Bain Retail Holiday Newsletter #1

October 24, 2008

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

Holiday spending is crucial to retailers' success, and this season could be one of the most challenging in decades. For many retailers, holiday sales account for 25% to 40% of annual revenue and an even greater percentage of profits. The purpose of this newsletter is to provide relevant information about holiday sales trends and strategies for success in this critical period. Updates will be distributed every two to three weeks throughout the holiday season to help you monitor both trends and results as the season unfolds.

There's a tough holiday season, and year, ahead

Over the last 40 years, holiday sales have grown an average of 6.6%. Although holiday sales growth has never been negative during this period, it was flat in 1990 and grew only 0.8% in 1974 and 1.0% in 2002 ***(Chart 1)***. Early holiday forecasts, ranging from flat to 3.0%, suggest that this season could be one of the most challenging in decades ***(Chart 2)***. Moreover, most of these forecasts were released before September 29, when the first $700 billion bailout was defeated in the House and the Dow fell 774 points. Forecasters often revise their estimates as new data emerge and the holiday season draws closer. We will provide updates and new estimates in future newsletters.

Last year we underestimated the speed and force with which troubles in the mortgage market would impact retail sales. This was just the beginning of a series of difficult economic events. Since then we have seen housing values deteriorate further, credit markets tighten, fuel and food costs spike and banks fail. And given the ups and downs in the Dow we are experiencing right now—an average swing of 764 points daily[1]—forecasting GAFO is even more challenging this year.[2]

The different product segments within GAFO will likely see dramatically different results this season, and companies within each segment may see even wider disparities. This variation means that an overall GAFO forecast is probably less meaningful than

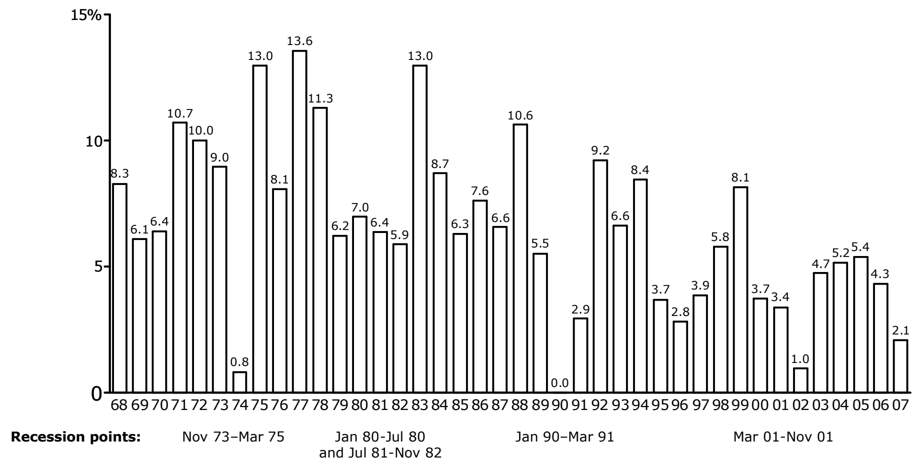
[1] Based on the average spread between the Dow's daily highs and lows from October 6 through October 17, 2008.

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

ever before to individual retailers. With that in mind, Bain predicts November and December GAFO sales growth to be roughly flat. Frankly, if this unprecedented situation continues to deteriorate, holiday sales growth could go negative.

Chart 1:

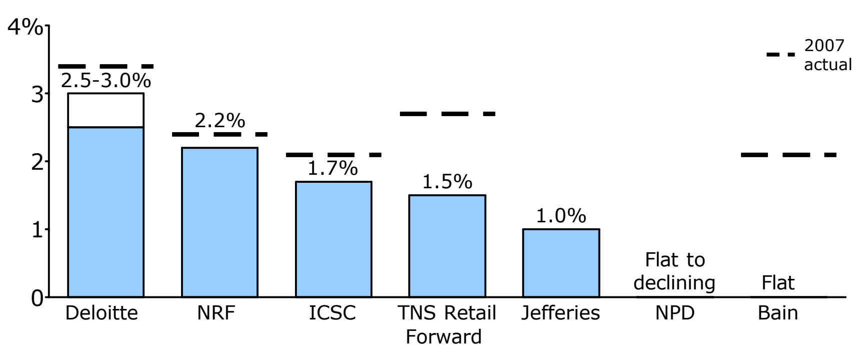
November and December sales growth, 1968-2007



Note: 1968-1978 annual growth rates shown are for GAF excluding miscellaneous shopping goods stores; 1979-1992 growth rates shown are for GAF; 1993-2007 growth rates shown are for GAFO; average difference between Nov-Dec growth rate for GAF and GAF excluding miscellaneous shopping goods is 0.6 percentage points; average difference between GAF and GAFO is 0.4 percentage points
Source: US Census Bureau

Chart 2:

