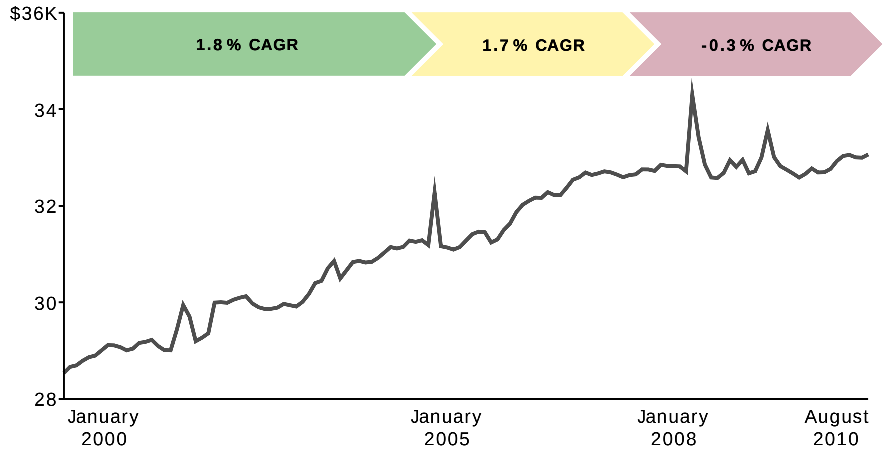
[4] Based on Euromonitor data for mass merchandisers, department stores, warehouse clubs, clothing and footwear, furniture and furnishings, electronics and appliances, book sellers and stationers, audiovisual stores, toys and games stores, and sports good stores.

[5] Based on nondefense federal government spending.

[6] Based on the S&P 500 Index on October 21, 2010.

Chart 5:

Real per capita US disposable personal income, 2000-2010



Note: All figures are in 2005 dollars; CAGR is the compounded annual growth rate
Source: Bureau of Economic Analysis

Several other economic indicators have not improved but have remained stable. Unemployment continues at 9.6%, near its highest level since the early 1980s. We estimate that "fully loaded unemployment" is as high as 18%. This measure includes the underemployed (those working only part-time who would like to be working more) and the discouraged (those who have given up looking for work). Disposable income growth, which historically has been at about 2%, has completely flattened ***(Chart 5)***. Consumer confidence also remains near its lowest point this decade.

A tale of three households

High-level indicators based on household averages are interesting but may be misleading. The Bain Macro Trends Group has taken an in-depth look at the health of consumers' balance sheets and income statements and identified three tiers of households, each in a unique financial situation: the affluent, the aspirational, and the lower income ***(Chart 6).*** Of these, only the affluent consumer segment is in a strong position to spend.

In speaking with consumers, the differences between these tiers become even more apparent. Over the last two months, Bain has worked with Communispace, a market research company that builds and runs online consumer communities, to better understand how consumers are feeling about the holidays and what will motivate them to shop this season.[7]

[7] 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.

Chart 6:

Three distinct US household tiers

	Affluent	Aspirational	Lower Income
Income	• $100,000+ per year • 1.5% growth 2006-2010	• $50,000-$100,000 per year • 2% decline 2006-2010	• <$50,000 per year • Tied to unemployment & government benefits • 4% decline 2006-2010
Population	• 21% of households	• 36% of households	• 43% of households
Consumption	• 38% share of overall consumption (up 5 percentage points 2006-2010)	• 33% share of overall consumption (down 2 percentage points 2006-2010)	• 29% share of overall consumption (down 3 percentage points 2006-2010)
Jobs	• Unemployment: <4%	• Unemployment: ~6%	• Unemployment: ~15% • Represent over two-thirds of recent employment losses
Assets	• Housing represents one-third of assets • Financial investments represent two-thirds of assets	• Housing dominates assets	

