

BAIN RETAIL HOLIDAY NEWSLETTER

WILL AMAZON STEAL CHRISTMAS?

By Aaron Chervis, Darrell Rigby and Suzanne Tager



The holiday shopping season is now officially under way, and Amazon.com is busy filling stockings. The online juggernaut continues to expand its offerings—notably in apparel, groceries and Amazon-branded electronics—while maintaining aggressive pricing on best sellers and resetting shoppers’ expectations in terms of service and shipping speed. In this issue we dig beneath the headlines and examine where and how Amazon is investing this season ... and whether Seattle is becoming the new North Pole.

Holiday sales expected to pick up pace post-election

Recent data from the US Census Bureau bolsters our view that holiday sales will grow at approximately the same rate as last year, between 3.5% and 3.9%. According to a survey from the National Retail Foundation taken before the US election, more than 25% of shoppers said the contest would affect their holiday spending. This seems to be reflected in preliminary data for October showing that sales grew by about 2.5% year-over-year. However, retail executives have confirmed our view that shoppers are poised to open their wallets again now that the election is over. We’ll keep track of how this translates to sales at the register.

One company is continuing to deliver breakneck growth: Amazon. Its third-quarter earnings announcement showcased a year-over-year revenue increase of 26% in its North American retail business. Estimates for growth of gross merchandise value in the region—the total sales value of merchandise sold through Amazon,

including items sold by third-party sellers via the Amazon Marketplace—tally even higher, between 30% and 35%. Although the company disappointed investors with lower-than-expected earnings, Amazon clearly signaled to its competitors that it remains willing to sacrifice margins for market share.

Amazon's winning streak

We estimate that US e-commerce sales will reach approximately \$390 billion this year, and that Amazon's share, including its Marketplace sales, will be close to 35%. Our analysis further suggests that by 2018, US e-commerce sales will grow to nearly \$500 billion and that Amazon's share will increase to almost 50%—a 30% compound annual growth rate.

Amazon's rapid growth is being fueled in part by the expansion of Amazon Prime. Several sources estimate that there are currently upward of 60 million Prime members in the US, and that number is likely to grow this holiday season. In 2015 Amazon added more than 3 million new Prime members in the third week of December alone. This year Amazon is promoting the debut of its original series, *The Grand Tour*, with a one-day Prime membership promotion. On November 18, new members will be eligible for 20% off the first year's annual fee.

For customers, Prime is not just about fast and free shipping; membership offers a large and growing number of benefits (*see Exhibit 1*). For Amazon, Prime builds loyalty. Prime customers spend an estimated \$1,200 per year—more than twice as much as their non-Prime counterparts.

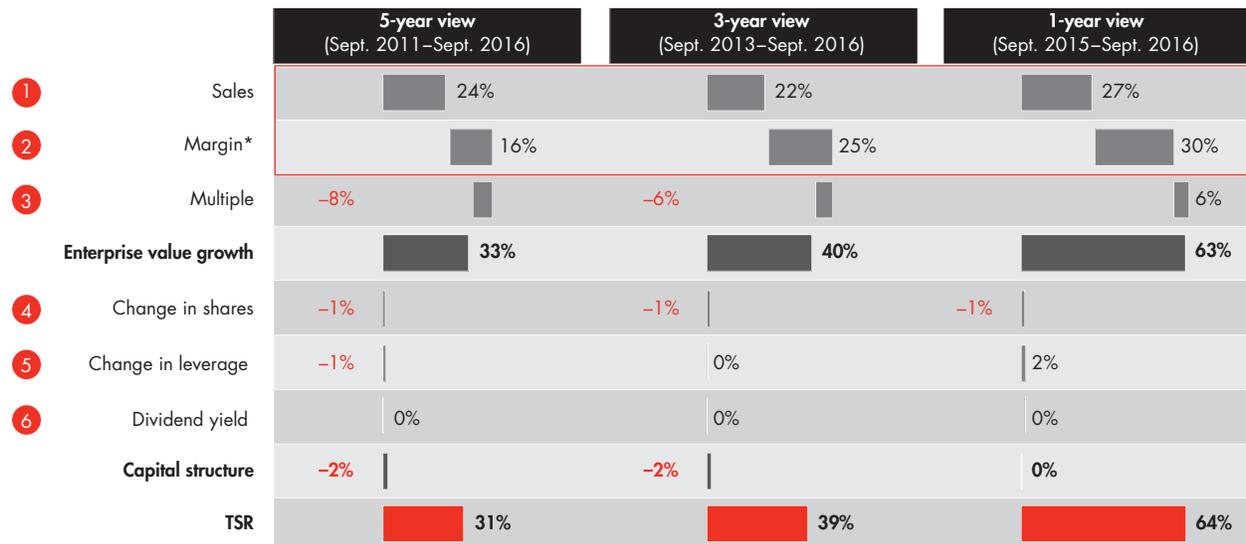
What is the formula behind Amazon's growth? The company continues to invest in its “flywheel,” the three accelerators that sustain its success:

- **Maintaining the broadest assortment.** Amazon offers hundreds of millions of items through Amazon-sold products (first-party sales) and those sold through the Amazon Marketplace (third-party sales). Some third-party goods are warehoused and then distributed by Amazon through the Fulfillment by Amazon (FBA) program; others are simply transacted through Amazon's site (self-fulfilled by third parties).
- **Offering attractive prices.** Amazon wants to win on low prices ... or at least the perception of low prices.
- **Delivering an extraordinary customer experience.** From an intuitive user interface to one-click ordering, to simple returns, to fast shipping, to new Prime benefits and more, Amazon continues to delight shoppers and raise their expectations. In fact, ordering from Amazon is so easy that a federal judge recently found that children playing games on mobile devices rang up \$86 million in unauthorized charges.

