Bain Retail Newsletter

May 1, 2009

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

We are in the 17th month of a recession that has caused tremendous turmoil for retailers. Consumers' income, wealth and access to credit have been shaken, and their spending patterns have changed significantly. Retail sales are expected to fall throughout 2009. But industry averages and totals don't tell the whole story. Just as the speed and the impact of the downturn have varied by retailer, so will the speed and the impact of the recovery. This newsletter discusses how forward-thinking retailers can assess their specific circumstances, find ways to do well in the downturn and thrive in the upturn.

Retail in 2009: Managing through extended turbulence

First-quarter results for retailers have been disappointing but not surprising: GAFO sales fell by 3.6%, while same-store sales dropped an average of 1.3%.[1] More than a dozen retailers have filed for bankruptcy since January 1, 2009. And of the more than 25 retailers that took cover under Chapter 11 in 2008, only one—Mrs. Fields—emerged under the same ownership. Four others were sold at auction and remain mostly intact; the rest liquidated their assets or are still in bankruptcy.

Behind these statistics is the fact that US consumers have dramatically changed their spending habits. As has been widely reported, they are trading down, deferring purchases, shopping for value and doing without. Conspicuous consumption has become unfashionable. Wallets are still opening, but there is more angst associated with buying. Before they spend, consumers are asking themselves "Do I really need this?" "Is this really worth it?" "Can I afford it?" "What if I lose my job?" and, of course, "When will this end?"

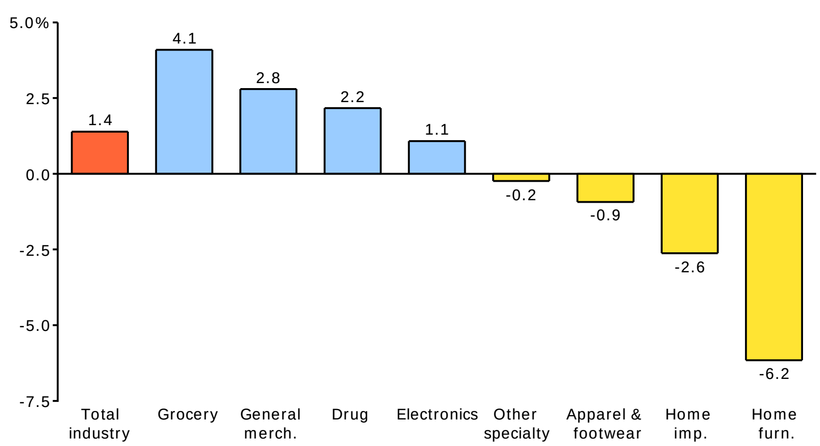
[1] GAFO is a measure of sales at stores that sell merchandise normally sold in department stores. It reflects sales of general merchandise, clothing and clothing accessories, furniture and home furnishings, electronics and appliances, sporting goods, hobby items, books and music, office supplies, stationery and gifts. GAFO numbers are available for January and February 2009; for March 2009, we used an advance estimate for GAFS (a similar metric), and compared it to the March 2008 GAFS number. The same-store sales figure is the average of January, February and March ICSC data.

The best crystal balls concur: The overall economic outlook remains sluggish. No one knows how fast or how dramatically the federal government's stimulus actions will drive a recovery. We believe gross domestic product will fall roughly 3% in 2009 and grow anemically in 2010 before returning to traditional growth rates of approximately 3% in 2011. Given escalating unemployment rates, deflated asset values and low consumer confidence, we expect personal consumption expenditures—which include retail spending—to recover even more slowly. One reasonable scenario suggests it will be 2012 before total retail spending rebounds to 2007 levels.

