PJ SOLOMON
unrivaled wisdom

RETAIL OUTLOOK 2019

TRENDS IMPACTING RETAIL M&A

+1 212 508 1600
www.pjsolomon.com
New York | Houston
info@pjsolomon.com

JANUARY 2019

PJ SOLOMON GLOBAL RETAIL, CONSUMER, FOOD RETAIL & RESTAURANTS GROUPS

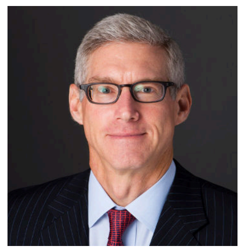
MARC S. COOPER
mcooper@pjsolomon.com
+1.212.508.1680

DAVID A. SHIFFMAN
dshiffman@pjsolomon.com
+1.212.508.1642

CATHY LEONHARDT
cleonhardt@pjsolomon.com
+1.212.508.1660

JEFFREY DERMAN
jderman@pjsolomon.com
+1.212.508.1625

SCOTT MOSES
smoses@pjsolomon.com
+1.212.508.1675



MICHAEL GOTTSCHALK
mgottschalk@pjsolomon.com
+1.212.508.1649

GREG GRAMBLING
ggrambling@pjsolomon.com
+1.212.508.1674

The wave of disruption to the retail industry continues, but retailers and stakeholders now have a clearer vision of where the industry is headed. Against the backdrop of the strongest consumer market in over a decade, supported by near 50 year-low unemployment, robust consumer spending and strong 18 year-high consumer confidence, the 2018 holiday season brought healthy results for a select number of retailers, particularly those executing a strategy designed for the new world order of retailing. It also amplified the ongoing narrative of the industry's big getting stronger – one of the themes highlighted in this paper.

Despite this reasonably positive setting, we have entered 2019 amidst market volatility, a nascent trade war with China and the prospects of a slowdown in global growth, particularly in China and Europe. Any combination of such factors could once again cloud the retail sector picture and challenge retailers less prepared for change.

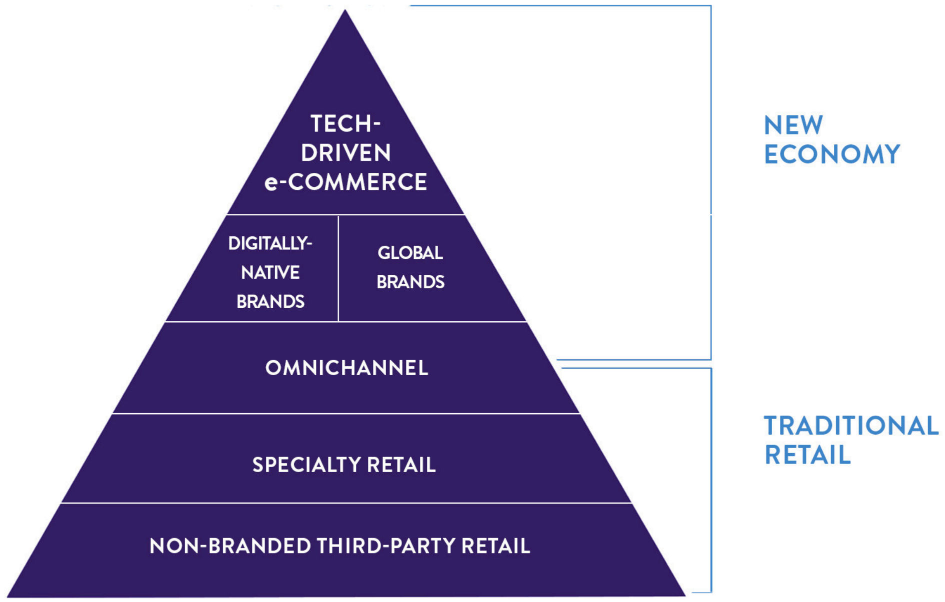
With an eye towards these developing factors, we evaluate the trends shaping retail today and spotlight the critical themes we believe will impact retail deal-making in 2019.

