McGladrey Spotlight on Consumer Products and Services

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2Q 2015
By Joe Brusuelas, McGladrey Chief Economist

A modest rebound in the U.S economy is taking shape after what will likely prove to have been a contraction in output during the first three months of the year. An appreciating U.S. dollar and the work slowdown at West Coast ports weighed heavily on the manufacturing and tradable sectors, along with soft external demand related to the economic slowdown in Europe, China and emerging markets. It’s also worth noting the 48.7 percent decline in energy-related investments acted as a major drag on economic activity in the first quarter, as well. Now, however, those drags are slowly easing, and it wouldn’t be surprising to see a rebound in energy-related investment in the second half of the year.

Keys to growth

The two keys to economic performance going forward will be household spending and residential investment. Employment conditions continue to improve amid a tightening labor market and rising wages. This should translate to improving household spending. Consumers are building a potent arsenal of spending power via the increase in household savings to 5.3 percent, a 2.8 gain in wages and salaries from a year ago, and a jump in real disposable income to 6.1 percent, thanks to falling gasoline prices.

Meanwhile, residential investment is up 20.2 percent on a year ago basis through April. Base effects due to year ago comparisons are likely to boost the contribution of growth by the housing sector, which still contributes about 3.1 percent to gross domestic product (GDP). Keep in mind that purchases of housing-related services still comprise 12.29 percent of GDP, which, given rising wages and inflation-adjusted disposable income, bodes well for the remainder of the year. Not surprisingly, demand for housing and utilities are up 4.9 percent, well above the 1.9 percent rate of overall consumption through the end of March.

A closer look at B2C

Demand for consumer products and services (B2C) is somewhat uneven now. Services were up 2.5 percent in the first quarter after the 4.3 percent surge to close out last year. While retail sales slowed in April, the weakness was in price-sensitive areas and the top line likely suffered from faulty seasonal adjustments made by the Commerce Department. This suggests possible upward revisions to the data next month.

M&A activity

Low interest rates should continue to support M&A activity in the business products and services (B2B) and B2C markets. The pickup in economic activity should boost transportation, which improved by 3.4 percent. Outlays on software were up 5.8 percent, and business equipment increased by 0.1 percent through March.

Service spending accelerating

![Graph showing service spending acceleration from 2003 to 2015. The graph indicates that service spending and inflation-adjusted service spending are both trending upwards, with service spending rising from negative year-over-year percentage changes to positive values by 2014. Source: McGladrey, BEA.]
A powder keg for consumers
Growth in the U.S. B2C space has lagged recently, despite low gas prices and rising consumer confidence. Expectations of a spending bump failed to materialize in the first quarter. Savings at the gas pump were instead funneled into savings accounts or big-ticket purchases, like travel. “We’re seeing spending trend on the same slow pace over the last several quarters,” says Jeff Edelman, director of retail and consumer advisory services at McGladrey. “We’re missing a catalyst for the consumer to spend.” Today’s low-growth environment is considered “the new normal” by some, though it may be the result of distortions rooted in the dot-com and housing bubbles, which have muddied the waters as to what’s real and what’s not.

Even so, the U.S. B2C sector may be poised for a breakout. Despite a less-than-impressive Q1, the industry is in a good position in the business cycle, according to Joe Brusuelas, chief economist at McGladrey. “When you get into mid-to-late business cycles, you’re going to see an upswing in overall activity and demand. The economy has added, on average, about 260,000 jobs per month over the past 14 months, which means more people have more money to spend on discretionary items. Private sector hiring is expected to remain around the 225,000-250,000-per-month range going forward, which should bring wages back up around 3 percent. The savings rate jumped to 5.5 percent, and thanks to falling gas prices, real disposable income was up 6.1 percent through the end of March. “That’s what we’d call a ‘powder keg’ for the consumer,” says Brusuelas. “Consumers have some dry powder to put to use going forward, and I expect to see a healthy increase in consumption in the middle part of the year.” Consumer confidence, which is highly sensitive to movements in gas prices and employment reports, is at or near cyclical highs.

Companies exposed to consumer spending should note that consumption patterns appear to be changing. Older consumers are spending less on discretionary items today and more on health care-related expenses. At the same time, younger consumers, particularly millennials, appear more interested in lifestyles and travel and less interested in logos and brands. Shifts in consumption may be rooted in changing behavioral practices, perhaps on a fundamental, structural level. “Consumers are gravitating toward companies that can take them on a journey,” notes Brusuelas. “If you want to drive organic growth, you need to take your product and put it in an overall narrative that provides an experience and shows your customers what they’re buying and how it will help them and their bottom line.” Companies need to tailor their strategies to adapt to this new dynamic, which appears to be moving beyond omnichannel.