What does this mean for individual retailers? Given that a quick turnaround is unlikely, retailers will need to adjust to the new reality. Already we've seen them react to traffic and sales declines by reducing inventory and shuttering stores. Although there is no definitive source for overall industry productivity, Bain estimates that first-quarter 2009 sales per square foot dropped approximately 3% over the first quarter of last year. This comes on top of annual growth of just 1.4% in 2008 ***(Chart 1)***.[2]

Chart 1:

Change in sales per square foot by retail sector, 2007-2008



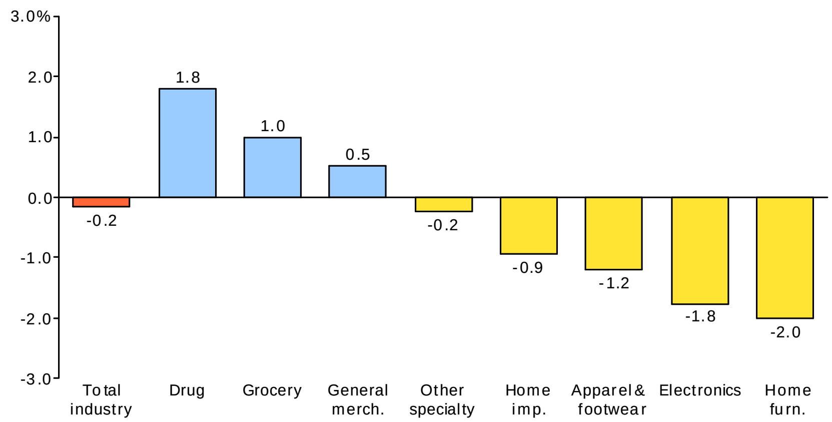
Note: Total industry includes sectors shown here, and excludes auto, gasoline stations, nonstore retailers and restaurants.
Other specialty includes sporting goods, hobby, book and jewelry stores among others.
Source: Euromonitor; US Census Bureau

As of February 2009, retail inventories were down 3.2% from prior-year levels, largely due to a 6.2% drop in the general merchandise sector. Euromonitor reported that about 17 million square feet of retail real estate went dark in 2008. And Reis, Inc. estimates additional declines of 8.7 million square feet of mall and shopping center space in the first quarter of 2009. The closures have been sharpest in electronics and home furnishings, while drug and grocery stores have buoyed the averages ***(Chart 2)***.

[2] Excluding grocery sales, annual growth per square foot last year was only 0.5%.

<u>Chart 2:</u>

Change in square footage by retail sector, 2007-2008



	Total industry	Drug	Grocery	General merch.	Other specialty	Home imp.	Apparel & footwear	Electronics	Home furn.
Total square footage (2008)	10.1B	0.5B	2.3B	1.5B	1.6B	2.0B	1.1B	0.3B	0.7B

Note: Total industry includes sectors shown here, and excludes auto, gasoline stations, nonstore retailers, restaurants, and other non-grocery retailers. Other specialty includes sporting goods, hobby, book and jewelry stores among others.
Source: Euromonitor

Not surprisingly, the pain has extended to landlords. Mall operator General Growth Properties (GGP) filed for bankruptcy on April 16, failing under the weight of debt used to finance a series of acquisitions. Although it is too early to say if GGP is an isolated case or a precursor of more mall bankruptcies or even foreclosures, it is clear that mall operators are facing higher vacancy rates and strained finances. And landlords that pursued an aggressive strategy of trying to win share through debt-funded acquisitions face the greatest risk.

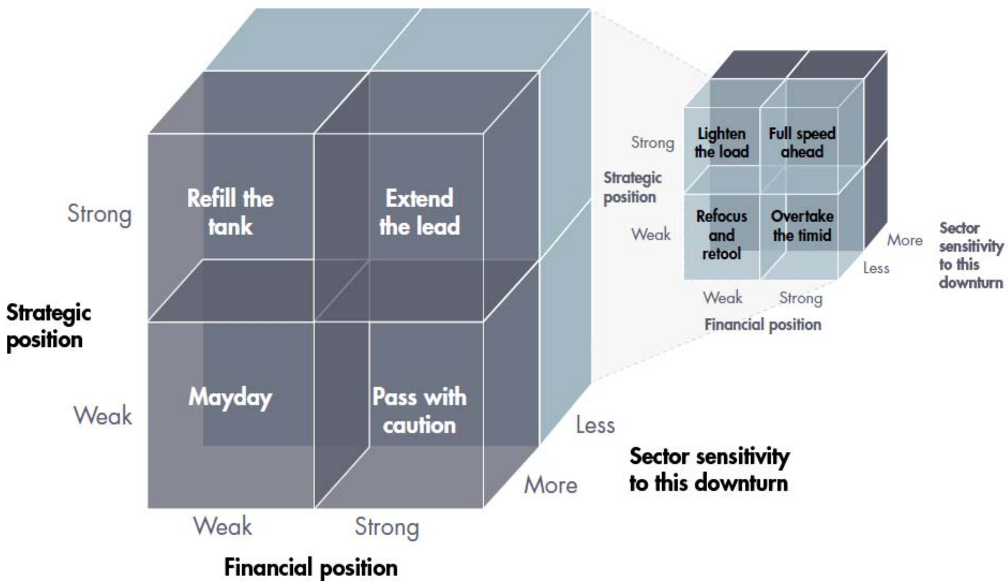
Determining where you stand can keep you standing

