Bain Retail Holiday Newsletter #3

November 14, 2008

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

Retail sales fell in October for the second straight month.[1] Nearly every sector posted declines as rising unemployment and a sharp slowdown in personal-income growth drove consumers to make deep cuts in spending. Consumer sentiment remains at an all-time low, and recent research suggests that consumers are more worried than excited about the holidays. Those who are shopping are determined to find the best deals, and retailers are responding by launching early and creative promotions to help drive and convert traffic. But slowing sales and heavy promotional activity may expose retailers to a liquidity crisis and an increased risk of bankruptcy.

Consumers are putting the brakes on spending

Year-over-year GAFS sales fell by 1.0% in October. September GAFS growth has been revised downward to −1.9% from the advance estimate of −1.0% published last month.[2] This is only the second time in the last 40 years that retail sales have dropped in two consecutive months, another sign that this could be one of the most challenging holiday seasons in decades.[3]

We often see widely different results across GAFO segments. But in October (and in September based on revised figures), all but one segment shared a common reality: negative growth.

- General merchandise, which accounts for 50% of total GAFO sales ***(Chart 1)***, has been experiencing the strongest growth all year. It was the only segment to grow in October, at a rate of 3.5% ***(Chart 2)***. This growth is in line with recent same-store sales figures and is driven by the relative strength of discounters and warehouse clubs offering value prices to consumers.[4]

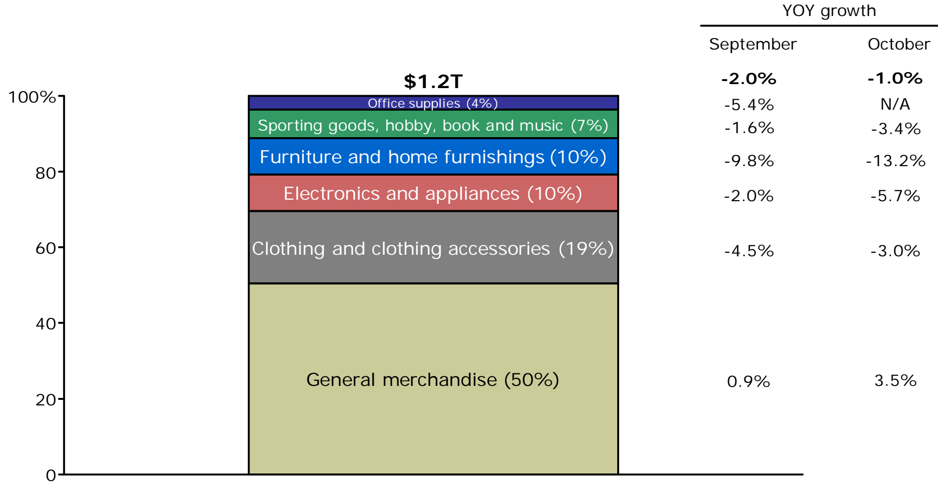
[1] October sales growth is based on advance GAFS. September sales growth is based on preliminary GAFO. See Chart A in the Appendix for definitions of GAFS, GAFO and other sales measures.

[2] Advance estimates are based on early reports and are often revised. Preliminary September 2008 GAFO growth is −2.0%.

[3] Retail sales were negative in December 1990 and January 1991. Due to data availability, 1968–1978 annual growth rates used were for GAF sales excluding miscellaneous shopping goods stores; 1979–1992 growth rates were for GAF sales; and 1993–2007 growth rates were for GAFO sales.

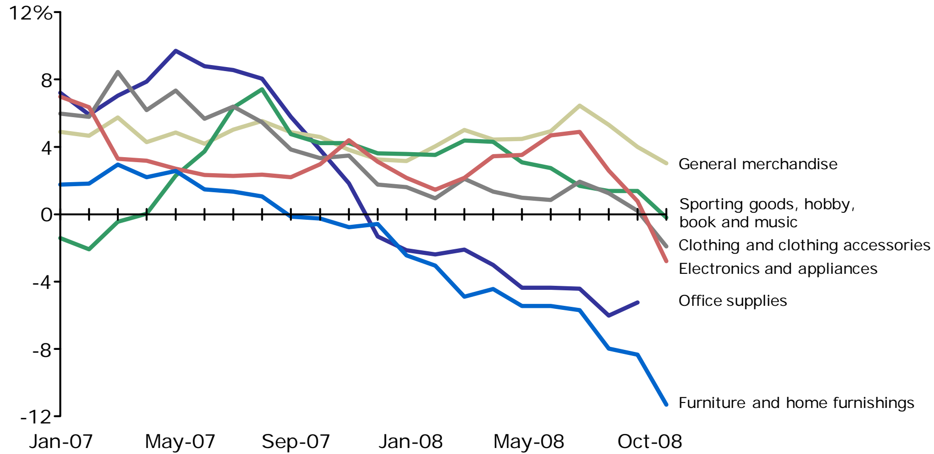
[4] *Same-store sales* are sales in stores that have been open for more than one year.

