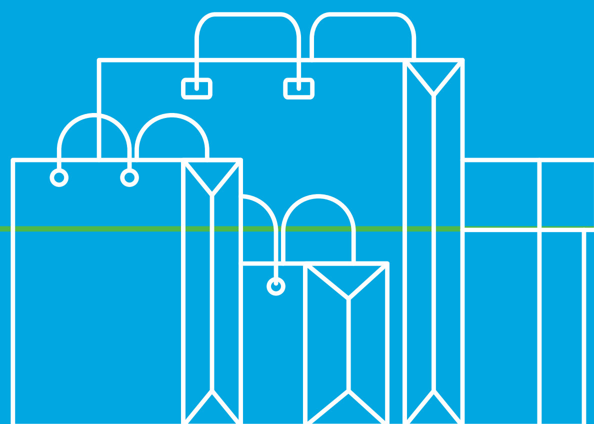
QUARTER 4 2016

# RSM QUARTERLY **SPOTLIGHT**

## CONSUMER PRODUCTS



### In this issue:



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# PERSPECTIVES ON THE REAL ECONOMY

By Joe Brusuelas, RSM Chief Economist

The upset presidential election victory of Donald J. Trump and the Republican hold of the House of Representatives and the Senate signal major changes ahead in both the federal government's approach to growth and the Federal Reserve's approach to monetary policy. Most evident will be a return of supply-side tax cuts, large operating fiscal deficits, and a move back toward more traditional monetary policies that, over time, should lead to higher short- and long-term interest rates.

Below we outline our views on the implications of a Trump presidency for economic growth and trade, in particular, with other issues considered at greater length online.

**Economic growth**

We anticipate that the Trump administration will attempt to achieve the economic equivalence of a strategic breakout with respect to the pace of economic growth. It will also seek significant reform of Dodd-Frank, which would be a boost for Wall Street, and move to inject private competition into the health care system. Because the GOP does not have veto-proof majority, the reform of regulation governing finance and health care will be quite challenging and difficult to obtain.

While there will likely be a faster pace of growth in the near term, uncertainty about the role and status of the United States in the global economy may combine to create longer-term issues that, ironically, act as a drag on growth.

**Trade**

In our estimation, the Trans-Pacific Partnership (TPP) represents a once-in-a-lifetime opportunity for the middle market to be given preference in a multilateral trade treaty. It would not be any surprise if the TPP quickly becomes the last major policy debate of the outgoing Obama administration.  Given the outcome of the election, the upcoming lame-duck session of Congress represents likely the last opportunity for a number of years to pass multilateral trade policies that decisively favor the middle market.

It is here where the greatest risks lie. It is quite clear that Trump intends to slow down the pace of economic integration between the U.S. and its trade partners. More than half of all U.S. trade is with its North American partners, and is an important source of growth in the economy. To the extent that Trump either intends to, or can, renegotiate portions of NAFTA will define what appears to be neomercantilist policies that the new administration may adopt.

Because of the relative lack of substantial policy preferences set out by the Trump campaign, at the current time, it's difficult to quantify the overall economic impact from what policies do emerge. It is safe to say that it is best to avoid starting trade wars, which are always popular at the outset but end up harming everyone over the long term.

For consideration of the implications of a Trump presidency on taxes, infrastructure, central bank policy and interest rates, click here.

## OTHER RESOURCES


### The Real Economy

A monthly publication to help the middle market anticipate and address the unique issues and challenges facing their businesses and the industries in which they operate. We also release a Global Edition on a semi-annual basis that addresses issues affecting business on a global scale. Read more.

### Consumer Products

In a rapidly evolving marketplace, we explore the trends, challenges and ideas directly related to the consumer products industry and offer insights for how to address them and improve business. Read more.

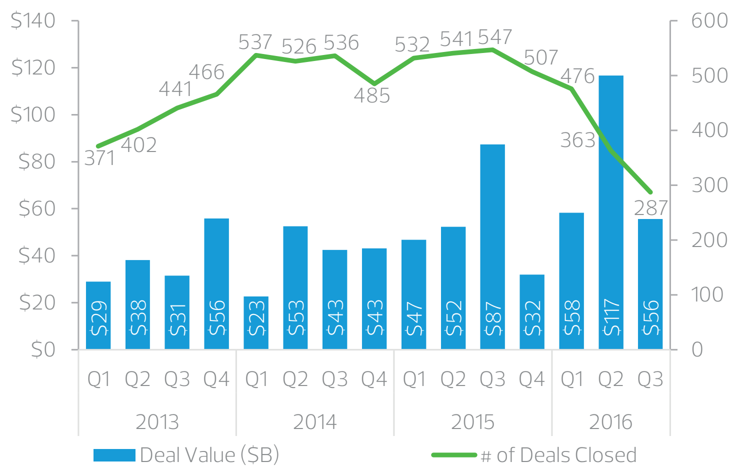
# B2C AT A GLANCE

## Structural shifts and the status quo

In the wake of one of the more contentious and potentially game-changing U.S. presidential election cycles in memory, hesitation on the part of buyers across many sectors is entirely reasonable. Trade policies may shift, which could impact costs of importation among other inputs, while potential tax cuts could boost consumers' disposable income in the short term. As of yet, however, many of the most significant factors remain shrouded in uncertainty. Accordingly, sentiment remains relatively guarded, while a focus on quality and clear, established, rationales for acquisitions will continue to be paramount. Elsewhere, many trends still hold strong, in the consumer space in particular. Even as consumers still benefit from persistently low gas prices and interest rates—as noted in a prior edition of this report series—confidence remains variable. After a strong September, the University of Michigan U.S. consumer sentiment index slid to a two-year low. In brief, many remain expectant of a downturn that has yet to manifest, likely due to the weakness of the economic recovery since the financial crisis.

