2017 BDO RETAIL RISKFACTOR REPORT

2017 BDO Retail RiskFactor Report

Disrupted by technology, slowing foot traffic and consumers' evolving tastes, retailers are hustling to keep up with swift changes driven by industry modernization and broader economic forces. If you follow the headlines, the outlook can seem bleak.

To be sure, there are complex business issues to navigate: Retailers are scaling back their headcount amid slow sales and reporting challenges with competition from peers and agile e-commerce platforms in earnings reports. But the ***2017 BDO Retail RiskFactor Report*** reveals that today's largest retailers are weighing their challenges and adapting accordingly.

"Retailers' top risks show their eyes are wide open to the new wave of emerging and evolving risks, from widespread store closures and bankruptcies, to uncertain regulatory changes and mass digital disruption and its associated security threats. While awareness is a key first step, retailers' proactive responses to these vulnerabilities will ultimately determine their fate."

Jennifer Valdivia, partner in BDO's Consumer Business practice

The ***2017 BDO Retail RiskFactor Report*** examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. retail companies; the factors are analyzed and ranked by order of frequency cited.

ABOUT THE BDO CONSUMER BUSINESS PRACTICE

BDO has been a valued business advisor to consumer business 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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Top 20 Risk Factors

cited by 100 largest publicly traded U.S. retailers

RISK FACTOR CITED IN 10-K FILING	2017		2016		2015	
General Economic Conditions	#1	100%	#1	100%	#1	100%
Security Breaches	#1t	100%	#1t	100%	#4	99%
Federal, State and/or Local Regulations	#1t	100%	#4	96%	#1t	100%
Industry Competition and Consolidation	#4	99%	#3	98%	#1t	100%
Suppliers and Vendors	#4t	99%	#6	93%	#6	98%
Labor	#6	98%	#9	91%	#7	96%
Natural Disasters, Terrorism and Geo-Political Events	#6t	98%	#5	94%	#7t	96%
Legal Proceedings, Litigation	#8	97%	#6t	93%	#9	95%
Implementation and Maintenance of IT Systems	#8t	97%	#6t	93%	#4t	99%
Credit Markets/Availability of Financing and Company Indebtedness	#8t	97%	#13	85%	#11	94%
Dependence on Consumer Trends, Client Demand	#11	93%	#11	88%	#9t	95%
Consumer Confidence and Spending	#12	90%	#12	87%	#15	89%
International Operations	#13	89%	#16	73%	#17	86%
Loss of Key Management, New Leadership	#14	85%	#16	73%	#19	80%
Impediments to U.S. Expansion and Growth	#15	84%	#10	90%	#12	92%
Marketing, Advertising, Promotions, Public Relations	#16	83%	#18	66%	#25	68%
Failure to Properly Execute Business Strategy	#17	80%	#14	82%	#12t	92%
U.S. Accounting Standards and Regulations, Internal Controls	#18	76%	#15	76%	#14	90%
Cost and Reliability of Insurance	#19	74%	#22	59%	#20	77%
Intellectual Property Rights, Trademarks	#20	70%	#28	50%	#22	72%

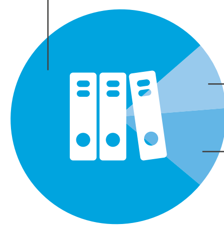
**t indicates a tie in the rankings*

TRUMP MOVES RAISE REGULATORY FLAGS

With a median 10-K filing date of March 1, 2017, nearly six weeks after President Donald J. Trump's inauguration, 16 percent of retailers specifically cite concerns around the new administration. Overall, federal, state and local regulations are tied for the #1 risk, as retailers consider existing and anticipated regulatory and compliance requirements across business functions.

44% cite concerns around potential **border tax**

36% list **FCPA** as a risk factor



76% reference **U.S. accounting rule changes, internal controls and financial reporting risks**

12% are concerned about **Revenue Recognition standards**

10% cite the new **Lease Accounting standards** as a risk

RETAILERS ON CYBER REGULATION WATCH

The industry is no stranger to cybersecurity risks, as hackers have long been targeting retailers' systems. As companies grow more knowledgeable about their unique vulnerabilities and are increasingly held accountable for safeguarding sensitive data, they anticipate more cybersecurity guidance from regulators.

