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BAIN RETAIL HOLIDAY NEWSLETTER

DIGICAL® RETAIL AND WHY STORES MATTER

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Although e-commerce sales are growing at double-digit rates, the reality is that 90% of retail sales still happen in stores. In this issue, we look at the holiday shopping season to date and explore the evolving role of stores in a Digical® world. We examine how the most successful retailers are blending the best aspects of digital and physical to deliver better experiences and better economics this holiday season.

Moderate growth in November led by digital sales

Bain estimates that the combined growth of in-store and e-commerce retail sales for November hit 3%, with online sales growing at mid-double-digit rates:[1]

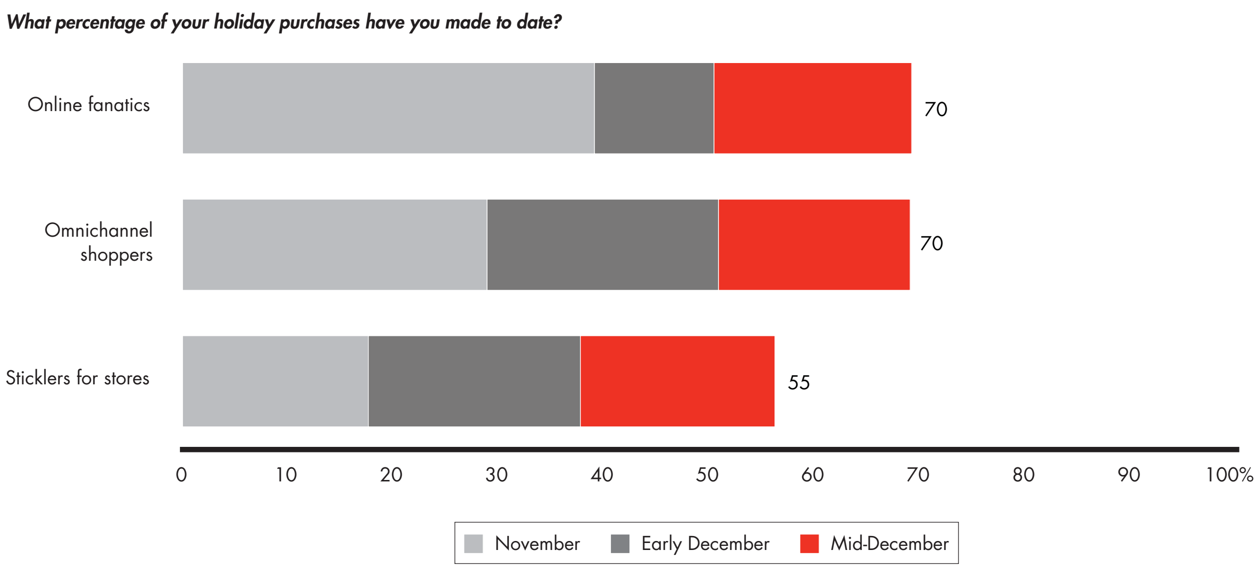
- Early data from the US Census Bureau suggest that November in-store sales increased 1.8% over November 2014. The Census Bureau reported strong results (4% to 5% year over year) for home and home improvement and sporting goods and hobby retailers, and negative growth for both electronics and clothing retailers. Consumers continued to shift spending to nontraditional retail categories—cars and eating out—a trend that is weakening, though, as we get deeper into the holiday season. Year-over-year growth for motor vehicle and parts dealers was 4.3% in November vs. 6.5% in October. Similarly, sales at restaurants grew by 5.4% in November vs. 7.6% in October relative to last year.
- MasterCard estimates that total e-commerce sales in November increased by 16% over the same

period last year. Cyber Monday in particular saw a record-breaking $3 billion in revenue—driven in large part by growth in mobile sales of more than 50%. Mobile sales, including purchases using smartphones and tablets, accounted for more than a quarter of e-commerce sales on Cyber Monday, up from 20% last year. It's important to note, though, that Cyber Monday fell on December 1 in 2014; it fell on November 30 this year. So year-over-year growth estimates for November inclusive of Cyber Monday 2014 are closer to 12%.

Holiday shopping tracker results: Shoppers are two-thirds of the way there

This year, Bain has partnered with Vision Critical to follow a panel of consumers as they shop for the holidays.[2] Our panelists are making progress on their lists: Most completed an additional 20% of their shopping in the two weeks following Black Friday and are now two-thirds of the way there (see Figure 1). Our "online fanatics" continue to lead the charge, with more than 30% having completed all of their holiday buying. While our "sticklers for stores" made the most progress over the five-day Thanksgiving weekend, to date only 20% report that they've completed their shopping, and almost 15% have yet to start. Research suggests consumers are delaying their holiday shopping this year relative to previous years. Of those who still need to complete their shopping, 20% are holding out for last-minute discounts.

