



SOLOMON
PARTNERS

TRENDS IMPACTING RETAIL M&A 2023

ANNUAL CONSUMER RETAIL LETTER

INTRODUCTION

Following unprecedented 2021 retail M&A and IPO volumes, sector activity in 2022 significantly eroded as numerous macro factors created volatility and uncertainty in the equity and debt markets. The U.S. Federal Reserve addressed soaring inflation through aggressive tightening of monetary policy, raising fears of the first U.S. recession in over a decade. By December 2022, the Conference Board's survey revealed that 98% of CEO respondents were preparing for a recession.¹

Given this challenging backdrop, traditional retail trading valuations declined steeply, and such declines were often more severe than for the broader markets. While the broad-based S&P 500 was down 19% for the year, the retailing-specific RLX index was down 35%. Direct-to-consumer (DTC) company valuations were generally down even further, the causes of which we discuss below.

On the M&A front, the headlines regarding the 2022 M&A market "collapse" have been difficult to ignore. While total U.S. deal value was down 39% versus 2021, the 6% decrease relative to 2019 evidences more the fact that 2021 was extraordinarily strong, than 2022 being catastrophically weak. Reduced M&A activity was more acute in the retail sector, with the multi-faceted impact of weakened financing markets, increasingly fragile consumers and the uncertain macroeconomy grinding both sponsor and strategic M&A to a near halt in the second half of the year. In total, U.S. consumer-retail deal volume was down 50% vs. 2021, but only 6% off 2019 levels.

Entering 2023, we believe macro factors and still scarce financing will contribute to muted retail M&A in the first half of the year. Notwithstanding, we are optimistic that by the back half of 2023, stability in the markets — and, correspondingly, the return of financial predictability — will drive parties' willingness to turn again to M&A, whether to build scale, generate synergies, go private and/or provide returns to stakeholders.

What follows is a discussion of three critical topics we believe will impact 2023 deal-making and valuation in the retailing sector.

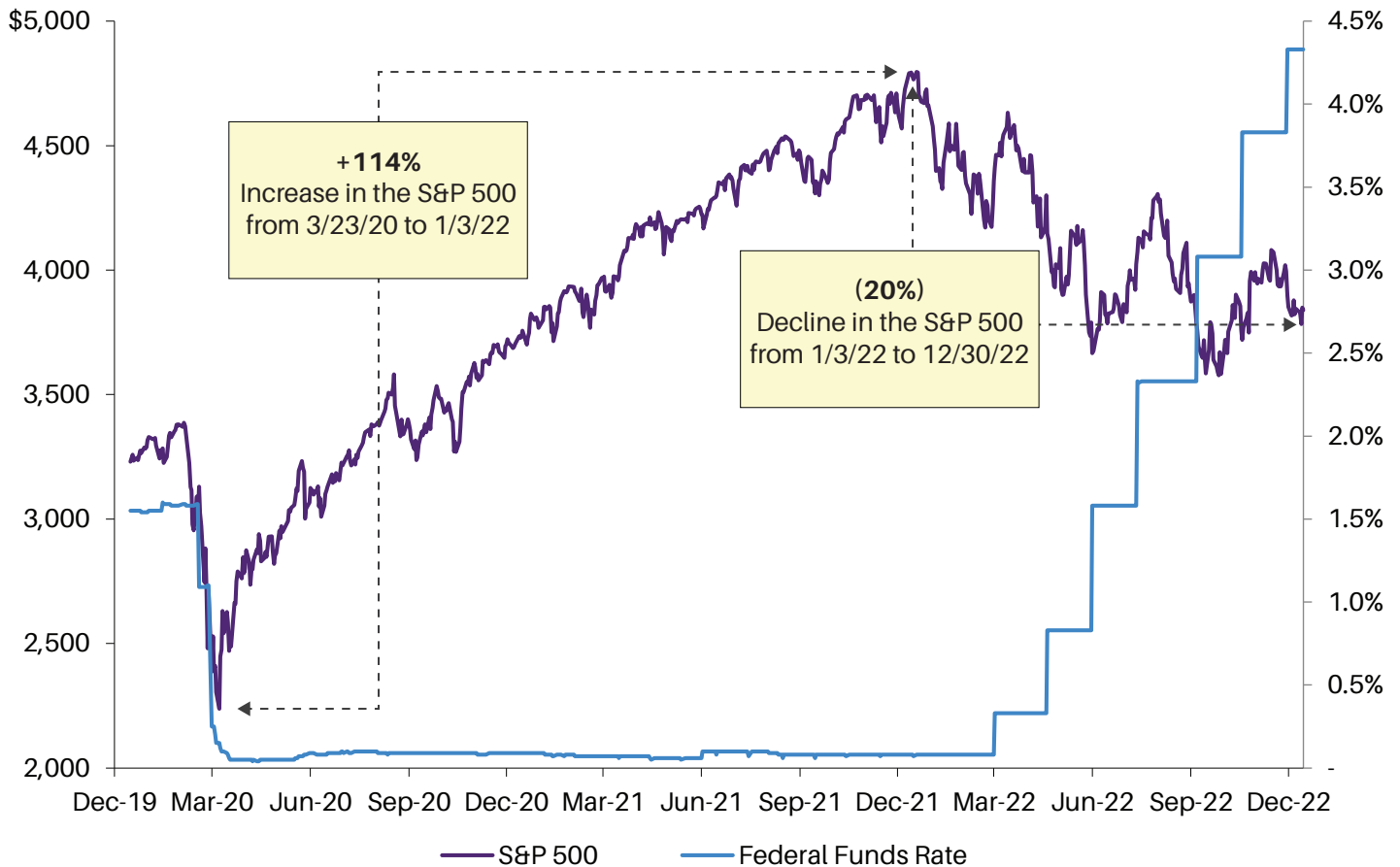
1. The Conference Board is a research organization which polled 136 CEOs across all industries to measure confidence in economic conditions.