Note: The growth rates for 2010 are estimates

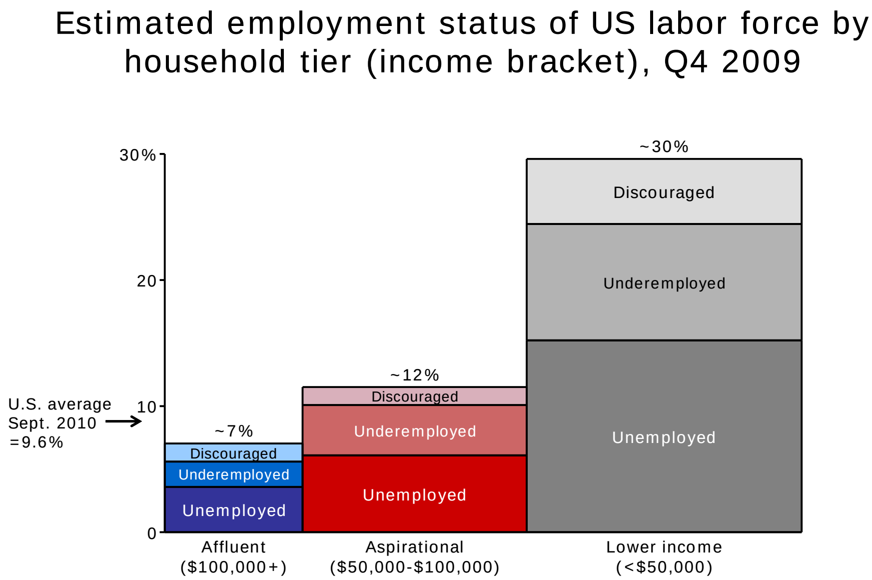
The Affluent

The Greens are an affluent household, earning an income of more than $100,000 a year. After a few years of holding back, the Greens are looking forward to spending again during the holiday season. Just like last year, the majority of affluent families in our Communispace communities are comfortable they will have enough money for the holidays. They are in the only tier of the population that is actually increasing its consumption: In the last four years, their share of total consumption rose 5 percentage points. This is largely thanks to the recovery in the financial markets and to the fact that households in this segment have seen incomes rise an average of 1.5% each year. And even today, unemployment—at less than 4%—is not a major concern for this tier ***(Chart 7)***.[8]

Affluent households are significantly more positive about the holidays this year than they were in 2009. More than half of our affluent community members indicate they are excited or happy about the upcoming season. Mrs. Green loves holiday decorations, festive music and the holiday spirit, so retailers that act early may entice her to start spending sooner. She says that hearing Christmas music and seeing Christmas trees in stores are signs to start her family's holiday shopping. They get the family "into the

[8] Again, this measure excludes the underemployed and the discouraged.

Chart 7:



Note: The official unemployment rate for the fourth quarter of 2009 was 10.0%; bar width represents each segment's share of the population
Source: Center for Labor Market Studies

shopping mood" and "heighten the whole family's general level of excitement." "As soon as I hear Christmas music, I am straight off to the mall!" The Greens are also influenced by the weather: "When it starts getting cold outside or when the first few snowflakes start to fall, then I know it's getting close to the holiday season . . . and I'm ready to shop." That said, the Greens will be thoughtful about how they spend. As Mrs. Green noted: "The recession has caused my family and friends to think about everything in a new light. It isn't about volume of gifts anymore; quality is much more important."

The Aspirational

The Johnsons are an aspirational household, earning between $50,000 and $100,000 a year. They aspire to the "American Dream" of owning their own home and being comfortable. But they are still reeling from the effects of the housing crisis because two-thirds of their wealth is tied to their home equity. Unemployment —ranging from approximately 6% to a "fully loaded" 12%— is also a concern ***(see Chart 7)***. Households in this segment have seen income drop an average of 2% in each of the last four years. Over that period, their share of total consumption has gone down 2 percentage points. The Johnsons are going to be cautious about spending this holiday season. Just like last year, half of aspirational households in our Communispace communities are concerned about having enough money for holiday shopping. Says Mrs. Johnson: "Money drives my shopping, and I can't predict what cash we get and when we get it. So we generally stick to the enjoyment of purchasing smaller gifts."

Still, the Johnsons, and more than half of aspirational Communispace community members, share a more positive feeling about this year's holiday season than they did about last year's. Although they are somewhat drawn by stores' Christmas decorations and holiday music, what is most important to them are deals and sales, particularly those that are well advertised. Retailers that get the word out quickly and effectively to aspirational households will pique their interest. Mrs. Johnson explains: “Once I start to see the ads in the paper for holiday sales, I know that Christmas is fast approaching and I am ready to shop. But I like to compare sales and will only shop if the sale promises particularly good deals.”

