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RETAIL OUTLOOK 2021

TRENDS IMPACTING RETAIL M&A

A YEAR OF EXTREMES FOR RETAIL

2020 was an exceptional year of highs and lows for the retail sector. Heightened expectations for deal-making were thwarted by the emergence of Covid-19 in early March, with widespread stay-at-home and quarantine orders being issued. While retailers deemed “essential” flourished as consumers stocked up on necessities, others languished with their stores closed and eventually succumbed to bankruptcy. As the world adjusted to a “new normal” and M&A activity gradually resumed after a pause in Spring, it became clearer what retailers would need to survive and thrive in this evolving environment. Looking ahead to 2021, and as stability and predictability slowly return, we remain optimistic about the prospects for the US retail landscape.



THE BIG GET BIGGER

The shift to e-commerce rapidly accelerated and successful retailers knew to focus on this. The pandemic fostered a winner takes all environment as first-movers and essential retailers of size and scale continued to gain share.

Shutdowns and work-from-home mandates forced technologically averse shoppers online, creating a new cohort of e-commerce consumers to supplement the existing base of omni-channel shoppers who simultaneously increased the frequency of their online transactions. Consumers learned to appreciate the flexibility and convenience of enhanced online shopping, with new options like curbside pickup and

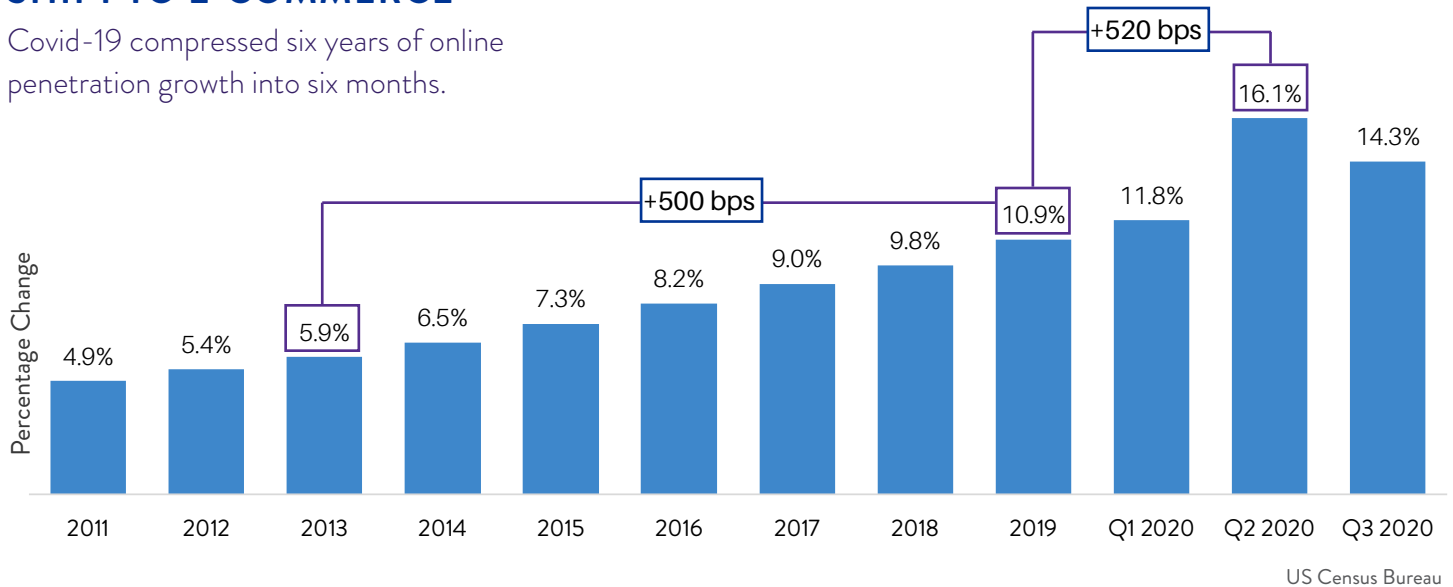
expanded same-day delivery. We anticipate this shift in shopping preference to persist as consumers continue to expect flexibility from retailers, even in a post-Covid environment.

