2014 BDO USA, LLP
RETAIL COMPASS SURVEY OF CFOs

RETAILERS PROJECT PROMISING 2014 GROWTH FUELED BY E-COMMERCE

Despite ongoing market uncertainty and a tepid start to 2014, retail chief financial officers are feeling more confident about the state of the consumer.

This January, we surveyed 100 retail chief financial officers (CFOs) for our annual ***Retail Compass Survey of CFOs***, and we found that most remain optimistic about the state of the consumer and the health of the industry overall in 2014. Markets wavered throughout much of January and February, but stronger-than-expected February job gains and improving weather should help convince the Federal Reserve to continue reducing its monthly bond buying in March. These developments could also help realign actual sales growth with the sunnier forecast offered by CFOs in our survey this year: They project a 5.1 percent increase in total sales in the year ahead, a solid increase from last year's expected 3.2 percent gain, and slightly higher than the National Retail Federation's 4.1 percent expected increase. Similarly, CFOs anticipate 4.8 percent growth in comparable store sales this year, compared to 2.3 percent in 2013.

Behind these upbeat sales projections are brighter expectations around the stability of consumer confidence throughout the rest of the year. Digital retail channels should also help accelerate growth this year as e-commerce and m-commerce further establish their presence as mainstays of this increasingly competitive industry.

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THE BDO RETAIL COMPASS SURVEY OF CFOs is a national telephone survey conducted by Market Measurement, Inc., an independent market research consulting firm, whose executive interviewers spoke directly with chief financial officers. The survey was conducted within a scientifically developed, pure random sample of the nation's leading retailers. The retailers in the study were among the largest in the country. The seventh annual survey was conducted in January of 2014.

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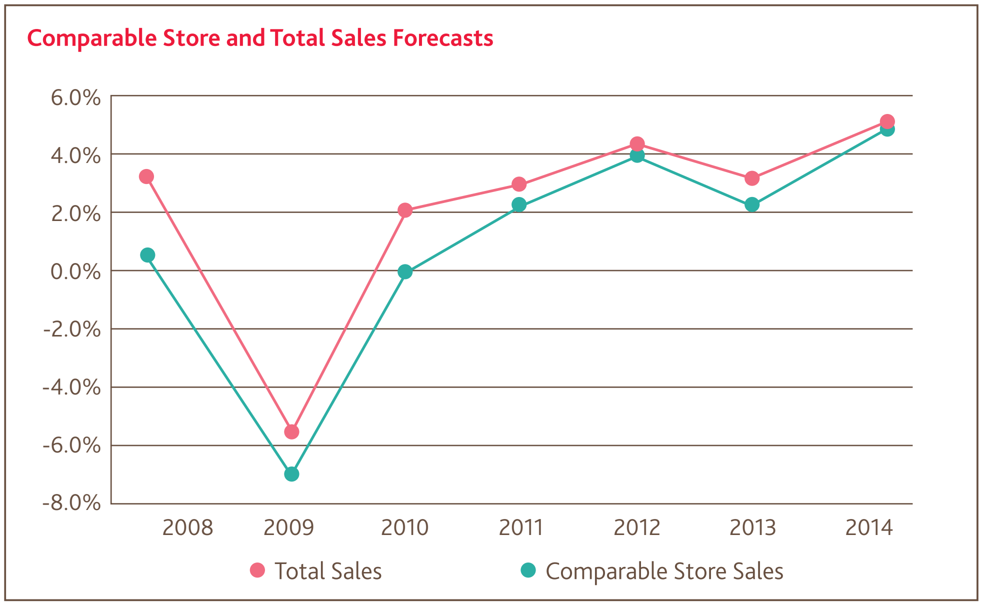
"While high-level concerns remain about unemployment and financial market volatility due to the Fed's pullback, they appear to be offset by the housing market recovery and less concern over Washington gridlock," said Doug Hart, partner in the Retail and Consumer Products practice at BDO. "Retailers are feeling relatively bullish about 2014 sales overall, and are hoping that those factors will help boost consumer confidence in the coming year."



