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Stay within the guardrails

Top retail risks 2018

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Stay within the guardrails

Managing retail risk in a disruptive environment

Retail had its best holiday season in years in 2017. Consumers were active in all buying channels and the majority of retail subsectors saw significant growth.

So why is there so much uncertainty in the industry? Why is there a feeling that retailers are not in control of their own destiny? Why did 21 retailers declare bankruptcy in the United States in 2017?

Retail has undergone incredible disruption over the last 10 years. The industry has been transformed by the dramatic growth of platform companies, which have influenced legions of consumers, impacting how they shop and what they demand and expect from retailers.

While there is opportunity in retail, as the results from the last holiday season suggest, there remain significant risks that can impact both top-line growth and long-term viability. There is no universal formula for success in today's disruptive business environment. To compete, retailers must be creative, have an open mind, and take a more balanced approach to managing risk.

Each retailer is unique based on a number of factors—strategic, operational, financial, data, risk/compliance, talent, technology, and culture/reputation. We refer to these factors as "guardrails" because they line the path to business success—remaining aware of the boundaries they set keeps you from veering off into dangerous terrain. They also change the dynamic around relevant risks in the retail space.

The guardrails are neither stand-alone nor static. Risks in retail, as in many industries, are heavily interconnected and rapidly evolving. To illustrate the inevitable overlap between these factors you will see accompanying each of the top 14 risks covered in this report a depiction of which guardrails are most pertinent.

Competition

It's stiffer than you think

Despite retail growing over five percent during the most recent holiday period, not everyone had a stellar experience. The exodus of consumers from bricks to clicks has exacerbated the challenges of how and where to compete.

Competition in virtually every industry has ramped up, but in the retail space it is brutal. Because of a number of factors that we cover throughout this report, 21 retailers in the United States declared bankruptcy in 2017, blowing up the record of 18 set in 2009. Some of the biggest names in the business sought protection as they tried to reorganize to meet the demands of modern retail.

A number of factors provided the headwinds against growth for many retailers. Amazon, and its ability to innovate, test and learn, and offer superior online service, presents a major challenge for other players in the space. Now with a large brick-and-mortar presence, this internet pioneer is putting many retailers on the defensive. Indeed, Walmart's move into digital real estate is a direct effort to combat Amazon. The sheer size and the impact of Walmart's spending power on suppliers and margin, as well as its ability to dictate terms, squeezes margin from other retailers.

Another force is the "ankle biters"—smaller start-up retailers that offer niche products and services (think Harry's razors, Stitch Fix, and others). Individually, they do not propose a significant threat, but collectively they are rapidly eating into sales and margins for all retailers.

For retailers that rely heavily on a brand story, vendors upstream are expanding their direct-to-consumer offerings. Given that they can set pricing to cut out retailers, this continues to expand and pose a problem. While we have seen this primarily in the apparel and specialty space, other areas of retail are not immune.

Risk drivers

- **Lack of innovation**
- **Inability to adapt business model**
- **Sub-optimal real estate investment**
- **Ineffective inventory lifecycle management**
- **Imbalance between establishing customer centricity and maintaining brand loyalty**
- **Inability to adapt to the evolving consumer landscape**
- **Too much capital spent "keeping the lights on"**
- **Following vs. leading**

Consumer expectations

Ignore at your peril

The clear and present risk is that the consumer is moving faster than the retail business can adapt.

Consumers are drawn to retailers who make the experience of browsing, shopping, discovering, and ultimately purchasing pleasant, efficient, and cost-effective. The biggest issue for retailers is to understand how customer gravitation is trending and adapt.

There's much to learn: What are customers truly looking for? What services have they received from competitors that has now reset their expectations? How are they comparing products, services, and entire brands, and how has that changed over time? How might you differentiate yourself from other retailers in the customer's perception?

Consumers make purchasing decisions based on a number of factors that have historically held true:

- Product
- Price
- Availability
- Customer service (including delivery)
- Ease of interaction
- Brand loyalty

Retailers must decide which of these factors to focus on to differentiate themselves from their competition.

