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BAIN RETAIL HOLIDAY NEWSLETTER

HOLIDAY RECAP AND TECHNOLOGY TRENDS FOR 2019

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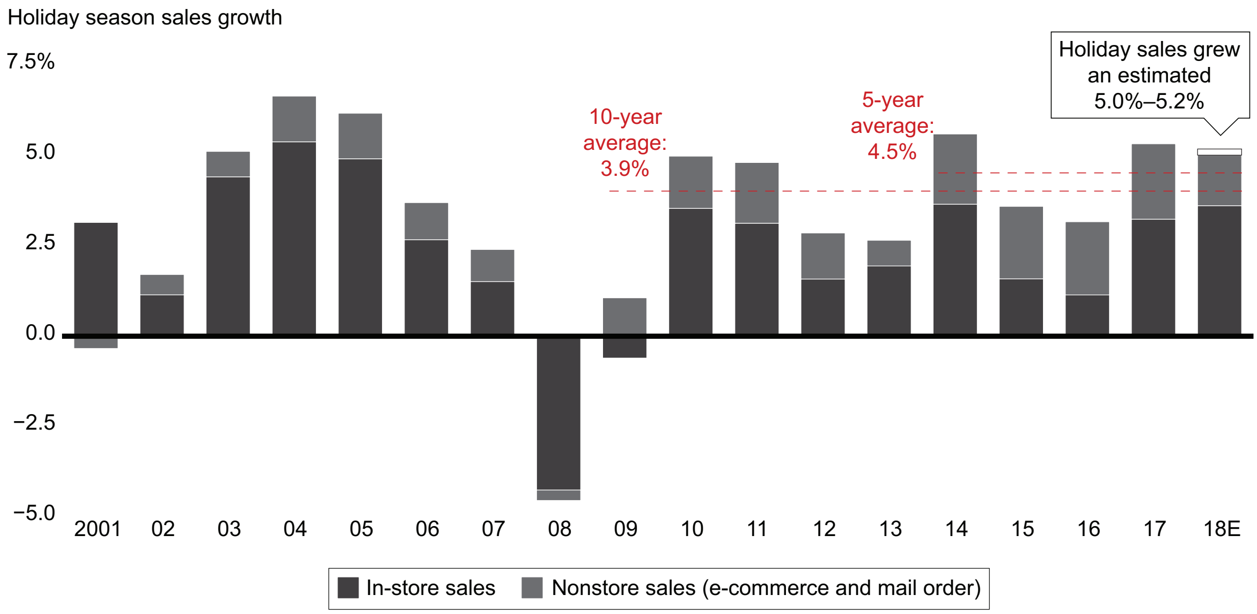
Consumers propelled a stellar holiday season, with overall retail sales growing an estimated 5.0% to 5.2%, well above the 10-year average of 3.9% and just below last year's 5.3%. In-store sales accounted for much of this success, increasing more than 4% over last year. E-commerce growth remained strong, with estimated gains of 14% over last year. However, while the industry results met Bain's expectations, winners and losers are diverging. As customer demands heighten, which retailers will continue to win? In this issue, we examine disruptive technologies that retailers are deploying to delight customers and win share in 2019 and the years to come.

2018 holiday recap

Early estimates suggest that retailers had a stellar holiday season in 2018. Though the US government shutdown has delayed the Census Bureau's estimate of December sales, other data sources provide strong evidence of success. In partnership with Earnest Research, we analyzed the sales performance of 21 major retailers. Our sample, combined with the Census Bureau's advanced November sales estimates, indicates that sales were up 5.0% to 5.2% this holiday season *(see Figure 1)*. While these preliminary top-line results are encouraging, it is important to note that they are only part of the picture. Retailers have lowered and raised their earnings guidance, yet full details on the season's profitability are still pending.

Figure 1: Holiday sales grew an estimated 5.0% to 5.2%, which is higher than the average for the past decade



Notes: Holiday season is November and December; 2018 growth is an estimate based on data from Earnest Research and the US Census Bureau's November advanced retail sales data; 2001–2017 growth is based on US Census Bureau retail sales data
Sources: US Census Bureau; Earnest Research; Bain analysis

Postholiday quiz

Can you discern fact from fiction in sales results?