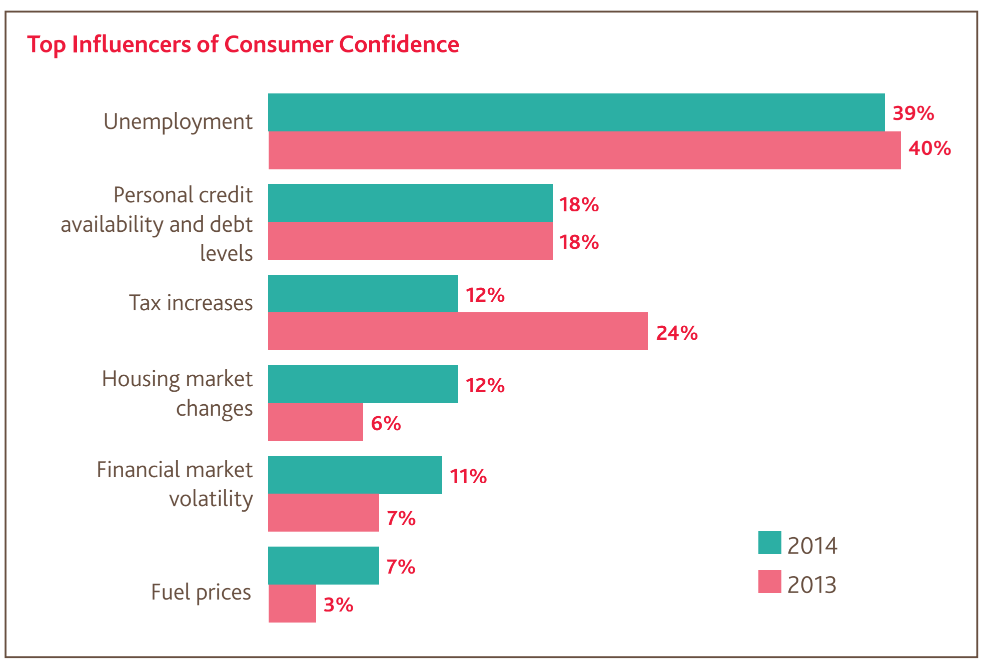
▶ONLINE SALES WILL CONTINUE TO GROW, BUT WILL DECELERATE SLIGHTLY

Mobile and online sales will continue to drive growth for retailers in 2014, but now that e-commerce has firmly taken root in the industry, growth is beginning to stabilize. A majority (64 percent) of retail CFOs expect that online sales will grow in the year ahead, representing a modest decline from the number of CFOs expressing similar sentiments last year (74 percent). At the same time, 34 percent anticipate that their online sales will remain consistent with last year, up 62 percent from 2013. Despite this realignment, however, retailers are confident that e-commerce will remain a profitable channel in 2014: They project 8.2 percent growth in online sales this year.

▶TEMPERED OPTIMISM AROUND CONSUMER CONFIDENCE AS WORRIES OVER TAXES DECLINE OVERALL

Consumer confidence levels vacillated throughout the first three quarters of 2013 and plunged briefly during the fall as a result of the government shutdown. But they have since recovered to 78.1 in February, marking a significant uptick since November, when a pessimistic labor outlook pushed the Index down to a seven-month low of 70.4, according to the Conference Board. Looking to the year ahead, a majority of retailers (56 percent) say that they expect consumer confidence will increase. Still, retailers remain wary of obstacles to growth, particularly a weak jobs outlook.

Job creation across sectors continues to be sluggish; as a result, a plurality (39 percent) of retail CFOs cite unemployment as the top factor influencing consumer confidence in 2014. Personal credit availability and debt levels (18 percent) also continue to place pressure on consumers, and are collectively the second most-frequently cited factor by CFOs. These numbers remain consistent with last year's survey, when a combined 58 percent cited unemployment and personal credit/debt availability as leading influencers of consumer confidence. CFOs share this concern as well: About three-quarters of those surveyed expect to face difficulty refinancing their debt in the coming year. However, with the political climate surrounding the federal budget stabilizing after a contentious 2013, CFOs are less concerned overall about the impact of tax changes on the consumer: This year, only 12 percent say that tax increases will be the top influencer of consumer confidence, a 50 percent decrease from 2013.



