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Economic activity appears to have rebounded strongly in the second quarter of the year with noticeable advances in household spending, increasing housing starts and a modest improvement in overall manufacturing and industrial production. We anticipate growth in the second quarter of 2016 should come in between 2.5 and 2.8 percent. Excluding autos and gasoline, overall retail sales are gaining momentum and have a 4 percent run rate on a three month annualized basis. Household outlays on consumer services remain strong amidst solid job growth and improvement in wages and salaries. Rising gasoline prices over the past few months have caused consumers to pull back somewhat on dining out, and they are buying more groceries. Most encouraging is the rebound in industrial production, which increased 0.9 percent in April. Industry surveys indicate that a two–month surge in new orders should set the stage for a modest rebound throughout the remainder of the year as the industry shakes off the lagged impact of U.S. dollar appreciation, soggy external demand and the effects of the downsizing in oil, gas and mining. Thus, with the manufacturing sector moving back to growth, the major risks to the outlook remain decisively in the external sector.

On a micro level the disruption to big box retail stores and malls with large retail anchors is accelerating which has caused something of a shakeout in publically–held retail firms, many of which have observed significant declines in share prices. The structural transformation of the retail portion of the consumer products (B2C) industry is likely to continue for the foreseeable future and middle market firms that feed into the supply chain will need to adapt accordingly.

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.
Foreign troubles hit U.S. CP industry

The negative currency impact on the consumer products space driven by a volatile foreign exchange market has become a much more pronounced story as of late. With the majority of U.S. businesses operating within the core of the middle market, many of these companies are at a point in their lifecycle where they are both buyers of foreign materials and goods, as well as sellers of final products into foreign markets. With that, the impacts of volatile currencies have caused a series of headwinds, whether in the form of true dollars being lost due to fluctuations, the impacts of currency volatility on financial reporting, or the translation differences that affect the balance sheet.

Forex fluctuations are having a huge impact on our middle market clients,” says Carol Lapidus, consumer products practice leader at RSM US. “Whether they’re doing business in Japan, China, Canada, Europe or any other location, they’re having a very tough time wrapping their arms around the foreign currency swings.” While major corporations employ substantial teams that look to mitigate this issue via the exchange rate agreements they hold with their banking partners or by outright trading in and out of various currencies, among other initiatives, the reality is that many middle-market enterprises do not have the sophistication or the resources to support similar practices. Therefore, hedging against currency risks and working with banks to find the most cost efficient methods to move large sums of business capital has become a heightened initiative for B2C executives.

Companies must also be sure not to downplay the need to continue with the aforementioned protective measures despite the macro data providing slightly changing metrics. “One of the challenging things going forward is that we’re talking to clients about a previous quarter, which is perfectly appropriate. Yet if the dollar appreciation in some cases stalls or partially reverses, some clients may begin feeling less pressure and may choose not to purchase hedging products,” according to Joe Bruesuelas, chief economist at RSM US. Mr. Bruesuelas stresses the fact that businesses with any sort of external exposure should think of hedging products as a form of insurance that they have to buy, and hope to never have to exercise.

The currency volatility we’ve discussed above has also given way to a rather significant decline in foreign spending in the U.S. So, while domestic spending has grown at a respectable rate, the impact of less capital supporting U.S. tourism, retail and other consumer products has become a growing uncertainty for U.S. businesses.

In terms of the factors that have served as either drivers or headwinds for the core operations of the CP sector, nothing material has changed. Companies continue to see consumers spend in other places outside of traditional product markets, and further look to shop in much more tech–enabled and experiential ways. Rising rent costs continue to eat away at the increases consumers have seen in their spending power, and top–lines across the industry haven’t shown meaningful growth signs, leaving business leaders in a difficult space to navigate how to guide their businesses in a global economy that seems far from finding solid grounding. “You want to continue spending money on developing closer relationships with millennials through technology, but if your business isn’t making as much money, you’re not going to be as open to doing that,” explains Lapidus.

The headwinds the industry is facing appear to be more fundamental in nature. Many businesses may not have control over the global macro environment, yet those willing to invest in the sales drivers the changing consumer has shown are effective, in addition to actively managing financial and currency risks in a slow growth environment will be able to outperform. While valuations remain expensive on the mergers and acquisitions (M&A) front, concepts and brands able to outpace gross domestic product (GDP) will serve as attractive acquisition targets, especially in an environment where strategic acquirers are looking to find more transformational and accretive deals that can move revenue growth higher in a shorter time frame.
Consumer Products