Understanding overall totals and industry trends is important, but it is not enough to help an individual retailer chart a winning course. Just as there is no such thing as an average consumer, there is no such thing as an average retailer either. In the December 12, 2008, issue of the *<u>Bain Retail Holiday Newsletter</u>*, we described how each retailer must carefully assess its current position based on three key dimensions ***(Chart 3)***:

- *Sector sensitivity to this downturn.* How severe is it? And how fast is the sector likely to recover?
- *Strategic position.* How loyal are our customers? What actions might our competitors or vendors take? What opportunities exist to grow share and profits?
- *Financial position*. How much flexibility are we likely to have after all our nondiscretionary cash needs are met?

Chart 3:

The assessment cube: Three factors that determine
a retailer's position

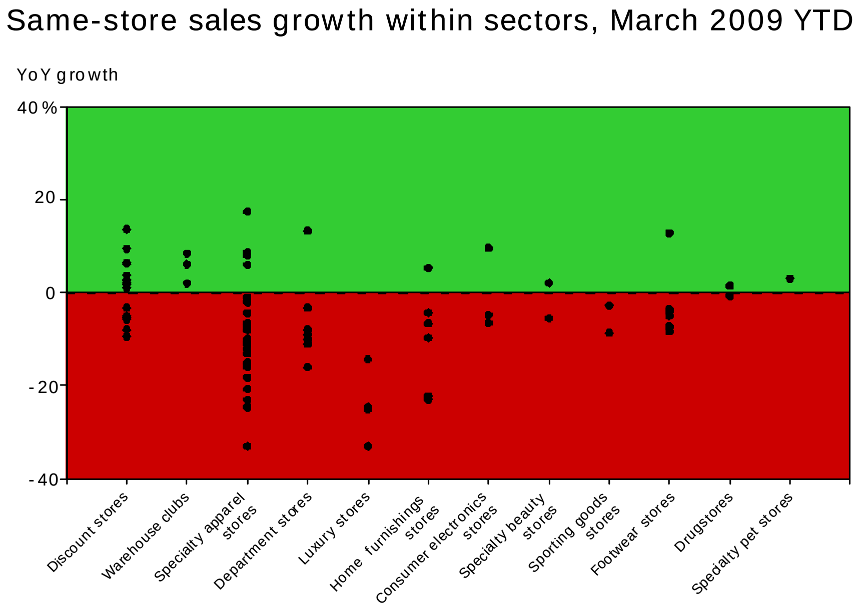


Each sector has a different level of exposure to the downturn. For example, grocers are not as concerned about customers' deferring purchases as apparel and electronics retailers are. And there are differences *within* sectors based on a retailer's strategic and financial positions. Some retailers have more protected or loyal customer bases, more attractive real estate or stronger relationships with vendors than their peers do. Witness the dramatic difference in performance among teen retailers: Buckle and Hot Topic enjoyed 17% and 9% same-store sales growth through March of this year, respectively, while competitor Abercrombie & Fitch experienced a 33% drop in sales over the same period. In fact, variation within a sector often is wider than variation across sectors *(Chart 4)*.

Retailers must always know exactly where they stand and have a clear sense of where they're going. This means developing scenarios that look at least two years ahead to help them plan for the worst. First and foremost, retailers need to know how much liquidity they need to survive in a worst-case scenario. Only with this understanding can they ride out the crisis and explore growth options.

