Bain Retail Holiday Newsletter #2

November 6, 2008

To: **U.S. Retail Partners**
From: **Darrell Rigby and Kris Miller**

Retail sales headwinds are still raging. Consumer confidence plummeted to an all-time low in October as consumers continued to grapple with stock market volatility, rising unemployment and limited access to credit. And as consumers pull back, retailers are being hit hard, most reporting negative same-store sales growth in October. But retailers aren't standing still. Many are cutting costs to protect profitability, and some are evaluating bold strokes to either grasp strategic opportunities or avoid joining the growing roster of bankruptcies.

Consumer spending slows as fears continue to mount

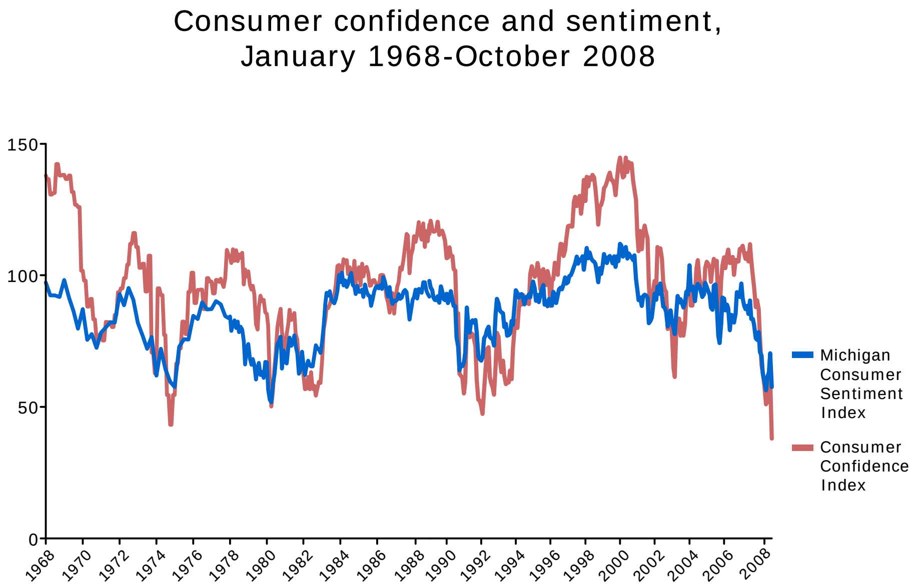
Consumers have made clear how they feel about the recent economic turmoil. Consumer confidence fell to an all-time low of 38.0 in October, down from 61.4 in September ***(Chart 1)***. To put this in perspective, the previous low of 43.2 was set in December 1974 shortly after the Watergate scandal and toward the end of the Vietnam War. In November 2001, during the last recession (and following the attacks of September 11), consumer confidence bottomed out at 84.9.

Even as gas prices continue to slide downward from summer highs—the national average has fallen to $2.40 per gallon, the lowest since February 2007 ***(Chart 2)***—consumers seem underwhelmed. Although initial price spikes last summer were enough to spook consumers and cause them to cut spending, the return to more reasonable prices has not been enough to comfort them in the face of negative economic news.

Consumers' concerns are rippling through the economy. Third-quarter estimates indicate a drop of 0.3% in real gross domestic product. This was driven by a 3.1% decline in personal consumption expenditures (PCEs), which account for approximately 70% of GDP. This is the first time that real PCE growth has been negative since the fourth quarter of 1991, and its largest drop since the second quarter of 1980. And PCEs may continue to slide as more and more people are unable to find work. In the week ending October 25, the number of US residents collecting state unemployment benefits reached its highest level in 25 years.