This formula—and the impressive revenue growth it has enabled—has fueled Amazon's industry-leading total shareholder return (TSR) of 31% over the past five years. In our analysis, we decomposed the elements that contribute to TSR and then calculated percentages to indicate how much each element contributes. Higher percentages reflect a larger contribution, and negative percentages reduce cumulative returns. The company's TSR has gone up even more over the last year, in part due to high margins from the Amazon Web Services business (*see Figure 1*).

Moreover, in comparison with its peers, Amazon's TSR is one of the highest across multiple time periods (*see Figure 2*).

Figure 1: Strong sales growth and margin expansion power Amazon's total shareholder return

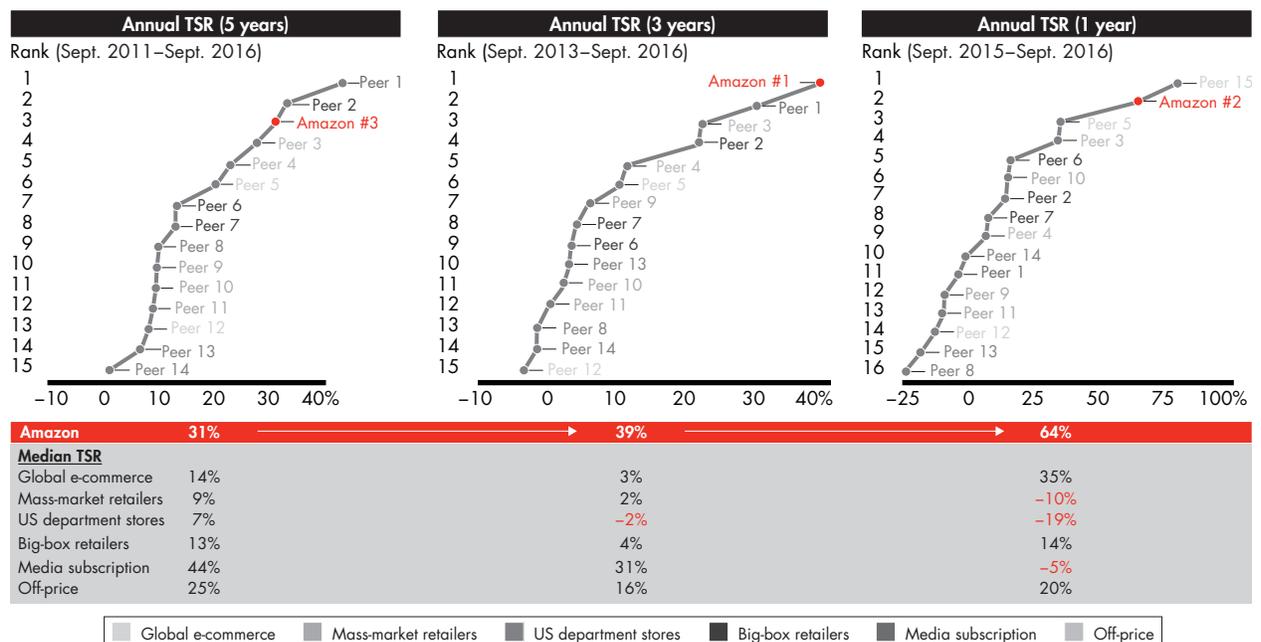


*Margin expansion, particularly in recent years, is in part a result of the Amazon Web Services business

Notes: Numbers may not sum up due to rounding; margin refers to annualized growth in EBITDA margin; multiple refers to annualized growth in EV/EBITDA multiple; for change in shares, positive change implies buybacks and negative change implies capital issuance; change in leverage is change in ratio of market cap to enterprise value (market cap+net debt+minority interest)

Sources: S&P Capital IQ; Bain analysis

Figure 2: Amazon's total shareholder return leads its peers



Notes: Alibaba was excluded from 5-year and 3-year analyses due to listing in 2014; Amazon is not included in peer median; TSR is total shareholder return and was based on trading currency; TSR=(share price difference+dividend)/initial share price; time value of dividends was not considered
Sources: S&P Capital IQ; Bain analysis

Unwrapping Amazon’s flywheel this holiday season

What’s in store this holiday season? All signs point to Amazon continuing to invest in its flywheel strategy across all fronts.

