PJ SOLOMON
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RETAIL OUTLOOK 2020

TRENDS IMPACTING RETAIL M&A

+1.212.508.1600
pjsolomon.com
New York | Houston
info@pjsolomon.com

PJ SOLOMON CONSUMER RETAIL GROUP

Jeff Derman
Managing Director
Consumer Retail Group
+1.212.508.1625
jderman@pjsolomon.com

Cathy Leonhardt
Managing Director
Co-Head of Consumer Retail Group
+1.212.508.1660
cleonhardt@pjsolomon.com

David A. Shiffman
Managing Director
Co-Head of Consumer Retail Group
+1.212.508.1642
dshiffman@pjsolomon.com

As we begin 2020, we expect the retail industry's dynamic transformation to continue unabated as technology, new entrants and competition for market share shape the modern retail landscape. While ecommerce continues to take share, omnichannel has emerged as the winning model as consumers demand seamless and convenient shopping experiences wherever they are.

Within this environment, and to meet rising consumer expectations, we expect legacy retailers to continue to invest and acquire to improve their competitive positions, digitally native companies to increasingly extend into physical formats and Amazon and other mass retailers to continue to aggressively compete for wallet share. All retailers must prepare for continued competition from digitally native upstarts, growth of new consumption models including rental and resale, and continued international competition, as brands become increasingly global and as low-cost manufacturers evolve into bona-fide competitors.

2019 VS. 2018 HOLIDAY SALES

18.8% Digital Sales

3.4% Overall Sales

Throughout this disruption, consumers continue to be the ultimate beneficiaries, enjoying ever-improving choice, convenience, value, personalization and greater access to socially and environmentally responsible goods. Consumers have also been happy to spend, bolstered by consistently strong employment, a record bull market and low interest rates. The 2019 holiday season demonstraed continued strength with an 18.8 percent rise in digital sales and overall sales growth of 3.4 percent year-over-year.[1]

Against this backdrop, we explore five major retail trends that will influence investors and impact deal-making in 2020 and beyond.

1) Mastercard SpendingPulse

1 THE 'HAVES' PREVAIL, THE 'HAVE NOTS' PERSEVERE (AT BEST)

As we expected in 2019, large, well-capitalized retailers continue to have an outsized impact on the retail landscape. Costco, Target, The Home Depot and Walmart leverage their scale, including their low cost of capital and expansive physical infrastructures, to compete on cost, convenience, speed of delivery and product assortment and availability.

As investments to improve convenience and delivery speed pressure profitability, merchandising-led strategies have returned to the forefront to drive product differentiation and margin. Through own brands, exclusive brands and innovative or aspirational third-party brands, these retailers are better able to drive traffic and customer engagement. They are also able to attract top talent, lured by competitive compensation, innovation-driven cultures, rising stock prices and a desire to work for the companies shaping the future of retail.

The world's two largest retailers embody the benefits that size brings. With capital to deploy, Walmart has transformed into an omnichannel distribution network, leveraging physical stores within 10 miles of roughly 90 percent of the U.S. population and investments into ecommerce to provide customers with a uniquely accessible and convenient service and delivery model. Walmart's online sales have grown 30+ percent for the last seven consecutive quarters, reaching $34 billion in the LTM period. Despite the de-emphasizing of Jet.com, Walmart's market cap has risen from ~$230 billion prior

LARGEST NORTH AMERICAN RETAIL MARKET CAP STOCKS

(All figures in milllions)

Market Cap on 12.31.19	YoY Market Cap Increase		YoY Market Cap Increase	LTM Revenue	YoY Revenue Increase
$916,154	$181,738	Amazon.com, Inc.	25%	$265,469	$44,512
$337,170	$66,545	Walmart Inc.	25%	$521,086	$9,207
$238,216	$44,140	The Home Depot, Inc.	23%	$110,934	$5,339
$158,150	$40,408	NIKE, Inc.	34%	$40,781	$2,686
$129,841	$40,109	Costco Wholesale Corporation	45%	$154,674	$9,838
		S&P Retail Index	(8%)		

Sources: CapIQ as of December 31, 2019.
Note: Market capitalization on December 31, 2019. Index represented by the SPDR S&P Retail ETF.

to the 2016 acquisition to over $330 billion at the end of 2019. For Walmart and other major industry participants, public markets have rewarded these investments and long-term re-positioning initiatives.