Many B2C companies remain behind the curve in that area, says Edelman. “We’re seeing technology expenditures being based on need, rather than the overall framework on a planned budget. There’s increased concern on margin pressures just from these expenses that they have to make.”

There are other concerns in the industry. Cristin Singer, food and beverage practice leader at McGladrey, continues fielding questions surrounding Food and Drug Administration (FDA) requirements and food safety, particularly recalls and product quality. “Companies are looking at what policies and procedures they have in place to avoid serious issues,” adding that some recalls are affecting more than just retailers and manufacturers. Packaging providers can also be caught in the crosshairs. The California drought is another food-related concern; the water shortage is a headache for farmers in the state and may be impacting the national food supply.

One California-related problem that didn’t have much impact on B2C was the West Coast port strike. The labor dispute lasted around nine months and came to an end in late February. “If anything, costs were a little higher and markdowns were a little higher, but it didn’t impact sales very much,” says Edelman. Suppliers and vendors were hit harder due to order cancellations and late receipts. The silver lining is that the episode prompted many consumer-facing companies to revisit their shipping methodologies.

Bill Spizman, partner of transaction advisory services at McGladrey, identifies one more concern in the industry: uncertain deal flow. “On the sell side, companies are wondering when they should go to market. They don’t want to lose opportunities that come with high-multiple environments.”
Brands are key

Another $39.4 billion worth of B2C deals were completed in Q1, the highest quarterly total since the $47.6 billion spent in Q2 2014. While aggregate value totals have crept back up over the last three quarters, deal flow has fallen. “Current deal flow is reflective of the competitive and frothy deal environment in the industry,” says Michael Grossman, principal of transaction advisory services at McGladrey. “Finding deal flow is challenging, particularly a good deal with a great brand, and multiples are still very high.”

Brands are key in U.S. B2C. Even with high valuations, buyer demand is still strong. Singer cites more discussion in the food space around acquisitions. Carol Lapidus, consumer products practice leader at McGladrey, says anything brand-related is in high demand. “If you have a branded growth company that consumers like and are excited about, the sky’s the limit right now.” There are several deals in the market right now; it’s just a question of what buyers are willing to pay.

Deal flow may be affected if the stock market sees a significant correction. Activity could be hindered because of the psychological effect, and Spizman thinks the market has begun to see some corrections over the past year or two. On the other hand, private equity (PE) deal flow could see a boost if the initial public offering (IPO) window closes or if the economy goes back into recession, says Grossman. “That type of economy might discourage companies from going public and choose instead to go the private equity route.”
No signs of a slowdown

PE deal flow remains strong in B2C. Another $32.1 billion was invested in the first quarter through 139 deals. The latter figure is on the low end of recent quarters, but total value hit its highest point since Q2 2013.

While deal flow has been difficult for financial investors, several opportunities are proving too good to pass up, despite today’s multiples. “Buyers are willing to paying more for the deal if they can foresee a successful return on investment,” says Spizman. “If the company is growing and has enough potential for a good exit, the deal is still going to happen, even if the multiple is high.

The company represents a story they can build and develop.” He adds that he hasn’t noticed any buyers pulling out of the market because of valuations, though multiples may be adding some hesitation among investors.

The specter of an interest rate hike doesn’t seem to be impacting deal flow too much, but it may down the road. Right now, it’s not so much about the cost of money, but about the availability of money. If rates go up, there may be some drawback on the availability front, which may bring prices down a bit.
Still a seller’s market

PE firms continue to focus on exits in the current seller’s market. Coming off a record 2014, another 50 B2C portfolio companies were exited in Q1, including 31 via strategic sales. 16 of those Q1 exits were for consumer nondurable companies, a historically high percentage broken down by industry.

With the continuing seller’s market, sell-side due diligence is becoming the norm in the industry, according to Spizman. “Investment bankers are finding the sell-side due diligence process helpful, because it keeps more buyers in the process, and sales are becoming more efficient as well. Sell-side diligence shortens the sales process and is a value-add proposition to sellers, who can identify adjustments and issues to be made before buyers do.” Sellers are better prepared to go to market with sell-side due diligence reports, which help reduce re-trading and last-minute surprises for both sides of the deal.
IPO activity

IPO activity for B2C companies has oscillated quite a bit over the last two years, though on the whole, it’s been on a downward trend. Stock market jitters may explain more recent IPO totals, though between 2012 and 2014, IPOs were a relatively large portion of PE exit activity versus outright sales. It may be the case that with the M&A boom in full swing, IPOs are seen as a less predictable (and possibly less lucrative) route to take, compared to strategic acquisitions or PE buyouts. With demand strong enough and buyers willing to pay high multiples, IPOs could be seen as less preferable by sellers.

