DRAX Leadership Capital

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Consumer Market Insights

Reflecting on year to date and looking forward to 2023

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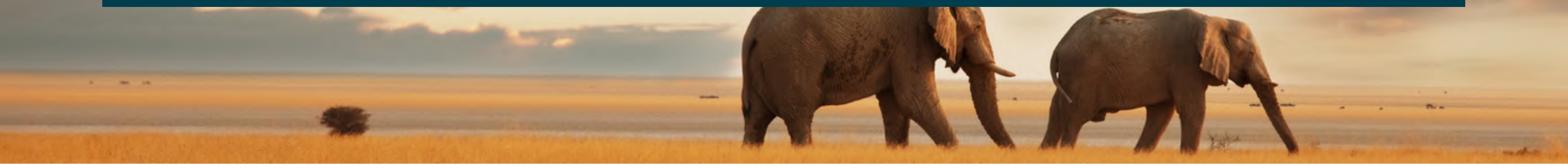
He has substantial experience in the sector, with expertise in consumer products, food and beverage, leisure businesses and travel and tourism.



Judging by what we have seen over the last six months from the businesses we've worked with, it is likely to be a reflection of the opportunities to come over the next six months. The cost-of-living squeeze has been around for some time, and is only going to become more apparent as we head into the second half of the year.

We have been working in sectors where there is deemed to be resilience or historic evidence of long-term resilience. In particular, products or sectors where there is a longstanding base of customers that will likely continue to buy, regardless of the economic situation, will remain resilient. Generically, this is enthusiast areas (or hobbies) and other segments where people can treat themselves without overindulging (such as beauty products, makeup, etc.) Historically, we have also seen that British consumers are likely to prioritize holiday spend over other things during economic downturn, and as domestic holidays are typically cheaper than international holidays, we are likely to see resilience in domestic holiday venues, caravan parks and staycation operators. Another resilient area is industries which operate year-round such as gifting, toy and birthday products. The pet sector has also proven robust, although it's a competitive market for our private equity clients.

We have no doubt we are going to witness a challenging time with the consumer sector off the investment agenda for funds, so we anticipate that unless you are a specialist in that area it is going to be a tough time.

Shaun Browne

Co-Head Consumer, Food & Retail Europe and Co-Head Corporate Finance, Europe at Houlihan Lokey

HOULIHAN LOKEY

Shaun is a Managing Director and Co-Head of UK Corporate Finance at Houlihan Lokey, working with all industry teams as well as the Financial Sponsors and Capital Markets groups. In addition, he is Co-Head of Houlihan Lokey's Consumer, Food & Retail Group in Europe. Shaun's original area of specific expertise is in the food and beverage sector, where he has advised on more than 150 completed transactions. Shaun was previously a Managing Director of McQueen, the London-based investment bank focused on the consumer sectors, which he co-founded in 2002. McQueen grew to be one of the most successful M&A advisors to the European consumer sector prior to its acquisition by Houlihan Lokey in 2015.

When the Queen ascended to the throne in 1952, approximately 40% of consumers' disposable income was spent on food for home consumption. 70 years later, as we celebrate her Platinum Jubilee, that figure has dropped to around 8%. This is in part due to significant improvements in agronomy, agriculture and efficiency in food manufacturing, as well as longer shelf life of products, freezing technology and the invention of microwaves. So where has this extra disposable income been spent? Predominantly on products and activities which either did not exist or were far less accessible 70 years ago such as car ownership, foreign holidays, technology, gym memberships, streaming services, eating out, etc. A whole range of industries and products have emerged to tempt consumers to spend their excess income as the economy has grown, and the percentage spent on food for home consumption has declined.

Food is a necessary requirement for survival, so it is difficult for humans to consume meaningfully less food than they currently do. Therefore, I believe that it will be the non-food areas of the consumer sector that will be hit hardest as a result of the current cost of living crisis. People must eat, whereas other consumer items are more discretionary.

Current market trends show food prices are rising sharply. This is due to a number of factors including raw material inflation, significant increases in energy costs and labour shortages. Energy plays a big part in the cost of food manufacturing (whether it is running factories, logistics, the cost of packaging or the cost of raw materials) and we are seeing instances of wholesale energy prices being up to 10x prices available a year ago. The labour shortages mean food companies are unable to produce and sell their products, and they are also having to pay their employees more to attract and retain them. For food manufacturing companies today, almost every cost line is increasing:

raw materials, labour and energy, logistics and distribution. As a result, profit margins are being severely compressed and in order to maintain the level of profitability, food prices must increase.