M&A DEAL FLOW

Strategics look for transformational deals

Given the consumer spending and global growth concerns highlighted in the previous section, executive teams and boardrooms across the U.S have continued to employ an acquisition-based strategy to locate growth. The financial engineering tactics used to prop up bottom lines and earnings per share (EPS) figures over recent years have served their purpose, yet to weather against an uncertain macroeconomic future, consumer products businesses are in need of material growth increases to bolster their core operations. With that, strategic acquirers have looked for much more transformational and impactful deals to help appease to shareholders, so although total transaction volumes have moved lower, total deal value has risen. The first quarter of 2016 saw $54.3 billion in total CP deal value close across 410 transactions, representing a rather impressive 71 percent increase in total M&A value in the sector, yet a 14 percent drop in total counts. On a yearly basis, value was still higher relative to what we saw in 1Q 2015, with year over year (YoY) volume coming in lower as well.

Advantageously, the CP space can still foster many businesses that can weather a slowdown in the economy more than other sectors that are much more closely linked to GDP growth. Companies that have been able to build strong brand recognition and adjust to shifting consumer preferences have continued to receive outsized multiples as dealmakers are willing to pay hefty price tags for relative growth, yet the market nonetheless remains a challenge to navigate.

“I think the sentiment out there is that valuations are still too high and the number of quality businesses looking to exit or find a financial sponsor just aren’t there,” says David Cho, a director in RSM US’s transaction advisory practice. “So we aren’t seeing as many books being passed around, and our pipeline hasn’t been as strong as it has been in the past few months.”

As we move through the remainder of 2016, deal flow will remain subdued and we’ll likely continue to see a distinct bifurcation in the quality of businesses coming to market. Strategics will look to make meaningful deals which will help support total transaction value. But with market-ready inventory simply slowing, corporate-to-corporate deal volume likely won’t move higher at a heightened clip.

Average and median M&A deal size (SM)

M&A transactions (count) by sector

Deal multiples

Source: PitchBook

*As of 3/31/16
SECTOR SPOTLIGHT: RESTAURANT AND RETAIL

Labor costs in the crosshairs

From a macro perspective, changing consumer tastes and preferences have created real waves across the restaurant and retail sectors and a failure to pick up on those changes can leave businesses in a vulnerable position as new players enter the market. Both strategic and private equity (PE) firms remain hungry to take over branded retailers and hot concepts across the fast casual space that can outperform GDP, yet a widening gap remains in terms of the types of businesses dealmakers will pay inflated multiples for and those that will need to accept lower prices if they are looking to exit. “There is a broader disparity between A opportunities, B opportunities, C opportunities and so on,” says RSM US retail sector lead John Niccolopulus, speaking to the quality of deals coming to market. “I think there is a lot more scrutiny on average companies and concepts relative to what we were seeing 18 months ago, but the exciting concepts are still generating a boatload of excitement,” says Niccolopulus.

With that, retailers looking to maintain and grow revenues will need to focus on interfacing and developing strong consumer relationships. While companies are surely aware of the shift from brick and mortar to ecommerce, businesses can navigate this issue and invest to develop their omnichannel operation. But according to Niccolopulus, the real issue is staying relevant with the changing demographics, lifestyles, preferences and priorities of shoppers today. As millennials continue to account for more and more of dollars spent across the retail and restaurant sectors, it has also become extremely valuable to decipher within the millennial group, as the spending profile of a young family with children residing in a suburban setting will be much different than that of a younger professional living in an urban environment. Being able to collect data, analyze your demographic and reimagine to cater to your core customer will remain a challenging but necessary task moving forward.

On the restaurant side, “the number one headwind is labor, in terms of both the cost of labor but also the availability of it as well,” says Niccolopulus. With regulations surfacing around potential changes across overtime pay, many quick serve restaurants and fast casual businesses could see material cost increases, as managers within those sub-sectors tend to be paid less than those working for sit-down restaurants. Lower commodity prices have helped offset wage increases from hitting gross margins, but with the potential of operating in a rising wage and rising commodity environment looming, restaurants need to find ways to attract productive talent, manage costs tightly and create the more profound experience a younger and healthier consumer is seeking out today.

SELECT B2C RETAIL Q1 2016 M&A/PE TRANSACTIONS

<table>
<thead>
<tr>
<th>Company name</th>
<th>Buyer</th>
<th>Sector</th>
<th>Amount ($M)</th>
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<tr>
<td>Flash Foods</td>
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<td>Gilt</td>
<td>Hudson’s Bay</td>
<td>Internet Retail</td>
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<td>Darice</td>
<td>Michael’s</td>
<td>Distributors/Wholesale</td>
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<td>Haggen</td>
<td>BDT Capital Partners, JAB</td>
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*As of 3/31/16
Private equity activity during the first quarter of 2016 experienced much of the same trends we saw unfold in the overall M&A space. Underpinned by the $14 billion take-private of Keurig Green Mountain, total B2C PE deal value moved higher during Q1, with volume continuing to slide on a quarterly basis. Nearly $36 billion was invested by PE dealmakers across 154 consumer-based deals, representing a quarter over quarter (QoQ) rise in deal value of more than 28 percent and a decline of 9 percent in terms of volume during the same period.

