Bain Retail Holiday Newsletter #6

January 17, 2011

To: **US Retail Partners**
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The retail sector has reason to celebrate the 2010 holiday season. Preliminary sales growth for November and December rang in at 4.9%, beating even the most bullish analysts' predictions. That growth, combined with 11 straight months of GAFO sales increases, gives retailers hope that sales this year will continue on an upward trajectory. But as we look ahead, it is clear that success will remain challenging. Our last newsletter of the season addresses some of the growth opportunities and potential game changers retailers will face in 2011.

Holiday 2010 beat expectations, but retail's recovery is far from over

Holiday sales were up 4.9% over 2009, exceeding most analysts' original expectations and almost matching the trailing 30-year average growth rate of 5% ***(Chart 1)***. The season kicked off with a strong November in which GAFO sales increased 5.3% over last year.[1] After that strong start, many analysts raised their sales-growth estimates for December. Momentum slowed slightly that month, causing some retailers to miss the revised targets, but December GAFS sales still increased an impressive 4.6% over 2009. Although 2010 holiday spending came in 1.6% short of peak levels achieved in 2007, full-year 2010 sales were up 3.4% over 2009 and ended just 0.3% below retail's 2007 peak ***(Chart 2).***

In December, there was wide variation in growth across GAFO segments ***(Chart 3)***. Clothing and clothing accessories led the way with an impressive gain of 8.4% over 2009, followed by sporting goods, hobby, books and music (up 8.2%). Though still positive, growth was not as strong in other segments. General merchandise, which accounts for more than half of GAFO sales and includes mass merchandisers, department stores, warehouse clubs and luxury stores, increased 3.4%. The two remaining segments, furniture and home furnishings, and electronics and appliances, posted the softest growth in December, up 2.2% and 1.4%, respectively.

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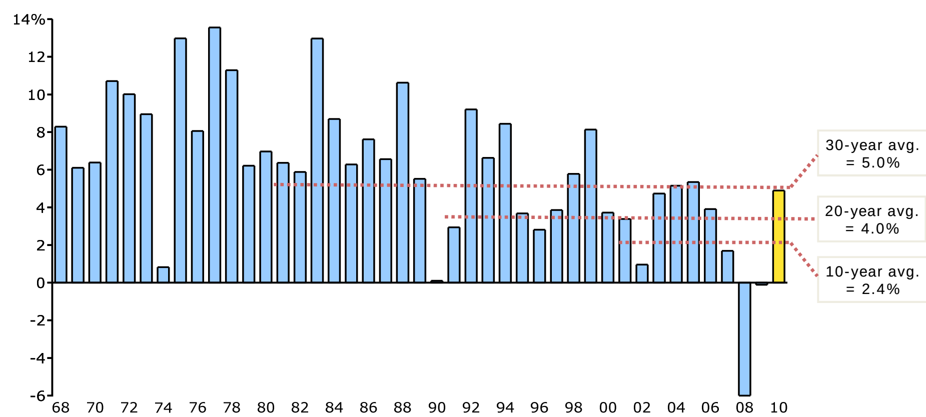
[1] See Chart A in the Appendix for definitions of GAFO and other retail sales measures.

Chart 1:

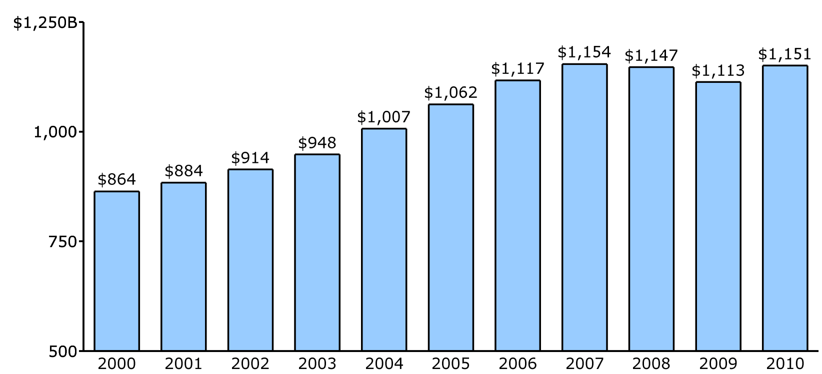
Holiday sales growth, 1968-2010



Note: *Holiday* is defined as November and December; growth rates are based on the 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; the 2010 growth rate is calculated using growth rates for November GAFO and December GAFS
Source: US Census Bureau

Chart 2:

Annual GAFO sales, 2000-2010

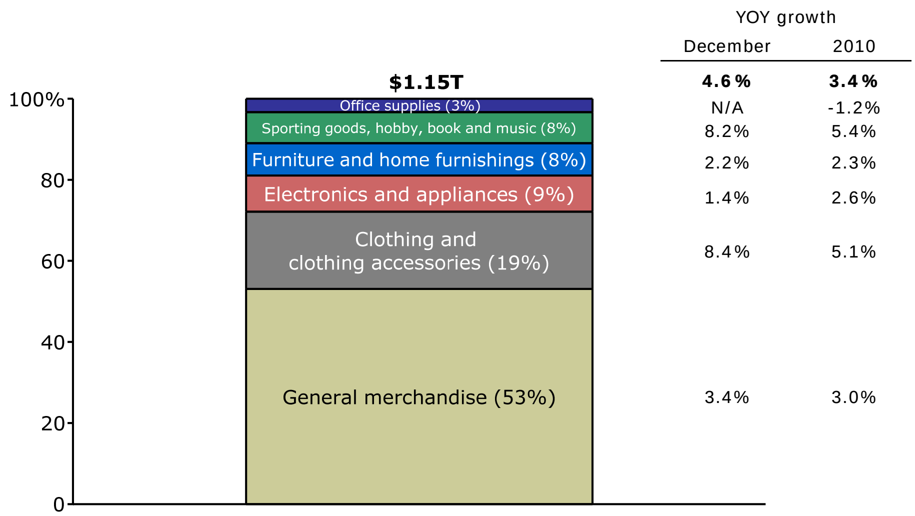


Year-over-year change	5.8%	2.3%	3.4%	3.7%	6.2%	5.5%	5.1%	3.3%	-0.6%	-3.0%	3.4%

Note: Growth rates are based on the 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; the 2010 growth rate is calculated with January-November GAFO and December GAFS for both 2009 and 2010
Source: US Census Bureau

Chart 3:

GAFO sales by sector, 2010



Note: December overall growth rate is for GAFS; 2010 data do not include office supplies for December; office supplies 2010 growth rate is for January to November because data have not yet been reported for December; December data are based on advanced data published January 14, 2011
Source: US Census Bureau

Let's not forget that GAFO figures exclude online sales. E-commerce was once again the shining star of the holidays, surging 12% over last year, climbing to a record $32.6 billion, according to comScore. This strong finish helped full-year e-commerce sales increase a healthy 9.8% over 2009.

Going forward, retailers face two major challenges. The first is setting realistic expectations in an environment of continued uncertainty. The second is developing innovative long-term growth strategies and building the capabilities to execute them.

A strong core is a necessary foundation for growth

With the recession gradually loosening its grip on the economy, many retailers are again setting their sights on expansion. But the odds of success are slim unless they start with a strong core business.[2] Bain analysis shows that only 1 in 10 companies achieves sustainable top- and bottom-line growth with returns above the cost of capital.[3] A full 95% of those that do are leaders in their core business: They excel at delivering a unique value proposition, and they generate twice the level of customer advocacy that their followers do.[4] What does this mean for retailers in 2011? The most successful will strengthen their core capabilities to fully engage their existing customers and to grow into complementary adjacencies, all of which should further strengthen the core.

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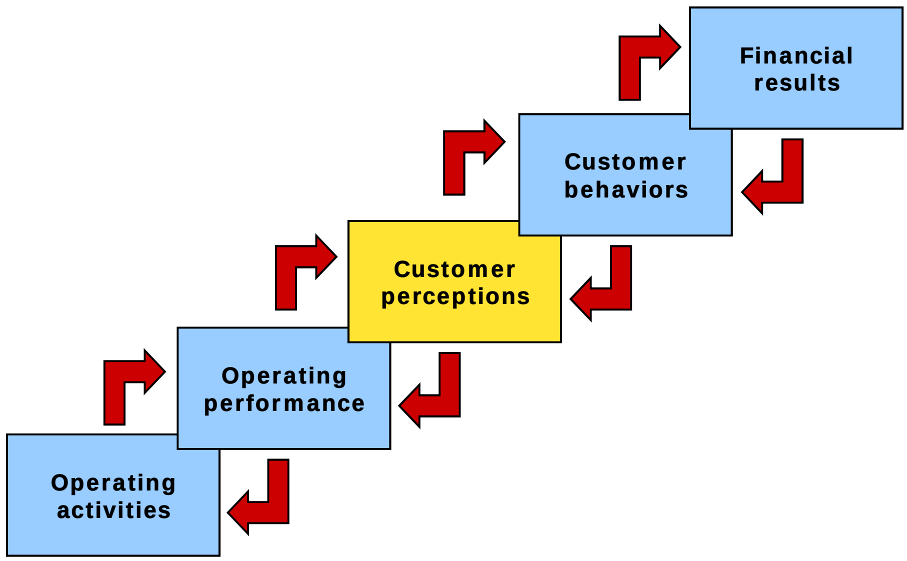
[2] A company's core business is what makes it unique and what really gives it its competitive advantage.