True or false?

1 E-commerce represented more than one-third of total holiday sales

2 Big box retailers won big online this holiday season

3 Online conversion rates (that is, the percentage of browsers who followed through with purchases) peaked on Cyber Monday

4 E-commerce basket sizes boomed this holiday season

5 In December 2018, department stores saw higher return rates than other retailers

Consumers spent a healthy amount this season, but where, when and how did they shop? As we unwrap the 2018 results, we invite you take our postholiday quiz to learn what was fact and what was fiction this season. Some of the answers to the five questions below may surprise you.

Question No. 1: True or false? E-commerce represented more than one-third of total holiday sales

False. Though e-commerce sales generate the most attention, in-store sales accounted for more than 80% of total sales and more than 70% of sales growth this holiday season. In-store sales grew by more than 4% vs. last holiday season, according to analysis we did in conjunction with Earnest Research. During the first half of the season, electronics retailers grew the fastest, followed by general merchandise retailers and clothing retailers, according to Census data. Far from dead, the physical store is critical to modern retail success.

Question No. 2: True or false? Big box retailers won big online this holiday season

True. Our early analysis with Earnest Research suggests that this season's e-commerce sales were up 14%. Much of this growth is attributable to big box retailers such as Target and Costco, both of which reported approximately 30% higher digital sales. Early estimates also show that Walmart.com sales grew more than 25%. Amazon remains a notable unknown, though initial credit card panel data suggests that the online giant's growth slowed compared with last year and was more in line with the market overall.

For many big box retailers, more convenient delivery options and better use of physical stores fueled these impressive results. Target attributed its e-commerce success entirely to digital sales fulfilled in stores. According to the retailer, buy online, pick up in store (BOPIS) orders were up 60% from last year. Adobe Analytics estimates that the 2018 holiday season was the biggest ever for in-store pickup of online orders.

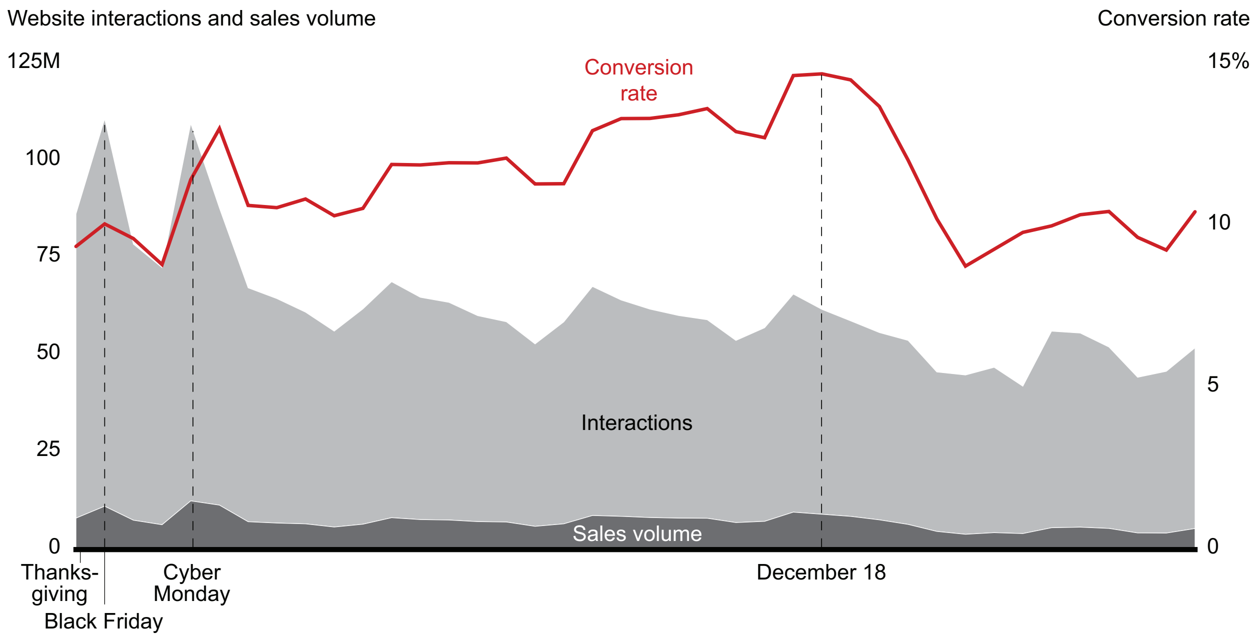
Question No. 3: True or false? Online conversion rates (that is, the percentage of browsers who followed through with purchases) peaked on Cyber Monday