When it comes to structural shifts in the consumer products space, perhaps the most important to highlight is the continued outperformance of online sales. This shift has been heralded for some time, yet how much change it is still driving cannot be underestimated. Via Reuters, Morningstar Credit Ratings data suggests that $128 billion in commercial real estate loans are due to refinance between October 2016 and the end of 2017, with a significant portion of that attributable to retailers' borrowing. With malls in general suffering many closures of storefronts as consumers increasingly prefer to purchase online or visit discount chains, meeting debt obligations could become increasingly challenging and encourage foreclosures. Many chains primarily focused on brick-and-mortar locations are struggling to stand out, with the merging of online and physical operations a considerable challenge. It is important to note that this is attributable in part to overexpansion in the past across suburban areas, with affluent urban areas seeing relatively fewer closures and helping skew retail rents, but the overall trend toward digital remains unmistakable. Notwithstanding discount chains' success, viable e-commerce offerings are a primary focus for retailers of all kinds nowadays. Examples such as Alibaba's record-setting single-day purchase totals—an eye-popping $17.7 billion in 2016—abound, even while Amazon among others moves into fashion and other segments. It's not that delivery alone will suffice for current consumers, as the relative success of smaller companies such as Bonobos or Warby Parker that do operate multiple retail locations illustrates, but the integration of digital and delivery is crucial. Ensuring a quality in-store experience isn't merely a matter of just having many locations in many malls. Millennials with the requisite disposable income are willing to pay up for customized offerings blended in with an experiential setting and expeditious shipping later, but that blend is what is most appealing.

## B2C M&A deal flow by quarter




*Source: PitchBook*

Consequently, many giants are plowing more and more into their e-commerce offerings, beyond even more durable goods such as apparel. The perishable products space is distinctly more challenging, which is why disruption on a wide scale has yet to be truly evidenced therein. As vaunted as AmazonFresh or Prime Pantry may be, the benefits of models such as Costco's remain intact. The primary narrative in comestibles has been and still remains a growing focus on healthier foods in general, with increased transparency around food chain sourcing, but as those items are pricier, the importance of such offerings is largely geographic, with richer urban centers seeing stronger demand for organic produce, for example. In fact, other consumer packaged goods are also experiencing increased interest in whether or not their production chains are environmentally friendly. On the whole, certain consumer populations are only more interested in whether their dollars are going to products that are sustainably made with care. The restaurant space is also seeing a similar transformation, with fast-casual concepts still experiencing significant interest on the part of investors and buyers. Same-store sales and customer traffic improved in September, according to the National Restaurant Association's Restaurant Performance Index, which gained 1.2 percent to stand at 100.8, just slightly above the steady-state basis.

In summary, the consumer products space is seeing its greatest transformations occur within select segments, while others remain somewhat proof against digital disruption, but all are still subject to general unease on the part of consumers and acquirers alike. Hence the premiums commanded by "hot" brands and concepts, coupled with the overall decline in mergers and acquisitions (M&A). Rationales for R&D via M&A remain, but spooked by examples such as Nordstrom's $197 million write-down on online men's fashion service, Trunk Club, acquirers are still wary. In general, a distinct air of caution still hangs over the marketplace.

# M&A DEAL FLOW

## As volume slides, bifurcations open

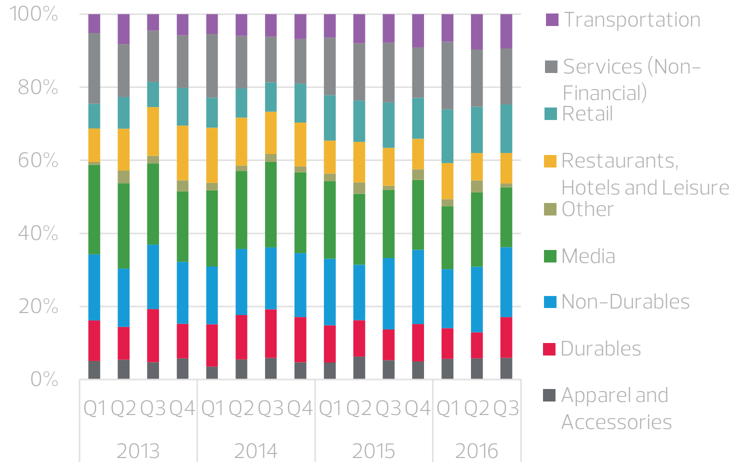
At $55.6 billion, total deal value in the third quarter of 2016 remained robust even as the tally of closed transactions declined to 287, a year-over-year decrease of 47.5 percent. The final count of completed transactions could be revised upward somewhat, but the general trend is unmistakable.

"Overall, from a volume perspective, the trend of being a somewhat down year over year continues," says David Cho, director with transaction advisory services at RSM. At the same time, as deal multiples remain relatively strong at 10.1x for the year to date, Cho underlines how capital providers are still very hungry but tempering their appetite. Hence the spread in asking prices that Cho has observed, which is also attributable in part to the level of competition still remaining quite high. The median deal size hit $167.0 million in the third quarter, not only a significant margin higher than the $105.5 million the previous quarter but substantially greater than nearly every other comparable period going back to the start of 2013.

"The lower middle market is not yet accustomed to how competitive it is," Cho says. "We are continuing to get engaged earlier in the process. On the sales side, we are increasingly working with banks and companies preparing to go to market."