AILING CAPITAL MARKETS UNDERLIE M&A VOLUME DECLINES

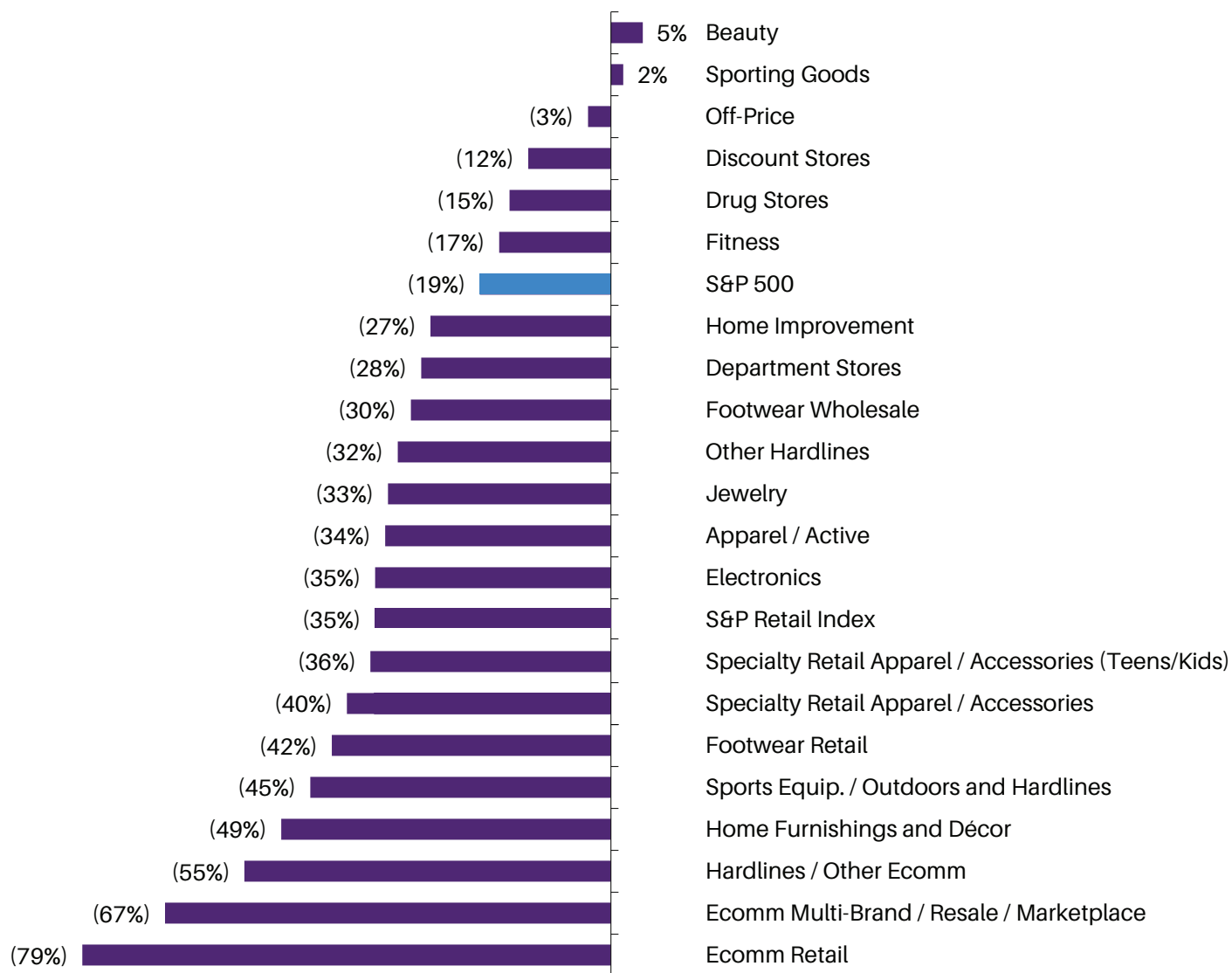
2023 M&A activity will closely correlate to the state of the capital markets. A major factor will be future activity by the Fed, which has raised rates by 425 bps since March 2022, the fastest rate of increase since 1982. That steep and rapid rate increase had a meaningfully negative impact on the equity markets.