One positive trend we are seeing is that, over the last six months or so, many food companies are telling us that the environment for increasing their prices to supermarkets, has never been better. Supermarkets are more amenable to accept price increases than they have been for many years. In part, this is because the scale of the price increases is so substantial, it simply cannot be absorbed or overcome by creating more efficiencies in manufacturing. However, there may come a point where supermarkets push back to keep their own prices competitive, so there is a question about how easy it will be for food companies to continue to put prices up. Additionally, when food companies do put prices up, it is hard to predict the reaction of consumers and if they will continue to buy your products or switch to cheaper alternatives. This takes us back to the fundamental point that consumers still need to eat, so they will continue to buy similar levels of food for home consumption.

We are seeing a shift in consumer behaviour as a result of the cost-of-living crisis and food price increases. On the one hand, we are seeing consumers who would have previously gone to restaurants, but can no longer afford to do so, treating themselves to a premium ready meal or a premium product from the supermarket. However, we are also seeing a shift within consumer behaviour and a movement towards consumers down trading - purchasing cheaper products or own label items, rather than branded products. With some down trading from premium to cheaper brands or to own label, there are many companies who manufacture those cheaper brands and own label products, and the trend may be beneficial for them. So it is not all doom and gloom, there is an element of change going on in consumption patterns, which will accelerate if inflation stays high and raw materials continue to grow and exacerbate the current problems. If you are a Financial Director, Chief Executive Officer or Chairman of a food manufacturer at the moment, it is incredibly difficult to forecast your future financial performance.

It has probably never been harder for food manufacturers to predict what their profit and loss account will look like over the next 12 months, as there are so many variables. There are variables in consumer demand, raw material input prices, energy costs and labour prices. This means it's difficult to predict your expected future profitability, which means that Merger & Acquisition ("M&A") activity will decline.

If you have a stable P&L account, it is relatively easy for a buyer and a seller to reach agreement on valuation. There are always going to be some disagreements, but there is a fundamental agreement on how the business is performing at the moment.

What we are currently seeing is fundamental disagreements on how the business is performing. Vendors are saying the economic climate is temporary and will pick up, whereas the buyers are worried it will deteriorate. Therefore, if the buyers are predicting a decline in profitability and the vendors are predicting an uptick in profitability, they are unlikely to reach agreement on likely value and therefore M&A activity will be reduced. We are seeing these in the numbers already, as transaction volumes this year are well down on last year.

What will resolve this impasse is what we are starting to see in a number of categories, namely prices of raw material stabilizing and in some cases coming down quite materially. It may take a while for these changes to feed through the system, but it will be interesting to see how retailers react. If retailers have already put up prices due to higher raw material costs, will retailers lower their prices when those raw material prices start to decline?

I hope that inflation will peak in the next six months and then start coming down and I also think that we've probably seen the worst of the raw material price inflation issues, so we should start to see some stability. Whilst it is precarious at the moment, we expect to see a bit more visibility on likely financial outcome as the year progresses. If you get more consensus around likely financial results, you will start seeing M&A activity picking up.

The other factor impacting M&A activity is that share prices of many listed food companies have come down quite sharply this year, mostly around 20 to 25%. People in M&A look at public companies as a proxy for private company valuations, so when you're valuing a business and you can see a comparable company on the stock market trading at a 20 to 25% reduced valuation over where it was six months ago, you read across and apply that low valuation to the business that you want to buy or sell. How will vendors react if they think their business is down in valuation by 20 to 25%? Many will decide to wait a year or two until it has gone up in value again. As a result, we do not anticipate we will see a quick rebound in M&A activity.

I expect we will see more sell-side activity from corporates as opposed to private equity. When private equity own an asset and the valuation is down 20 or 25% over where it was six or eight months ago, they normally hold onto it and wait for it to recover. With corporates, if they've got a non-core division or a non-core subsidiary that they want to divest, many are less concerned about the decrease in valuation of 20 or 25%. Once they have made a decision that it is non-core and they want to sell it, they usually crack on and sell it. Often, it was acquired by a management team that is not the current management team and therefore the current management team can blame it on their predecessors and saying they should never have bought it in the first place. So, I think activity will gradually start to pick up over the next six to 12 months, but the balance will shift more towards corporate divestments rather than private equity sales.

