AXIAL

February 2022

GREEN SHOOTS EMERGE

Out of the Retail Apocalypse

Roughly ten years into the so-called “retail apocalypse,” the haunting images of abandoned storefronts and empty malls no longer shocks observers in the same way they would have in 2012. But while the imposing duopoly of Amazon and Wal-Mart has only gotten stronger over the past two years, an undercurrent of deal activity in the lower middle market is beginning to reveal the changes afoot in the broader consumer goods space.

To be sure, M&A can sometimes be a lagging indicator. However, the activity is now providing clear signals underscoring the omnichannel era has arrived. It’s not that merchandising is any less important to success in retail, but actually getting goods to consumers is becoming as critical as brand names or price points to establish a differentiated value proposition. Moreover, new retail models are emerging that not only account for the Amazon threat, but have instead turned its massive presence and infrastructure into an opportunity. The data is beginning to bear this out.

Wholesale & Distribution Segment in Focus

Last year, the consumer goods sector saw the biggest year-over-year increase in sell-side activity across the Axial platform, as new sale processes in the lower middle market grew by 35% from 2020 levels. In unpacking the data, it wasn’t the retail or consumer goods manufacturing subsectors that drove the increase, but rather the wholesale & distribution segment, which is emerging as the engine that drives omnichannel. And within this specific niche, 2021 deal flow jumped by 44% over the previous 12 months and accounted for 40% of all sell-side activity in the consumer goods space last year.

The volume, alone, only tells half the story. More pertinent to sellers is that the available assets in the wholesale & distribution segment also accounted for a disproportionate number of targets in the sector, almost half, that boast pursuit rates eclipsing the 15% average across all sell-side deal flow over the previous two years. (Pursuit rates, for those new to these readings, track the level of buyer interest generated as assets are introduced onto the Axial platform and then increase as new prospective acquirers request more information.)

It’s not that brick and mortar is dead, but retail today might be better represented by the steel and plastic that characterizes the warehouses and distribution centers now at the heart of consumer activity.

WHAT YOU’LL FIND INSIDE:

Omnichannel Era Finally Takes Shape

For just about a decade, retailers have been proselytizing about the potential of "omnichannel." However, for much of that time, its promise may have sounded like "tech washing" from an industry that hadn't yet come up with its answer to Amazon.

In fact, nobody was more persuasive or ardent than former Macy's CEO Terry Lundgren. Whenever the department store would announce its same store sales, they'd sprinkle in mentions of omnichannel as being supportive of the company's growth; in the company's earnings calls, he'd point to online metrics, extrapolating increases in Macys.com visits to increased store traffic and ultimately purchases within the four walls. In 2014, at the company's Investor Day, Lundgren outlined a future in which Macy's 500 brick-and-mortar stores would double as 500 independent fulfillment centers, dotted across the country, attracting customers who wanted the in-store experience, while also representing the engine to its digital operations.

It was a fantastic vision, although one that seemed to come apart at its "Alfani" seams before Lundgren ever had the chance to see it through. (He retired in 2017 after a long and storied career, but also amid a protracted sales slump that seemed to undermine his prophecy.)

Fast forward to December, 2020, however, and necessity forced retailers to actually deliver on the long-promised potential of omnichannel. Target unveiled delivery and drive-up services and enhanced its "buy online / pick up in store" capabilities; Best Buy, after a successful pilot program during the 2020 holiday season, is today remodeling a significant number of stores to serve as fulfillment hubs; and brands like Nike and others have doubled down on their direct-to-consumer strategy underscoring the opportunity among manufacturers to disintermediate retailers altogether.

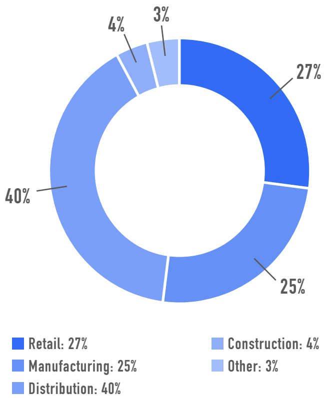
Terry Lundgren, it turns out, wasn't wrong, he was just too early. In February, the Macy's board decided not to separate its physical and digital assets, despite activist pressure. But while digital capabilities are now facilitating a frictionless and more facultative experience for consumers, behind the "screen," retailers' omnichannel ambitions are being underpinned by sophistication around fulfillment. Even ten years ago, investments in these areas were creating competitive advantages.

Venture capitalist Marc Andreesen, in his seminal op-ed, "Why Software is Eating the World," astutely observed that Wal-Mart was the leading retailer in the country at the time (in 2011), not because of its locations or its ubiquitous smiley face logo, but because it "uses software to power its logistics and distribution capabilities, which it has used to crush its competition."