100% of retailers cite **cybersecurity** for the second year in a row

78% point to risks associated with **data privacy and security regulations**

30% name **Payment Card Industry standards and EMV compliance** as a concern

CLICKS OUTPACE BRICKS: PHYSICAL STORES ON SHAKY GROUND

Retail space overcapacity is a pressing issue. As e-commerce continues to accelerate, the pressure is on for retailers to reassess and optimize their real estate portfolios.

Owning and leasing real estate ranked as **risk #21**, up from #25 in 2016 and #36 in 2015

76% of retail REITs point to the **growth of e-commerce** as a threat, according to the *2017 RiskFactor Report for REITs*

44% cite risks associated with **mall traffic and competition for prime commercial real estate**

LABORING OVER LABOR OBSTACLES

Overall, job gains have averaged 185,000 over the first four months of 2017, in line with the first four months of 2016, according to the Bureau of Labor Statistics. On the other hand, widespread store closures have led to job losses in the industry, including 6,100 retail jobs in May.

AMONG THE 98% OF RETAILERS WHO CITE LABOR CONCERNS AS POTENTIAL RISKS:

49%
point to **minimum wage** increases

85%
are concerned about the **loss of key management or new leadership**, up from 73% last year

58%
cite **healthcare reform and benefits** risks

RELIANCE ON DISCRETIONARY SPENDING INCITES RISK

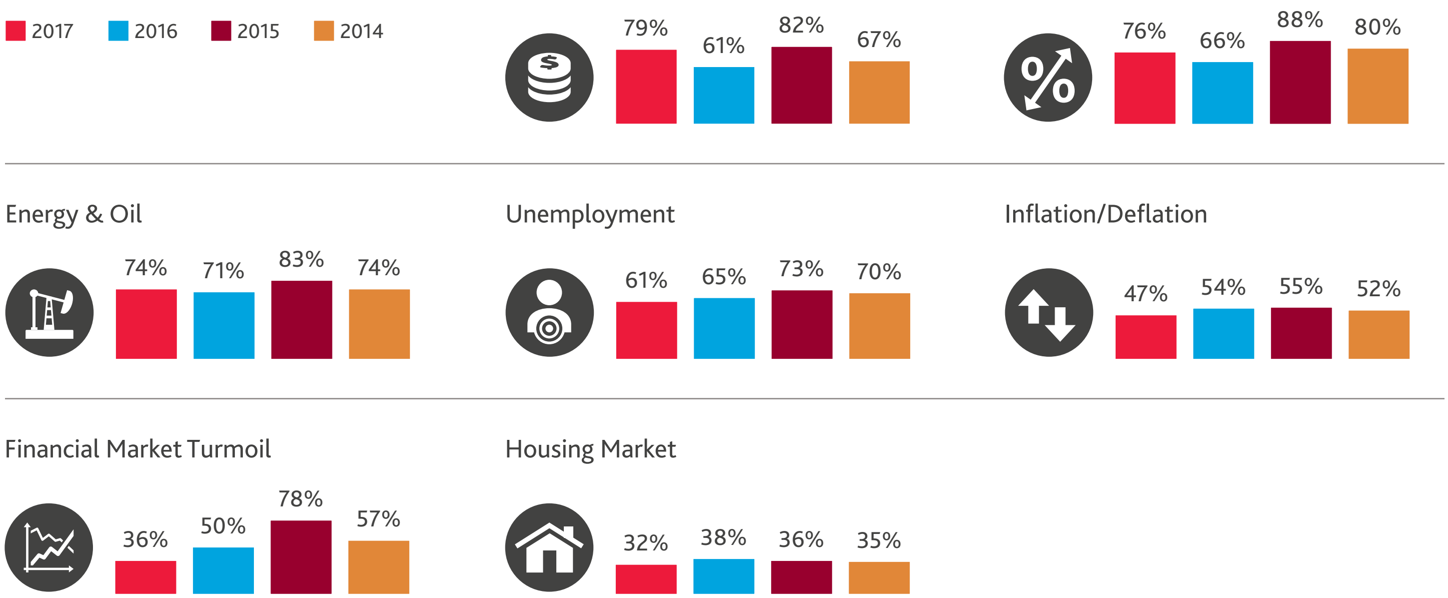
Understanding the factors that underlie consumer spending is critical to success. Consumer confidence remains strong, but retailers are closely monitoring general economic conditions that could have a destabilizing effect.

