



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

The 2010 holiday season kicked off with near-record-breaking growth in November. Sales continued to increase into December, slowly at first, then picking up steam. It's not unusual for growth in December to be weaker than November; still, sales this month seem healthy enough to generate holiday growth above most analysts' original forecasts. This is welcome news for retailers, but their work isn't done. The challenge now: to finish up December strong and head into 2011 with positive momentum.

November GAFS sales approached its all-time high

GAFS sales surged 5.7% last month, nearly matching November peak sales of \$104 billion achieved in 2007.¹ This growth marked the strongest start to the holiday season since 2005, when November GAFS sales rose 6.6% (**Chart 1**). We make it our policy not to revise our forecast as the season unfolds, though we expect holiday sales growth will exceed everyone's original estimates. In fact, December sales only need to rise 1% for holiday growth to meet our prediction of 3%, which initially seemed optimistic relative to other forecasts (**Chart 2**). Of course, after two straight years of decline, absolute holiday sales will almost certainly fall short of 2007 levels.²

Growth varied significantly across segments last month, although sales in each were up over 2009 (**Chart 3**). The largest absolute growth occurred in the general merchandise segment, which accounts for more than half of total GAFO: Sales in the segment increased 4.2% over last year, reaching an all-time November high of \$56.2 billion. Data on same-store sales growth for the month suggest that warehouse clubs and department stores drove the increase. Growth was slower at discount stores, which typically suffered less over the course of the economic downturn, making the comparison tougher.

Sales in the clothing and clothing accessories segment jumped 9.6% in November, also reaching a new November high of \$20.6 billion. Several factors impacted sales in this

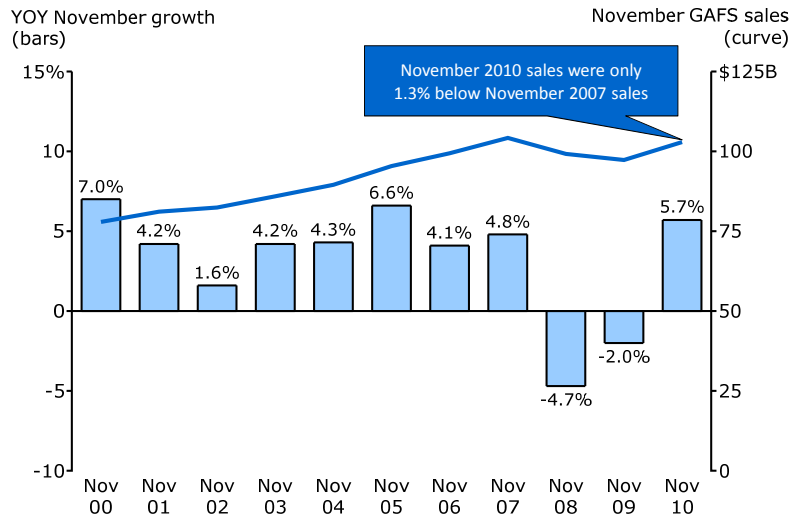
¹ See Chart A in the Appendix for definitions of GAFS, GAFO and other sales measures.

² To match total 2007 holiday sales, December GAFO would need to rise 7.3% year over year.

segment: Apparel remains the most requested gift category behind gift cards, with 48.2% of adults asking for clothing this year according to the National Retail Federation and BIGresearch; consumers also caught up on winter shopping following an unseasonably warm October; and many shoppers were buying for themselves again, taking advantage of holiday discounts to update their wardrobes.

Chart 1:

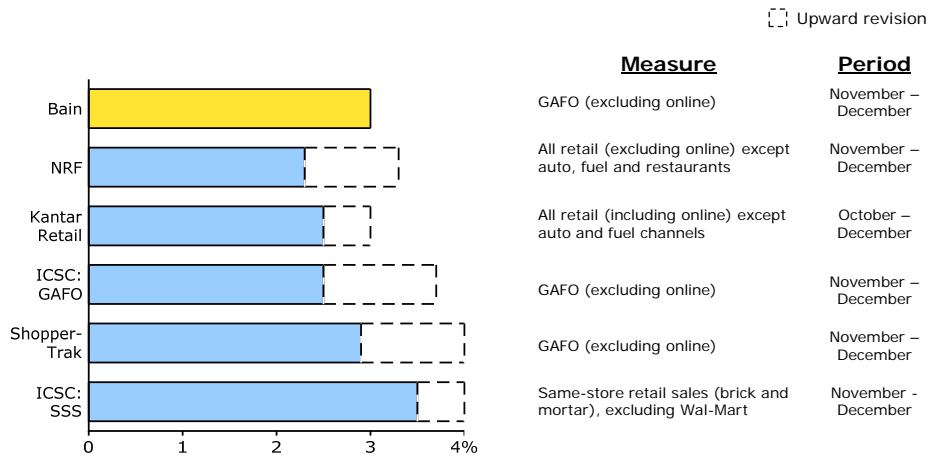
Year-over-year November GAFS sales growth, 2000-2010