Risk drivers

- **Product and price have become commoditized**
- **Consumers have more information about the product than the retailer**
- **Too many choices eroding brand differentiation**
- **Inadequate focus on customer service and ease of interaction**
- **Customer experiences that are not meaningful, memorable, shareable, and personalized**

Balance sheet and debt

Keep it clean

Retailers must get their balance sheets cleaned up to survive in this environment.

Many devote substantial amounts of cash to servicing their debt, as opposed to activities intended to acquire customers and upgrade services. This is one of the principal reasons why so many retailers filed for bankruptcy protection last year. They've spent so much money paying off their interest expense that they haven't been able to upgrade, leaving many physical stores in disrepair and online capabilities lagging. Consumers have noticed and foot traffic has suffered.

Another reason is insufficient short-term working capital. More than 80 percent of retailers had a level of current-assets-less-inventory that was not adequate for meeting current liabilities.*

A third factor behind the bankruptcy trend is inventory levels getting out of sync with the rest of the balance sheet. Old, out-of-season inventory absorbs working capital space and retailers have not been aggressive enough in managing it.

An overly leveraged balance sheet leaves many retailers unable to invest in areas such as new technologies, training/development, product/service development, etc. Eventually, these businesses are forced to raise pricing and reduce customer service—not an effective combination.

Risk drivers

- **Runaway debt loads, particularly early in the life cycle**
- **Inability to invest for the future**
- **Noncompetitive pricing**
- **Larger-than-expected working capital changes**
- **Impact of private equity ownership**

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Business transformation

Planning, flexibility, agility are key

Major strategic transformation is ongoing at virtually every retailer, large and small, for multiple reasons.

Given the speed of the strategic shift occurring, retailers are feeling the pressure to deliver—and quickly. If initiatives go wrong, the company can be set back substantially if there is not proper planning and risk management.

Contrary to popular belief, it's not about technology. The vast majority of business-transforming projects (86 percent) fail because of people and process issues.*

When retailers initiate these big transformational projects—upgraded IT systems, better data/analytics, new online capabilities, overall organizational restructuring—they've got to think beyond the desired happy ending. What can go wrong? Are worst-case scenarios being considered up front? Do you have enough time and budget factored in to do a thorough risk assessment?

Change fails when programs are exclusively focused on the technical excellence of the team. Probability of failure increases if people are not proactively managed and organizational resistance to change is not considered. Managing the planning process according to "doing the right project" and "doing the project right" can help focus risk mitigation into manageable parts.

Risk drivers

- **Transformation project not aligned with the company's strategic goals**
- **Inefficient project sequencing**
- **Failure to identify potential bottlenecks early enough**
- **No vetted plan to deal with change management and people issues**
- **No vision for ROI**
- **Failure to secure buy-in from the entire organization**

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Organizational structure

Make it a growth driver, not an obstacle

Most retailers are structured as they were 15–20 years ago. In an environment in which retailers have to move fast, many are set up to move at the speed of their slowest denominator. To be effective, they have to examine and tweak, as needed, their organizational structure for what's coming next—whatever that may be—in this evolving market environment.

That said, companies must get a handle on what the customer-centric retail organization of the future looks like—for the customers they want to attract. How do marketing, call centers, store operations, inventory, distribution, accounting, etc. work together?

Unfortunately, most retailers are disjointed, with groups of people who are very customer-centric, others who are product-based, and still others who are thinking exclusively about support and service.

The siloed structure is a deterrent in today's market. Retailers, like all companies, must be sure they have the best organizational people leading the most critical functions.

Risk drivers

- **Excessive bureaucracy and empire-building**
- **Lack of single organizational vision**
- **Unequipped for innovation and rapid response**
- **Perpetual short-term survival mode**

Inventory management and working capital

Working hard or hardly working?

Are your inventory management processes optimizing your working capital or are they undercutting it without your knowledge?

It's becoming increasingly apparent that one of the keys to flourishing in the current and future environment is effectively managing the principal retail asset—inventory. Unfortunately, processes and systems across the industry have not kept up with consumer expectations.

