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RETAIL OUTLOOK 2018

TRENDS IMPACTING RETAIL M&A

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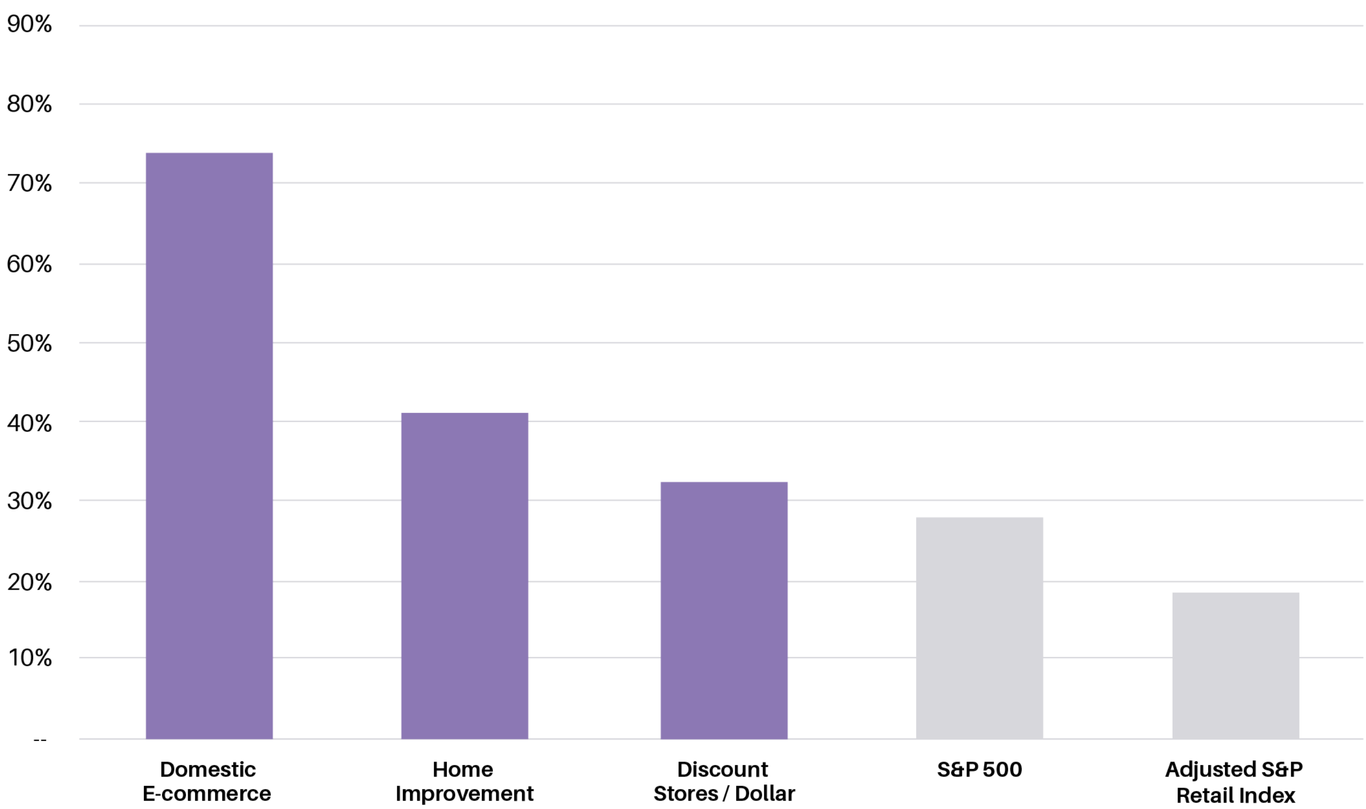
Following years of negative same-store sales declines, store closures and retail bankruptcies, the retail sector emerged from 2017 on more solid footing. A strengthening U.S. economy, driven by robust employment and near record-level consumer confidence, helped drive consumer spending in the latter half of 2017 and provides the strongest backdrop since the Great Recession for retailers entering 2018.