Forecasted holiday sales growth, 2008



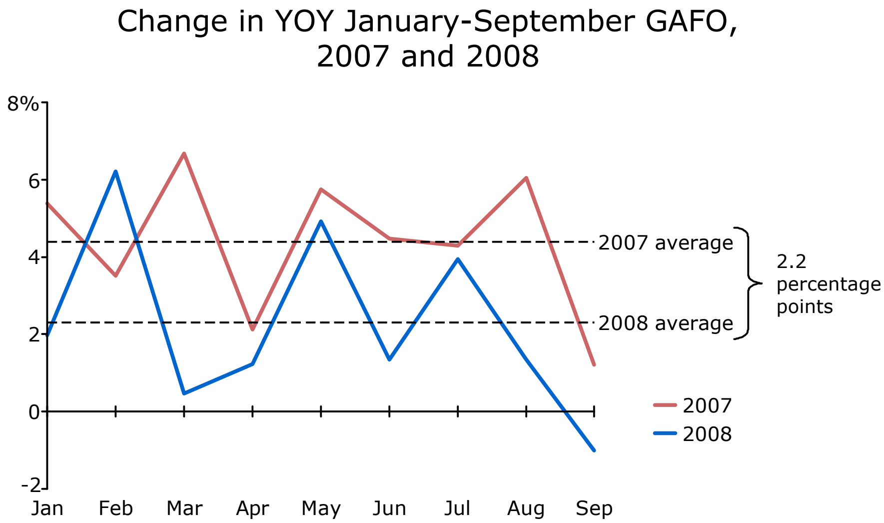
	Deloitte	NRF	ICSC	TNS Retail Forward	Jefferies	NPD	Bain
Measure	Exlcudes motor vehicle and gas; includes online	Exlcudes motor vehicle and gas; includes online	Same-store sales	Nonauto sales excl. gas stations, restaurants and nonstore	Not specified	Not specified	GAFO
Forecast period	Nov.-Jan.	Nov.-Dec.	Nov.-Dec.	Oct.-Dec.	"Holiday"	"Holiday"	Nov.-Dec.
Date forecast released	Sept. 16	Sept. 23	Oct. 21	Sept. 17	Sept. 19	Oct. 14	Oct. 24

Note: All GAFO forecasts are unadjusted; 2007 actuals are specific to each forecast
Source: Deloitte; National Retail Federation; International Council of Shopping Centers; TNS Retail Forward; Jefferies; NPD Group

Momentum going into the holidays has slowed significantly

GAFO sales growth figures have fallen short of 2007 levels all year, with the exception of February. Preliminary 2008 GAFO growth through September was 2.5% compared to 4.3% during the same nine-month period in 2007. And momentum is slowing, with advance September GAFS growth coming in at -1.0% ***(Chart 3)***. Since 1993, there have only been two other instances of negative monthly GAFS growth (March 2003 at -1.5% and September 2001 at -2.5%).

Chart 3:



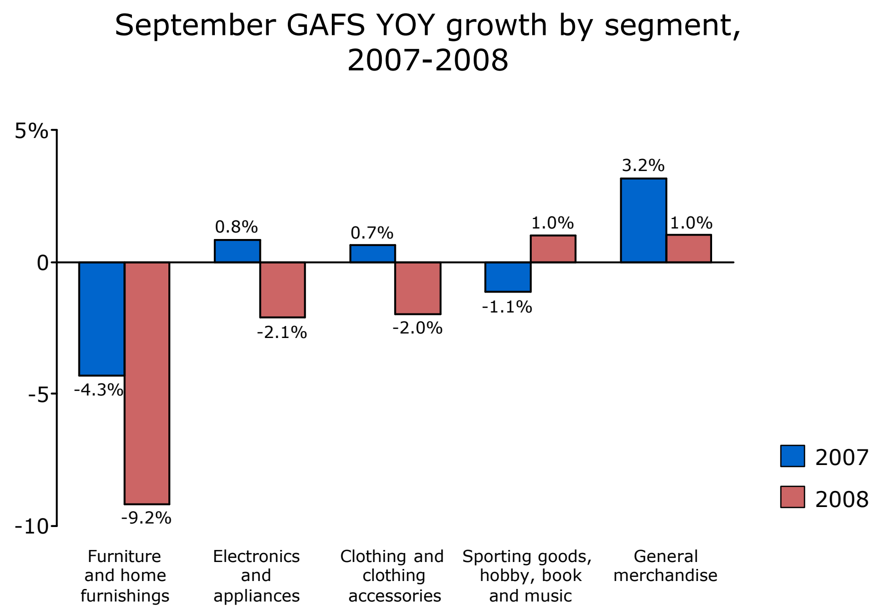
Note: September data based on advance GAFS
Source: US Census Bureau

Growth has varied significantly among the individual components of GAFO. General merchandise was one of only two segments to show positive growth in September (the other was Sporting goods, hobby and books), increasing 1.0% over 2007 ***(Chart 4)***. But like most categories, General merchandise has been on a downward trajectory recently ***(Chart 5)***. It is important to note that General merchandise includes discount stores and warehouse clubs like Wal-Mart and Costco. As we will discuss later, these stores are faring better than others of late.

Other segments within GAFO have seen recent declines as economic uncertainty has driven consumers to scrutinize and often reduce their spending. After modest growth for much of the year, the Clothing and clothing accessories segment fell 2.0% in September on a year-over-year basis ***(see Chart 4)***. Similarly, the Electronics and appliances segment, which had been on an upward trajectory at the start of the summer, has taken a downward turn, falling 0.9% in August and 2.1% in September.