Chart 1:



Note: Data are not seasonally adjusted; total sales based on September 2008 trailing 12 months; October overall growth rate is for GAFS; office supplies data have not yet been reported for October
Source: Census Bureau

Chart 2:



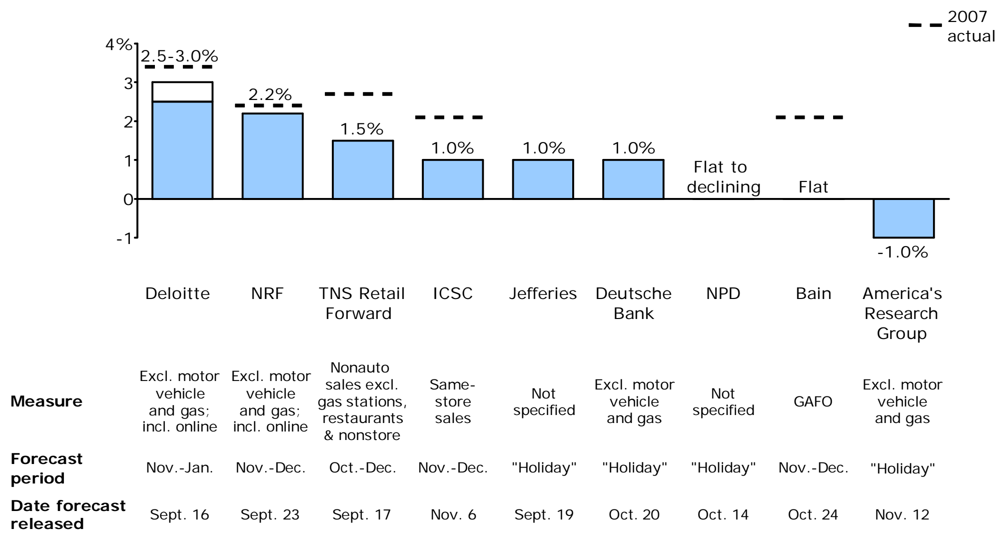
Note: Data are not seasonally adjusted; Office supplies data have not yet been reported for October
Source: Census Bureau

- Clothing and clothing accessories, the second largest segment, slid 3.0% in October as consumers continued to cut back on discretionary purchases. Further, September's previously reported −2.0% growth was revised down to −4.5%.
- Consumer electronics, which had strong sales growth through the first half of 2008, has seen accelerating declines since August. In October, sales dropped 5.7%.
- Furniture and home furnishings continued its decline, dropping 13.2% versus last October. This segment has seen the worst overall performance of all segments this year.
- Sporting goods, hobby, book and music saw sales fall 3.4% in October. Originally projected to have been one of just two growing segments in September, revised data show a 1.6% drop that month.

Through mid-October, most forecasts had been projecting positive growth for the holiday season. Forecasts since have been more pessimistic. In its holiday estimate released November 12, America's Research Group predicts a 1% drop in retail sales this season ***(Chart 3)***. And on November 6, the International Council of Shopping Centers revised its original same-store sales forecast for November and December down from 1.7% to 1.0%. Given the September and October sales data from the Census Bureau, it is likely that others will revise their forecasts downward as well.

Chart 3:

Forecasted holiday sales growth, 2008



	Deloitte	NRF	TNS Retail Forward	ICSC	Jefferies	Deutsche Bank	NPD	Bain	America's Research Group
Measure	Excl. motor vehicle and gas; incl. online	Excl. motor vehicle and gas; incl. online	Nonauto sales excl. gas stations, restaurants & nonstore	Same-store sales	Not specified	Excl. motor vehicle and gas	Not specified	GAFO	Excl. motor vehicle and gas
Forecast period	Nov.-Jan.	Nov.-Dec.	Oct.-Dec.	Nov.-Dec.	"Holiday"	"Holiday"	"Holiday"	Nov.-Dec.	"Holiday"
Date forecast released	Sept. 16	Sept. 23	Sept. 17	Nov. 6	Sept. 19	Oct. 20	Oct. 14	Oct. 24	Nov. 12