Figure 1: Holiday shopping completion by customer segment, as of December 13, 2015



Notes: Survey question asked on three separate occasions to the same group of respondents in November, early December and mid-December; sticklers for stores defined as >80% of purchases between January and October made in store; online fanatics defined as >80% of purchases between January and October made online; omnichannel shoppers defined as >20% of purchases between January and October made online and in-store, respectively; holiday season as of December 13
Source: Vision Critical/Bain customer survey (n=757)

1 Retail sales include North American Industry Classification System (NAICS) categories 442 (furniture and home furnishings stores), 443 (electronics and appliance stores), 444 (building materials and garden equipment and supplies dealers), 445 (food and beverage stores), 446 (health and personal care stores), 448 (clothing and clothing accessories stores), 451 (sporting goods, hobby, book and music stores), 452 (general merchandise stores) and 453 (miscellaneous store retailers), and e-commerce and mail-order sales across these categories.

2 Vision Critical (www.visioncritical.com) provides a cloud-based customer intelligence platform that allows companies to build engaged secure communities of customers they can use continuously, across the enterprise, for ongoing real-time feedback and insight. Vision Critical's Consumer, Retail, & Shopper Insights Consulting Practice uses its proprietary national community, Springboard America, to provide longitudinal insight on consumers' holiday shopping.

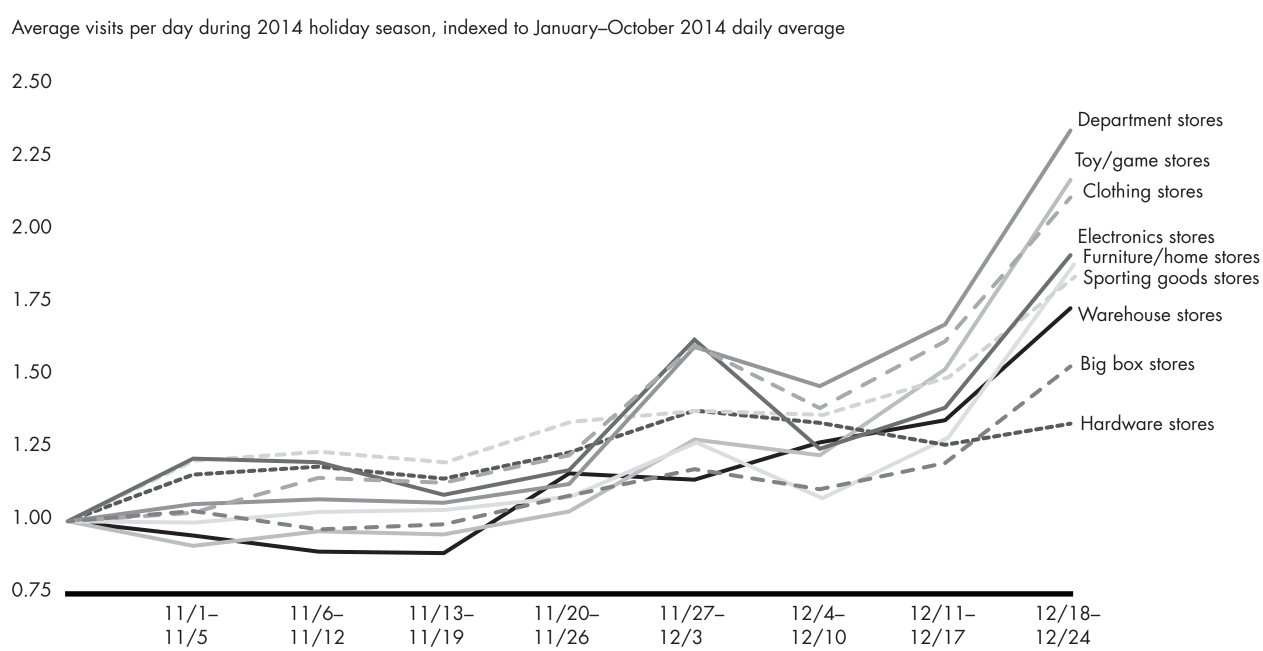
Consumers spend more online during the holidays than they do the rest of the year. Last year, online penetration averaged 10% of all retail sales from January through October, and 12% during November and December. Our Vision Critical panelists confirm this shopping behavior. Both “sticklers for stores” and “omnichannel shoppers” have done a greater percentage of their shopping online this holiday season than they typically do in non-holiday periods. “Online fanatics” continue to make more than 80% of their purchases online.

