Momentum remains mostly positive as we enter the prime holiday months. Increases in consumer sentiment, healthy growth in personal income and stable interest rates all bode well for retailers. But anemic growth over the third quarter in gross domestic product, mixed same-store sales in October, and hesitant consumer spending signal that records are not likely to be set this holiday season. In this newsletter we also explore multichannel shopping trends. Retailers who successfully implement multichannel strategies will likely capture a greater share of this year’s holiday spending.
Additional forecasts support our prediction of a solid holiday season

Forecasts released since our last newsletter support our prediction of a solid holiday season this year (Chart 1). These estimates continue to trail 2005 growth, however, primarily because of uncertainty in the housing market, the strain on consumers’ budgets produced by higher interest rates and the recent underperformance of Wal-Mart. (See Charts A and B in the Appendix for the methodologies and definitions each organization uses.)

Chart 1:

**Forecasted holiday sales growth, 2006**

Note: All GAF0 forecasts are unadjusted; 2005 actuals are specific to each forecast Source: Analyst reports; Bain analysis

October’s same-store sales, though healthy, were affected significantly by Wal-Mart

According to the ICSC, overall October same-store sales grew by 3% (Chart 2). This figure is in line with expectations but trails performance in recent months. Retailers that outperformed the average include Nordstrom (10.7% growth), American Eagle Outfitters (8% growth) and Federated Department Stores (7.7% growth).

Same-store sales are sales in stores that have been open for more than one year. Historically, same-store sales growth has been approximately 1.5 to 2 percentage points below total sales growth.

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October same-store sales growth was significantly dampened by Wal-Mart’s performance. The retailer posted same-store sales gains of just 0.5%. According to Wal-Mart executives, sales are being pulled down by store-remodeling efforts and poor merchandising (i.e., carrying too many trendy clothes). In addition, Wal-Mart’s core customers skew toward lower- to middle-income households, shoppers who are most susceptible to budget constraints. Without Wal-Mart, same-store sales would have grown 4.9%, above October 2005 results of 4.5%.

The US Census Bureau will release October advance retail sales numbers in mid-November, which should shed further light on the holiday season outlook.

The South should continue to be the strongest-performing region this holiday season

Sales growth over the holiday season tends to vary by region, and we expect the same to hold true this year. Over the past 10 years, the South has experienced the fastest growth in retail sales, outpacing the Northeast, Midwest and West by 9%. The 2005 holiday season averaged

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* There are four regions. The Northeast includes Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Vermont; the South includes Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, West Virginia, and the District of Columbia; the Midwest includes Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin; and the West includes Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, New Mexico, Nevada, Oregon, Utah, Washington and Wyoming.

† Retail sales are defined as GAFO plus building materials, food and beverage stores, gasoline station and nonstore retailers. This measure typically posts 0.5% to 1.5% higher than GAFO but is dependent on gas prices.

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6% retail sales growth, with the South posting 6.4% growth, and the Northeast trailing the other regions with just 5.8% growth. Recent year-over-year figures suggest that the South will continue to dominate this holiday season: The South witnessed the fastest growth in retail sales (5.8%) between January and September of this year (Chart 3). Year-to-date figures show the West with the slowest rate of growth (4.5%).

Chart 3:

**Year-over-year retail sales growth by region, January 2006–September 2006**

Note: Retail sales estimates include GAF0 plus building materials, food and beverage stores, health and personal care stores, gasoline stations and nonstore retailers, and exclude food services; August is preliminary.

Source: ICSC; US Department of Commerce
The South also experienced the most retail construction activity in the first half of 2006, claiming over 40% of retail new-square-foot construction. In the same period, the Northeast lagged, with just 9% of retail new-square-foot construction versus rates of 25% in the West and 24% in the Midwest.

According to the National Retail Federation’s Consumer Intentions and Actions Survey, Northeast consumers are expected to spend the most on gifts this holiday season, an average of $630.28. But the survey also suggests that year-over-year growth in holiday spending in the Northeast will trail growth in the West by 1%.