IPO window closing

Recent B2C IPOs

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<thead>
<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount ($M)</th>
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<tbody>
<tr>
<td>Michael's Stores</td>
<td>Bain Capital, Blackstone, Highfields Capital</td>
<td>Retail</td>
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<td>Wayfair</td>
<td>HarbourVest, Great Hill Partners, Battery Ventures</td>
<td>Retail</td>
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<tr>
<td>Shake Shack</td>
<td>Leonard Green &amp; Partners, Alliance Consumer Growth, Select Equity Group</td>
<td>Restaurants</td>
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B2C IPO pipeline

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<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount ($M)</th>
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<tbody>
<tr>
<td>Performance Food Group</td>
<td>Quilvest Private Equity, The Blackstone Group</td>
<td>Food Products</td>
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<tr>
<td>Floor &amp; Decor Holdings</td>
<td>Freeman Spogli &amp; Co., Ares Private Equity Group</td>
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<tr>
<td>Claire's</td>
<td>Apollo Global Management</td>
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<tr>
<td>J. Alexanders</td>
<td>Fidelity National Financial</td>
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Select B2C Q1 2015 M&A/PE transactions

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<th>Buyer</th>
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<tr>
<td>Gold Coast</td>
<td>Reyes Beverage Group</td>
<td>Beverages</td>
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<td>Cassidy Turley</td>
<td>TPG Capital, PAG Asia Capital, OTPP</td>
<td>Real Estate Services</td>
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<td>MyFitnessPal</td>
<td>Under Armour</td>
<td>Recreational Goods</td>
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<td>Expedia</td>
<td>Travel Services</td>
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<tr>
<td>Halifax Media Group</td>
<td>New Media Investment</td>
<td>Publishing</td>
<td>$280</td>
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Source: PitchBook
9 trends in consumer products and retail for 2015

Many industry analysts are predicting that 2015 will be better than 2014 for consumer products companies and U.S. retailers. The level of success individual companies enjoy will depend on their ability to connect with customers and provide the goods and services they want, when they want them and at reasonable prices.

The retail dialog in 2015 is expected to be a continuation of many of the discussion points made in 2014, but with a few twists. That dialog is expected to include the following topics:

1. **Consumer spending**
   Getting a lift from lower gasoline prices and an improved job market.

2. **Black Friday**
   Interpreting the impact of the early discounting both from a results and margin perspective.

3. **Meaningful relationships with consumers**
   Maintaining strong relationships with existing customers is potentially more profitable than trying to find new patrons who may have allegiances to competitors.

4. **Impact of millennials**
   Using technology to connect with this generation of decision-makers and maintain relationships with them.

5. **Omnichannel**
   Become vital for retailers since 80 percent of shoppers now use their digital devices to research products and services, and to comparison-shop either before or while walking through a store.

6. **Security and privacy**
   Failing to maintain proper security not only results in devastating financial and legal liabilities but also may seriously damage consumer trust.

7. **Capital investments**
   Devoting the financial resources to updating the look and feel of stores to entice existing and potential customers.

8. **Mergers and acquisitions**
   Looking for capital infusions to fuel expanded growth.

9. **International opportunities and threats**
   Facing an uphill battles when it comes to international expansion.

**Credits and incentives can add real value to your deal**

Companies traditionally pursue state and local tax credits and economic incentives when they are investing new capital and creating new jobs. Economic development agencies are interested in helping companies achieve their growth goals while attracting or retaining jobs and workforce skills in their local communities. M&A activity has not always been a focus area of these agencies, or the companies themselves. However, capital investment into an existing company as a new owner is increasingly recognized by state and local agencies, and private equity investment is clearly part of that trend.

When buyers are acquiring businesses in new locations, the activity may be treated as original investment in a community even if the acquisition does not include new jobs or construction. Too often, buyers overlook the opportunity to take advantage of statutory and discretionary incentives because they are unaware of what is offered or how the local agencies respond to M&A activity.

New owners represent an opportunity for state and local representatives to establish relationships that are centered on a shared interest in economic growth of the community. Companies want a vibrant business community with a strong workforce, and agencies want a strong business base and solid employment opportunities for their constituents. For these reasons, M&A activity creates an opportunity to discuss and secure financial and economic incentives that may ordinarily be overlooked and can even add value to a deal.

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The value of McGladrey’s middle-market leadership

Focusing on the middle market, McGladrey 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 1,900 deals, over 00 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.
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The following list shows a detailed breakdown of the PitchBook industry codes for the B2C industry.

2. Consumer Products and Services (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 (nonfinancial)
2.8 Transportation
2.9 Other consumer products and services
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