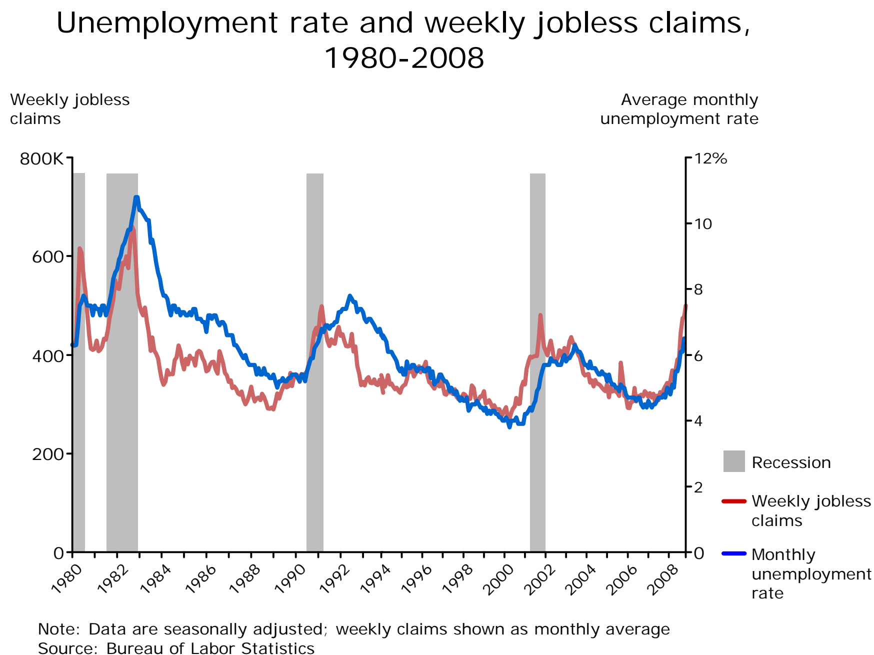
Note: All GAFO forecasts are unadjusted; 2007 actuals are specific to each forecast
Source: Deloitte; National Retail Federation; TNS Retail Forward; International Council of Shopping Centers; Jefferies; Deutsche Bank; NPD Group; America's Research Group

Macroeconomic indicators continue to deteriorate

Recent macroeconomic data paint an alarming picture. Unemployment leads the news, rising to 6.5% in October—its highest level since April 1994 and up 1.8 percentage points from the same month last year. Jobless claims have increased accordingly, reaching their highest level since September 2001 ***(Chart 4)***. Retail is a major driver of overall unemployment: The net loss of retail jobs represents 25% of the total net change in nonfarm jobs so far this year, approaching the level seen following the last recession and nearly 10 percentage points higher than the average over the last four years ***(Chart 5)***.

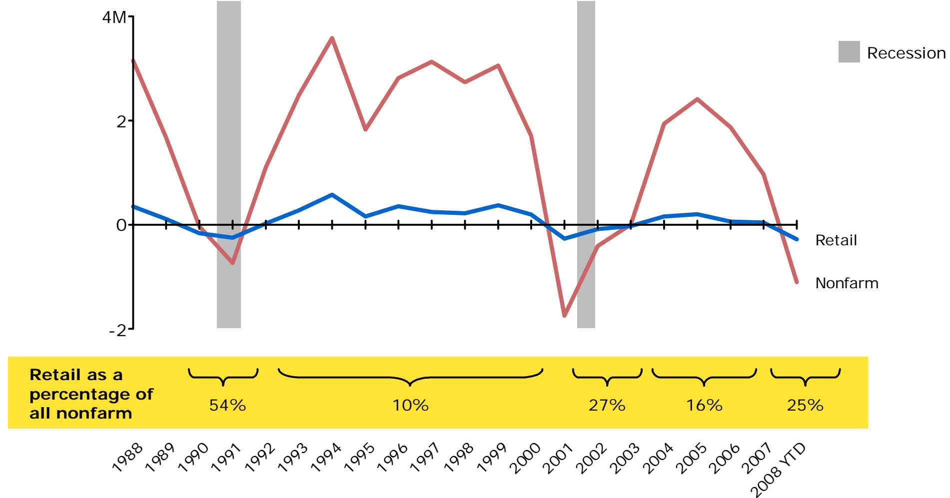
Personal-income growth slowed and savings both dropped dramatically in the third quarter. Personal-income growth fell to 0.3%, down from a much stronger 1.9% in the second quarter ***(Chart 6)***. And although many consumers may want to save more during this period of economic uncertainty, lower income are higher costs are restricting their ability to do so. The personal-savings rate fell by more than half in the third quarter of the year, from 2.7% in the second quarter to 1.3% ***(Chart 7)***.