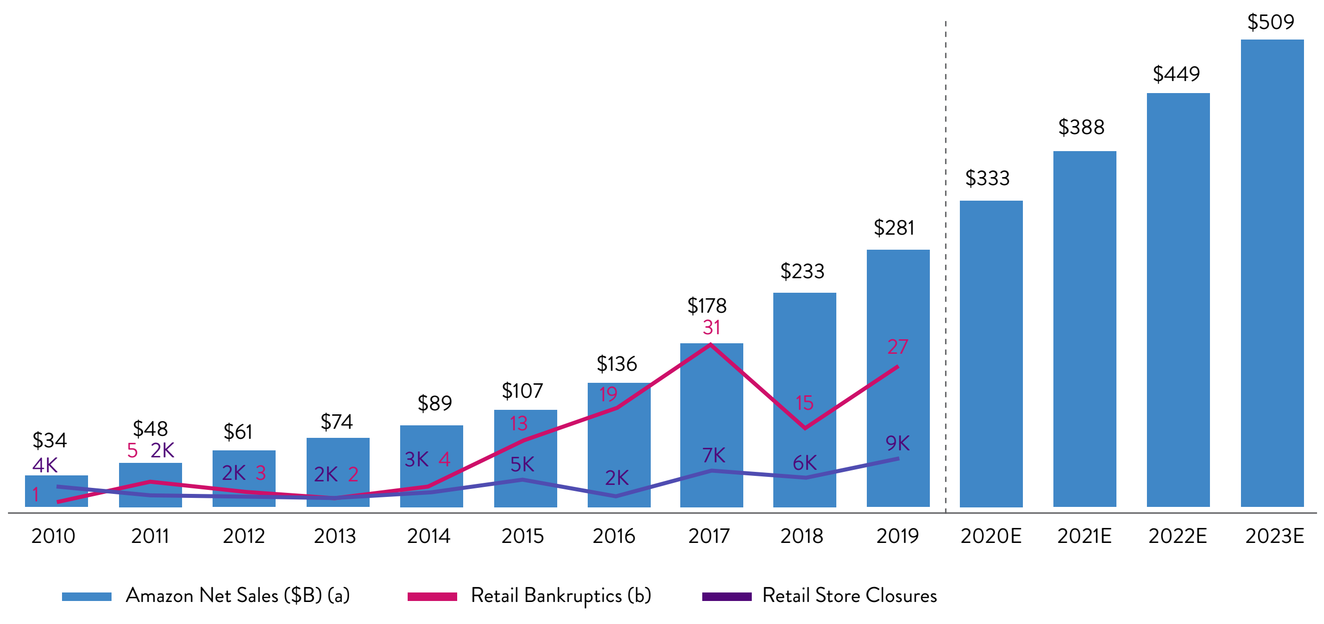
For Amazon, it took more than 20 years to reach over $200 billion in sales, but analysts now expect the company to exceed $500 billion in topline revenue by 2023 through its relentless efforts to innovate and integrate into every facet of consumers' shopping habits. We anticipate the pressure on retail competitors to continue to mount as Amazon effectively doubles its revenue again in the coming years – in just a fraction of the time it took to get to the initial $200 billion mark.

Technology has become the all-important enabler, allowing retailers and brands to build and extend their winning positions. An entire ecosystem of software and technology providers in distribution and supply chain has been created to help retailers of all sizes compete with Amazon. Shopify - the pioneer in democratized ecommerce - acquired 6 River Systems, allowing it to help businesses improve their fulfillment operations, a critical link to delivering goods quickly and efficiently. Separately, eBay is rolling out its shipping and logistics services for big sellers to help its vendors be more competitive in distributing to consumers.

As major retailers and brands continue to upgrade their supply chains, technology acquisitions and investments will be part of the solution, including artificial intelligence that optimizes product supply chain from origination to last mile destination. A notable example is Nike's acquisition of Celect, a firm designed to optimize inventory across an omnichannel environment through hyper-local demand predictions.

For smaller retailers lacking scale and technological advantages, we expect price competition, customer acquisition costs, technology investments and fulfillment costs to further pressure margins and cash flows. We fully anticipate retail sector rationalization and consolidation to continue in 2020.