100%
cite **general economic conditions** as a top risk for the 9th consecutive year

90%
cite **consumer spending** concerns

65%
identify risks associated with **changing internet trends and retailers' e-commerce initiatives**

CHIEF ECONOMIC RISKS

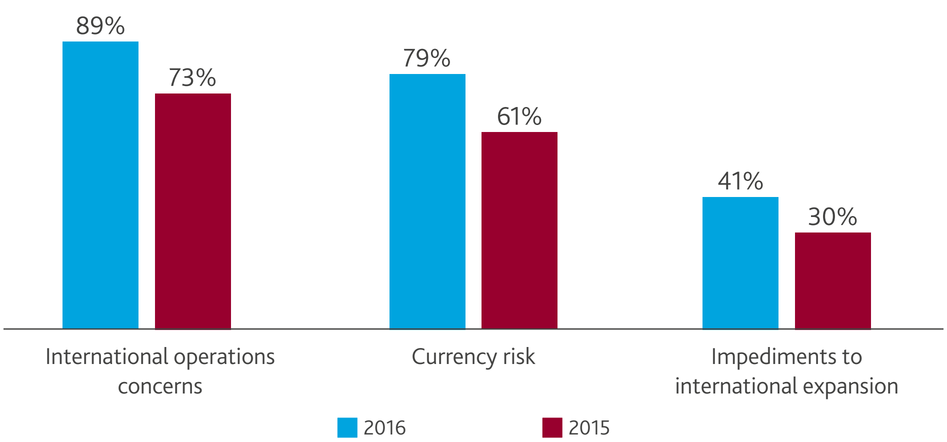


SPOTLIGHT

Navigating Risk Overseas Amid Geopolitical Change

Since the beginning of 2017, the effects of Brexit, the French election, potential U.S. import and trade policy changes and other geopolitical events have been under a global microscope—and retailers are glued to the lens. Whether by virtue of their physical store locations, supply chains or e-commerce sales, nearly all retail players are exposed to some degree of international risk. This year, 89 percent of retailers cite international operations risks as a potential impediment to their business in their 10-K filings, up from 73 percent last year. Meanwhile, more retailers are wary about expanding their global footprints this year, as the pace of store closures accelerates domestically and abroad.

INTERNATIONAL RISKS ESCALATE



22% of retailers cite **Brexit** in their 10-Ks, 95% of which have UK operations

“The most telling sign we’re seeing in the UK is that businesses aren’t panicking. They are keeping abreast of new developments as the process unfolds and being proactive in addressing associated challenges and opportunities. In most cases, this translates to taking lower risk approaches. U.S. retailers—whether they have a UK arm, are sourcing from or exporting to the UK—would be prudent to follow suit.”

Stuart Lisle, tax partner with BDO UK

Concern about the impact of Brexit was specifically named by one in four retailers that cited global operations risks more broadly, or 22 percent of all retailers included in the analysis. Among the companies that cited Brexit as a risk in their 10-Ks, 95 percent have UK operations. In the immediate aftermath of the vote, both the UK and U.S. experienced currency volatility, a risk which remains top of mind for 79 percent of retailers, compared to 61 percent last year.

The long-term picture remains uncertain as the UK negotiates the terms of its withdrawal from the European Union, and as the potential for a “Soft Brexit” came to light after the Parliamentary election in June. Still, Prime Minister Theresa May’s trigger of Article 50 of the Lisbon Treaty at the end of March formally set UK’s divorce from the EU in motion and initiated a two-year limit to finalize negotiations…The clock is ticking.

The unprecedented move has retailers re-evaluating their workforce strategies, as Brexit may mean the end of EU free movement and the subsequent loss of non-UK workers. Without free trade with the EU, an increase in cost of goods purchased overseas is also likely, which would require UK arms of U.S. retailers to offset higher prices by either passing them on to consumers or absorbing losses.

However, until the terms of Brexit are agreed upon—and the extent to which Britain is authorized to participate in the EU single market is made clear—it’s largely business as usual for the retail sector.

