Bain Retail Holiday Newsletter #5

December 12, 2008

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

Retail sales fell for a record third straight month in November. Over the last 40 years, holiday sales growth has never been negative, but it could take a holiday miracle to avoid that this year. Although consumer sentiment has increased slightly as gas prices have fallen and stock market volatility has lessened, consumers continue to pull back on spending. The next year or two are likely to pose substantial ongoing challenges for retailers, and some firms won't rise to the occasion. But those that take the appropriate actions may survive and find themselves well positioned to seize unique opportunities, emerging from these difficult times stronger than ever.

November GAFS results mark new record lows

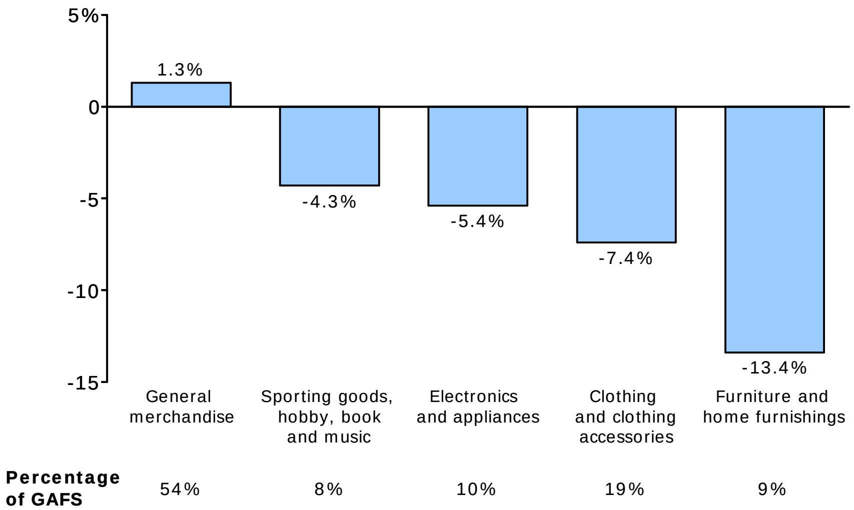
GAFS sales fell by 3.1% in November, marking the first time GAFS sales have dropped over three consecutive months in the last forty years of comparable data.[1] Most GAFS segments were down versus last year ***(Chart 1)***, and all have been trending down since July ***(Chart 2)***. For furniture and home furnishings, the strongly negative results of the past few months continued in November, with the category falling 13.4%. The clothing and clothing accessories segment was the second-worst performer, with a 7.4% drop. Electronics and appliances, and sporting goods, hobby, books and music also declined more sharply than last month, showing 5.4% and 4.3% drops, respectively—probably a function, at least in part, of deep promotions throughout the month and over the holiday weekend.

General merchandise was the only segment that saw positive gains in November, with 1.3% growth versus 2007 ***(see Chart 1)***. This segment includes discount stores and warehouse clubs like Wal-Mart and Costco, retailers benefiting from consumers trading down. Though much smaller in size, many secondhand stores are also in this segment. According to the National Association of Resale & Thrift Shops, three-fourths of second-hand stores increased sales in September and October by an average of 35%. The same trend likely continued in November.

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

Chart 1:

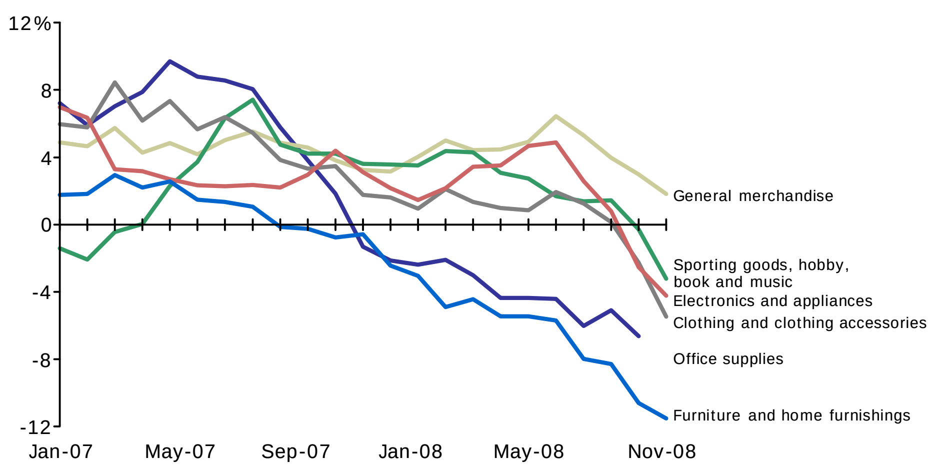
GAFS sales growth by segment,
November 2008