A conservative outlook for the Northeast is also reflected in consumer confidence. All regions saw a drop in consumer confidence in August and bounced back in September, as gas prices fell (Chart 4). But the Northeast experienced the smallest bounce, moving from 83.1 in August to just 87.7 in September. The Midwest saw the largest jump, moving from 78.1 to 93.5.

Chart 4:

![Chart 4: Consumer confidence, September 2005–September 2006](chart.png)
October macroeconomic indicators continue to support a healthy outlook

Across the nation, aggregate consumer confidence and sentiment remain positive. The University of Michigan Consumer Sentiment Index rose to 93.6 in October, beating a preliminary estimate of 92.3 and reaching its highest reading since July 2005. Results continue to be driven by falling gas prices, which are now at a 2006 low of $2.21—down from a high of $3.04 in August. The Conference Board’s Consumer Confidence Index posted results of 105.4, above the August low of 100.2 and even with September. Consumer confidence is also above the 2005 holiday average of 101.1.

Recent stability in interest rates is another good sign for retailers. The Federal Open Market Committee decided to hold its target for the federal funds rate at 5.25% (Chart 5), a decision that reflects its view that inflationary pressures are lessening as energy prices drop and the housing market slows. Furthermore, the federal funds rate is expected to remain flat through the holiday season as inflation continues to slow.

Chart 5:

Federal funds rate, October 2001-October 2006

Note: October 2006 data is average of October daily rates
Source: Federal Reserve Board
We expect healthy growth in personal income to support consumer optimism heading into the holiday season. In September, personal income posted a solid year-over-year gain of 6.8%, significantly above the four-year average of 5.1% (Chart 6). The August spike of 9.4% was driven by lower-than-average growth in August 2005.

This increase in income, however, continues to be disproportionately concentrated in the top 5% of US households (Chart 7). As a result, we believe retailers that cater to higher-income consumers have the opportunity to outperform retailers with a lower-income customer base.
On a more cautious note, personal spending continues to be sluggish. Year-over-year growth in personal spending slowed in September to 5.5%, below the four-year average of 5.8% (Chart 8). The weakness in spending was driven primarily by falling energy prices, which dropped 7.2% in September. The “core” consumer price index (CPI), which excludes energy and food prices, rose 0.2% in September versus the overall CPI, which fell 0.5%. Energy sales are not included in GAFO, so GAFO should not be affected negatively by these trends. In fact, falling energy prices should put more money into consumers’ pockets, which should have a positive impact on GAFO.

Another piece of sobering news is gross domestic product growth. The GDP grew by just 1.6% in the third quarter of this year—following a 5.6% increase in the first quarter and a 2.6% increase in the second—in large part a function of the cooling housing market. Despite this news, we believe that housing trends will not significantly depress GAFO during the holiday season. We expect the impact to be felt in the home-building-products sector this holiday season and in the early-2007 GAFO figure.

Although slow growth in personal spending and GDP prompt some concern, we don’t believe that either should prevent a solid 2006 holiday season. Of course we will continue to monitor these macroeconomic indicators as the season unfolds.
Multichannel results will be an important driver of success this holiday season

Multichannel shopping is a reality, especially for big spenders. More than ever before, consumers are moving back and forth from physical stores to e-tail Web sites to mail-order catalogs when making retail purchases. Bain research has found that multichannel shoppers spend about 50% more than their single-channel counterparts. We predict that among this season’s strongest performers will be companies that capitalize on this trend by giving consumers what they want through the channels they prefer.