The Lower Income

The Smiths are a lower-income household, with earnings under $50,000 a year. This tier has been hardest hit by the economic downturn. Much like many other lower-income members of the Communispace communities, the Smiths say they will not have enough money for all of their holiday shopping. Mrs. Smith says: “Because money is so tight, I won’t be able to buy too many gifts.”These households account for two-thirds of employment losses during the recession and have a “fully loaded” unemployment level as high as 30% ***(see Chart 7)***. Their overall household income has decreased 4% a year since 2006. Over that period, they have seen their share of consumption go down 4 percentage points.

Surprisingly, we still see lots of holiday spirit in the Smiths and in other households in their income tier, almost twice as much as last year. Mr. Smith explains that “the holidays are a time to forget whatever financial constraints you face and enjoy the mood.” The Smiths want to shop but are focused on deals and sales and “good-value gifts.” “For the little shopping we can do, our timing is completely dependent on sales. We even wait to see what is on sale before deciding what gifts to give,” Mr. Smith told us.

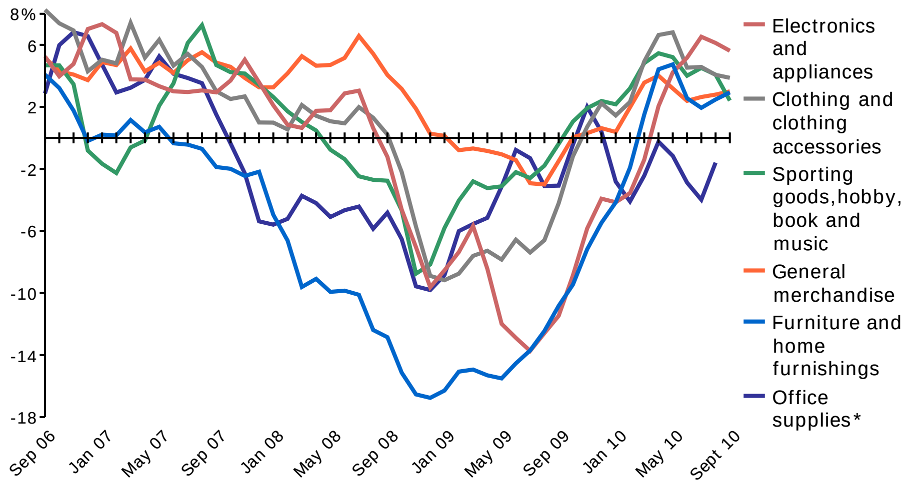
What do these differences mean for retailers? More than ever, one size doesn’t fit all. For example, retailers who cater to lower-income consumers may find item-level discounts work best to prompt gift ideas that feel affordable. In contrast, retailers that serve more affluent consumers may well find that an emphasis on service or the enduring quality of holiday gifts is more effective. It gets a little trickier for retailers that cater to multiple segments within the same store or across regions. Meeting everyone’s needs without ignoring any one group is never easy. Among retailers that face this challenge, the holiday winners will likely be those with more localized assortments, marketing, and experiences that can both drive sales and protect margins.

Some GAFO segments are on firmer footing than others

Sales growth has been trending upward across all GAFO segments over the last year ***(Chart 8)***. But during the recession, differences in demand due to both structural and cyclical trends led to varying levels of sales declines and square footage adjustments. Each segment is now faced with its own opportunities and challenges ***(Table 1)***.

Chart 8:

GAFO sales growth by segment, 3-month rolling average, September 2006-September 2010



*Office supplies data are available only through August 2010
Source: US Census Bureau