Chart 4:



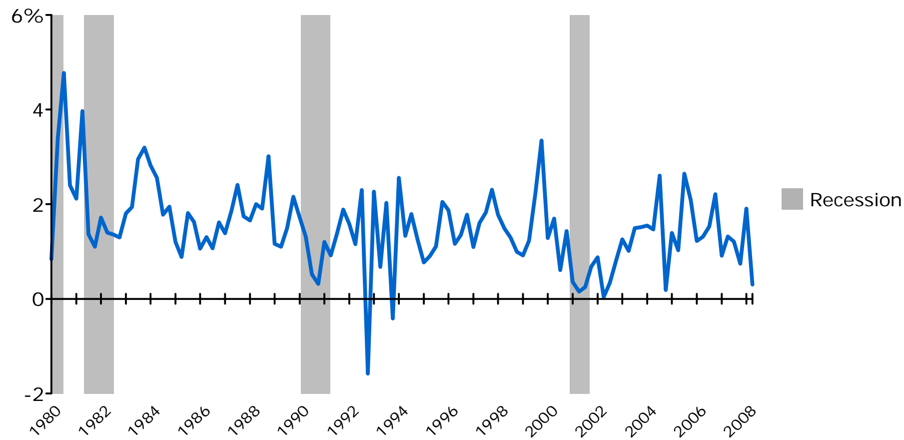
Note: Data are seasonally adjusted; weekly claims shown as monthly average
Source: Bureau of Labor Statistics

Chart 5:



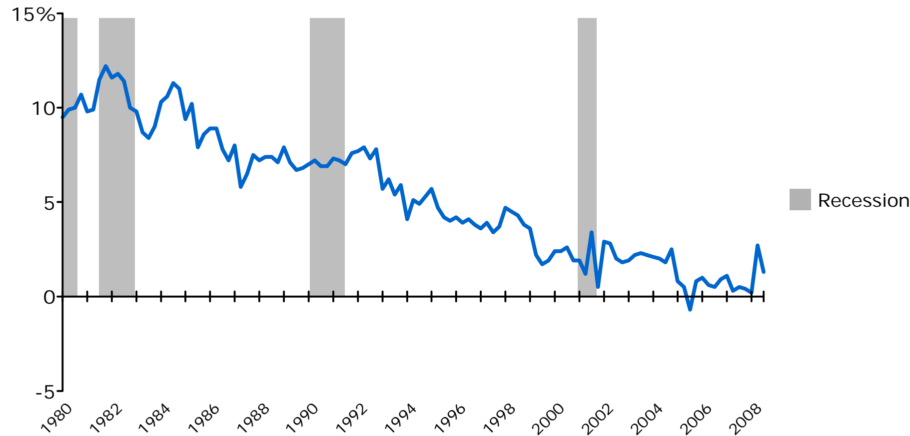
Note: Seasonally adjusted; nonfarm includes retail; 2008 YTD is January through October
Source: Bureau of Labor Statistics

Chart 6:



Note: 2008 shown through Q3; months seasonally adjusted at annual rates
Source: Bureau of Economic Analysis

Chart 7:



Note: 2008 shown through Q3; months seasonally adjusted at annual rates; personal-savings rate is personal savings (disposable personal income less personal consumption, interest and transfer payments) divided by disposable personal income (personal income less personal current taxes)
Source: Bureau of Economic Analysis

Although most macroeconomic data are grim, interest rates bring some positive news. For the week ended November 7, the effective federal funds rate was 0.24%—the second-lowest weekly rate on record.[5] However, rates that more directly impact consumers and that typically are tied to the federal funds rate have not dropped equivalently:

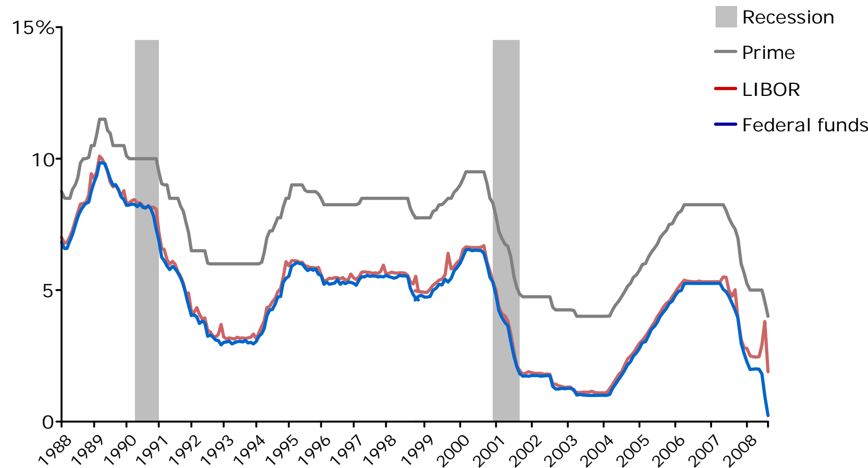
- The London Interbank Offered Rate (LIBOR), the rate at which banks lend funds to one another, stands at 1.9%. This is 166 basis points higher than the effective federal funds rate. Historically the average spread between the two rates is just 17 basis points ***(Chart 8)***.[6] Most commercial loans and many personal mortgages and home equity credit lines are tied to LIBOR.
- The US prime interest rate, the rate used as the basis for many credit cards, mortgages and home equity credit lines, stands at 4.0%, approximately 376 basis points higher than the federal funds rate. Since 1993, the average spread between the two rates has been a consistent 300 basis points ***(see Chart 8)***.

This growing divide reflects banks' continued reluctance to lend. The Federal Reserve is trying to inject liquidity into the economy by lowering the federal funds rate, but it cannot force banks to lower their rates in turn. For the Federal Reserve's rate drops to significantly help the economy, we will need to see equivalent drops in LIBOR and the prime rate.

[5] Based on weekly values from the Board of Governors of the Federal Reserve System. The lowest level on record is 0.20% for the week ended March 28, 1958.

[6] Based on the average monthly federal funds rates and LIBOR from December 1984, when LIBOR was introduced, through August 2008.

Chart 8:



Note: November 2008 federal funds rate based on effective rate for the week ended November 7
Source: Federal Reserve Board; British Bankers' Association; Bloomberg

'Tis the season to be jolly . . . isn't it?

Over the last month, Bain worked with Communispace, a market research company that builds and runs online consumer communities, to better understand what consumers are thinking about shopping this season.[7] When asked "When you think about holiday shopping, what is the first feeling that comes to mind?" approximately one in ten indicated "excitement" about the holidays this year, down from three in ten last year. And approximately 50 percent of respondents said they were "stressed" or "depressed" this year, up from 25 percent last year. And when asked to "tell us why you feel that way," panelists often cited concern about the economy. For example, one explained: "I'm really downbeat [about] this upcoming holiday season. It just isn't going to be the festive, happy season with the economy so battered."

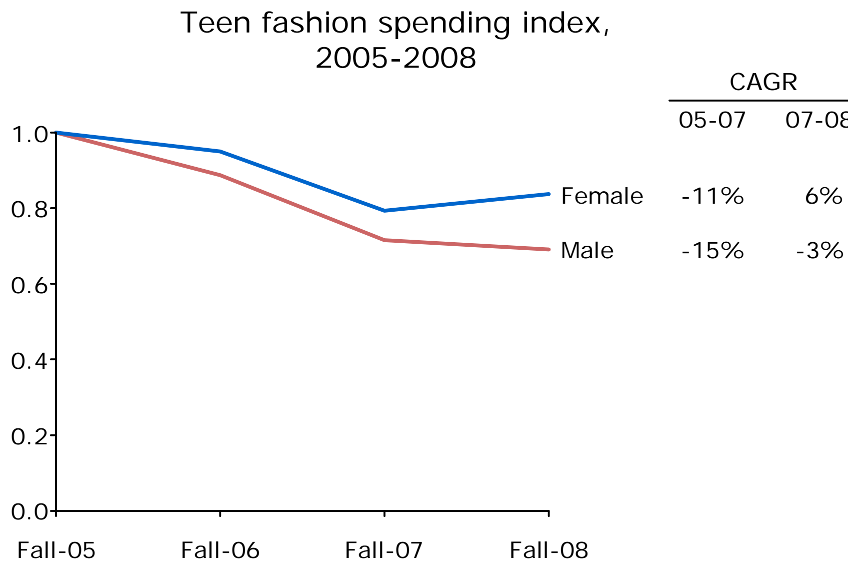
These concerns continue to impact consumer spend. Each year TNS Retail Forward asks shoppers if they plan to spend more or less than the previous year during the holidays. This year there's a significant jump in the percentage of respondents who report they will spend less, up 19 percentage points, from 31% last year to 50% this year. Although it's difficult to know what actual sales numbers will be from a forward-looking survey, the findings are an indicator of consumers' mood heading into the holidays.