S&P 500 AND FED FUNDS RATE



Within retail equities this past year, certain sub-sectors (for instance, beauty, sporting goods and off-price) outperformed, while others like DTC e-commerce retail, home furnishings and footwear retail lagged. But even the relative standouts struggled as overall negative market conditions left few parties unscathed.

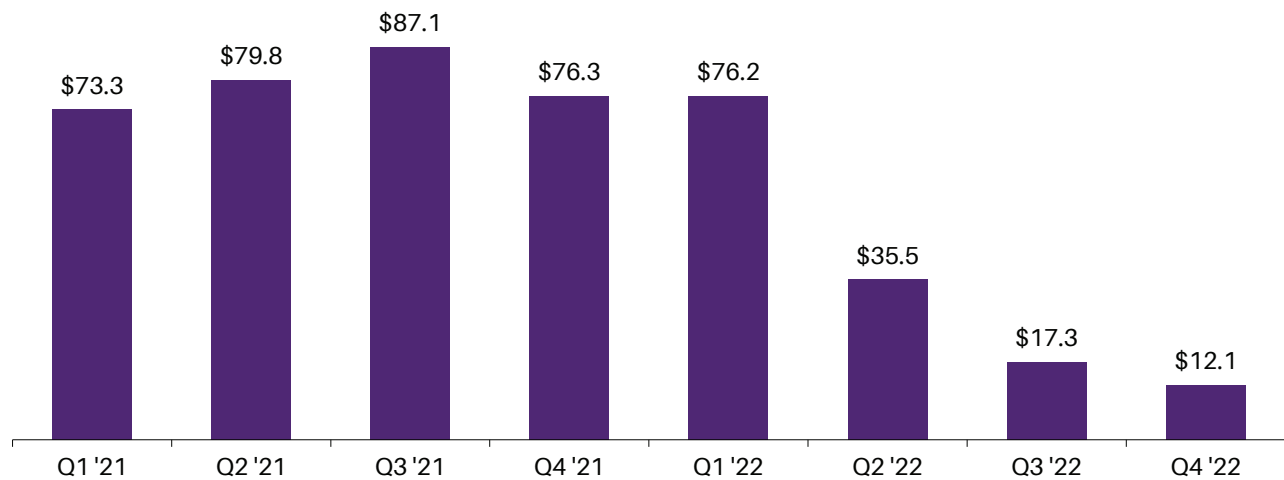
RETAIL SUBSECTOR 2022 INDEXED PERFORMANCE



Correspondingly, as public valuations fell, 2022 retail IPOs largely disappeared, in contrast to the record setting 2021. In reality, though, 2022 retail IPO activity mirrored that of pre-pandemic times, during which just a small handful of new retail issues got public in any given year. While financial sponsors took advantage of the favorable conditions in 2021, by the second half of 2022, sponsors were once again viewing an IPO as an unlikely exit alternative. Even if market conditions stabilize in 2023, we expect retail IPOs to remain infrequent, much like activity levels during the decade before the pandemic.

Turning to the lending markets, the impact was also swift and profound. In the second half of 2022, total U.S. M&A loan issuance declined 82% year over year. New issue borrowing costs roughly doubled from ~5.5% to ~11.0% and maximum available leverage came down.

U.S. M&A TOTAL LOAN VOLUME BY QUARTER (\$ IN BILLIONS)