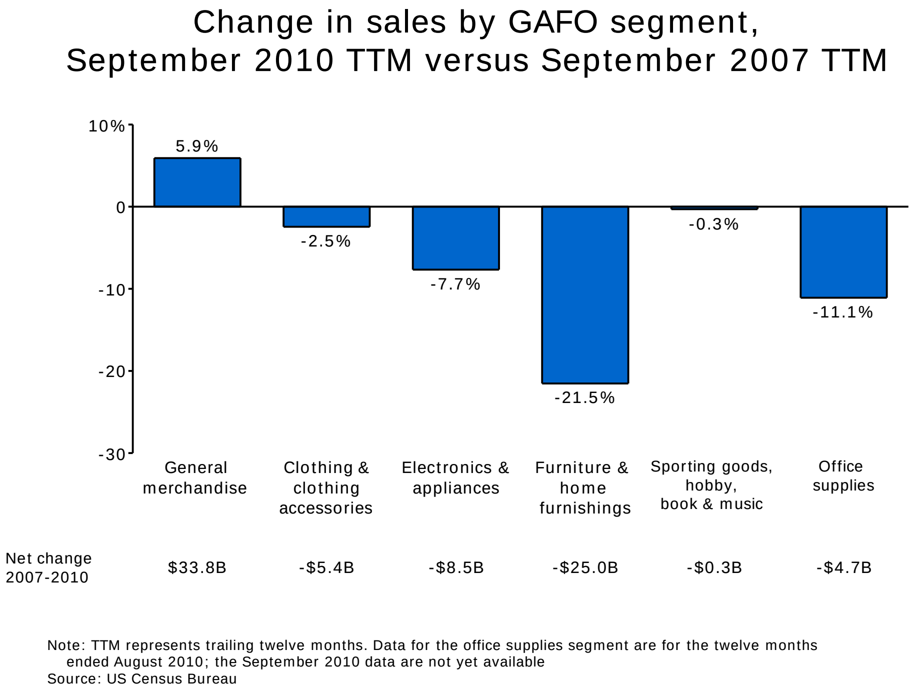
Table 1:

Key data by GAFO segment

GAFO Segment	Change in retail space (2007-2010F)	Change in sales/ square ft (Sept. 2010 TTM vs. Sept. 2007 TTM)*	Change in sales vs. prerecession (Sept. 2010 TTM vs. Sept. 2007 TTM)*		Change in sales vs. last year (Sept. 2010 TTM vs. Sept. 2009 TTM)*	
General merchandise	-4.0%	10.4%	$33,783	5.9%	$13,536	2.3%
Clothing and clothing accessories	-9.9%	8.3%	-$5,405	-2.5%	$7,799	3.8%
Electronics and appliances	-10.5%	3.2%	-$8,488	-7.7%	$857	0.8%
Furniture and home furnishings	-17.3%	-5.2%	-$24,978	-21.5%	$135	0.1%
Sporting goods, hobby, book and music	-1.7%	1.5%	-$263	-0.3%	$2,743	3.3%
Office supplies	--	--	-$4,749	-11.1%	-$494	-1.3%

*Dollar amounts are in millions
Note: TTM is trailing twelve months. All sales data are from the US Census Bureau. All retail space data are from Euromonitor; general merchandise includes Euromonitor's mass merchandisers, department stores, and warehouse categories; sporting goods includes book sellers and stationers, audiovisual stores, toys and games stores, and sports good stores; clothing and clothing accessories includes clothing and footwear. Office supplies data are not available from Euromonitor. Office supplies sales figures are based on August 2007 trailing twelve months versus August 2010 trailing twelve months because September 2010 data are not yet available.
Source: US Census Bureau, Euromonitor

Chart 9:



The general merchandise segment may post slower growth this season than last because it is coming off a relatively strong base. Sales in the 12 months that ended in September were up 5.9% from the same period in 2007. This is the only segment that has seen net growth in the period ***(Chart 9)***. But again the average masks wide variation by sub-segment:

- *Growth is a challenge for warehouse clubs and discounters*. Warehouse clubs and discounters are faced with the toughest comparables in the general merchandise cohort. As cash-strapped consumers traded down and focused on value during the recession, these were the only subsegments that did not see significant drops in same-store sales ***(Chart 10)***. But as the economy recovers, these stores may lose affluent consumers who slowly start to trade back up. An NRF consumer survey reports that 65% of shoppers plan to buy gifts at discount stores this year, a 5 percentage point drop from 2009 and the lowest level since 2004.

- *Luxury has turned the corner but still has a long way to go*. Luxury department stores are seeing strong growth as their affluent customer base relaxes its hold on spending. A study Bain conducted for Italian fashion association Altagamma predicts that the overall luxury market will increase 12% in the United States in 2010.[9] Same-store sales are growing fastest among all the general merchandise subcategories in 2010, but these are the same stores that experienced the sharpest decreases over the last two years ***(see Chart 10)***. Although the tide is rising, it is