For the sake of illustration, it is probably easiest to imagine retailers in two camps: (1) those that face an acute struggle to survive a prolonged downside and (2) those with enough cash and security to give them greater flexibility.

Chart 4:



Note: Where March YTD data were not available, February or January data were used.
Source: Financo; company filings and press releases

For retailers in the first group, hunkering down and focusing on aggressive cash management is the prudent course of action. For these companies, it's about survival: Taking excessive risks may make you bold, but it can also make you bankrupt. For retailers that can comfortably cover nondiscretionary cash needs, this is a time to strengthen the core business and gain market share at bargain prices. Practically speaking, stronger companies have more options.

Taking action: Pull the right levers for your situation

Just as the human body reacts instinctively to life-threatening situations, so must retailers. They need to heighten their sense of priorities, external awareness and readiness to act during this market turmoil. Already we've seen most retailers take critical, if predictable, actions—trimming inventories, closing underperforming stores, boosting promotions and cutting overhead costs. But what will separate winners from losers is the ability to take well-known basics to a higher level of innovation and execution. Today's extreme market conditions demand amplified focus and leave less room for error.

1. Clarify strategies and shift resources to core activities

Forward-thinking retailers are protecting and growing customer loyalty by carefully choosing where and against whom to compete. They are getting inside the heads of their customers to understand how the economy has affected various segments; how shopping habits, decision criteria and usage patterns have changed; and, most important, what products, services and messages will bring profitable customers back to checkout counters. Here are some of the actions retailers are taking:

- *Define and invest in the core.* Focusing on the most profitable areas—geographies, brands, products, customers and channels—sounds simple, but it requires insight and discipline. Wal-Mart's "Win, Play, Show" merchandising strategy measures each product category in terms of growth outlook, potential for scale advantage, credibility with customers and importance to the overall value proposition. Wal-Mart classifies categories into those worthy of high investment ("Win"), those that are important to consumers but less differentiated ("Play"), and those that require narrower assortments ("Show"). This strategy emphasizes growth products while still allowing Wal-Mart to be a one-stop shop. PetSmart serves as another relevant example: going into the last downturn, it redefined its core, focusing on a customer segment it called "pet parents." These are pet owners who are passionately committed to their pets and consider their pets to be family members. The company developed a one-stop-shopping value proposition for these customers called Total Lifetime Care™ that included new grooming and boarding services and redesigned store layouts to help shoppers navigate the store. The strategy helped reshape the pet store sector and drive a sixfold stock price increase over four years.
- *Reframe the battlefield*. Today's consumers increasingly face tradeoffs about where and how to spend their money. Defining consideration sets—reframing consumers' options—can increase retailers' odds of ending up winners. Several quick-service restaurants are taking aim at a new foe: Starbucks. McDonald's has billboards that ridicule the idea of paying $4 for an espresso, while a Quiznos advertisement compares the value of a latte to a foot-long "Toasty Torpedo" sandwich at the same price. The goal of these aggressive campaigns is to win over customers who are open to trading down in this economy. In a similar way, Kroger is betting that consumers will view its gourmet take-home meals as a better choice than dining out or restaurant takeout. The grocer has extended its offering of chef-prepared meats and seafood, sushi, natural and organic meals and gourmet cheeses.
- *Instill trust and a sense of security in nervous consumers.* With consumer confidence shaken to its core, strategies or tactics that ease consumers' anxiety are proving effective both at boosting sales and creating loyalty. Consider Jos. A. Bank's "Risk Free Suit" offer: Any customer buying a "Risk Free Suit" during the promotional period is eligible for a full refund if he subsequently loses his job—and he gets to keep the suit. Walgreens announced that it would continue welcoming customers to its health clinics even if they lose their insurance. And Office Depot is allowing job seekers to copy and fax their résumés for free.
- *Bolster talent.* Keeping your best talent is a good investment in any economic cycle. Bain experience demonstrates that stores run by more tenured managers typically perform better. In addition to retaining their best managers and executives, retailers in a strong financial position may see this as an opportunity to poach top talent from competitors. Dollar General is adding up to 4,000 corporate and store-based jobs in 2009.