Online sales will set new records this holiday season. As we reported in our first newsletter, forecasts of growth in online holiday sales range from 18% to 25%. A record 114 million people are expected to buy online this holiday season. The busiest online shopping days are expected to be Monday’s between Thanksgiving and New Year’s, including Cyber Monday. * Paving the way for this growth is an increase in broadband Internet service. Nearly 48% of US households will have high-speed connections by year’s end (Chart 9). Many of these online shoppers will make holiday purchases earlier than their offline counterparts, driven largely by shipping cutoff dates. In line with this trend, according to Shop.org research, more than 38% of retailers plan to start their Internet marketing earlier this year. A sizable percentage of online holiday purchases are expected to be made on the nation’s most popular e-commerce site, eBay.com, which is

* Cyber-Monday is the Monday immediately following Black Friday, the day after Thanksgiving.
expected to register $5.9 billion in sales in 2006 and has already listed 1.5 billion products this year.

Chart 9:

![Chart showing US households with broadband, 2002-2010](chart-image)

Catalogs are also a key component of a multichannel strategy because they increase brand awareness and draw shoppers to both Web sites and physical stores. The number of catalogs mailed in the United States grew from 16.6 billion in 2002 to 18.1 billion in 2004, and we expect that figure to approach 20 billion in 2006. US Postal Service research suggests that consumers who receive a catalog from a retailer are almost twice as likely to make a purchase at that retailer’s Web site. Moreover, catalog recipients tend to spend 16% more online than nonrecipients do.

Retailers recognize that their catalog and Internet offerings are not independent from their brick-and-mortar operations and brands. Heading into the holiday season, many retailers are strengthening the links among their channels. Crate & Barrel has put an interactive version of its holiday catalog on its Web site. Nordstrom has been busy aligning merchandise offerings between its Web site and its physical stores: Approximately 90% of what is available on Nordstrom.com can also be found in Nordstrom stores. Last holiday season we noted that some 10% of retailers allowed customers to buy products online and pick them up at a physical store. Circuit City led the pack with its “24/24 pickup guarantee,” promising consumers a $24 gift certificate if products ordered online were not ready for store pickup within 24 minutes. This holiday season we expect an even higher percentage of retailers to offer either “buy online, pick
up at store” or “buy online, return at store” options. Customers who do the former typically increase their market basket by 58%.

Investment in one channel can have a halo effect on the other channels. In tests of its recently revamped Web site, Wal-Mart found that customers’ perceptions of the company’s brand improved significantly after they had seen the new online visuals. Of course, consumers’ experiences of retail Web sites can swing both ways: According to Gómez, 65% of online shoppers would either stop or reconsider shopping at a company’s physical store if they had a bad experience with the retailer online.

Integrating online and in-store operations is by no means easy. In fact, Bain research finds that only one in three multichannel retailers has actually managed to coordinate brands across channels. Retailers that do manage to implement a successful cross-channel strategy typically have several things in common.

First, these companies design their multichannel strategy with specific channel roles in mind. In other words, they are clear about which channels will appeal to which segments of their customer base, and adjust both merchandise and service in each channel accordingly. Lands’ End, for instance, is attracting younger customers to its Web site; at the same time, the company’s catalog business remains focused on its older, more traditional customer base. Williams-Sonoma recognizes segments of cooking enthusiasts ranging from skilled chefs to the “kitchen-challenged,” and tailors its channel offerings to specific segments. A recent innovation is a catalog featuring an assortment of gift merchandise for corporate buyers.

These retailers also tend to provide consumers with a consistent experience across channels. This does not mean that product mix is identical in every channel. Neiman Marcus has crafted its Web site to emphasize product categories that consumers are more likely to purchase online—items for their homes and cosmetics, for example. Its physical stores focus more on “try-before-you-buy” categories like clothing and shoes. Customers have responded well to this model: The average multichannel Neiman Marcus shopper spends three times more than his or her single-channel counterpart. However, even though Neiman Marcus may vary product focus across channels, the company ensures that its consumers’ shopping experience and, more fundamentally, brand experience remain constant.

Multichannel shopping is booming, but it is still in the very early stages of development. Consumers will set records this holiday season that will be dwarfed in the future. Retailers who prepare themselves both strategically and operationally today will be winners tomorrow.