Almost all (99 percent) retailers cited risks associated with suppliers and vendors in the U.S. and internationally. When it comes to international supply chain operations, U.S. retailers are gearing up for potential disruption driven by trade policy changes and proposed tax reform plans to encourage U.S.-based manufacturing. With a median 10-K filing date of March 1, 2017, nearly six weeks after President Donald J. Trump’s inauguration, just under half (44 percent) of retailers alluded to concerns about a potential **destination-basis tax system** with border adjustments. Specifically, companies wrote that significant changes in tax or trade policies, tariffs or trade relations between the U.S. and other countries, such as the disallowance of tax deductions for imported merchandise, could result in significant cost increases and limited access to suppliers.

The absence of the border tax adjustment from the initial White House tax plan raises questions about whether it will ultimately come to fruition. But import/export controls and other potential trade policies aren’t the only regulations that present compliance challenges for retailers that function overseas. International relationships also expose U.S. retailers to risks around the Foreign Corrupt Practices Act, which was cited in more than one-third (36 percent) of the 10-Ks analyzed.

Beyond the clear-cut regulatory lines that retailers must walk, conducting business abroad opens the door to more intangible vulnerabilities, from acceptance of products and offerings in local markets to adapting to local business customs.

The lure of globalization is compelling as retailers seek growth and diversification, but success abroad varies widely. Looking ahead, businesses will need to strike a careful balance between the risks and rewards of operating overseas, along with political currents drifting toward national trends and interests at home.

44%

of retailers cite risks related to potential border-adjustment tax in their 10-Ks

SPOTLIGHT

Retail Real Estate: Time to Return for a Better Fit?

News of store closures and the mass move online has already created big changes for traditional retailers. As the industry's evolution continues to make headlines, retail real estate is seeing something of a revolution. The battle cry? Right-size, reimagine and refocus.

According to data provided by CNBC, the shift is overdue: The U.S. has more retail store space per person than any other country at 7.3 square feet per person. This compares to 1.7 square feet per person in France and Japan. As a result of these challenges and others, the number of retailers citing risks associated with leasing and owning real estate increased by 28 percent this year.

Disappointing same-store sales, rising rents and the e-commerce creep have become retail's Bermuda Triangle. Stores appear to be disappearing on every corner, and retail bankruptcies are being announced at levels not seen since the recession, according to Fitch Ratings. This type of fiscal turmoil threatens credit ratings and financing availability—hazards for businesses looking to diversify.

However, where some see threats and crumble, others find opportunity and thrive. Many traditional retailers are looking to strategic acquisitions to propel their businesses into the digital age. Stores like Walmart are on acquisition sprees, picking up e-commerce brands like Bonobos, Jet.com and ModCloth to bolster their presence online. This type

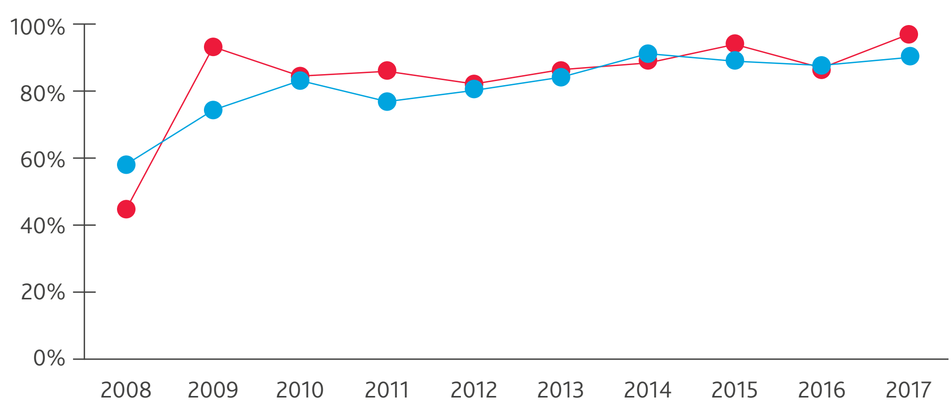
point to **impediments to U.S. expansion,** including real estate

identify risks associated with **owning and leasing real estate**, up from 54%

cite failure to successfully **invest new capital in new stores or projects**, up from 41%

are concerned about **mall traffic and competition for prime real estate**

FINANCIAL MARKET CHALLENGES AND SLOW CONSUMER SPENDING PROVIDE ONE-TWO PUNCH FOR SOME RETAILERS



Risks associated with credit markets/availability of financing and company indebtedness

Risks around consumer confidence and spending

"Traditional retailers must answer some tough questions about their physical presence and model in the year ahead. With consumer confidence yet to translate into significant sales increases, right-sizing and restructuring is a strategic imperative. At the same time, many are facing pressure from mounting debt and more limited opportunities for turnarounds."

