CONSUMER SECTOR INVESTMENT REPORT

Capital flows to those who expand margins and embrace changes in consumer behavior

SEPTEMBER 2022

DATA PROVIDED BY PitchBook

CohnReznick
ADVISORY • ASSURANCE • TAX

EXECUTIVE SUMMARY

As an industry, the consumer sector faces an inflection point. The past two years ushered in new challenges to maintaining margins, like the increased costs associated with logistics, sourcing, procurement, and returns. Changes in consumer behavior and buying patterns are pressuring consumer companies to differentiate with quick commerce—delivery in hours, not days—and building infrastructure to support these shifts in the market. Now, there are also newer shifts requiring companies' attention. To battle high inflation and fears of a recession, consumer companies must double their efforts to maintain customer loyalty and profit margins. To that end, brands must place the customer experience at a premium while juggling logistical headwinds and shifting market trends. Private equity (PE) investors are paying close attention to the companies succeeding in this environment.

Prior to COVID-19, consumers demonstrated a clear preference for experiential purchases—such as festivals and sporting events—as opposed to buying more "stuff." The pandemic and its aftermath changed that preference to some degree. In the place of experiential purchases, "experiential goods," products that make consumers feel unique or connect with their values, are emerging.

COVID-19 also formed new consumer habits. Working from home and conducting meetings from living rooms have led to increases in furnishing purchases and home improvement projects. Lenient schedules have caused consumers to veer away from consuming three distinct meals every day; instead, snacking has become more popular. At restaurants, some consumers are ordering wine in the afternoon, as they don't have to return to the office.

CONTENTS

While subtle, these changes can have significant impacts on a brand's profit margins. Retail management teams are using advanced data analytics to identify these trends and get ahead of them, and PE investors are now performing more due diligence on those capabilities before investing.

Developed in conjunction with PitchBook, this report details PE investment trends in the consumer space across several metrics.

A CAUTIOUS MARKET

2021 was a historic year for consumer investing. Altogether, PE firms completed almost 1,400 transactions, crossing the 1,000-deal threshold for the first time. In the process, $187.7 billion was invested, a 70.9% increase over 2020 levels. The surge pre-dated 2021, as deal activity heated up in earnest in Q4 2020.

So far, 2022 has been a different story. Deal flow has trended downward since Q4 2021, and between February and July 2022, hit its lowest levels since summer 2020.

PitchBook data suggests a cautious investment market, though deals are still going forward. Today's PE investors in consumer brands:

- have become more specialized in recent years, hiring premier operators who know their markets inside and out
- seek brands that provide unique solutions to their customers' needs while maintaining healthy profit margins
- are looking for dedication to product quality and customer experience, which gives a brand an opportunity to counteract inflationary pressures and consumer uncertainty
- want brands that can benefit from distribution improvements, introductions to new retailers, better relationships within their supply chains, and savvier digital marketing campaigns
- emphasize management teams, including chief marketing and chief revenue officers, who understand the underlying dynamics in their markets

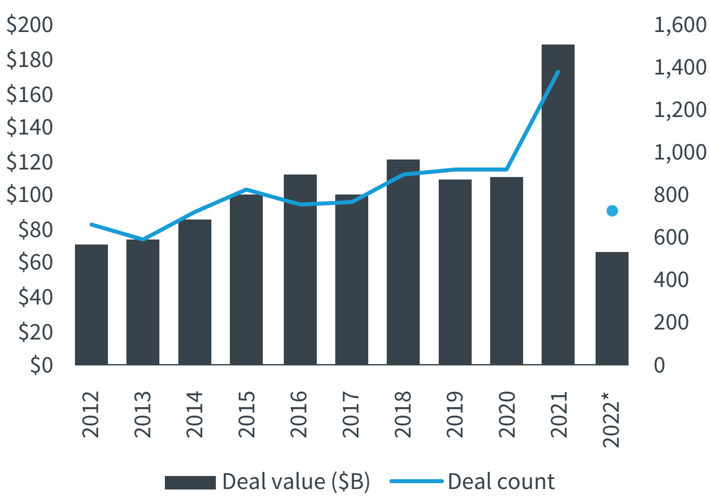
Middle-market brands in particular are better positioned to benefit from PE sponsorship.

Customer loyalty plays a significant role for consumer companies navigating this environment, as price-conscious customers weigh cheaper alternatives, product availability, and trying something new. As a result, customer acquisition and retention costs have gone up, and consumer brands are incorporating modernized marketing techniques such as texting to maintain customer interaction and interest. For the same reasons, customer loyalty programs have also become more important.

To that end, PE investors emphasize the need for detailed, actionable consumer data that sheds light on shifting consumption patterns. These investors are using advanced analytics earlier in the due diligence process and are looking to quantify customer experience as much as possible. Beyond revenues and profits, investors seek to understand consumer motivations and identify which customers can become recurring ones.