Note: Data are not seasonally adjusted
Source: Census Bureau

Chart 2:

GAFO sales growth by segment, three-month rolling average,
January 2007-November 2008



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

Current trends suggest holiday (November and December) sales growth may be negative for the first time in the last 40 years. December year-over-year GAFO growth will be buoyed by a weak December 2007 (up only 0.1% over 2006) and the fact that this year's Cyber Monday occurred in this month.[2] Still, we're unlikely to see positive GAFO sales growth this holiday season: December sales would have to rise 2.3% just to hold holiday sales flat. This would be the highest monthly growth rate since July.

The macroeconomic picture remains bleak

As we discussed in our last newsletter, unemployment rose for the fifth straight month in November, to 6.7%, the highest level since 1993 ***(Chart 3)***. And nonfarm payrolls fell by 533,000 in the month, the largest drop in 34 years. Since then, jobless claims reached a 26-year high of 573,000 for the week ending December 6, a number not seen since the 1982 recession ***(Chart 4)***. As job losses continue, increasing apprehension may lead to further contraction in consumer spending. Personal spending in October had already gone down by 1.0%, the largest monthly drop since September 2001.

The Michigan Consumer Sentiment Index rose slightly this month, to 59.1 ***(Chart 5)***. The increase was likely related to the sustained decline in gas prices and recent easing of the Dow's volatility. This week the US average price per gallon fell to $1.70, the lowest since February 2004, down almost 60% from the summer high. And the average daily swing in the Dow over the last three weeks has shrunk by about one third from the 600+ point average experienced from October 10 to November 24.[3]

Chart 3:

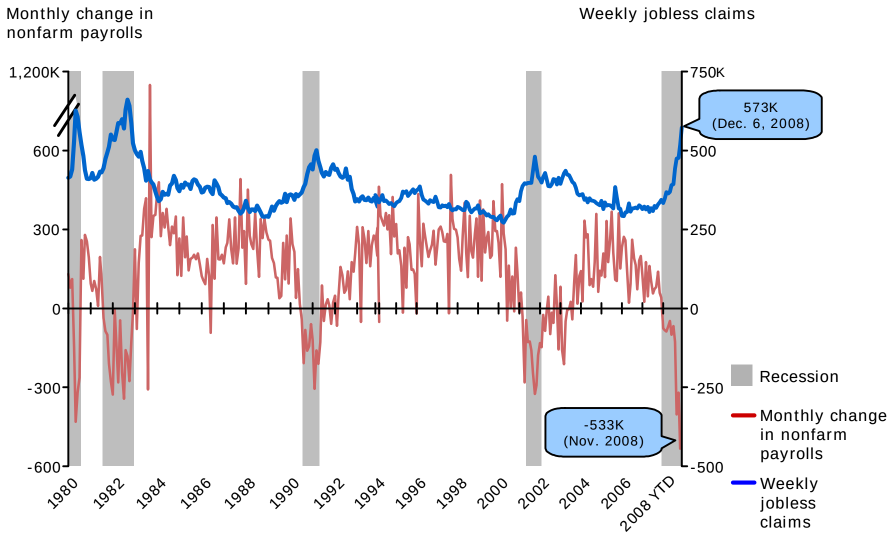
Note: Data are seasonally adjusted
Source: Bureau of Labor Statistics

[2] Cyber Monday results are a component of GAFO, which includes both store retailers and nonstore retailers.