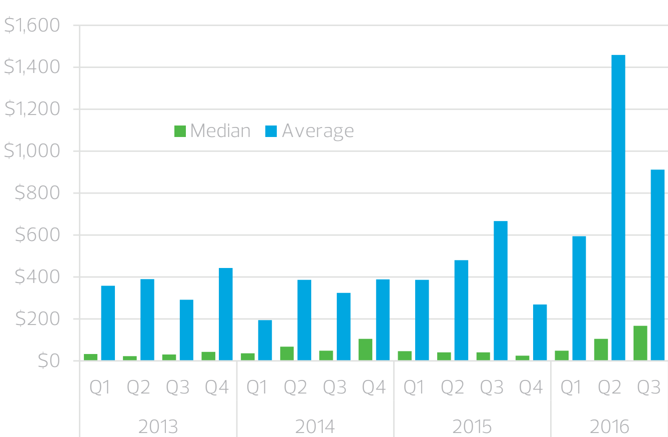
That last point speaks to businesses looking to stand out in a high-multiple environment rife with cautious buyers. According to Michael Grossman, partner with transaction advisory services at RSM US LLP, current multiple levels are unlikely to slide as demand will simply continue to prop them up for the foreseeable future. It's not so much a matter of only a select few companies being able to command the strongest multiples either, but more than the quality of the typical company is relatively present. "Usually, the quality is apparent in the companies that we look at," says Grossman. "We're not really seeing bad deals or deals that are falling apart as a result of diligence." However, that isn't to say that the companies are highly sophisticated before they enter the transaction process. "There are a lot of messy situations," says Grossman, noting that, of course, sophistication does not imply quality and vice versa. So, all in all, the current deal-making environment is more marked by a handful of companies that stand out amid a market of mid-range businesses in terms of quality, which is consistent with stubbornly high multiples as deal volume lowers.

### M&A transactions (count) by sector



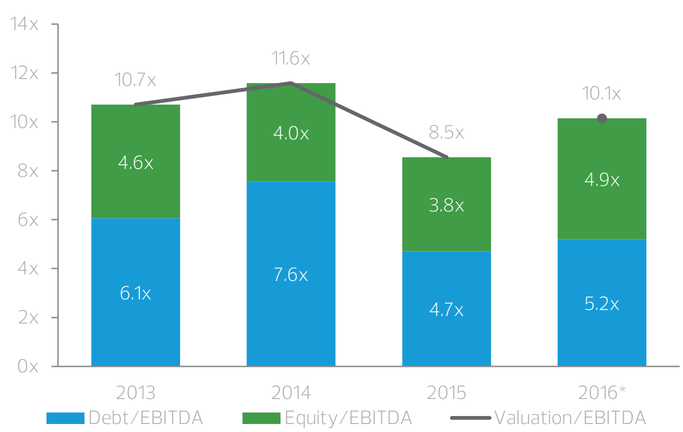

*Source: PitchBook*

### Average and median M&A deal size ($M)




*Source: PitchBook*

### Deal multiples




*Source: PitchBook*
**As of 9/30/16*

# SECTOR SPOTLIGHT: APPAREL & HOME FURNISHING

## Engaging the consumer

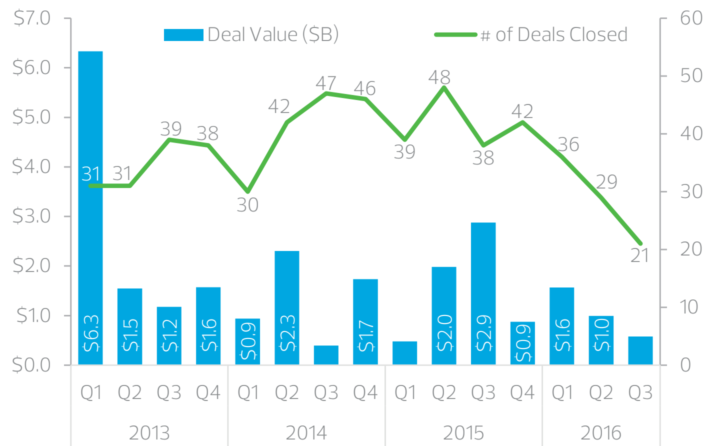
As discussed above, the more notable changes in the consumer products industry are occurring within the apparel segment. One trend that has become more pronounced over recent quarters has been decreasing consumer spend on apparel. With today's consumer, one of the key challenges facing the segment is creating the want to purchase rather than the need.

Brand loyalty, especially among younger consumers, has waned over the last few years. "Millennials are not necessarily excited by logos and the material things that they have," explains Carol Lapidus, consumer products practice leader at RSM US LLP. More and more on the apparel and fashion side, consumers are looking for what's new and different—something they can get excited about. And if the product isn't new or different, then consumers focus even more intensely on the best value. With today's consumer, brands also must be more creative when it comes to their marketing efforts. Lapidus says the smart companies are spending their money on social media marketing and engaging the consumer to be not merely a fan but also a loyal customer.

Dollars spent on home furnishings has increased, albeit slightly, which illustrates how brick-and-mortar experiences can't be counted out just yet. For high-end labels when it comes to fashion or long-lived items like those in home furnishings, consumers being able to assess quality in person remains crucial.