[3] We call these companies *sustained value creators* and define them as public companies with (1) more than $500 million in sales in 1999, (2) sales growth over 5.5% between 1999 and 2009, (3) profit growth over 5.5% and (4) above-average total shareholder return.

[4] Customer advocacy is measured by Net Promoter® Score.

Chart 4:

Linkage between operating activities and financial results



Fully engaging customers starts with understanding their perceptions and behaviors. This means listening to them, learning what really matters to them and watching what they actually do. Then retailers can take what they've learned and use it to inform changes to their operating activities ***(Chart 4)***. Little will change until credible and compelling linkages can be established among operating activities, customer perceptions and financial results.

The reality is that many companies let pride cloud their understanding of customers. Our research shows that 80% of companies believe they deliver a superior customer experience, but only 8% of their customers agree. How can retailers close this delivery gap? By improving loyalty. Bain's approach to improving loyalty aims to raise the Net Promoter® Score (NPS), a measure of customers' willingness to recommend a brand to trusted friends.[5] The process is not unlike social media monitoring systems that track what customers really think and say to others about their experiences. Retailers can integrate this information into a closed-loop management system that focuses on exceeding customers' expectations. The goal is to create more promoters: customers who stay longer, buy more and refer more ***(Chart 5).*** Apple is one company that excels at this. A 2010 poll of more than 19,500 consumers gave Apple the highest NPS among retailers. This comes as little surprise given that its stores are consistently on the cutting edge of service delivery supported by technology, and that they offer a suite of innovative products that not only are complementary but also are linked by a carefully constructed (and guarded) operating system and service mechanisms designed to create a rich and seamless experience for customers.

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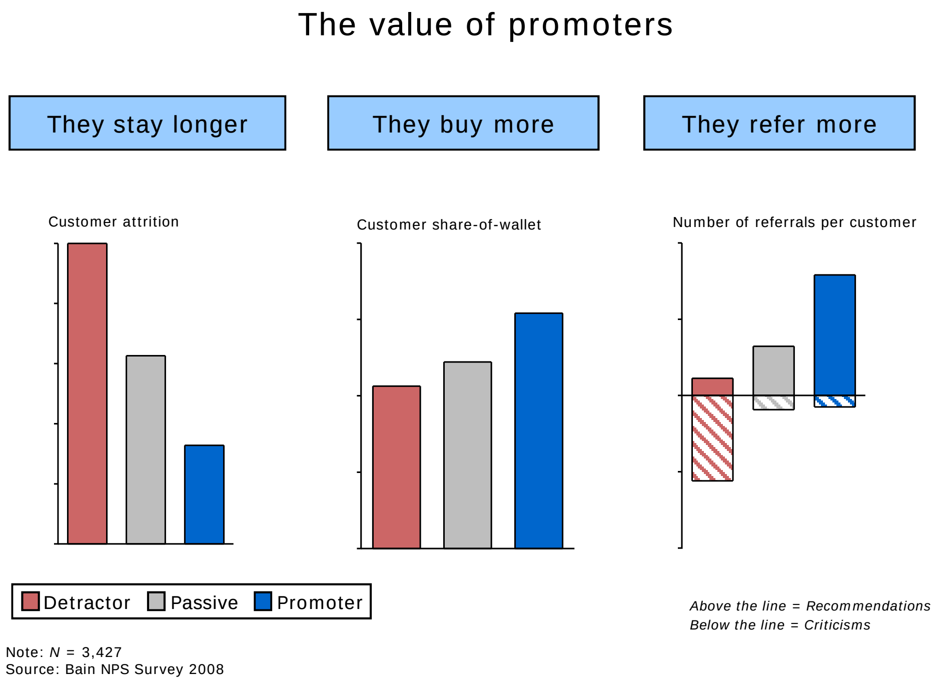
[5] Consumers are asked how likely they are to recommend a brand to a friend or colleague on a scale from 0 to 10, where 0 means "not likely" and 10 means "extremely likely." Promoters rate their likelihood a 9 or 10; detractors rate their likelihood a 6 or less.