THE NEW VALUATION HIERARCHY

The widening gap in valuations between e-Commerce companies and traditional retailers constitutes a key part of the industry's new normal. Over the course of 2018, e-Commerce driven retailers dominated growth in both market-share and mind-share, leading to valuations notably higher than those of their old economy peers.

But the story is no longer as simple as "online vs. brick-and-mortar"; many retailers are now blurring the line between channels and boasting increasingly sophisticated business models. The consumer, however, ultimately decides the winners – and market valuations follow. The result is a new valuation hierarchy, which allows us to examine the following question: What is likely to draw the interest of retail investors in the public and private markets in 2019?

THE NEW VALUATION HIERARCHY



At the top of valuation hierarchy sit the new disruptors: Tech-driven e-Commerce retailers delivering next generation business models that provide the requisite superior customer service and relevant products and positioning, combined with content, data-driven analytics and other tools to drive engagement and repeat purchase. These best-of-breed companies are considered most likely to succeed, fetching the highest public valuations today or, if private, offering the promise of a public market exit or sale to a strategic at a robust valuation. These include marketplaces and “category killers” (e.g., Farfetch, Wayfair) who best understand consumers’ wants and needs in that category and are succeeding in gaining dominant mindshare in an attractive niche.

Just below the tech-driven disruptors sit digitally-native vertical brands and established global brands. Many of the former combine relevant product and pricing with technology and customer information to carve out a following. Whether it is streamlining a traditionally inefficient shopping experience (e.g., Warby Parker, ThirdLove), offering a targeted product for an under-served audience (e.g., Fashion Nova) or simply eliminating the offline middle-man (e.g., Harry’s), brands that can get to scale by following these approaches see all types of investors underwriting their businesses, driving sky-high valuations. Sitting adjacent to digitally-native brands, iconic global brands enjoy a similarly favorable position, as a considerable valuation gap has emerged in favor of established branded companies, a trend we will discuss later in this piece.