Assortment: All eyes on apparel, groceries and Amazon-branded electronics

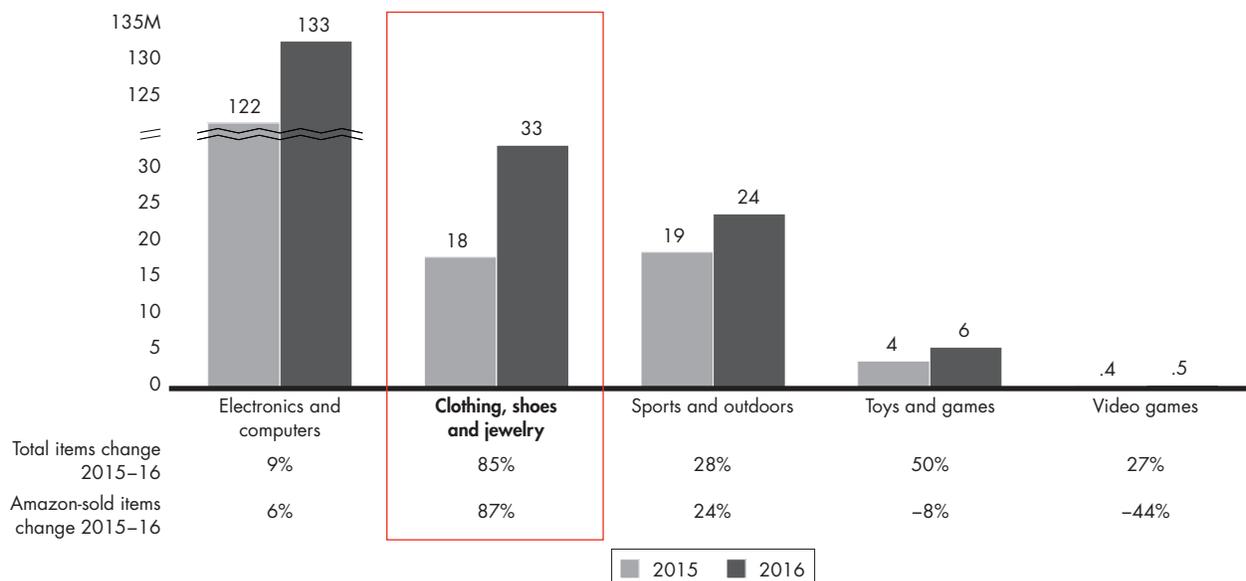
From Santa hats to Christmas hams to virtual personal assistants, Amazon wants to sell it all—in ever greater quantities—this holiday season. Books and consumer electronics remain leading categories; but apparel, groceries and Amazon-branded consumer electronics look to be this year’s headline grabbers.

Apparel: Everything to fill your closet. There has been lots of discussion about Amazon’s increasing sales of clothing products. Although it’s hard to confirm published totals of the online giant’s apparel sales, Bain’s analysis confirms Amazon has become a significant force in the sector, particularly if we include footwear and Zappos.com. In partnership with 360pi, we’ve seen a year-over-year doubling of items listed in the clothing, shoes and jewelry category to approximately 33 million items (see Figure 3). The vast majority of this merchandise is listed on the Amazon Marketplace, meaning it’s sold by third-party vendors through Amazon’s site. But the number of Amazon-sold products also has doubled. Among those products are more than 1,300 private-label items across multiple brands for men, women and children.

What kind of clothing is Amazon selling in large quantities? The company’s year-round best sellers—items that were on the best-seller list for more than 70% of the year—are largely basic items like men’s jeans and sneakers from familiar brands like Levi’s, ASICS and Skechers.

Figure 3: Amazon has significantly increased available items across categories

Items available on Amazon in select categories in May 2015 and 2016



Notes: Total count includes products listed for sale by both Amazon and its third-party sellers; percentages might differ from item number differences due to rounding
Source: 360pi

Third-party sellers are an important contributor to the breadth of Amazon's assortment. Yet the profitability of the Amazon Marketplace differs depending on whether or not third-party sellers participate in the Fulfillment by Amazon program. Bain estimates the company makes less on FBA sales than it does on third-party sales fulfilled by the sellers—even after increasing FBA fees this holiday season. Still, Amazon's FBA program allows it to offer Prime customers free two-day shipping on a broader variety of goods, which in turn makes Prime membership more attractive.

Groceries: Everything to fill your fridge, freezer and cupboards. Amazon is expanding its grocery offerings, and, in many markets, Amazon's website is a source for everything shoppers need to plan, cook, host and clean up after holiday feasts.

In addition to shelf-stable groceries—long an Amazon offering—this holiday more shoppers than ever are able to buy fresh and frozen foods through AmazonFresh, the company's fresh-food service. This year the service expanded to Boston, Baltimore, Chicago, Dallas and London. The company also has increased its coverage in existing markets. For example, New York service now reaches parts of Connecticut.

We analyzed demographic characteristics of the US metropolitan areas where AmazonFresh is available and found that those areas are wealthier than average and that the specific zip codes AmazonFresh serves are more densely populated than those metropolitan areas as a whole. If Amazon continues with its current model, we project it will reach about 18 million households—approximately 15% to 20% of US households. However, given Amazon's history of rapid innovation, the model could change. Rumor has it that the company will open 20 small-format physical grocery stores by the end of 2018 and as many as 2,000 by 2025.