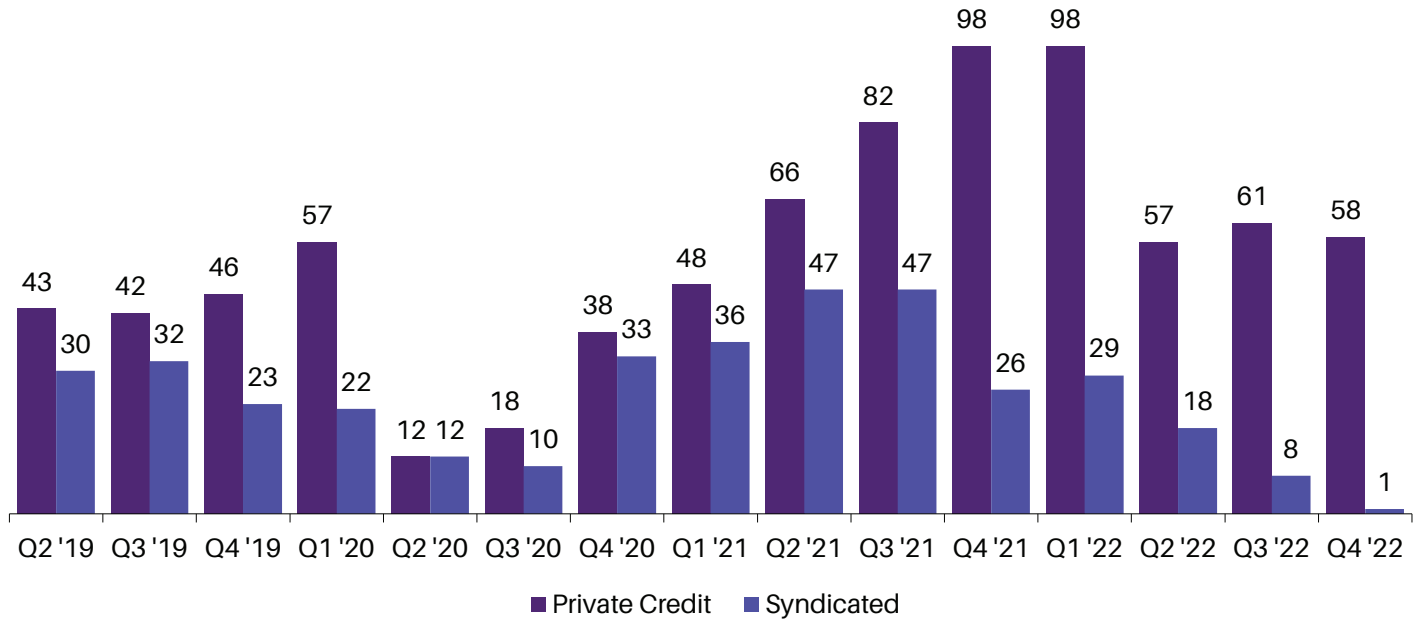


In the broadly syndicated debt markets, we expect lenders and borrowers across all sectors to continue to be negatively affected in several notable ways, at least through the first half of 2023. Banks will struggle to syndicate several high profile “hung” deals, electing to hold troubled debt on their balance sheets rather than sell at losses. Those impacted banks are likely to remain in a “risk-off” posture, reducing their lending volumes and further squeezing the markets. Other lenders will also continue to underwrite selectively and with reduced hold sizes. With all these factors, cash strapped borrowers will continue to face a dearth of capital availability.

Retailers are likely to face an even tighter syndicated lending environment compared to the overall market, given perceptions of outsized risk for companies directly exposed to deteriorating consumer sentiment. For those retailers that can access capital, more restrictive covenant baskets and ratios will prevail as lenders currently command more negotiating power.

Fortunately, the private credit markets, populated by sophisticated “buy-and-hold” institutional investors, remain accessible, albeit on more lender-friendly terms than during the year prior. Private lenders have been able to exploit their longer-term approach — and the fact their loans do not trade and therefore are not subject to frequent repricing — to step in as risk aversion roils the bank-driven lending markets. In fact, in the fourth quarter of 2022, nearly all take-private lending in the U.S. was provided by private lenders.

NUMBER OF U.S. LBOs FINANCED BY PRIVATE CREDIT AND IN THE BROADLY SYNDICATED LOAN MARKET



In 2023, while the syndicated markets remain tight, we expect borrowers to continue to turn to these private markets in support of acquisitions and for general corporate purposes. We also believe that borrowers (both corporates and sponsors) will learn to adapt to the newer interest rate norms — but perhaps only once there is visibility on the end of interest rate hikes, and as cash flow models can be produced with greater predictability. We believe this predictability will bode well for an increase in M&A activity — albeit at lower valuations than when borrowed money was far less costly.

STRATEGIC ACQUIRERS MAY HAVE A LEG UP ON PRIVATE EQUITY IN 2023