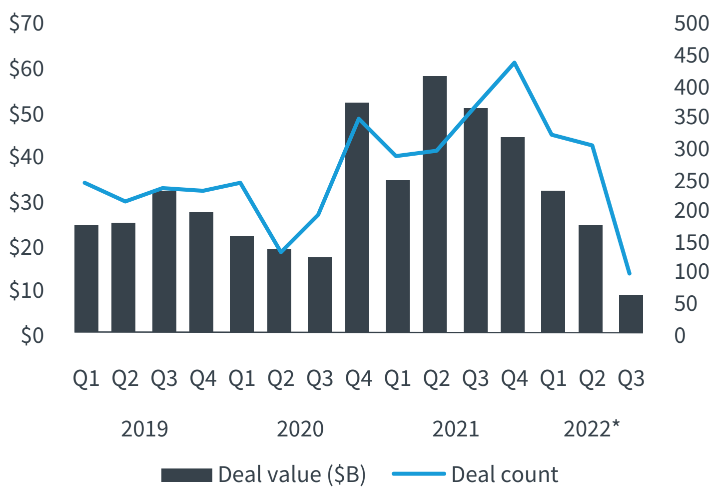
In terms of revenue, investors are also analyzing growth metrics and whether price increases are disguising inadequate unit sales growth. Ideal investment candidates can point to growing customer bases, an expansion of sales channels, outstanding customer engagement, increased "direct-to-consumer" activity, and the ability to pass on price increases without harming sales.

Consumer products & services PE deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

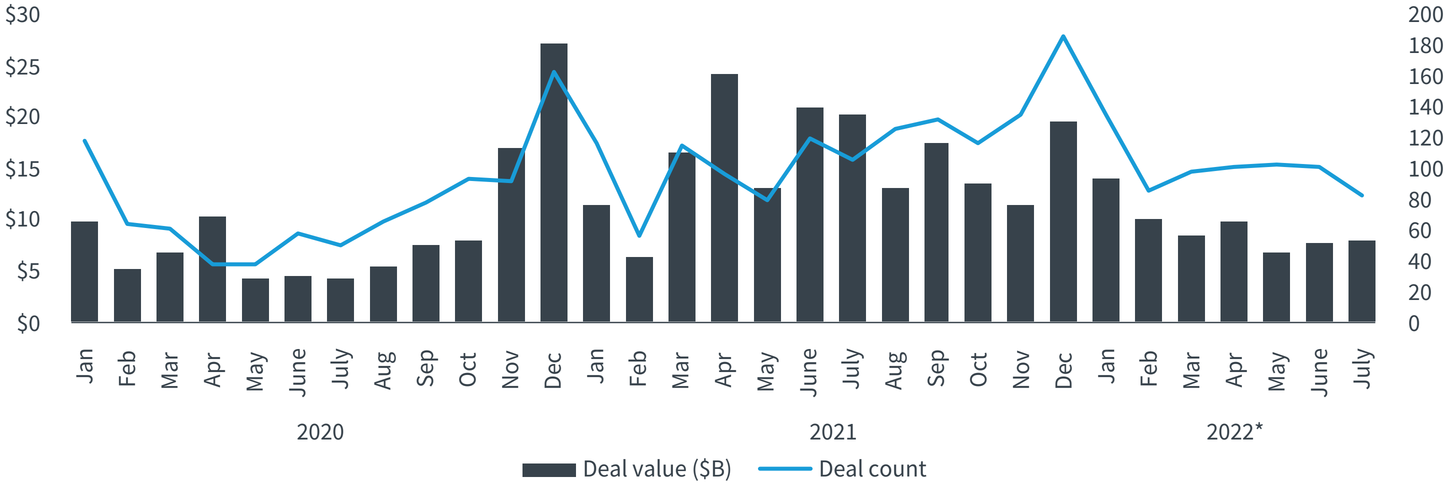
Consumer products & services PE deal activity by quarter



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

A CAUTIOUS MARKET

Consumer products & services PE deal activity by month



Source: PitchBook | **Geography:** U.S.
*As of July 31, 2022
Note: Uses extrapolated value for unknown deal sizes

"Investors are analyzing revenue metrics and whether price increases are disguising inadequate unit sales growth. Ideal investment candidates can point to growing customer bases and an ability to pass on price increases without harming sales."

- **Margaret Shanley**, Principal, Transactional Services Practice Leader, CohnReznick LLP

"I see a lot of private equity firms getting into the space earlier and becoming practically venture capitalists, looking at products they believe are unique solutions that have the potential for long-term growth."

- **Stephen Wyss**, Partner, Consumer Industry Leader, CohnReznick LLP

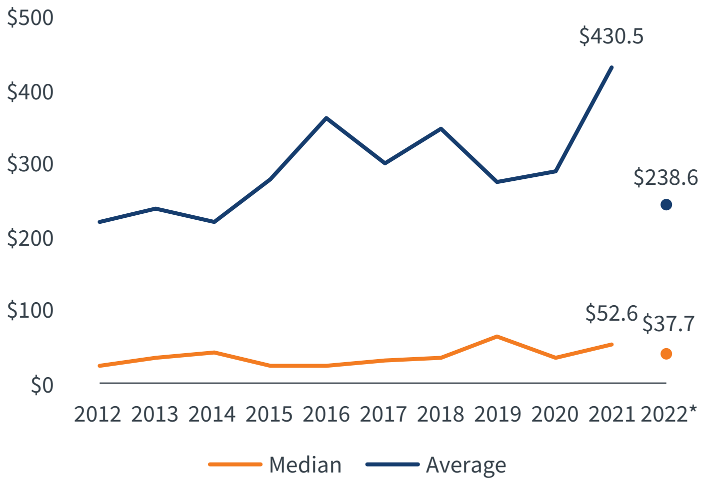
SMALLER DEALS, MORE ADD-ONS

In 2021, PE deal sizes in the consumer sector increased significantly. The average price tag rose to a record $430.5 million, while the median deal size increased from $35.0 million to $52.6 million, up 50.2% YoY. EV/EBITDA margins have remained healthy throughout the PE market, and competition for premier brands in the consumer space has boosted overall valuations and deal sizes.