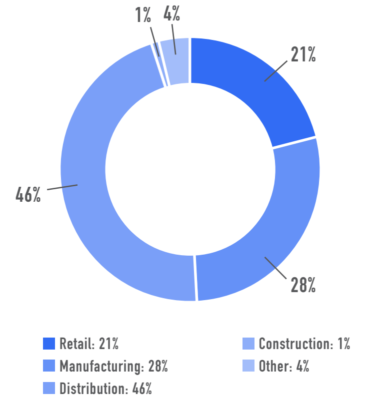
Ten years later, the rest of industry is figuring this out and many are turning to M&A to catch up.

While digital capabilities are now facilitating a frictionless and more facultative experience for consumers, behind the "screen," retailers' omnichannel ambitions are being underpinned by sophistication around fulfillment.

PERCENTAGE OF SELL-SIDE DEAL FLOW ACROSS CONSUMER GOODS SUBSECTORS (2021)



PERCENTAGE OF TARGETS W/ PURSUIT RATES > 15% (2021)



Omnichannel Era Now Shaping Deal Flow

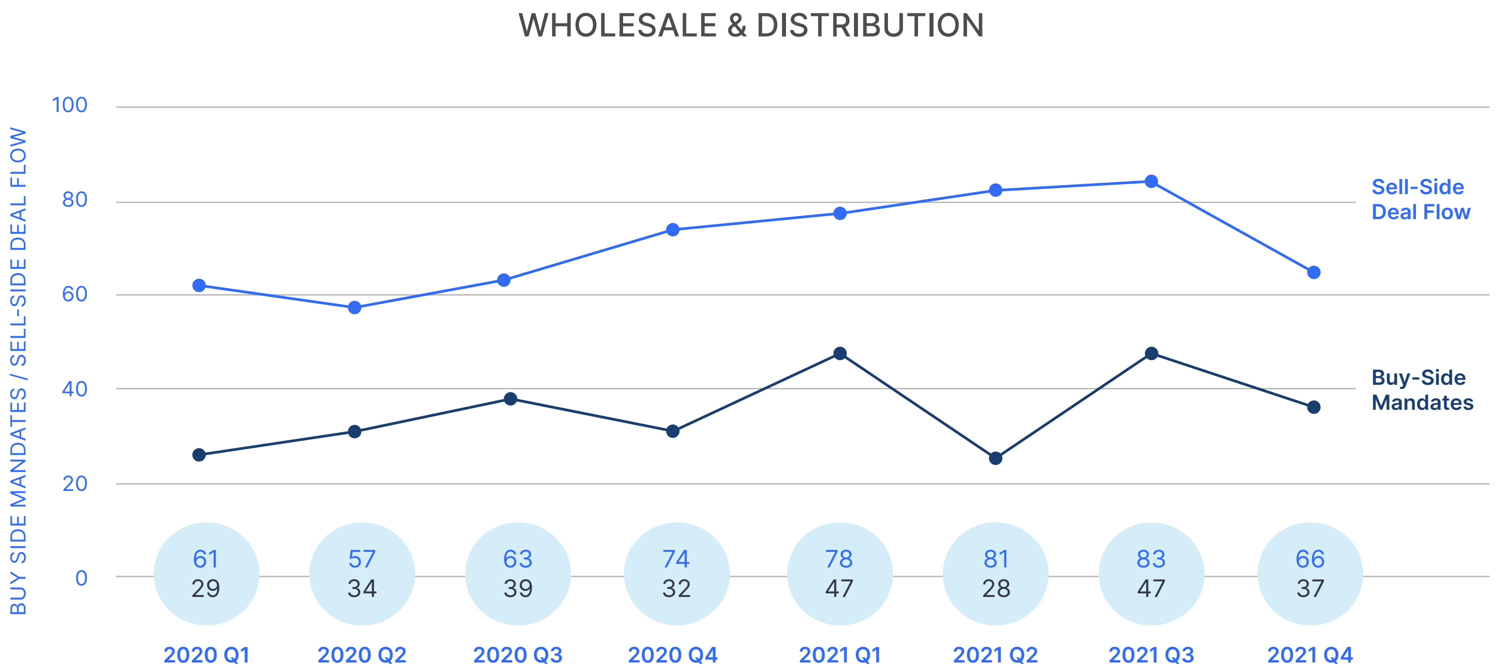
The question on the minds of lower middle market deal professionals, of course, is how these trends will influence consumer M&A. This is particularly the case as the Wal-Mart and Amazon duopoly gains momentum with every passing year and after a decade in which more traditional consolidation activity has largely been ineffective to level the playing field.

