

THE NEWSLETTER OF THE BDO RETAIL AND CONSUMER PRODUCTS PRACTICE

CONSUMER BUSINESS COMPASS



2013: READING THE RETAIL TEA LEAVES

By David Berliner, Doug Hart, Alan Sellitti and Stephen Wyss

THE NEW YEAR HAS GOTTEN OFF TO AN UNCERTAIN START FOR RETAILERS.

The fourth quarter of 2012 brought disappointment in the form of natural disaster-induced business interruption, less-than-stellar holiday sales and a drop in previously robust consumer confidence. In late January, retailers received the news that after three quarters of modest growth, the U.S. economy grew only by an extremely conservative 0.1 percent in the final quarter of 2012, significantly below expectations. At the same time, retailers saw mixed same-store sales results. Some retailers, such as Macy's and Kohl's, reported strong gains, while others, including Wal-Mart, saw softer sales. On the consumer confidence side, the housing market — a key indicator of consumer

confidence — began to rebound, but gas prices remained stubbornly high and the payroll tax holiday expired. According to our *2013 Retail Compass Survey of CFOs*, retail executives are hedging their expectations in the midst of all these contradictory signals: they project a 3.2 percent increase in total store sales, down from last year's expected 4.5 percent increase.

How are retailers to read the ambiguous tea leaves and plan for the year ahead? We've identified a few trends that retailers should be keeping an eye on as the year progresses.

▶ DID YOU KNOW...

According to our *2013 BDO Compass Survey of Retail CFOs*, retail executives expect online sales to increase 6.9 percent in the coming year.

Trustwave's 2013 Global Security Report finds that the retail industry was the target of 45 percent of cybercriminal attacks in 2012.

PCWorld reports that mobile payments are expected to total \$1 trillion by 2015.

Restaurant industry job growth reached a 17-year high in 2012, reports the *National Restaurant Association*.

Our recent *IPO Outlook Survey* found that 30 percent of capital markets execs expect retail IPOs to increase in 2013, up from 23 percent in last year's survey.

According to *comScore*, mobile transactions account for 11 percent of e-commerce spending.

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►Continued from page 1

RETAIL TEA LEAVES

►THE "HOLIDAY SEASON" IS BEING REDEFINED

Over the past several years, we've seen the holiday shopping season start earlier and earlier, and now it's started to extend into January. As retailers consider their holiday performance, January can no longer be ignored for two major reasons. First, we are increasingly seeing a dual-polarization of holiday sales: a big burst in sales early in the season, then a slowdown of spending

until post-holiday markdowns. Second, gift cards have become incredibly popular holiday purchases. Gift card purchases are not recognized as revenue until they are redeemed, which means that retailers get a better picture of holiday sales in January when consumers start cashing in their gift cards.

This year, January sales were strong for many retailers and gift cards were likely responsible, at least in part, for the better-than-expected results. As retailers think about their holiday

promotions for 2013, they will be carefully considering January 2014 sales and how they can capitalize on the renewed seasonal momentum.

►CONSUMER CONFIDENCE LIKELY TO REMAIN UNEVEN

The beginning of 2013 saw consumer confidence at a one-year low. Consumers watched nervously as policymakers squabbled over the fiscal cliff, reaching resolution only at the last minute. Part of that deal involved ending the payroll tax holiday that Americans had enjoyed since 2010, and consumers saw their take-home pay decrease starting with the first paycheck of 2013. In addition, higher-income consumers (those making \$400,000 per year or more) saw their taxes go up for the first time in 20 years. While higher-income consumers were able to weather these changes, lower-income consumers felt the crunch acutely: they faced the triple blow of tax increases, higher gas prices and delayed tax refunds. The strong sales results for department stores at the beginning of the year--and the weaker results for chain and discount retailers--reinforce this stratification of consumer confidence.

Yet the Washington debate over the future of U.S. fiscal policy continues. The debt ceiling remains an ongoing thorn in lawmakers' sides, and spending cuts remain contentious. Meanwhile, in his 2013 State of the Union address, the president indicated that he would seek further tax increases on higher-income Americans. Consumers at all income levels are understandably concerned that higher taxes loom on the horizon as policymakers broker deals to avert another economic downturn.

Nevertheless, consumer confidence is often shaped by breathless media coverage and is not always based on firm developments on the ground. Consumers are generally inclined to spend, and it's unlikely that there will be a mass closing of pocketbooks in the coming year. Rather, retailers can expect to see consumer confidence ebb and flow based on how each piece of the fiscal puzzle falls into place against the backdrop of perennial consumer patterns: increased spending around federal holidays, back-to-school shopping and the end-of-year holiday blitz.

