Five Trends to Know

The most important factors driving deals in the retail and consumer products industry—and four compelling investment opportunities.

It's a great time to be a part of the retail and consumer products industry.

U.S. retail deals shot up 124% to $19.7 billion in the first three quarters of 2012, while overall U.S. PE-backed M&A fell 20% in the same time period, according to Dealogic. Globally, there was $324.6 billion in consumer and retail M&A activity in 2012, up 33% from the prior year, making it the busiest year since 2007.

These deals represent a wide range of sectors and segments, from Savers to Party City to Cole Haan. Looking forward to the rest of 2013, retail and consumer M&A shows no signs of slowing down, with the $23 billion acquisition of Heinz kicking off the year in a big way.

These deals come in the midst of dramatic industry-wide changes. Retailers are taking innovative steps to respond to these changes, from JC Penney's ongoing reinvention to Etsy's recent purchase of collage maker Mixel for its mobile talents to Target's online price-matching offer.

Driving these changes are five key factors that all investors and retail strategists should use in determining value: macro demographic changes, lifestyle shifts, technological trends, new business models and intensified competitive dynamics.

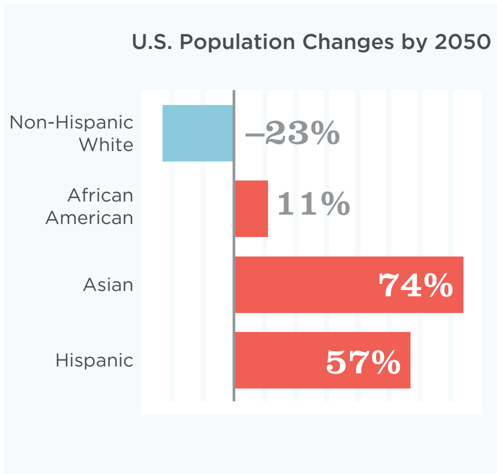
1. Macro Demographic Changes

Growing income gap. The income gap between top earners and lower-income consumers is now the highest it has been since the Great Depression, according to a 2012 study by UC Berkeley economists. On one end of that gap, luxury is booming. For example, Michael Kors recently reported fourth-quarter comps of 45%. And Neiman Marcus and Saks Fifth Avenue have averaged 8.1% comps in 2011 and 2012, well above the mid-range department store average of 1.8%. At the same time, lower-income consumers will be increasingly pressed. The median household income dropped 1.5% in 2011 to the lowest level since 1995 when adjusted for inflation. This has led to the success of dollar stores and discount chains like Ollie's, plus growth of private label to make up roughly 25% of most grocery store shelves.

Urban migration. Nearly 80% of the U.S. population lives in major metropolitan areas and, according to the Census Bureau, cities are now growing faster than their suburbs for the first time in a century. This trend will drive several important changes. First, concepts like The Container Store that help people make the most of small spaces will thrive. Secondly, traditional big-box retailers are figuring out how to reach this growing market. This has led to a rise in small-format stores like Walmart Express, City Target and Best Buy Mobile, but will also fuel the continued popularity of dollar stores and c-stores, both of which will expand their assortments to more closely resemble their mass and grocery competitors.

A population shift. Currently, 13% of Americans are 65 or older; that will grow to 18% by 2030. As baby boomers age, there will be new demand for leisure activities and convenience because of limited mobility, including delivery services for basic needs like groceries and drugs. This trend will also drive closer integration between traditional retail settings and health care services—like CVS' MinuteClinic. On the other hand, millennials are growing rapidly—30% of all retail sales will come from this group by 2020.

Racial and ethnic diversification. The U.S. is becoming increasingly racially and ethnically diverse, with the non-Hispanic white population projected to shrink 23% by 2050, according to the U.S. Census Bureau. At the same time, the African American population is expected to increase by 11%, the Asian population by 74% and the Hispanic population by 57%. This demographic shift will lead to the continued diversification of store shelves to meet changing tastes.



2. Lifestyle Shifts

Personalization. From news to music to advertisements to credit card rewards, companies of all kinds are using consumer data to craft personalized recommendations and experiences. So it's no surprise that consum-

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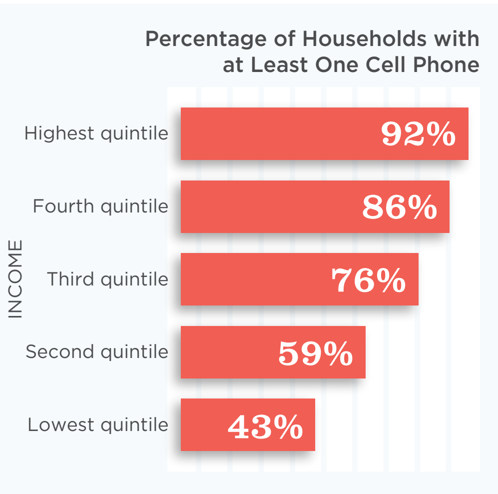
ers are beginning to expect the same level of individualized treatment from retailers. Of course, we've all heard about Target sending promotional offers to pregnant women, but other retailers are using less controversial—but equally effective—methods. For example, Walmart's Shopycat Facebook app provides recommendations based on customers' social media habits. In one promotion, Walmart saw a 42% conversion rate for users allowing the app and 50% of users shared it with their friends. Retailers are also seeing incredible success when it comes to personalized products. For example, Nike has built NIKEiD, which lets customers design their own shoes, clothes and gear bags, into a $100 million business.