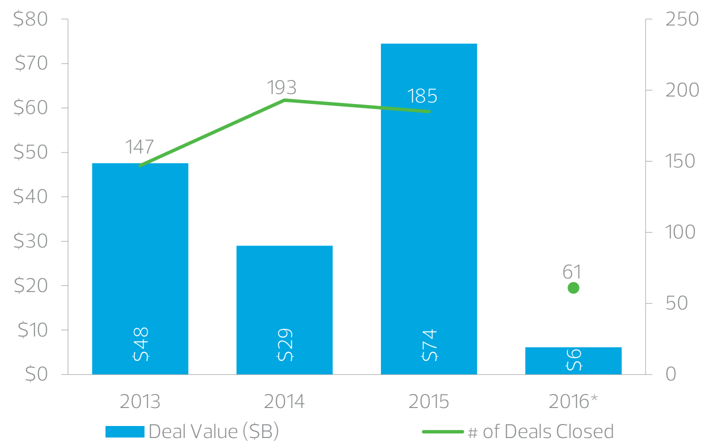
On a related note, home furnishings and travel are doing better among younger consumers that are focused on experience-based offerings or sheer value. In an era of shaky consumer confidence, the discount segment is likelier to post stronger performance, while other chains that can manage costs shrewdly by reducing the need for inventory management or owning certain factors of production will also handle change better than many of the industry stalwarts. "Retailers such as HomeGoods or Bed Bath & Beyond have been able to leverage their omni-channel efforts, generating a higher rate of impulse purchases at their brick & mortar locations," adds Jeff Edelman, a director in RSM US LLP's consumer products practice. Another key factor playing into home furnishings has been the anticipated onset of millennials' first-time home purchases. Not only are financing costs still relatively low when it comes to home buying but also for purchasing big-ticket furniture items.

### Apparel & home furnishing M&A deal flow by quarter




*Source: PitchBook*

### Apparel & home furnishing M&A deal flow by year




*Source: PitchBook*
**As of 9/30/16*

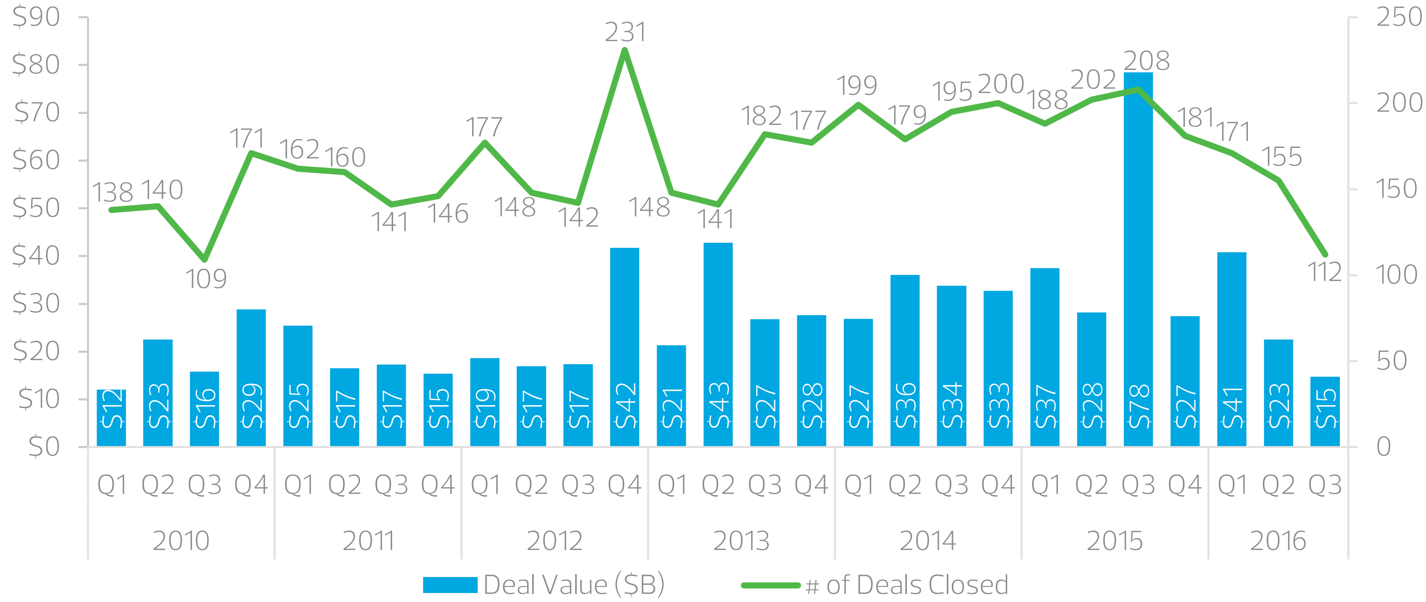
## SELECT APPAREL & HOME FURNISHINGS Q3 2016 M&A/PE TRANSACTIONS

| Company name | Buyer | Sector | Amount ($M) |
|---|---|---|---|
| 5.11 | Compass Group Management | Clothing | $400 |
| Newell Rubbermaid (Kirsch business) | Hunter Douglas | Home Furnishings | $270 |
| Gaiam | Sequential Brands Group | Accessories | $146 |

*Source: PitchBook*

# PRIVATE EQUITY DEAL FLOW

## B2C private equity deal flow by quarter

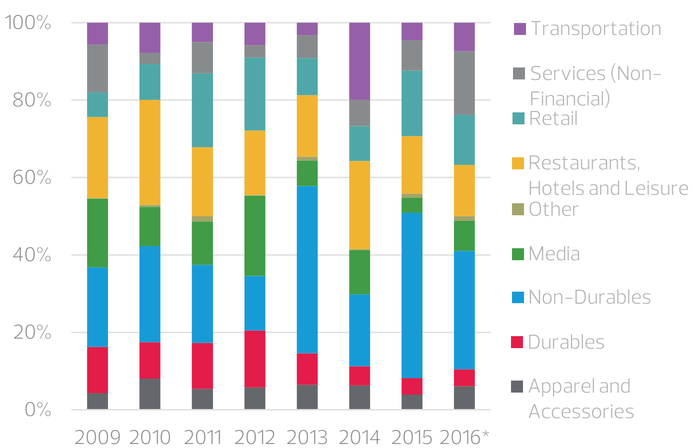



## PE activity winds down

Despite active interest on the part of private equity (PE) firms in strong brands, the rate of investment continues to slide. Analyzing that decline in tandem with the surge in add-ons as a proportion of overall PE consumer activity, it's clear that many PE firms are simply not finding compelling opportunities currently as a result of higher costs, and thus are turning more toward add-ons when they can as a way to mitigate prices. Investors are not going to overspend on original platform buys in an expensive climate as they typically have the luxury of long fund life cycles, and thus can wait out periods of heightened uncertainty. Some will be able to justify cutting fairly hefty checks, but in general, a slower pace suggests most are not, and moreover, transaction processes are getting prolonged, due to more careful preparation in dealmaking processes. RSM US LLP professionals, as they are engaged earlier and earlier, are seeing a variety of issues crop up on a fairly regular basis.