Effective inventory management has been disrupted by the onset of omnichannel. The speed of change has overtaken retailers' ability to adapt their engagement and supply chain models. Consumer expectations are demanding more flexible and accurate management of product, including:

- The ability to know the level of your inventory at all times.
- Real-time updates.
- Omnichannel capability.
- Free delivery or a flat annual fee, within a 1- to 48-hour window.

For retailers to compete, inventory accuracy needs to be above 99 percent. Right now this isn't possible for most retailers for a number of reasons:

- Managing and handling too many SKUs dilutes resources and efforts away from the SKUs that drive profitability.
- Shrink continues to be a problem that impacts inventory accuracy, with more than 80 percent running from between 0.5 percent to nearly 3 percent.*
- The reverse logistics process continues to be an issue. The retail industry had $3.5 trillion in sales last year, with 10 percent, or $351 billion, lost to returns.**
- Retailers are still using batch updates of inventory positions.

A number of these issues are controllable areas that retailers can focus on now to impact working capital.

Risk drivers

- **Not understanding the net SKU profitability, including logistics, shrink, and handling costs**
- **No life cycle methodology**
- **Not understanding the economic impact of reverse logistics**
- **Leakage across the supply chain**
- **Impact of tariffs on costs and consumer willingness/ability to spend**

**Source: National Retail Federation, 2017.*

***Source: Appriss Retail, "Consumer Returns in the Retail Industry" (December 2017).*

Cyber security

An ever-evolving challenge

Board and senior management oversight of cyber security in retail is no longer simply a recommended best practice. It's a requirement.

Cyber security is not merely an internal IT risk, but a strategic business risk—especially for retailers who handle confidential customer data. Reputations, brands, trust, and sales are all potentially at peril.

Investors, governments, and global regulators are increasingly challenging board members to actively demonstrate diligence in this area. Regulators expect personal information to be protected and systems to be resilient to both accidents and deliberate attacks.

This is an opportunity for businesses who make a focus on cyber security a pillar of their customer-facing business proposition, along with pricing, product, and service.

Risk drivers

- **New and emerging cyber security threats and how they affect the entire organization**
- **The readiness, or lack thereof, of the organization's cyber security program**
- **Key risk indicators that should be under constant review at the executive management and board levels**

There are a number of interconnected, accelerating trends across the retail cyber security landscape:

New market and client needs—Consumer identity and omnichannel; enhanced customer expectations; "As-a-Service" on-demand offerings.

Change in the way business is conducted—Intelligent automation is helping bridge the skills gap; third-party synergies in a hyper-connected world are more crucial than ever; gamification and crowdsourcing are mainstreaming rapidly.

Technological breakthroughs—Artificial intelligence, machine learning, virtual and augmented reality, internet of things, blockchain, and other emerging technologies are smashing the concept of what's possible and creating new sources of risk.

Regulatory compliance—Governance and oversight, both internally and at the government level, around privacy and general data protection, data sovereignty, and intellectual property protection all must be a daily focus.

External threats—It is truly a moving target, all of which must be considered seriously: nation-states, organized crime, insider threats, hacktivism.

Bottom line, customers expect retailers to keep their information safe, whether it is identity, credit card or loyalty data, or any other defining characteristics.

Technology disruption

Make sure your tech strategy aligns with your business strategy

Too many retailers pursue new technological advancements without assessing whether they are right for their business model and customer base. Combined with an inability among many companies to move off of outdated core systems, this is an impediment to growth.

Technology disruption has had a huge impact on retail that will continue for the foreseeable future. The retail response may involve some radical rethinking of the overall approach to technology and how effectively companies address consumer expectations.

An organization's strategy around technology should be flexible and support the broad business strategy for the next three to five years, but it should not drive that strategy. That's the part many retailers get wrong.

Intelligent automation—such as robotic processes, machine learning, and cognitive solutions—is changing business right before our eyes and should be a main part of retail technology plans. These emerging technologies, which both complement and augment human skills, have the power to exponentially increase the speed, scale, quality, precision, and operational efficiency of retailers' ability to anticipate and satisfy customer needs.