False. Working with Jumpshot, we tracked interactions (the number of online sessions in which a search is performed or a product page is viewed) and conversions across a sample of 10 major retailers' desktop and mobile sites from Thanksgiving to the end of December. The number of site interactions was highest on Black Friday, while sales volume peaked on Cyber Monday. Conversion rates were highest on Tuesday, December 18, however, as shoppers hurried to purchase last-minute gifts in time for Christmas *(see Figure 2)*.

Question No. 4: True or false? E-commerce basket sizes boomed this holiday season

False. Across the major retailers we sampled, the number of e-commerce transactions increased nearly 16% vs. last year, while basket sizes declined 2%. Mass merchandisers and home improvement

Figure 2: Online conversion rates peaked on December 18



Notes: Conversion rates are the percentage of interactions that resulted in a purchase; interactions refer to site visitors who viewed a product page or performed an on-site search; analysis based on data from 10 major retailers
Source: Jumpshot

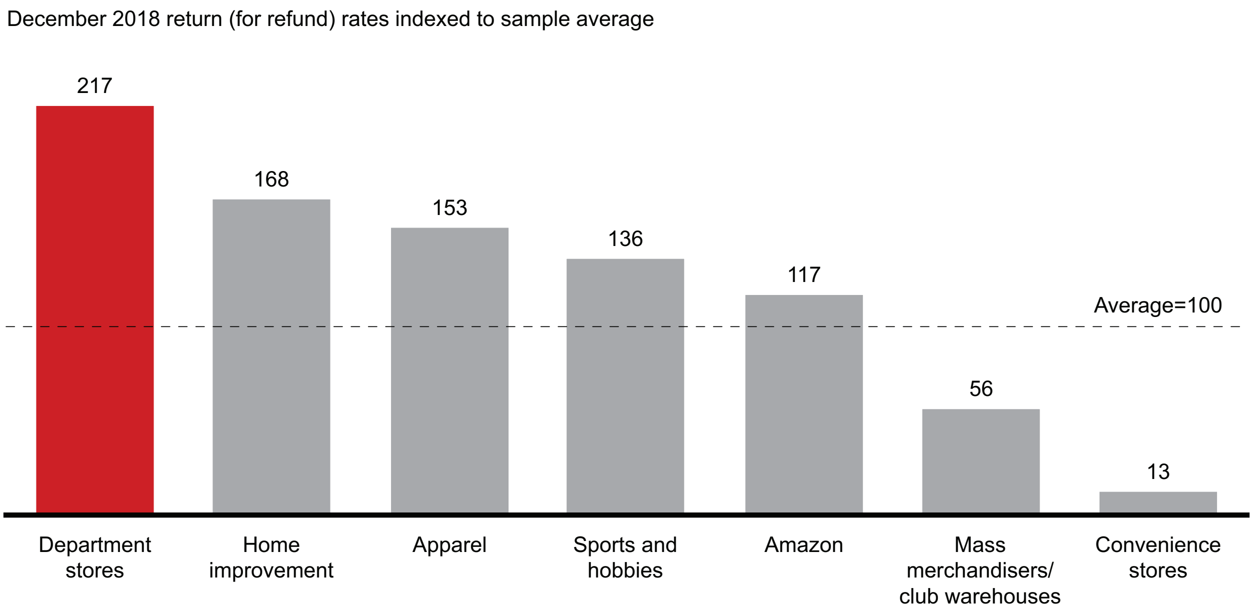
retailers saw the most significant increases in online transaction volume, with 24% and 23% higher volumes, respectively. This growth can be attributed partially to expanded free shipping with lower minimum or no minimum purchase requirements. For example, this holiday season, Target introduced free two-day shipping with no purchase minimum, while Walmart expanded the number of items available for free two-day delivery with a $35 purchase minimum.