David Berliner, leader of BDO's Business Restructuring and Turnaround Services practice

of deal is a win-win for both parties, allowing e-retailers to move offline and into their customers' neighborhoods, while also making Walmart more competitive with Amazon.

LEASE WITH CAUTION

Navigating the online and physical marketplaces is a balancing act that retailers are learning to master, and it's worrisome for their landlords too. Among the 25 retail REITs analyzed in the *2017 BDO RiskFactor Report for REITs*, nearly all (96 percent) cited tenants being unable to pay rent as a risk to their businesses, closely followed by falling rental rates at 92 percent. As a result of a retail landscape in flux, companies are experimenting with opting online entirely, or opening temporary pop-up shops to avoid committing to long-term leases. This leaves retailers free to provide in-store experiences to consumers, but poses challenges for building owners.

While e-commerce growth presents a challenge to store profitability and retail REITs, we may soon see more leasing activity from e-commerce players. According to a report by L2, a majority of venture-backed "pure-play" e-retailers raise funds with the intention of building physical stores. Warby Parker announced in late 2016 that the company intended to significantly expand its brick-and-mortar presence in the coming year. In addition, prior to its acquisition by Walmart, online menswear shop Bonobos shared that the business envisioned opening at least 100 stores by 2020.

THREATS TO RETAIL REITS*

96% Tenant unable to pay rent

92% Rental rates falling

72% Loss of an anchor tenant

**According to BDO's RiskFactor Report for REITs*

Perhaps most telling of this trend are Amazon's moves to open a variety of retail locations—from bookstores to grocery—punctuated by its recent acquisition of Whole Foods..

DON'T DISCOUNT LEASE ACCOUNTING

While some industry players are grappling with disruptions to their store presence and business strategy, all companies have a common thread in that they will soon be required to adjust their balance sheets to the Financial Accounting Standards Board's new guidance on lease accounting, Accounting Standards Update (ASU) 2016-02. Though the standard will touch many industries, it will place a greater burden on retailers. With a looming deadline—financial statements released after December 15, 2019, for public companies with an additional one year for private companies—one in 10 retailers cited lease accounting as a risk to business.

To prepare, lessees and lessors will need to implement lease classification changes that will likely impact portfolios and fiscal planning. Lessees will be required to record a right-of-use (ROU) asset and lease liability on balance sheets for all leases with terms longer than 12 months. Lease classification then determines the pattern of expense recognition. The International Accounting Standards Board estimates that roughly $3.8 trillion will be added to balance sheets across industries, with the retail industry seeing significant changes given their reliance on leasing.

Gearing up for implementation, retailers should evaluate how the standard will impact key performance metrics and ensure investors and stakeholders are educated about the change to financial reporting and their real estate and management strategy. More broadly, given the challenging dynamics with real estate, we expect retail leaders and boards of directors will be closely examining store and leasing strategies in the year ahead to optimize their presence and portfolio.

"The retail industry is struggling between overstoring and itching to expand. In a world of omnichannel retailing, companies need to take a hard look at their brick-and-mortar store portfolio and understand exactly how to position those stores for success. Those looking to optimize their portfolio should act consistently and transparently, with well-defined parameters on which stores they plan to remodel, relocate or close. It's also important they start playing the long game when it comes to real estate and understand that adding stores isn't the only way to grow."

Michael Pappas, leader of BDO's Corporate Real Estate Advisory practice

SPOTLIGHT

Retailers Balance E-commerce Model with Data Security Concerns

The e-commerce model, promising as it may be, carries enormous risk for retailers and consumers alike. Consumers entrust their financial and personal information when they make purchases both in-store and online, thereby tasking retailers with securing data spread across multiple digital platforms.

Our study reflects the weight of this process, as 100 percent of retailers cited risks associated with possible security breaches in their most recent 10-Ks. In specific terms, these businesses are concerned with the potential release of confidential customer, employee and corporate information, which could be exploited for identity fraud, financial theft or brand reputation damage.