AMAZON'S ASCENSION



Sources: Amazon filings, CapIQ, Wall Street estimates, media estimates, and publicly available information.
a) Reported consolidated total net sales.
b) Bankruptcy screen includes consumer durables and apparel, retailing, household and personal products companies with LTM revenue greater than $100M.

2 DIGITALLY NATIVE RETAILERS MAKING INROADS BUT FACING INCREASED INVESTOR SCRUTINY

Heading into 2020, we expect new retailing entrants to continue to make inroads, with growth by digitally native vertical brands (DNVBs), resale marketplaces, rental offerings and subscription services outpacing the broader retail market. These new, technology enabled retailing models are taking share based on a combination of proprietary product, values-alignment, transparency and consumer brand affinity.

Over 40 percent of consumers purchased from a DNVB in 2019, as these brands continue to take share from traditional retailers.[2] DNVBs benefit from the ability to target their consumers through digital channels and content, leveraging data to reach audiences effectively across age, social value and socio-economic segments. Many also simplify the customer shopping experience for traditionally complex or opaque categories, often gaining traction with a "hero" product offering. Examples include apparel retailers such as Reformation and Dolls Kill; home purveyors like Article and Snowe Home and consumer product sellers like The Honest Company, Warby Parker and Harry's.

Many of these DNVBs have sprung from the minds of Millennial and Gen Z founders, with an innate understanding of their generational peers' values and preferences. These values include sustainability and conscious consumption, price and supply chain transparency, as well as inclusivity and diversity across product and consumer messaging.

2019 saw the crowning of new DNVB unicorns including Away and Allbirds, with others like ThirdLove close behind, but acquisition activity in the DNVB space has been disciplined, with 85 percent of acquisitions happening below $250 million.[3]

That said, we expect increased investor scrutiny heading into 2020 around many DNVBs' customer economics and progress on the "path to profitability." As increasing acquisition costs pressure growth and profits, the ability to realize an exit and satisfy investor expectations is a primary market concern.

OVER **40%** **of consumers purchased from a DNVB in 2019**

2) Survey from communications agency Diffusion.
3) Pitchbook 2019.

3 INTENSIFYING FOCUS ON PROFITABILITY

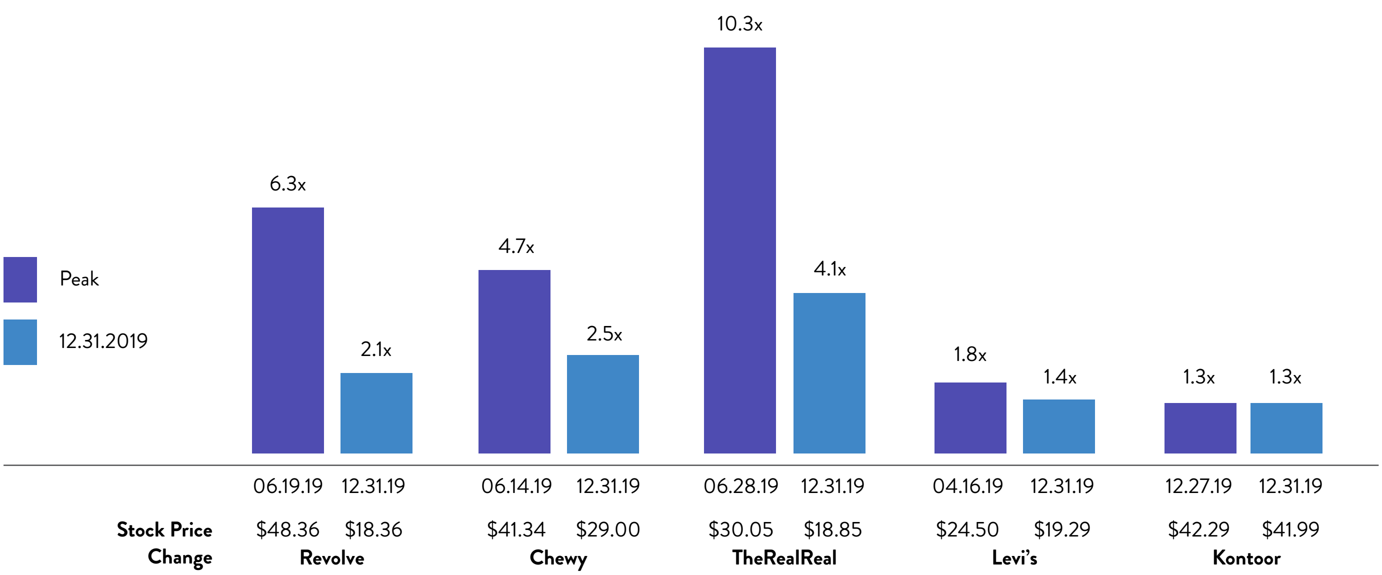
Traditionally, venture capital and growth equity investors have prioritized growth trajectory and ability to capture market share over near-term profitability. This appears to be shifting as Wall Street grows increasingly skeptical. Several companies – Uber, WeWork and SmileDirectClub, among others – have stumbled on the aforementioned "path to profitability." Though capital remains available, the sudden downfall of WeWork's mega-unicorn status may signify the very public pivot point for the pendulum swinging back toward a more rational view of rewarding profitability over growth at all costs.