THE WINNER’S CONUNDRUM

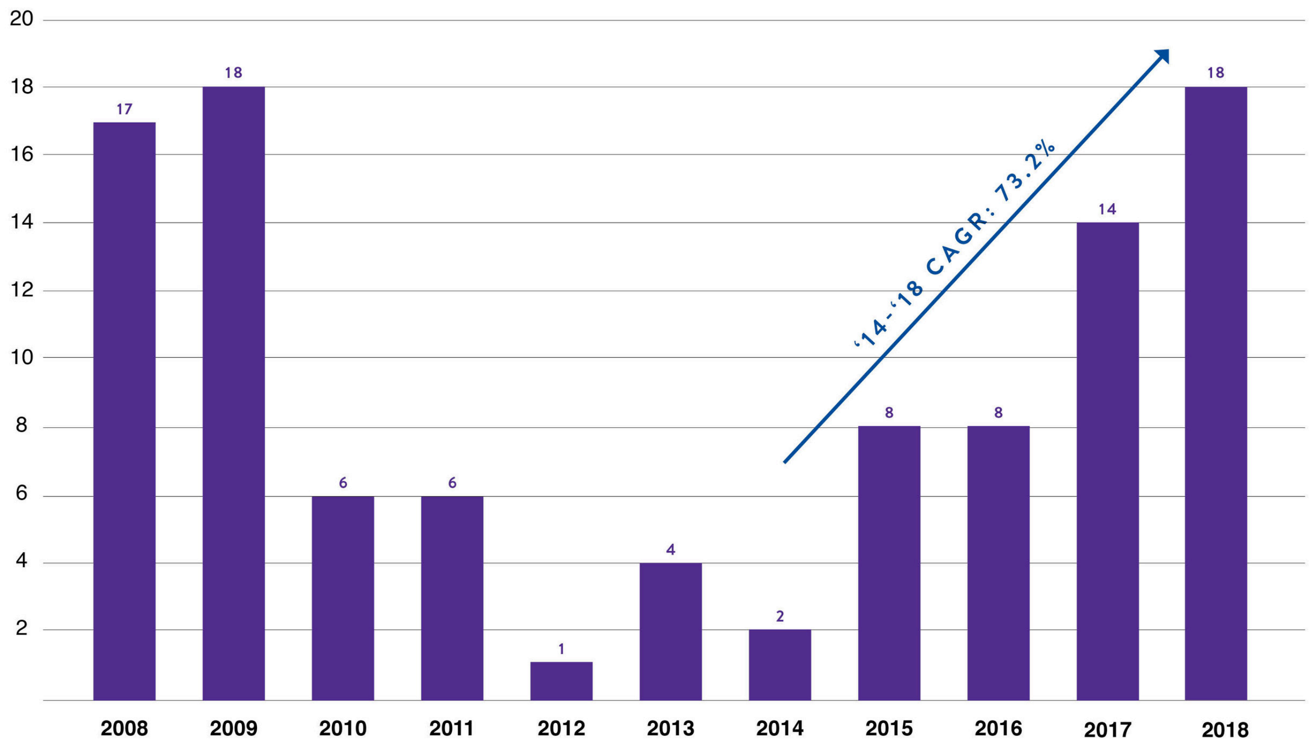
When considering who sits at the apex of this new valuation construct, an ironic quirk is the fact that top performers (largely venture capital-backed, private new economy companies) face a winner’s conundrum: Because of their success and resulting high valuations, they may face a narrowed range of exit options. Many of these companies are neither scaled, nor have the infrastructure to successfully go public, given the capriciousness of today’s IPO market. In addition, at these rich valuations, they also run the risk of pricing themselves out of being acquired by a strategic party. Few strategic acquirers with substantial scale and financial wherewithal can afford the costs – and take on the risks – associated with what, for most retailers, would be “bet the house” transactions. This may mean that if Walmart, Amazon, Home Depot, Target – or a select few other mega retailers – are not natural fits, there may not be a capable buyer. For victims of this winner’s conundrum, the path to turning billions on paper into real dollars is likely to remain murky in 2019.

BIG GET STRONGER, SMALL DISAPPEAR

In the foregoing section, we touched on the ability of large companies with deep pockets to make strategic moves not only because they can afford them, but also because of the flexibility they possess in withstanding potential risks should new models fail to prove resilient.

Industry giants like Amazon and Walmart have entrenched themselves in all aspects of the American marketplace and, correspondingly, smaller companies have found it progressively difficult to compete on various fronts. From pricing power, to supplier relationships, to distribution channels, and notably, brand recognition, smaller companies in the retail sector continue to be structurally challenged. This is a trend we expect to accelerate in 2019 and beyond.