Larger retailers with capital to invest in omni-channel capabilities were best positioned to adapt to changing consumer demands. Target, Walmart and other deep-pocketed retailers made investments that paid dividends and propelled them to new levels of sector leadership and market share gains. Amazon continued its dominance, gaining over \$700 billion in market capitalization in 2020. Amazon grew revenue by over 35% last year, surpassing \$385 billion in revenue and \$215 billion in product sales (representing 25% of US e-commerce sales)¹, a nearly eight-fold increase from a

decade earlier. As Amazon continues to scale, its access to low-cost capital remains a competitive advantage, with its latest June 2020 \$10 billion bond offering completed at below market rates (\$2 billion note tranche due 2060 at 2.7%). To its credit, Walmart remains in close pursuit of Amazon. While Walmart’s market capitalization and revenue have grown more gradually, its e-commerce sales have surged and are expected to surpass \$40 billion for 2020; representing roughly 5% of all US e-commerce.¹

SHIFT TO E-COMMERCE

Covid-19 compressed six years of online penetration growth into six months.



A decade ago, the top-ten retailers represented \$588 billion in market cap and \$906 billion in revenue. Today the top-ten stand at \$3.10 trillion and \$1.53 trillion, respectively. To be in the top-ten 10 years ago, a retailer needed ~\$24 billion of market cap, where as today it would need \$40+ billion. Margin pressure across the sector has left those with the greatest scale best positioned to excel. Retailers have not only shifted capex spend from new store build-outs to investments in technology and infrastructure, but have also grown overall outlays, with the top-ten retailers’ capex nearly doubling from \$29 billion to \$51 billion. This collective reinvestment fuels growth and makes it extraordinarily difficult for smaller businesses that lack size and scale to compete.

+ 428%
Top 10 Market Cap

+ 69%
Top 10 Revenue

+ 86%
Top 10 Capex

Company Filings & S&P CapIQ

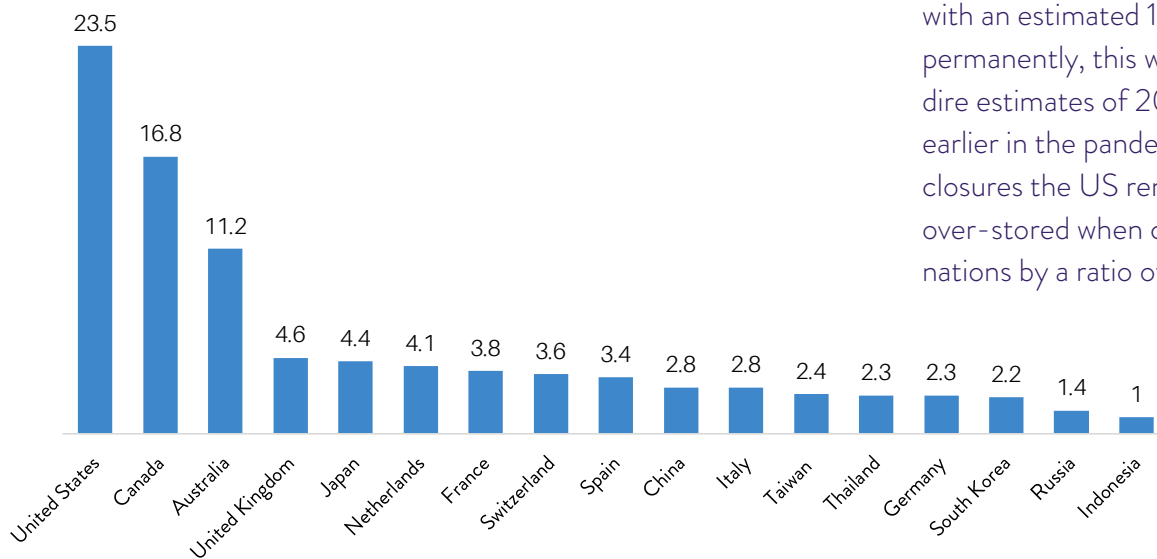
As larger, traditional retailers scaled operations, digital first businesses took advantage of the favorable IPO, equity and debt markets to develop scale and infrastructure of their own. By the end of 2020 the class of online native “winners” had been crowned, commanding significant shares of consumer dollars (e.g. Chewy, Etsy, Wayfair, among others) and establishing the positioning needed to compete with category giants. Having made significant investments behind technology and infrastructure, this new breed of e-commerce company is more flexible and able to meet changing consumer demands than ever before.

