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The U.S. economy will likely see another year of growth between 2.2 and 2.5 percent, with risk of a slower overall pace of activity. Sales to private domestic firms, which is a good proxy for middle-market growth and the real economy, has expanded by about 2.6 percent during the past two years, well above the 2.2 percent average growth rate of the overall economy during that same time. That trend for the middle market is poised to continue this year.

The major growth engines this year will be the household sector, residential investment and support from government spending. We anticipate household spending will grow at 3 percent, residential starts to increase to 1.45 million units at an annualized pace, and the combined lifting of sequestration caps and increased outlays on roads should boost overall growth by 0.2 to 0.3 percent on the year.

The drags on growth will be manufacturing and net exports. Meanwhile, the major question mark will continue to be fixed business investment. Improvement in that area of the economy will depend on oil, energy and commodities finding a price floor. If that doesn’t happen, then growth could revert back to the long-term trend of 1.5 percent.

Consumer products are poised to have another solid year of growth with the composition of spending moving from autos to non-durables and services. The structural shift in retail will continue and favor non-publicly held firms that are nimble, integrate advanced technology into their production, products and marketing and are in touch with their clients’ rapidly changing tastes and preferences. Food products and restaurants are poised to receive support from job creation and rising wages. On January 1 this year 20 states lifted the minimum wage, including California, and on February 20 Wal-Mart will lift the wages for one million of its employees to $10 per hour. While on the margin this will support overall spending, some firms in retail, leisure and hospitality sectors will face margin compression due to rising labor costs.

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 Commentary
In a rapidly evolving marketplace, RSM director, consumer products industry, former industry analyst Jeffrey B. Edelman, takes a look at trends, challenges and ideas directly related to the consumer products industry and makes recommendations for how to address them, improve business and contribute to your success. Read more.
Healthy activity, albeit at a slower pace

While factors including lower oil prices and continually increasing consumer spending have provided benefits to the consumer products (B2C) space, businesses in the sector are still facing profitability challenges as they navigate a changing environment. Spending behavior has remained relatively similar to what we’ve seen in recent quarters, with consumers continuing to spend, but deploying their disposable incomes in nontraditional avenues and bigger-ticket items. Jeff Edelman, a director with the consumer products industry practice at RSM US, points out that consumer expenditures, such as health care premiums and increasing rent prices, will continue to grow, in turn swallowing up a significant portion of the consumer’s increased current disposable income. “Economic indicators suggest that we’re going to see inflation in health care costs and in rent prices as more individuals choose to rent, rather than buy. So in most markets where things such as low oil prices are positive for the consumer, that additional income will be taken up by basic necessities.”

Retail businesses experienced a heightened headwind in Q4 in the form of bad weather. Edelman points to that as a potential cause of the divergence between Q4 consumer spending and the portion of that attributable to retail sales. “Weather was a significant issue this year,” he says. “And while it’s a near-term phenomenon, I believe that retailers entering Q4 with much higher than normal inventory-to-sales ratios ended in a somewhat similar pattern, so they’ll have to take a conservative approach for the spring season.”

While evolving headwinds will continue to pressure the B2C space in the near future, the strategic and financial need for M&A remains as private equity (PE) buyers and strategics alike compete for quality growth opportunities in an era of low bottom-line growth. Edelman suspects that many brands’ businesses will be below plan due to the challenges previously mentioned—among others—yet the factors that have led to the attractiveness of strong brands from an acquisition point of view should continue. As we’ve touched on in earlier editions, the B2C space is continually facing increasing costs that cannot necessarily be mitigated. The rush to omnichannel to offer enhanced consumer experiences has forced technology expenditures to rise faster than most companies expected, across both retail and various other brands. From a restaurant angle, John Nicolopoulos, retail sector leader at RSM US, points to technology investments coming in areas that are contrary to where many might think. “We’re actually seeing companies invest more in operational types of technologies that would enable them to manage labor and food costs better and become more efficient operators.” Nicolopoulos also points to the historical absence of this investment finally impacting businesses. Younger companies are realizing that these operating systems need to be in place for them to be as lean as possible, he iterates, in turn helping them battle other unavoidable costs.