Having experienced a slate of well-capitalized, tech-enabled retail failures, both investors and operators are re-orienting to construct growth plans that do not rely on continued capital infusions. As digital acquisition costs continue to grow and returns on online advertising spend moderate, retailers dependent on out-year scale or capital bridges have become increasingly vulnerable to heightened financial risk on top of operational and execution risk.

Public market valuations have mirrored these profitability concerns, as 2019's leading tech-centric retail IPOs have seen market values drop by 43 percent on average since trading peaks, with average EV/revenue multiples contracting from 7.1x to 2.9x. [4]

2019 SELECTED RETAIL IPOS

EV / Revenue at Peak Share Price vs. EV / Revenue at 12/31/2019 Share Price



Sources: CapIQ as of December 31, 2019.
4) Based off the average, equal-weighted performance of Chewy, TheRealReal and Revolve from peak trading performance in 2019 vs. closing trading price on December 31, 2019.

Outside of the public markets, no clear exits for *large*, venture-backed retailers have materialized. Further, the valuations that these unicorns or near-unicorns have achieved in the private markets preclude most traditional retailers that trade on profitability from pursuing these companies as acquisition targets. For those lucky enough to attract strategic attention or access incremental capital, we expect valuations to be pressured. Founders should carefully consider the appropriate amount of capital to raise and what valuation expectations (and exit implications) accompany these equity infusions.

> **Though capital remains available, the sudden downfall of WeWork's mega-unicorn status may signify the very public pivot point for the pendulum swinging back toward a more rational view of rewarding profitability over growth at all costs.**