When it comes to the retail sector, financial sponsors have been highly selective for years — and well in advance of the pandemic. In fact, in the past five years, only two traditional retail LBOs greater than \$1 billion occurred (At Home Group and Michaels). Recent debt market conditions have only served to further dampen sponsor appetite for the sector. In 2022, financials sponsors both reduced their level of consumer investment activity (2H 2022 activity was down 74% to \$7 billion) and shifted their focus away from investing in consumer discretionary categories to non-discretionary themed investments. We expect that trend to be reinforced as U.S. macroeconomic uncertainty continues.

Strategic activity, while generally less dependent on financing, was also impacted by macro uncertainty, as well as lower CEO confidence, which typically correlates to M&A volumes. Furthermore, it didn't help that even

as market conditions worsened, many potential sellers continued to have rich value expectations with the still-fresh memory of frothy conditions in 2021. As a result, year-over-year strategic consumer-retail M&A was off 40%, totaling \$36 billion in 2022. As the year progressed, the number of stalled processes increased as the external environment became even more challenging, and as many targets' performances deteriorated.

Looking ahead, we anticipate a muted first half of 2023 for both sponsor and strategic M&A activity. Some of those stalled processes will retest the market, and companies that outperformed in 2022 may look to take advantage of less congested market conditions, but we expect many sellers will wait for greater market clarity that may come as the year progresses. Once steady transaction flow resumes, sponsors and strategic buyers will experience differing drivers of overall activity:

- As debt capital remains tight, sponsors will need to remain highly selective and price disciplined to hope to generate their return targets. To help

make acquisitions work in the current environment, some sponsors may turn to structure (for instance, liquidation preferences) to mitigate risk and drive investment returns. However, this will not be available or effective in many circumstances.

One bright spot for sponsor owners of so-called “platform” investments is the ability to execute synergistic bolt-on investments at reduced target prices — assuming those investments can be done under existing capital structures. Multi-unit operators in fragmented sectors — for instance auto services — will look to take advantage this way.