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▶DIGITAL OPPORTUNITIES DRIVE GROWTH STRATEGIES AND CAPITAL INVESTMENT

In their attempt to capitalize on future digital sales growth, 34 percent of CFOs say that their primary growth strategy focuses on developing their e-commerce and mobile commerce platforms in order to streamline and integrate multiple channels and compete with major players like Amazon. Along with e-commerce and mobile commerce, CFOs are also improving their merchandise assortment (28 percent) and expanding within the U.S. (24 percent) to achieve growth in the year ahead.

With digital growth comes risk, and CFOs are planning accordingly. Following recent, high-profile data security breaches at Target and Neiman Marcus, it's no surprise that a plurality of CFOs (27 percent) say they will invest the most capital in 2014 in IT systems and technology. However, retailers' risk management strategies will not deter their pursuit of online growth. Eighteen percent of CFOs plan to invest the most capital in e-commerce channels, and 12 percent say that mobile application development will encompass their largest investment, with a full 40 percent planning to increase spending on mobile over 2013 levels. Retailers are increasingly attempting to engage the 63 percent of Americans that now own smartphones, and companies such as Nordstrom are investing considerably to revamp their mobile and online platforms this year and better stay in front of these consumers.

"E-commerce and m-commerce both soared to new heights in 2013, and retailers largely expect these platforms to keep delivering big returns in the year ahead," said Natalie Kotlyar, partner in the Retail and Consumer Products practice at BDO. "But retailers must continue to invest across channels in order to deliver a safe, seamless and efficient experience for shoppers. All the moving parts—mobile apps, websites, supply chain IT systems, brick-and-mortar—need to be carefully coordinated for companies to hold their own in this fiercely competitive landscape."

▶RETAILERS MAINTAIN DOMESTIC FOCUS

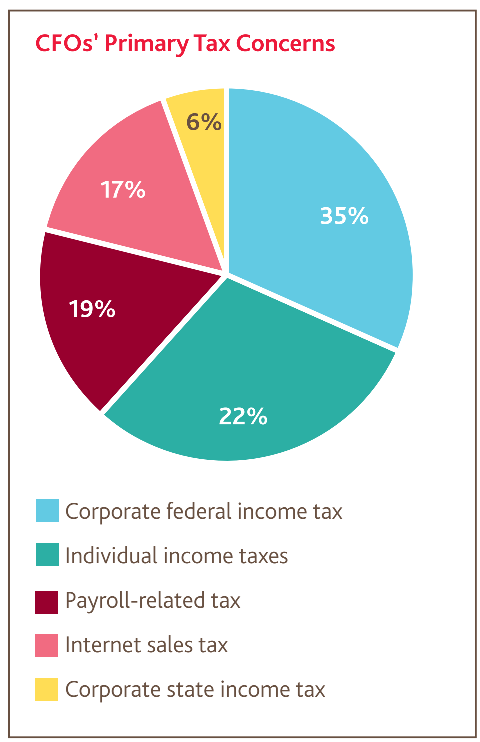
Several of the largest U.S. retailers, including Target and Wal-Mart, have faced challenges enacting their plans for international expansion over the past two years. Wal-Mart continues to struggle to establish its presence in China, while Target has encountered roadblocks expanding into Canada, such as inconsistent inventory availability, poor merchandise assortment and customer concerns over pricing.

On the heels of these headlines, only 29 percent of CFOs say that they plan to expand internationally in 2014. Challenges associated with international expansion have proven difficult to manage, as customer loyalty to local brands can stonewall foreign brands' penetration in some markets. Additionally, intangibles surrounding market scope and brand awareness can lead to unforeseen issues of scale when retailers open up shop overseas, which can make long-term success elusive. As a result, many are opting to stabilize their domestic operations to stay competitive locally, while also bolstering their e-commerce channels in order to reach the growing pool of global online shoppers.