[3] Based on the average spread between the Dow's daily highs and lows from October 10 through December 11, 2008.

Chart 4:

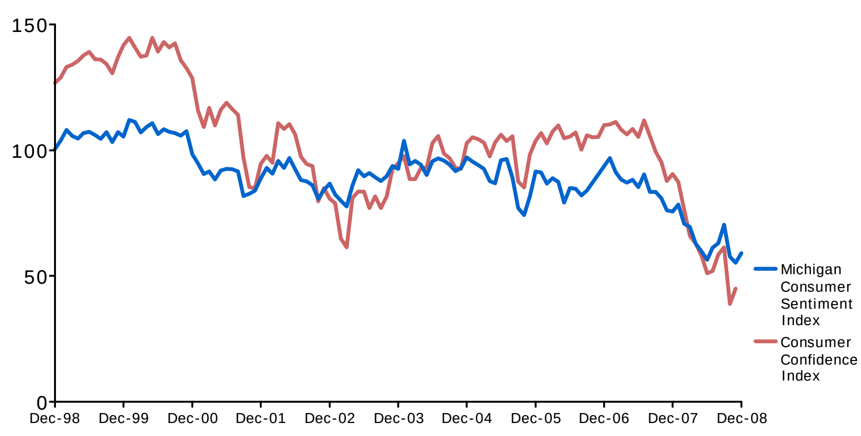
Weekly jobless claims and change in nonfarm payrolls, 1980-2008



Note: Data are seasonally adjusted
Source: Bureau of Labor Statistics

Chart 5:

Consumer sentiment and confidence
December 1998-December 2008



Note: December 2008 MCSI and November 2008 CCI are preliminary; CCI indexed to 1985; MCSI indexed to 1966
Source: The Conference Board; Reuters/University of Michigan

Desperate times call for planning for the unthinkable

Nobody knows how long or how deep this economic crisis will go. And although the recession will affect every retailer differently, most will suffer significant drops in both sales and profits. That's why 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.

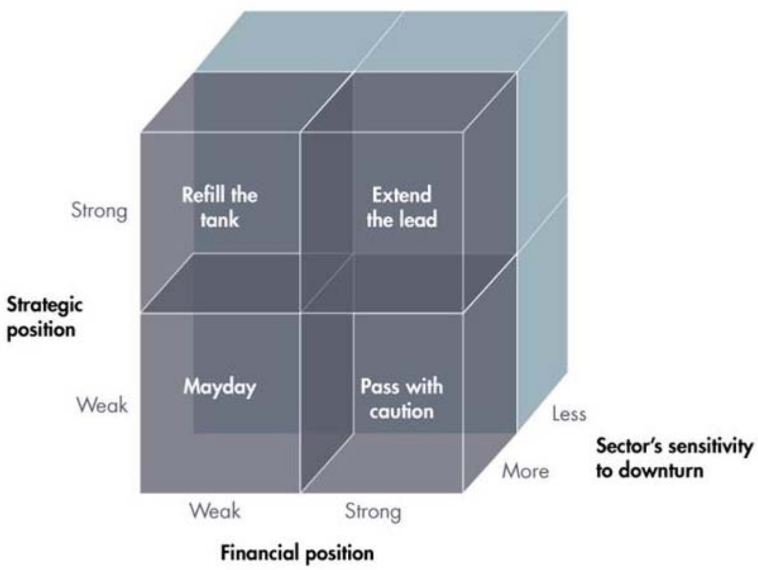
First and foremost, retailers need to actively manage and know how much liquidity it will take just to survive. Only with this understanding can they ride out the crisis and explore growth options.