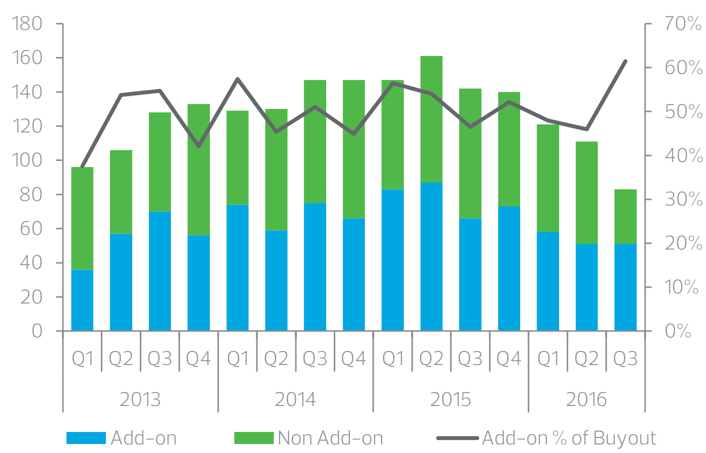
"Margins are an issue, especially from a classification perspective," Grossman says. "The bottom line may be increasing, but are margins old and steady or are there pricing pressures?" Specifically for the restaurant and retail segments, buyers and lenders need to be aware of post-transaction purchase accounting matters that influence debt covenants, particularly when it comes to lease reevaluations. Another key observation when it comes to the timing of deal flow is that the supply of quality brands in the market is not endless. After a fairly long run of activity across much of 2014 and 2015, a lull is only to be expected as the pipeline refills.