When it comes to sourcing opportunities, however, CFOs are interested in both domestic and international operations: 39 percent of retailers find Asia to be the most attractive region, but as rising manufacturing costs begin to strip Asia of its competitive advantage, 30 percent of CFOs indicate that they are primarily focused on leveraging sourcing opportunities at home, which may offer a glimpse of optimism for job growth in the U.S. in the year ahead.

▶DISAGREEMENT AMONGST RETAILERS OVER TAX CONCERNS

As retailers look to improve margins and cut costs in this increasingly competitive environment, a plurality of CFOs (35 percent) are primarily worried about corporate federal income tax and its impact on their bottom line. The relatively high U.S. corporate tax rate, along with the various methods that many corporations use to reduce their tax liability, remain significant issues in Washington, and their immediate impact on earnings will stay top of mind for retailers in 2014 as Congress continues to debate the tax code. Meanwhile, as retailers stay cognizant of their customers' disposable income levels, individual income tax remains a concern for 22 percent of respondents, and payroll-related tax comes in at 19 percent.



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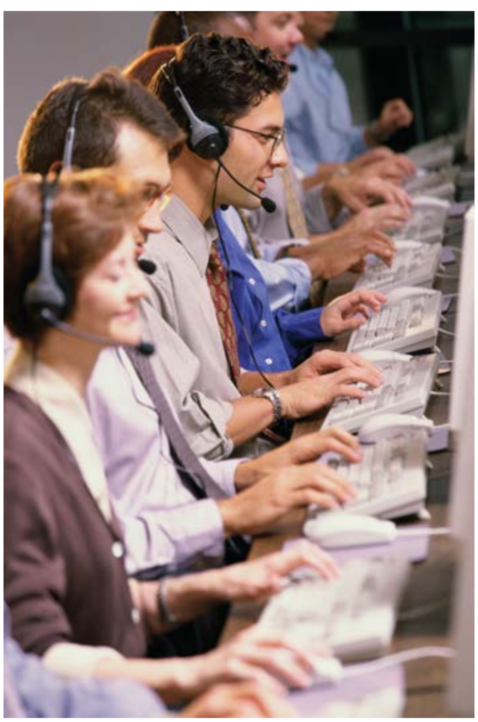
Concerns over Internet sales tax (cited as a top tax challenge by 17 percent of CFOs) remain subdued overall. When asked to what extent their business would be impacted if the Marketplace Fairness Act were to pass this year, more than half say that they would expect minimal impact. Only 9 percent of CFOs expect a decline in e-commerce if the bill were enacted, while 19 percent anticipate that it would increase the cost of the systems they use to track and report sales.

▶REGULATIONS IMPACTING RETAIL EMPLOYMENT

With growth on the horizon, retailers are taking a close look at how employment levels support their business goals. While a majority of CFOs (55 percent) say that the number of employees at their firm will stay about the same this year, a notable 40 percent say they will increase headcount, despite reports of staff layoffs and a shrinking of retailers' brick-and-mortar presences. In particular, major retailers including Staples and RadioShack are planning store closings in the months ahead, while Macy's also anticipates layoffs. This suggests that where retailers may not be hiring to support their in-store operations, they may be looking to bolster their e-commerce capabilities, such as online customer support and shipment fulfillment capacity.



Retailers are similarly split when it comes to compensation levels, with 46 percent expecting average compensation per employee will increase and 54 percent saying it will stay about the same. With a plurality (37 percent) of CFOs citing federal, state and local regulations as a top risk in the coming year, it appears that retailers are trying to strike a balance between creating an employee base to support their growth while managing increased regulatory burdens. Actual and potential regulatory changes, such as the implementation of the Affordable Care Act and debates around minimum wage, may continue to impact retailers and their hiring plans in the coming year.