How do retailers make this assessment? They need to carefully consider where they stand on three factors ***(Chart 6)***:

- Their strategic position
- Their financial position
- Their sector's sensitivity to the economic downturn

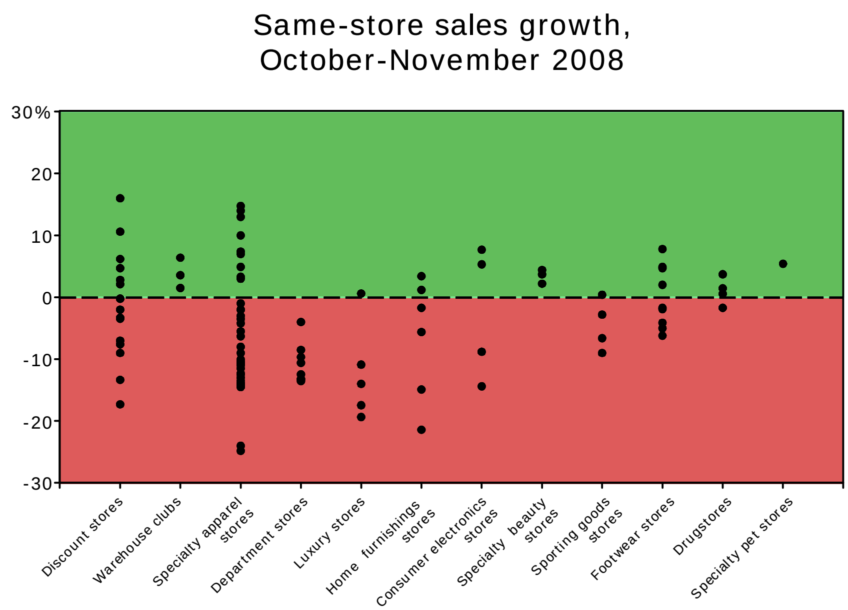
Chart 6:

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



Even a sharp downturn affects individual sectors differently ***(Chart 7)***. As mentioned above, warehouse clubs and discount stores are faring better overall. But other sectors are holding too. Specialty beauty, for example, is doing relatively well as consumers continue to spend on looking good and taking care of themselves. This sector also skews to younger women who are more likely to still have money to spend, and to lower-price-point products that consumers are still willing to buy. The specialty pet sector is also holding, with consumers continuing to buy food and other consumables for the family friend. On the other hand, the luxury and home furnishings sectors are suffering as consumers cut back on discretionary items and the housing market continues to deteriorate.

Chart 7:



Note: Straight average of October and November year-over-year same-store sales growth rates; for companies that only report same-store sales quarterly, data shown are for the most recent quarter
Source: Financo; ICSC; company press releases

Within sectors that are sensitive to the downturn—the front half of the cube—each company has particular strengths and vulnerabilities based on their strategic and financial positions. The following examples illustrate some of the actions that retailers in different positions have taken in the past.

Example 1: Extend the lead

Now-bankrupt Circuit City has found itself in the bottom left of the cube, suffering from years of both share declines and earnings losses. On the other hand, Best Buy sits at the top right of the cube, a reflection of its strong strategic and financial position in its sector. Best Buy invested to further strengthen its position—localizing stores to primary customer segments and improving customer service, for example. It also led the industry by expanding into services in 2003 with the acquisition of Geek Squad. (It took Circuit City four more years to launch Firedog.) Best Buy continues to innovate in assortment, from adding Apple computers and other popular products to developing its private Blue Label products in response to customers' feedback. These investments have led to continued share gains and 2.1% fiscal year to date same-store sales growth through October. They also have positioned Best Buy to take over many of Circuit City's customers and cherry-pick its store locations.