RETAIL BANKRUPTCIES



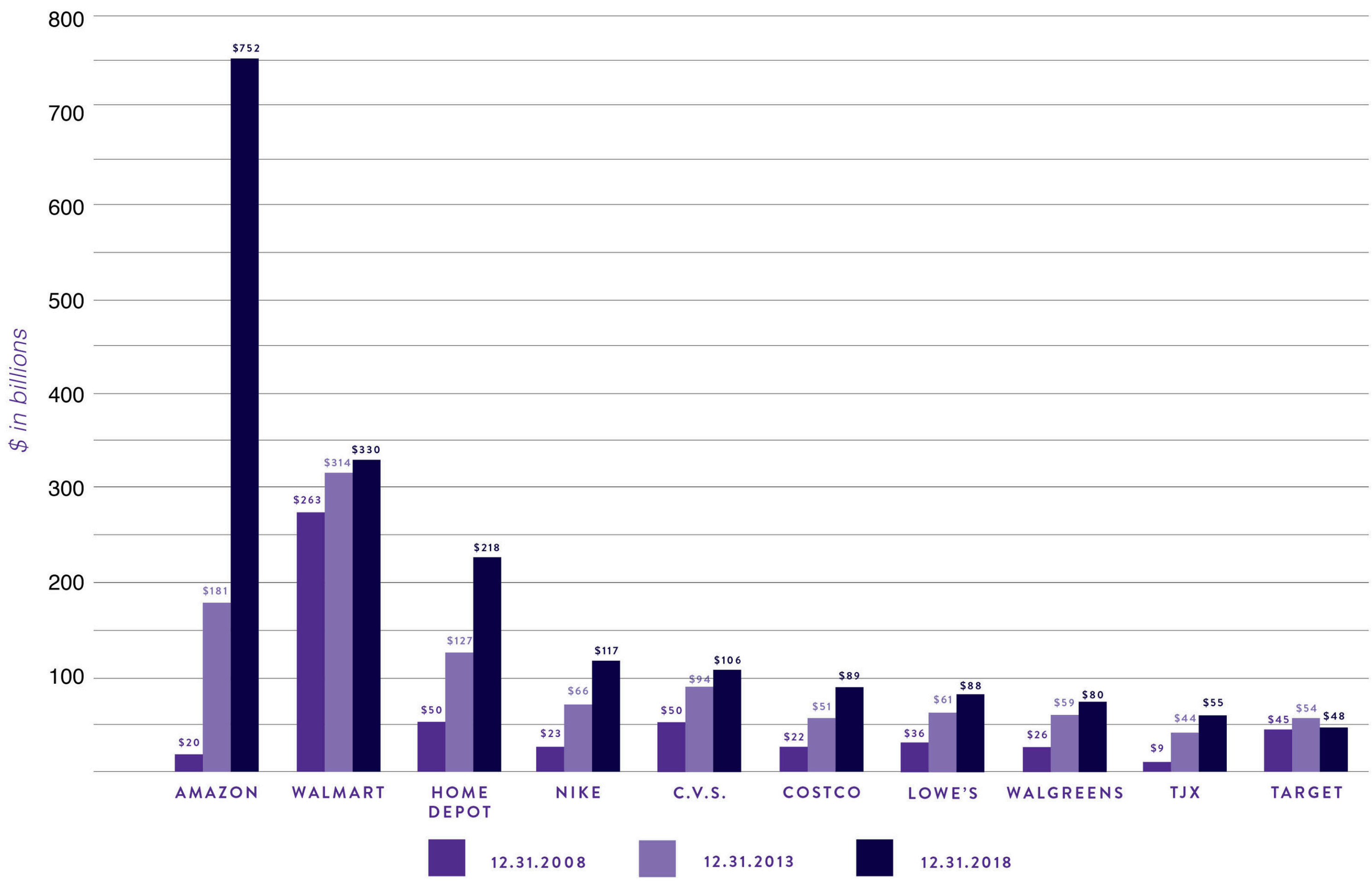
Source: Capital IQ as of December 31, 2018.

Note: Reflects retail companies based in the U.S., excluding restaurants, automotive dealerships and tech-enabled retail service providers and any transactions of less than $100M.

Strong evidence of this trend can be seen in the recent spate of retail bankruptcies, increasing from one in 2012, climbing to levels not seen since the Great Recession. As these companies exit the market – including the long-awaited Sears bankruptcy – often as liquidations or with drastically reduced retail footprints, industry giants have taken an ever-growing share. We believe the markets will be less forgiving in 2019; as such, we are likely to see more liquidations than reorganizations.

Moreover, this trend is even more pronounced when looking at the concentrated growth of retail public market value over the last decade. Ten years ago, Amazon accounted for $20 billion in enterprise value. Today, it towers above the marketplace at greater than $750 billion, well in excess of the enterprise values of the next three largest retail companies COMBINED.

TOP 10 US-BASED RETAIL COMPANIES
(ENTERPRISE VALUE)



Source: Capital IQ
Note: Reflects Top 10 US-based retail companies by Total Enterprise Value as of December 31, 2018.