Source: US Census Bureau

Chart 2:

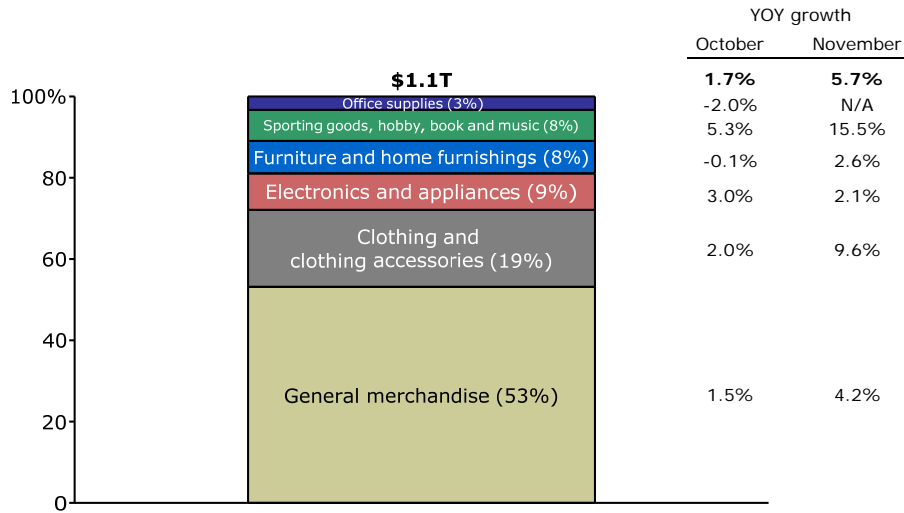
Holiday sales growth forecasts, 2010



Source: National Retail Federation; Kantar Retail; International Council of Shopping Centers; ShopperTrak

Chart 3:

**GAFO sales by segment,
October 2009-November 2010**



Note: November overall growth rate is for GAFO; office supplies data have not yet been reported for November; October data are based on preliminary numbers, and November data are based on advanced data published December 14, 2010
Source: US Census Bureau

Electronics and appliance stores posted disappointing 2.1% growth in November, down from 3% in October and 6.2% in September. At nearly \$10 billion, the segment remains approximately 10% below its all-time November high set in 2007. Some of this slow-down can be attributed to a drop in sales of televisions and computers, the latter as budget-conscious shoppers chose to purchase lower-priced tablet devices instead. The segment also suffered as consumers turned to online pure plays and general merchandise stores to buy their electronics.

The furniture and home furnishings segment continued its slow recovery last month, with sales up 2.6%. As the housing market has stabilized, the segment has grown slowly since February – with a minor 0.1% dip in October – but this growth comes on the heels of 29 straight months of falling sales. Despite recent improvements, November sales came in 23% below the segment’s all-time November peak, reached back in 2006.

The sporting goods, hobby, book and music segment saw an impressive sales increase of 15.5%, bringing it to an all-time November high of \$8.1 billion. After slipping deeply during the recession, the segment is bouncing back as consumers relax their discretionary budgets. In sporting goods, many shoppers are treating themselves to innovative new products like moisture-wicking compression fitness wear and technologically advanced running shoes. According to the NPD Group’s chief analyst, athletic footwear is one of the leading categories to come out of the recession. And bookstore sales received a significant boost from eReaders, which are near the top of this season’s wish lists.

Economic recovery has slowed, but the affluent continue to drive retail sales growth

Recent economic news shows reasonable stability, but does not suggest a broad economic rebound:

- Consumer Confidence and Consumer Sentiment edged upward in the last few weeks. Both indexes sit at their highest levels since June.
- Equity markets have gained 5.1% since the beginning of the holiday season.³
- Real disposable personal income growth was essentially flat (up 0.3%) in October.
- The personal savings rate remained flat at 5.7% in October.
- The federal interest rate has been flat for 10 months.
- Housing prices have fallen slightly – the Case-Schiller Index dipped 2% in the third quarter – and are now 1.5% below last year's levels.
- Unemployment edged up in November, from 9.6% to 9.8%, primarily impacting lower-income consumers. Though initial jobless claims are slowing – last week they fell to their lowest level since the summer of 2008 – the unemployment rate is also affected by growth in the labor pool. For the total unemployment situation to get better, new job creation also needs to increase.