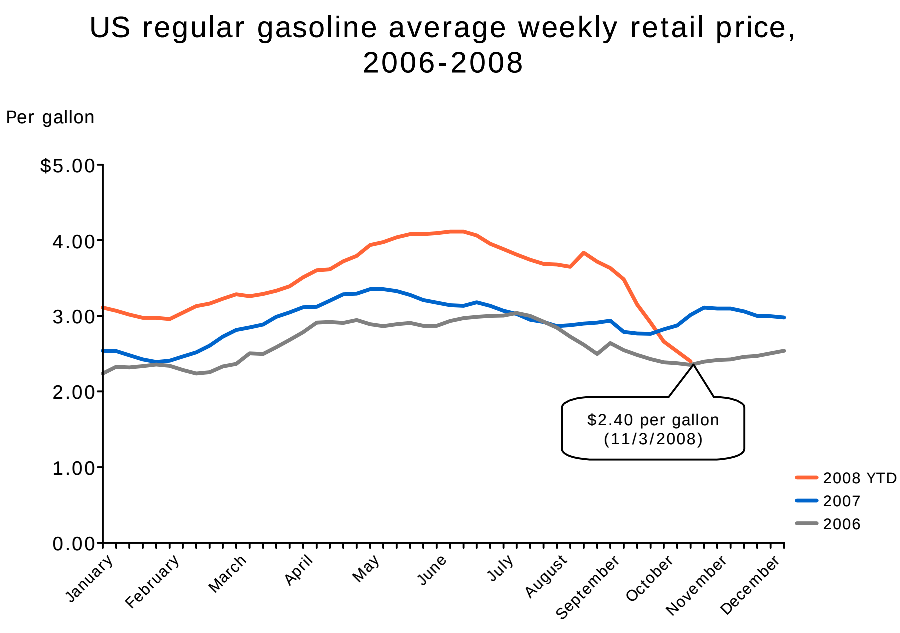
Several retailers have reacted to the slowdown by announcing significant downward revisions—of 20%, 30% or more—in earnings per share guidance ***(Chart 3)***.

Chart 1:



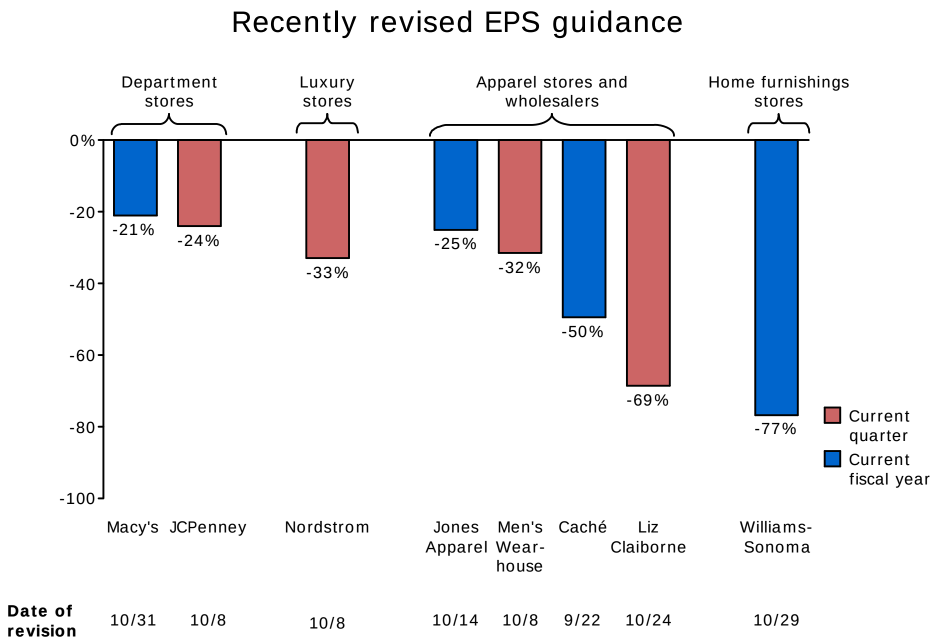
Note: October CCI is preliminary; CCI values indexed to 1985; MCSI values indexed to 1966
Source: Bloomberg; The Conference Board; Reuters/University of Michigan

Chart 2:



Note: Weekly average retail gasoline prices for all formulations of regular-grade gasoline
Source: Energy Information Administration

Chart 3:



Note: Percentage change based on average of original and revised EPS ranges
Source: Company press releases

Same-store sales tumbled in October

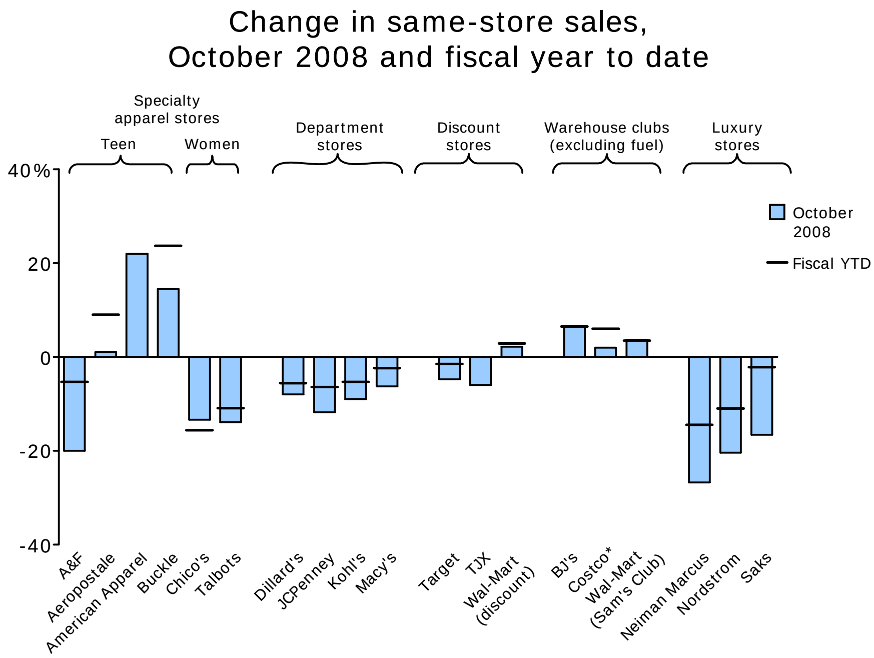
Same-store sales dropped 0.9% in the industry's worst October in over 35 years of collecting data—this according to the International Council of Shopping Centers (ICSC). Excluding Wal-Mart's figures, growth was even worse, plummeting 4.2% versus last October.

Luxury stores were hardest hit, sales falling an average of 19.2% from last year as consumers continued to pull back and splurging became less fashionable. Department stores also suffered, their sales shrinking an average of 10.9%.

Apparel stores saw sales go down 11% on average. But performance was again mixed in this sector. Continuing to outperform specialty apparel as a whole, some teen apparel retailers posted positive results in October. American Apparel and Buckle had notably strong results, at 22.0% and 14.5%, respectively. Higher-priced Abercrombie & Fitch continued to struggle as same-store sales dropped 20%. In contrast to many teen stores, same-store sales at women's apparel stores continued to be down ***(Chart 4)***.

But as consumers continued to focus on value and limit discretionary purchases, some discount stores and warehouse clubs benefited. Wal-Mart posted 2.0% same-store sales growth in October ***(see Chart 4)***. As CEO and President Lee Scott said in a recent article, "This is Wal-Mart time," referring to the company's favorable position as a low-price retailer in the current price-conscious environment. Warehouse clubs' same-store sales increased 1.2% in October (excluding the impact of fuel). BJ's had the strongest performance, with a 6.6% increase, but Sam's Club and Costco still outperformed most other retailers, with 3.6% and 2.0% growth respectively.