To better assess where retail is headed, we look back on the retail winners of 2017 and the factors that shaped their successes, drawing out the key themes that will also separate the standout performers in 2018. In addition, we evaluate the factors that influenced retail deal-making activity in the past year, and highlight the trends we believe will play a central role in retail deal making in the year to come.

WINNERS IN RETAIL

In the midst of what some have described as the retail apocalypse of the past few years, 2017 saw breakout stock performance by a handful of sectors and a number of individual retailers.

SUBSECTOR PERFORMANCE COMPARED TO S&P 500 PERFORMANCE (MEDIAN)



Note: Adjusted S&P Retail Index includes all of the companies in the S&P 500 Retailing Index except NFLX, AMZN, PCLN, EXPE, TRIP.

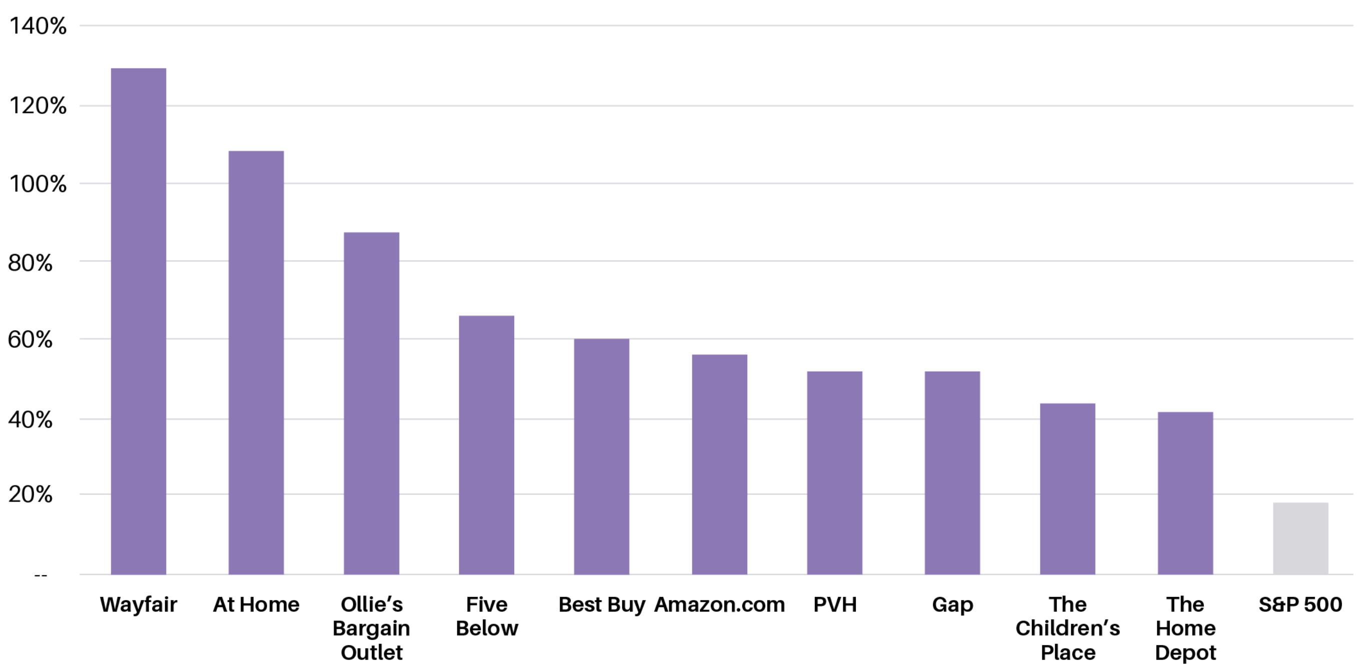
As evidenced in the chart above, sector winners included deep discount, off-price, and dollar stores – where collectively, the preponderance of new store growth continues to be concentrated – as well as digital retail / e-commerce and home improvement.