Midway through 2022, deal sizes are lower and more in line with historical figures. Add-on activity, meanwhile, is proving healthy. As of early August, 437 consumer add-ons had been completed, worth a combined $30.1 billion. Those 437 add-ons have almost eclipsed 2019 and 2020 figures, with five months of dealmaking left. At this pace, it's possible 2022 will see a record number of add-ons in the sector, even as overall deal flow declines. PE firms prioritized new platform investments in 2021, which included plans for acquisitive growth via add-ons. 2022 statistics are starting to reflect those efforts, and 2023 should see more of the same.

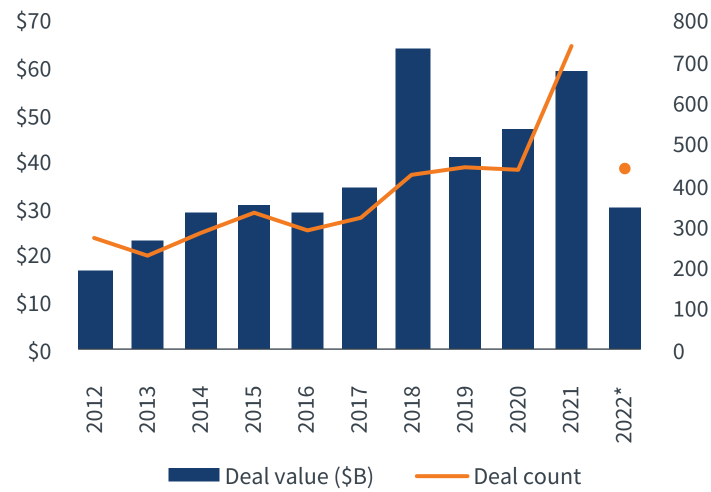
Among other benefits, add-ons help blend down the multiples paid for the original platform companies. Today, profit margins and a brand's ability to meet their forecasts highly affect EV/EBITDA valuations. PE firms want to see companies deliver on their forecasts, which includes having reasonable forecasts to begin with. According to Margaret Shanley, Transactional Services Practice Leader, valuation disputes are more likely in the current environment, especially if there were no earnout components involved in the original transaction. The potential for disputes has increased over the past two years, due to a lack of visibility among dealmakers about goings-on in their markets.

Median and average consumer products & services PE deal values ($M)



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022

Consumer products & services PE add-on deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

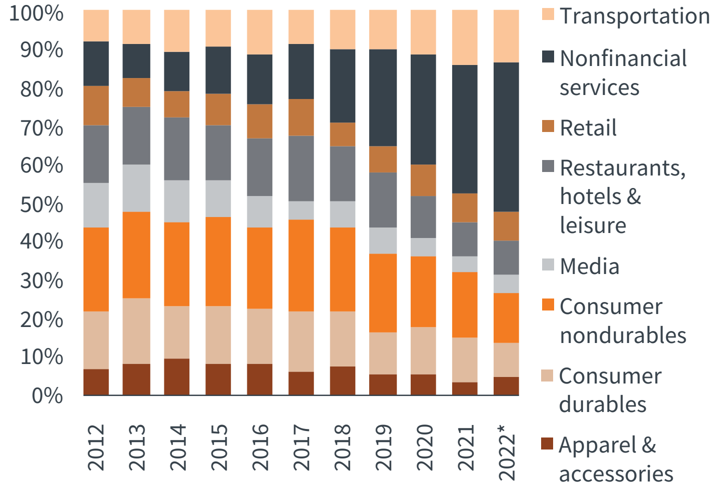
SECTOR BETS

Inflationary pressures are affecting the consumer sector. Discretionary spending is vulnerable to macroeconomic trends, and PE investors need to carefully navigate the market to find standout companies. As mentioned earlier, investors are looking for brands that can form bonds with their customers—making them feel unique—while potentially bypassing difficult decisions those customers have to make over discretionary spending. Niches such as specialty beverages and personal care products are benefiting. More broadly, PE firms have zeroed in on home furnishings and pet products, two markets that experienced a burst of activity during the pandemic and the shift to telecommuting. In some instances, PE firms are pursuing pre-revenue companies, an arena typically left to venture capitalists.

COVID-19 forced brands to buttress their e-commerce capabilities. The shift toward e-commerce was well underway before the pandemic, but social distancing requirements made it a necessity for retailers. As new spending habits have formed, e-commerce capabilities now need to make the buying process frictionless. Unsurprisingly, PE investment in e-commerce companies broke records in 2021, with 153 investments made worth $22.7 billion altogether.