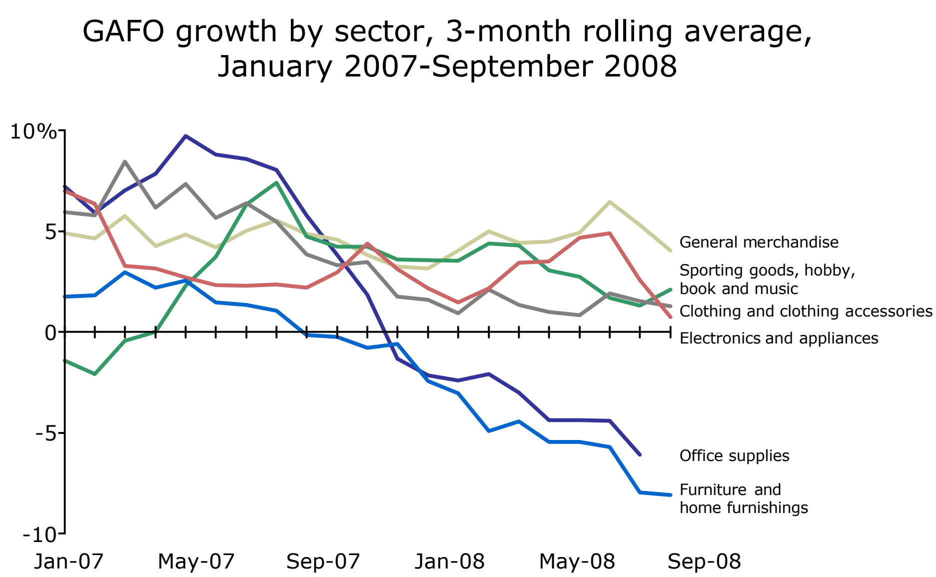
In the Furniture and home furnishings segment, year-over-year sales growth has been negative throughout 2008, and was down a sharp 9.2% in September ***(see Chart 4)***. This negative trend began with the first signs of the downturn in the housing market in 2007, and there is no evidence to suggest that a recovery is imminent.

Chart 4:



Source: US Census Bureau

Chart 5:

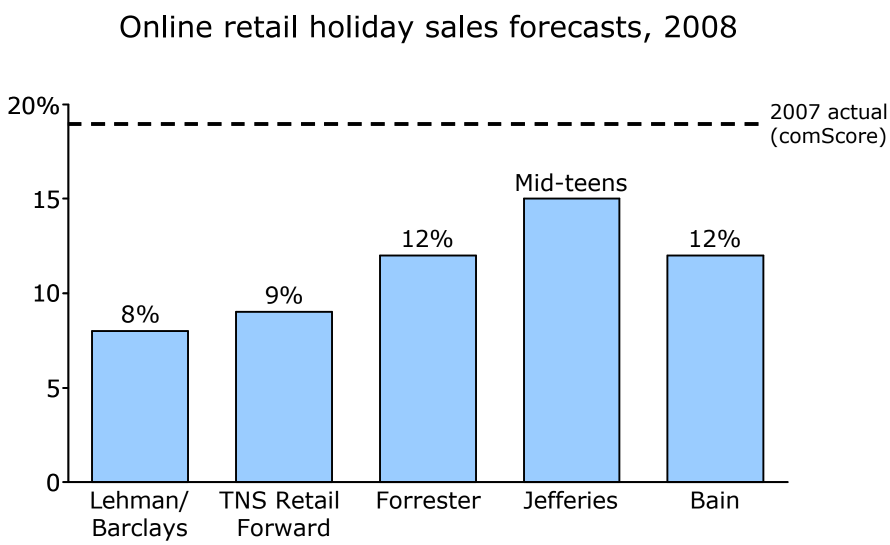


Note: Office supplies data have not yet been reported for September
Source: US Census Bureau

Online will shine again this season, but not as brightly as in years past

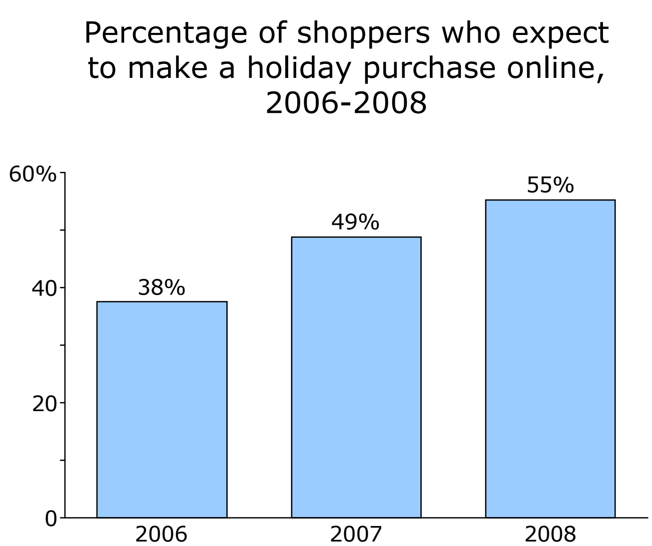
Growth in online retail sales has outpaced growth in in-store sales for many years, and it will do so again this holiday season. But the growth rate of online sales will slow significantly from historical levels. Forecasts for this holiday season range from a low of 8% to a high of approximately 15%, down from growth in 2007 of 19% ***(Chart 6)***. Given our expectations for overall holiday GAFO growth as well as the online growth data for the first half of the year, we estimate that online holiday sales growth will be 12%.