- Conversely, strategic acquirers — at least those whose core businesses are holding up reasonably well — face a relatively more favorable M&A outlook. With sponsors posing less competition, we think 2023 can be a fertile period for healthy strategics to pay fair prices to acquire strategically valuable assets to build scale, add capabilities and/or drive synergies. Strategics also benefit from the ability to finance off their balance sheets (and the balance sheets of their targets). As discussed below, we also think strategics will have renewed interest in profitable DTC assets that augment capabilities and channel access but are now available at far more accessible valuations.

DTC BRAND ACQUISITIONS WILL BE A DRIVER OF M&A ACTIVITY IN 2023 AND BEYOND

Following a massive shift to online purchasing during the pandemic, the e-commerce sector faced headwinds this past year, with DTC brands reporting slower growth, reduced profits and consequent valuation declines. The DTC sector has been impacted by the return of consumer in-store shopping behavior and economic pressures on consumer spending, as well as heightened competition to acquire online customers and rising costs. However, e-commerce remains the growth engine of retailing, with online channel growth expected to continue at double digit rates and with top line growth of digitally native brands continuing to outpace that of traditional competitors. As such, the online channel will continue to be an area of investment for both organic and inorganic growth.

After lofty tech-like valuations achieved during 2021 IPO debuts, DTC brand trading valuations have reset. Over 2022, Solomon Partners’ index of profitable DTC brands declined 62% and the unprofitable brands index declined 84%. The combination of rising customer acquisition cost and slackening consumer demand has caused unit economics to deteriorate. With public markets effectively closed and private market valuations following public market trends, companies that once contemplated public listings will need to seek alternative exit strategies, with more modest value expectations for the foreseeable future.

Selling to sector consolidators is an increasingly attractive exit strategy for DTC brands, as growth capital in DTC is more scarce and costly in 2023. Consolidation provides tangible operational benefits, such as multi-brand revenue opportunities, improved marketing efficiency, better pricing power, stronger supply chain networks and category diversification. This also enables buyers and their targets to leverage best practices, teams and technologies across brands throughout the portfolio. Acquisitions of this nature thus far have occurred through DTC aggregators adding businesses to leverage their existing operational infrastructures, and traditional retailers enhancing their offerings through the acquisition of DTC-centric brands.

With DTC valuations trending towards traditional brand or retail valuations, we anticipate M&A activity from both strategics and sponsors to accelerate. The proliferation of DTC businesses through the beginning of the pandemic created a vast landscape of potential targets. DTC brands with scale, differentiated positioning, brand affinity, nimble, content-based marketing, and those which have a clear ability to navigate the “new normal,” are likely to draw acquisition suitors.

CONCLUSION

Despite current market complexities, we believe attractive M&A opportunities will present themselves, albeit in more selective, situation-specific ways. A number of these opportunities will come from carveout activity by large retailers exiting smaller or non-strategic brands or business units. Some retailers will also look to jettison units that divert too much focus from core operations in today's challenging environment.

For buyers, it will be critical to sort through which segments and companies have the ability to sustain growth through continuing economic dislocation and which have been able to favorably anniversary any COVID-driven trends. For any given seller, it will be critical to recalibrate price expectations based on a realistic performance and valuation outlook in light of the prevailing macroeconomic backdrop. We are at the end of a decades-long economic boom fueled by a global surplus of liquidity, which drove asset valuations to unprecedented levels. Companies and disciplined financial investors have waited for this market recalibration to invest. As has been proven through prior down cycles, some of the best transactions have been executed when conditions have been more challenging and creativity comes into play.

As always, our experienced senior consumer-retail advisory team welcomes the opportunity to help you think through how to best address critical strategic decisions in these unprecedented complex times, and to capitalize on opportunities that may help reshape your businesses for durable competitive and financial advantage.

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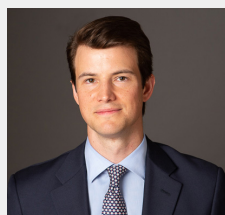
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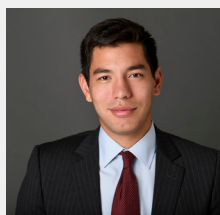
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