PErerspective in Retail & Consumer Products

Private equity investment in the consumer products and services (B2C) industry has waned over the past few years, as consumer spending has been unsteady. According to Pitchbook, aside from 2009, 2012 was one of the slowest years for B2C private equity deal flow in the last decade (2012: 364 deals; 2009: 331 deals), despite a flurry of activity in the fourth quarter spurred by the anticipation of higher tax rates in 2013. However, the retail sector has slowly been recovering its piece of the consumer pie. In 2012, retail accounted for 30 percent of total capital invested in B2C companies, up from just 18 percent in 2011.



Even so, dealmakers do not expect a sudden boom in investment activity in the retail sector anytime soon. According to the fourth annual BDO PErerspective Private Equity Study, only 3 percent of fund managers believe the retail and distribution industry will provide the greatest opportunities for new investments during 2013. That's a slightly less optimistic outlook for the sector than was reported last year, when 6 percent of fund managers identified retail and distribution as the sector that would provide the greatest opportunities for new investments in 2012.

When it comes to pricing considerations, 24 percent of fund managers indicated that the retail and distribution sector is the most likely to experience decreasing valuations in the next 24 months. That's compared to only 3 percent of fund managers who think the sector is the most likely to experience increasing valuations during that time frame. With payroll tax increases hitting shoppers who were already battling tough economic conditions, retailers may have to continue to cut costs, which will increase pressure on margins and impact private equity investment activity.

PErerspective in Retail & Consumer Products is a feature examining the role of private equity in the retail and consumer products industry.

[Read more](#)

►Continued from page 2

RETAIL TEA LEAVES



►OMNICHANNEL IS THE NEW NORMAL

Omnichannel retailing is no longer a buzzword for the industry. Savvy retailers are reorienting their entire sales strategy to ensure a unified, seamless brand experience across multiple channels that appeals to a variety of consumer needs. In a nod to the strategy's growing importance, many retailers are even adding new executive positions dedicated to integrating platforms: Macy's announced in January that it was adding a chief omnichannel officer to its C-suite, and Saks and Belk have made similar moves.

Retailers who already straddle the online-offline divide, including Target, Nordstrom and Macy's, are looking to experiment more across their existing platforms. Many have started offering in-store pickup for items purchased online, and for these retailers, mobile is the next frontier in developing an omnichannel strategy. We began to see these innovations this past holiday season when they rolled out various mobile apps geared toward making the shopping frenzy more manageable. Macy's, for example, debuted an in-store GPS app designed to help consumers navigate their stores, and Target launched an app that allowed customers to instantaneously locate CNET reviews for any gadgets they were eyeing. Nordstrom, meanwhile, has been pioneering in-store mobile technology, replacing cumbersome cash registers with

more nimble, customer-friendly iPod and iPad checkouts.

It's clear that these strategies are working, because online and mobile retailing is beginning to occupy a bigger piece of the sales pie. Our recent survey found that 74 percent of CFOs expect e-commerce sales to rise this year, projecting an average increase of 6.9 percent. Meanwhile, retailers are also refining their investment in mobile commerce. According to our survey, 38 percent are planning to increase their investment and 60 percent of CFOs plan to maintain their level of investment, suggesting that many have made inroads into the technology and are now working to determine what tactics win the most customers.

Increasingly brick-and-mortar and e-commerce no longer stand in opposition to each other. Rather, retailers are beginning to understand them as complementary pieces and are seeking to balance their investments in each. For some retailers, this means taking their presence online for the first time; for some digital retailers, it means acquiring storefronts for the first time.

►CLICKS BECOME BRICKS, AND BRICKS BECOME CLICKS

Despite lukewarm enthusiasm for private equity investment in the retail sector this

year, there may nevertheless be an increase in strategic investments to satisfy growing omnichannel demands. When TJX acquired Sierra Trading Post in late 2012, it signaled that the company was looking to grow its e-commerce presence. Expanding online capabilities through acquisition has been a popular strategy for a number of brands including Walgreens, Nordstrom and Wal-Mart, and we expect that trend will continue. In fact, following a busy year for deals in 2012, 94 percent of retail CFOs expect M&A activity will increase or remain stable this year. We're also seeing a number of international brick-and-mortar brands move to launch a U.S. online presence. Following Zara, Uniqlo launched its long-awaited e-commerce site in October, and H&M looks to be preparing its entry into U.S. e-commerce later this year.

In the same vein, a number of online-only retailers are beginning explore establishing a physical presence in key markets. Some brands, like Net-a-Porter and Etsy, are testing the waters with temporary pop-up shops, while others are diving right in. Finding that many consumers sought the opportunity to touch and try on merchandise before buying, popular online retailers Bonobos and Warby Parker have begun opening brick-and-mortar stores. A number of online giants have also expressed interest in establishing storefronts. In addition to Microsoft's experiments with stores, Amazon has long been rumored to be exploring a flagship in Seattle, and even Google may be getting in the game.

As the lines between brick-and-mortar and e-commerce continue to blur, the retail industry is poised to see great innovation and, with it, many opportunities to win customer loyalty. While the outlook for consumer spending is a little less bright, retailers that adapt to consumers' growing expectations of convenience, instant access and a personalized experience can ride out the waves of a shaky economy and make inroads in the year ahead.