Example 2: Pass with caution

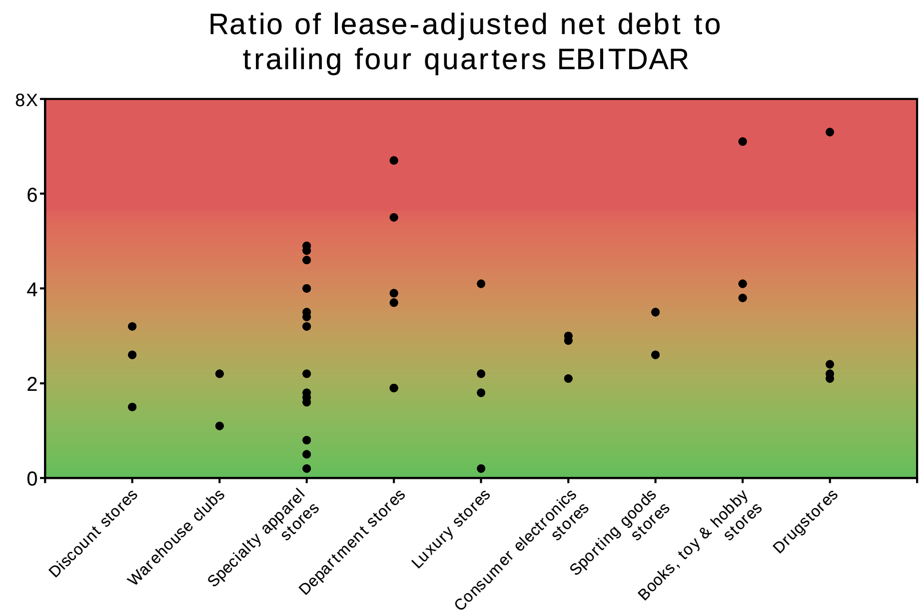
Coming out of the last downturn, Burger King found itself in a weak strategic position, its market share eroding. Although its financial position was fairly strong, its costs were rising. After assessing the situation, the company developed a comprehensive turnaround program to more effectively target core customers and optimize its cost base. This included activities such as optimizing its supply chain, streamlining its new product development process, refranchising (or buying back or closing) underperforming stores and revamping its marketing. The result was a 10% to 20% increase in weekly comparable-store sales, more than $60 million in cost savings and a recapitalization and IPO that resulted in a 300% return for the company's private equity owners.

Example 3: Refill the tank

Now consider a company that is in a strong strategic but weak financial position. J.Crew survived the last downturn from this position but still faced challenges as the economy turned around: With falling same-store sales and a negative operating margin, the company was again nearing bankruptcy in 2003. New management launched a number of actions to turn the company around. J.Crew overhauled its design process while rationalizing assortment to improve productivity. At the same time, it slowed store expansion, improved product quality and design, and repositioned the brand as "luxury for less." The changes resulted in a 50% increase in revenue from 2003 to 2008 and a 70% increase in store productivity. And the company's operating margin improved from −5% to +11%.

Regardless of where a retailer is situated in the cube, cash is still king. A weak financial position can be difficult to overcome, particularly in today's economy. Many retailers are burdened with high debt levels that significantly limit their ability to maneuver ***(Chart 8)***. And although high market share alone is not enough to earn a good credit rating, sector followers are more likely to be hindered by poor credit ratings and greater difficulty accessing capital ***(Chart 9)***. Weaker players that were able to secure financing to expand when capital was plentiful and cheap may now be unable to refinance their debt, repay it or grow earnings to deleverage. The result is not necessarily bankruptcy, but these companies will likely need to curtail store growth and other capital-intensive initiatives.