The pace of improvement in the indicators raises the question: Where is retail sales growth coming from? The answer: the affluent – households with income over \$100,000 a year. With an unemployment rate of approximately 3%, this income segment is largely shielded from unemployment swings. Affluent consumers have money to spend; and when encouraged by stock market gains and not scared off by volatile indicators, they are willing to spend it. Although they represent just 21% of total households, higher-income households account for 38% of total consumption.⁴

Affluent households are driving growth across retail categories, but their impact is especially apparent in luxury goods, where margins also have soared. This is likely a function of lower discounts and increasing sales at higher price points with higher margins. Saks CEO Steve Sadove recently noted: "High-end prices (the best price points) have come back even stronger than I thought they would, and more quickly." In November, Tiffany & Co. reported sales that were 5% higher than expected, beating analysts' average earnings per share expectations by 24%. Neiman Marcus's most recent quarter earnings were more than triple those in the same period in 2009. Moreover, this boost in luxury sales is expected to continue into 2011. A study Bain conducted for Italian fashion association Altgamma predicts that luxury sales will increase 12% in the United States in 2010 and 3% to 5% worldwide in 2011.⁵

³ Based on the S&P 500 Index on October 29, 2010, and December 17, 2010.

⁴ Estimated as of September 2010.

⁵ For a copy of the study, please contact Cheryl Krauss at cheryl.krauss@bain.com.

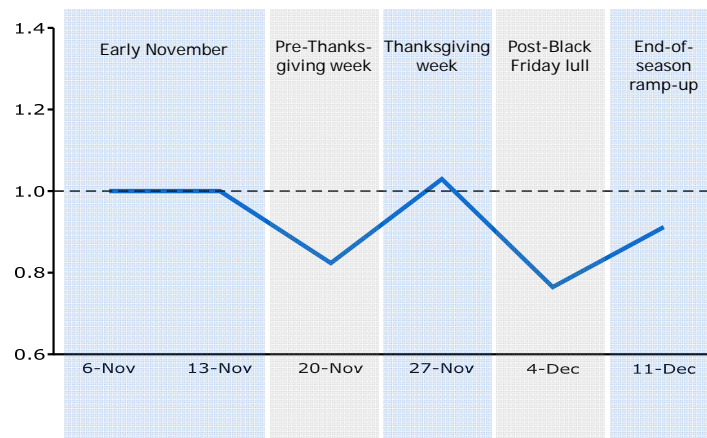
After a slow start, December sales are bouncing back

The International Council of Shopping Centers reports that sales growth was positive in the first week of December, though notably lower than growth in November. The good news is that we are already seeing a moderate bounce-back: Sales growth accelerated in the second week of December (**Chart 4**) and the odds are good that it will remain strong. According to the National Retail Federation, as of December 15, the average American had completed just under half of his or her holiday shopping. “With the big day falling on a Saturday this year and a lot of shopping left to be done,” says NRF president and CEO Matthew Shay, “retailers will continue to push aggressive promotions in the weekdays leading up to [the holiday].” E-commerce sales also slowed in the first two weeks of December, this according to comScore. From November 29 to December 13, sales grew at 10.2%, down from November’s year-over-year increase of 13% (November 1 to 29). Here, too, sales accelerated in the second week (December 6 to 13), up 11.9% over last year.

A slowdown in December following a promotion-rich November and record-beating Black Friday weekend is not surprising, nor would it be unprecedented. In fact, in 12 of the last 18 years, year-over-year growth in December fell short of the rate achieved in November by an average of 2 percentage points.