Question No. 5: True or false? In December 2018, department stores saw higher return rates than other retailers

True. In partnership with Earnest Research, we analyzed returns made for refunds (as opposed to store credit or gift cards) during the month of December across a sample of major retailers. Department stores saw the highest return rates at twice the sample average *(see Figure 3)*.

Though returns are costly for retailers, research confirms that they are a critical part of the customer experience. In a recent Optoro survey, more than half of respondents said that they always or frequently check a retailer's return policy before buying an item. Free shipping and the option to receive a full refund instead of store credit are the most important factors consumers consider when evaluating a retailer's return policy.

Figure 3: In December, department store return rates were more than twice the average



Notes: Return rates reflect December refunds as a percentage of December sales; analysis based on a sample of 20 major retailers; convenience store return rates exclude sales and returns made online
Sources: Earnest Research; Bain analysis

Factors for success in 2019 and beyond

The holidays capped off a great 2018 for many retailers—overall market sales for the year were about 4.8% higher than 2017, according to our analysis. Leaders are cracking the code on key strategic issues, such as how to use physical stores more efficiently. For instance, Target and Walmart have started using some stores as mini distribution centers, delivering product orders to customers faster and often at lower cost than through traditional distribution centers. Many others, however, were able to reap the rewards of positive macroeconomic factors by executing on traditional retail fundamentals.

As we begin 2019, the political and economic climate is turning more uncertain. The S&P 500 dropped in 2018 for the first time since 2008, with recent gains not yet compensating for 14% fourth-quarter declines. The tariffs enacted last year are likely to have a negative impact on the industry, but the exact implications are difficult to predict as negotiations remain unresolved. The US has experienced its longest government shutdown in history. Further, the retail landscape continues to evolve quickly. What allowed retailers to succeed up to this point may not be enough to win in the long run.

The basis of competition in retail has changed. In the past, customers were mostly local, often limited to what was nearby and convenient—or they were at the mercy of long shipping periods. In that world, capturing a high share of the local market led to success. Retailers won with traditional fundamentals: great products at attractive prices, optimal store locations, a memorable brand, friendly service, and the ability to operate efficiently and consistently at scale. But with the ubiquity of global connectivity, e-commerce and rapid delivery, the competitive landscape has broadened. Local market share is still important, but retailers also need to stand out among national and global competitors.

Today's consumers want relevant recommendations and attention alongside access to digital communities via social networks and online reviews. They still value attractive prices but also demand easy, seamless transactions. Two-day shipping is now the norm, and expectations are escalating. Customers, who value their time more, want convenience and speed without sacrificing on-demand service and at-your-fingertips access. Brands should not only be memorable but also meaningful and unique.

So what does a winning formula look like in 2019 and the years to come? One easy prediction: To continually deliver on heightened customer desires, retailers need to increasingly implement data and technology solutions or risk becoming obsolete. But which technologies are worth their cost and which are shiny distractions?

Delighting customers in the new year and beyond

Today's consumers demand more from retailers. As a result, winning retailers will be those that orient their strategy and key decisions around the ultimate goal of improving their customers' experiences. Industry leaders recognize the value of consumer time, and they work to ensure convenience, ease of access and quality service throughout the customer journey. While old strategies may have aimed to keep shoppers in stores longer, customer-centric retailers use convenience as a point of differentiation for time-starved consumers. For instance, 7-Eleven is piloting scan-and-go technology that allows customers to bypass checkout lines. Walmart, which suspended its scan-and-go pilot in Walmart locations but continues to test with Sam's Club, is offering virtual store maps to help shoppers locate products quickly and easily. Other retailers win by delighting customers with standout service.