Bifurcating between retail and the food and beverage spaces, the continued economic slowdowns outside of the U.S., along with the relative plunges in foreign currencies against the U.S. dollar have had different effects on each sector. Looking at retail and products businesses, “We didn’t get the expected foreign and international consumer shopping in the U.S. last holiday season due to the foreign currency fluctuations,” says Carol Lapidus, consumer products practice leader at RSM US. “And with the U.S. dollar remaining so strong and the continued uncertainty remaining abroad, I think this trend is going to continue throughout at least most of 2016,” she adds. Food importers and distributors, however, have actually experienced a positive impact from declining foreign currencies. According to Cristin Singer, RSM US’s food and beverage practice leader, many of these businesses have seen significant increases in income due to cheaper product purchases on a currency basis and being able to generate an alpha from selling that product in U.S. dollars in Q4. Singer does note that importers and distributors are limited in the benefit they can realize from this as varying shelf lives of food products influence the total amount of inventory they can realistically hold before expiration dates are reached.

As we experienced in 2015, profitability across the B2C space will likely remain below the levels we reached in 2014 through the remainder of the current year. Increasing wage expenses and technology expenditures, among others, will impact earnings, while growing consumer expenditures will put a damper on growing disposable incomes. In addition, demand may also soften a bit in a slower growth environment and businesses will look to offset unavoidable expenses by scrutinizing overheads closely. That said, ample amounts of capital remain on the sidelines and attractive brands and concepts are still being developed, so dealmakers will remain active, albeit at a slower pace than what we’ve experienced in the past couple of years.
M&A DEAL FLOW

Necessity for growth will bolster M&A

2015 business-to-consumer (B2C) M&A aggregate value soared higher by 41 percent relative to 2014 numbers, driven by a few outlying mega-transactions. Deal value for the period came in at just shy of $214 billion across 1,865 transactions, representing a 3.7 percent decline in year-over-year (YoY) volume. On a quarterly basis, we witnessed a more pronounced drop in volume, accompanied by a decline in value as well. $27.5 billion in merger activity was completed during the last quarter of 2015 across 392 completed deals, a quarter-over-quarter (QoQ) decline of more than 68 percent and 21.3 percent, respectively. While Q3 saw the largest consumer deal of the year close, total deal worth was still down near 13 percent on a quarterly basis when backing that out.

Economic jitters across the globe, coupled with increased trepidations in both equity and debt markets have heightened concerns around where the U.S. may be positioned in the business cycle. These concerns have also contributed to increasing scrutiny around the quality of company inventory coming to market. With this, buyer-to-seller discrepancies continue to arise regarding valuations, which can contribute to deals taking longer to close. “There’s probably some special situations out there that are going to hit us in terms of uncertainties and more complicated deals such as carveouts, so it’s taking more time to get companies to market,” says Bill Spizman, a partner with the transactions advisory services practice at RSM US.

As dealmakers evaluate the market state, there is still a dire necessity for growth and strategics will not shy away from locating synergistic acquisitions. Multiples appear to have declined a significant amount in 2015, yet that was primarily driven by the drop-off in volume and lower-tier businesses coming to market. Growing companies will remain in the forefront and in the limelight, notes Nicolopoulos, which will keep multiples heightened for such enterprises. Further, smaller and younger middle-market companies are still enjoying promising futures. “RSM US continues to spend considerable time with these clients to help develop the infrastructure and internal control structure around their organizations to help them scale appropriately,” states Nicolopoulos, “and we’re very bullish on where they’re headed and where they’re likely to finish in 2016.”

Average and median M&A deal size (SM)

Source: PitchBook

Deal multiples

Source: PitchBook
Dealmaking environment remains competitive

From a high level, PE activity in B2C saw a considerable 34 percent YoY rise in value across a decline of near 7 percent in volume; however, that number is heavily skewed by the 3G Capital-backed Kraft–Heinz merger in Q3. While this transaction has received extensive press, backing it out paints a much different picture for PE that more accurately depicts the current competitive environment. Excluding that transaction, 2015 saw both YoY capital invested and volume decline for the first time since 2009. $123.5 billion worth of PE transactions were completed last year across 708 transactions, a decline of around 7 percent in both value and volume. Looking at QoQ performance, Q4 experienced a rather noticeable decline, with $23 billion across 148 completed deals, a consecutive decline of 23 percent in both metrics, again excluding the aforementioned mega-merger.