Chart 4:

ICSC weekly retail same-store sales growth index, November-December 2010



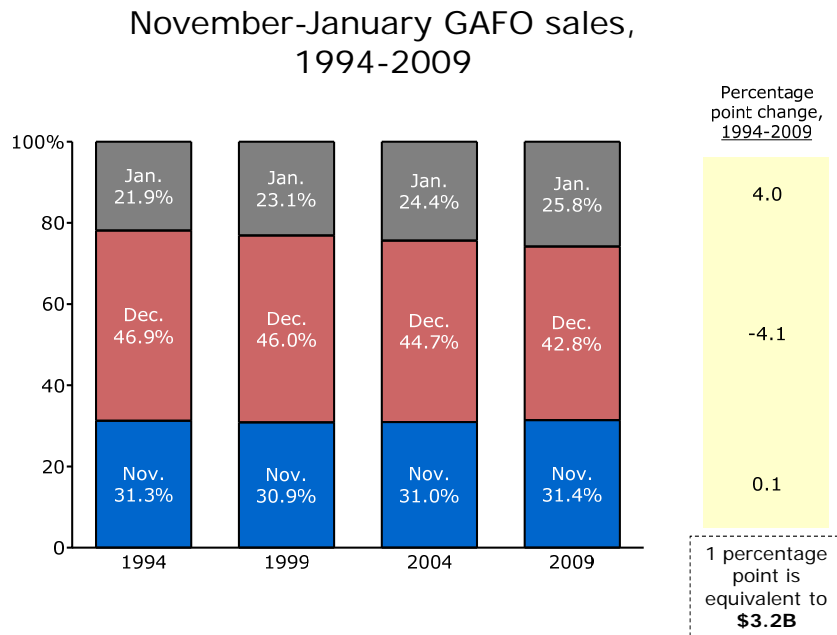
Note: Data are indexed to the first week of November; weeks run Sunday through Saturday; the ICSC's weekly growth estimates are based on a different sample of stores than its monthly figures and so are not directly comparable to monthly totals
Source: ICSC-Goldman Sachs

January is playing an increasingly important role in holiday sales

December has always been the breadwinner month of the holiday season, yet its share of November-January GAFO sales has been dropping steadily. Over the last 15 years, it has gone down more than 4 percentage points, reaching a low of 42.8% in 2009 (*Chart 5*). This shift is significant: Each percentage point represents approximately \$3.2 billion in sales.⁶

January has been taking the bulk of the offset, due in no small part to the increasing popularity of gift cards. The first retail gift card that recorded value on a magnetic strip appeared in the mid-1990s; by 2005, gift cards had replaced clothing as the number one item sold during the holidays. The NRF estimates that shoppers will spend \$24.8 billion on gift cards this holiday season, more than Americans spent on them during the entire year in 1999. According to the NPD Group's chief retail analyst, up to 15% of January sales, or roughly \$12 billion in 2009, are attributable to gift cards.⁷ That dollar figure equates roughly to the value of the 4 percentage point shift in sales from December to January since 1994. And the trend has been picking up: Since 2006, the proportion of Americans who reported they would like to receive a gift card has grown from 50.2% to 57%.

Chart 5:



Note: The percentage point equivalent was calculated using November 2009 through January 2010 GAFO sales
Source: US Census Bureau

⁶ Based on sales figures from November 2009 through January 2010.

⁷ Revenue from gift cards is recognized when the card is redeemed, not when it is purchased.

Looking ahead, the key is to keep shoppers coming back

There are still plenty of holiday shopping days left until Christmas. According to the NPD Group, 27% of consumers plan to shop up to the last minute this year. America's Research Group estimates this proportion to be 35%, the highest level in 10 years. To maintain sales momentum through the holidays and beyond, retailers are looking to motivate shoppers to visit stores and websites by:

- Fueling the holiday spirit
- Offering values that are too good to pass up
- Wowing shoppers with a flawless experience

Fueling the holiday spirit

Shoppers have been in a particularly festive mood this year compared to recent years – a full 35% of shoppers are buying gifts for more people this holiday season, according to America's Research Group. But retailers face the challenge of keeping the spirit alive. What's the best way to convince shoppers to buy that one extra gift, or to treat themselves to something special?

Many retailers look to capture the imagination of holiday crowds with dazzling (and increasingly high-tech) window displays. Saks executive vice president Terron Schaefer said that this year the store is taking window displays “to another level” with a two-and-a-half-minute music and light show that runs every 10 minutes from 5:00 p.m. to 10:30 p.m. Although some question the cost of these displays – Saks and Bergdorf Goodman each spent more than \$300,000 to decorate the windows at their flagship stores in New York – and whether they lead to more shopping or just more browsing, many retailers claim the attention is well worth it. Macy's estimates 7,000 people per hour see its windows during the holiday season, and Saks claims the number of people walking by its windows doubles during the holiday season.