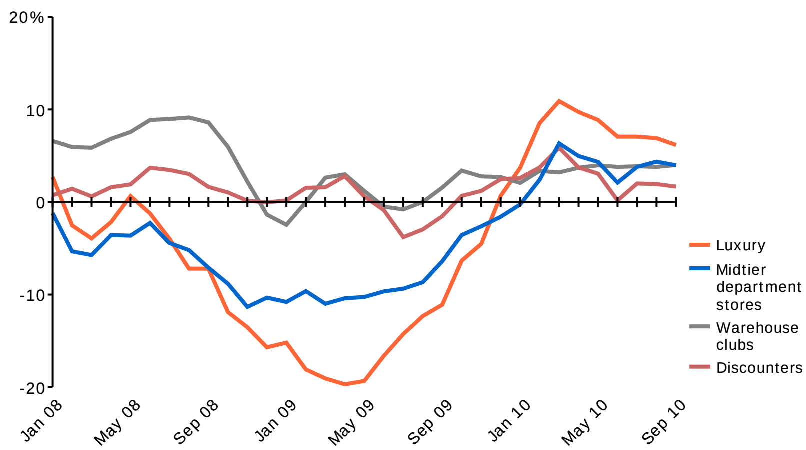
[9] For a copy of the study please contact Cheryl Krauss at cheryl.krauss@bain.com.

not lifting all boats equally. Nordstrom saw a 9.3% increase in same-store salesthrough September of this year after witnessing a decrease of 9.8% in the same period last year. Meanwhile, Saks Fifth Avenue same-store sales have increased only 5.1% so far this year, this after a much steeper decline of 20.6% in 2009.

- *Midtier department stores are spread thin*. Midtier department stores are doing well of late, but they face a special challenge because they cater to the broadest range of customers and must effectively straddle multiple selling strategies. Although year-to-date same-store sales growth is positive at 4.3%, it comes after a 5.9% average drop last year. To help drive growth, some midtier stores are working to attract more affluent and aspirational consumers. Sears recently entered into a partnership with upscale French Connection UK to sell an exclusive line, UK Style by French Connection, starting in March 2011. Macy's is also targeting fashion-forward juniors with a new limited-edition runway collection from designer Kinder Aggugini.

Chart 10:

Change in same-store sales, 3-month rolling average, January 2008-September 2010



Note: Warehouse clubs exclude the impact of fuel
Source: International Council of Shopping Centers

Although sales in the clothing and clothing accessories sector rebounded significantly over the last 12 months, they are far from making up for the segment's losses during the recession. Sales grew by $7.8 billion over the last 12 months, but this came after a $15.5 billion loss in 2009 alone (for the 12 months ending in September), and the segment still trails its prerecession sales levels by 2.5%. This forced many stores to close: The last three years have seen a 10% drop in retail space for clothing and clothing accessories retailers. The bonus for the remaining stores is that productivity is actually 8.3% higher than it was in 2007. Recent results also have been promising: Back-to-school August saw modest year-over-year growth of 1.9%, followed by an even more hopeful September, which ended with a 4.4% increase over last year ***(see Chart 8)***. Growth is being differentially driven by fashion-forward shoppers. A joint study by Bain and *Vogue* conducted this summer shows that style-conscious women spend about three times what the average American consumer spends on clothing and accessories.

The electronics and appliances segment has been making a comeback, and is expected to continue on a positive trajectory through the holidays. Although its sales for the 12 months ending in September 2010 were 7.7% below 2007 levels, and grew only 0.8% in the last twelve months, it has recently been the fastest-growing of GAFO segments ***(see Chart 8)***. And store productivity actually has increased 3.2% as retail selling space fell 10.5% over the same period, driven largely by Circuit City's closing of its last 567 stores in 2008 and 2009. Sales growth this season will likely get a boost from a few hot products. Our Communispace community members are particularly excited by LED and 3-D TVs, iPads and increasingly affordable smartphones and digital cameras.

The furniture and home furnishings segment was hit hardest during the recession and has a long road ahead. As the housing market faltered, sales dropped 21% from the 12 months ending in September 2007 to the same period this year, the largest sales drop of all GAFO segments. Store closures have been widespread: This segment has seen a 17% drop in retail space since 2007. Stores that survived suffered a 5.2% drop in productivity over the same period. Sales growth this year, however, gives these retailers some tailwind going into the holiday season. At the furniture market this month in High Point, North Carolina, Market Authority president and CEO Brian Casey reported an increased number of buyers, further fueling a positive outlook for the holidays. Among the trends driving the increased activity are innovative designs to accommodate large flat-panel TVs and other new technologies.