[7] A Communispace community, or panel, is a private online site where up to 400 invited prospects and customers regularly spend time brainstorming, sharing feelings and experiences, and discussing trends to help a company figure out its marketing and business strategies. These private communities are facilitated by Communispace to keep the "conversation" relevant and insightful.

Most of the Communispace respondents reported spending less on shopping in the past six months. The vast majority—80 percent—said they were "buying less"; the rest reported "trading down" (to less expensive items). For many, *buying less* means purchasing only necessary items: "I am shopping less now everywhere than I was six months ago. We've lost money in the stock market, so we are trying to spend less to offset those losses. And when I do shop, I try to go in and out and get only what I need, no browsing so I can't spend more than anticipated." Those respondents who are trading down for the most part are shopping in different stores: "I used to visit the mall and outlets at least once a month, but those days have gone. Now the mall is more for walking around and quick trips. Target and Wal-Mart are my go-to stores now, for mostly price [reasons], and they are more of a one-stop shop [and] that also helps save on gas."

Younger panelists (ages 18 to 24) continue to report being somewhat less impacted by the current slowdown. Approximately half of these panelists described "no change" in their shopping behavior, and almost a fifth described actually spending more than they did six months ago. A recent Piper Jaffray report on teen spending shows a similar trend, with female teens spending more this fall than last, while male teens spent 3% less ***(Chart 9)***. However, overall teen spending on fashion remains at less than 80% of 2005 levels.

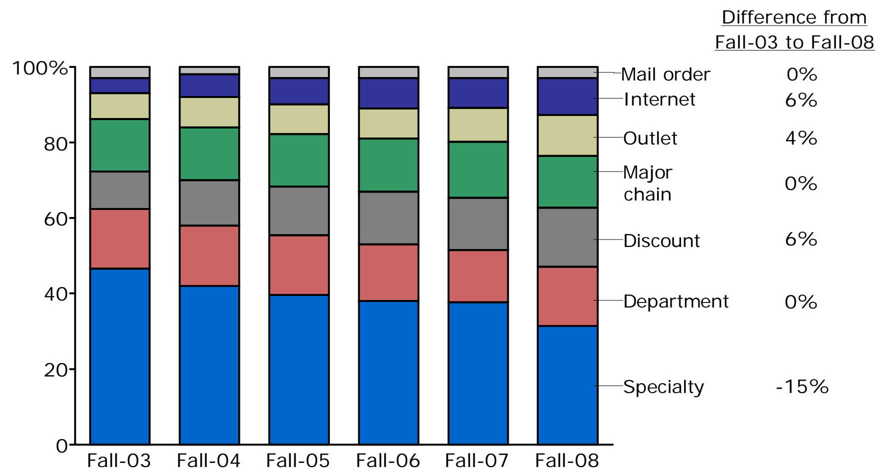
Chart 9:



Note: Figures are indexed to 2005; *CAGR* means "compound annual growth rate"
Source: Piper Jaffray

Both teens and adults continue to seek out low prices. Specialty retailers are losing share as teens increasingly shop at discount stores, outlets and online ***(Chart 10)***. One teen told us: “I am shopping less at the mall and more at strip malls and T.J.Maxx. I don’t prefer it, but it is cheaper and I need the money for gas.” Adults described similar changes in their shopping behavior: “I am an avid shopper and have stayed away from the malls for months. I shop a lot at Costco now and still go to Target. . . . I have also gone to T.J.Maxx and Marshall’s, but I have very much cut down.” And the findings from a recent survey of women shoppers further illustrate this shift. The Marketing to Moms Coalition reports that 87% of moms will shop for gifts this holiday at Wal-Mart, Target and other discounters, while less than 40% will shop at department stores and specialty apparel stores.