Meanwhile, as retailers attempt to attract and retain top leaders to guide their organizations, 46 percent of CFOs anticipate that executive compensation will grow this year—a jump from last year, when only 30 percent expected pay increases. According to the 2013 BDO 600 Director Compensation Survey, compensation in the industry jumped 6 percent from 2012 to 2013. This increase likely signifies the fact that retailers remain attentive about the need to leverage incentives in order to maintain the most innovative and nimble leaders as consolidation and new technologies spur changes throughout the industry. The remaining 54 percent of CFOs believe that compensation levels will remain about the same in 2014.

▶CONSOLIDATION AND GREATER COMPETITION TO FUEL EXTENSIVE DEAL ACTIVITY

The retail industry is poised for another year of vibrant deal activity, as an overwhelming majority of CFOs (96 percent) expect M&A activity to increase or remain consistent with 2013 levels in the coming year. These expectations follow a robust year for mergers and acquisitions. Though the total number of U.S. retail and consumer products deals fell last year from 2012 levels, total deal value grew by 26 percent to about $176 billion, according to S&P Capital IQ. Two-thirds of CFOs anticipate that the majority of deal activity will occur in the United States, followed distantly by Asia-Pacific (17 percent) and Europe (8 percent). Survey respondents also project that potential buyers can expect to see an average EBITDA multiple of 4.24, down slightly from last year's projection of 5.15.

The driving forces behind the expected increase in transactions are consolidation and fierce competition in the sector—which about one-third of CFOs cited as a leading risk to their business. With several noteworthy deals either closing or in the works, including Office Depot's merger with Office Max and the recent $1.8 billion purchase of Jos. A. Bank by Men's Wearhouse, retailers are under increasing pressure to grow their offerings. Some choose to do so by pursuing mergers or acquisitions of their own. Just over half of CFOs surveyed say that strategic buyers, as opposed to financial buyers, will propel M&A activity in 2014, and a plurality (42 percent) cite increasing market share as the main impetus behind deal activity.

"There's an increased willingness to spend from consumers. But retailers realize that their customers are still price-conscious in 2014, so they need to meet consumer demands around convenience, product assortment and low prices," said Ted Vaughan, partner in the Retail and Consumer Products practice at BDO. "Pursuing an acquisition is one strategy to manage these pressures. Many retailers see it as a way to add capabilities or grow their geographic reach, while others hope to build market share by joining forces with a once-competitor."

▶CFOs PREDICT DECLINE IN IPOS FOLLOWING BANNER YEAR

There is no doubt that 2013 was a record year for retail and consumer products public offerings, with Renaissance Capital reporting 19 initial public offerings (IPOs) yielding $8.3 billion in proceeds. The strong performance saw an average overall return of 41 percent, and four retail chains in particular doubled their IPO price since going public in 2013:

