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The U.S. economy closed out 2016 on a strong note, growing by 2.7 percent during the second half of the year with a strong probability of upward revisions to the Q4 2016 data. The increase in growth was bolstered by sustained gains in jobs and wages, which supported a roughly 3 percent pace of spending throughout last year. While the topline slowed to 1.9 percent to close out the quarter, gross domestic purchases increased by 2.5 percent and final sales to domestic purchasers 2.8 percent.

More encouraging was the rebound in capital expenditures and corporate earning that have lagged since mid-2015. Private fixed business investment—which expanded by 10.7 percent during the quarter—and corporate earnings are up by roughly 7 percent on the quarter. Nonresidential investment advanced 2.4 percent, investment in equipment jumped 3.1 percent and outlays on intellectual property leaped 6.4 percent. Investment on structures declined by 5 percent and residential investment improved by 10.2 percent.

The 4.7 percent average annualized pace of growth in wages to close out the year will likely create some momentum in household spending that will spill over into 2017. The key to 2017 will be the tax and policy changes supported by the GOP-led Congress and the Trump administration. Important areas to watch are the rollback of regulations, comprehensive tax reform, including the abolition of the corporate income tax and the adoption of a destination-based cash flow tax with border arrangement, and the sharp reduction in individual income tax brackets.

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.

The RSM Middle Market Business Index (MMBI)
The RSM Middle Market Business Index developed in partnership with Moody’s Analytics, is designed to accurately reflect business conditions in the U.S. middle market, while providing a statistically significant measure of the health and outlook for these businesses. Read more.
B2C AT A GLANCE

Are significant shifts in the offing?

Across multiple sectors, a distinct vein of uncertainty is detectable in the atmosphere. Even more so than normal, multiple, exceedingly important variables remain in flux currently. Among the most pressing—particularly to the consumer products (B2C) industry—are any changes to U.S. federal tax policies, whether they be the border-adjusted tax scheme or tariffs, that could completely transform the landscape for many players within the space.

“The idea is to align incentives within the tax code to produce and source domestically,” says Joe Brusuelas, chief economist at RSM US LLP. “The best way to think about the prospective tax plan is as a destination-based cash flow tax with border adjustment. It favors imports over exports and equity over debt.”

In brief, businesses can deduct revenues derived from exports from taxable income calculations, while importers would see their taxable income increase significantly. This would have a huge impact on many companies focused on consumer products, especially large chains reliant on cheap labor or goods sourced from overseas.

“In order for this to work, the U.S. dollar is going to have to depreciate by 20 percent to 25 percent so there are no more than modest distortions to price levels and value chains,” Brusuelas states. “That’s one of the real challenges here, as currency markets are prone to extended periods of overshooting or undershooting.”

And that is just one of the major policy changes that are potentially in the offing. Taxes could well be another threat for apparel and retail enterprises to grapple with, given the relative unpredictability of the new U.S. administration. As Carol Lapidus, consumer products practice leader at RSM US LLP, says: “The proposed border-adjusted tax (BAT) is the elephant in the room. In the apparel sector 95 percent of all products are manufactured overseas. Whatever percentage this BAT ends up being, it will have a tremendous financial impact on a lot of companies.” Lapidus notes that there could be some offsets by proposed decreases to corporate and individual tax rates but by and large, the BAT would be such a significant obstacle to overcome, few offsets would be able to mitigate its impact. If passed onto the consumer, this could mean an increase of up to 15 percent at the cash register. “There is plenty of talk of excluding certain industries from BAT,” Lapidus says, “but at this point, there is uncertainty so executives should start planning, just in case. They’ll have to look at their supply chain and expenses and evaluate where they can cut costs.”

Adaptation would also have to occur on the part of the U.S. consumer, who has been trained to anticipate discount prices, as Lapidus points out. After all, one of the prevailing narratives over the past few years has been the unrolling decline in stock prices among upscale retailers like Nordstrom or Macy’s, particularly given the lackluster holiday sales season. Some of the more luminous spots in the department store firmament have been discount retailers such as T.J. Maxx.

Consumers simply have been conditioned for some time to pursue value, especially given the progression of the economic climate over the past few years. Any major shock to prices in areas such as apparel, even if one time, will wreak a fair amount of havoc. Absorption of such pricing would take some time; engendering domestic production would take even longer, given higher wage rates and lack of skilled labor.