Chart 10:



Source: Piper Jaffray

Retailers are amping up promotions to entice consumers to shop

Faced with what could be the slowest holiday sales growth in decades, retailers are scrambling to get consumers out and shopping. In a recent survey of 100 chief marketing officers, 88 indicated that they plan to offer more discounts and promotions than last year. As a result, we are seeing great variety in the promotions being advertised.

Several retailers started early promotions tied to current events rather than the holidays. Last month Restoration Hardware offered customers a $100 voucher that looked like a rebate check, in celebration of the (first) government bailout bill’s passing. Barnes & Noble’s “The Choice Is Yours” promotion offered shoppers a 30% discount on 100-plus books related to the election. And Saks’s recent “Chic-onomics 101” promotion encouraged customers to buy high-end designer “investment bags, to have and to hold . . . for a

lifetime." Customers who purchased one of the expensive bags received up to a $500 gift card.

Sears and Radio Shack are helping consumers who want to be green *and* save money. Both are inviting customers to trade in consumer electronics. The consumer sends the item in for inspection—the retailer pays the shipping—and then the retailer determines a value and sends the consumer a gift card in that amount.

Overstock.com is addressing the "homeward bound" consumer behavior we discussed in our first newsletter. The company's new television commercial shows family and friends gathered together for the holidays, with a Christmas tree and presents in the background. Although it mentions "generously low prices" and "$2.95 shipping," the focus appears to be on the final tagline, "At home with the 'O.'"

Many retailers remain squarely focused on value. Wal-Mart started early in October by offering 10 toys for $10 each. It has now announced "Operation Main Street," a new round of price cuts every week until Christmas. After surveying moms to understand how they plan to shop for the holidays, Wal-Mart designed the price cuts to align with those plans. To help them even more, Wal-Mart's customers can sign up for mobile alerts that list each week's repriced items. Toys "R" Us has published its biggest Toy Book ever, with up to $5,000 in savings, compared to $1,500 last year. And in an extreme move, Kmart introduced "Early Black Friday" sales beginning the weekend after Halloween, more than three weeks before Thanksgiving.

With Black Friday still two weeks away, we are seeing a new tactic this year: A number of retailers have already given out details of their promotions on and around this crucial day. Sears has released its Black Friday circular, and Kmart has made its Thanksgiving Day ad public. The depth of the retailers' price cuts seems in line with cuts made in their corresponding sales last year, but that's where the similarities end.[8] Sears has quadrupled the number of items in its circular, from 165 last year to 677 this year. New this year are more big-ticket items with discounts of up to $900, and more practical items, like tires, have been included. Kmart has not added individual items: It has 156 individual items listed this year, down slightly from 167 last year. But it has added categorywide discounts of 25% to 70% in six categories, up from just three categories last year. Also new are several pages of gifts under $5, $10, $20 and $30.

Depressed sales and deep promotions could threaten liquidity for some retailers

In today's environment, significant declines in same-store sales combined with deep promotional discounts may expose retailers to greater risk of defaulting on debt covenants and could trigger a liquidity crisis. Specifically, many retailers may struggle to meet important liquidity ratios that are frequently tied to covenants in their credit agreements:

[8] We sampled 44 items from Sears from 2007 and 2008 and found an average discount of 47%. We sampled 30 items from Kmart from 2007 and 2008 and found an average discount of 40% in 2007 and 41% in 2008.

- **Interest coverage ratio:** This ratio measures how easily a company can pay the interest on its outstanding debt. [9] An interest coverage ratio below 1.5 suggests the company may have difficulty meeting its debt service obligations and could cause alarm among investors and creditors.
- **Debt-to-EBITDA:** This ratio measures a company's ability to pay off its outstanding debt and is commonly used to assess the likelihood of a company defaulting on its debt. [10] A high debt-to-EBITDA ratio may be a cause of concern for creditors and investors.

In our last newsletter we reported a record number of retail bankruptcies through October of this year. In the week since that newsletter was published, the number has gone up. Circuit City surprised some industry experts when it filed for Chapter 11 only days after announcing a large number of store closures. As a reason for the filing, the retailer cited concern that it would not receive products from vendors.

If negative same-store sales trends continue and retailers are not prepared to manage their business in the face of rapidly declining profitability, many will find themselves in tenuous situations. Standard & Poor's publishes a list of companies across industries that have the greatest risk of default in the coming 12 to 24 months. These "weakest links" have both a negative outlook and a debt rating of B– or lower. From October 2007 to October 2008, the number of retailers and restaurants on the list grew by more than 40%, to 17, suggesting we are likely to see more bankruptcies in 2009 ***(Chart 11)***.[11] Moreover, the 40% increase does not include the many retailers already removed from the list after filing for bankruptcy this year.