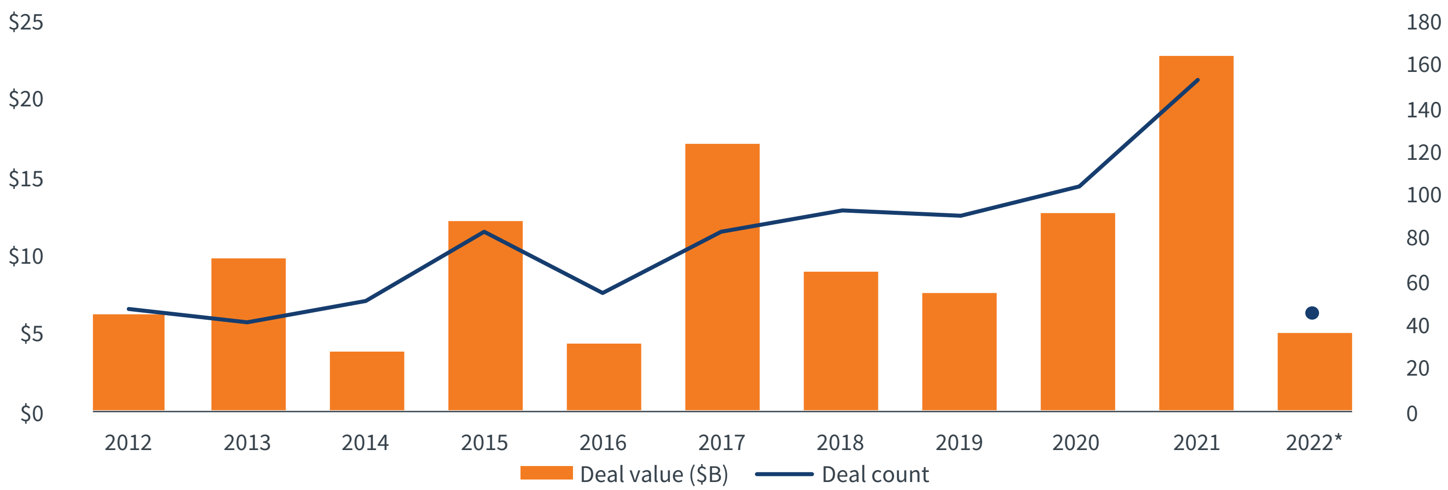
Going forward, the demand for e-commerce introduces new questions about potential portfolio companies. Succinctly put, how much does brand loyalty cost, and are companies getting adequate results for their efforts? Thanks to a tectonic shift toward online purchases, answers to those questions will more heavily factor into a company's valuation in the years ahead.

Share of consumer products & services PE deal count by subsector



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022

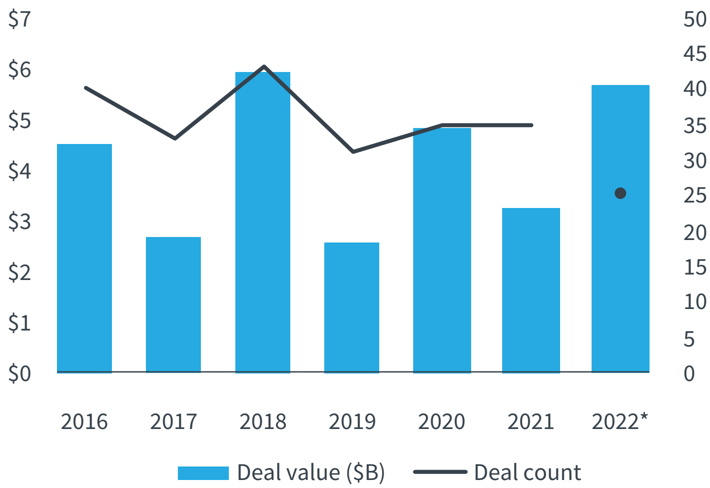
E-commerce PE deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

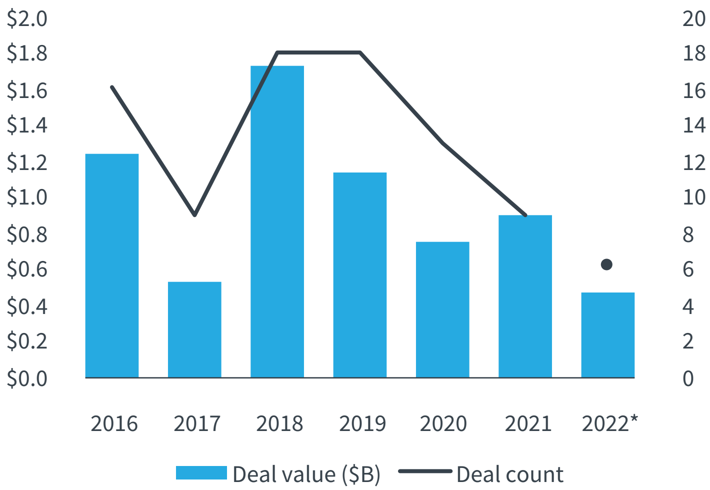
CONSUMER DEALS BY THE NUMBERS

Clothing and footwear PE deal activity



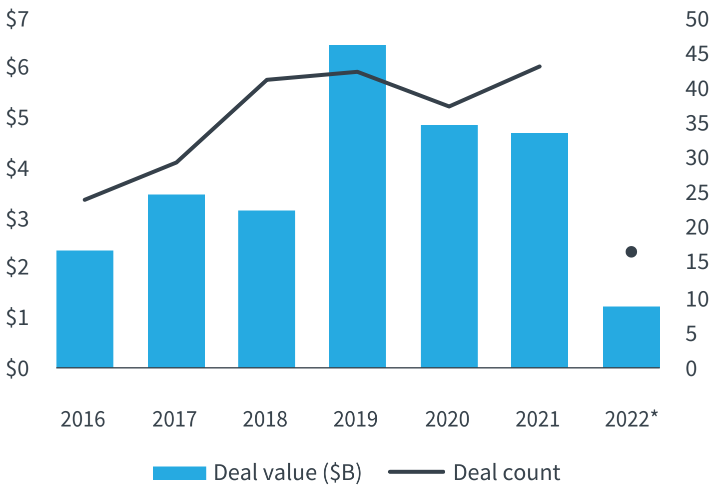
Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