10 YEARS OF CHANNEL SHIFT IN ONE MONTH

Consumers have expressed their preference for an omni-channel experience and brick-and-mortar stores remain a necessary fulfillment channel for many retailers. Curbside pickup emerged as a means to leverage a store’s portfolio and localized inventory to provide the convenience of contact-less, online shopping with the immediate nature of grab-and-go — which for much of the pandemic, was the only way to serve immediate retail needs. These new retailing methods ultimately served to enhance the perceived importance of physical stores.

In a recent study by CommerceHub, 59% of consumers said they are more likely to continue to use curbside pickup following the pandemic. Moreover, we saw increased traffic to stores during the holiday season even with a second-wave of the pandemic looming, with conversion benefiting as shoppers had greater purchasing intent. However, despite the closing of nearly 11,000 stores in 2020, over-storing remains an issue. Consumers will eventually force retailers to re-envision how their stores are used, leveraging them as competitive assets, and there will be continued fallout for those who remain behind the omni-channel curve.²

RETAIL SPACE (SQ FT) PER CAPITA IN SELECTED COUNTRIES WORLDWIDE IN 2018³



While 2020 continued to see a shake-out in the brick-and-mortar retail landscape with an estimated 11,000 stores closing permanently, this was a far cry from more dire estimates of 20,000 – 25,000 earlier in the pandemic. Even with these closures the US remains significantly over-stored when compared to other nations by a ratio of more than 5 to 1.

Interestingly, while the Great Recession led to the emergence of many successful flash-sale retailers such as Rue La La and Hautelook, we witnessed a noticeable exception this time in the off-price market, where product sourcing can be less predictable and therefore lead to challenges with consistent, online offerings. Moreover, unlike the great recession where over-inventoried retailers and brands dumped excess product in droves, many retailers took the unprecedented step to “pack and hold” spring / summer inventory for the 2021 season rather

1 in 7

Americans moved or plan to move to less urban areas due to Covid⁴

+ 7%

Increase in Housing Starts in 2020⁵

1 in 4

Americans plan to add another vehicle in 2021⁶

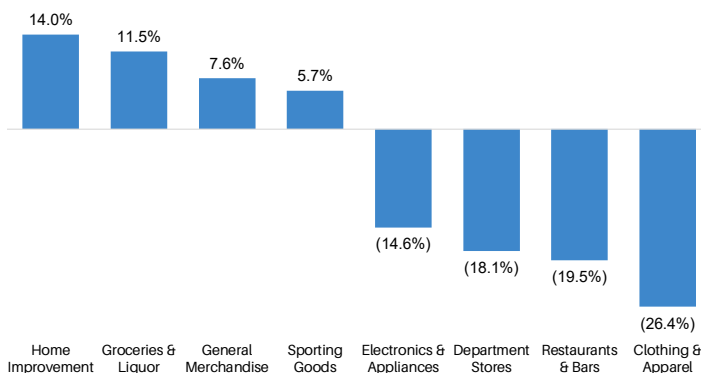
than liquidate through off-price channels, which, in many categories, were offering cents on the dollar.