Another seemingly obvious, but often forgotten area to think about in connection with technology is ROI. What are you spending? What are you getting back? What are the efficiencies? How is it helping the organization better engage with new and existing customers? Few retailers do this well, and it is critical for success.

More than ever, retailers are being impacted by the rapid pace of digital change. Global and cross-industry collaborations and partnerships are going to be crucial. Getting the right mix of talent, capital, and entrepreneurial vision to nimbly embrace new technologies is a must for survival.

Risk drivers

- **Being an IT bottleneck, rather than a catalyst for change**
- **Spending on applications that you don't need**
- **Continuing to pay for old, out-of-date systems**
- **Maintaining a technology plan that is connected to your current state rather than your desired future state**
- **Failing to regularly check potential areas of financial leakage in IT, such as software licenses, vendor fees on evergreen contracts, and IT project costs**

Data and analytics

Make it an asset

The big data transformation has not yet occurred in mainstream retail. While retailers capture a large amount of data on customers, purchases, and trends, few have managed to turn it into valuable insight that gives them an edge.

The issues are exacerbated by the recent implementation of omnichannel fulfillment strategies without devoting adequate thought to the data and reporting needs that come out of new processes.

The explosion of change and transformation in retail has led companies to implement tools, systems, and processes, but there also has not been enough consideration given to enhancing, maintaining, and learning from the massive amount of underlying data. Retailers want the advanced analytics to be able to make better decisions, but have not displayed a willingness to invest in the fundamental basics to gather it. And then, when they do, they don't trust the output.

Perhaps even more important, retailers overall have never considered having a distinct data strategy that aligns with their technology and business strategies. This is incredibly shortsighted when other assets—real estate, capital, etc.—are considered and used strategically.

Data is often thought of as an IT problem. It is not. IT owns the systems that hold and transport it, but the data itself is a fundamental business resource that should be owned by the business. Failing to make this distinction will only prolong retailers' data issues and continue to feed the frustrations of all involved.

Risk drivers

- **Not aligning a data strategy with the overall business strategy**
- **Not ensuring organizational data is reliable**
- **No data governance plan**
- **Lack of consistent database definitions and standards that everyone follows (sales, profit, margin)**
- **Spending more time vetting data and reports rather than analyzing them**
- **Insufficient or nonexistent insight levers that trigger directional change within the organization**

Compliance and regulations

The changing nature of enforcement

Under the current administration, we are seeing a trend toward less regulations. However, this is being offset globally by an increase in regulations in Europe and China. In this fluid scenario, retailers operating internationally must remain focused on maintaining compliance standards to minimize risk.

Worldwide, there is increased focus on regulations pertaining to fraud, cyber and data security, operations, product liability, competition, consumer protection, price controls, and social and environmental considerations.

However, while U.S. federal regulations are being rescinded at a feverish pace, state-level actions and litigation against U.S. retailers is rising, class actions in particular. It goes without saying that litigation is expensive and requires strong internal business controls and experienced legal departments.

A deregulatory policy agenda in the United States does not mean there are less regulatory challenges for retailers. In 2018, regulators will continue to demand companies pay strict attention to core risk management governance, controls, practices, and reporting—particularly in the areas of cyber security, third-party risk management, and conduct and culture. And with consumer privacy and data security high on the list of regulatory priorities, retailers may soon see GDPR-like rules, such as the recently proposed California Data Protection Agency, enacted in the United States.

Continued adoption of automation and emerging cognitive technologies will help drive sustainable and effective change across these regulatory challenges.

Risk drivers

- **New revenue recognition and lease accounting rules**
- **Impact of global controls over GDPR if data on European citizens is held**
- **FCPA/UK Bribery Act**
- **Labor compliance (Min wage, FLSA, Minors, California)**
- **ADA impact on omnichannel**
- **Corporate social responsibility and controls**
- **SOX and PCAOB changes**
- **Class action lawsuits in connection with performance, compliance breach, or other issues**
- **International compliance for product safety, labor, pricing, etc.**
- **Impact of U.S. tariffs on prices of international products**

Culture and reputation

Critical in the millennial age

In the not-so-distant past retailers had the power of branding and messaging. The communication formats—TV, print, radio—were well established, and consumers had limited purchase options and choices. The retailer was able to influence consumer behavior and control messaging. It was all so organized.