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BDO SPOTLIGHT:

Q&A with Al Ferrara, Retail & Consumer Products practice leader

What led you to focus your accounting work in the retail industry?

In my first accounting job after graduating from college, my first assignments were two retail stores – an appliance chain and a department store. What I find most interesting about retail is that the business is an open book: You can walk in and see the merchandising and the layout, and because we're all consumers, you can see what's working and what's not working. It's also been exciting to work in an industry that's seen so much change. Over the past 25 to 30 years, we've seen specialty retail stores really explode, and now e-commerce and mobile are changing the game. Early on, I also joined the National Retail Federation and, because the business was growing so fast, I was able to develop a lot of relationships that have helped build my career.

What do you see as some of the biggest challenges facing the industry today?

Competition continues to be a major challenge. There are a number of brands with similar offerings in both the hard lines and soft lines sectors who are struggling to differentiate. I expect the industry will see more consolidation as they wage these battles.

Location has been a key differentiator in the past. Retailers were able to secure good deals in attractive locations, but now many of those leases are coming up for renewal and it will be challenging for stores to secure favorable rent terms. Locations are plentiful, but it's tougher for retailers to find attractive locations that are convenient for shoppers. At the same time, convenience shopping is increasingly moving online and, now, many retailers are finding that they are overstored or oversized. We're seeing a number of retailers going the boutique route and working to maximize their

floor space. I expect to see more retailers adjusting store and location strategy in 2013 to adapt to these challenges.

What some of are the biggest growth opportunities in the retail industry?

Despite slower economic growth, I do think there are many opportunities for growth in the industry. Most brands are not going to see double-digit growth in revenue, but I expect to see a lot of growth through acquisition. Specialty brands, in particular, look ripe for mergers, and we may also see some leveraged buyouts. I think some companies may also decide this year that they would be better-positioned being owned by a private equity firm. Retail is a highly transparent industry, especially for public companies, and investors have little patience for a bad quarter. Going private may be a good opportunity for some retailers who are adapting or investing in a new strategy and are looking for greater flexibility.

What's ahead for BDO's Retail & Consumer Products practice?

There's a great deal of momentum in our industry group. We've started several new engagements this year, and we're continuing to expand our presence across the country. As part of that, we're working closely with the professionals that came to BDO last year through acquisition in order to grow our practice in their markets. I'm very proud to lead a practice with professionals who have such deep industry knowledge and a clear commitment to client service. Part of that commitment means that we collaborate across regions and across service lines, including BDO Consulting, to ensure we're positioning our clients across the country for growth in 2013.



How would you characterize the impact of the work you do?

Ultimately, we want to help our clients achieve their business goals. We do this not just by providing technical advice and information, but by being committed to the industry that's so important to them. We work every day to ensure our clients consider us trusted business advisors, and to provide all the resources they need, whenever and wherever they need it. We're focused on becoming thought leaders so that we're constantly adding value to our clients and the retail and consumer products industry overall.

Al Ferrara is a partner and the Retail & Consumer Products practice leader. He can be reached at aferrara@bdo.com.

2013 CALENDAR

The following is a list of upcoming conferences and seminars of interest for retail and consumer product executives:

MARCH 2013

March 17-20

Chain Store Age SPECS 2013
Hilton Anatole
Dallas, Texas

March 27

2013 ICSC Retail Connections
Business Design Centre
London, UK

APRIL 2013

April 8-10

Shopper Marketing Summit
Renaissance Schaumburg Convention
Center Hotel
Schaumburg, Ill.

April 9-11

NACS State of the Industry Summit
InterContinental Chicago O'Hare
Chicago, Ill.

April 20-23

2013 NACDS Annual Meeting
The Breakers
Palm Beach, Fla.

April 28-May 1

Retail Asset Protection Conference 2013
Gaylord Palms Resort and Convention
Center
Orlando, Fla.

April 29-May 2

Food Marketing Institute Future Connect
The Peabody-Orlando
Orlando, Fla.

MAY 2013

May 14

Imperial Capital 5th Annual Consumer
Summit
Loews Santa Monica Beach Hotel
Santa Monica, Calif.

May 18-21

National Restaurant Association Show
2013
McCormick Place
Chicago, Ill.

May 19-21

NRF Supply Chain Summit 2013
Adolphus Hotel
Dallas, Texas

May 19-22

ICSC 2013 RECon: The Global Retail Real
Estate Convention
Las Vegas Convention Center
Las Vegas, Nev.

May 19-22

Food Marketing Institute Internal
Auditing Conference
Hyatt Regency San Antonio
San Antonio, Texas

May 22-24

Personal Care Products Council Legal
and Regulatory Conference
Le Westin Montreal
Montreal, Canada

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BDO RETAIL AND CONSUMER PRODUCTS PRACTICE

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