Chart 5:



Once retailers have identified their target consumers' needs, they can change their operating activities to address them. Retailers that consistently do this will tend to deliver on three things:

- Fostering innovation
- Embracing technology
- Enabling customization

Fostering innovation

Retail changes have been slow but substantial over the last 40 years ***(Chart 6)***. One thing is clear: If you think innovation is risky, try stagnation. As technology continues to play an increasingly important role in retail—notice the rise of eBay to number 5 in 2010 and Amazon.com to number 12—the pace of change in the industry is accelerating. This means that the need for constant innovation—and therefore better testing and learning—will accelerate as well. Good ideas demand more than creativity. The most innovative companies bring together the best of right-brain creativity with left-brain commercial skills, developing ideas that are both imaginative and economically viable. We consistently see these creative–commercial partnerships in innovative organizations. Take Nike, for example. Without Phil Knight's business acumen, Bill Bowerman's waffle-tread shoe may never have turned into a $19 billion company. Other well-known examples include Polo Ralph Lauren (Ralph Lauren and Roger Farah), Marc Jacobs (Marc Jacobs and Robert Duffy), Calvin Klein (Calvin Klein and Barry Schwartz) and Apple (Steve Jobs and Tim Cook).

Chart 6:

Top-10 retail profit leaders in the United States, 1970-2010

	1970	1980	1990	2000	2010	2015
1.	Lucky	Tandy	Wal-Mart	Wal-Mart	Wal-Mart	?
2.	Winn-Dixie	Wal-Mart	Food Lion	The Home Depot	CVS	
3.	J. C. Penney	Lucky	The Limited	Sears	The Home Depot	
4.	Albertsons	Melville	Rite Aid	Target	Target	
5.	S. S. Kresge	Albertsons	Giant Food	Safeway	eBay	
6.	W. T. Grant	American Stores	Melville	Gap	Walgreen	
7.	Giant Food	Winn-Dixie	J. C. Penney	Kroger	Lowe's	
8.	Borman's	Dayton Hudson	Albertsons	May Dept. Stores	Best Buy	
9.	Zayre	Supermarket General	Service Merchandise	Lowe's	TJX	
10.	Federated Dept. Stores	Revco	The Home Depot	Walgreen	Costco	
11.					*Gap*	
12.					*Amazon.com*	

Note: 2010 data represent August 2010 trailing 12 months
Source: *Fortune*

Embracing technology

Gone are the days when retail success required only hiring the best merchants. Today retailers need to make technology a core competence. Technology impacts more than information systems, supply chains and pricing; it's become essential to improving the customer experience. In time, of course, today's leading-edge innovations will simply be the norm, and new rounds of breakthrough technologies will take their place. Remember when point-of-sale scanners and then self-checkout kiosks at the local supermarket or home improvement center were significant advancements? Now consider how Apple's mobile point-of-sale technologies allow salespeople to complete transactions anywhere in the store. By fusing mobile devices with credit-card processing, Apple has turned every sales associate into a cash register and has eliminated long lines, reduced walkouts and made the shopping experience more personal. As Apple has shown, leaders use each advancement to enhance their brand image and customer loyalty. Followers, unfortunately, end up spending nearly as much while only solidifying their reputation as laggards.

The rapid influx of technologies is changing customers faster than it is changing many retailers. A recent IBM survey of 30,000 consumers revealed that 49% of them are "instrumented consumers"—people who use two or more technologies (website, mobile device or in-store kiosk) to shop—up 13 points from just one year ago.

Enabling customization

Standardized stores with standardized offerings are easy, but Bain's experience suggests they leave growth and margin on the table. Savvy retailers are always looking for ways to make products and the shopping experience more personal and individualized. As a retailer’s focus grows increasingly customer-centric, leading localizers are learning to maximize not just same-*store* sales, but same-*shopper* sales.

Localization is one way to customize offerings to consumers’ tastes and preferences. Strong execution of this strategy works: An analysis of leading-edge retailers shows localized products increased sales an average of 10% to 15% and reduced markdowns by 8 percentage points. Macy’s continues to tout the success of its “My Macy’s” initiative, which Deborah Weinswig at Citigroup expected to add as much as 3 percentage points to the company’s holiday sales this season at stores open at least a year.