Stores remain in the spotlight this holiday season

Although online penetration spikes during the holiday season, the reality is that nearly 90% of retail sales still happen in stores. This year, Bain worked with Foursquare to understand how retail foot traffic changes during the holiday months.[3] Our findings indicate that consumers go to stores more during the holidays, particularly in the two weeks leading up to Christmas Day *(see Figure 2)*.

We recognize that data on foot traffic are challenging to collect and synthesize. Several providers count traffic in a subset of retailers and then develop algorithms to gross up across the industry, which makes comprehensive data sets difficult to assemble. Moreover, some traffic counters have a tough time distinguishing between an actual store visit and a “pass-through”—a false positive—where a shopper is simply passing through a store vs. shopping in it. Foursquare uses technology to “snap to place” active and passive users of its mobile app when a phone is stationary for five or more minutes in one of 65 million known places. Although Foursquare’s user base skews younger and more urban than the general population, its data offer a pulse on changes in traffic patterns over the holidays.

Figure 2: Traffic lift during the 2014 holiday season by retailer category



Source: Foursquare

3 Foursquare is a technology company that uses location intelligence to build meaningful consumer experiences and business solutions. The company’s consumer properties, Foursquare and Swarm, are used monthly by more than 50 million people, and its Places Database powers location data for Twitter, Apple, Samsung, Garmin and 100,000 other developers. Foursquare’s Snap-to-Place Technology designates venue locations for millions of anonymized smartphones based on GPS locations and other signals. The Place Insights analytics tool uses this foot traffic panel to provide complex insights on what’s trending and where people go to analysts, marketers and decision makers across a range of industries.

Once in a store, shoppers are much less likely than they are online to leave empty-handed. Stores also trigger impulse purchases in a way that pure-play e-tailers can't.

Everyone knows that traffic increases during the holiday season, but by how much? And by how much relative to increases in sales? Our analysis of holiday 2014 indicates that the surge in store traffic is greater than the increases in sales. Foursquare data suggest a 30% lift in store traffic during the months of November and December relative to the rest of the year, as compared with a 20% lift in retail sales. Moreover, the data indicate that stores become increasingly important to shoppers the closer it gets to Christmas. Last year, we saw a 70% increase in foot traffic in the week leading up to Christmas Day over traffic during non-holiday periods. Though of course patterns vary by sector. Retailers selling products that customers typically want to see and feel before purchasing—clothing, for example—saw a greater lift in traffic in late December than did retailers selling more transactional and easy-to-compare products like electronics and tools *(see Figure 2)*.

Our Vision Critical panelists mirrored the behavior we observed in the Foursquare data: Each of our three segments visited stores with greater frequency the closer it got to Christmas, averaging 1.3 visits per week in early November and two visits per week beginning on Black Friday. The top reasons cited were consistent across segments: to see and touch products, to get inspiration, to get products immediately and to avoid shipping costs. As of mid-December, more than 90% of our shoppers told us they still had gifts to buy, and almost 50% told us these last-minute purchases would be for clothing and jewelry and other items that are easier to see and compare in-store than online, or for gift cards.

In addition to traffic, physical stores have higher conversion. Once in a store, shoppers are much less likely than they are online to leave empty-handed. Store conversion rates average 25% to 45%, while online conversion is only 2% to 5%. Stores also trigger impulse purchases in a way that pure-play e-tailers can't. One study suggests that 40% of customers spend more money than planned during in-store visits, vs. 25% of online shoppers. Finally, while brick-and-mortar retailers bemoan showrooming (checking products out in stores but then buying them online), e-tailers are finding "webrooming"—shopping online and then buying in stores—in full effect this holiday season. Forty-five percent of the "sticklers for stores" on our Vision Critical panel reported visiting a retailer's website to research products—this despite the fact that they make more than 80% of their purchases in stores. Their reasoning? In addition to a more sensory experience, stores offer shoppers instant gratification: They leave with the product in hand at no extra cost.

Stores also represent an important acquisition channel for retailers over the holidays, both to attract new shoppers and to win back lapsed ones. Nearly half of our Vision Critical survey respondents visited at least one store this holiday season that they had not visited earlier in 2015. And although the main reason they gave for visiting the store was an attractive holiday deal, 80% suggested they would go back to the store in the next six months.