Chart 6:



Source: Lehman Brothers/Barclays Capital; TNS Retail Forward; Forrester; Jefferies

Chart 7:



Source: Burst Media

Of course shopping online may become more attractive to consumers as the economy slows. Being able to compare prices and features, save on gas and avoid sales tax helps reduce the cost of holiday shopping. In an online survey of 3,000 Internet users, consumers report they will shop online more this holiday season than they have in the past. According to Burst Media, 55% of respondents report they will do some holiday shopping online this year, up from 49% in 2007 and 38% in 2006 ***(Chart 7)***. Further, as retailers manage costs by limiting in-store inventories and reducing holiday hiring, the flexibility and convenience of shopping online may prove even more important.

Call it what you will, but most signs indicate we are in a recession[3]

We expect the growth rate of the US gross domestic product to deteriorate toward negative growth by the fourth quarter of 2008 and into the first half of 2009. Although growth is currently positive, that does not mean that we are not already in a recession. The financial press often defines a recession as two consecutive quarters of negative GDP growth. However, the National Bureau of Economic Research (NBER) actually defines a recession as "a period of *diminishing* activity rather than *diminished* activity." This is normally visible in real GDP, real income, employment, industrial production and wholesale–retail sales. But these figures are difficult to pinpoint in real time; it can be months or even years after a recession before the NBER officially declares the dates on which a recession began or ended. For example, the organization determined that the beginning of the last recession was March 2001, but it didn't officially announce that date until eight months later, in November 2001.

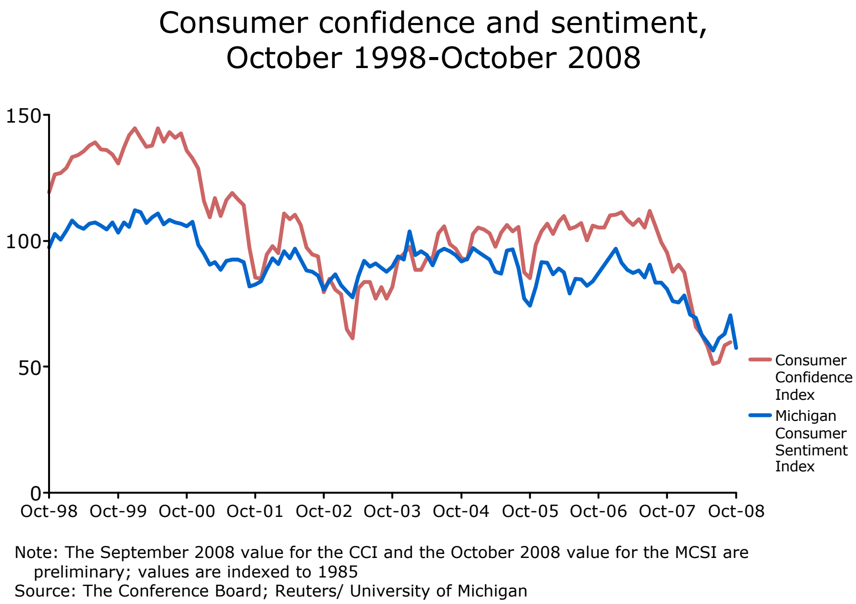
Definitions aside, we appear to be in the middle of a consumer-led downturn. Consumers are being bombarded with negative headlines on a daily basis. Inflation, which had been approaching 1980s levels until last month, has forced up household spending on nondiscretionary items like food, utilities and gasoline. At the same time, jobs and wage rates have experienced downward pressure; and people have lost wealth in the form of stock holdings and home equity as national median home prices have fallen by 20% from their peak—and we expect them to drop another 10% to 20% before bottoming out. The combination of these factors has driven consumer confidence to all-time lows ***(Chart 8)***.

To make matters worse, credit markets have dried up after years of loose credit that enabled consumers to spend above sustainable levels through credit cards, home equity loans and second mortgages. Nearly 4% of all US expenditures for personal consumption in 2005 ($327 billion) was financed by home equity loans. And in that year, as the price of housing neared its peak, $378 billion was made available by home equity loans and cash-out refinances versus just $164 billion five years earlier. Today the spigot has been turned off, and consumers are being forced to cut back spending. Banks are tightening their lending standards, and some credit card companies are even raising the

[3] See the macroeconomic supplement for a complete set of macroeconomic data.

standard requirements for getting a new credit card, demanding higher FICO scores to qualify.[4]

Chart 8:



Given these facts, we believe that the economy is not likely to turn around until at least the second half of 2009, or perhaps 2010. Unfortunately, the return to strong growth may be sluggish for retailers. In the case of the past four recessions (1973–1975, 1981–1982, 1990–1991, and 2001), retail growth in the six months following each recession averaged 3 percentage points less than in the six months leading up to it.

In response to economic pressures, consumers are changing their behavior

As the economy has slowed, we've noticed five key changes in consumers' behavior:

1. Is it *really* worth it?
2. What is in or near Wal-Mart?
3. "Reduce, reuse, and recycle" has new meaning
4. Some wallets are thicker than others
5. Homeward bound