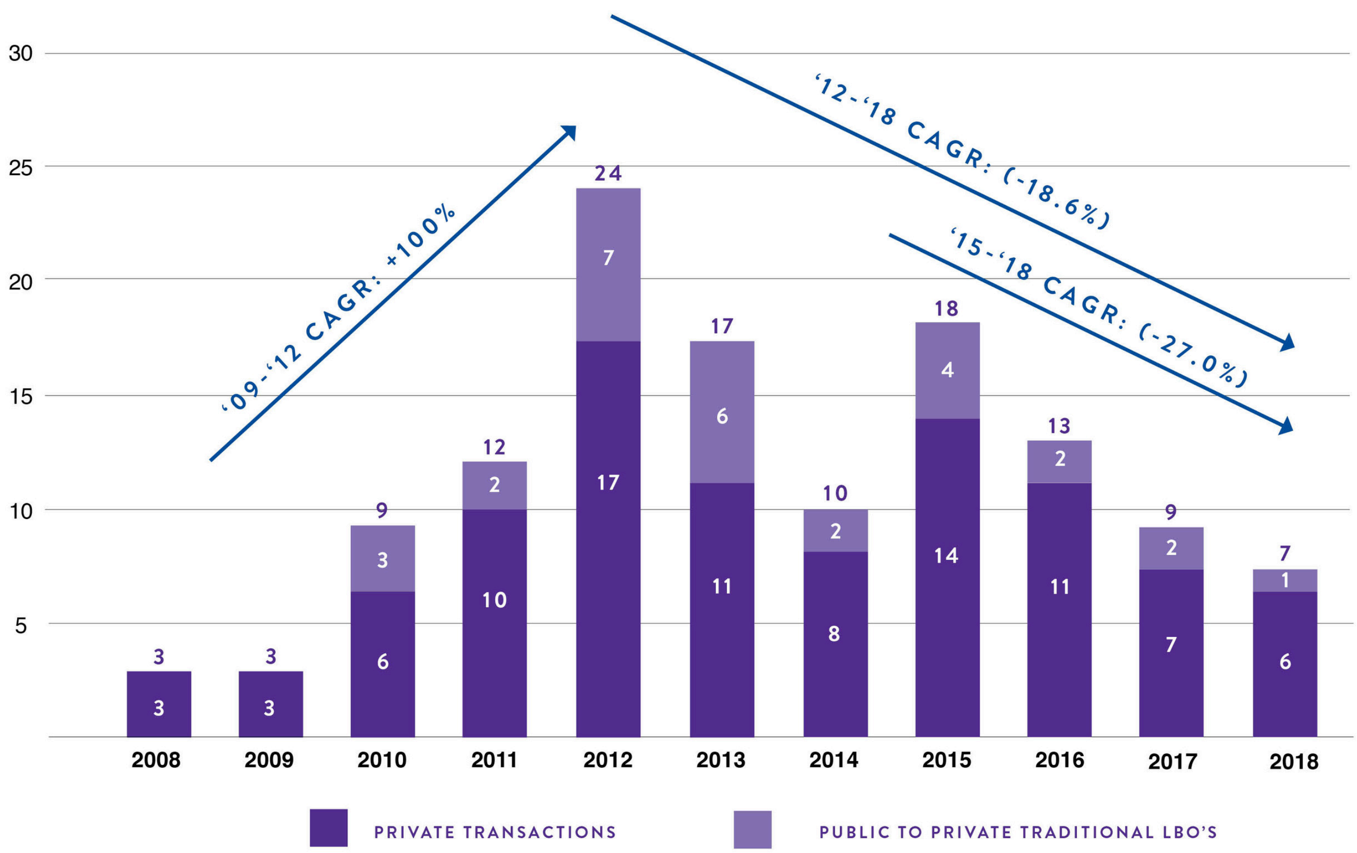
When we evaluate what drives this, it goes back to large equity market capitalizations coupled with bigger balance sheets and greater purchasing power, that has allowed retail behemoths to more aggressively use their structural advantages in taking calculated risks. They can take a venture capital-like approach to investing, able to financially and operationally survive a failure or two in the hopes that they end up with one or two long-term difference-making acquisitions.