Technology: Making ordering gifts as easy as saying, "Hey, Alexa." Amazon is aggressively promoting its "device family" this holiday season, particularly the Echo, Echo Dot, and Tap, all of which feature the Alexa personal assistant. These products are marketed as smart-home devices and Bluetooth speakers, and they're sold at Amazon and other retailers. Alexa can play music, tell you the weather, connect to other devices and much more. It's also designed to make ordering from Amazon effortless. Estimates are that more than 1 million Alexa-enabled devices have been sold, and their owners are reported to have increased their spending on Amazon by 10%. Amazon is also offering "Alexa-exclusive deals" through a variety of promotions.

Despite an initial stumble or two, last year's ordering innovation, the Dash Button, continues to expand in scope. *The Wall Street Journal* reported this summer that the Dash Buttons were not doing well with customers, but Amazon announced in October that it was adding more than 60 brands to the program—bringing the total above 200—and that orders were up more than 500% over the past year.

Ring in the season with low prices ... on best sellers

The second element in the Amazon flywheel is price, and consumers continue to give the retailer credit for good prices. According to Bain's Shopping Experience Pulse, a survey in collaboration with Research Now, nearly 75% of consumers who shopped at Amazon said that the company offers good prices. This sentiment was validated by our finding that 50% of online shoppers checked Amazon before buying elsewhere, as did more than 30% of those who shopped in stores.

The skinny on pricing. Are Amazon's prices really the lowest? On best sellers, often yes. On everything else, not always. In October Bain partnered with 360pi to compare the online retailer's prices with competitors' prices across four product categories. On its best-selling items, Amazon had the lowest price around 70% of the time

across categories and was tied for the lowest price approximately 20% of the time. For example, Bain comparison-shopped eight best-selling styles of Levi’s jeans across five retailers, including Amazon, and found that Amazon was offering lower prices than the competition by more than 10% on average.

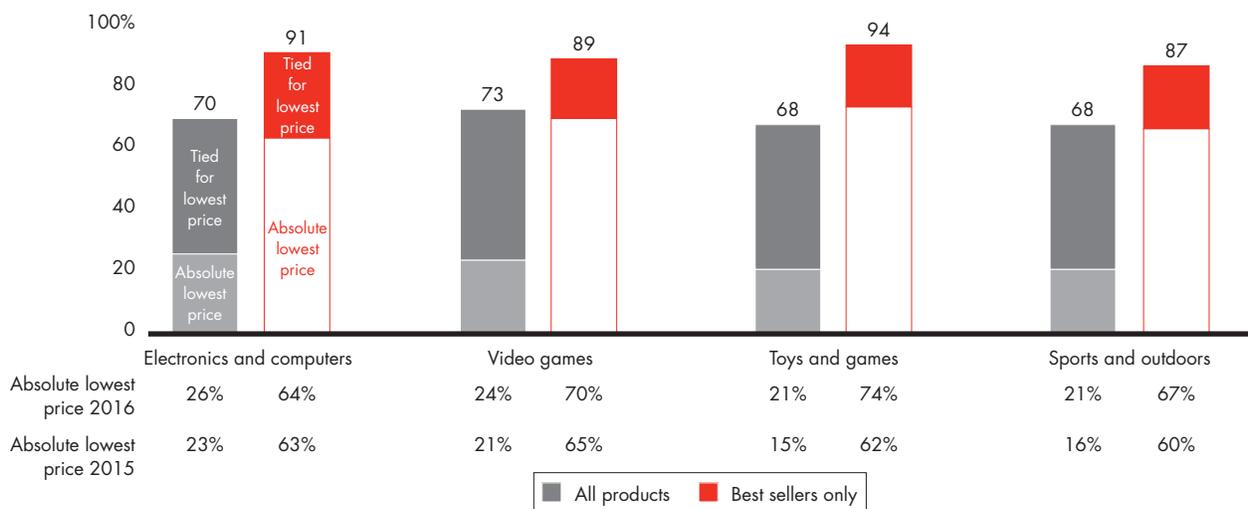
However, looking at all the products in the categories we studied, Amazon had the lowest price only between 20% and 30% of the time and was tied for the lowest price between 40% and 50% of the time—a noticeable difference from its pricing strategy for best sellers (see Figure 4).

Another revelation: Amazon’s customers are not always steered to the lowest-priced item on the site. The company’s algorithm favors items sold by Amazon and FBA sellers by not including shipping charges as part of the total cost. These items are assigned a higher rank in the “buy box” on the basis of price than they should be around 80% of the time. (The buy box is where customers can compare what different sellers are charging for the same item. In addition to price, it ranks based on availability, customer service and other factors.) Although this bias doesn’t impact Amazon Prime members or customers who purchase enough items to earn free shipping, other shoppers may be paying more than they could.

Frequent price changes. Amazon also changes its prices more often than the competition. What’s a good deal now may not be such a good deal in a day or even an hour. Or it could get even better. Bain and 360pi monitored the prices of a basket of goods across four major categories and found that Amazon changes its prices up to three times more often than do any of its competitors individually (see Figure 5).