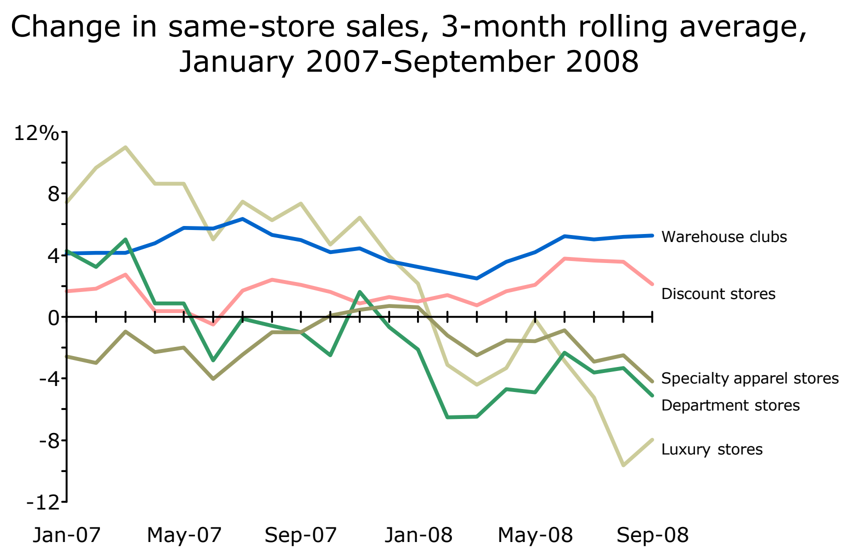
Consumer behavior #1: Is it **really** *worth it?*

Consumers have been searching for "best value" for a long time, and now they've taken out the magnifying glass. Bargain hunting and trading down for "good-enough" goods are very much in evidence as shoppers look to stretch their dollars. They are more will-

[4] FICO scores represent an individual's credit rating, and range from 300 to 850. The median FICO score in the United States is 723. Scores are based on payment history, amounts owed, length of credit history, new credit and types of credit used.

ing to search for deals or wait for items to go on sale before buying, and spending is shifting to value-oriented channels like warehouse clubs and discounters ***(Chart 9)***.

Chart 9:



Note: The 3-month rolling average is based on a subset of retailers within each category and calculated from monthly same-store sales data weighted by quarterly revenues; the data for warehouse clubs exclude the impact of fuel prices for BJ's from January 2007 onward, for Sam's Club from February 2007 onward and for Costco from October 2007 onward
Source: Financo; ICSC; CapitalIQ; MarketWatch; company press releases

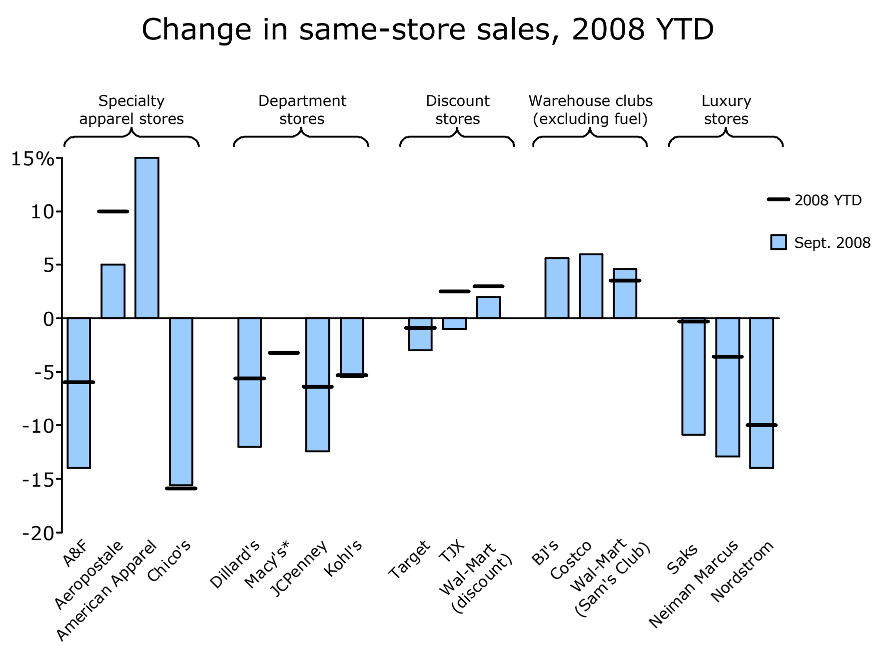
September same-store sales results tell the same tale.[5] Sales at warehouse clubs rose 5.2% (excluding fuel sales) over September 2007; and discounters saw a year-over-year increase of 0.9%. Among warehouse clubs, the top performers were Costco and BJ's, where September same-store sales excluding fuel increased 6.0% and 5.6%, respectively ***(Chart 10)***. Costco noted that consumers continue to purchase nondiscretionary items like food and gasoline, but are postponing more discretionary purchases—furniture, appliances and electronics, for example. Sam's Club, where September same-store sales went up 4.6%, is focusing on keeping store traffic high. It has just announced a new membership promotion: $10 for a 10-week membership. The company hopes the temporary membership will give consumers an opportunity to see the value the club store offers and keep them shopping there.

Among discounters, Wal-Mart had the strongest September performance, with same-store sales up 2.0% ***(see Chart 10)***. Wal-Mart has already launched holiday promotions in its stores, and earlier this month announced a promotion on toys, selling ten popular toys for $10 each. Target, whose September same-stores sales fell 3.0%, has started emphasizing the "pay less" portion of its "Expect more, pay less" tagline to keep up with Wal-Mart's well-recognized low-price focus. Target's weekly circular is using bolder type to make deals more prominent, and signs in stores highlight promotions to

[5] *Same-store sales* are sales in stores that have been open for more than one year.

make them more visible to shoppers. Target even says that it "remains keenly focused on ensuring [its] prices are the same as Wal-Mart's on all identical and similar products in local markets."