When cyberattacks occur, retailers not only have to answer to their consumers and employees, but they are also increasingly held accountable by regulators. The majority of retailers (78 percent) cite concerns about data privacy and security regulations in their 10-Ks this year, in line with the results of BDO's 2017 Retail Compass Survey of CFOs, which found that 70 percent of retail CFOs anticipate heightened

100% cite **cybersecurity risk** for the 2nd consecutive year

78% list concerns around **data privacy regulation**

cybersecurity regulations through 2017. The Trump administration recently enacted cybersecurity regulation to clarify the federal government's role in cyber risk management, and states such as New York are working to more clearly define data privacy guidelines for various industries.

Retailers can protect data and minimize regulatory scrutiny by organizing employee training programs and creating coordinated incident response plans. Should regulators come knocking at retailers' doors, having a thoughtfully developed, communicated and audited plan is a much stronger defense than simply delegating full responsibility to the IT department.

A CHIP ON RETAIL'S SHOULDER

Since credit cards are a primary method of payment for consumers, retailers also face pressure from the payment card industry (PCI) to strengthen their cybersecurity, including working to ensure Europay, MasterCard and Visa (EMV) compliance. This year, 30 percent of retailers cited PCI standards and EMV compliance as a potential risk to their

"Retailers should not let the fear of data breaches prevent them from establishing robust omnichannel presences. They should, however, be aware of their unique digital vulnerabilities and implement strategies to safeguard the information of their employees, customers and business. Retailers can protect their bottom line and reputation by assessing their unique risks, designing a cyber security program that addresses those specific risks using a thoughtfully constructed program of security controls, policies and procedures, data breach insurance and supply chain risk management across all functional areas, and not just credit card data."

Deena Coffman, managing director in BDO Consulting's Technology Advisory Services practice

business. While the Retail Compass Survey of CFOs found that 82 percent of those surveyed in 2017 are EMV-compliant, the proportion of retailers who still see it as a risk reveals how the industry's security standards are maturing as cyber threats evolve.

The economic impact of data breaches is a significant area of concern for retailers. In August 2016, Eddie Bauer reported that approximately 350 of its stores were attacked by ransomware, indicating that customers' credit card data was potentially compromised. This led Eddie Bauer to sponsor a year of free identity protection services for those who made purchases at the store during the time of the attack. It may be difficult for retailers to anticipate a data breach's impact on brand perception and to calculate the influence on stock prices, but they should not underestimate the blunt financial costs of a cyberattack.

Despite the challenges posed by digitization, retailers are still experimenting with new ways to engage customers via technology. According to e-Marketer, Americans will spend 2 hours and 25 minutes per day on mobile apps in 2017, a 10 percent increase from 2016. Today's retailers can connect with customers in more ways than ever before, but this opportunity brings its own unique challenges. In fact, 23 percent of retailers noted concerns around their mobile platforms in their 10-Ks. Contributing to these concerns are issues related to heavy app competition, demands for improved user experience, security challenges and the fact that the number of mobile apps consumers use regularly is dropping.

RETAILERS NAVIGATE A MAZE OF DIGITAL CHANNELS

23%
cite **mobile platform development risks**, compared to 11% in 2016

65%
point to **impediments to e-commerce initiatives**, up from 57% last year

Wariness around risks associated with virtual shopping is also demonstrated by the 65 percent of retailers who noted their concerns about potential impediments to their e-commerce initiatives in their 10-Ks this year, up from 57 percent in 2016. These rising concerns may be driven by the increasingly crowded e-retail space, competitive delivery rates and consumers' changing expectations toward personalized shopping experiences. Flattening in-store sales, however, might leave many retailers with no other choice than to invest in bolstering online sales platforms.

As more consumers' shopping habits and preferences diversify across platforms, retailers face a growing responsibility of protecting millions of Americans' sensitive information. Given this burden, retailers are right to be concerned with their financial and reputational liability. Designing a tailored, penetration-tested cybersecurity program is the first step toward a strong, proactive defense against hackers.

At face value, retail's greatest risks are largely documented in today's challenging headlines. Our closer analysis suggests that retailers are listening to consumers' changing demands and adapting to the sector's rapid shifts while confronting global economic uncertainty, rising cybersecurity threats, physical store closures and rife competition amid e-commerce's dominating sales streak. A comprehensive understanding of these formidable challenges will be the most powerful tool for retailers to thoughtfully shape their business models, engage customers and tackle external issues in the years ahead.

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