Figure 4: Amazon offers low prices on best-selling items, less so on others

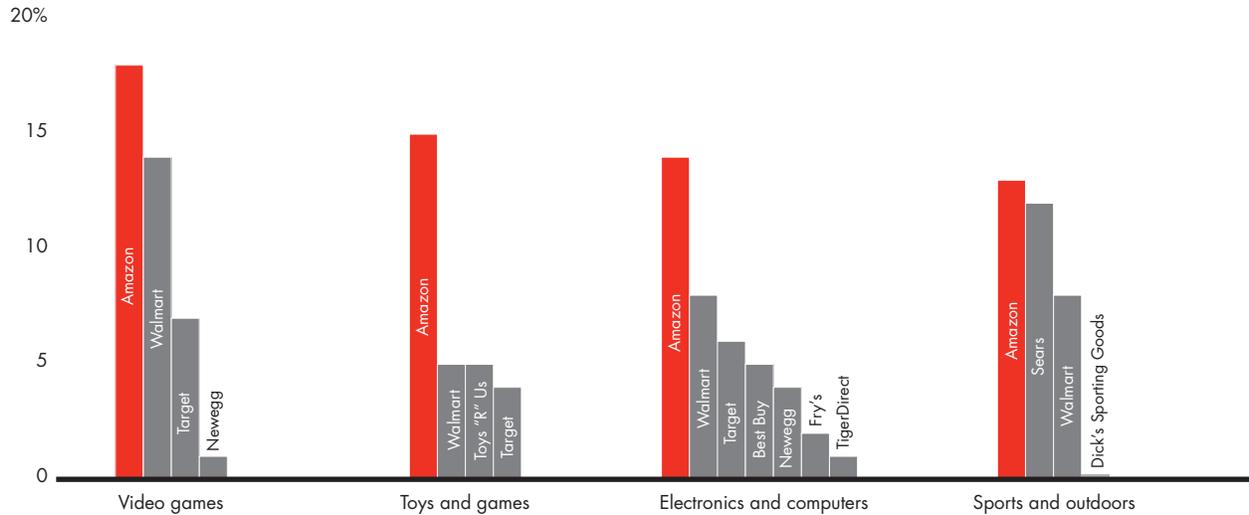
Percentage of Amazon’s products that had the lowest online price (average Oct. 1–Nov. 7, 2016)



Notes: We compared about 11,000 products; each category consisted of exact matched products available for purchase online across more than 25 retailers, including Sears, Overstock, Jet, Walmart, Target, Best Buy, Newegg, Rakuten, Toys “R” Us, Sam’s Club and Dick’s Sporting Goods; Amazon products do not include third-party marketplace items; prices were captured once per day and do not include shipping fees, overlay coupons or promotions, or membership fees; tied for lowest prices are those within 1% of the absolute lowest price; best sellers includes more than 550 products from Amazon’s best-seller listings
Source: 360pi

Figure 5: Amazon changes prices more frequently than its competitors

Average percentage of products within basket of tracked goods that changed prices at least once each day from Oct. 1–Nov. 7, 2016



Notes: We compared about 11,000 products; each category included only products that were the same as those offered by other retailers; Amazon products do not include third-party items; prices were captured once per day and do not include shipping fees, overlay coupons or promotions, or membership fees
Source: 360pi

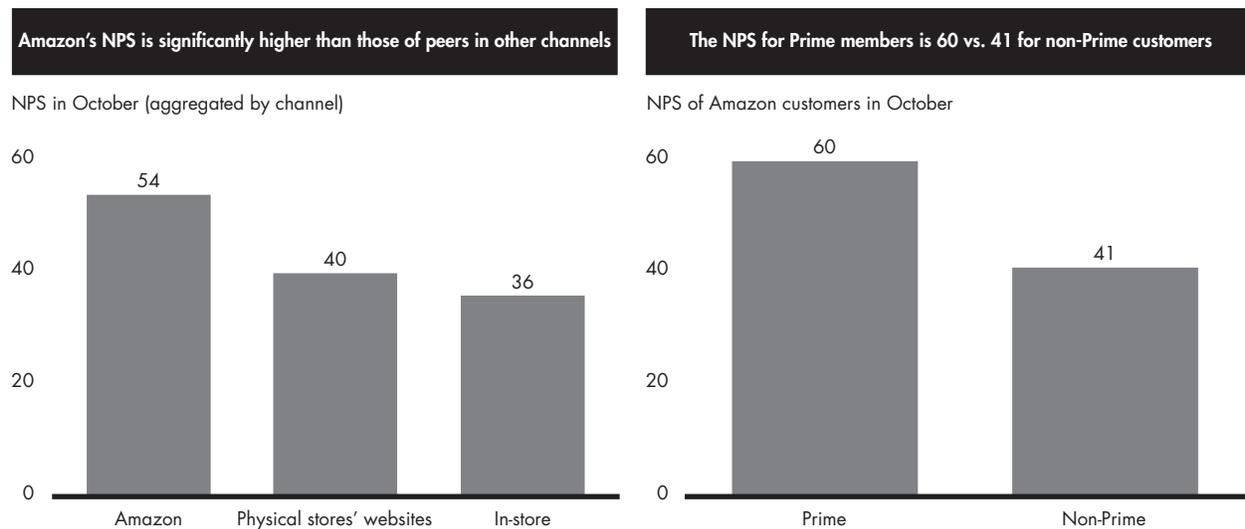
Keeping customers happy

Experience: Upping customer satisfaction. Delighting customers during the holidays pays high returns in sales and loyalty, and Amazon seems to know exactly how to do that. Bain's Shopping Experience Pulse shows that as of early November, Amazon customers had a considerably higher Net Promoter Score® (NPS®)¹, a measure of customer advocacy and satisfaction, than did customers of other retailers: 54 compared with 40 for customers who bought from a physical store's website and 36 for customers who bought in a store (see Figure 6). And our survey suggests that Prime members have an even better experience than regular Amazon shoppers, with an NPS of 60 vs. 41.