Chart 10:



*Macy's reports same store-sales growth quarterly; it has not released growth for September
Note: Nordstrom includes full-line stores only; BJ's and Costco have not reported September YTD comparable revenue growth excluding fuel
Source: ICSC; Financo; company press releases

Changes in consumer behavior are also noteworthy in the luxury segment. Same-store sales for luxury retailers have dropped almost every month this year. In September, same-store sales growth at luxury stores was down 10.9%, proving that this segment is not as recession-proof as some once believed. (We never believed it, honest!) Luxury retailers are facing several challenges:

- Aspirational shoppers who at one time may have bought an expensive handbag or jacket are now being forced to trade down.
- Many consumers are suffering from a negative wealth effect: As they look at their shrinking 401(k)s and stock portfolios, they are reconsidering their purchases.
- Even the wealthiest consumers are not shopping at the same levels as they were last year. With the nation's economy in trouble, some would argue that extravagant spending is irresponsible or even un-American.

A recent Bain study estimates that global luxury sales will fall by 3% to 7% during 2009, with declines starting in the last quarter of 2008. But long-term market drivers remain strong—more high-net-worth individuals, larger tourist flows and increased spending by working women—lending some hope that the downturn in this segment could be relatively short.

Finally, the Is-it-*really*-worth-it trend is very obvious in our talks with consumers. Bain recently conducted a series of consumer interviews, during which responses supported the idea that consumers are looking for good deals and trading down to less expensive stores. “I’ve been a bit more frugal in looking for higher-quality goods for less money,” remarked one woman. And another shopper summed up the trading-down effect when she said, “I don’t see why I should shop at high-end clothing stores when places like Wal-Mart are so much cheaper.”

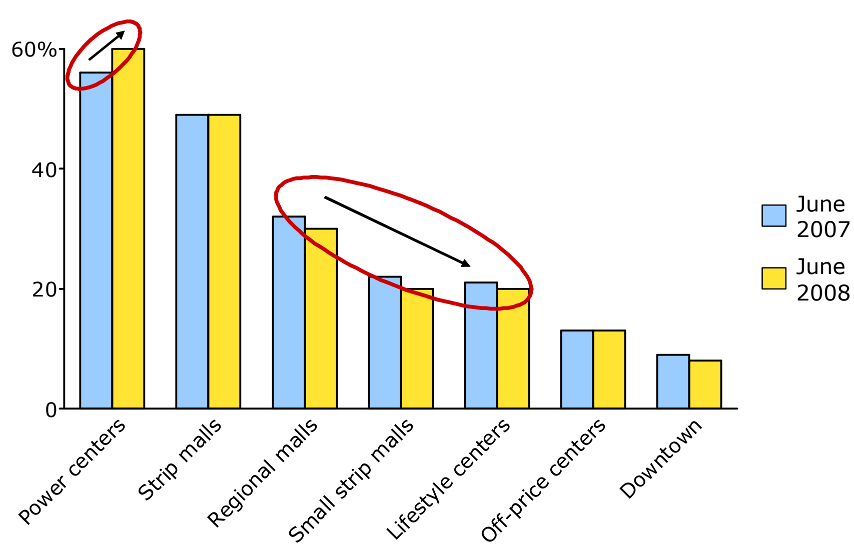
Consumer behavior #2: What is in or near Wal-Mart?

As consumers shift spending to discounters and warehouse clubs, they look to nearby stores to complete their shopping. Consolidating trips saves both gas and time. According to Nielsen research, 70% of consumers are planning to combine errands, and TNS Retail Forward reports that 58% of shoppers are going to stores where they can one-stop shop. The effect of this is that power centers are gaining share at the expense of regional shopping malls and small strip malls ***(Chart 11)***. And the traffic that discounters and warehouse clubs are generating may benefit neighboring retailers even more than usual.

One example of this is Tween Brands’ Justice stores, which are often co-located in off-mall locations with a Wal-Mart. During the quarters ended May and August 2008, Justice posted same-store sales growth of 22% and 3% respectively. This was significantly better performance that Justice’s higher-priced sister concept, Limited Too. Typically located in regional malls, Limited Too saw same-store sales declines of 7% and 11% in those same quarters.