Liberty

Dan Martinez

Partner at Liberty Corporate Finance

Dan has over 15 years corporate finance experience and has been advising founders and managers throughout his professional career. Dan joined Liberty in 2015 regularly advises management teams across the globe. His experience includes advising on primary through to quaternary transactions, carve-outs, Public to Privates, and sales to strategic and infrastructure acquirers.

Macroeconomic and geopolitical events over the last few months have impacted consumer confidence which appears to have resulted in a softening of M&A activity in the consumer sector. However, changing consumer preferences are likely to continue to create opportunities for M&A as companies seek to transform business models and reposition themselves for future growth.

Consumer health, pet products and e-commerce which achieved rapid growth pre and during the pandemic are still attracting M&A interest. Inflation is also impacting spending decisions (moving from durable and discretionary in favour of staples and non-discretionary categories) and how investors are looking to structure investments – and shareholder debt yields in some cases are being pushed up from 10% to 12%. In addition some investors are seeking to protect their downside exposure by having their investment rank ahead of founders and re-investing shareholders/managers through a liquidity preference.

As a result, deal processes are typically taking longer and we are seeing heightened scrutiny from investors. The covid bounce back is also making it difficult to analyse recent historical performance and uncertain near-term outlook. Debt terms and capacity are also being heavily scrutinised both when considering covenants, headroom and acquisition funding.

New trends are starting to emerge in respect of leaver provisions; firstly the concept of a very bad leaver which is intended to penalise management re-investment in a very limited set of circumstances. Secondly, Sponsors are increasingly wanting the ability to call leaver shares, this has always been typical for incentive equity but is expanding to cover institutional strip. Thirdly sponsors are seeking to be able to settle leaver shares for loan notes redeemed at exit rather than for cash at the point the instruments are acquired.

Finally, there is a greater focus on exit provisions by certain investors trying to accommodate for a broader spectrum of outcomes and keep their options as open as possible. Equally managers are also thinking more broadly about exit in relation to continuation funds, partial sales and other hybrid outcomes which were not necessarily contemplated at the time of the original deal.

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Mark Sherman

Managing Director, Consumer Practice at DRAX

Mark joined DRAX over a decade ago and has been responsible for developing and growing the Consumer & Leisure business over the last five years. The Consumer & Leisure business is now made up of 12 individuals and has a strong track record across the private capital landscape both in the UK and internationally. The team has built out an excellent track record across private label and branded FMCG, e-commerce and technology enabled businesses, travel and leisure, beauty and fashion.

There is no doubt that the Consumer M&A market has softened as 2022 progresses, and that there has been a fundamental swing in terms of sub-sector focus. Post - COVID we have seen a circling back towards non-discretionary spend (food, drink, household staples) partly down to the return to 'normal life' and partly down to the very real fear of a cost-of-living crisis and looming recession seeing spend deviate from discretionary sectors. That said, the resurgence in the travel and broader leisure sector is a good indicator that whilst the consumer is looking to cut back in certain areas, they are redirecting their money to focus on experience.

We have seen a significant uptick in terms of management change. In the FMCG sector there is focus on hiring senior talent within Operations, largely to mitigate the impact of inflation and raw material shortages through efficiencies within the supply chain. Historically, the focus has been on strong executors; now there is great demand for more strategic operators, especially those from analogous 'best in class' industries who can bring a fresh perspective on what good looks like. Elsewhere, consumer businesses in the "tech-enabled" space continue to look for strong commercial hires who can help maximise their top line growth, in a world where the cost of customer acquisition in digital channels is increasing. Finally, we are seeing an increased trend of funds and portfolio companies looking to grapple with the ESG agenda through hiring individuals in a Non-Executive or Advisory capacity. This is an interesting challenge from a talent perspective, as we have found that the most experienced and relevant individuals are often in an executive role today and therefore lack capacity, or have questions over how much these businesses are ready to commit to this kind of investment, or are they just following a trend?

What do we predict in terms of deal flow in the next 6 months? We will see a continued slowdown in the market until Q4, when increased deal activity is expected; although we feel this is much more likely to be focused in 'core' defensive categories, with some rays of light from the rebounding travel/leisure market. As always in a challenging market, we expect to see our fair share of turnarounds hitting the pipeline, and already the turnaround funds and debt investors are stirring.

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