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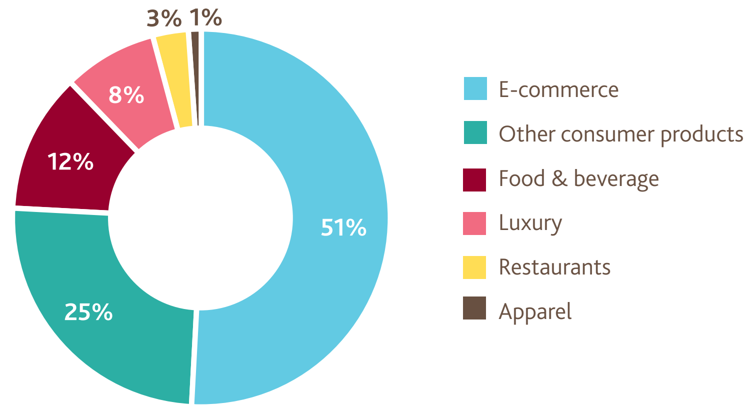
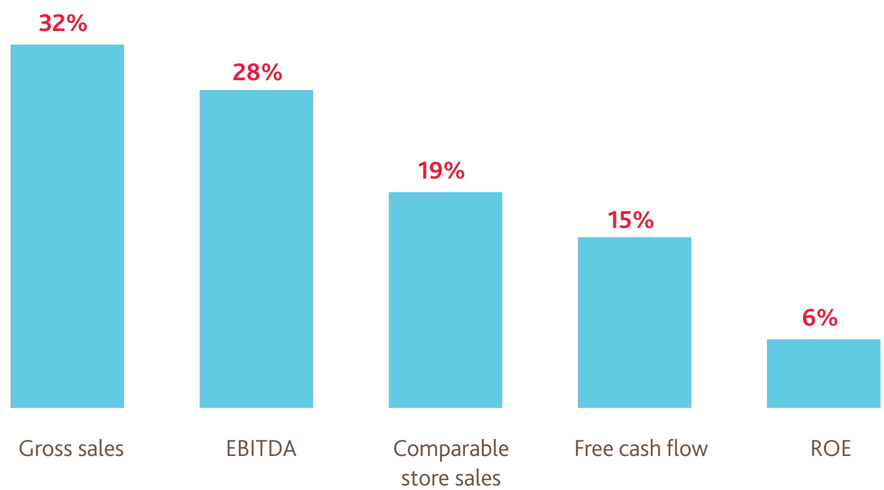
Container Store, Potbelly, Noodles & Co and Sprouts. Retail CFOs have decidedly mixed sentiments about whether the industry can sustain this pace: A majority (58 percent) anticipate that the number of offerings will decline in 2014 as the IPO environment right-sizes.

However, some CFOs believe that last year's positive momentum will continue this year, with 33 percent projecting an increase, more than double the number who did so in 2012. Overall, about half expect that the majority of IPOs will occur in the e-commerce sector, followed by non-food and beverage consumer products (25 percent) and food and beverage (12 percent). Similar to last year, a plurality (35 percent) indicate that the strength of the U.S. economy and stock market will be the most important driver of a company's ability to go public this year.

Which Sectors Will See the Most IPO Activity?



Priority Financial Metrics



▶SALES REMAIN PRIORITY FINANCIAL METRIC

Sales continue to be a key measurement against which the retail industry assesses performance. As a result, a majority (51 percent) of CFOs cite it as their primary financial metric, with 32 percent specifically pointing to gross sales and 19 percent pointing to comparable store sales. These numbers remain broadly consistent with last year's survey, when 35 percent and 18 percent of CFOs cited gross sales and comparable store sales, respectively, as their main focus.

▶ONLINE PROMOTIONS OUTPERFORM OTHER TACTICS FOR THE HOLIDAYS

Holiday season sales can pull in anywhere from 20 to 40 percent of total annual sales for some retailers, and after a frustrating 2013 season overall, many companies are already mulling over the best strategies for 2014's holiday rush. As Thanksgiving was particularly late in 2013, this past season was shorter and more competitive, leading to heavy discounting that took a toll on some retailers' margins. When asked about which promotion strategies worked well this past season, CFOs indicate that online promotions that added convenience for shoppers were the top performers. Retailers cite free shipping (28 percent) and email and social media promotions (24 percent) as the most successful promotions, with extended hours (40 percent) and price-matching (20 percent) noted as the least successful tactics. For some retailers, price-matching policies may have helped drive holiday sales, but they also contributed to compressed margins that have caused some stores to adjust earnings expectations.

Overall, retail CFOs maintain an optimistic outlook for 2014. With the economy slowly but steadily improving, consumer confidence should continue to stabilize over the months ahead. Coupled with further digital growth and investment, retailers expect these forces to propel stronger sales throughout the year. Still, heightened competition and consolidation, along with uncertainty around regulations and market stability, require retailers to maintain a nimble stance and proactive focus in order to stay ahead of the pack in the current environment.

ABOUT THE RETAIL AND CONSUMER PRODUCTS PRACTICE AT BDO USA, LLP

BDO has been a valued business advisor to retail and consumer product companies for over 100 years. The firm works with a wide variety of retail clients, ranging from multinational Fortune 500 corporations to more entrepreneurial businesses, on myriad accounting, tax and other financial issues.

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