## B2C private equity deals ($) by sector




*Source: PitchBook*
**As of 9/30/16*

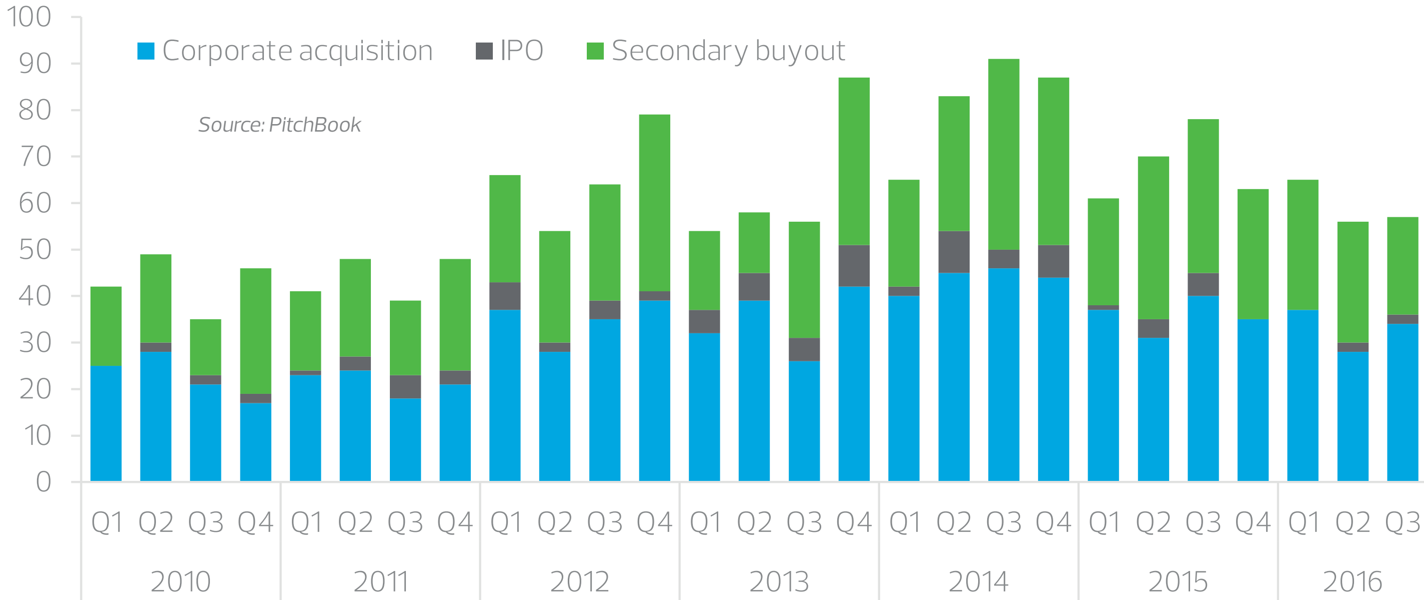
## B2C add-on activity




*Source: PitchBook*

# PRIVATE EQUITY EXIT ACTIVITY

### B2C private equity exits by quarter

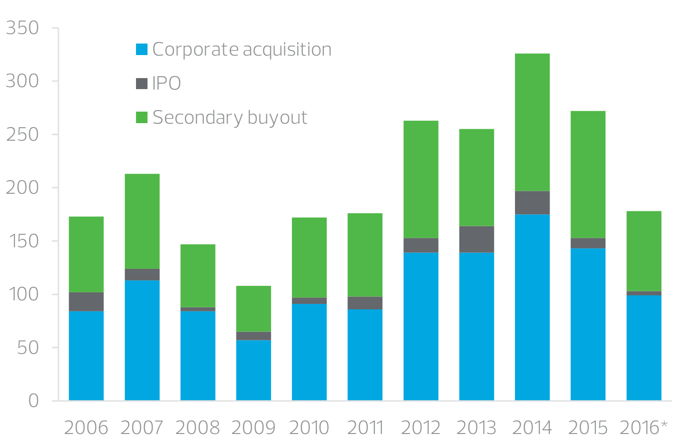



## Exit activity in a subdued plateau

Three quarters into 2016, PE-backed exit activity in the consumer products sector looks set to record a decline from the level observed in 2015. Barring a significant surge in the last quarter of the year, PE selling will land on a level somewhere short of what was seen in 2012 and 2013. There are several conclusions to be drawn from this decline, chief among which is that the pipeline of market-ready companies had to refill at some point, and given the elevated levels of buying in the past two to three years, many PE portfolios simply need to digest their acquisitions further before unloading them. Secondly, certain segments are not only experiencing their own pipeline refilling in terms of companies that are ready and willing to come to market, but also are at different points in consolidation cycles. Last but not least, in today's climate, PE sellers may be scrutinizing their own companies at greater length than in the past, as the M&A boom, in particular, subsides gently.

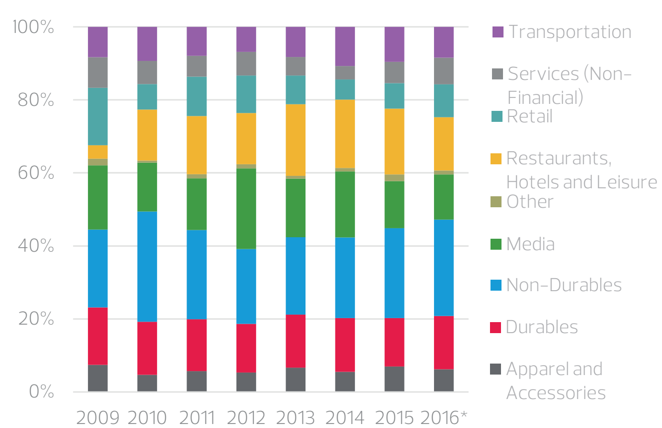
"The amount of activity we're seeing from the sales side has increased dramatically," says Cho. "As we get engaged earlier on in the process for a buy-side transaction in turn, buyers are also getting more pressure from sellers to put in a sharpened working capital bid as part of their package."

### B2C private equity exits by year




Source: PitchBook
*As of 6/30/16

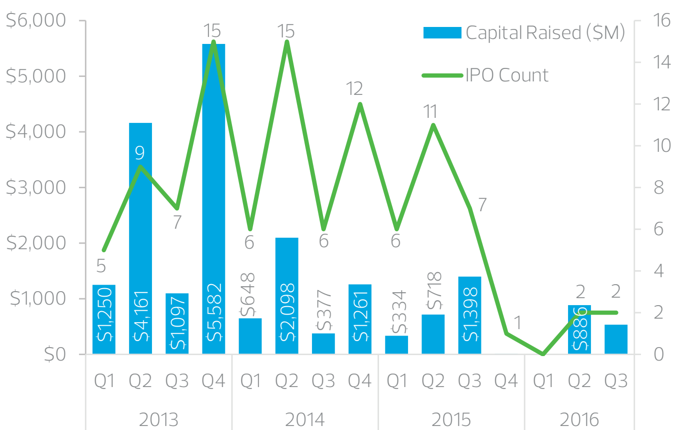
### B2C private equity exits (count) by sector