These sectors have, in fact, continued multi-year runs of market outperformance, thanks in large part to the following factors:

- DEEP DISCOUNT, OFF-PRICE AND DOLLAR STORES offer a powerful combination of convenience and clear price advantage in largely non-discretionary product categories
- HOME IMPROVEMENT retailers (particularly in DIY) have benefited from housing cycle tailwinds, with confident consumers making significant investments in their homes, whether completing necessary maintenance and repair or adding distinctive furnishings
- DIGITAL/E-COMMERCE retailers are led by large first-movers that have captured substantial market share and continue to extend their leads as many newer entrants struggle for relevance or fall away entirely

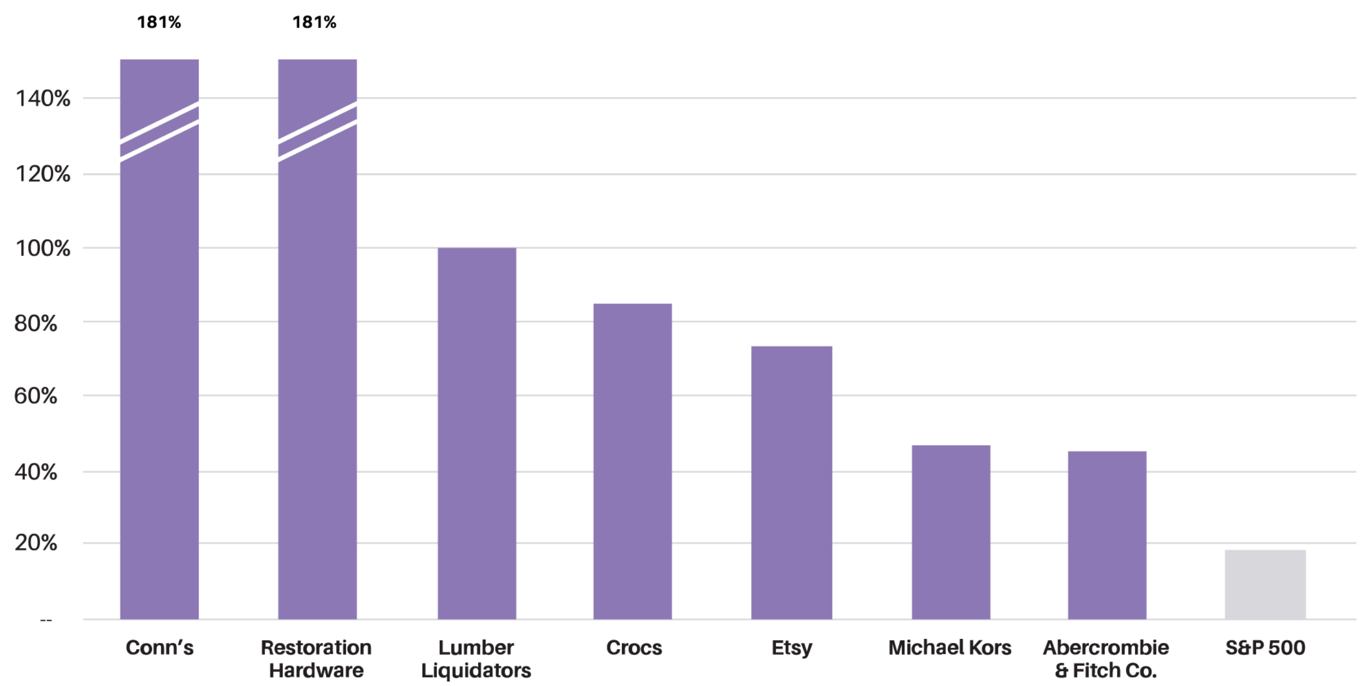
In looking at individual companies' stock outperformance in the charts below, the top performers shared a number of key attributes. They provided a combination of superior customer service, whether online or in-store, an indisputable price/value proposition, and/or superior branding and customer engagement, all with an underpinning of operational excellence.

TOP STOCK PRICE PERFORMERS IN 2017



Not surprisingly, many of these companies also reside in one or more of the winning sectors highlighted above. Others, however, represented compelling bounce-back stories. These are companies once thought to be fighting for sustainable performance, but are now regaining investor confidence, with the upward stock price movement to match – albeit off of long-term lows.