Customization does not end with localized offerings. Crowdsourcing—incorporating input from customers in the development of products—and personalization tailor offerings to smaller segments and individual shoppers. Apparel store Threadless runs design competitions on its social network sites and prints the winners on T-shirts. And Keds has partnered with the Whitney Museum of American Art and Bloomingdale’s to bring up-and-coming artists’ designs to its canvas shoes, selling exclusively through select Bloomingdale’s stores and online.

A website is a good ingredient; omnichannel is the secret sauce

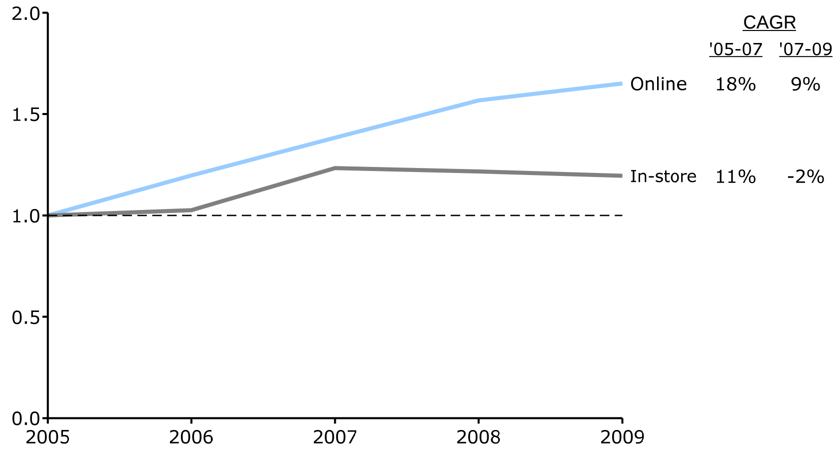
Digital commerce is both the greatest opportunity for, and the most serious threat to, the retail industry in decades. For years, top retailers have seen the growth of e-commerce far outpace that of brick-and-mortar stores. In fact, a breakout of top retailers’ sales shows that online sales grew at a compound annual rate of 9% from 2007 to 2009, compared to a drop of 2% for in-store sales over the same period ***(Chart 7)***. E-commerce is critical today, when it makes up about 8% of total retail sales; it will become absolutely essential to retailers’ survival as penetration increases. Forrester Research expects online sales to reach 13% of total retail sales by 2015. And this figure could ultimately approach 25%. Moreover, mobile commerce is projected to grow at a compound annual rate of 64% over the next five years, from $2 billion in 2010 to $24 billion in 2015.

The challenge for retailers is that technology is moving at lightning speed. Online pure plays—retailers with only digital storefronts—are forced to use digital technologies to steal share from stores. By necessity, then, pure plays embrace the speed of innovation and wield it as a competitive advantage. Traditional retailers must match pure plays’ strides while leveraging their core advantage: physical stores. Innovation that brings together the best of online and offline should give traditional retailers an edge in this rapidly evolving environment.

Omnichannel retailing gives traditional retailers an opportunity to outperform their pure-play competitors by using the best of each channel at each step in the customer-experience chain for individual customers. It means moving from a multiple-channel operation, in which stores and websites operate somewhat independently, to a new infrastructure that seamlessly integrates the customer experience across all channels of interaction—stores, websites, direct mail, mobile devices (including mobile phones, GPS devices, tablets and in-vehicle services like OnStar), social networks, home shopping, gaming and other channels that may yet emerge.

Chart 7:

Index of in-store and online sales for top retailers, 2005-2009



Note: Top retailers are based on *Internet Retailer*'s 2009 top 100 excluding pure plays and non-GAFO retailers; CAGR is the compound annual growth rate
Source: *Internet Retailer*

Omnichannel retailing requires a new mindset and operating model, and it impacts nearly every function and decision within a retailer's organization. We can't cover all aspects of the model in this newsletter, but we can share a few examples of what retailers are doing on some of the most important fronts:

- Bringing the best of each channel to each customer at each touchpoint
- Integrating infrastructure and support functions
- Organizing for an omnichannel world

Bringing the best of each channel to each customer at each touchpoint

By using a sophisticated channel mix and staying on the cutting edge of innovation, omnichannel retailers are able to enhance the customer experience at every touchpoint. Again, the key is to know what customers want. So the first step is to develop a detailed view of customers and their needs. For this, retailers rely on a growing number of sources: Store visits and customer intercepts, more-sophisticated door-counting devices and other in-store monitoring, purchasing data from loyalty programs, e-mail and promotion response rates, online searches and viewing histories, social media conversations, abandoned shopping carts, online shopping patterns and mobile tracking devices are just a few of the sources from which retailers can extract valuable data. Those data help them define and segment their customers more accurately than ever before—in some cases to different segments of a single individual.