Following a couple of years that saw many tier-one companies come to market, valuations have reached levels that many PE buyers cannot afford as corporates remain hungry to deploy cash reserves in pursuit of income growth. “It’s difficult for PE firms to deploy funds right now because of the high multiples auctions are making them pay,” explains Spizman. As PE dry powder levels remain high, GPs are scouring for opportunities, yet they need to be creative and more selective in deploying capital, in many cases leading them to look to lower ends of the middle market to find less expensive, non-auction deals. Diligence processes remain vital to help set buyers apart from competition and are being called on earlier in the deal process than has historically been the case. Concerns continue to play out across global economies, and while investors are certainly apprised of these issues, they need to remain prudently active. “Buyers are looking to understand the impact of recessions, but they’re more concerned with understanding the basics of a business, such as who the customers are and their related buying habits, more than being overly concerned around recession probabilities,” adds Spizman.
Exits decline amid buyer–to–seller discrepancies

PE-backed exits last quarter declined close to 18 percent on a yearly basis. Given the continued volatility of public markets in the back half of 2015, it comes as no surprise that public offerings by PE-backed portfolio companies declined over 57 percent compared to 2014 numbers, yet it should be noted that all exit ramps saw volume slide. In a conflicting environment where valuations have been bid up while the quality of companies looking to come to market has ostensibly slipped, the same buyer–to–seller discrepancies that we touched on in the previous section applies in the exit context. Expectations remain high from sellers, which can contribute to a longer negotiation period that led many prospective Q4 sales to extend out into 2016. The strategic exit ramp remains the most prevalent, with close to 54 percent of all PE-backed sales going to a corporate acquirer. That ramp is mutually beneficial: corporate buyers can afford to pay the frothy prices that many GPs are looking for and also provide a less costly sale process relative to public flotations. Further, as companies looking to go public will face challenges should they have certain flaws in their financials, a strategic acquirer can still find value in certain portions or business lines of such companies, again allowing a greater probability that selling GPs can capture adequate value for their exits through this route. Secondary buyouts have seen a slight, but consistent yearly increase from 2013 through 2015, accounting for near 43 percent of PE sales in 2015. With concerns around the current buyout cycle, managers looking to provide limited partners with focused, deep value and operational strategies can find many positives in portfolio companies that may not be suited for their current owner at this time, potentially contributing to the increase in B2C secondary buyouts.
IPO ACTIVITY

IPOs in the B2C Industry

$2.4 billion was exited through the ramp across 17 offerings in 2015, representing a YoY slide of 53 percent and 51 percent, respectively. On a quarterly basis, Q4 saw just a single B2C IPO come to market, raising $48 billion in the process, a massive drop-off from an already depleted $1.5 billion raised via 5 listings in Q3—no PE-backed offerings were completed in Q4. “We don’t see many IPOs in non-restaurant sectors, and I don’t know that that’s going to change in 2016 with PE firms and strategic acquirers competing for branded companies that have base growth strategies,” says Lapidus. With median offering sizes fluctuating across quarters in 2015, best-in-class brands and concepts were able to list and receive better acceptance from investors, yet the continued public market rout we saw unfold at the end of the year has increased the reluctance to exit through that route. On the PE front, larger, heavily leveraged companies may be forced to tap the capital markets in order to pay down debt given the recent wariness from lenders at the high end. Outside of this scenario, B2C listings should remain dampened in 2016.