Source: PitchBook
*As of 9/30/16

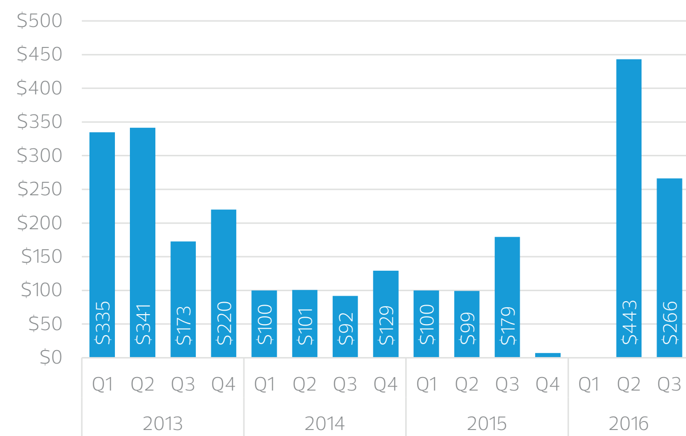
# IPO ACTIVITY

### IPOs in the B2C industry




*Source: PitchBook*

### Median IPO size ($M)

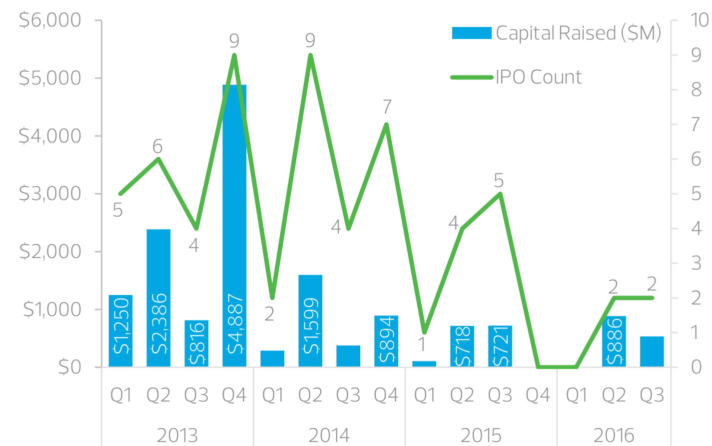



*Source: PitchBook*

### An uncertain environment

Two consumer products companies went public in the third quarter of 2016, leaving the year as a whole with a grand total of four initial public offerings (IPOs) and $1.4 billion raised in that sector. As is further evidenced by the robust median offering size in the second and third quarters, the challenging prospect of going public in a tumultuous span of time has led to only quite healthy and well-prepared companies braving public markets. The number of companies that either has filed to go public or is preparing to file is somewhat stronger, but by and large, 2016 will end up being quite a lackluster year for companies' public debuts. There are many reasons cited for such an occurrence, ranging from volatility to more lenient sources of private capital to timing. All of them doubtless played a part, but one that gets overlooked is how the structural shift in key consumer segments is necessitating a changing of the old guard while younger businesses have yet to mature into going public, while some admittedly are being targeted by PE firms instead and staying private.

### PE-backed IPOs




*Source: PitchBook*

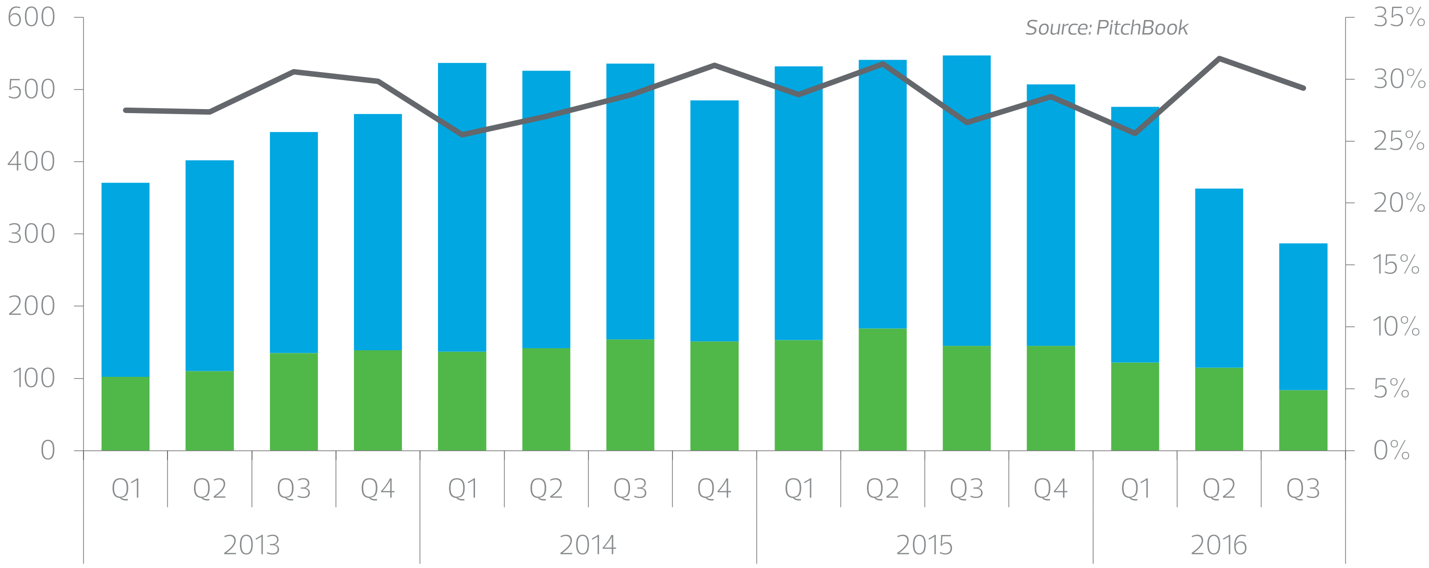
# B2C IPO PIPELINE

| Company name | Sponsor(s) | Sector | Amount ($M) |
|---|---|---|---|
| Albertsons | Cerberus Capital Management | Department Stores | $1,599 |
| CBS Radio | N/A | Broadcasting, Radio and Television | $100 |
| YETI Coolers | Cortec Group, Fifth Street Asset Management | Recreational Goods | $100 |
| Univision Communications | AlpInvest Partners, Providence Equity Partners, TPG, Canada Pension Plan Investment Board, Madison Dearborn Partners, Pamlico Capital | Broadcasting, Radio and Television | $100 |

*Source: PitchBook*

# PUBLIC-TO-PRIVATE ACTIVITY

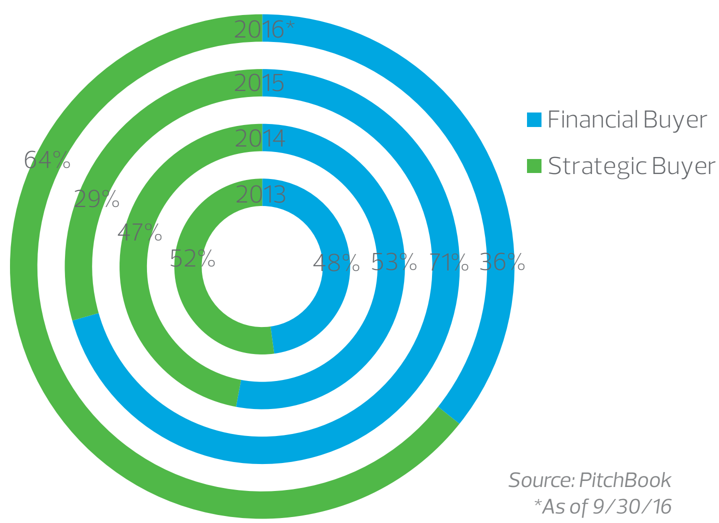
### Private equity as % of overall M&A activity