Chart 4:



* Costco includes US stores only; Costco's October same-store sales for all locations declined 1.0%
Note: Nordstrom includes full-line stores only; American Apparel and TJX fiscal YTD same store sales growth has not been reported
Source: ICSC; Financo; company press releases

New online growth data show a surprising slowdown

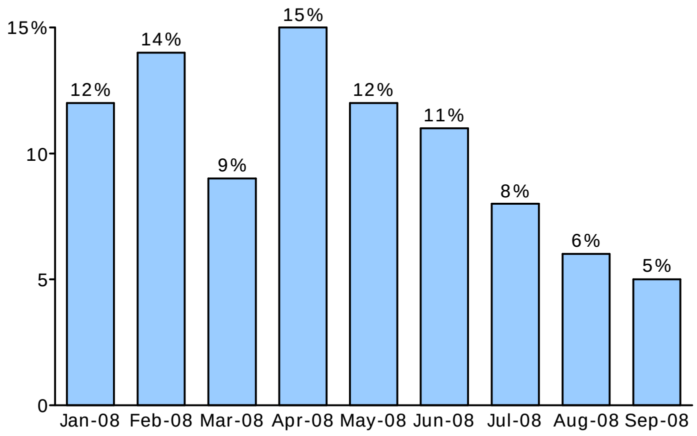
Growth in retail e-commerce in 2008 has been trending lower than in 2007. Last week comScore released third-quarter retail e-commerce growth data showing the downward trend continuing. Online retail e-commerce grew at just over 6% in the third quarter, ending the quarter with just 5% growth, an all-time low ***(Chart 5)***. The Census Bureau will release its official figures on November 19.

Two of the major sources for e-commerce data are comScore and the Census Bureau. The former derives its estimates by monitoring the browsing habits of 2 million Internet users and by conducting consumer panels. The latter surveys approximately 11,000 retailers to build its estimates. Although their methodologies are different, the two sources have published very similar results over the last several years ***(Chart 6)***.

Looking ahead, the Census Bureau does not forecast holiday growth, and comScore has not yet released its holiday projection. But other companies have recently published forecasts that are more optimistic than recent sales growth. Forrester Research projected growth of 12% for November and December in an October 21 report. And eMarketer published its online forecast of 10% on October 30, saying that “online retailers have reason to be guardedly optimistic.”

Chart 5:

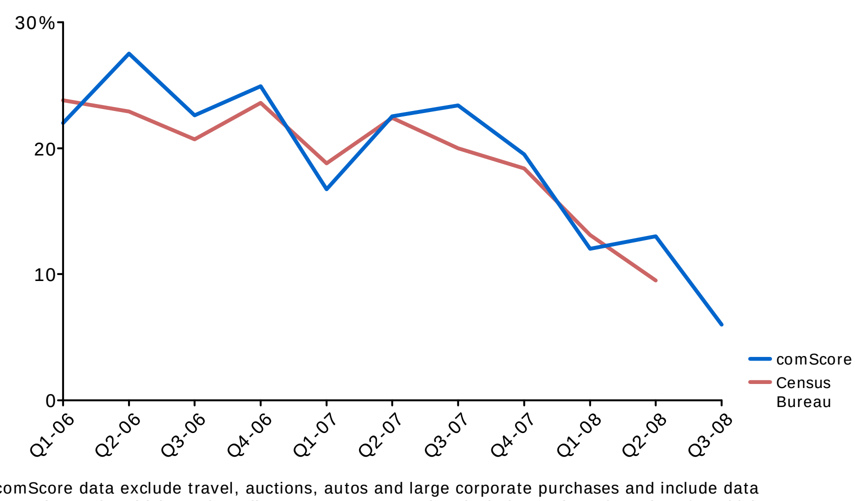
Retail e-commerce growth rates,
January-September 2008



Note: Excludes travel, auctions, autos and large corporate purchases
Source: comScore