RECENT B2C IPOs

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<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount (SM)</th>
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<tr>
<td>Ollie’s Bargain Outlet</td>
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<td>Arrowhead Mezzanine, Gemini Investors, Roark Capital Group</td>
<td>Restaurants &amp; Bars</td>
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PE-backed IPOs

Source: Pitchbook

B2C IPO PIPELINE

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<th>Company name</th>
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<th>Sector</th>
<th>Amount (SM)</th>
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<td>McGraw–Hill Education</td>
<td>Apollo Global Management</td>
<td>Education &amp; Training</td>
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Source: Pitchbook
Consumer Products

PUBLIC-TO-PRIVATE ACTIVITY

Private equity as % of overall M&A activity

PE's portion of M&A bumps higher

While total deal volume was lower, PE groups accounted for approximately 29.3 percent of all M&A activity in 2015, inching higher from the 28.8 percent financial buyers accounted for in 2014. During Q4 2015, PE represented the same proportion of M&A as it did for the entire year, jumping from the 26.3 percent they accounted for in Q3 as corporate acquirers appeared to have held back during the period more than PE. Looking at public-to-private deals, 11 PE-backed B2C take-privates were completed during the year compared to just four from strategic acquirers. With many public companies looking to address starved top and bottom lines, uncertain and volatile market participants can be unforgiven to transformational investments and strategies that can negatively impact profits before bearing significant positive outcomes. With that, moving to the private markets can be an attractive route in order to make those changes without public shareholder scrutiny, which is contributing to the P2P activity we see from financial buyers.

SELECT B2C Q4 2015 M&A/PE TRANSACTIONS

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<td>Elmer’s Products</td>
<td>Newell Rubbermaid</td>
<td>Consumer Products</td>
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<td>Pandora Media</td>
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<td>Brentwood Associates</td>
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<td>Stumptown Coffee Roasters</td>
<td>BDT Capital Partners, JAB</td>
<td>Beverages</td>
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Source: Pitchbook
Consumer Products

INSIGHTS YOU CAN USE

5 cybersecurity predictions for 2016

As companies become increasingly reliant on technology to improve efficiency, productivity and mobility, vulnerabilities to cyberattacks are growing. While breaches at large organizations make headlines, no organization is too small to be a valuable target, and most companies will likely suffer a cybercrime at some point.

1. Cybercriminals will not just go after bits and pieces of data, as has been common practice in the past. Instead, cybercriminals will increasingly seek to build entire profiles from data collected and sell it as entire identities for monetization or for nation states to use for their targeted attacks.

2. The “Internet of things” is still growing as seemingly everything (vehicles, appliances, children’s toys, safety systems and others) a business or consumer purchases is “Internet ready.” Unfortunately, we continue to read about these systems being broken into and either remotely controlled in disturbing ways or used to gather information on businesses or families without their knowledge.

3. Cybercriminals will continue to use social engineering to facilitate their system breach efforts. Postmortem breach reviews indicate that many successful breaches are dependent on attacking the organization’s employees, customers or business partners through social engineering efforts.

4. Health care information has more value per stolen record than most other forms of data theft (bank account, credit card, PII). Health care information is often tied to a social security number, and it is difficult to get a new number issued that does not tie back to the original number. It simply isn’t as easy as getting a new credit card.

5. System security configuration issues continue to be a common source of security incidents and potential breaches. RSM continues to see too many weak security implementations for servers, workstations and other network devices during testing. New systems should be implemented using a National Institute of Standards and Technology (NIST) security reference or other guidelines to create a “base” image. That base image should then be used as a starting point when new systems are implemented.

Tax changes affecting consumer products companies

There were a variety of industry trends impacting consumer products companies in 2015 and many of these will likely continue into 2016, including:

- Leveraging increased consumer spending power due to lower gas prices and an improving job market
- Implementing early discounting before the traditional Black Friday retail push
- Nurturing meaningful relationships with consumers to establish and maintain customer loyalty
- Understanding the unique needs and wishes of the millennial consumer
- Deploying omnichannel strategies to increase market reach to customers
- Establishing further information technology security and privacy measures to protect the business and customers
- Making major capital investments in the business to remain competitive and fulfill the preferences of customer
- Exploring mergers and acquisitions avenues for the business
- Seeking international opportunities, and understanding the challenges of this endeavor

Many of these trends were important to consumer products companies in advancing growth and meeting the needs of customers; however, some provided even further tax challenges, as well as opportunities, for businesses. In our webcast, *2015 tax changes affecting consumer products companies*, presenters explored these specific trends a bit further to uncover key tax implications, changes and ways to address them.

Visit [www.rsmus.com](http://www.rsmus.com) for more popular insights.
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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