Bed Bath & Beyond, for instance, used M&A to dip its toes into the off-price category (Christmas Tree Shops) and try its hand at flash sales (One Kings Lane). It also used vertical M&A to boost its sourcing capabilities (Linen Holdings) and added a new growth engine (Cost Plus World Markets). The retailer, however, spent most of 2020 divesting these and other assets and late last year opted to launch its own digital marketplace. Imitation isn't just the highest form of a flattery, it can be a last-gasp effort for survival.

Others, though, are more focused on building out their logistics and fulfillment capabilities. Take American Eagle. In the last week of December, the teen retailer completed its acquisition of Quiet Logistics, an operator of "in-market" fulfillment centers that will enable same-day and next-day delivery. This investment followed its August acquisition to acquire shipper-aggregation startup AirTerra, which was launched by a Wal-Mart and Nordstrom logistics veteran one month into the pandemic.

This builds on recent trends over the past five years in which retail M&A activity is extending further and further outside of the traditional retail markets. Witness Target's acquisition of same-day delivery company Shipt; Wal-Mart's deal for peer-to-peer last-mile delivery platform JoyRun; and Amazon's purchase of cloud-based customs broker INLT, to support its marketplace vendors.

In the lower middle market, however, this kind of vertical integration may be less feasible for retailers without sufficient scale. But for sellers in the distribution niche who can help incumbents fill out key parts of the value chain, these trends should drive buy-side demand for some time, particularly as these types of investments are viewed as more strategic to growth in a hyper-competitive landscape. Indeed, the number of wholesale & distribution buy-side mandates initiated over the Axial platform in 2021 grew by approximately 14%, year over year, while sell-side deal flow grew by 18%. The supply chain challenges that emerged last year were certainly a contributor, but the rise of omnichannel can't be overlooked.



The Lower Middle Market's Evolving Retail Appetites

While the pandemic accelerated and helped to cement "omnichannel" trends, it also had an unexpected effect on retail generally. The surge in home sales, for instance, provided a tailwind that supported consumer activity, and fueled performance in the home goods and home improvement segments in particular. This surge in real estate, even if it cools as interest rates climb, could have a long tail, as new homeowners turn their attention to furnishing and finishing their homes.

Across the entire consumer goods sector, companies that play into the home and DIY sectors accounted for nearly a third (or 31%) of all sell-side activity last year. Among the most in-demand targets, based on pursuit rates, included a smart-home device manufacturer, an energy-efficient home-product manufacturer, and an online seller of patio lighting and shade solutions.

Perhaps more interesting, though, is the extent to which lower middle market operators have found a niche helping to form a new ecosystem in the wreckage of brick and mortar and under the canopy of the Amazon and Wal-Mart duopoly. For instance, a DTC athleisure designer boasted one of the highest pursuit rates in the sector last year. While its revenues

Lower middle market operators have found a niche helping to form a new ecosystem in the wreckage of brick and mortar and under the canopy of the Amazon and Wal-Mart duopoly.

SURVEY OF ONE

Bo Stump
Partner
Stump & Company

Q. The pandemic has accelerated omnichannel trends considerably. How are you seeing this alter the operating model of the incumbents now directing more resources, attention and capital investments into building out these capabilities?

A. *The last two to three years have resulted in incredible change for both retailers and pure play e-commerce companies. We feel e-commerce penetration has been accelerated by 10 years. Brick and mortar stores have realized that the e-comm trend is not going away and are investing heavily into building out an online presence and capability to sell directly through their own sites, online. For instance, in our focus area (furniture & furnishings), Pottery Barn now sells a majority of its furnishings online. While COVID-19 was a boon for the business, they closed several stores as the mix shifted further toward e-comm.*

On the other hand, we see other prominent retailers banking on the symbiotic relationship between e-commerce sales and brick and mortar... while certain pure-play e-comm incumbents open physical locations. Wayfair made waves late last year as they began opening their own branded stores – with many more on the horizon for their various brands.

Q. Digital channels represent one factor, but where are some of the overlooked areas that are receiving investments as retailers adapt?

A. *It's not just front-end digital capabilities but back-end logistics driving the most successful firms out there. We've had several incumbents in our sector purchasing trucking companies to help create company-controlled delivery networks across the nation. We are also seeing investment in distribution centers near key ports throughout the country to assist in more streamlined logistics*

Another key component of investment is in more sophisticated enterprise-wide software to connect all the components of the business, from sales, marketing, inventory, finance, and relationship management. With more sales taking place online, it's critical that businesses have easy insights into all levers of the business and have the systems in place to respond in real-time.

Q. For distribution companies, what are the types of assets in this niche that will be most in demand?

A. *The buyer universe has grown for distribution companies. Within the furnishing segment, retailers are no longer content to just rely on third parties anymore; they have witnessed the shortcomings of that strategy – no control over rising prices and unclear timelines. So distribution companies that create efficiency and control for retailers or manufacturers will have robust interest in this current climate. For example, adjustable desk-manufacturer Loctek just committed $32 million dollars to build their own container ship.*

Responses edited for brevity

were in the bottom half of the sector, its profit margin, just outside the top decile, underscored the potential efficiency of the model.