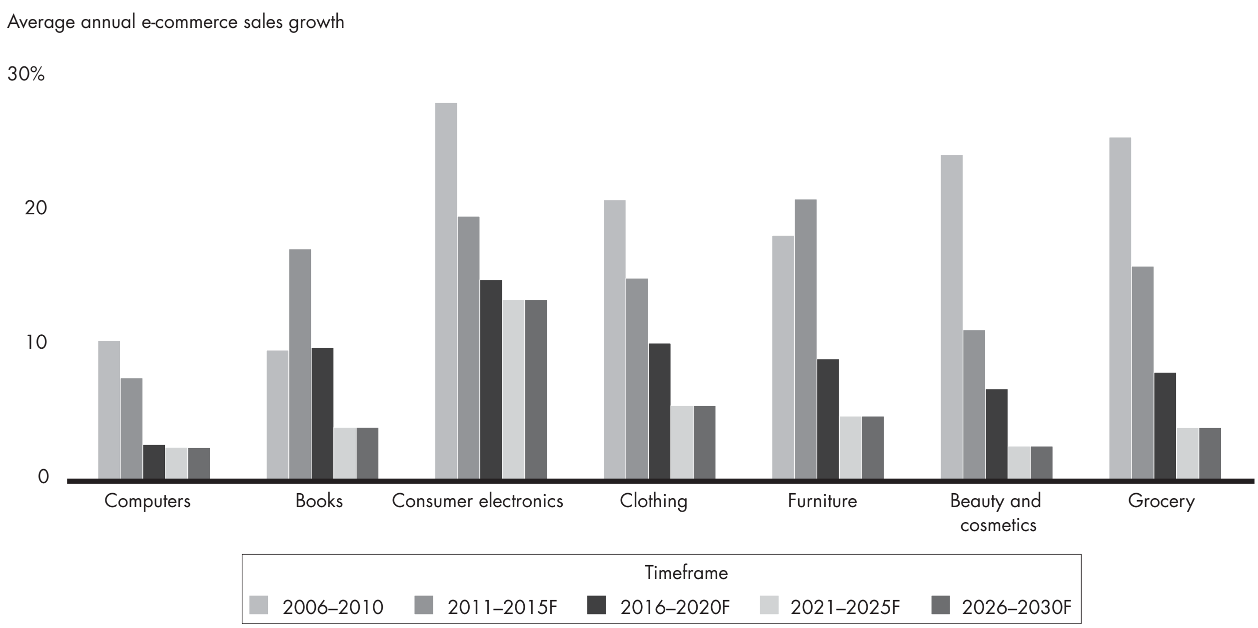
More traffic in stores is a good thing as long as retailers are ready to deal with the increase. The uptick in traffic leads to long lines, quick inventory turnover and an influx of temporary workers, all of which make it particularly challenging for retailers to deliver an exceptional shopping experience during the holidays. In fact, one survey found that nearly 70% of customers reported worse service during the holidays than at other times of the year. And the cost of poor customer service is high. Research suggests that nearly 9 out of 10 consumers stop doing business with a company after experiencing poor customer service. Customers with bad experiences are also two times more likely to talk with friends and family about these negative interactions than they are to talk about positive ones.

The outlook for stores

There's no doubt that the impact of online is increasing. But as we look forward, we expect 80% of retail sales to come from stores. Why? Because e-commerce growth is slowing *(see Figure 3)*. Across retail categories, annual e-commerce growth rates in the United States averaged about 15% from 2011 to 2015. These growth rates are projected to decelerate to an average closer to 10% over the next 5 years, and we estimate further declines to 5% by 2030. The end product of this deceleration: E-commerce penetration rates should flatten out at about 20% 15 years from now, vs. 10% today.

