DRAX

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Consumer Market Insights

What to expect as we kick off 2023...

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The challenges businesses are going through now are, in my opinion, very different to anything we've experienced before. Many business managers have been through inflationary periods and recessionary periods. What is different this time is that this is not consumption led inflation, which is fundamentally different to inflationary periods we have experienced in the past. This is inflation driven by several factors outside of a business managers control such as raw material prices, wage inflation, US dollar shipping costs etc and, in my opinion, interest rates.

In previous recessions we have been able to compare data and cycles from historical recessions, but due to the differences between this and historical, the data may not be comparable. If the big drivers continue to increase, even if interest rates increase up to 6%, I don't think it is going to change inflation in the next 12 to 18 months. This creates a hyper negative environment for a short period of time. Looking at the next 12 months, I don't see us coming out of the issues we've got in the next 12 months.

However, we all expected this autumn/winter to be more apocalyptic than it has been, but the data around the numbers following Black Friday and Cyber Monday was up significantly more than expected. Consumers are still spending; however, questions arise as to whether this will continue beyond Christmas or if consumers will spend to enjoy a restriction free Christmas since 2019, but will then cut back in Q1 of 2023.

Wage Inflation

The biggest challenge for consumer businesses in my opinion, will be the pressure wage inflation at a time when you have pressure on everything else. Most consumer facing or product businesses, have been able to pass on the majority of the cost increase, having been forced to, coming out of COVID. These are already in a relatively weak position and cannot swallow the cost of goods increases that we've seen in various sectors. The question is, if we get wage inflation on top of those increases, can businesses pass that wage inflation?

Many businesses haven't faced into that yet and these discussions may take place end of December for a January pay rise, or end of March for an April pay rise to coincide with the end of the tax year. If that conversation starts at the current rate of inflation, businesses are going to have to try and pass that on.

In my opinion, this is going to be a period where business leaders are going to be challenged in a way like never before, and the next six to nine months, will be more challenging than the March 2020 to September 2020 period because we won't have the government aid assisting businesses.

Management teams

In my experience working on turnaround and restructuring work, I consistently see management and executive teams not facing into the problems and recognising the severity of the challenges they face. I refer to this as the 'rose tinted spectacles'. Sitting down with management teams and talking about why the business is underperforming, they will often look at external factors first rather than having the tough conversations around the business model or internal factors. I also see management teams talking about tough decisions but are semi-reluctant to take them and only taking a half tough decision or taking a tough decision too late. My advice would be to bin the rose-tinted spectacles, decide what the tough decisions are and make them. I don't think I've ever seen an underperforming business make tough decisions too early, but I have seen them make a tough decision too late.

Private Equity

I find it hard to believe UK based PE houses will be looking to transact in the consumer retail sector in the next 12 months. If I were a UK PE house, I would be doubling down on my assets and portfolio companies, and focus on getting them through the next 12 months, recognising the potential need to increase the capital base of those businesses or find external funding.

Both the UK and US have lots of dry powder, but UK houses will look to stay away from Consumer retail for the next 12 months. The US houses will consider UK consumer retail as high risk, but due to the rate of the pound, US PE are buying at a 30 – 40% discount from the norm, de-risking the investment. Considering the price UK funds have to pay (and have paid) for assets, many funds may find themselves in the position where they have to hold onto the investment for a little longer in order to wait for the asset to turn around and get a return they are happy with.

The US equity houses may have a slight advantage over the next 12 months, but the flip side is that they are buying at a slight disadvantage to UK PE houses who have a fuller range of visibility about the UK consumer retail or omni business.

The biggest challenge everyone is going to face both in the US or UK, is servicing your debt. We've gone through a 10-year period where interest rates never really got off the floor, and I think everybody's got out the habit of hedging interest. To an extent, some of the US players may be therefore focusing in on fixing their issues at home before looking to spend multi-millions overseas.

Conclusion

To summarise, my three main takeaways looking ahead to 2023 would be:

- Believe it will be worse than you think it will be - if you start from this premise, you will anticipate and be prepared for the worst outcome.
- Cut costs early
- Preserve cash

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Taking an optimistic new year's view, I think the market needs time to recalibrate, but when it does, opportunities will arise, especially as people don't like to be sedentary too long. The problem is that at the moment almost everything we are reading in the press involves another consumer business going into administration and being acquired through a pre-pack . This, understandably feeds the worries that every deal is distressed and the market is on its knees. What we need are a handful of really good (positive news) transactions to get over the line...I am confident these are out there and will happen in H1 2023. This will set the tone and start to build confidence in the market. If there is positive activity, it will lead to more positive activity.

Strategics with healthy balance sheets are continuing to be acquisitive, but are more likely to look for accretive bolt-on deals, rather than attempt something transformational. In particular we are seeing sponsors actively look to support their existing investee companies as they pursue buy and build strategies. From a PE and banking perspective, ICs and credit committees will hopefully start to gain more conviction once they can see how potential investee companies have performed into H1 2023 and also see other competitor funds start investing. As we came out of the pandemic period, many ICs looking to invest in the consumer sector said they would rather pay more money and wait another year to see if forecast growth is actually achieved. Given the economic headwinds, I think this is even more the case at the moment, although there is a risk that this might mean they miss out on good opportunities today if they sit on their hands for too long.