Accessories PE deal activity



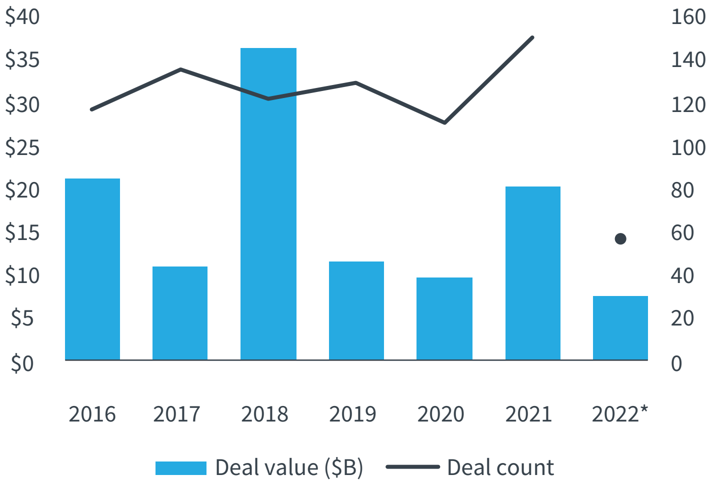
Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

Personal products (nondurable) PE deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

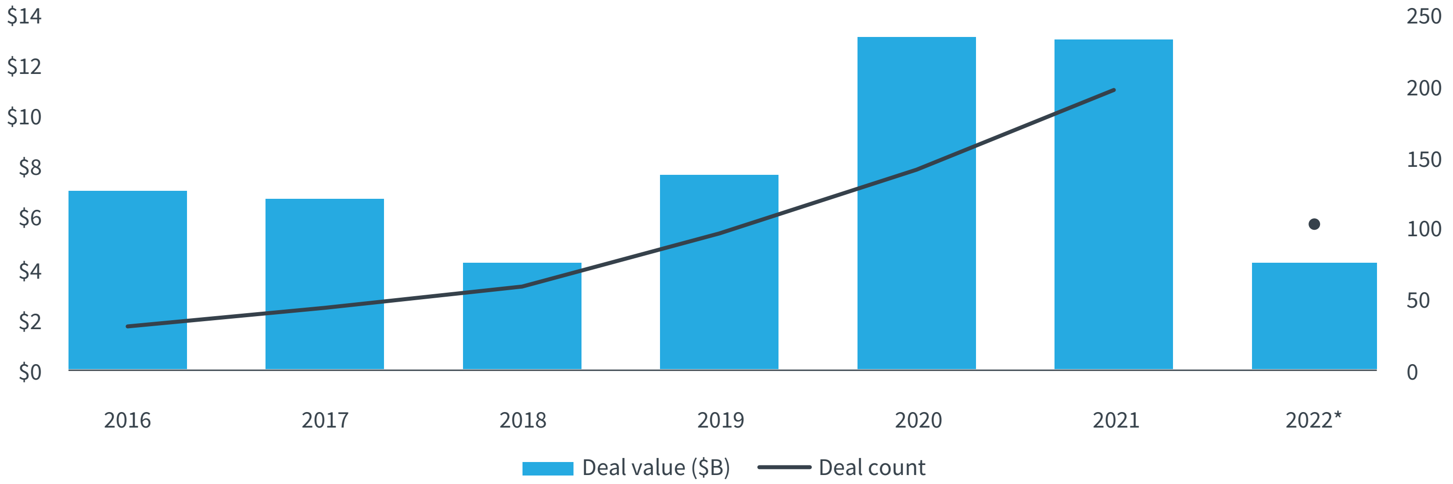
Food & beverage PE deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