In light of declining sales growth and profit-squeezing promotional activities, many companies have been aggressively running scenarios and developing contingency plans to prepare for what lies ahead. Effective scenarios must include downside cases to determine what will be needed to survive a steep and protracted downturn. In this instance, that means at least a two- to three-year time horizon, a realistic estimate of how long companies may be feeling the effects of this downturn. Only then can a company know how many "surplus" resources it has available to invest in improving its position. The answer, of course, is that companies with strong strategic and financial positions will have more "surplus" for investment, even after leaving conservative safety stocks for surviving the downturn. But survival must be the first priority.

In retail, there is a common question about how to balance the cost of having too much inventory with the cost of not having enough. This is answered by comparing the cost of underage to the cost of overage to determine how much inventory is appropriate:

$$\frac{\text{Cost of underage}}{\text{Cost of underage + Cost of overage}}$$

[9] The interest coverage ratio is defined as Earnings before interest and taxes/Interest expense.

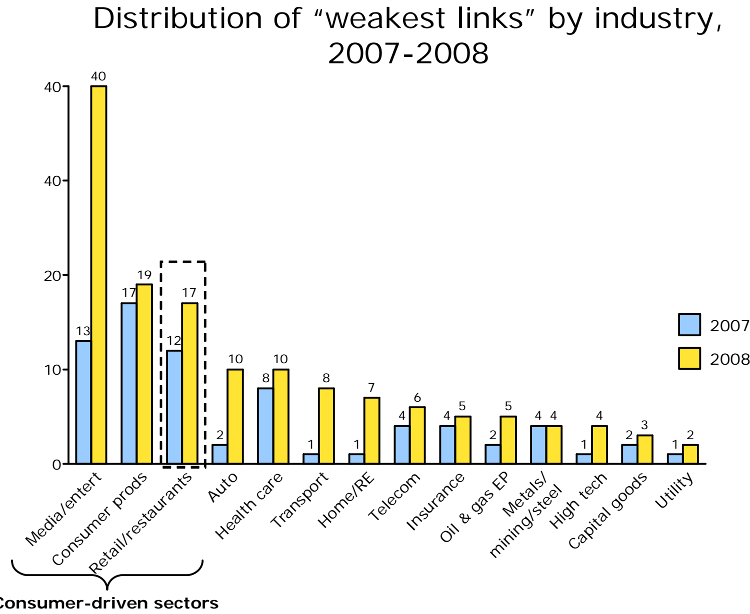
[10] The debt-to-EBITDA ratio is defined as Debt/Earnings before interest, taxes, depreciation and amortization.

[11] Standard & Poor's reports retail and restaurants together.

The higher the resulting percentage, the more important it is to have sufficient safety stocks.

The analogy here is comparing the cost of too little or too much inventory to the cost of having too few or too many financial resources to meet their financial obligations. With too few resources, a company may face liquidity shortages that in turn may trip debt covenants. If this occurs and a company is able to refinance, new debt will likely come at a higher cost. And if a company is unable to refinance, it faces bankruptcy—an almost infinite cost.

Chart 11:



Note: *Weakest links* refers to the issuers of corporate debt that have a negative outlook (downward trajectory) and a B- debt rating or lower; chart includes a subset of industries
Source: Standard & Poor's

Newsletter schedule

Our next newsletter will be released in early December, with a new issue roughly every two to three weeks after that through the holiday season ***(Chart 12)***. This schedule allows us to incorporate newly released holiday forecasts and performance data in a timely manner. Please let us know if you have any questions or need additional analysis.

Chart 12:

Indicator and forecast update schedule

Data Source	Nov		Dec					Jan			
	19	26	3	10	17	24	31	7	14	21	28
US Census Bureau Advance Retail Sales				▲ 12-Dec					▲ 14-Jan		
Monthly same-store sales			▲ 4-Dec					▲ 8-Jan			
Michigan Consumer Sentiment Index		▲ 26-Nov		▶ 12-Dec		▲ 23-Dec			▶ 16-Jan		
Consumer Confidence Index		▲ 25-Nov					▲ 30-Dec				▲ 27-Jan
Bain Holiday Newsletter				◆–◆		◆–◆			◆–◆		

▶ Denotes preliminary data release

Appendix

Chart A:

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: Census Bureau; analyst reports

Selected References

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

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