Here's to a happy holiday season!

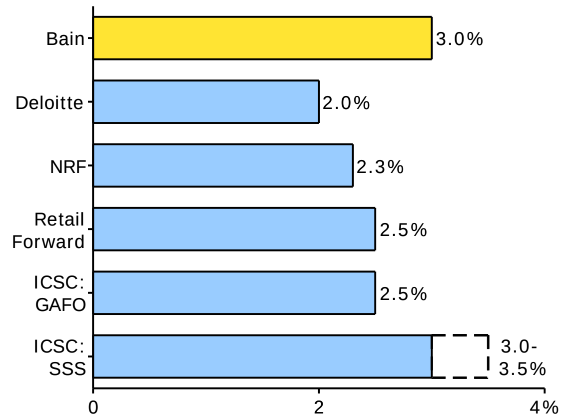
Hopes are high that this holiday season will be the best in years. Bain's estimate of 3% growth is at the high end of other holiday forecasts, which range from 2.0% to 3.5% ***(Chart 11)***.[10] But growth is not a given. As the season gets set to kick off, an unseasonably warm October could hurt sales of winter merchandise—or at least delay them until November. This, combined with higher inventory levels could pressure retailers to step up promotional activity early, threatening margins.

We will continue to report on those retailers who are succeeding and to examine the practices that are most important in driving their success.

[10] The forecasts are not all directly comparable because they may cover different sector mixes and periods.

Chart 11:

Forecasted holiday sales growth, 2010



	Measure	Period
Bain	GAFO (excluding online)	November – December
Deloitte	All retail (including online) except auto, gas and food services	November – January
NRF	All retail (excluding online) except auto, gas and restaurants	November – December
Retail Forward	All retail (including online) except auto, food and drug channels	October – December
ICSC: GAFO	GAFO (excluding online)	November – December
ICSC: SSS	Same-store retail sales (brick and mortar), excluding Wal-Mart	November - December

Source: International Council of Shopping Centers; Retail Forward; Deloitte; National Retail Federation

Newsletter schedule

Our next newsletter will be released in early November, with a new issue every two to three weeks through the holiday season ***(Chart 12)***. 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 suggestions for additional analysis.

Chart 12:

Indicator update and newsletter schedule

Data Source	Oct (3, 10, 17, 24, 31)	Nov (7, 14, 21, 28)	Dec (5, 12, 19, 26)	Jan (2, 9, 16)
US Census Bureau Advance Retail Sales (GAFS/GAFO)	▲ 15-Oct	▲ 15-Nov	▲ 14-Dec	▲ 14-Jan
ICSC Monthly Same Store Sales	▲ 7-Oct	▲ 4-Nov	▲ 2-Dec	▲ 6-Jan
Michigan Consumer Sentiment Index	▲ 15-Oct, ▲ 29-Oct	▲ 12-Nov, ▲ 24-Nov	▲ 10-Dec, ▲ 23-Dec	
Consumer Confidence Index	▲ 26-Oct	▲ 30-Nov	▲ 28-Dec	
Bain Retail Holiday Newsletter	☆	☆ ☆	☆ ☆	☆

Appendix

Chart A:

Definitions

	GAFO	GAFS	GAF	Nonauto retail sales
General merchandise stores	✓	✓	✓	✓
Clothing and clothing accessories stores	✓	✓	✓	✓
Furniture and home furnishings stores	✓	✓	✓	✓
Electronics and appliances stores	✓	✓		✓
Sporting goods, hobby, book and music stores	✓	✓		✓
Office supplies, stationery and gift stores	✓			✓
Nonstore sales, including traditional retailers' online sales				✓
All other retail trade sales not listed above (excluding auto and auto parts)				✓
Auto and auto parts sales				

Selected References

Bain & Company has included in this document information and analyses based on the sources referenced below as well as our own research and experience. Bain has not independently verified this information and makes no representation or warranty, express or implied, that such information is accurate or complete. Projected market and financial information, analyses and conclusions contained herein are based (unless sourced otherwise) on the information described above, and Bain's judgments should not be construed as definitive forecasts or guarantees of future performance or results. Neither Bain & Company nor any of its subsidiaries or their respective officers, directors, shareholders, employees or agents accept any responsibility or liability with respect to this document.

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