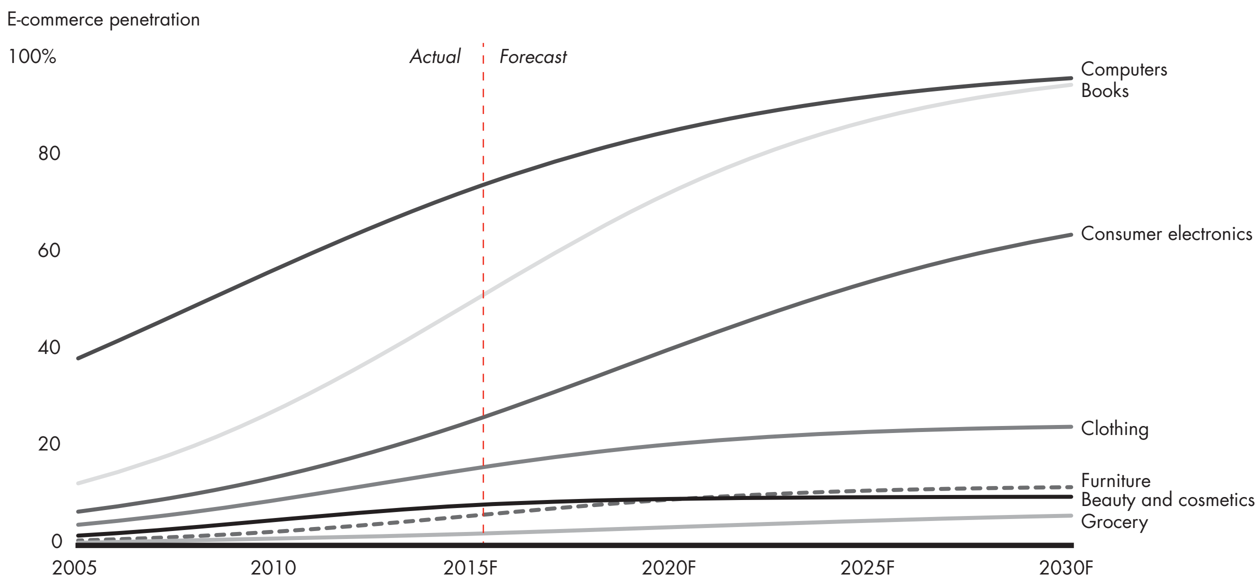
Projected e-commerce penetration rates vary considerably by retail category *(see Figure 4)*. Computers, for example, have an online penetration rate of 75% today. We expect that rate to reach 90% by 2030, with growth rates decelerating from an annual average of 15% a year to 3%. For apparel and other categories with lower e-commerce penetration today, stores will continue to be critical to the success of retailers, pending major disruptions that remove barriers to incremental online adoption. Our analysis suggests digital saturation in the apparel category is closer to 20% to 25%. Why? Online shoppers worry about fit and feel. Retailers attempt to address those concerns by improving shipping and returns. Customers then buy and return in large quantities, which gets expensive for retailers, so they adjust their offers accordingly. Factors that could accelerate adoption include new shopping technologies that solve for fit and feel and less expensive delivery options, including store fulfillment.

Figure 3: E-commerce growth for select product categories, 2006–2030F



Sources: Forrester; Bain analysis

Figure 4: E-commerce penetration for select product categories, 2005–2030F



Sources: Forrester; Bain analysis

"Shrink to grow" is a difficult strategy

Even with e-commerce sales growing more slowly, the economics of stores can look troubling. An additional 10 percentage points of volume shifting online strains financial plans: It dampens store growth and creates pressure to cut fixed costs. Although stores will certainly be relevant moving forward, their role and operations need to change dramatically. As more sales shift to e-commerce, winning retailers won't close a broad swath of stores. Instead, they will transform stores to combine the best of physical and digital (that is, Digical) to deliver seamless, differentiated and exciting new experiences.

The premise of the shrink-to-grow strategy is certainly compelling: Closing underperforming stores should yield a stronger base of high-return stores with better growth. Retailers can then focus investment dollars and resources on these stores, accelerating growth prospects moving forward. Yet this is a risky strategy. To evaluate its effectiveness, Bain analyzed the sales impact of net store closures on 40 public retailers over the last 15 years. We recognize that it's hard to separate true cause and effect in this analysis because many variables contribute to sales performance. However, our analysis does suggest that when large numbers of stores are closed, the problem is less likely to be bad stores and more likely to be a flawed concept in need of reinvention. And reinvention demands radical innovation, the kind that becomes harder to do in a downsizing culture.

Eight retailers in our data set closed more than 20% of their stores in a single year. Average year-over-year growth for this group in the three years following the closures was –50%, with five retailers—Blockbuster, Borders, Movie Gallery, Ritz Camera Centers and Tweeter—shuttering operations entirely in subsequent years. In contrast, 18 retailers, including Lowe's, Nordstrom and Starbucks, trimmed less than 5% of their portfolio and grew by an average of 5% in the years following the closures. The remaining retailers—among them The Body Shop and Abercrombie & Fitch—closed 5% to 15% of their stores in any given year and experienced relatively flat growth (1%) moving forward. Essentially, the data suggest that the retailers that closed a larger group of stores failed to generate meaningful future growth.

Substantial store closures (outside merger integrations) are a signal of poor performance and brand weakness. They raise questions for customers: "Will the store be around anymore?" "Will it honor returns?" And they're inconvenient. The likelihood that consumers will travel farther to an alternate store location is low. They are much more likely to defect from the brand and switch to a conveniently located retailer offering similar products. Moreover, closing stores impacts the broader catchment area, which includes online sales. Bain analysis suggests a halo effect: Within a given catchment area, online sales increase as new stores open. In contrast, closing stores can have a negative impact—by as much as 20%—on e-commerce. And transfer rates post-closure are typically very low, less than 10%, with any near-term lifts eroding over time. In many ways, stores function as a marketing vehicle for e-commerce, keeping the brand top of mind for shoppers within a given trade area. They also act as a return center for e-commerce merchandise. When a store closes, online customers lose the ability to return in-store, and retailers lose the incremental sales generated by in-person return visits.