<u>Chart 11:</u>

Percentage of shoppers visiting various locations



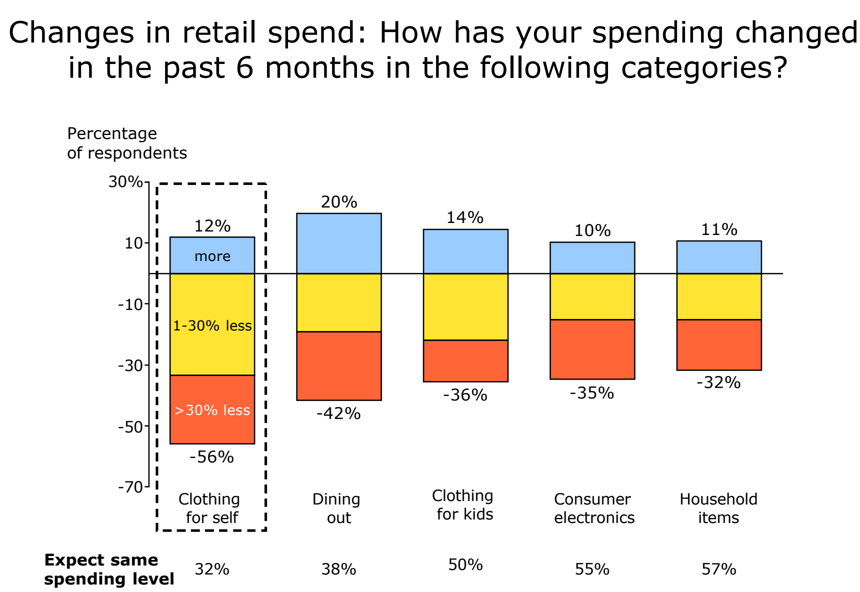
Source: TNS Retail Forward

Consumer behavior #3: "Reduce, reuse, and recycle" has new meaning

More and more, consumers are "shopping their closets," reusing purchases from the past several years. This is particularly true of clothing. Looking at a three-month rolling average of same-stores sales growth, specialty apparel and department stores have both seen negative growth in every month since January 2008. Of course the impact is on new clothing; sales of secondhand clothing can go up as the economy softens. In addition to cost savings, secondhand clothing is becoming "cool" both as fashion and as a green alternative.

During Bain's recent consumer interviews, respondents consistently reported cutting back more on purchases of clothing for themselves than on other purchases ***(Chart 12)***. Instead of buying new wardrobes, shoppers are trying to update their old ones inexpensively. This trend may bode well for accessories and footwear this season. Talbots is hoping to capitalize on this by inviting some of its best customers to host an evening event at their local Talbots store, where they and their friends can have cocktails and get fashion advice with an emphasis on ways to refresh their wardrobes with key items and accessories.

Chart 12:



Source: Bain consumer survey, October 2008

Consumer behavior #4: Some wallets are thicker than others

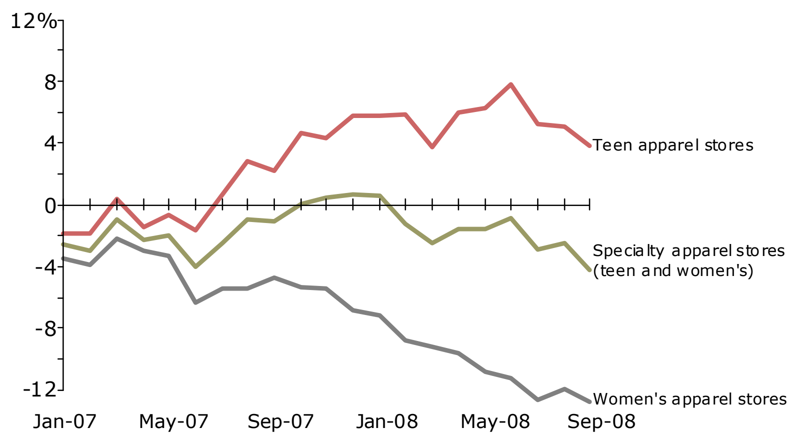
Not all consumer segments are cutting back to the same extent. With no mortgage and no children of their own, some teenagers and young adults have not cut their spending as significantly as other adults. "I live with my mom, so I don't really have to worry about bills or anything," explained one teenager, when asked how her spending has changed in the past six months. Another young man was more cautious but still spending: "I have the money to shop right now, but I still have to think ahead."

The differential between teens and other shoppers can be seen in same-store sales. Performance for specialty apparel stores as a group has fallen; but when women's apparel stores and teen apparel stores are disaggregated, the difference is significant. Looking at a three-month rolling average growth rate, teen-apparel stores have seen positive same-store sales growth since mid-2007, while women's apparel stores have seen negative growth for almost two years ***(Chart 13)***.

There are also wide differences in performance within segments. In the teen segment, for example, American Apparel and Aeropostale stand-out as winners ***(see Chart 10)***. Aeropostale has attracted bargain hunters with its lower prices and promotions. American Apparel appears to have struck the right balance of price and perceived value, as well as differentiation. Its logo-free basic items mix and match easily with consumers' own vintage, luxury or discount clothing.

Chart 13:

Same-store sales, 3-month rolling average,
January 2007 – September 2008



Note: The 3-month rolling average is based on a subset of retailers within each category and calculated from monthly same-store sales data weighted by quarterly revenues. Teen includes Abercrombie & Fitch, Aeropostale, Urban Outfitters and American Apparel; Women's apparel stores includes Talbot's, Ann Taylor and Chico's.
Source: Financo; ICSC; CapitalIQ; MarketWatch; company press releases

Consumer behavior #5: Homeward bound

Consumers are also spending more time at home. Growth in dine-in spending outpaced growth in dine-out spending for the first time in 11 years in 2007, and the trend continued through the first nine months of 2008. Although dine-out and spending at traditional grocers are not included in GAFO results, many consumers are now buying more of their groceries at discount stores and warehouse clubs. Sales growth at these stores, then, reflects both changes in consumer behavior and increases in grocery prices this year.

Families are also shifting a greater portion of their entertainment and recreation activities to home. A recent Gallup poll showed that 73% of consumers cut back spending on entertainment, recreation and eating out, and increased their spending on groceries and in-home entertainment.