During the actual in-store shopping experience, interactions are no longer limited to a simple dialogue between sales associates and customers. Retailers increasingly are incorporating mobile devices to enhance in-store visits. Sephora's customers can use an app on their phones to scan product display barcodes for information and reviews;

shopkick alerts customers to the latest promotions as they walk into the store; Apple store representatives have products or information in hand for customers who have checked in on their iPhone; and Urban Outfitters is experimenting with mobile-phone checkout capabilities.

Integrating infrastructure and support functions

Traditional retailers face a challenge that their pure-play competitors do not: They must innovate in multiple channels and then integrate those channels to capitalize on the best of each one. This means they must design an infrastructure that not only supports multiple independent channels but also can fully integrate them. Nordstrom and Best Buy are two retailers that have integrated their supply chain and inventory management functions, allowing customers to shop across channels—to check stock at a local store from their computer or smartphone, to order online and then pick up at a store, to find a certain color or size at another store while still shopping. Key to the success of an omnichannel infrastructure is an integrated logistics plan; and key to the efficiency of that infrastructure are cross-functional teams that can support all channels and integrated systems across all facilities.

Effective omnichannel retailers also must extend integration to support functions and their decision making. Innovative retailers are doing this. For example, finance prioritizes capital investments across channels, and human resources hires talent versed in dynamic environments and aligns incentives with cross-channel metrics.

Organizing for an omnichannel world

Although organizational changes don't solve all problems, they can make omnichannel retailing easier (or harder if poorly designed) to execute. In determining their optimal organizational structure, retailers need to determine how major decisions will be made in this new environment. In merchandising, for example, retailers should be asking: Will online or in-store channels make vendor relationship decisions? Will they be made jointly or across all channels? Who decides which vendor promotions to run and in which channel? Some retailers have taken the first step in setting up an omnichannel organization, creating enterprise-wide teams in functions like merchandising and marketing to serve customers across all channels. Although the opportunities produced by these changes are significant, they are not without challenges. And their impact on sales may not be immediate—especially if smaller, highly specialized digital operations are shortchanged—adding to the pain of making complex changes.

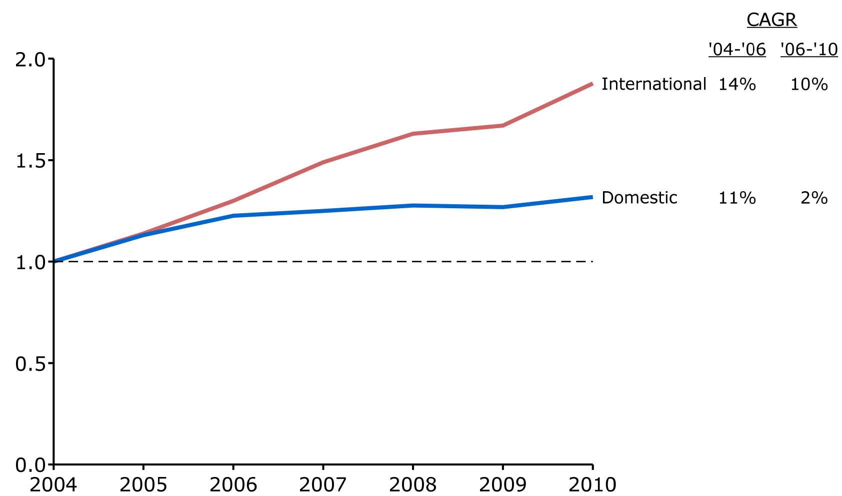
Becoming an omnichannel retailer is not an overnight endeavor. The next three to five years will be a critical time for retailers to gain digital share. Traditional retailers face a massive challenge: They need their online innovation to match that of pure plays; but they also have to be innovating in stores, on mobile devices and on social networks at the same time.

International expansion can be a retailer's ticket to growth . . . or to a rocky ride

International expansion is more attractive than ever, particularly for retailers who are in the position to take advantage of it. Although domestic sales of the top-25 US-based multinational retailers nearly flattened between 2006 and 2010, their international sales grew 10% over the same period ***(Chart 8)***. This pattern likely will continue. Economists expect GDP in India and China over the next decade to grow at double the rate of GDP in the United States.[6] In fact, by 2020 China is expected to jump from the seventh largest consumer market in the world to the second. As Ajay Khaitan, CEO of Emerisque Brands, explains: "[There are] tens of millions of new, aspirational middle-class Asian consumers entering the branded consumption economy . . . every year, and there is a race . . . to meet this new demand."