Not anymore. The onset of the platform economy, the growth of social media, and the seismic shift in access to information has put all the power in the hands of the consumer and those tools that facilitate the consumer's understanding of what they need or want. Retailers largely have been left struggling to catch up to this power shift. The situation is most apparent in efforts to protect brand and reputation.

All it takes is one negative tweet, Facebook post, blog entry, or Youtube video for a brand to lose intrinsic value. A company's reputation for being a great place to work and pursue a career also could be damaged. The board might be forced to remove a senior executive or board member without recourse.

The point is, retailers do not control messaging anymore. They must compete for attention with every other signal consumers receive via their mobile devices. There is always a risk of some development becoming a reputational concern before the business can take steps to counteract it. Considering the numerous daily customer touchpoints, the chances of something significant happening are high.

In short, much like cyber security, it's not a matter of "if," it's a matter of "when"—retailers must be prepared.

Risk drivers

Failure to:

- **Perform full background checks, including social media and dark web scans, for all board members and senior executives, and update these files regularly**
- **Make brand and reputation risk management part of your business continuity/crisis response plan**
- **Scenario test your response plan for different areas/levels of exposure**
- **Ensure employee hotlines are monitored, complaints are addressed, and look for trends and patterns of behavior**
- **Ensure your policies on acceptable behavior are up-to-date and require all employees, senior executives, and board members to adhere**

Talent and retention

It should be all about the front line, not the C-suite

Most talk around talent and turnover focuses on the C-suite. Senior leadership is, of course, critical, but the biggest talent risk to retailers right now is customer-facing, on the ground, whether that's in-store or online.

Retailers are going to have to rethink their labor models. Considering labor is one of the top three costs for a retailer, after product and real estate, this will have a significant impact over the next three to five years.

It's no revelation to say that happy employees are better advocates for your store/product/service. If you have 25,000 employees, you may likely have thousands of customer contact points every day, every one of which will impact what the consumer thinks about you. If the employee doesn't feel cared for, it's going to show in their attitude and the level of service they provide. There's always an employer (i.e., a competitor) who will provide that extra touch that contributes to employee loyalty, which contributes directly to customer loyalty.

What drives a customer to make a purchase decision? Price, a quality product, and service. Retailers have long competed either on price or product. Service has been a niche—historically, some customers are sticklers, some are not. That's changing. Retailers are finding out the hard way: when virtually all competitors can compete on price and everyone has access to the same products, what's left for you to differentiate yourself? Service—and that's the domain of your people.

Make the lowest common denominator in the store an advocate for the brand. When they feel cared for and valued, when they love the brand, it will show and it will rub off on customers.

Risk drivers

- **Thinking about talent from the top down, rather than from the bottom up**
- **Failing to acquire the talent you need today to be the customer's company of choice tomorrow**
- **Not training employees, especially those who interact with customers, to be true believers in the brand**

Tax reform

Known benefit to companies, unknown impact on consumers

Tax reform legislation is now law, and we have some sense of what companies might do. They might invest in their people. They might invest in automation. They might put it to the bottom line. There are a lot of options that retailers are considering. However, there is little talk currently about the long-term impact. How will consumers react?

There will be clarity over time as the tax tables change and people start seeing the impact in their paychecks. The greatest uncertainty is the positive and/or negative affects this dynamic will have on Main Street.

This is a big issue for retailers because if tax reform doesn't have the desired effect, if it doesn't make people feel like they can comfortably put more money into the economy, we could see a negative impact on consumer spending later in the year.

A tangential issue is the administration's recently announced tariffs on steel and aluminum, which are likely to have an effect on products produced across the U.S. economy. National Retail Federation President and CEO Matthew Shay said: "Make no mistake, this is a tax on American families. When costs of raw materials like steel and aluminum are artificially driven up, all Americans ultimately foot the bill in the form of higher prices for everything from canned goods to electronics and automobiles."

Stay tuned.