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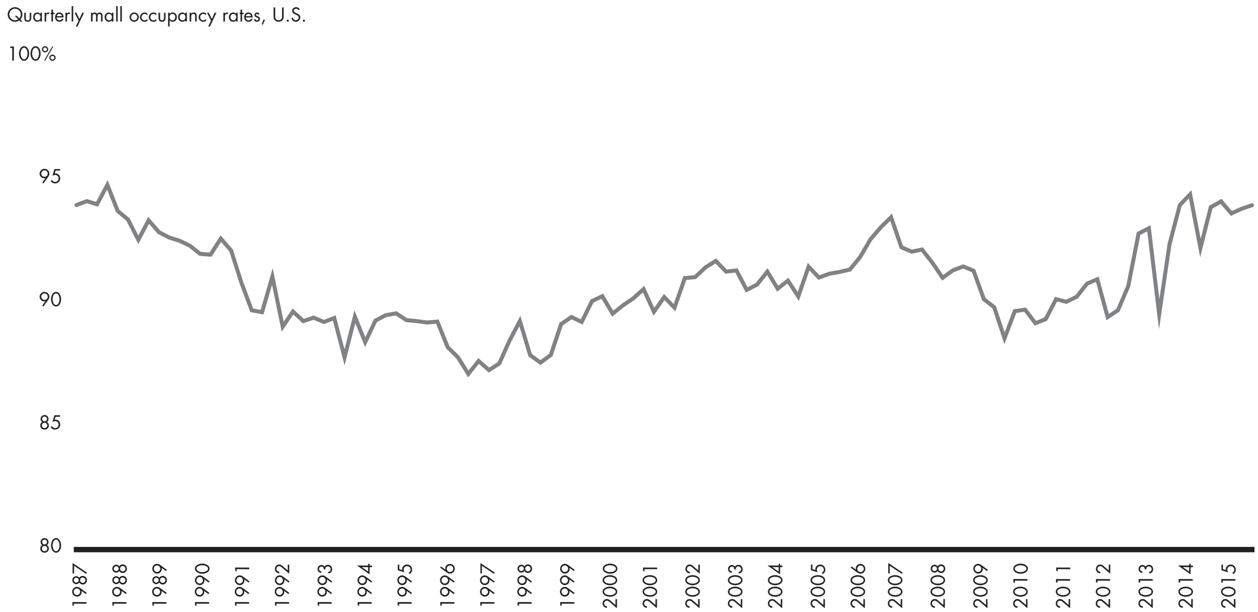
Extensive store closures typically prompt a reduction in corporate overhead. This year, for example, Gap announced plans to close 175 stores in conjunction with plans to lay off 250 central employees. Restrictions in resources at this scale inevitably dampen creativity, as remaining staff members focus their attention on essential operations. Research on corporate innovation by Harvard Business School's Teresa Amabile suggests that resource restrictions "push people to channel their creativity into finding additional resources, not actually developing new products or services." For underperforming retailers, failing to innovate and differentiate themselves from their competition only perpetuates the downward spiral.

Many retailers cite the decline of malls as a reason for store closures. After the financial downturn, the percentage of malls with vacancy rates of 10% or more increased from 5% in 2006 to nearly 25% in 2010. Moreover, consumers began to spend significantly less time shopping for discretionary goods; that is, their mall trips became more targeted. The average number of stores visited per mall trip fell to just three, compared with more than five in 2006.

However, data from the International Council of Shopping Centers (ICSC) suggest recent mall performance isn't nearly as bad as people think. First, both sales productivity and net operating income have increased over time. Monthly sales productivity through September was up from $31 per square foot in 2010 to $37 in 2015; and net operating income went up from $5.20 to $7.50 per square foot over the same period. Second, mall occupancy rates continue to improve coming out of the recession (see Figure 5). Occupancy of both regional and super-regional malls reached 94% in the fourth quarter of 2013, a level not seen since 1987, and have remained at that

Figure 5: Quarterly mall occupancy rates, United States, 1987–2015



Note: Includes regional and super regional malls, not seasonally adjusted
Source: International Council of Shopping Centers

level to date. Finally, while some suggest that the mall-going demographic is aging, data from an ICSC survey suggest that younger customers have a stronger preference for shopping centers (including not only malls but also strip centers, neighborhood centers, outlets and outdoor shopping sites) than older customers do: More than 90% of 18- to 24-year-olds visit a shopping center at least once a week, vs. 83% of all US consumers. In fact, younger shoppers visit shopping centers nearly 11 times a week, a function of the number of dining, fitness and entertainment venues now incorporated into the tenant mix.