With the inventory of quality businesses coming to market slowing, GPs have certainly looked to manage the prices they pay to get attractive deals done, yet the increase in total transaction value also speaks partially to the inability of managers to simply walk away from various transactions, given the amount of dry powder they continue to hold. “Private equity buyers don’t like the valuations being assigned to many companies today, and they’re frustrated because they feel, in some cases, they’re almost forced to do a deal,” says David Cho. To mitigate some of the valuation troubles managers are facing, deal sourcing has continued to shift towards the lower middle market and we saw that show up in the median buyout size of CP companies during the first quarter of 2016, which came in at just under $88 million. “The lower middle-market is less competitive from a PE perspective,” says Bruesuelas. “So they feel there’s more value down there to be had versus some of the larger assets and auction processes you have to go through for larger companies.”

While sourcing transactions in the LMM can be an attractive proposition for PE managers, completing such deals doesn’t come without a unique challenge and set of risks. PE managers will need to dedicate an increased time commitment to help develop standardized accounting structures and place key personnel within those organizations to drive performance, among other initiatives. Nonetheless, PE players continue to find the value in navigating through these different variables and see the risk-to-reward leaning in their favor to execute smaller transactions.
PRIVATE EQUITY EXIT ACTIVITY

Exits decline amid buyer-to-seller discrepancies

PE-backed exits continue to move lower in a consistent trajectory. A total of 47 PE-backed exits closed during Q1 2016, representing a 20 percent decline over what we saw in the last quarter of 2015. All exit types declined, but only three fewer corporate acquisitions were completed last quarter relative to 4Q 2015. Secondary buyouts were down over 32 percent, however, with only 19 such exits closing during the period.

The deal environment continues to move itself through a natural progression, with many of the most sought after assets already coming to market in 2015, iterates Scott Walti, a director in RSM US’s transaction advisory group. Although capital remains on the sidelines for PE players to do deals, and corporations remain ready to add synergistic businesses to their cores, the mismatch between quality and price, as well as buyer and seller expectations will remain in place— in turn suppressing exit volume for the next few quarters. One thing that will help differentiate businesses looking to exit in the current market dynamic will be the utilization of quality of earnings work to help soften the suspicious eye that many buyers are looking at companies with. “We’ve seen a little bit more sophistication in the LMM with companies hiring investment bankers to obtain quality of earnings reports after being approached by buyers,” according to Cho. Buyers are wary of acquiring businesses without the ability to execute on an exit strategy, either due to overpaying or acquiring assets that don’t live up to their growth potential. If sellers can help address potential issues early in a process, as well as reaffirm the quality and accuracy of their growth projections early, they may be able to find more success taking advantage of the multiples buyers will pay for growth, despite overall exit counts in the market staying low.
Not a single IPO comes to market

Nothing has changed in the IPO market as companies continue to shy away from exiting through public offerings and the pipeline remains subdued. Not a single B2C IPO came to market during the first quarter and PE firms haven’t pushed a single company through this exit ramp in two consecutive quarters. In an industry that is arguably seeing the most shifts in terms of its fundamental make up, the M&A route continues to serve as the best exit play for owners as companies are in desperate need of tailoring their brands towards a younger and more difficult shopper, “It’s much easier to buy than invest,” states Jeff Edelman, a director in RSM US’s consumer products practice. “As long as it is a quality brand, acquisitions give you a chance to expand your distribution channels and product mix much faster than you can by yourself,” he says. With that mindset engrained into the agendas of boardrooms across the CP space, the need to find liquidity through an IPO is non-existent, and sponsors looking for lower-multiple add-ons and larger strategics looking to invest for the aforementioned reasons will drive liquidity for sellers.