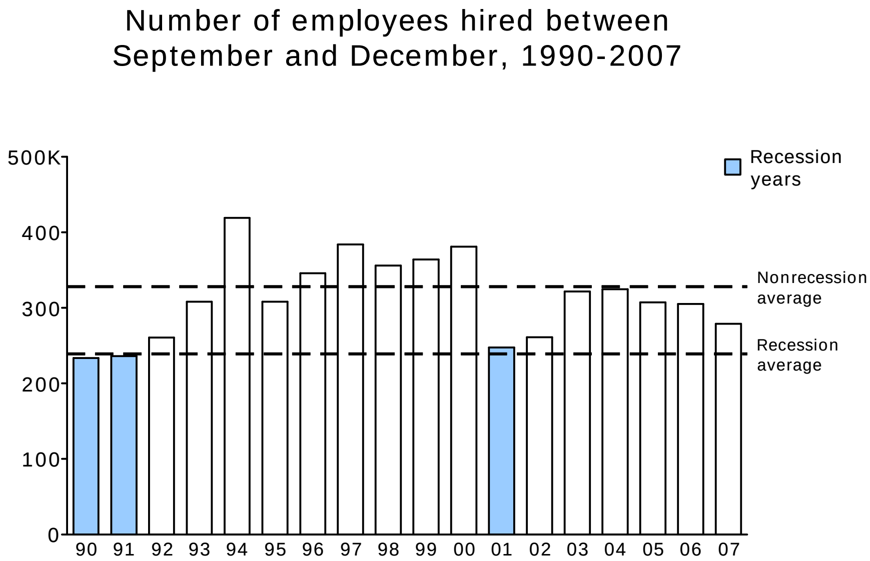
Chart 6:

Retail e-commerce YOY growth,
Q1 2006-Q3 2008



Note: comScore data exclude travel, auctions, autos and large corporate purchases and include data for pure-play and multichannel retailers; Census Bureau data include goods and services for which an order has been placed online by the buyer or the price and terms have been negotiated online
Source: Census Bureau; comScore

Chart 7:



Note: Includes the general merchandise, clothing and clothing accessories, furniture, electronics, sporting goods and hobby sectors of retail
Source: Bureau of Labor Statistics

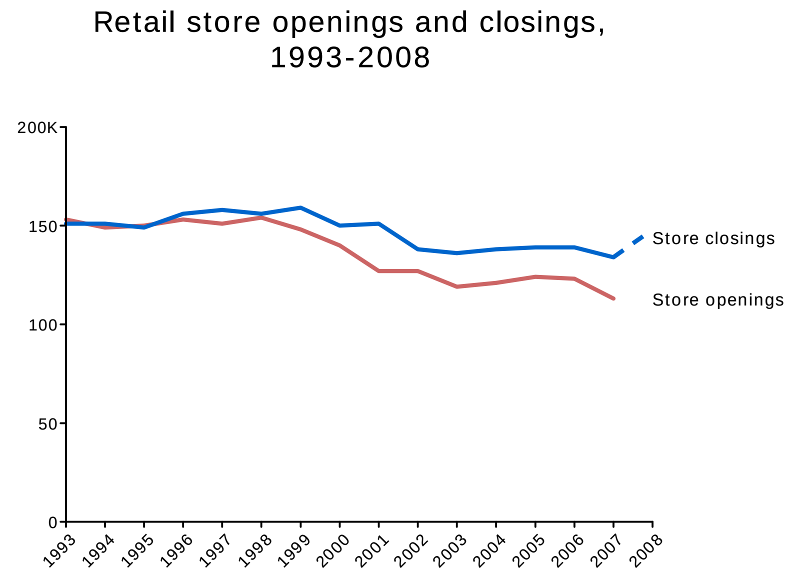
As consumers pull back on spending, some retailers are cutting back on staffing

Many retailers are keeping a watchful eye on costs as they work to preserve the bottom line. For some this means cutting back on holiday hiring, which is expected to be the weakest since 2001. Best Buy announced that it will bring in just 16,000 to 20,000 holiday hires this year, down from 26,000 in 2007; and Target and JCPenney have announced flat to falling hiring levels. Although a number of retailers, including Toys "R" Us and Victoria's Secret, have stated they intend to hire at the same levels as last year, we should note that 2007 was already a below-average year overall. And as the economy softens, the numbers could get worse. During the last two recessions, retailers hired over 25% fewer holiday employees than in nonrecession years ***(Chart 7).***

Store closings are on the rise

Last week the ICSC predicted that 148,000 stores will close this year, a 10% increase over 2007. This figure is slightly higher than the 144,000 closings the ICSC predicted in July, when it also noted it expected a "similarly large" increase in new-store openings. But data from the last few years suggest that closings will exceed openings by a wider margin ***(Chart 8)***. And as some retailers slash costs in an effort to avoid bankruptcy, more closings are likely. This week Circuit City reported it will close 20% of its stores, 155 locations, to better its financial position. Many other retailers have announced similar plans, either as part of a restructuring or as a way to improve finances. Add to that a number of announced cutbacks in new-store plans, and we may see net store-closing figures that exceed 2001 levels.