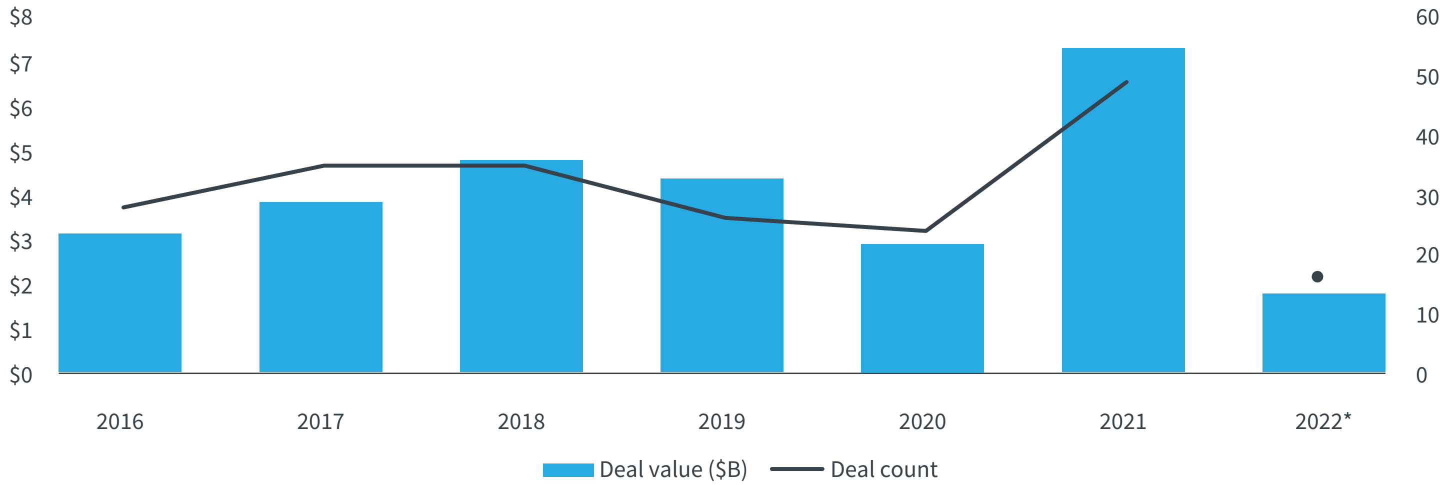
CONSUMER DEALS BY THE NUMBERS

Pet products & services PE deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

Home furnishings PE deal activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022
Note: Uses extrapolated value for unknown deal sizes

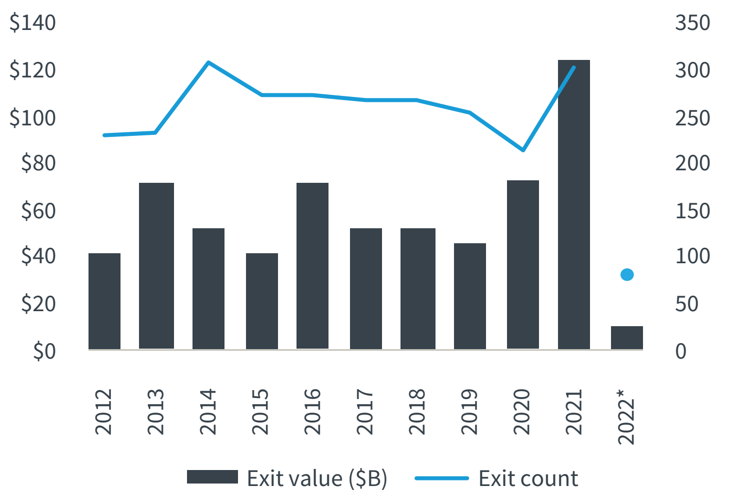
THE EXIT QUESTION

Most PE exits in the consumer sector revolve around acquisitions. For over a decade, most exits every year have been comprised of sales to strategic buyers. In 2020, almost two-thirds of all consumer exits were via M&A. The other major exit ramp is the secondary buyout, as consumer brands stay under PE sponsorship but with different owners. Though they often make headlines, PE-backed consumer IPOs are relatively rare. The typical year sees fewer than a dozen of them.

With strategic acquisitions, PE investors can plan ahead to some degree. Conglomerates in the industry value exposure to multiple markets and often choose to pay to enter new markets via acquisitions over building out new products or business lines from scratch. PE firms can make some exit assumptions about which companies and brands will be in demand after their holding periods. Especially for niche or emerging markets, corporate buyers think of those segments as “white spaces” that need to be filled. PE investors can fill these voids, and they did so with gusto in 2021. According to PitchBook, a record 301 exits were completed in the consumer market, valued at $124.0 billion in total.

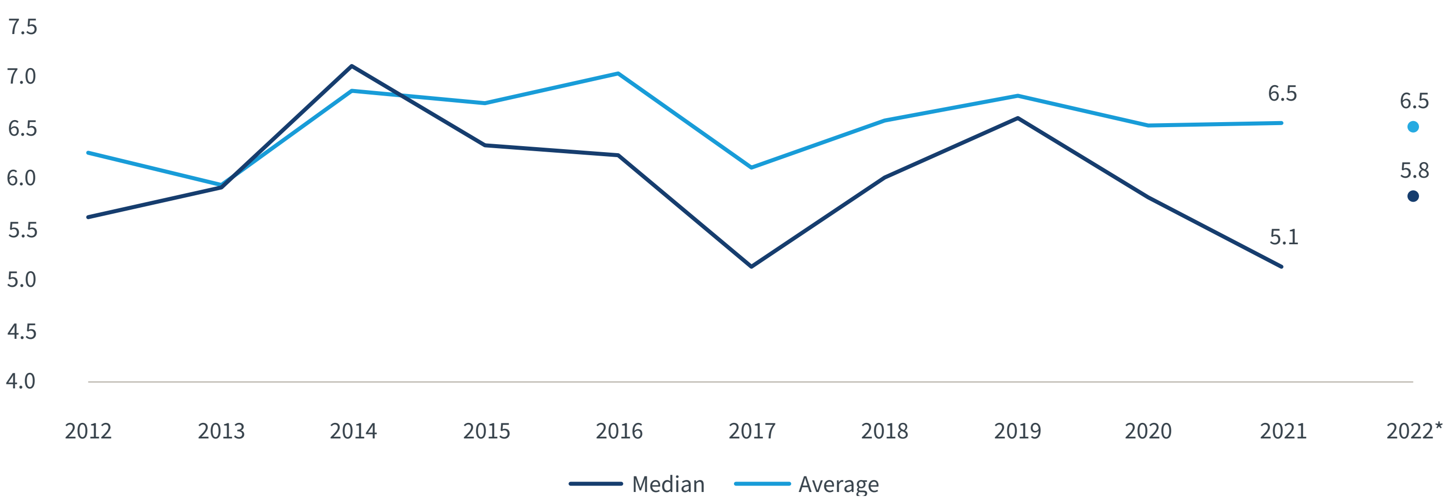
While exits are down so far in 2022, the sell-side calculus remains the same. Strategic buyers are looking for improvements in their gross margins, and PE-backed brands that can boost those margins are prized. PE sellers can fetch premium prices for those companies if their margins are attractive enough. It takes time to get portfolio companies into that position, but PitchBook figures show shortening holding periods over the past two years. Companies that were exited in 2019 were held, on a median basis, for about 6.5 years. Thanks to historic buy-side demand, the median holding period fell to just 5.1 years in 2021.