In recent years, retailers and their partners have turned to many emerging technologies to help redefine and improve the customer experience. Others improve efficiency and provide savings that can be reinvested in enhancing the customer journey. As these innovations reach a larger scale, they will change the face of retail. Below are nine technology-enabled trends that we foresee reshaping the industry in 2019.

Trends that cater to consumer habits and interests:

- **Platforms enabling retailers to meet customers where they are.** Many retailers strive to make shopping more convenient and easily accessible by embedding shopping moments into everyday life. Instagram recently expanded its "shoppable" posts to include videos and stories, offering consumers new options for one-tap shopping.

- **Alternative ways to shop.** Some retailers are looking beyond traditional mobile and app shopping to voice shopping, text and image recognition. Shopping can now be as easy as speaking—orders made through Amazon's Alexa tripled this holiday season. In addition, retail giant Walmart rolled out a text capability that allows consumers to simply text a description, photo or idea of a product, and it will be delivered by the following day.

- **Artificial intelligence enabling hyperpersonalization.** Tools powered by artificial intelligence make the shopping experience dramatically more relevant to individual consumers. Apparel retail start-up Intelistyle uses artificial intelligence to combine trending fashion photography with customers' unique styles and preferences to showcase personalized fashion recommendations. Similarly, Dynamic Yield's personalization engine, used by retailers such as Ikea, Sephora and Urban Outfitters, uses machine learning algorithms to customize content and coordinate across independent channel interactions for a consistent omnichannel experience. Additionally, retailers such as Ikea and Wayfair use augmented and virtual reality to create more personalized shopping experiences for consumers.

Trends that optimize convenience:

- **Technology allowing for convenient access to products.** Retailers are providing customers with more flexible access to purchases. These range from automated BOPIS lockers and vending machines (placed everywhere from stores to apartment buildings) to concepts such as Amazon Key, which allows for package delivery inside consumers' homes. BOPIS is rapidly rising in popularity—sales in the category increased 47% from November 1 to December 19 over last holiday season. Technology is also making stores themselves more convenient—China is seeing more and more completely unmanned stores that offer customers around-the-clock access.

- **Computer vision streamlining shopping.** Retailers are trading store labor for automated facial and product recognition tools within their cashierless stores, allowing them to eliminate checkout lines and capture new data on how customers shop and interact with products. Alibaba's Futuremart and Amazon Go stores are at the forefront of this trend, while Yum China expanded its "smile to pay" facial recognition payment software to more than 300 KFC stores just before the holidays, allowing customers to leave without touching their wallets.

- **Autonomous vehicles transforming store visits and delivery.** Self-driving cars will eventually make it less expensive and more convenient for customers to visit physical stores, which could further buoy sales. In the meantime, autonomous vehicles can enable faster delivery to customers and reduce costs with more efficient last-mile transport. Kroger is piloting same-day grocery drop-offs, while college campuses such as the University of the Pacific are testing autonomous "snackbots" that can deliver food and drinks around campus. And with Amazon's announcement of Prime Air, we might see gifts delivered via autonomous drones by next holiday season—although Federal Aviation Administration approval is still needed.

Trends that maximize efficiencies:

- **Robotics automating physical tasks.** Robots that long ago found their way into warehouses are moving into stores. Robots can reduce the need for labor by taking ownership of manual tasks, such as monitoring and restocking shelf inventory or autonomously retrieving products. For example, Ahold Delhaize deployed Marty robots to roam Giant Foods, Stop & Shop and Giant Martin's supermarkets independently and report spills or shelves in need of restocking, and even to verify prices posted in the aisles. This frees up employee time, enabling them to focus on serving customers.

- **Machine learning automating product selection and inventory decisions.** Retailers are recruiting smart machines to make decisions for them, removing human bias from the process and maximizing efficiencies. For example, business tool developer Relex creates tech solutions that automate store and shelf–space planning activities for retailers, optimizing return on investment based on customer shopping patterns. Other tools use artificial intelligence to optimize promotions based on business targets and to plan inventory levels more efficiently—an ideal capability for huge sales events such as Black Friday or Cyber Monday.