Chart 8:



Net change in retail establishments (K)	2	-2	1	-3	-7	-2	-11	-10	-24	-11	-17	-17	-15	-16	-21	TBD

Note: The total store closings in 2008 is an estimate; store openings in 2008 are to be determined
Source: Bureau of Labor Statistics; ICSC

With turbulence comes the opportunity for "bold strokes"

Retailers with strong financials often invest to take advantage of a market disruption, making use of the opportunity to reposition themselves. During the last downturn, PetSmart implemented sweeping changes to better adapt its offerings to its core "pet parents" customer segment. First it increased its emphasis on grooming, pet hotels and other services. Then it made improvements in store layout by regrouping merchandise and addressing aesthetics. The result: a sevenfold increase in stock price between 2001 and 2003.

We are already seeing bold moves in this downturn. We discussed one recent example in our last newsletter. In August, Tween Brands announced that it was converting approximately 600 Limited Too stores to its more value-oriented Justice brand to take advantage of Justice's stronger growth of late. Although the company anticipates recording a charge of approximately $18 million related to the transition, it expects to more than offset that charge with annual after-tax savings of $20 million to $25 million—largely from back-office consolidation and reduced marketing expense.

Wal-Mart is also making some changes. The world's largest retailer recently announced that it would scale back on new-store openings over the next two years. Instead it will focus on improving the customer experience through an extensive remodeling plan. The company intends to spend $1.6 billion to $1.7 billion on remodels next year, a 60% to 70% increase over this year and approximately a 100% increase over last year. The timing of this move may not be coincidental: Wal-Mart's efforts to improve the in-store experience may convince some new consumers to remain loyal to the discounter even when the economy turns around.

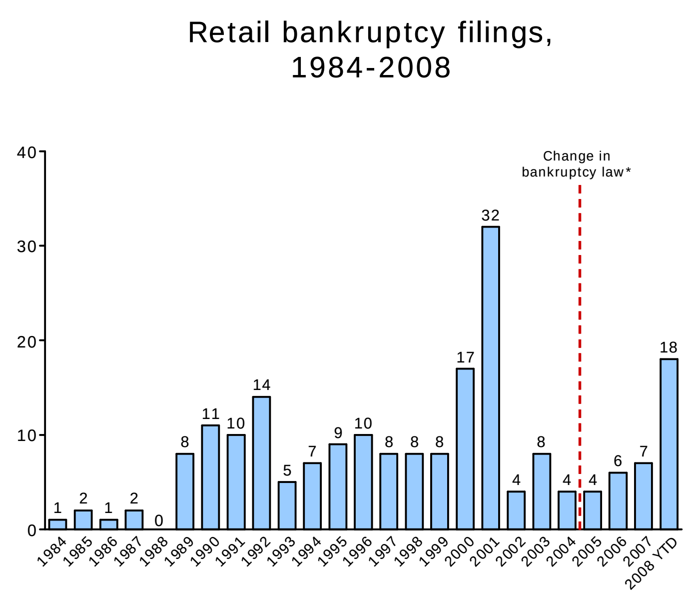
At the "request" of major stockholder Pershing Square Capital Management, Target is currently considering a shift in how it manages its real estate holdings. Pershing Square asserts that Target's vast land holdings—the largest of any retailer—are undervalued by the market. Pershing Square further expects that spinning off the land holdings into a separate publicly traded real estate investment trust will result in significant combined share price appreciation. Target is investigating the proposal, but it has noted that there are risks that Pershing Square may not have considered fully.