Consumer products & services PE exit activity



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022

Median and average consumer products & services PE holding time (years)



Source: PitchBook | **Geography:** U.S.
*As of August 3, 2022

CONSUMER BEHAVIOR IS EVOLVING – A Q&A with CohnReznick

With a wide range of macroeconomic conditions affecting consumer spending and otherwise threatening company margins—inflation, supply chain disruptions, talk of a recession, and gluts of inventory or seasonal promotions leading to higher discounts, to name a few—how are you seeing consumer brands affected, and how are they adjusting to keep their margins up?

Stephen Wyss: Many of our consumer clients are responding to today's market conditions. One thing is for sure: Maintaining margins is going to be critical for consumer brands. The key for branded merchandisers is to develop a special relationship with their customers that would support pricing increases and brand loyalty.

Margaret Shanley: Middle-market brands are certainly seeing a decline in their margins from pre-pandemic levels. They are being impacted by supply chain issues, labor costs, and the costs involved in attracting and retaining customers, all of which are contributing to margin degradation. For premium brands, the story is a bit different. I have a consumer client right now that's improving their margins; they've been able to pass along high price increases because they've evolved into a specialty channel. Another client has engaged a supply chain consultant to improve their margins. They're really being strategic around their costs and logistics, and where their logistical providers are based. Additionally, they are having thoughtful discussions around costs, making sure the costs are being updated in their systems.

Besides potentially less spending, what other changes are you seeing in consumer purchasing behavior?

Wyss: I'm seeing a mix of what I would call "experiential goods" purchases. Companies that are having success in selling their goods are providing some experience that the consumer values. It's not just about the goods; it can tie back to how the company views diversity, equity, and inclusion, and what they do in their communities. There's an experience that people are obtaining by interacting with those goods. I do think the post-pandemic world is going to look at experiential purchases differently than they did pre-pandemic. I think the consumer psyche has shifted; now, we feel good when we're interacting with brands and products that we believe in or that provide us with something extra. Products that give us a sense of pride or that give us a real sense of experience when we shop in their stores. That's the shift that I see, and it's an experience associated with products that will drive additional sales.

The consumer's relationship with subscription-based experiences is one worth watching. If consumers reduce their spending, many of the subscription-based services, such as streaming entertainment providers, may suffer. Even the more specialized meal preparation, clothing, and beauty subscriptions may be at risk of losing customers.

Margaret Shanley
Principal, Transactional Services Practice Leader
CohnReznick LLP
Margaret.Shanley@CohnReznick.com

Stephen Wyss, CPA
Partner, Consumer Industry Leader
CohnReznick LLP
Stephen.Wyss@CohnReznick.com

CONSUMER BEHAVIOR IS EVOLVING – A Q&A with CohnReznick

We've seen some shifts in brand loyalty due to macroeconomic conditions, with consumers looking for cheaper alternatives due to inflation; more available alternatives due to supply chain issues; and, coming out of COVID-19, a simple urge to try something new. Is it fair to say consumer brands are facing a loyalty problem? And what role has e-commerce played?

Wyss: The diversification of offerings and segmentation that's been fueled by e-commerce really accelerated during the pandemic, and consumers were forced to look to e-commerce for their needs. Companies responded by enhancing and investing in their overall e-commerce experience, making the shopping experience frictionless while tying it into their brick and mortar as well. That has created this opportunity for the consumer to find new products very quickly and have a great experience with them. But there is a huge challenge to maintaining that brand loyalty. Companies have also become much more efficient with their use of social media and with technology. But retention and engagement rates are critical factors that PE investors look at when assessing the potential long-term success of a brand or company. How much is it costing you to engage and retain your customers, especially your repeat customers, and to maintain their rates of purchase? Those have become important metrics in assessing potential success for brands.

How have consumers' eating and food-buying habits changed in the wake of COVID-19?