SELECTED TOP STOCK PRICE BOUNCE-BACKS IN 2017



We predict there will be others who find their footing in 2018 and re-establish a long-term investor base.

IDENTIFYING THE INNOVATORS

Against the backdrop of ongoing consumer migration to online channels, perhaps the clearest new reality is the importance of innovation. Retailers must innovate and differentiate or risk disintermediation by more nimble competitors with superior abilities to serve – or more importantly, influence – consumers' rapidly changing purchasing behavior.

New economy, digitally native players figure prominently among innovators. Some of these new entrants, which we have mentioned in past letters, scaled to the point of going public, including Etsy, StitchFix, and Wayfair. Others, such as Zulily, Chewy, Jet, and Dollar Shave Club, achieved billion-dollar-plus sale transactions to strategic acquirers. These few companies stand out from among hundreds of other new economy companies, some which achieved less than stellar exits, many others which soldier on under private ownership, and others that are no longer with us. So what innovations made these billion-dollar companies break through from amongst the hundreds or thousands of other new economy contenders?

What these companies did was much more than simply offer products conveniently online. Rather, they innovated by seamlessly integrating sales and returns across channels, creatively acquiring and retaining customers, mastering customer data, offering better price and value, and taking new approaches to providing superior service and shopping experience. Of late, lots of eyes have been on so-called "enabling technology" companies, such as last mile delivery providers, that further separate the innovators from more traditional omni-channel retailers. With their scale and financial wherewithal, Target and Walmart have been early movers in the space, bolting on enabling tech companies in order to further distinguish their own customer-centric capabilities.

Walmart vs. amazon

Walmart has proven to be one of the more interesting innovation stories to come out of 2017 — becoming a central story of retail today, notwithstanding the many headlines devoted to Amazon. How Walmart is utilizing its physical retail assets, and the other steps it has taken to combat Amazon, deserve careful consideration. Certainly the stock market has taken notice, driving Walmart shares up 56% in 2017 to near all-time highs.

Walmart has leveraged its entrenched position in the American market deftly, proving that it is a potential threat to retake market share from Amazon on its own turf. Walmart is demonstrating its innovation through acquisitions, led first and foremost by its Jet.com purchase, and augmented by the expansion of their product catalog both organically and via further acquisitions. Walmart then put its tremendous physical distribution assets to work in support of Jet.com and Walmart.com's e-commerce platforms, resulting in roughly 60% growth in their gross merchandise value on average over the past few quarters.

Whereas Amazon is the prototype of how a retailer should transact online, Walmart is rapidly becoming the prototype for how omni-channel can and should work. Not every retailer has the ability to leverage a 5,000+ store base all across America. But Walmart has shown how to innovate on it — with discounts on in-store pickups, curbside fulfillment, same-day delivery, as well as other services that cut into Amazon's value proposition and may be impossible for the (predominantly) online retailer to replicate. Furthermore, with Jet.com, Walmart has finally begun to penetrate richly populated urban centers — just witness the number of purple boxes in the back of any UPS or FedEx truck running routes in Manhattan.

Amazon, for its part, made its first major move in the opposite direction, purchasing a strategic foothold in the $1.5 trillion food retail sector [1] with its Whole Foods acquisition. That the two giants are converging speaks to their strategic acumen, with Walmart emerging from years of slow-growth to rise again as a dominating force in American retailing, and Amazon further entrenching itself in ever-more aspects of the American consumer's life. One thing is for certain – this will be a fascinating battle for years to come, with much of the rest of U.S. retail trying to stay apace.

[1] Includes grocery and restaurants.