Changing consumer behaviors have clear implications for retailers

Retailers that adapt most effectively to changing consumer behaviors are more likely to capture consumers' attention—and cash—this holiday season. Here are three guidelines:

1. Tailor offerings to make them more relevant to today's consumers
2. Prioritize and drive out nonessential costs to fund investments
3. Continue to innovate and invest in future growth platforms

Implication #1: Tailor offerings to make them more relevant to today's consumers

When times are tough, it's even more important to understand your target consumers' needs. Retailers across the spectrum—from value to luxury—are making adjustments. What do you do if you are at the lower end of the spectrum and some of your customers simply don't have the cash or the credit they need? Kmart has begun advertising lay-away—a retailing invention from the Great Depression—on prime-time television to give cash- and credit-challenged consumers the means to shop. Target is tailoring its television advertising to address consumers' budgets: In their "A new day, new ways to save" commercial, Target highlights products that help keep costs down. For instance, the *new* movie night is a DVD for $13 and the *new* gym is an exercise ball for $11.88.

At the higher end of the spectrum, luxury retailers are also making adjustments. Nordstrom is adding lower-price-point items to its product selection to prevent consumers from trading down to lower-priced retailers. Saks pursued a similar strategy during the last economic downturn, but faced problems when the economy rebounded: The store had lost some of its luxury appeal. This time around, instead of bringing cheaper products upmarket, Saks is investing in its outlet division, Off 5th, and bringing new services downmarket. In the outlet stores, Saks will offer alterations and other new services, more staff and upgraded fitting rooms. Promotional activity has also increased at both Saks and Off 5th stores.

Implication #2: Prioritize and drive out nonessential costs to fund investments

Cutting costs without adversely impacting sales can be difficult, particularly when you're forced to cut on the front line. Wal-Mart's new "win, play, show" strategy is intended to streamline its product offerings while ensuring that consumers can find all their one-stop-shopping items. In "win" categories, like televisions and groceries, the discounter will continue to stock a complete selection of products. In "play" categories (denim, for example), it will reduce its selection slightly. And in tools and other "show" categories, it plans to offer only limited options.

Back-end cost cutting can also free up funds and may have less direct impact on the consumer. Macy's has been reducing overhead expenses in order to reinvest in the store experience and to fund its My Macy's program, which tailors product assortments by store type to better meet the needs of shoppers.

Implication #3: Continue to innovate and invest in future growth platforms

Selectively investing in future growth platforms during a downturn can help accelerate growth when the economy begins to recover. For example, Victoria's Secret is continuing to drive Pink's multiyear expansion. And it has recently added on-campus pop-up stores as a new approach to growing the brand without the same capital investment required for new stores. In a different type of move, Tween Brands recently discontinued its Limited Too brand and converted approximately 600 Limited Too stores to its lower-priced Justice brand.

Platform bets are not limited to domestic activities. International retailers are looking at the United States for growth. H&M continues to expand here, with 150-plus stores open as of this month, approximately 25% of them added in 2007 and 2008. US retailers, in turn, are also looking to international markets for growth. Anthropologie has announced plans to expand into Europe, likely starting in London. Its goal: to open 20 to 40 stores over the next five years. And bebe began launching international stores two years ago. With 21 now in place, it plans to add another 17 in 2009.

Plan for the worst, but hope for the best

There is little argument that this is going to be a very difficult holiday season. The winners coming out of it are likely to be those that have accepted *and adapted* to what we are facing.[6] Winners in recessions tend to brake quickly heading into a downturn by managing costs carefully and consistently. It's like downshifting to a lower gear to slow momentum and increase responsiveness. They focus on what the company does best, reinforcing the core business and spending to gain share. And they aggressively monitor the competition to ensure they have the best possible position to navigate the turbulence. That sets them up to accelerate when the economy starts to improve.

We will continue to report on the "winners" this holiday season, and will further examine the practices that are most important in driving their success.

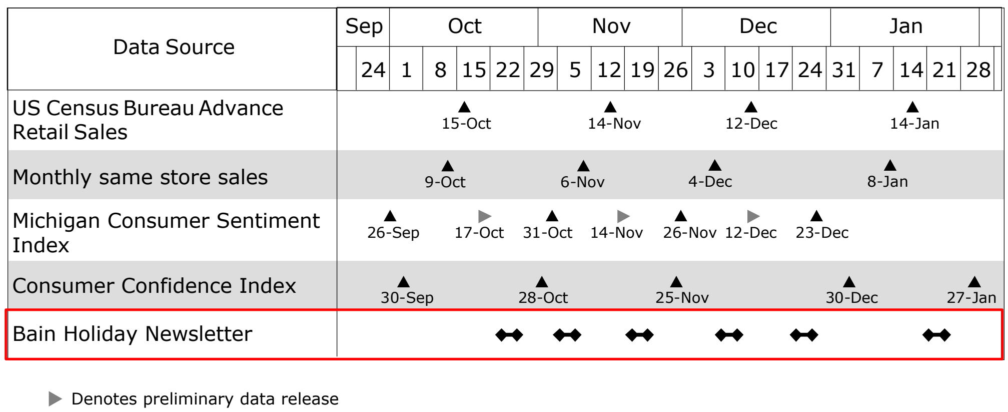
Newsletter schedule

Our next newsletter will be released in early November, with a new issue roughly every two to three weeks after that through the holiday season ***(Chart 14)***. 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.

[6] The text in this section is taken in large part from Darrell Rigby and Steve Ellis, "In Chaos Lies Opportunity," Wall Street Journal, September 22, 2008.

Chart 14:

Indicator and forecast update schedule



Appendix

<u>Chart A:</u>

Definitions

	GAFO	GAFS	GAF	General merchandise	Nonauto retail sales
• 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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