Walmart is the prototypical example here, as the company has leveraged its scope and scale to make both larger, transformational acquisitions (e.g. Jet.com), as well as smaller, diverse category investments including Modcloth, Moosejaw, Bonobos, Bare Necessities and Art.com. These venture acquisitions are expanding its "tail" offerings and supporting growth and competitiveness with both Amazon, as well as niche peers suddenly competing with the Bentonville goliath. Other retailers like Target (acquired Grand Junction and Shipt), Kroger (invested in Ocado and acquired Relish Labs) and Kohl's (partnered with Amazon and Under Armour) are similarly using scale to deepen their competitive advantages in areas such as supply chain and last-mile fulfillment, positioning themselves for tomorrow's consumer preferences.

AN UNCERTAIN EXIT FOR TRADITIONAL RETAIL INVESTORS

Private equity has significantly reduced its investment in traditional retail while public market interest (via the IPO) has also declined, making it increasingly challenging for owners and operators to exit.

RETAIL PRIVATE EQUITY TRANSACTIONS



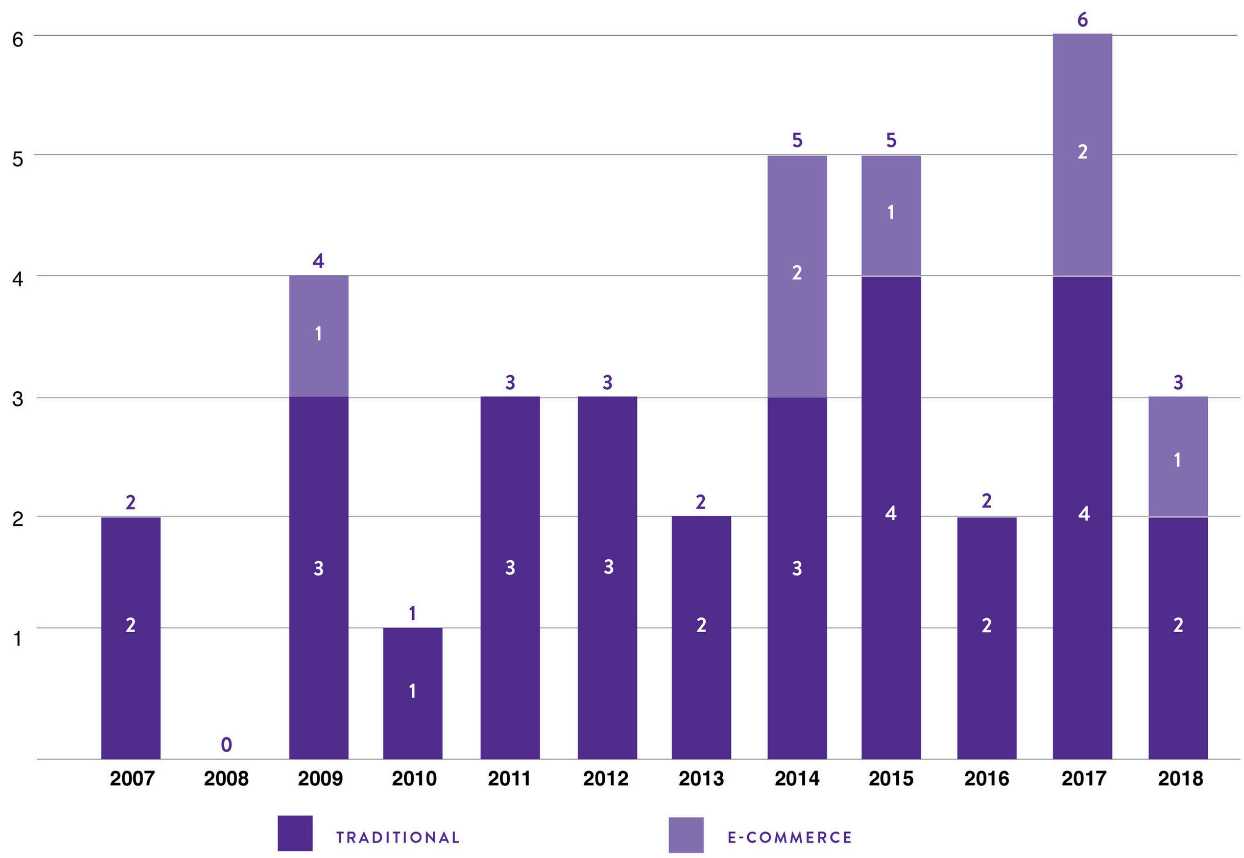
Source: Capital IQ as of December 31, 2018.