Distribution: Delivering a great holiday experience. Amazon continues to set the gold standard in customer experience, particularly for fast delivery, and it has expanded its capacity significantly this holiday season. The company is on track to add 26 fulfillment centers this year, which will grow its total square footage by 30%, well above the 20% growth seen in 2015. To free up warehouse capacity, it has increased its storage fees for third-party sellers, encouraging those sellers to delay shipments of nonholiday goods. And it's increasing seasonal hiring by 20% over last year, to 120,000 workers, while many of Amazon's competitors are hiring roughly the same number of seasonal workers they did last year.

Amazon's distribution network is estimated to have a fulfillment node within 20 miles of nearly 50% of the US population, a total of almost 200 domestic facilities ranging from fulfillment centers to Prime Now hubs. (Prime Now is the company's one- to two-hour delivery service.) Yet the company is making additional investments to

Figure 6: Customers give Amazon high Net Promoter Scores—Prime members give even higher scores



Note: The NPS is derived from a survey that asks consumers, "On a scale of zero to 10, how likely would you be to recommend this company (or this product) to friends and colleagues?" Ratings of 9 or 10 indicate promoters; 7 and 8, passives; and zero through 6, detractors. The score is the percentage of promoters minus the percentage of detractors. Excludes respondents who did not know if they had access to a Prime membership
Source: Bain's Shopping Experience Pulse (n=1,406 for survey round 1, n=1,500 for round 2)

gain control over its operations, bringing the online retailer into competition with its logistics partners UPS, the US Postal Service and FedEx:

- Amazon leased 40 Boeing 767s, acquired 4,000 truck trailers and began to offer ocean freight forwarding—building its logistics capabilities by air, land and sea.
- Amazon is growing its last-mile delivery service, in part by expanding Amazon Flex, hiring contract drivers to deliver both Prime Now and regular packages. This means that in select markets, the company can now deliver products from local bakeries, butchers and grocery stores to shoppers nearby.
- Amazon is also investing in delivery drones and other technology. Of course, the impact of that technology on delivery in the near terms is limited, but it does speak to the company's commitment to faster shipping.

We believe that Amazon will keep up its breakneck pace of innovation in logistics. We also believe that it will continue to change the expectations of all online shoppers.

Winning against Amazon

No question, Amazon is a formidable competitor. But that doesn't mean Amazon will steal Christmas. Here are some ways for retailers to make their own holiday magic:

- **Add unique inventory.** Stock quality inventory that is unique—private-label goods or exclusive brands and products—that offers good value. Amazon can't undersell you if it doesn't have access to the products customers covet and you carry.

- **Nurture elements of value.** The value of a product or service lies in the eye of the beholder. Bain has identified 30 distinct sources of value for consumers (*see Exhibit 2*), which are explained in detail in “The Elements of Value,” an article in the September issue of *Harvard Business Review*. You can access the article, with its cutting-edge research and examples, at <http://www.bain.com/eov>.
- **Connect at an emotional level.** Customer loyalty tends to go up when retailers meet their customers’ emotional needs. There are lots of ways to form emotional connections with customers, among them reducing anxiety and providing a sense of nostalgia.
- **Embrace your brand.** Once you’ve established a brand promise, it’s critical that individual touchpoints bolster that message. Understanding the moments that matter most to your customers and ensuring that those experiences fit your brand goals can keep customers coming back for more.
- **Get smart about loyalty programs.** A well-designed loyalty program (more than just “rewards”) can both delight customers and provide access to actionable customer data. We believe an effective loyalty program goes beyond individual transactions and gives customers a reason to build a relationship with the retailer.
- **Reinvent stores as omnichannel hubs.** Although it may be tempting to underinvest in or even close stores in the age of e-commerce, reimagining the role of physical stores is an advantage in an omnichannel world. Advances in in-store technologies make stores much more than showrooms: They can become digitally enabled inspiration sites and test labs, purchase points, instant pickup places, help desks, shipping centers and return locations.
- **Gain share online.** There is no excuse for losing market share in e-commerce. Even as the costs of doing business online go up, it’s important to invest in capabilities that improve the customer’s experience. We believe omnichannel retailers—those that seamlessly integrate the best of both the digital and physical worlds into a well-executed Digical® strategy—can turbocharge growth.
- **Target your promotions.** Bain’s research suggests that shoppers’ price perceptions are based on more than ticket prices. Targeted but clear messaging can both earn recognition for price concessions and reduce the risk of overpromoting brands. Other tactics that improve price perception include clear signage, user-friendly price-matching policies and great value on high-profile items (*see Exhibit 3*).
- **Team up with vendors.** Strengthening vendor partnerships can shift the basis of competition from price to the broader customer experience. Working collaboratively to ensure compliance with minimum advertised prices, to keep key items available and to merchandise products and services more effectively—through product descriptions, photography and videos, for example—can help shoppers find products that excite them and then purchase them seamlessly.