While traditional retailers are evaluating store closures, "born-digital" retailers are recognizing the power of a physical presence. Warby Parker, for example, has opened 19 offline stores in the last two years. The eyeglass e-tailer discovered that more than a third of customers coming into its physical stores were unlikely to ever make a purchase on the company's website. However, after their in-store experience, many of these shoppers turned to the website to make a second or third purchase. A recent article in the MIT Sloan Management Review compared sales in cities where Warby Parker had opened inventory showrooms with sales in similar cities where it had not. The study found that online sales in cities with showrooms increased by about 3.5%, confirming that the offline presence didn't cannibalize the online channel; it complemented it. Similarly, Bonobos, an online men's clothing store, now touts 20 physical "Guideshops" in the United States, where shoppers can interact with an associate, try on different styles and have purchases shipped directly home. More than half of the company's new customers now come in through Guideshops, typically spending more money than first-timers on the Bonobos site.

Stores still matter, but their role is evolving

The role of stores is evolving in the Digical world, and traditional retailers are innovating with a range of technologies, formats and capabilities to delight customers in stores over the holidays. Here are some of the things shoppers are experiencing this holiday season:

- *Help me find what I want:* Many retailers are deploying new technologies to enable shoppers to cut through the clutter and make better, faster decisions while in stores. Walmart's mobile app streamlines consumers' in-store experience: Shoppers find items using GPS navigation, pay for their products with their smartphone and get additional savings by scanning their receipts and earning the difference when a local competitor is selling an item at a lower price than Walmart. This holiday season, shoppers can even search for a friend's wish list using the app, making buying gifts faster and easier. Retailers are also experimenting with interactive dressing room technology to streamline the decision-making process in stores. Ralph Lauren, for example, partnered with startup Oak Labs to create interactive mirrors. Radio frequency identification technology in the company's Fifth Avenue flagship store displays shoppers' selected items in the mirror, side by side for easy comparison. Shoppers can use the mirror to change the lighting in the room, get style recommendations, browse through other items and request different items be brought to the dressing room.

- *Get me my order quickly and reliably:* Amazon.com has shifted the basis of competition to faster delivery at low or no cost to consumers, and retailers have had to invest to keep pace. Many retailers are promoting buy-online-pick-up-in-store options this holiday season, a cost-effective alternative to expedited shipping. However, operational challenges with in-store pickups—including poor signage, long lines and lost orders—are creating new frustrations for customers. Curbside pickup programs, like those offered by Best Buy and Target, are delivering better customer experiences to date and appear more likely to encourage repeat use. Omnichannel retailers are also using stores as mini-fulfillment centers to get items to online shoppers faster without a costly investment in new warehouses. This year, Best Buy delivered 67% of its packages in two days or less, and averaged shipping speeds faster than Amazon (standard, non-Prime delivery) by tapping into its ship-from-store capabilities. In addition to facilitating delivery, stores are evolving into return centers. More than 60% of consumers prefer to return or exchange purchases made online in stores. Although greater return volume creates logistical complexity for stores, it also generates opportunity for more customer visits and new sales. (See our second newsletter, "'Tis the Season for Free Shipping," for more information on store fulfillment capabilities.)

- *Inspire and educate me:* Today's shoppers crave inspiration, and omnichannel retailers are tapping into physical stores to provide them with easy access to ideas and information. Target has redesigned the home section of select stores with "lifestyle layouts" to help shoppers envision what products would look like in their own homes. Sephora recently unveiled its new store concept, the Sephora Beauty TIP (teach, inspire, play) Workshop, to serve as the vision for both current stores and future locations. Twelve beauty workstations sit in the heart of the store, equipped with USB ports, iPads and Wi-Fi. Shoppers can watch YouTube how-to videos; use Sephora's color, fragrance and skin care IQ systems for product suggestions; and upload selfies and their own recommendations to the digital beauty board in the store. Other retailers are experimenting with new technology—digital mannequins and displays, for example—to better showcase brands and merchandise. House of Fraser has introduced beacon-equipped mannequins to enhance the shopping experience: When a customer is within 50 meters of a mannequin, a beacon sends a signal providing information about the clothes and accessories the mannequin is wearing. Lowe's smaller-format stores in Manhattan are utilizing life-sized screens to allow shoppers to search a larger variety of appliances, see them at actual size and explore product details using 3-D imaging.