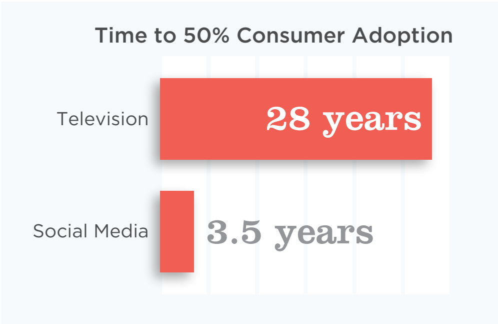


Technology is no longer a luxury. Even lower-income consumers are allocating large shares of their incomes to purchasing technology. In fact, 43% and 59% of lowest and second quintile households by income had cell phones in 2005, the last year for which data is available. And these numbers have likely only grown since then. This has led to the success of companies with products accessible at a variety of price points, like Apple. EBay is another beneficiary, as mobile transactions through its app doubled in 2012 to $13 billion. From point-of-sale technology to mobile apps, every consumer expects better technology solutions.

Renewed emphasis on health. Sedentary lifestyles and growing waistbands have led consumers to seek healthier options, from wellness products like vitamin supplements and organic food to services like yoga classes. Whole Foods has benefitted from this trend, averaging 8.3% comps from 2001 to 2011 versus 2% for the rest of the grocery industry. Juice cleanses, gyms and active apparel are all growing.

3. Technological Trends

Moore's Law continues. Moore's Law—which dictates that the number of transistors on a computer chip will double every two years—is widely applicable to technological change in general, in that the pace of change accelerates



over time. Consider that it took 28 years for the TV to be adopted by 50% of consumers, but it took social media only three and a half years to reach the same level of adoption. From RFIDto mobile POS, technological changes will continue to shape the future of retail. For example, Tesco has installed virtual store walls in South Korean subway stations. Consumers scan QR codes next to each product, check out on their mobile phones and the products are delivered by the time they get home.

The push for omnichannel. Creating a consistent experience—and delivering products—across channels is the industry's biggest mandate and challenge. HSN was an early leader in developing an integrated experience across channels. As CEO Mindy Grossman puts it, "The days of trying to get a consumer to come to you are over. You really have to be in the consumer's world, wherever, whenever and however."

Analytics. Technological advances are enabling retailers to collect and analyze data quickly and cost-effectively and use it to drive better decision-making. For example, Walmart scans the prices of competitors' websites every 20 minutes and uses the data to adjust its own prices accordingly.

Rise of smart products. Smart products—like Under Armour's shirt that can monitor the wearer's heart rate and Nike's shoes that track movement—will grow in popularity as consumers increasingly value personalized products and experiences.

4. New Business Models

New and now. Product development cycles continue to shrink as the demand for super-current products increases, led by retailers like Zara and Forever 21. This push also translates into distribution, with Amazon, eBay and Walmart all venturing into same-day delivery.

Near-shoring. Bringing manufacturing closer to home can help reduce cycle times, save money on transportation and labor costs, and engender goodwill. Retailers from Target to The Children's Place to Zara are near-shoring. Some brands, like Nine West, choose to near-shore only a small portion of a given assortment, handing the full order to China if the initial sample sells well.

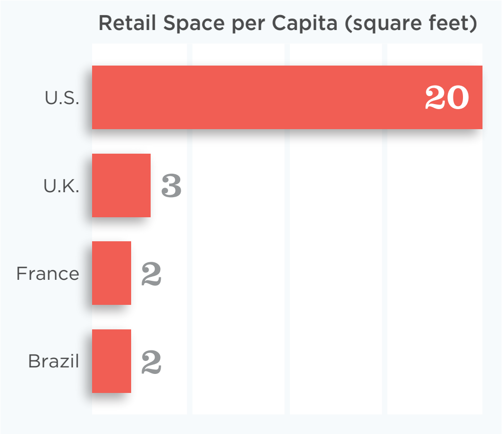
Blurring the lines between retail and wholesale. Retailers are becoming more vertically integrated to save money and boost efficiency—like Party City, which manufactures its own balloons. Similarly, the percentage of manufacturers selling directly to consumers is expected to grow 71% over the next year, according to an Economist Intelligence Unit Survey.