Quantifying holiday cheer: Introducing Bain’s Shopping Experience Pulse

We love consumer data and wanted to better understand how people are feeling about shopping this holiday season. Will the customer experience deteriorate as lines get longer and shelves go bare? Or will retailers delight customers with unique and inspiring products and a seamless shopping experience? For answers, we launched Bain’s Shopping Experience Pulse to track shoppers’ behaviors and feelings.

We surveyed 1,500 consumers across the country twice in October in partnership with Research Now, asking about their most recent shopping experience. We wanted to know everything from would they recommend a

particular retailer to a friend based on their recent experience, to whether they were excited about shopping for the holidays. Here are a few of our key findings:

- **Shoppers are excited this holiday season.** Nearly 60% of the people we surveyed are excited about holiday shopping. This was consistent throughout the month.
- **Early birds are out in force.** Approximately 75% of shoppers want to get their shopping done early, and more than 30% of shoppers claimed they had done so by the end of October.
- **Retailers are winning or losing on price perception.** Both promoters (customers who rate their experience 9 or 10) and detractors (ratings of zero to 6) most frequently mention price as the reason for their satisfaction or dissatisfaction. This was consistent whether they shopped at Amazon or on a physical store's website or in a store.
- **Factors that delight or dismay online shoppers differ for Amazon and other retailers.** Amazon's promoters focus on shipping and convenience; its detractors talk about sizing and fit. The responses were different among shoppers on physical stores' websites. These promoters focus on product offerings and convenience, while detractors talk about customer service and quality.
- **Shoppers' Net Promoter Score dipped slightly in October.** The Net Promoter Score fell from 43 to 41 in October. We're not sure if this is statistical noise or the beginning of a trend. We'll learn more in the coming weeks.

We will continue measuring shoppers' satisfaction and sentiment throughout the holiday season with a new Pulse every other week. Stay tuned for additional insights in upcoming newsletters.

Looking forward: Future release dates and topics

We wish you all success over the upcoming Thanksgiving shopping weekend. We'll be back soon after with sales results and our perspectives on e-commerce and the role physical stores can play today.

Here's what we're planning for the next few issues:

Issue #3, early December: Holiday Halftime Wrap

Issue #4, mid-December: What's in Store This Holiday Season?

Issue #5, late January: Bain's Post-Holiday Outlook: New Year's Resolutions

Please let us know if you have any questions or would like to arrange a follow-up discussion on the issues addressed in this newsletter or any other retail topics. We look forward to sharing news of other innovations and strategies with you throughout the holiday season.

¹The Net Promoter Score® is derived by asking consumers, "On a scale of zero to 10, how likely would you be to recommend this company (or this product) to friends and colleagues?" Ratings of 9 or 10 indicate promoters; 7 and 8, passives; and zero through 6, detractors. The score is simply the percentage of promoters minus the percentage of detractors. Net Promoter®, Net Promoter System®, Net Promoter Score® and NPS® are registered trademarks of Bain & Company, Inc., Fred Reichheld and Satmetrix Systems, Inc.

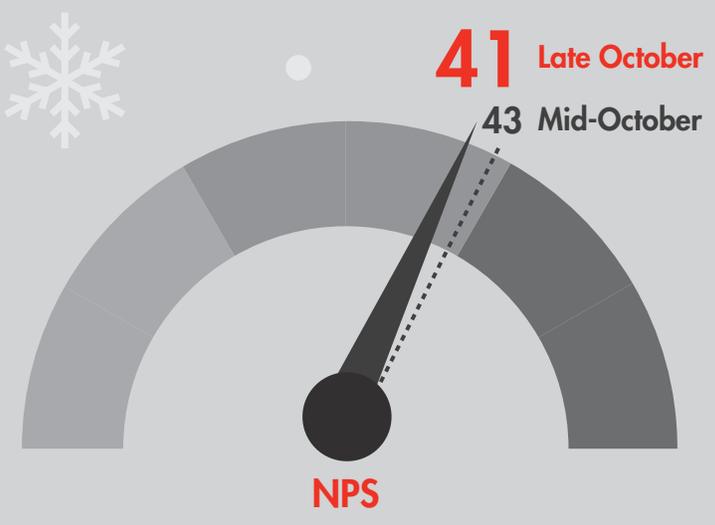
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Bain's Shopping Experience Pulse

Bain has partnered with Research Now to survey 1,500 holiday shoppers every two weeks this season. Here's what we found.

Customers' Net Promoter Score dipped slightly during October. Is it the start of a trend?