There are obviously a number of serious macro issues affecting the market and the cost of living crisis is hitting many consumers hard. Many economists are suggesting the UK will be in recession during 2023, but it will hopefully be a shallower, rather than a deeper recession. For buyers and investors (and debt providers) confidence is critical, as is conviction. I would suggest that in terms of the UK Consumer PE market, there will be a thinner volume of transactions over the next 12 months compared to other sectors. We have already seen a number of processes paused, but importantly deals are not cratering. If the economists are right and we begin to see improvements into H2 2023, my hope is that things will settle down, recalibrate, and we will be able to point to a new normal. The new normal might be similar to the old normal in some parts of the sector, but in others the market will adjust to reflect different multiples (as well as different earnings trajectories).

Given concerns/question marks around how consumers will react to all of the challenges being thrown at them, we would expect there to be a greater level of interest initially in investing in sub-sectors that are considered to be less discretionary, such as core staples (i.e. food and beverage), Home & Personal Care, B2B and private label suppliers and food ingredients.

Multiples and Valuations

One of the main challenges we are currently facing involves helping buyers and sellers agree what is the right multiple set to use (whether it is a revenue or a profit multiple). Typically, you look to listed companies as a sensible proxy for valuation metrics, but the challenge recently has been the level of volatility across the sector. The prices of a lot of listed stocks are down significantly compared to their highs and it is hard to determine whether this is a temporary correction or if multiples have been more permanently re-set. In parallel you would also look at comparable historical transactions to give a guide on the right valuation metrics, but the problem is that once you exclude the distressed deals in a lot of sub sectors of consumer, many others are now looking out of date given the relative lack of deals in recent times. So as a result, buyers and sellers are faced with the difficult task of trying to calibrate what is the right multiple to apply, but then importantly, trying to calibrate what is the right number to apply it to. Should they use latest 2022 revenue or EBITDA numbers, updated 2023 projections, which are of yet uncertain, or even go back to pre-covid trading numbers (2019 does increasingly feel like a long time ago!). I think we will see more structured deals, including earnouts or deferred payments, as a way for buyers and sellers to bridge valuation and expectation gaps.

In private equity, I think we will likely see an increased use of different approaches to structuring investments, with the use of liquidation preference instruments and non pari passu structuring, where a rollover shareholder sits behind rather than alongside an incoming investor. Whilst there are different levers we can use, ultimately deals will still require the seller, buyer and management (if relevant) being on broadly the same page, as structuring mechanisms will only get you so far if there are fundamental disagreements on valuation.

Consumer Private Equity

Where multi-sector PE funds have the chance to deploy capital into other non-consumer sectors, it may be perceived to be safer for some of them to invest their money elsewhere if the consumer sector is seen as more volatile in the interim. However consumer focused funds, or funds that have a remit to invest in maybe consumer and one or two other sectors, may start to feel the pressure from their LPs to invest rather than sit it out for a long period. As we have seen from other recessionary periods, many funds that invested through the cycle did really well, although going into 2023 we would expect funds to continue to tread cautiously given the risk to their existing fund (or their ability to raise a new fund) of getting it very wrong.

However, there is clearly a lot of dry powder out there for investors to deploy and there is only so long that potential sellers will want to wait before pressing ahead with their own exit plans. Once a new equilibrium is reached, even if at first it's off a low volume of transactions, we would expect activity to pick up.

<u>Management Teams</u>

From a management perspective, one of the key skills teams will need to be able to demonstrate is their ability to align and manage their different stakeholders. NEDs will definitely play a more important role as they help companies navigate these more challenging times. It is crucial for teams to have the ability to make quick decisions in a rapidly changing environment, as they react to pricing, supply chain or operational challenges.

However strong a brand is, investors are looking closely at the teams they are choosing to partner with. The success of their investment will often be down to the strength and performance of the management team they are backing. I think this difficult market will provide the stronger management teams the chance to really stand out from their peers.

<u>Standing out</u>

Another key theme we would expect to see across the broader consumer space, is that there will be clear winners and losers. The most successful companies and management teams will be the ones that stand out, be it on the high street or online, or across the hospitality sector. More have ever, brands and companies need to have a reason to exist. They need to be better than their competitors, whether this is measured in terms of pricing, value for money, customer service or the overall consumer experience. Given the tougher economic environment, consumers will be making decisions on what to cut back on, on what expenditure to prioritise. For example, whilst consumers are still choosing to go out, they are cutting back on the number of times a week or month they do so and are being more discerning. Whilst they want to feel that they are getting 'value' for their money, this isn't just about the relative price of the food or the drinks they are selecting. It is also about the whole experience (whether it's in retail or hospitality) and management teams have a huge role to play in ensuring that the create the right environment to attract and retain their customers and wow them each time they come.

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