Real estate purchases may account for a large portion of near-term moves. As weaker players fold, some will leave behind very desirable retail locations. This year Best Buy has said it will try to "snap up" stores closed by its rivals and connect with their customers. And Wal-Mart recently noted the possibility of acquiring sites from other retailers that were going out of business, with the chance to "negotiate very good rents."

The roster of bankruptcies continues to grow

Despite their efforts, many retailers have not been able to adapt to the economic environment. So far in 2008, 18 retail chains have declared bankruptcy ***(Chart 9)***—more than two and a half times the 2007 total—and the year is not over**.** This number also exceeds the number of bankruptcies in 2000, heading into the last recession.

Chart 9:



* The federal bankruptcy code was revised in 2005 to significantly tighten deadlines for restructuring
Note: Retailer bankruptcies include those filed by all public companies and selected private companies with public debt or deemed significant and newsworthy
Source: BankruptcyData.com

Chapter 11 used to provide companies with some protection and a period to restructure. In today's environment, particularly given the limited access to credit, retailers often do not have the time they need to turn around their business and reemerge. Of the companies entering bankruptcy, a large number are moving to liquidate all their stores and close shop completely within months or even weeks:

- Levitz filed to liquidate 15 days after filing Chapter 11 in November 2007.
- Sharper Image filed to liquidate only weeks after filing Chapter 11 in February.
- Mervyns filed to liquidate about four months after filing Chapter 11 in July.
- Linens 'n Things filed to liquidate less than six months after filing Chapter 11 in May.

It is noteworthy that none of the declared bankruptcies to date are from sector leaders, companies whose generally healthier balance sheets, larger cash reserves and greater economies of scale may offer the flexibility to weather economic storms ***(Chart 10)***.

Leadership is not the only determinant of who is more likely to survive; sector is also an important factor. The housing crisis has severely impacted home accessory purchases, and general economic concerns are taking a toll on the most discretionary of purchases —jewelry, for example. In fact 9 of the 18 retailers that have declared bankruptcy so far this year sold home products (Linens 'n Things, Wickes Furniture, Home Interiors & Gifts, Mattress Discounters and Sharper Image) or jewelry (Whitehall Jewelers, Friedman's, Fred Leighton Holdings and Source Financing, which owned Fortunoff).

Chart 10:

Select performance metrics:
Market leaders vs. bankrupt followers

Market leader
Bankrupt follower

	DSW	Shoe Pavilion	Brook-stone	Sharper Image	Bed Bath & Beyond	Linens 'n Things
Number of stores	285	117	312	86	994	371
2007 sales	$1,406M	$153M	$563M	$375M	$7,049M	$2,795M
2006-2007 sales growth	10%	18%	10%	-29%	7%	-1%
2007 EBIT margin	6%	-9%	7%	-45%	12%	-1%

Note: Sharper Image EBIT margin is for Q1-Q3 2007
Source: OneSource; company filings

Even luxury is feeling the pinch

The global luxury goods market has begun to feel the effects of the worldwide economic slowdown and will likely see sales growth drop in 2009. According to the seventh edition of Bain's *Luxury Goods Worldwide Market Study,* growth of luxury goods sales globally will slow sharply in 2008 to 3.0%, down from 9.0% in 2006 and 6.5% in 2007. In 2009, sales of luxury goods will face their first decline in six years, as exchange rate fluctuations and economic turbulence eat into the confidence of many luxury consumers in mature markets. Sales are expected to fall as much as 7% using constant exchange rates, in contrast to a possible 2% drop using current exchange rates. For the different segments and companies in the luxury sector, the rate and duration of the decline will depend in part on how companies react. The most resilient will be those with strong international and diversified brands.

Because mature markets contribute nearly 80% to worldwide luxury sales, soft spending in each region is already taking a toll. Europe remains the "first market" of luxury, representing 38% of the global market. Growth in Europe was a strong 10% in 2007, but the region can expect sales growth to slow by half, to 5%, in 2008. Much of the region's growth both this year and next will be propped up by Eastern Europe. The Americas, which saw 4% growth in luxury sales in 2007, will be flat year over year in 2008—the first year of stagnation since spending retreated after September 11, 2001. And declines in Japan's luxury market, 12% of the global total, are expected to accelerate from −2% in 2007 to −7% in 2008.