We asked customers across major retailers and channels: **"How likely are you to recommend your most recent shopping experience to a friend?"**

Prices and products matter to customers—but so do service and convenience

Mid-October rank	Late October rank	Likely to delight
1	1	Price
2	2	Product offering
3	3	Convenience
4	4	Shipping
5	5	Product quality

Mid-October rank	Late October rank	Likely to disappoint
2	1	Product offering
3	2	Customer service
1	3	Price
4*	4*	Doesn't fit (online shoppers)
4*	4*	Product quality

* The difference in frequency of mentions about size and product quality wasn't statistically significant

Customers are excited to shop this holiday season—and many have



33% claim to have finished their holiday shopping at the end of October

The Net Promoter Score® is derived by asking consumers, "On a scale of zero to 10, how likely would you be to recommend this company (or this product) to friends and colleagues?" Ratings of 9 or 10 indicate promoters; 7 and 8, passives; and zero through 6, detractors. The score is the percentage of promoters minus the percentage of detractors.

APPENDIX

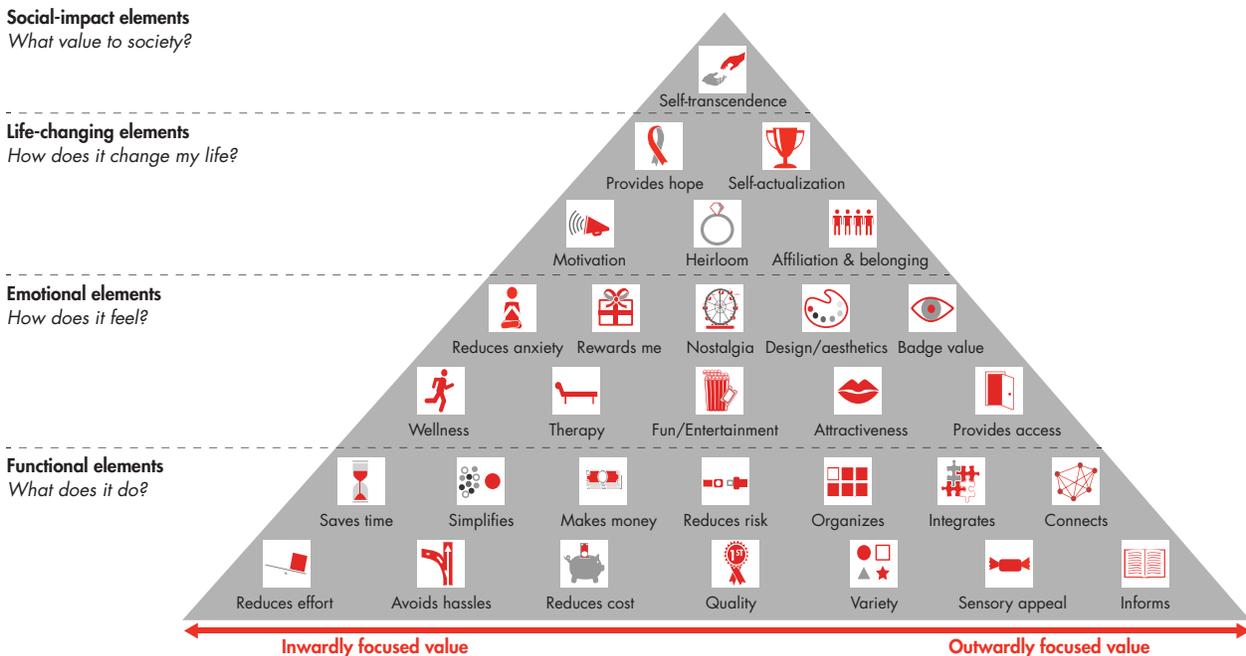
Exhibit 1: Amazon Prime has significant benefits beyond free two-day shipping

Amazon Prime: Estimated 40 million to 60 million Prime members (\$99/year* after a 30-day trial)			
Lowest psychological barrier to purchasing	Offers compelling value proposition, based solely on nonshipping services		
Unlimited free shipping	Digital content	Access to e-books	Other benefits
<ul style="list-style-type: none"> • Free two-day shipping on millions of items; no minimum order • Free same-day delivery when available • Prime Now two-hour delivery where available • Promotional credit for choosing No-Rush Delivery • Share shipping benefits with up to two adults living in the same household 	<ul style="list-style-type: none"> • Prime Video: unlimited streaming movies and TV shows; an alternative to Netflix • Prime Music: unlimited streaming music; an alternative to Spotify • Twitch Prime: content for gamers 	<ul style="list-style-type: none"> • Prime Reading allows users to “borrow” books and magazines • Audible allows access to audio book content • One free “Kindle First” prerelease book each month 	<ul style="list-style-type: none"> • Prime Photo: unlimited photo storage • Prime Pantry: discounts on bulk goods • Prime Early Access: early access to lightning deals • Access to Amazon Elements and Amazon Restaurants with free food delivery

*Amazon also offers a monthly subscription for \$10.99 per month

Sources: Amazon’s website and press releases; Cantor Fitzgerald; RBC Capital Markets; Piper Jaffray; Cowen and Company; Morgan Stanley; JMP

Exhibit 2: Consumers perceive 30 elements of value



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Exhibit 3: Various tactics can influence price perception



Source: Bain & Company

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360pi

Retail analytics company 360pi helps top retailers and brands make smarter product and pricing decisions with real-time insight about who is selling what, where, when and for how much. This intelligence helps its clients offer the right products at the right price and time. For more information, visit 360pi.com.

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