B2C IPO PIPELINE

<table>
<thead>
<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount (SM)</th>
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<td>Performance Health</td>
<td>Brookside Equity Partners, Gridiron Capital, Maranon Capital, Triangle Capital Corporation</td>
<td>Personal Products</td>
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<td>Laureate Education</td>
<td>Bregal Investments, KKR, Makena Capital, Sterling Partners</td>
<td>Education &amp; Training Services</td>
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<tr>
<td>McGraw–Hill Education</td>
<td>Apollo Global Management</td>
<td>Education &amp; Training Services</td>
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Source: PitchBook
Despite deal flow dropping across the board, PE saw its percentage of total B2C M&A decline to one of its lowest levels we’ve seen over the past few years. With 106 platform buyouts or sponsor-backed acquisitions closing during 1Q, PE only represented 26 percent of all M&A. On a sheer volume basis, PE-backed M&A was down more than 22 percent QoQ, with strategic M&A activity down around 11 percent. Based on many of the deal drivers and industry shifts we’ve touched on in previous sections, PE players aren’t equipped to compete in some of the larger strategic-driven auctions, nor is it worth it to compete in many situations. While flexible capital remains available for many PE sponsors to fund transactions and add-on acquisitions, paying an outsized valuation for a deal could lead to the firm needing to put up more equity, in turn hurting the fund’s exit value down the road. Strategics don’t necessarily have this problem, as they can utilize multiple levers to find the right cost savings, and synergies to drive top and bottom lines. In addition, their hold periods and integration plans speak to a more permanent mindset regarding the transactions they do, while PE buyers have much more sensitive timelines.

**SELECT B2C Q1 2016 M&A/PE TRANSACTIONS**

<table>
<thead>
<tr>
<th>Company name</th>
<th>Buyer</th>
<th>Sector</th>
<th>Amount (SM)</th>
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<td>Boulder Brands</td>
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<td>Rizvi Traverse Management</td>
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<td>Cybex</td>
<td>LifeFitness</td>
<td>Recreational Goods</td>
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<tr>
<td>Toppik</td>
<td>Church &amp; Dwight Company</td>
<td>Personal Products</td>
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<tr>
<td>Panos Brands</td>
<td>Hammond, Kennedy, Whitney &amp; Company</td>
<td>Food Products</td>
<td>$39.5</td>
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</tbody>
</table>

Source: PitchBook

*As of 3/31/16
Consumer Products

INSIGHTS YOU CAN USE

Drive value and growth through enterprise resource planning

If you’ve been in the private equity space, you’ve likely seen this scenario. A privately held investment holding company has acquired three companies in related businesses, each of which was using its own QuickBooks database, along with proprietary operational systems and Excel spreadsheets. As one would expect, monthly or quarterly financial reporting was a nightmare; there was an inability to efficiently roll up data as part of an overall system function. Reporting was done manually, which resulted in a continued lack of visibility to management and was often subject to burdensome errors. This inefficient process continued to be ripe for business risk for the holding company and its portfolio businesses and guaranteed stalled growth.

Sound familiar? Private equity firms struggle with this scenario frequently, as they work to effectively manage their diverse portfolio businesses with their antiquated and clunky legacy systems. How can they pull these often competing financial processes together into a harmonious system that drives value? Enterprise resource planning (ERP) is a strategy some firms are using to consolidate and automate their processes and initiate profitable growth. What’s the first step to herd these disparate systems into ERP efficiency?

First take a step back to initially understand your own system landscape and those of your businesses. In this assessment, some foundational questions should be weighed, including:

- What are the unique issues to consider within my businesses’ industry?
- What are the specific challenges and dynamics to consider in my portfolio businesses?
- What are my firm’s growth goals for the businesses?
- What are the existing financial systems currently in place?
- Who is involved, and what is their role?

Following this inquiry and assessment, and carefully considering current and future needs, it’s then time to look at various ERP systems that could align with business objectives and cost criteria. And after that, a further fit analysis can be completed to narrow down appropriate ERP solutions.

Finance function transformation: Three things you should know

An enhanced finance function can be a vital strategic business partner to your organization.

1. **Modernizing the finance function is essential for your organization’s maturity and growth.** Ensure that finance is properly aligned to the organization’s strategy and is operating effectively from a people, process and technology standpoint, linking strategy to execution and moving away from reactive processes to proactive strategies.

2. **The finance function’s increased visibility and interaction within your business has a real impact on decreasing operational and functional gaps and increasing return on investment.** Having a robust, mature and strategic finance function can offer meaningful and actionable management information by providing key performance indicators, profitability assessments, control monitoring, continuous improvement strategies and more. Partnering with finance allows an organization to rationalize, monitor and execute in an optimal and sophisticated way to increase the all-important return on investment on its many programs and initiatives. Utilizing the best resources to their strengths, investing in technology and new budgeting methods, and challenging the “way we’ve always done it” will allow organizations to succeed.

3. **Finance function modernization and transformation affects many areas in a productive and lasting way.** Forming strategic partnerships among the company’s lines of business allows for a better understanding of the key business areas, their needs and how to better serve them. It moves finance from “overhead” to a “partner” that has a voice in the business. If finance is assisting with analysis and planning, and is sought out when issues arise and when products or acquisitions are considered, the growth of the organization is fostered.

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