Different product categories within luxury goods are yielding different results. Sales of luxury apparel for both men and women are expected to show little or no growth this year as other categories steal consumers' discretionary spend. Accessories remain a particularly strong category as fashion-conscious consumers, constrained by budget, work to give last year's clothing a new look. Although sales growth in this category has slowed from 2007, sales of shoes and leather goods continue to grow, at 8% and 4% respectively. Fueled by emerging markets, watches also are holding their pace relatively well, with sales growing at 9% this year. Jewelry is the one category to see a dramatic slowdown in sales, growing at just 2.5% in 2008, down from 9.0% in 2007.

We are also seeing unevenness across brand segments. Bain divides the luxury market into three main groups: accessible, aspirational and absolute ***(Chart 11)***. Consumers of accessible brands are directly affected by the global economy. Overall, this segment is significantly underperforming the market: It grew just 4% in 2007 and is estimated to be flat in 2008. However, select brands may still manage to thrive. For instance, driven by a boost from its factory stores and higher European wholesale sales, Polo Ralph Lauren's net income grew 40% in the quarter ended September 27. Aspirational brands are purchased by consumers looking to buy into the lifestyles the brands connote. Their growth remained steady in 2007 at 9%, as new consumers entered and left the luxury segment, and they will grow at the luxury-market rate of 3% in 2008. Absolute luxury brands remain more resilient because they appeal to the wealthiest global consumers. Sales of these goods grew 10% in 2007, and are expected to increase 8% in 2008.

Chart 11:

The 3 As of Luxury

Despite a slower 2008 and the prospect of declines in 2009, Bain expects sales in the global luxury market to start growing again quickly. Likely winners will resist cutting directly into consumers' shopping experience but will manage overhead costs effectively. To capture share coming out of the downturn, luxury players will need to adhere to three golden rules: Improve customer targeting, push for organic growth and build a smart cost culture ***(Chart 12)***.

Chart 12:

Three golden rules for luxury players
coming out of a downturn

Improve customer targeting

- Rethink the shopping experience
- Drive growth through localized marketing activities

Push for organic growth

- Slow retail expansion
- Strengthen entry price offerings; selectively increase other prices
- Avoid increasing prices across the product line

Build a smart cost culture

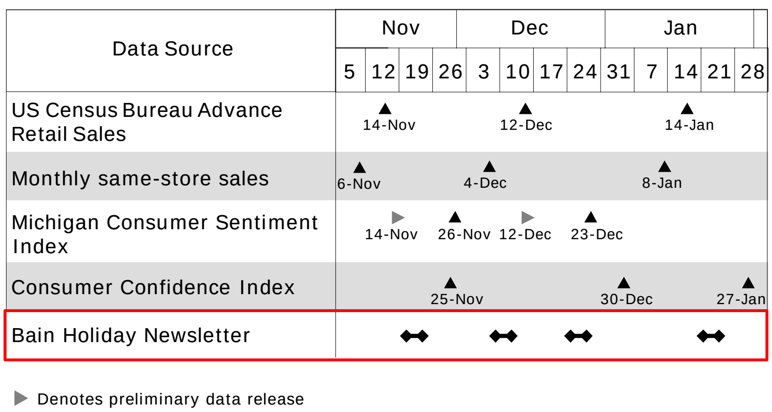
- Hunt for profits in working capital, G&A expenses, supply chain
- Avoid cutting marketing and other strategic costs
- Don't underspend competitors

Newsletter schedule

Our next newsletter will be released in mid-November, with a new issue roughly every two to three weeks after that through the holiday season ***(Chart 13)***. This schedule allows us to incorporate newly released holiday forecasts and performance data in a timely manner. Please let us know if you have any questions or need additional analysis.

Chart 13:

Indicator and forecast update schedule



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