A related trend that plays into the unique niches that often define the lower middle market are the affiliate marketing companies that often specialize in very specific categories. An affiliate marketing brand for survival gear products was also among the pursuit rate leaders in the consumer goods sector last year, which showcased very strong fundamentals.

Again, looking at the specific assets with some of the highest pursuit rates tracking buyer interest last year, another strategy creating buzz in the lower middle market are the FBA vendors who aren't competing with Amazon, but instead have developed a proficiency selling through its channels. As of January, there were approximately 9.7 million sellers on Amazon globally, nearly three quarters of which use its Fulfillment by Amazon services to reach consumers and leverage its logistics network to pick, pack and ship orders. The most successful FBA sellers are attracting buyers keen to roll-up and scale these businesses.

As of January, there were approximately 9.7 million sellers on Amazon globally.

SURVEY OF ONE

Jason Somerville
Founder, Managing Partner
Global Wired Advisors

Q. The pandemic obviously had an impact on e-commerce, but how has it changed buyer appetites for digitally native companies?

A. *Pre-Covid, while most people agreed e-commerce was going to be a big part of the future of consumer spending, it was still treated as a relatively small part of the landscape and digitally-native companies were viewed as off-the-run assets. This was especially true for Amazon-native brands, which were widely considered to be high-risk due to their extreme reliance on Amazon's marketplace for customers.*

The pandemic not only fast-forwarded the size of the e-commerce wallet share, it also created large changes in how acquirers of consumer businesses viewed digitally-native assets and opportunities.

Q. This is quickly becoming evident through the data. From your perspective, what's the prevailing investment thesis among investors in these areas?

A. *Pre-Covid, e-commerce related strategies and opportunities were primarily viewed as accessories or add-ons to traditional consumer products platforms and brands... With increases in market share, the sector became a primary focus area, and, in many cases, a purely stand-alone and very lucrative segment.*

Since early 2020, tens of billions of dollars of capital has been raised to fund Amazon FBAs and other e-commerce roll-up platforms... This available capital, coupled with the fact that valuations in the sector were and remain attractive, has created a boom in M&A transaction volume in DTC, Amazon FBA and affiliate marketing companies.

Q. What are some of the characteristics, outside of just the financials, that appeal to buyers in this sector?

A. *Growth, first and foremost. The growth rate has slowed from its mid-pandemic highs, but the online consumer space is viewed as a high-growth sector across short-, medium- and long-term horizons. Opportunities for synergies is also key. Acquirers believe that many e-commerce brands can be acquired and brought under a single umbrella – with low friction and fast integration – to benefit from a shared operating structure. Data also can't be overlooked. One of the biggest advantages DTC and affiliate marketing companies have is access to vast quantities of customer data. This is even true, albeit to a lesser extent, for companies that derive a material portion of their revenue through the Amazon marketplace... Finally, control is another factor. DTC, Amazon FBA and affiliate-marketing companies have a great deal of control over customer communications, which is important to ensure their brands and products are positioned to consumers in exactly the manner that ownership or management wants.*

Responses edited for brevity

Up to the Challenge

The activity across the consumer goods sector exemplifies the entrepreneurialism that characterizes the lower middle market, as buyers and sellers are generally driven to innovate as circumstances change. Based on recent activity, it's clear many on both the buy- and sell-side are keen to re-write the retail M&A playbook altogether.

It's worth noting too, it's not merely local or niche investors pursuing the trends that, right now, are most acute in the lower middle market deal. These niches are attracting massive global investors including the likes of Advent International, Silver Lake and others who may not regularly dip into the lower middle market arena, but are well versed in the consumer and tech sectors and know a compelling thesis when they see one.

Already, 2022 seems to be bringing a new economic backdrop, one that will force retailers and consumer goods companies to be even more creative. But as the activity across the Axial platform has proven out, buyers and sellers will be up the challenge.

Axial Group, LLC
443 Park Avenue S, 8th Floor
New York, NY 10016

1.800.860.4519

axial.net

Special thanks to report contributors and Axial's data, analytics and thought leadership team:

Peter Lehrman
Founder and CEO
peter.lehrman@axial.net

LinkedIn

Dani Forman
Director of Research
dani.forman@axial.net

LinkedIn

Lisa Helme Danforth
Managing Director
lisa.helmedanforth@axial.net

LinkedIn

Founded in 2009, Axial is the largest online transaction platform empowering lower middle market deal makers. Axial's proprietary matching technology enables advisors & business owners to confidentially connect with relevant buyers & investors. To keep up with rankings, industry developments, original stories and more, sign up for Middle Market Review, here.