We look forward to monitoring retailers as they test their multichannel strategies this holiday season. In the coming weeks, we also will continue to comment on other strategies successful retailers are using to improve both their holiday sales and their performance in 2007.
Newsletter schedule (by week)

Our next newsletter will be released during the week of November 13 (Chart 10). Please let us know if you have any questions or need additional analysis.

Chart 10:

**Indicator and forecast update schedule**

<table>
<thead>
<tr>
<th>Indicator/Forecast</th>
<th>Mon. 11/6</th>
<th>Mon. 11/13</th>
<th>Mon. 11/20</th>
<th>Mon. 11/27</th>
<th>Mon. 12/4</th>
<th>Mon. 12/11</th>
<th>Mon. 12/18</th>
<th>Mon. 12/25</th>
<th>Mon. 1/1</th>
<th>Mon. 1/8</th>
<th>Mon. 1/15</th>
<th>Mon. 1/22</th>
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<td>ICSC Monthly Same Store Sales</td>
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<td>Redbook Weekly Same Store Sales</td>
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<td>Michigan Consumer Sentiment</td>
<td>11/7</td>
<td>11/14</td>
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<td>Conference Board Consumer Confidence</td>
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<td>NRF Consumer Reports</td>
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<td>Michigan Retail Index Holiday</td>
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<td>comScore Online Sales Forecast</td>
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<td>Bain Holiday Newsletter Release</td>
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Every Tuesday

11/9 11/17 11/26 12/6 12/18 19 12/28

TBD—week before Thanksgiving 11/15-11/22
### Appendix

#### Chart A:

**Methodologies of holiday forecasting**

<table>
<thead>
<tr>
<th>Organization</th>
<th>Sales definition</th>
<th>Holiday time frame</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Bain</td>
<td>• GAFO</td>
<td>• November-December</td>
</tr>
<tr>
<td>• Bernard Sands</td>
<td>• GAFO plus home improvement and food services</td>
<td>• Halloween - last weekend of January</td>
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<tr>
<td>• Citigroup</td>
<td>• GAFO</td>
<td>• Fourth quarter</td>
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<tr>
<td>• Deloitte Research</td>
<td>• Nonauto retail sales</td>
<td>• November-January</td>
</tr>
<tr>
<td>• Ernst &amp; Young</td>
<td>• Nonauto retail sales excluding highly inflationary items like food and gasoline</td>
<td>• November-December</td>
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<tr>
<td>• International Council of Shopping Centers (ICSC)</td>
<td>• GAFO</td>
<td>• November-December</td>
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<td>• Merrill Lynch</td>
<td>• General merchandise</td>
<td>• November-December</td>
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<tr>
<td>• National Retail Federation (NRF)</td>
<td>• Retail sales excluding auto, food and nonstore retail</td>
<td>• November-December</td>
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<tr>
<td>• Retail Forward</td>
<td>• GAFO plus home improvement and nonstore retail</td>
<td>• Fourth quarter</td>
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*Note: Sales definition for Ernst & Young is an estimate*

*Source: Analyst reports*
Chart B:

<table>
<thead>
<tr>
<th></th>
<th>GAFO</th>
<th>General merchandise</th>
<th>Nonauto retail sales</th>
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<td>General merchandise stores</td>
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<td>Clothing and clothing accessories stores</td>
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<td>✔</td>
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<tr>
<td>Furniture and home furnishing stores</td>
<td>✔</td>
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<td>✔</td>
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<tr>
<td>Electronics and appliances stores</td>
<td>✔</td>
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<td>✔</td>
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<tr>
<td>Sporting goods, hobby, book and music stores</td>
<td>✔</td>
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<td>✔</td>
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<tr>
<td>Office supplies, stationery and gift stores</td>
<td>✔</td>
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<tr>
<td>All other retail trade sales not included in GAFO (excluding auto and auto parts)</td>
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<tr>
<td>Auto and auto parts sales</td>
<td></td>
<td></td>
<td>✔</td>
</tr>
</tbody>
</table>

Source: US Census Bureau; Analyst definitions
Selected References


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