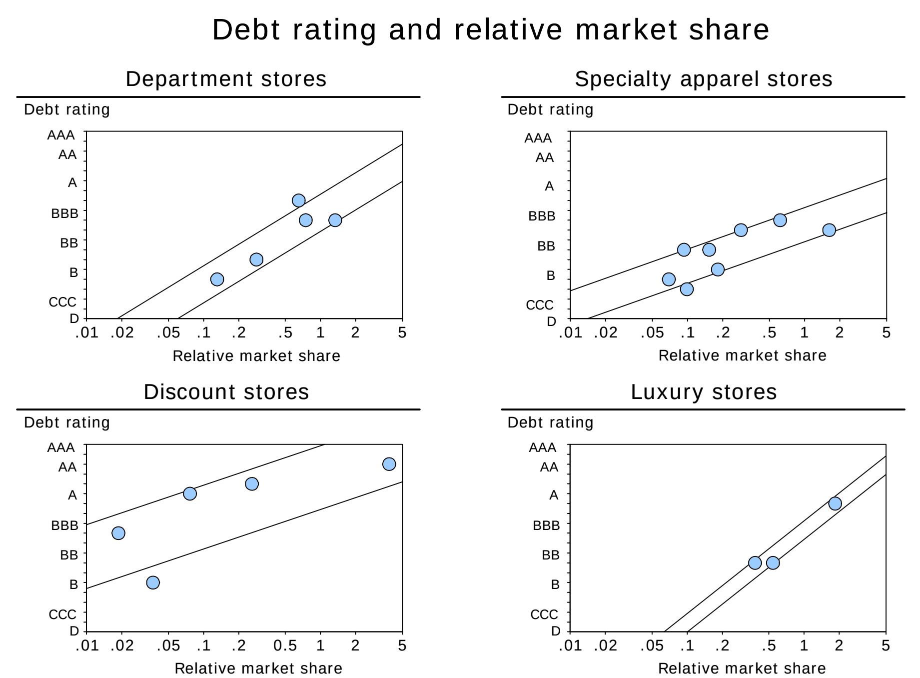
Chart 8:



Note: Net debt includes short-term debt and long-term debt minus cash and cash equivalents; lease-adjusted net debt includes rent adjustment, which is calculated as 8 x annual rent expense from the last fiscal year to reflect the present value of future lease obligations; EBITDAR is earnings before interest, taxes, depreciation and rent; excludes bankrupt retailers; data are based on most recently reported quarter

Source: Credit Suisse; Investopedia

Chart 9:



Note: Relative market share (RMS) measures each player's market share based on revenue relative to that of others; the RMS for the market leader is calculated relative to the Number 2 player; the RMS for all other players is calculated relative to the market leader; RMS is based on the last four quarters as of November 24; debt rating is based on Standard & Poor's rating as of November 24

Source: Standard & Poor's; Bloomberg

Bankruptcy is not likely to offer much protection these days

A number of retailers will be unable to avoid bankruptcy. Some will voluntarily file Chapter 11 to reorganize, but others will be forced into it at the hand of creditors or vendors. It takes just three creditors and an aggregate of $13,475 in delinquent debt to file an involuntary bankruptcy petition.[4] And vendors, by shortening payment terms, demanding letters of credit or other collateral or not delivering products, can de facto force a company into bankruptcy. Circuit City cited concern that it would not receive products from its vendors as a reason for its Chapter 11 filing.

Enter the credit crunch. Today's economic turmoil and general levels of balance sheet leverage further complicate the bankruptcy process. The reality is that actions to manage through and emerge from Chapter 11—for example, by closing underperforming stores, moving inventory or introducing new products or customer services—require capital. Retailers typically seek out debtor-in-possession (DIP) financing to fund these activities.[5] But DIP-financing terms are burdensome, restrictive and expensive, especially given the state of the capital markets.[6] This limits management's freedom so much that some DIP-financing agreements are simply intended to increase the probability of an orderly liquidation.

Add to this a new set of Chapter 11 challenges:

- **Shortened time to accept or reject leases:** The October 2005 changes to the bankruptcy code accelerated this strategic element of reorganization. A retailer that enters bankruptcy without a clear picture of how the business should look after emerging is more likely to make misguided decisions about its leases.
- **Increasingly litigious process:** Beyond debating or objecting to management's plans, disagreements over value between first and second lien holders are making life in Chapter 11 more complicated than ever.
- **Lack of buoying effect from economic growth:** In a downturn it can be harder to emerge from bankruptcy. We are seeing noticeably shorter time frames between entering Chapter 11 and liquidation ***(Chart 10)***. Some retailers are proceeding immediately to liquidation upon filing Chapter 11, as was announced by KB Toys on December 11.