- **Real-time information improving efficiency.** New technology can monitor systems and provide feedback in real time, allowing retailers to swiftly learn and adjust. For instance, tools developed by start-ups such as FourKites allow retailers to predict shipment times and even track current freight temperature conditions for improved fulfillment. Others such as fast-fashion retailer Choosy rapidly identify customer trends on social media to quickly align product offerings with in-demand styles.

Innovating and investing in 2019

Innovation in retail will naturally center on technology. Innovation more broadly, however, is the imperative. To be successful, companies will need to use Agile approaches to collect early customer feedback, continuously improve, and ultimately identify and scale the winning tools. This requires the right culture, the right operating model and sufficient funding.

Develop the culture and processes for innovation

The successful retailers in 2019 and beyond will be innovation masters. Great retail innovators experiment quickly, frequently, and at a meaningful scale to learn what works and what does not. This starts with establishing a culture and operating model that fosters innovation and rapid test-and-learn practices.

On innovation culture, Amazon stands out as world class. The e-commerce giant's CEO, Jeff Bezos, has stated that "failure and innovation are inseparable twins." The company prides itself on rewarding innovation and celebrating failure. Bezos was even unfazed by the costly public flop of the Fire Phone, stating that the company had already moved on to bigger failures that would "make the Fire Phone look like a tiny little blip." Amazon also puts its money where its mouth is, increasingly investing in IT to spur innovation. Those priorities permeate the company's operating model as well—an estimated 98% of its product development teams work in Agile, a systematic, repeatable and fast-moving method.

The concept is simple, and its benefits are well proven. Small, multifunctional teams tackle prioritized opportunities in short increments, constantly adjusting and adapting early prototypes based on customer feedback. The methodology has increased in popularity over recent years. During the holidays, BJ's Wholesale Club announced it was using Agile to quickly develop and launch new features in its mobile app. In other industries, many companies—including Bosch, Riot Games and Cigna—have seen tremendous improvements via Agile. When implemented correctly, Agile teams deliver increased productivity, elevated morale and faster time to market.

Yet only 25% of companies have fully adopted Agile across their organizations, and in our experience, retailers have been even slower to adopt. Retailers that can break down traditional silos, employ similar test-and-learn methodologies and embrace a lean, fast-paced culture will stand out as trailblazers in the evolving retail landscape.

Find the fuel to invest in new technology and ideas

While strong holiday sales may help, investing in new technologies and the behavior change to benefit from them will require more hard-to-find funding. With typical mid-single-digit retail operating margins, finding investment dollars in an uncertain economy may be difficult. But given that Amazon spent more than 10% of its revenue on IT in 2017 vs. the average retailer's less than 2%, companies will need to reinvent their cost structure to keep pace. In 2019, companies can explore three key ways to fund technology investments.

- **Zero-based cost transformation.** For many retailers, the holiday season is routinely followed by cost cutting—underperforming stores are closed, and workforces are reduced. Instead of continuing to repeat this cycle, many retailers are transforming their cost structures and significantly reducing operating expenditures with zero-based budgeting (ZBB). ZBB is an ongoing cost-management capability that requires companies to build granular budgets from a clean slate each year and that forces managers to aggressively simplify and automate business processes. Companies utilize scale to deploy fewer resources across their physical footprint, between stores and e-commerce, across brands and products, and so on. ZBB is a full-scale cost transformation implemented by companies such as Walmart, Mondelez, Unilever and 3G Capital–backed Kraft Heinz. In the months following its merger and transformation, Kraft Heinz saw profits jump more than 30% as a result of its cost transformation. These approaches are not quick fixes, though; they require significant changes in cost management practices and organizational culture. In our experience, when executed with the proper ambition and executive sponsorship, companies can save 20% or more by implementing ZBB.