A CASE OF WINNERS AND LOSERS

Many consumer and retail categories, including those that were previously challenged or were traditionally viewed as more at-risk during periods of economic uncertainty, benefited from Covid and outperformed in 2020. The health & wellness, personal care, outdoor recreation, household durables and food & beverage categories all demonstrated strength as consumers spent significantly more time at home for both work and leisure. “Reverse urbanization” trends, combined with consumer demands for activities conforming to social distancing guidelines, have led to broad re-engagement with outdoor recreation, driving sales of goods and equipment and even larger ticket items like RVs, boats and other powersports vehicles.

Household durables benefited from a rotation in discretionary spending as consumers had more resources to allocate to their home. DIY performed exceptionally well, even in more hard-hit industries, as consumers opted to use newfound “Covid time” to make repairs or improvements around their home.

2020 RETAIL SALES PERFORMANCE BY INDUSTRY (% CHANGE FROM 2019)



US Census Bureau

Conversely, retail categories which were neither deemed “essential” nor fit within the new Covid paradigm, found themselves facing significant headwinds and losses. We witnessed numerous soft-line and department store retailers left with largely unsaleable seasonal merchandise due to shuttered stores across the country for much of March, April, May and June.

Career-oriented clothing retailers also faced unique challenges as many consumers adjusted to a more “comfortable” out-of-office lifestyle. On the opposite end of the spectrum, we saw sporting goods and outdoor retailers as well as casual and athleisure apparel companies achieve record performance as consumers sought more flexible options suited to staying home and spending time outside.

A LUCRATIVE TIME FOR M&A

As investors remain flush with capital and starved for investment opportunities, those businesses best positioned for a post-Covid world have quickly become attractive targets for both strategic and institutional capital as investors weigh the potential for a step-function change in demand that will prove persistent. Accordingly, one of the biggest challenges facing buyers and investors is how to price the impact of Covid into transaction valuations. Many buyers are focusing on “Covid-adjusted” EBITDA and turning to accounting firms— long used to analyze seller financials and underwrite “quality of earnings”— to help arbitrate the “normalized” debate and determine the impact of Covid, be it transitory or permanent.

As a hedge against underwriting this uncertainty, and as a way of bridging potential valuation gaps, buyers are frequently demanding greater required equity rolls, greater earn-outs (based on 2022 and beyond performance) or other contingent forms of consideration.

CONCLUSION

Retail M&A roared back in the second half of 2020, as fears of a deep recession subsided and market participants took stock of Covid's impact on their businesses. Business leaders considered the steps necessary to either shore up their companies' weaknesses and/or enhance areas of strength. M&A again became a critical tool in these efforts, whether to augment technical capabilities, cross into new channels, access new customers or generate synergies.

So far 2021 is shaping up to carry on this strong M&A market trend. The lingering impact of Covid will undoubtedly shape the themes driving retail M&A this year (and likely beyond). Time will tell what the "new normal" means and whether businesses will revert to 2019 form or be changed forever (for better or for worse). Buyers and sellers alike are actively forming their hypotheses and making key strategic decisions about how and where to invest, or if and when to sell. With over three decades of sector experience, we welcome the opportunity to share our perspectives and insights as our clients tackle these key strategic decisions in what will undoubtedly be a complex 2021 - and beyond.

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1 <https://www.digitalcommerce360.com/article/usecommerce-sales/>

2 CNBC: <https://www.cnbc.com/2020/06/09/coresight-predicts-record-25000-retail-stores-will-close-in-2020.html>

3 ICSC, Cushman & Wakefield

4 Wells Fargo: <https://www.cnbc.com/2020/09/09/urban-flight-means-home-improvement-trends-will-become-a-sustained-shift.html>

5 US Census Bureau: <https://www.census.gov/construction/nrc/pdf/newresconst.pdf>

6 Cox Automotive: <https://www.coxautoinc.com/wp-content/uploads/2021/01/Cox-Automotive-2021-Predictions-Study.pdf>



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