- *Engage with me personally:* Many retailers are attempting to connect with customers personally via tailored local assortments and community outreach. West Elm, for example, expanded "Local Collections" to all of its stores ahead of the 2015 holiday season. Local Collections connects neighborhood "makers" with local customers in an attempt to "revive stores as the center of community." Other retailers are developing more-targeted store formats to better engage particular customer segments. Nike's women-only Newport Beach location started offering designer collaborations, fittings and tailoring, and an in-store fitness studio to create a more personal experience in the women's athletics sector. Next year, Whole Foods will launch a sub-brand targeted at millennials called "365." The stores will occupy a smaller footprint, offer a lower price point, incorporate more technology and a sleeker design, and carry a more curated assortment of products targeted at millennial preferences. Amazon leverages proprietary data to inform the stock and display counters in its new Seattle bookstore to better appeal to local shoppers. And Macy's is using mobile technology in collaboration with Shopkick to personalize the shopping experience for customers in real time. In-store beacons alert individual shoppers to promotions and items they may be interested in as they walk through the store.

- *Entertain me:* Retailers recognize that there is an inherent difference between shopping and buying, and increasingly are using their stores to improve the shopping experience. Teavana's new concept store, for example, features a 23-foot communal "make table" where shoppers can sample teas and craft their own signature tea blend with the guidance of an in-store tea expert. Urban Outfitters' Brooklyn store, Space Ninety 8, offers five stories of retail space with an in-house restaurant operated by celebrity chef Ilan Hall, a rooftop bar, a marketplace to highlight the works of local designers and open space for pop-up shops. By creating entertainment destinations, retailers are looking for new ways to differentiate between the brick-and-mortar shopping experience and the digital one.

Winning in Digical retail

Retailers today fall into three distinct camps: mature retailers in highly penetrated online businesses, mature retailers in less digitally penetrated sectors and early-stage retailers. For those in less digitally penetrated sectors and early-stage players, stores represent a platform for growth. These retailers can be much more opportunistic in their exploration of digital, leveraging tactics employed by their digitally dense counterparts to influence penetration. Winning retailers in these sectors will keep stores relevant and fresh, build digital capabilities and modernize systems to support future digital migration.

Mature retailers in digitally dense environments face more of a conundrum, finding themselves in an increasingly competitive fight for survival. Best-in-class omnichannel retailers in this camp are turning the one feature Internet retailers lack—stores—from a liability into a core asset. Here's how:

- *Make your stores great:* Differentiate the in-store shopping experience from the transactional nature of an online purchase. Don't just stock products. Instead, offer inspiration and curation. Explore new targeted store formats, locally tailored marketing, curated assortments, multi-sensory inspiration and personalized service to deepen relationships with existing customers and attract new ones.

- *Be smart and agile with technology:* Be prudent about how and where you spend on technology. Look for capabilities that will materially improve the in-store customer experience vs. fads that won't move the needle. Launch innovation scrum teams that will both attract and actively engage world-class technology experts.

- *Break down channel silos:* Continue to understand and invest in the infrastructure, systems and capabilities that reinforce linkages between stores and websites. This means optimizing inventory across the full supply chain, flexible fulfillment, system upgrades, advanced analytics (including cross-channel customer analytics and assortment navigation) and the right talent and operating model for designing and executing your strategies.

- *Migrate metrics:* Evaluate existing store economics and compensation systems. Do current accounting practices differentially penalize stores and dotcom? For example, are stores taking a hit for accepting online returns? Are they rewarded for incurring no additional costs for multi-unit orders, returns and faster vs. slower deliveries? Who's getting credit for buy-online-pick-up-in-store orders? Online and offline experiences are blurring, and winning retailers will adapt metrics to focus on and reward catchment productivity, not store or dotcom productivity in isolation.

- *Play offense, not defense:* Offer what customers crave, not what competitors are doing. Bain research suggests companies that do this profitably blend creative thinking with commercial principles. We call this BothBrain® Innovation.[4] Allow testing and learning to influence change with good ideas not just year to year or season to season, but week to week or even day to day. Create an omnichannel lab store to facilitate a continuous cycle of experimenting and learning.

What's in store for next year?

Our next and final newsletter, released at the end of January, will recap sales over this holiday season and examine trends retailers should watch for in 2016.

We wish you a happy holiday and strong sales, and look forward to connecting with you in the New Year.

4 Bain's BothBrain Innovation approach utilizes both the creative and the analytic talents within organizations to innovate across the full customer experience.

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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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