2. Aggressively manage costs and cash flow

As the downward pressure on sales continues, retailers are looking at next-level moves to reduce costs and improve cash flows without exacerbating a sales slump.

- *Take a strategic approach to inventory management.* It has never been more critical to rationalize inventory levels and mix—to align them with the new realities of consumer behavior. Macy's is hoping to achieve that alignment by shifting more decision-making power into the hands of store managers and local or regional executives. And it is not just about managing the different items in the product assortment pyramid; it is also about shrinking overall inventory. Nordstrom has equipped merchant teams with tools to analyze price "sweet spots" in various categories. The result: a 12% decrease in inventory per square foot in 2008 versus 2007, as well as inventory turns nearly double the sector averages.
- *Rethink, consolidate, and outsource G&A structures and other corporate spending.* Retailers should take a hard look at duplicate functions across regions or business units, as well as opportunities to outsource noncore capabilities. According to International Data Corporation, only 6% of the outsourcing deals in the United States in the last five years took place in the retail industry. Now is the time to take bolder actions to reset cost structures—actions that most companies find unpalatable when business is strong. METRO Group of Germany announced a plan to consolidate its finance, controlling and compliance operations under its headquarters staff. The move is part of a larger cost-reduction program expected to drive $1.9 billion in savings by 2012. Liz Claiborne recently assigned the majority of its Asian sourcing to a single vendor, Li & Fung. Li & Fung will pay the company $75 million for the right to handle all sourcing for brands including Lucky, Juicy Couture, Kate Spade and Liz Claiborne New York, while Liz Claiborne will pay an agency commission on future product purchases.
- *Get in-store costs in synch with new economics.* Many retailers can reap savings without damaging sales by taking a fresh look at store operating models. Some retailers are fundamentally changing their service models to challenge sacred cows: How many people does it take to open and close stores? How many labor zones are needed? What service levels do customers really value? Others are reducing floor space—even erecting new walls—to make lower inventory levels look like full stock. Of course, with retail vacancy rates sharply on the rise, tenants also are attempting to renegotiate rents, reduce store sizes, trigger cotenancy clauses and garner concessions from landlords. One REIT recently reported that approximately 1 in 12 of its tenants had attempted to renegotiate rents. But landlords are trying to hold the line: Another REIT reported that of the 672 rent-relief requests it had received from tenants, management approved just 20.
- *Be smart about capital expenditures.* Retail store closings continue. According to the ICSC, nearly 2,300 retail establishments announced closings through the first four months of 2009—on pace with the 6,900 announced closings in 2008. Retailers are rethinking and reprioritizing store investments. Wal-Mart has slowed new-store openings to focus on upgrading existing locations, increasing its remodeling spend from 6% of total capital expenditures in 2008 to a planned 10% in 2009 and 14% in 2010. Starbucks has already closed 600 underperforming

sites and plans to close an additional 300, and it is trimming its expansion plans. Kirkland's recently announced it is closing 35 to 40 stores this year but expects to open 15 to 20 new ones—in a shift from mall-based locations to open-air shopping centers. And Spanish retailer Inditex, the parent company of Zara, plans to be more "rigorous" in choosing locations, setting the ROI bar higher for new stores. Meanwhile, retailers in all sectors are redirecting capital dollars to outlet investments. Williams-Sonoma, Inc., Neiman Marcus Group and Saks are just a few that are expanding their presence in outlet centers.

3. Increase revenue and margins

Improving the shopping experience while applying some pricing science can turbocharge both sales and profits. This is an area for retailers with strong strategic and financial footing, in particular, to extend their lead.