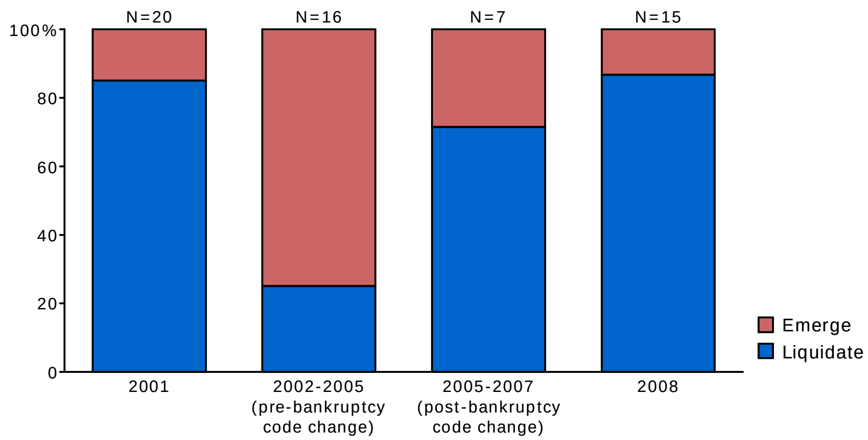
[4] If a debtor has 12 or more creditors, the petition must come from 3 of them. If a debtor has fewer than 12 creditors, the petition need only come from a single creditor.

[5] Debtor-in-possession financing is unique from other financing methods in that it has priority over existing debt, equity and other claims. Levels of DIP financing vary based on a company's needs: Harold's Stores obtained just $22 million, whereas Mervyn's obtained more than $460 million.

[6] Recent quoted pricing on DIP facilities has been the London Interbank Offered Rate (LIBOR) plus ~500 basis points or more. Steve and Barry's has secured $60 million in DIP financing at LIBOR plus 1,000; Mervyn's had rates of up to LIBOR plus 450 basis points.

Chart 10:

Percentage of retailers emerging from Chapter 11 or liquidating, 2001-2008



	2001	2002-2005	2005-2007	2008
Days to liquidate	124	150	117	90
Months to emerge	12	13	9	3

Note: Excludes firms that were acquired while they were in Chapter 11; "days to liquidate" figure excludes firms that announced liquidation immediately upon filing Chapter 11
Source: Bankruptcydata.com; Factiva newswires; company press releases

Ultimately bankruptcy is providing little protection for retailers. In the last 12 months just two retailers have successfully emerged from Chapter 11: Goody's Family Clothing and Mrs. Fields Famous Brands.[7]

As retailers develop their plans to navigate these dangerous economic waters, executives should be asking themselves a number of questions. The first set of questions acknowledges the importance of cash given the state of the capital markets:

- Do you have a clear and aggressive plan to manage costs and preserve the cash you need to be flexible?
- Do you actively (or can you better) manage your liquidity? Do you have a detailed understanding of the company's sources and uses of cash?
- Do you expect any covenant issues to arise in the next 12 months?
- Do you face any maturing debt obligations in the next 18 months?

With this understanding of how much excess cash will be available, a retailer can then determine the most beneficial ways to employ it. A second set of questions reflects the understanding that surviving (and thriving) will require a clear course of action:

- Do you have a game plan to seize strategic real estate, people assets, or market share?

[7] Analysis excludes companies that emerged from Chapter 11 via acquisition.

- Do you know how your customers are being impacted by the economy? Which of them can profitably be enticed to spend more without damaging your brand equity?
- What internal and external indicators should you monitor? What triggers would change your course of action?
- Is your organization aligned and decisive enough to take the right actions with confidence?
- Do you have a clear understanding of any potential problems with supply chain partners?

The next year or two are likely to present retailers with substantial long-term challenges. Some firms won't rise to the occasion. They'll fall back in the pack, be acquired, or face bankruptcy. But downturns create opportunities as well as risks. Retailers that take appropriate actions that reflect their unique position may emerge from this downturn stronger than ever.

Newsletter schedule

With Christmas less than two weeks away, there will be no aggregate retail results released until after the holidays. Our next newsletter, the last issue of the season, will report on overall holiday results. It will be released in mid-January as soon as those data are published. Please let us know if you have any questions or need additional analysis.

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

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