### PE buyers stay relatively active

As overall M&A activity in consumer products declines, PE buyers are more incentivized to stay active. For one, they can shift their strategies to accommodate a more diverse range of targets in terms of size and region. Secondly, although PE buyers won't overpay in a relatively high-priced climate, they do have mandates to deploy their capital within reasonable time frames and thus will continue to target smaller businesses that likely have more acceptable multiples. Hence PE firms focus on add-ons and consequent propping up of their relative share of overall activity. Not as much can be said of their portion of take-private activity. Public equities remain volatile but by and large, highly priced, while those consumer businesses that slump may be attractive only from a relative cost perspective. Accordingly, given the decline in PE firms looking to pick public companies off the exchanges, it can be assumed investors are not finding many suitable targets to delist thus far in the year, with only a token few transactions standing out, such as JAB and BDT Capital Partners' purchase of Keurig Green Mountain for $14.2 billion.

### Public-to-private deals (#) by acquirer type




*Source: PitchBook*
**As of 9/30/16*

# SELECT B2C Q3 2016 M&A/PE TRANSACTIONS

| Company name | Buyer | Sector | Amount ($M) |
|---|---|---|---|
| Dollar Shave Club | Unilever | Personal Products | $1,000 |
| Elizabeth Arden | Revlon | Personal Products | $870 |
| S&D Coffee | Cott | Beverages | $355 |
| Kahala Franchising | MTY Food Group | Restaurants and Bars | $310 |
| Laguna Dairy | Grupo LALA | Food Products | $246 |

*Source: PitchBook*

# INSIGHTS YOU CAN USE

## Holiday spending to show online surge

Without a doubt, U.S. households are on much firmer footing than at any time since 2007 just before the onset of the two-year Great Recession. Holiday retail sales will likely show a solid 3.4 percent overall gain to $647.3 billion this year, with spending per household increasing to $522. Online holiday shopping will likely increase 13 percent to $118 billion, up from $109 billion in 2015, which means there is some risk of a better rate of holiday spending than our forecast implies, especially in the online sales categories which continue to underestimate the true level of spending.

While that overall increase is indeed a positive development, it's the composition of spending to keep an eye on. This year that composition will likely feature a greater shift toward experiential, travel and services spending, as well as a steady increase toward online purchases, and that may present a challenge for middle market retailers.

The composition of recent income gains in the economy favors the lower end of the spectrum; that is, the bottom-two quintiles of income earners who received a boost from policy changes organized around targeting minimum and livable wages and the Department of Labor's new overtime rules that begin Dec. 1. While this will likely result in further margin pressure for the retail giants, it should, nonetheless, benefit the overall retail sales environment by boosting spending among the lower-two quintiles of income earners who have a higher marginal propensity to consume.

Data also shows the upper-two quintiles of income earners are for the first time since the previous business cycle tapping home equity lines of credit to fund overall outlays. This, in turn, should boost demand for luxury products, travel and accommodations.

Even so, with those income gains clustered in the large U.S. urban areas, and isolated at the upper and lower quintiles of income earners, middle market retail-focused businesses that feed into the traditional mall culture of the suburbs and exurbs, and the independent retailers in rural areas that serve the middle class, may feel somewhat disconnected from this holiday season's spending growth.

For more information, visit www.rsmus.com/fx.

## How retailers can respond to minimum wage, overtime pressures

Retailers already facing minimum wage increases across the country are now also facing new federal overtime rules that may further affect their labor costs. To combat the impact of the new regulations, there are three back-end strategies retailers can use to help maximize profitability and offset costs.

Optimize labor. Retailers need to reevaluate their staffing strategies. Adding part-time workers for specific purposes, such as for store closers, at lower wages and fewer hours; using hourly workers at wage levels lower than managers' salaries to perform less managerial tasks; and investing in high-skilled, more productive workers to help decrease the number of employees on the payroll can all help minimize the impact.

Manage margins. Managing the supply chain is becoming increasingly important. From purchase through delivery, operations need to be integrated, efficient and smooth to truly maximize margins and offset rising labor costs. The transition from multichannel to omnichannel to truly seamless commerce will drive long-term success. Since that doesn't happen overnight, focus on managing costs along the supply chain in the near-term.

Invest in technology. Many retailers have been slow to invest in technology, but labor pressures make investment imperative. Customer-facing technology can drive sales and also help control costs. For example, self-checkout is now common, especially in the supermarket sector, where it could eventually account for 50 percent of transactions.[1] Retailers also need to invest in technologies to streamline the on-line sales process. Growing at a much faster rate than overall retail sales, the on-line channel provides a significant opportunity for growth; it now represents only 10 percent of overall retail sales.[2] However, currently many retailers claim on-line sales have a higher cost associated with them.

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### The value of RSM's middle-market leadership

Focusing on the middle market, RSM US provides integrated transaction advisory, tax, assurance and consulting services. Our work with 4,000 middle-market consumer products and food and beverage companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 1,700 deals in the past five years, over 300 of which were consumer products and food and beverage transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.

The following list shows a detailed breakdown of the PitchBook industry codes for the B2C industry.

# 2. CONSUMER PRODUCTS (B2C)

2.1 Apparel and accessories
2.2 Consumer durables
2.3 Consumer nondurables
2.4 Media
2.5 Restaurants, hotels and leisure
2.6 Retail
2.7 Services (non-financial)
2.8 Transportation
2.9 Other consumer products and services

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