Shanley: Investors are paying attention to that question. There was a point during the pandemic when you couldn't go out to eat. People ordered in. And most people, to some degree, are still working from home. Those factors are captured by the food delivery services of the world. But as things have opened up, some restaurants are doing better than ever. People are going out to eat more. The restaurant space has become much more efficient in adapting to that. There have also been changes about where people eat and when they eat. Another big trend is people are snacking more. They're working from home. They might have one meal later in the day, but there isn't as much focus on having three discrete meals in a day. Strategics are looking at those trends very closely because they're losing growth and momentum with their staples. They aren't selling as much anymore, and some of that circles back to changing consumption habits due to the pandemic.

Amid all these changes, what are private equity investors looking for/at differently today during the due diligence/buying process? What are valuation conversations sounding like? What are PE firms zeroing in on when deciding what they're willing to pay for a company?

Shanley: I think they're trying to understand the company's customers as quickly as possible ahead of getting into the financial statements. They want to go in and see what the underlying trends are. They want to see any customer experience data that could be analyzed. They're trying to peel back those sales and revenue line items in order to understand what's driving them and how profitable they really are. We spend a lot of time with our clients really understanding true contribution margins broken out by channel. It goes beyond the direct cost of goods sold, though that is relevant. It's also things like knowing how much you're spending to have your product come in, how much you're spending to have it stored, and whether there are penalties around tariffs. Perhaps they circle back to broker commissions or promotional expenses. PE clients want that information before they get too far into the diligence process.

Meeting your numbers is incredibly important today. You don't want to look at the top line and realize you're not selling as much, or that the sales are happening but you've incurred more unplanned costs to get there. Being able to deliver on forecasts and having realistic ones to begin with, that's the most important aspect of this conversation. And you have to have the right people in place – that's the struggle with growing brands. You also need to have good finance people who can get a handle on the numbers, a Chief Marketing Officer or Chief Revenue Officer who can get to the forefront of looking at these trends in revenue and customer buying patterns. How are those trends changing? And how are they aligning with our forecast? Around valuations, right now there seems to be an increased potential for valuation disputes, especially if there wasn't a big earnout component included in the deal. How do we avoid disputes? Again, it's really important to set realistic forecasts around the numbers, and certainly meet them at a minimum, if not surpass them.

Consumers, employees, and other stakeholders want to build relationships with responsible companies. What role is ESG playing in consumer sector dealmaking and operations?

Shanley: Most private equity funds have started their ESG (environmental, social, and governance) journey. Some are more mature than others. This is especially true when it comes to marketing during a capital raise, making investment decisions, and managing those investments. I was talking with a client recently who has added a series of ESG-related items to the diligence process. I think most private equity funds have a similar focus, wanting to make sure they are acquiring "clean" brands, and supporting a healthy and happy workforce.

METHODOLOGIES

Deals
PitchBook's PE deal data includes buyouts and PE growth investments. Only closed transactions, not rumored or announced deals, are counted. PitchBook's total capital invested figures include deal amounts that were not collected by PitchBook but have been extrapolated using a multidimensional estimation matrix.

Exits
PitchBook's PE exit data tracks only completed exits, not rumored or announced transactions. Exit value, like deal value, includes exit amounts that were not collected by PitchBook but have been extrapolated using a multidimensional estimation matrix. Unless otherwise noted, IPO sizes are based on the pre-money valuation of the company at the time of the IPO. We exclude exits in which the only PE backing was a PIPE.

Consumer products & services (B2C)
Business-to-consumer refers to product or service transactions that are conducted between a business and a consumer, rather than between a company and a business or an individual consumer and another consumer.

E-commerce
E-commerce companies' primary purpose is to sell products or facilitate the selling of products online. This includes online retailers and marketplaces, social commerce and logistics and shipping for online retailers, and software providers and hosting services for online retailers.

Personal products
Manufacturers of personal products. Includes cosmetics, perfumes, and hygiene products, among others.

Food and beverage
A combination of two PitchBook sector methodologies, including Food Products (producers, processors, and distributors of food products, including companies engaged in food preparation, and manufacturers of packaged food, among others); and Beverages (producers and distributors of alcoholic and non-alcoholic beverages).

Clothing and footwear
A combination of two PitchBook sector methodologies, including Clothing (manufacturers or designers of clothing); and Footwear (manufacturers or designers of footwear, including athletic shoes, boots, and sandals, among others).

Accessories
Manufacturers or designers of fashion accessories. Includes jewelry, gloves, handbags, hats, belts, scarves, and sunglasses, among others.

Home furnishings
Manufacturers of home furniture and other decorative accessories. Includes couches, lamps, and draperies, among others.

Pet
A keyword-based search that includes manufacturers of pet food, pet accessories, and pet toys, among others.

CohnReznick
ADVISORY • ASSURANCE • TAX

About CohnReznick

As a leading advisory, assurance, and tax firm, CohnReznick helps forward-thinking organizations achieve their vision by optimizing performance, maximizing value, and managing risk. Clients benefit from the right team with the right capabilities; proven processes customized to their individual needs; and leaders with vital industry knowledge and relationships. Headquartered in New York, NY, with offices nationwide, the firm serves organizations around the world through its global subsidiaries and membership in Nexia International. For more information, visit
www.cohnreznick.com

A member of Nexia International

CohnReznick is an independent member of Nexia International