Note: Reflects retail companies based in the U.S., excluding restaurants, automotive dealerships and tech-enabled retail service providers and any transactions of less than $100M.

The traditional public-to-private LBO is now almost non-existent; with only five transactions occurring within the last three years. Once considered dependable buyers, private equity firms have become highly selective with their acquisitions and are buying fewer retail assets. The credit markets (with the exception of asset-based lenders) have been unreceptive to traditional retail as well, particularly for mall-based retail. We have seen financial investors pivot towards consumer and service-oriented businesses, especially those catering to millennial shoppers, beauty, and health & wellness categories. Some traditional retail-focused private equity firms have moved "earlier stage," leveraging their retail acumen to make more venture-type investments.

Traditional retail investors can no longer reliably look to the IPO market, which has tapered dramatically since the recession. The agent behind this decline has been a medley of public equity investors fearful of the transformation of the retail marketplace, coupled with fewer LBO's returning to the public market. Since the recession, there have been two to four traditional retail deals per year. In the last five years, nearly a third of retail IPOs have been for e-Commerce companies.

RETAIL / E-COMMERCE INITIAL PUBLIC OFFERINGS



Source: Capital IQ as of December 31, 2018.

Note: Reflects US-listed retail companies, excluding restaurants, automotive dealerships and tech-enabled retail service providers, as well as rights offerings and any transactions of less than $75M.

THE POWER OF BRANDS

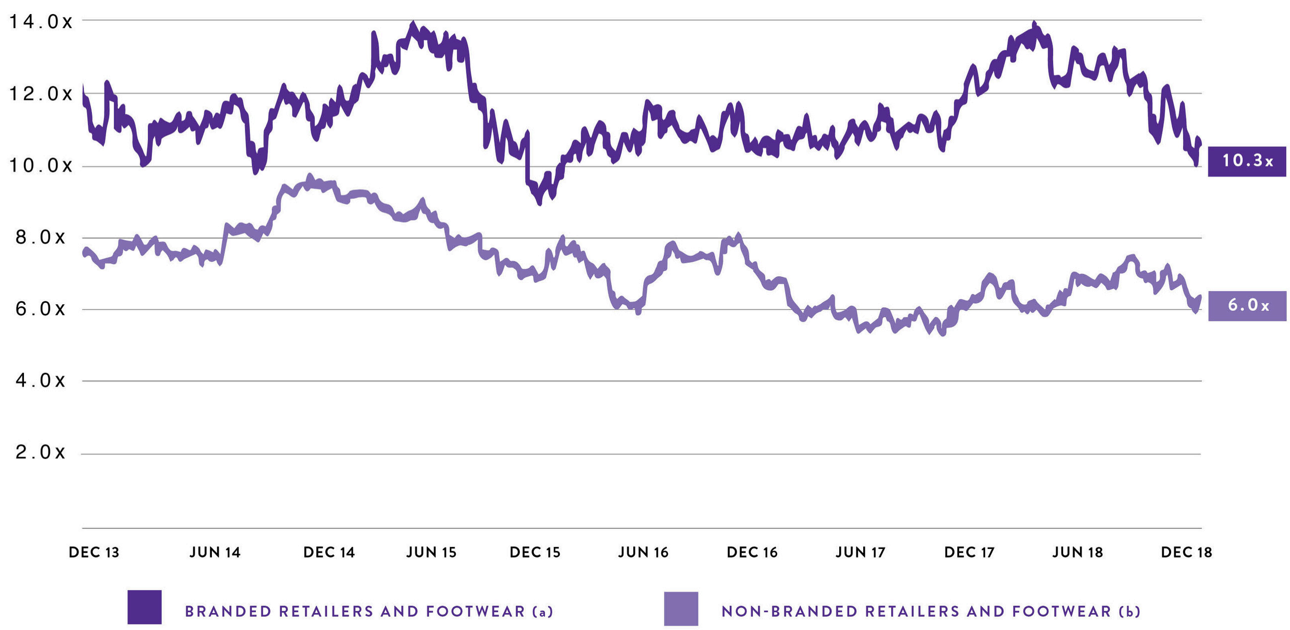
The market continues to reward strong consumer brands that have global reach. Free from the constraints of traditional marketing and retail channels, brands are creating innovative experiences that engage consumers and build brand equity.