- *Localize consumer offerings.* Macy's localization strategy ("My Macy's") is about tailoring merchandise categories and shopping experiences to drive growth and reduce costs. Macy's expects to spot and address trends more quickly, match store environments to the preferences of individual communities and appeal to its most profitable customers. Early returns have been favorable: My Macy's pilot stores generated same-store sales that were 1.5 points higher than legacy stores in the fourth quarter of 2008, so the company plans to roll the program out in all of its stores.
- *Add new dimensions of value.* Savvy retailers are taking a more strategic approach to delivering "value," choosing to adjust product assortments, pricing pyramids and brand offerings instead of implementing widespread discounts. Starbucks is messaging that lowest price does not always equal highest value with its new "Coffee Value & Values" campaign. The advertisements highlight not only exceptional coffee, but also the experience and social impact of a Starbucks purchase. J.Crew is among many retailers that have introduced lower entry-level price points to catch customers trading down, while maintaining premium products to preserve brand equity. The retailer is offering an increased number of knits and pants priced under $80 and has added an "instant gratification" section of items priced under $100 to its Web site. At the same time, J.Crew continues to promote its premium J. Crew Collection. Wal-Mart is revamping formulations of hundreds of its Great Value private-label products in dozens of categories to offer alternatives to national brands. Aeropostale has long offered affordable teen fashions, but many believe more-stylish merchandise is behind the company's nearly 100% stock price gain to date in 2009.
- *Make shopping fun and easy*. With penny-pinching on the rise, retailers face both the challenge and the opportunity to innovate across the entire customer experience. Apple retail stores have found a customer-friendly formula to drive the company's industry-leading revenue productivity. Apple uses a combination of innovative products merchandised in touch-and-try displays, well-trained sales and after-sales support staff, and technology tools like portable scanners and appointment reservation systems to speed service and checkout. Apple also

uses closed-loop Net Promoter® Score consumer feedback and customer call-backs to continuously enhance shoppers' in-store experience. [3]

- *Communicate with customers in new ways.* Successful retailers are driving sales by reaching customers through lower-cost and more-targeted marketing efforts than ever before. This can mean shifting from mass marketing to direct marketing, or from national to local advertising. Or it can mean experimenting with cost-effective electronic marketing channels. Amazon has tapped into the explosion of social media sites, launching a Twitter campaign. Customers who sign up to follow Amazon on Twitter receive occasional blasts promoting the retailer's "Lightning Deals." Other retailers have experimented with new points of distribution, mobile phone applications or targeted e-mail coupons to reach customers in new and direct ways.

4. Seek out bold, game-changing moves

Some retailers will need to take aggressive action to survive; others will find that bold action affords them an unprecedented opportunity to reach new levels. Depending on a retailer's circumstances, it may be able to pursue game-changing strategies:

- *Consolidate or restructure brands and formats.* For some retailers, strategic realignment may be an answer. In 2008, Sears unlocked value from its holdings by restructuring: organizing and managing its proprietary brands, real estate and online units as separate entities. This makes a potential sale or spinoff of any of these units more feasible. Other retailers with multiple formats are consolidating, betting on a single format to resonate with customers. Tween Brands announced last year it would convert approximately 560 Limited Too–branded stores to its value-oriented format and brand, Justice. Still, the conversions are costly, and the jury is out on the return on this significant investment.
- *Overhaul the business model.* Some business model reinventions are born of necessity, but others are proactive. After relaunching a number of CompUSA stores with a "Retail 2.0" initiative, Systemax Inc., the parent company of online retailer TigerDirect, has announced plans to acquire Circuit City's brand and relaunch it too, initially as a Web-only retailer. On a more experimental front, Sears plans to open a warehouse-style concept called MyGofer that will allow shoppers to order online and pick up their purchases at the store or a drive-through portal. In the new concept, 20% of the store will be a showroom, while 80% of the store will be built out for storage.
- *Change the dynamics with vendors.* While tensions have risen between some retailers and vendors—vendor pressure reportedly helped drive Filene's Basement to seek bankruptcy protection—others are pursuing win-win collaboration. Department stores in particular continue to increase their stables of exclusive brands, often offering manufacturers preferred floor space and greater open-to-buy dollars. Later this year, consumers will have to head to Macy's for Jones Apparel Group's Rachel Rachel Roy line, and come September, they will

[3] Net Promoter® is a registered trademark of Bain & Company, Inc., Fred Reichheld and Satmetrix Systems, Inc.

find JOE Joseph Abboud only at JCPenney. Other retailers are more aggressively pursuing “captive licensing” models. For example, reality television star Lauren Conrad recently announced an LC Lauren Conrad line for Kohl’s.