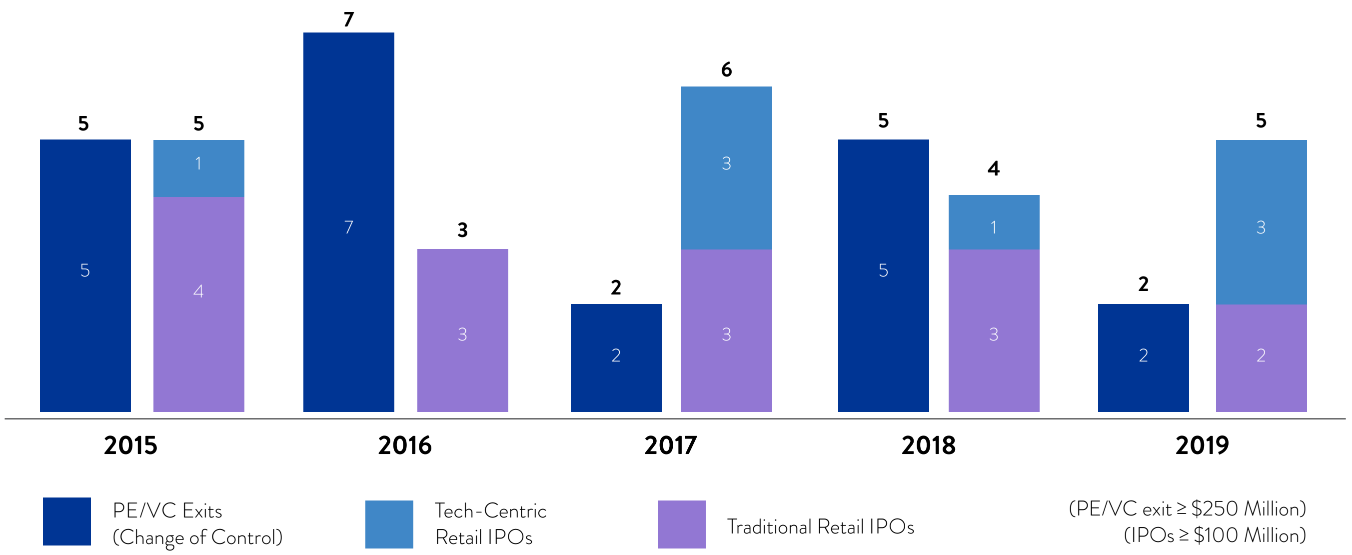
4 COMPLEXITY FOR PRIVATE EQUITY INVESTORS

Many market observers expected that private equity would adopt a contrarian view and buy retail assets at (theoretically) deeply discounted prices. With the exception of a select few acquisitions, including the purchase last year of maurices out of Ascena Retail Group by UK PE firm OpCapita, this largely has yet to occur. Traditional retail LBOs have all but disappeared with only three such transactions over a billion dollars occurring over the past 42 months.

While valuations are depressed, they reflect structural changes in the industry, as retailers get squeezed between the "Haves" (explored in Section 1) and the digital-first competitors (examined in Section 2). In addition, the recent onslaught of retail bankruptcies has scared investors: the landscape is now littered with both legacy names and ecommerce growth concepts that have proven unable to survive amidst industry disruption.

Until pressured retailers can provide evidence of the reversal of traffic, comp or profitability trends, it remains challenging to establish an appropriate entry point, especially when an exit is unclear. The scarcity of cash flow financing for LBOs makes completing transactions that much harder (and economic returns that much worse). For post-Great Recession private equity investments, the ability to monetize is dependent on a supportive equity market and/or strategic buyers' optimism about their own businesses.

PRIVATE EQUITY / VENTURE CAPITAL RETAIL EXITS



Sources: FactSet, CapIQ and publicly available information

Looking ahead to 2020, we expect continued cautiousness from private equity, exacerbated by the low appetite and limited tolerance for leverage in the sector. Against all of this sector-specific risk and broader macro-economic uncertainty, private equity must contend with idiosyncratic company risk as retailers reinvent themselves to meet the demands of the rapidly evolving, and increasingly fickle, consumer.

However, opportunities are emerging for retailers with integrated, omnichannel service models and proprietary product that addresses consumer preferences. As the retail store landscape rationalizes, these retailers, which leverage a combination of stores and online, should become attractive to private equity as they are better positioned to compete against digital disrupters and store-centric retailers.

"The landscape is now littered with both legacy names and ecommerce growth concepts that have proven unable to survive amidst industry disruption."

5 EARLY DAYS OF THE SOCIAL RESPONSIBILITY MOVEMENT

Millennials and Gen Z are increasingly seeking out retailers and brands that align with their values, including concerns for the planet and social consciousness.

As this consumer movement gains traction, retailers and investors are increasingly addressing these concerns. From digitally native offerings premised on sustainable materials and supply chain visibility (like Rothy's and Everlane) to large incumbents (like Patagonia and Kering), mission-driven retailing has become increasingly visible. Consider VF Corporation's Investor Day pronouncements in September when the company unveiled a new mission, "Purpose-Led and Performance-Driven" with an objective to "power movements of sustainable and active lifestyles for the betterment of people and our planet."

The fashion sector has joined the fray, most notably with the formation of the Fashion Pact which set shared objectives the fashion industry can work towards to reduce its environmental impact. The Pact, which has more than 150 prominent participants including Kering, Gap, and PVH is committed to stopping global warming, restoring biodiversity and protecting the oceans. Fast fashion companies, frequent focal points of critics of "disposable" fashion, have made similar commitments, including Inditex's commitments to increase its use of recycled materials and renewable energy sources while reducing landfill waste.

The impact of social responsibility and sustainability on retail M&A is still in nascent stages, but we believe values-based attributes will soon become a part of the investment criteria for all brand and retail acquisitions.

CONCLUSION

In the context of a still-positive macro-economic backdrop, we expect the above themes to continue to shape retail industry dynamics moving forward in 2020. As disruption accelerates, it is incumbent upon management teams, boards and investors to stay attuned to the ever-shifting attitudes and preferences of global consumers as they fight to thrive (or survive) in this increasingly dynamic retail environment.

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+1.212.508.1600 info@pjsolomon.com

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