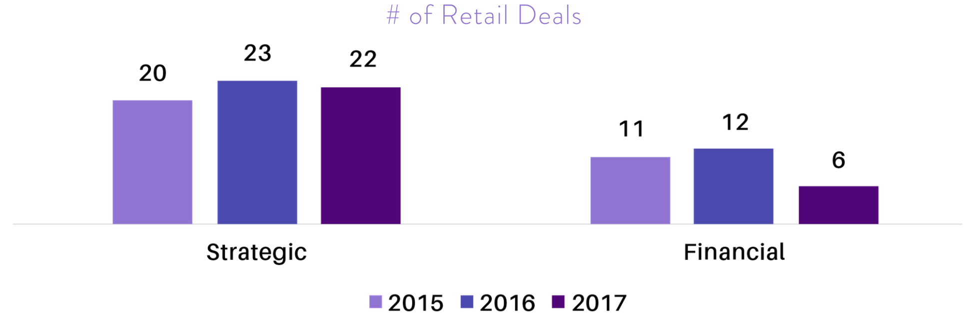
RETREAT OF PRIVATE EQUITY

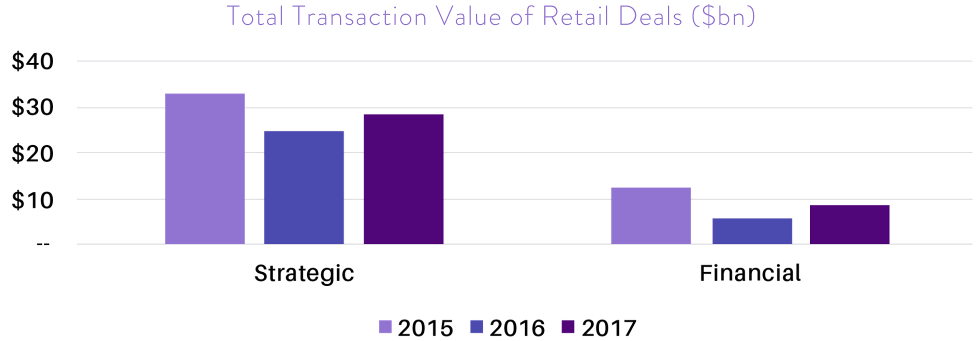
One of the most significant influences on retail M&A activity has been the retreat of private equity. For those businesses seeking to sell themselves, what was once a dependable buyer has now practically vanished. It is not an exaggeration to say that in 2017 we saw a complete sector rotation out of retail by PE.

These financial buyers are becoming highly selective, pivoting toward consumer- or service-oriented deals, particularly surrounding health and wellness trends, as opposed to pursuing traditional retailers. Part of the challenge has been the inability to risk-assess retail assets, given complex secular dynamics. Increasingly, they are also demonstrating interest in the infrastructure upon which the new economy is being built: for instance, logistics, returns processing and software.

In general, we continue to see fewer sponsor deals in traditional retail in the wake of heightened bankruptcies of sponsor-held companies.

PE DEALS AND DEAL VALUES





Note: Charts include all U.S. retail transactions greater than $100m in Enterprise Value, excluding Restaurants.

As we consider what lies on the horizon for 2018, we are keeping an eye on a particular set of questions and pending developments. Many retailers were encouraged by better-than-expected holiday comps, making for the strongest holiday season we've seen since 2005. Does this positive development signal that traditional retailers are finally conquering omni-channel and that traffic declines may finally be moderating? If so, these factors may embolden deal makers who have needed to see some form of stabilization to feel ready to act.

Another considerable and potentially negative impact on transaction activity may result from the so-called "Wall of Maturity," the increasing amount of debt coming due for retailers in the next few years. According to Bloomberg, this figure will jump from $100 million of high-yield retail debt in 2017 to $1.9 billion in 2018, and is expected to reach an average of $5 billion each year between 2019 and 2025, likely continuing to pressure retail in the eyes of the debt markets.

Conversely, the retail industry is expected to benefit substantially from sweeping U.S. tax code reform signed into law late last December. While changes to the deductibility of interest expense may further deter private equity buyers using high levels of debt, we expect corporate appetite for deal-making to rise in response to significant tax cuts, as management teams and shareholders enjoy expanded profitability and higher stock prices.

We look forward to hearing from you in the New Year

As ever, we remain dedicated to providing our clients with strategic and financial solutions that generate long-term shareholder value. On behalf of the Global Retail Group and all our PJ SOLOMON colleagues, we wish you a prosperous 2018. We would be interested to hear your thoughts on any of the topics raised above and look forward to the opportunity to work together in the months ahead.

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