Successful brands have recognized that it's no longer simply about selling a product; it's about the values and emotional attachment conveyed through products. As such, leading brands are fostering a relationship with their customers and creating a community among them. This effort, combined with relevant products that target global consumers' tastes and preferences, is solidifying brand loyalty.

BRANDED VS. NON-BRANDED TRADING HISTORY

(BRANDED VS. NON-BRANDED RETAILERS EBITDA MULTIPLES, LAST 5 YEARS)

	3 YEAR	2 YEAR	1 YEAR	CURRENT
BRANDED	10.7x	10.3x	12.5x	10.3x
NON-BRANDED	6.7x	6.9x	5.9x	6.0x
DIFFERENCE	4.0x	3.4x	6.6x	4.3x
PREMIUM	59%	50%	112%	72%



Source Capital IQ as of December 31, 2018.

(a) Branded Group includes V.F. Corporation, Tapestry, Michael Kors, Ralph Lauren, PVH, Under Armour, Columbia Sportswear Company, Hanesbrands, Guess?, Nike, Skechers USA, Wolverine World Wide, Deckers Brands, Steve Madden, Crocs and Tiffany.

(b) Non-Branded Group includes Target, Walmart, Costco, Kohl's, Macy's, Nordstrom, Dillard's, J.C.Penney Company, Foot Locker and DSW.

In evaluating the power of brands in relation to anticipated M&A activity, we have observed the valuation gap in favor of established branded companies versus retailers selling either non-branded or third party-branded products ranging from ~50% to ~110% over the past five years; this gap widened during much of 2018. As an example, for the luxury fashion sector, which typically represents the pinnacle of brand value, the median EV/EBITDA multiple for the top three luxury companies (LVMH, Kering, Hermes) is 13.3x.

We anticipate that more retailers of third-party goods, realizing how little they can control their future, will turn to M&A in 2019 to make strategic moves that foster long-term relevance by pursuing vertically integrated direct-to-consumer brands – even in the face of valuation disparities. However, they will be competing with established brand aggregators looking to enhance scale and leverage favorable valuations. As such, for quality brands looking to sell themselves, 2019 should provide an ample range of attractive options, continuing right where 2018 left off.

We look forward to hearing from you in the New Year

As we progress into the New Year, each retailer looking at M&A or capital markets activities should fully understand the dynamics of their various options and the implications of these options for the company's future. It is extremely important that management teams and boards of directors assess all systemic and non-systemic factors to ensure they make the optimal decision for their stakeholders. Those who evolve to accommodate the changing tastes and preferences of a global audience will enjoy long-term success.

The PJ SOLOMON Global Retail, Consumer and Food Retail & Restaurants Groups remain dedicated to providing our clients with strategic and financial solutions that help generate long-term shareholder value. On behalf of all our PJ SOLOMON colleagues, we wish you a prosperous 2019 and look forward to the opportunity to work together in the months ahead.

+1 212 508 1600

info@pjsolomon.com