Risk drivers

— **Loss of personal exemptions and W4 impact**

— **Loss of itemized deductions by the middle class**

— **Questions around whether tax reform will spur job creation or wealth redistribution**

— **Elimination of state and local tax deductions, which could lead to a higher overall tax bill for consumers, depending on their state of residence**

International retail

Many questions

Differences in cultural and economic conditions between the United States and other countries can form significant barriers-to-entry for U.S. retailers. Similarly, a lack of understanding of regional nuances where retailers are expanding can quickly result in significant costs and divert resources from other strategic initiatives.

Although the United States remains the leading force on the global scene, as markets and regions transform with emerging technologies, talent, and capital, a shift from West to East is underway. China, with its innovative and rapidly expanding platform businesses, is rising at a breakneck pace. India is ascending, and Japan has long been a contender. Counterbalancing this trend, the United Kingdom is progressing with a technology and start-up agenda that should have an interesting impact on the retail sector.

Various countries have proven to be challenging for U.S. retail success for a number of reasons:

Canada – Location and size

China – Extent of government influence and protection of homegrown competition

United Kingdom – Disruption caused by Brexit

India – Size and cultural norms

Across the globe, knowing who you are doing business with and ensuring you do not inadvertently violate local regulations, the Foreign Corrupt Practices Act, or any U.S. regulations is essential.

Risk drivers

- **Disruptions caused by changes in international, social, political, legal, and economic conditions**
- **Imposition of barriers on trade and retaliation that could have a cost/inflationary impact**
- **Currency fluctuations**
- **Local customs, language, and culture**
- **Unexpected regulatory changes**
- **Political instability and terrorism**
- **Changes in diplomatic and trade relationships**
- **Cargo delays as a result of security considerations or insolvency**
- **Lack of suitable physical location and price of real estate**
- **Administration’s tariffs on Chinese goods**

Summary

Key takeaways

As a sector, retail is at an inflection point. The confluence of channel evolution, customer influence, technology, and the availability of data-powered insight presents a precarious, albeit exciting opportunity for retailers. Here is a high-level look at some of the most vital considerations we explored in this report:

1. **Retailers are not considering risks holistically—silos still exist**
2. **Understand how and where the business risks you encounter are connected**
3. **Geography changes the risk velocity**
4. **Responsibility lies in many areas but ultimately falls on those who own strategic direction**
5. **Address customer engagement risk early and often**
6. **When it comes to technology—pay attention to and invest in solutions that are relevant to your business model**
7. **Data is an asset, not a liability—treat it as such**
8. **Focus on frontline talent, not just the C-suite**
9. **Monitor the impact of tax reform and tariffs on consumer spending**

10 **Manage your working capital with vigilance**

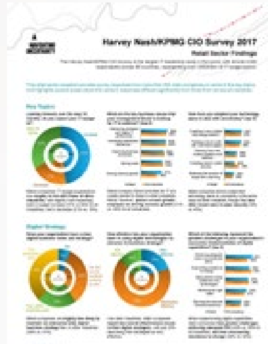
11 **Never, ever, relax on cyber security**

12 **Pay attention to the guardrails:**

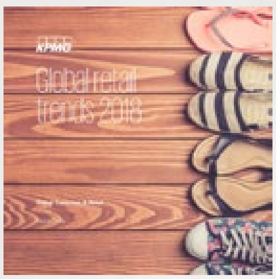
Additional resources

Enduring the IoT storm to unlock new paths to value
How a governance model protects you from a blizzard of IoT risk

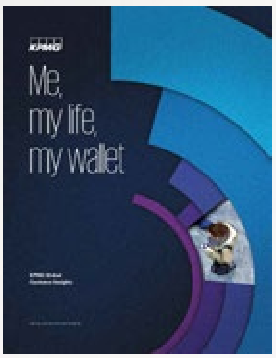
KPMG Internal Audit: Top 10 in 2018
Considerations for impactful internal audit departments



Harvey Nash/KPMG CIO Survey 2017
Retail Sector Findings



Global Retail Trends 2018



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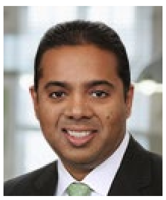

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