Chart 8:

Index of international and domestic sales for top retailers, 2004-2010



Note: Data are based on an index of 25 US-based GAFO retailers with international sales; CAGR is the compound annual growth rate
Source: Planet Retail

But international expansion can be a minefield. A Bain study of 60 US retailers found that 65% of geographic expansions failed, often due to poor strategic planning, and that only about 20% resulted in both positive net present value and the establishment of a significant foothold in international markets.[7] For some retailers, the issue is financial: Funding capital-intensive international operations puts additional stress on domestic operations. Others struggle with the sheer complexity and seeming unpredictability of the variables involved in global expansion. Much of that unpredictability, however, can be mitigated by paying particular attention to—and carefully evaluating tradeoffs among—four key parameters:

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[6] These projections, from the Economist Intelligence Unit, are based on GDP estimates at purchasing-power parity.

[7] By "significant foothold," we mean greater than 5% of revenue and profits.

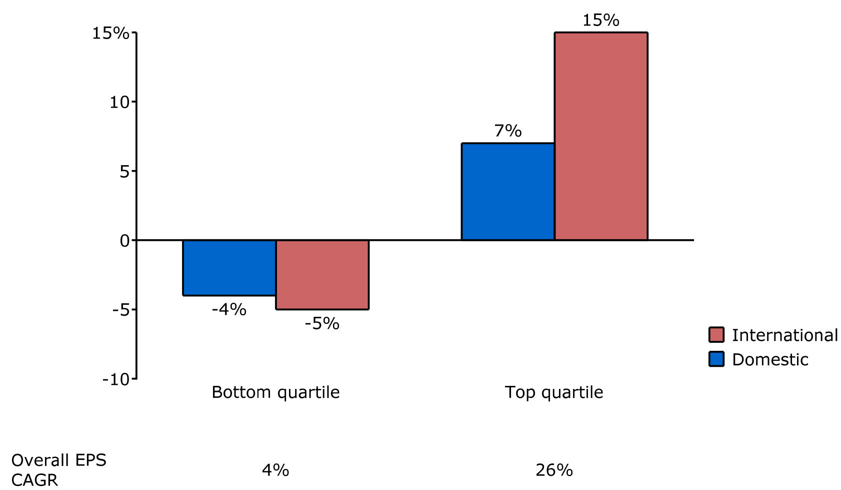
- Ensuring that the core business can sustain expansion
- Identifying where market conditions are favorable
- Creating a customized model for entry and expansion
- Choosing the most effective way to quickly build strong in-market capabilities

Ensuring that the core business can sustain expansion

A strong domestic core is the foundation of a thriving international venture. Of the top 25 US-based multinational retailers, bottom-quartile performers—those with the weakest domestic business based on sales growth—saw international growth go down 5% over the last three years, while those with strong domestic businesses saw international growth go up 15% over the same period ***(Chart 9)***. When Bed Bath & Beyond made the decision to expand internationally in 2007, cochairman Warren Eisenberg and analysts alike pointed to the excellent financial health of the company as evidence of its readiness to move into Canada.

Chart 9:

International and domestic sales growth
for top- and bottom-quartile retailers, 2008-2010



Note: Based on an index of 25 GAFO retailers with annual revenue over $4 billion; quartiles are based on total revenue growth between 2008 and 2010
Source: Planet Retail

With a strong core, a retailer can transport proven business concepts and capabilities to new markets. When H&M pursued its expansion strategy in the United States, it followed the same "fast fashion" approach that had worked so well in Europe, with limited sourcing outside of Asia and extensive advertising to establish the brand. But even with the right foundation, it can take years to achieve profitability; and without adequate resources over the initial period, retailers may pay the price without reaping the benefits. Although H&M planned to break even within two years of opening its New York flagship store, it was at least four years before it reached the breakeven point.

Identifying where market conditions are favorable

Choosing a target market can be difficult. Exploring and prioritizing options—identifying consumer profiles and trends; assessing leadership potential; getting educated on a market's political, social and economic stability and business climate—are essential first steps. The potential for growth is the obvious place to begin: It's what makes developing markets like India, Brazil and China a priority for almost every retailer thinking about international expansion.