In short, when it comes to potential policy changes that could affect the B2C industry, they are nothing so much as an untidy tumbleweed of uncertainties. Consequently, it is important to note that none are certain, and only a few have relatively higher probability of occurring. Moreover, all of the fevered discussion takes place against a backdrop of transformation, as omnichannel strategies only proliferate and increase in success. Experiential offerings have been a buzzword for some time, yet do not appear to show any sign of stopping as they pervade every B2C segment from retail—with curated pop-up shops—to dining—with even casual—premium becoming an explicit niche. “It’s not just a shift toward online,” says John Nicolopoulos, retail sector leader at RSM US LLP, “but a true convergence into multi-channel, which is providing middle market retailers a competitive advantage. Operating models need to be adjusted because this is where we are headed in the future.”

Already the effects of adopting such strategies are showing, with waves of store closings still occurring. As Jeff Edelman, director in consumer products industry at RSM US LLP, illustrates: “Omnichannel is great for retailers to build market share, but you begin to incur significant costs, which lowers the profitability of a lot of your freestanding stores. So at a point, it makes sense to start closing locations.” As the industry continues to evolve down this path, it is important to bear in mind that such ostensibly bad news may well be of the same ilk, and actually signs of adaptive health.
Still bifurcating

At 286 completed transactions, the final quarter of 2016 saw the lowest tally since at least the start of 2013, even as value remained quite robust. Such countervailing trends are symptomatic of a market bifurcating in quality—the surge in average deal size to exceed $1 billion is similarly indicative.

“There are pockets that are still active,” says Bill Spizman, partner with transaction advisory services at RSM US LLP, “but the businesses that are importing from overseas are revisiting what they’re going to do. Buyers have also slowed simply to see how things turn out in the political realm.”

As Nicolopoulos points out, even as overall deal flow is down, statistics like that average transaction size—second highest of the past four years—suggest there is still a very aggressive appetite among both strategic buyers and private equity investors, simply on a more segment-by-segment basis.

“Despite economic headwinds and uncertainty,” he states, “there is still a very strong appetite to invest in a brand that meets changing consumer tastes, particularly in the restaurant industry. For example, fast-casual is still getting a lot of attention even if traffic is down overall across the restaurant sector.”

In some ways such a development is a natural stage in the winding-down of an overall buying cycle, wherein both private equity (PE) groups and corporations flush with cash or equivalents and enjoying a lenient lending climate are simply more cautious given the quality of companies in the market. However, again, macro uncertainties are certainly exerting an upward pressure on the benchmarks buyers are assessing prospective targets against.
The buyout cycle takes a breather

“Deal flow still is an issue for many,” says David Cho, director with transaction advisory services at RSM US LLP. “The quality of deals in the market is lacking. Especially as availability of capital or fundraising isn’t a concern, and potential increases in interest rates aren’t creating too much concern, it really comes down to the lack of good targets, and the very high premiums paid for the few worthwhile opportunities.”

Nicolopoulos echoes the observation that there is no shortage of capital on hand to pay up for quality brands, and adds: “It’s an interesting dynamic out there, top quality targets are still getting a lot of attention, but there is an apprehension to investing in average companies that may have been more attractive to investors 18 months ago.” That apprehension is almost certainly driven in part by the perception that any newly acquired portfolio company may well have to handle significant negative changes in the near to midterm future. It should also be noted that after a highly active buying cycle like that seen throughout 2014 and 2015, timing is playing a part. Many of the best-positioned companies that were planning on coming to market likely took the opportunity to do so already, capitalizing on pricing levels. The pipeline of worthwhile targets isn’t endless, so at a certain point, the quantity of businesses looking to be acquired or well-placed to lure a bid was bound to slump. The more pressing question is whether there could be a turning of the tide sooner rather than later. “If you have the right company with the right product,” says Lapidus, “and branded is definitely better than nonbranded, then there is definitely an appetite on the part of buyers. They are looking for great companies with a future, and are willing to pay for it.
2016 closes as a strong year for sellers

Even if there is a wider gap in terms of the quality required for a company to draw plenty of attention nowadays, PE-held businesses may well be able to stand out when being brought to market, even in the current environment. If final tallies of PE-backed exits for 2016 are any indication, fund managers are definitely still finding exit avenues to be open, given overall selling sustained at the elevated pace observed over the past few years. In fact, a fifth year of robust exit volume is quite impressive, albeit driven by a decided uptick in the rate of secondary buyouts. Testament to the abundance of dry powder and dearth of fresh, proprietary targets, the increased incidence of secondary buyouts has been key since 2014 began in contributing to overall exit volume, although corporate buyers have kept up a steady clip of purchases.