- *Make opportunistic acquisitions and real estate investments.* For retailers with the financial flexibility, now is the time to consider investing in new capabilities, new brands and new markets. In February Toys “R” Us capitalized on the bankruptcy of a competitor, The Parent Company, acquiring several Web sites including eToys.com, BabyUniverse.com and ePregnancy.com. Meanwhile, Walgreens is acquiring 32 competing drug stores in New Jersey, and convenience chain The Pantry is buying 40 additional stores in the Southeast. Today there are once-in-a-decade (or longer) opportunities to secure space that was previously unaffordable or unavailable. Witness Kohl’s and Forever 21, which recently won an auction for leases on 46 stores previously occupied by bankrupt Mervyn’s.
- *Consider financial alternatives*. Creative financing can help retailers free up cash. Retailers may have intangible assets or future cash streams that could be securitized—department store brands, for example, or pharmacy reimbursements at a drug store. In 2007, Sears essentially securitized its top brands when it created a wholly owned subsidiary (KCD IP) to “own” the Kenmore, Craftsman and DieHard brands. This subsidiary then “sold” $1.8 billion worth of intellectual property bonds to another Sears subsidiary, a Bermuda-based insurance unit, which could sell the bonds to a third party at some point.

Until the sun shines . . . and it will

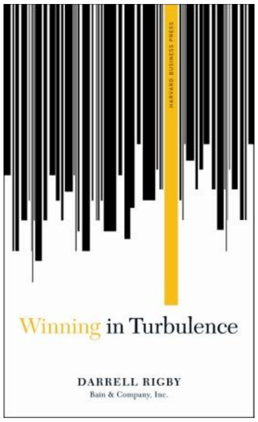
This downturn, like those before it, will “shuffle the deck” in the retail industry. The winners: retailers who find ways to turbocharge sales and grow share while boosting margins. Many of the losers will not survive. Pulling the right levers and mobilizing needed resources to ensure positive results can start with answering four key questions:

- Have we examined the worst-possible-case scenarios and prepared our management team with contingency plans, no matter how uncomfortable? What internal and external indicators are we watching?
- Have we clarified our core business activities and developed new game plans to guide where and how we will win in the downturn?
- Are we fully capitalizing on this unique opportunity to drive unproductive activities out of our system?
- Are we exploring game-changing moves that could position us for sustained success coming out of the downturn?

Retailers that answer these questions successfully will be better equipped to not only survive through this economic downturn but also thrive and separate themselves from the pack.

Appendix: Additional resources

Winning in Turbulence



- Additional information on Winning in Turbulence from Darrell Rigby and Bain & Company http://www.bain.com/bainweb/Consulting_Expertise/hot_topics/detail.asp?id=55
- Interactive diagnostic: Locate your company's position in this downturn on the three dimensions of the performance cube http://www6.intellisurvey.com/run/baincube
- Excerpt from the upcoming book, Winning in Turbulence, by Darrell Rigby http://ceomemo.harvardbusiness.org/flattmm/bain-turbulence-levers.pdf

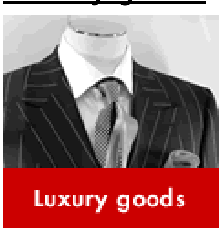
Localization: a quiet revolution in consumer markets

- Additional information on localization from Darrell Rigby and Vijay Vishwanath http://www.bain.com/bainweb/Consulting_Expertise/hot_topics/detail.asp?id=45

The Consumer of the Future

- A special study from Bain & Company on consumer behavior http://www.bain.com/bainweb/PDFs/cms/Public/ConsumerOfTheFuture_BainStudyJanuary2009.pdf

Luxury goods



- Latest Bain & Company luxury market forecast http://www.bain.com/bainweb/publications/publications_detail.asp?id=27025&menu_url=publications_overview.asp
- Additional thoughts on luxury goods from Bain & Company http://www.bain.com/bainweb/Consulting_Expertise/hot_topics/detail.asp?id=32

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- Issues of the 2008 *Bain Retail Holiday Newsletter* http://www.bain.com/bainweb/Publications/publications_results.asp?search=&date=&office=&capability=&industry=12&format=3

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