Beyond traditional holiday merchandising and decor, some retailers create elaborate in-store displays to stoke the holiday spirit. Bass Pro Shops feature a Santa's Wonderland with free crafts, gifts, photos with Santa, games and activities. And Neiman Marcus again boasts a four-story-tall Christmas tree in its San Francisco store.

Retailers also can evoke a sense of excitement with the help of the “latest and greatest” technology. JCPenney is among the first to connect with shoppers through Apple's new iAd platform, an interactive mobile ad that features a gift-hunting game: Users look for a coupon as they explore an assortment of gifts. And Macy's piloted a “magic mirror” in its flagship store this fall. The device allows users to upload a photo and try on clothes virtually.

Appealing to shoppers' compassion may not translate directly into sales, but supporting charitable causes certainly spreads holiday cheer. A number of retailers give shoppers a way to “do something good” at little additional cost. This year, Wal-Mart's Fighting Hunger Together program is going to donate a total of \$1.5 million to six communities across America. The company is asking shoppers to vote for the community they think deserves to “win,” and to post their vote on Facebook. Through Kohl's Cares, Kohl's

donates 100% of the profits on certain items to health and education charities. Barnes & Noble's Holiday Book Drive produces sales for the company's stores and books for children in need. Last year, the chain's customers bought 1.1 million children's books that were donated to school districts and charities.

Offering values that are too good to pass up

Retailers continue to "shout" about ongoing holiday promotions and other value propositions. Some are drawing shoppers to stores and websites by invoking Black Friday or Cyber Monday. Kmart started a "Better Than Black Friday" sale on December 10, while The Home Depot brought Cyber Monday back on December 6 and 13. Free shipping is another popular tactic, and it's one that more retailers than ever offered on December 17, this year's Free Shipping Day. During this one-day event, more than 1,500 retailers offered free shipping, with guaranteed delivery by Christmas Eve. Instead of big discounts, eBay is touting pure value to shoppers with Deal Finder, a tool that displays competitors' prices on thousands of items, proving eBay delivers the very best deals.

Bounce-back promotions are also prevalent this season. Earlier this month, Borders offered consumers who purchased \$100 in gift cards a \$20 bonus gift card, valid only during its after-holiday clearance. Snapfish is offering customers who've made a purchase in December 25% off and free shipping on additional orders through the end of the month. And a Victoria's Secret promotion really is a secret: Customers who made a purchase in November received a gift card worth \$10, \$50, \$100 or \$500 – the amount isn't revealed until the card is redeemed, which must happen by December 19.

Wowing shoppers with a flawless experience

The challenge for retailers is to make holiday shopping exhilarating, not exhausting – not an easy task when crowded stores can overwhelm shoppers. Best Buy is trying to spread out the crowds and give busy shoppers more time to shop by opening an hour earlier than usual, at 8:00 a.m., through Christmas. Macy's plans to have 14 of its stores open around the clock beginning on December 22. And Toys "R" Us is going to keep its stores open for 88 consecutive hours through Christmas Eve. More and more retailers are adding in-store pickup for online orders. Wal-Mart, for example, recently began offering this service on thousands of products. E-commerce sites also are working to improve the shopping experience. A recent shopper survey by ForeSee Results suggests that online retail sites are performing much better technically than they did last year: They are faster and more reliable, and they are experiencing fewer errors.

Retailers are taking the customer experience to new levels with more personalized communication and customized offers, giving all shoppers a taste of the one-on-one attention once reserved for consumers with personal shoppers. As the season wraps up, we expect to see retailers up their game even further. Some may make innovative use of technology – tapping into the data they have gathered about shoppers from wish lists and search histories – to offer unprecedented levels of service. For example, some retailers may offer special prices on unfulfilled wish list items, similar to the deals some offer on leftover items in wedding registries. Ultimately, it is up to retailers to impress their customers. But how they approach the challenge can make the difference between a lump of coal in the stocking and a shiny bike under the tree.

Newsletter schedule

Our next newsletter, the last of the season, will be released in mid-January. It will include a report of holiday sales results as well as a look at the year ahead. Please let us know if you have any questions or need additional analysis.

We look forward to reconnecting in 2011. Happy New Year!

Appendix

Chart A:

Definitions

	GAFO	GAFS	GAF	Nonauto retail sales
General merchandise stores	✓	✓	✓	✓
Clothing and clothing accessories stores	✓	✓	✓	✓
Furniture and home furnishings 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				

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