However, estimating a market's potential for growth is only the starting point. Figuring out how to win is what really matters. Ultimately, retailers must understand and then respond to local customers' needs in ways that build leadership positions, not just incremental sales. This demands a deeper level of strategizing about which countries to enter, in what order, at what speed and with what mix of vehicles. Consider Nike's entry into China in the 1990s: The company introduced high school basketball leagues, sponsored three-on-three tournaments and infused commercials with just enough American culture to be intriguing while still appealing to Chinese consumers' national pride. By 2004, Nike was expanding at the rate of 1.5 stores a day. Nike's creative, leadership-driven thinking has since paved the way for others. Adidas, for example, plans to open approximately 2,500 new stores in China over the next five years.

Creating a customized model for entry and expansion

To succeed in new markets, retailers have to develop a customized model for entry and expansion. Of course, the processes that underlie each model—researching and deciding on organic expansions, partnerships or acquisitions—are the same. But the resulting strategies should and do vary by retailer and market. When Guess? originally ventured into Europe, much of its expansion was via licensees. In fact, about three-quarters of the company's stores outside the United States are still operating under license agreements. However, when Guess? entered the Chinese and South Korean markets in 2007, it used a direct operating model: It now has 40 wholly owned stores in China and has plans to increase that number to 200 over the next three to five years. Starbucks also has used two basic models in its expansion efforts. Unlike Guess?, though, Starbucks opted for a direct operating model in larger Western markets (for example, Canada, the United Kingdom and Germany) and a licensee/joint venture model in markets where consumers and business processes shared fewer similarities with the company's US core (more than 60% of non-US Starbucks stores are licensed).

Choosing the most effective way to quickly build strong in-market capabilities

In-market capabilities—cultural understanding, store location selection, merchandising and supply chain strength, and management talent—are some of the most nuanced elements of success. In reality, though, they can have just as much impact on the success of international expansion as high-level strategy can. When Coach became interested in the Japanese market, it carefully staged its entry: It began by building a strong relationship with a local partner and a brand presence through wholesalers. The first Japanese stand-alone store did not appear until three years after the retailer entered the market. Indeed, partners are often indispensable for navigating local culture and politics. Diane von Furstenberg didn't begin expanding her DVF stores into Asia until she had secured the collaboration of Globalluxe Limited, a Hong Kong–based luxury distributor whose first customer was Kate Spade. Without the right preparation and hedging, differences in countries' business environments can mean failure. Witness the case of IKEA, which suspended further investment in Russia in 2009, reportedly because of pervasive corruption and demands for bribes.

As many US-based retailers begin to explore international operations, more are finding that online offerings are a low-risk entry tool. Forrester Research predicts that in 2011, international shipping will be the most popular way for US online retailers to reach international consumers. Says Stuart Rose, former chairman of Marks and Spencer: "Going into new countries before building stores is a non–capital intensive way of adding new markets. It's a very good way of a business transporting its brand overseas, it's a bit like the advance guard." J.Crew has begun to develop its shipping capabilities with Japan and plans to open up options to other destinations soon. In fact, it is getting easier for US retailers to ship packages around the globe, especially as third parties pop up to help with logistics.

As the digital world continues to penetrate retail operations, international digital expansion becomes a logical—if not necessary—move, both to hedge against the diminishing importance of brick-and-mortar stores and to create an avenue for sustained growth. But there is a difference between entering international markets using a US-based infrastructure and serving a market via in-country operations. The former functions well as a short-term solution or a marketing vehicle, but there are no shortcuts to success. Ultimately retailers must build a local presence to attain more than a peripheral market position.

Finally, success abroad can mean success at home too. Retailers can use lessons learned and capabilities developed in foreign markets to improve their domestic business. For example, experience in Latin America could help retailers better serve Hispanic customers in the United States; or experience in new, often smaller, formats abroad could lead to innovative ways to reach further into dense urban markets back home. Furthermore, relationships with international vendors and insights into a broad range of digital technologies are creating powerful competitive advantages.

Growth is out there in 2011

The good news: Many retailers may see modest growth returning in 2011. Still, there are always winners and losers; and with economic uncertainty lingering, nothing is a given. The fundamentals remain unchanged, though: Growth will always require a solid foundation first. Once that is laid, thoughtful planning and careful execution of moves into adjacencies can fuel the growth engine. With omnichannel innovation and international expansion leading the way, 2011 will be an exciting year for retail resurgence.

We hope you have enjoyed reading our Retail Holiday Newsletters this season. We will be back later this year to report on how retailers are faring.

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	✓			✓
All other retail trade sales not included in GAFO (excluding auto and auto parts)				✓
Auto and auto parts sales				

Selected References

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