“The reality is whether they’re well-branded fashion companies, retailers or restaurant chains,” says Nicolopoulos, “if you have a good brand, a good operating model and consistent execution, you can be a winner in this market.” At this point in the cycle, PE firms are still selling off long-held businesses and perhaps even portfolio holdings acquired relatively recently, in something of a quick flip. Given the persistence of exit activity, it’s not unreasonable to expect something of a softening going forward, if only attributable to the pipeline refilling.

B2C private equity exits by quarter

B2C private equity exits by year

B2C private equity exits (count) by sector

Source: PitchBook
IPO ACTIVITY

A slight uptick

Going public has been somewhat of a tricky prospect recently, even as indices track higher, with the memory of early 2016’s volatility still fresh. Furthermore, for those sponsored businesses looking to exit, given the prices still commanded via private auctions, taking the secondary buyout or strategic acquisition route may well be more alluring. In the end, it is largely a toss-up for most, with middle market businesses, in particular, probably not examining initial public offerings (IPOs) with any avidity given their alternative options and scale. Only businesses in the same size category as, say, Albertsons may be considering going public with more serious intent, as it is, frankly, more viable. Looking ahead, little may shift, especially given the state of flux the B2C industry as a whole is in.

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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<tbody>
<tr>
<td>Albertsons</td>
<td>Cerberus Capital Management</td>
<td>Department Stores</td>
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<tr>
<td>Frontier Airlines</td>
<td>Indigo Partners</td>
<td>Air</td>
<td>$500</td>
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<tr>
<td>Floor &amp; Decor Outlets of America</td>
<td>Ares Management, Freeman Spogli &amp; Co.</td>
<td>Specialty Retail</td>
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<tr>
<td>The J. Jill Group</td>
<td>TowerBrook Capital Partners</td>
<td>Accessories</td>
<td>$100</td>
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</table>

Source: PitchBook
No less than 68 percent of take-privates in 2016 were at the behest of strategic buyers, the greatest percentage of the past four years. In part attributable to structural changes in the B2C sector resulting in more businesses aligning in the crosshairs of activist funds or large private corporations, the fact that financial buyers have been focusing on finding value in lower reaches of the middle market in order to avoid overpaying in high-priced, competitive auctions should also not be neglected. It’s not that there aren’t targets for large PE buyout shops currently trading on public exchanges, but that there are simply relatively more attractive ones elsewhere. Being able to source worthwhile prospects elsewhere in a consistent manner is what has also led to the record-high (of the past four years) proportion of M&A activity driven by PE firms. Their buying rationales differ from those of corporate, and moreover, their scope can often be broader. Ample reserves of capital and mandates to spend it don’t hinder matters at all, either.

### SELECT B2C Q4 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>Copec</td>
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<td>Grand Design RV</td>
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<tr>
<td>Allen Edmonds</td>
<td>Caleres</td>
<td>Footwear</td>
<td>$255</td>
</tr>
</tbody>
</table>

Source: PitchBook
Top 2017 trends for food and beverage industry businesses

There are a variety of opportunities for growing food and beverage businesses in 2017, but staying on top of changing customer needs, understanding millennial preferences, leveraging key technology strategies and being mindful of strategic acquisitions will all be essential in this competitive marketplace. From spicy foods to smartphones, what should businesses focus on for 2017?

Our industry insiders, Cristin Singer, food and beverage practice lead, and Joe Brusuelas, chief economist at RSM US LLP, provide important insights to consider this year in this brief video.

That time Dr. Dre met David Rubenstein

Rodney Cohen, head of The Carlyle Group’s mid–market team, shares with Don Lipari, RSM’s national private equity leader, how he sourced the deal for Beats, the wildly popular headphones company that ended up delivering a big return to its PE backer.

He also tells the story about a funny meeting between the co–founder of Carlyle and hip–hop legend and Beats co–founder, Dr. Dre—two successful entrepreneurs from very different backgrounds.

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