- **Outsource select capabilities.** Retailers need to decide which capabilities will be their key differentiators and make them world class. For the remaining capabilities, outsourcing may be the most strategic and cost-effective approach. Ahold Delhaize went this route, recently announcing a partnership with start-up Takeoff to pilot the development of small, highly automated fulfillment centers. But retailers also must weigh the trade-offs of outsourcing, especially vis-à-vis their competitors. Amazon and Alibaba are building large ecosystems—vast, interconnected communities that offer a range of services, including those outside of traditional retail. Amazon has established itself as a one-stop shop for a huge base of loyal customers by satisfying a host of needs, from commerce to entertainment to cloud platforms and web services. Ecosystem customers tap into Amazon's stream of traffic as well as its advanced capabilities. Retailers can sell through Amazon's platform, use its supply chain (Fulfillment by Amazon) or advertise through its many channels. However, these retailers are left vulnerable to the ecosystem owners, which collect detailed data from those that rely on their model. Ecosystem owners can then use the information gleaned to turn from conduit to competitor, eventually pushing other retailers or even brands out of the equation entirely.

- **Profit from your own capabilities and hidden assets.** On the other side of that coin, retailers with unique or valuable capabilities can package these services and generate new revenue streams by selling to other companies. Just as Amazon decided to offer its world-class logistics systems, cloud capabilities and more to the market, Alibaba is empowering traditional trade retailers with sophisticated store operations tools via its Ling Shou Tong business. Kroger and Microsoft recently announced that they will codevelop and market a retail-as-a-service (RaaS) product with front- and back-end technology. Through RaaS, Kroger will resell its competency in generating consumer insights, measuring employee productivity, monitoring out-of-stock issues and more. Target sells its marketing expertise, providing first-party consumer data and marketing consulting to help brands advertise more effectively on digital channels through its Target Media Network. What capabilities does your company have that offer a competitive advantage? Have you developed expertise that can be packaged into a service and sold?

There are many potential ways to decrease costs, just as there are many technologies that could be adopted. The options can be dizzying. What will set the winners apart is a crisp strategy, staying focused on the elements that matter most to their customers and that help deliver their brand promises.

Here's to a retail-filled 2019!

This is the last issue of this season's holiday newsletter. Thank you for tracking the holiday season with us. We hope you've enjoyed our discussions of holiday trends, Amazon's influence, the shifting labor market, marketing that improves customer lifetime value and innovation in 2019.

We look forward to keeping in touch with you throughout the year, and we will be back later this year to share our 2019 holiday outlook. As always, we welcome your thoughts and questions at *RetailHolidayNewsletter@bain.com*.

APPENDIX

Exhibit A: Definitions of retail sales measures

	Omnichannel		Traditional in-store	
	Scope of Bain holiday forecast	Total retail sales	GAFO	GAFS
General merchandise stores	✓	✓	✓	✓
Clothing and clothing accessories stores	✓	✓	✓	✓
Furniture and home furnishings stores	✓	✓	✓	✓
Electronics and appliance stores	✓	✓	✓	✓
Sporting goods, hobby, book and music stores	✓	✓	✓	
Office supplies, stationery and gift stores*	✓	✓	✓	
Building materials and garden equipment/supplies dealers	✓	✓		
Food and beverage stores	✓	✓		
Health and personal care stores	✓	✓		
E-commerce sales in categories above	✓	✓		
Mail-order houses	✓	✓		
Auto and auto parts dealers		✓		
Gasoline stations		✓		
Food and beverage services		✓		
Other non-store retailers		✓		

*The US Census Bureau includes these sectors in GAFO as a subset of “miscellaneous store retailers”; all miscellaneous store retailers are included in both Bain’s forecast and total retail sales

Notes: Omnichannel sales include in-store and e-commerce sales for both omnichannel and online-only retailers; traditional in-store sales do not include sales of online-only retailers or the e-commerce sales of omnichannel retailers that report their e-commerce sales to the US Census Bureau in a separate filing; GAFO=general merchandise, apparel and accessories, furniture, and other sales; GAFS=goods available for sale

Source: US Census Bureau

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