Department stores become mini-malls. Excess capacity inside big-box retailers and department stores will fuel the growth of "stores within stores," such as Apple's stores in Best Buy, Sephora's branded boutiques within JC Penney and Home Depot's partnership with The Container Store.

5. Intensified Competitive Dynamics

Increased pricing pressure. The rise of Amazon and the ubiquity of smartphones have led to increased pricing pressure on commoditized products. To combat showrooming, leading retailers are creating unique products or experiences that cannot be replicated online, like Abercrombie & Fitch's perfume-heavy nightclub feel or Costco's free samples and treasure hunt vibe.

Excess industry capacity. The U.S. is overstored and inundated with websites. In fact, the U.S. has 20 square feet of retail space per capita, versus three in the U.K. and two in France and Brazil. The same is true online, where 9,675 daily deal sites have sprung up. This means that large chains will shrink, while smaller formats like dollar stores will grow. There will be a similar shakeout on the Web.



Four Promising Investment Opportunities

We believe that all attractive investment opportunities in 2013 and beyond will lie at the intersection of the above trends.

Those who are able to capitalize on multiple trends will see the highest economic returns. Here are a few possible scenarios:

Reimagining the convenience store. C-stores are uniquely positioned to exploit new demands for convenience and increasing urbanization. They're already closer to consumers than any other type of physical store, but there are still opportunities to improve the experience and assortment.

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First, margins and consumer loyalty can be improved by growing private-label offerings beyond packaged goods. C-stores are already starting to more closely resemble quick-serve restaurants in their offerings. For example, Casey's General Stores recently started offering fresh pizza.

But there is still tremendous opportunity to expand c-store private-label offerings to include more general merchandise, transforming c-stores into one-stop shops for modern urban consumers. For example, 7-Select at 7-Eleven in the U.S. includes more than 250 food items from donuts to frozen pizza. But in Taiwan, 7-Select also includes a much wider assortment of general merchandise, including clothing, laundry detergent and light bulbs. And the strategy is paying off, with 7-Eleven's operator in Taiwan reporting a 27% increase in net income in the third quarter.

And new technologies can also help make the c-store shopping experience easier and faster. For example, retailers could deploy RFID tags to let consumers check themselves out. Or U.S. c-stores could take a page from Tesco's book and build virtual stores. Finally, online ordering and in-store pickup would help make the experience even easier and give first adopters an incredible competitive advantage.

Retailers to watch: 7-Eleven, Alimentation Couche-Tard, Pantry, Casey's General Stores and Wawa

Customizing and localizing the high-end supermarket. Perfectly positioned at the intersection of luxury, health and convenience, high-end supermarkets have tremendous growth potential.

Gourmet supermarkets offer both wealthy and aspirational consumers a valued escape from their everyday stresses into a luxurious world, which will become increasingly important as consumers work longer hours and become increasingly urban. In addition, they typically offer higher-quality and higher-priced products, meaning they can easily cater to the demand for more organic and healthy products.

For example, Wegmans, a $6.2 billion, 72-store chain, sends hundreds of its employees on trips around the globe so that they will become experts in their products.

And cashiers can't start work until they have completed 40 hours of training. The result is a highly specialized, differentiated experience. Larger chains also have much to gain from offering localized assortments. For example, one $20 billion national grocery chain saw comps increase 2% to 7% across stores with

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localized assortments, and that was with only 10% to 15% of each store's assortment differentiated from the core.

Retailers to watch: Sprouts, Wagshal's, Wegmans and Balducci's

Creating an integrated wellness one-stop shop. Consumers leading a sedentary lifestyle are searching for ways to maintain their health into old age, a trend that is also supported by growing incomes and an aging population.

Athletic product sales, especially apparel and footwear, have been fueled by smart products. And the demand for knowledgeable sales associates to inform customers about the benefits of these products has kept pace. Companies have emerged to cater to health-conscious consumers at both ends of the economic spectrum. At the higher end, sports clubs like Equinox and retailers like lululemon and Athleta provide a luxurious experience and fashion-forward products. At the lower end, gyms like Blink create a supportive feel, while Champion provides high value through its C9 line at Target.

But a retailer who can bring everything a health-conscious consumer needs under one roof could gain significant competitive advantage. Offering apparel, sporting goods, healthy pre-prepared food and nutritional supplements at a gym or exercise facility would appeal to busy, urban consumers and combine cross-functional expertise in one location.

Retailers to watch: Life Time Fitness, Town Sports International and Equinox

Accelerating the diffusion of luxury. Combining luxury with experiential, deal-based shopping experiences that create a sense of urgency is helping to fuel significant top-line growth for luxury brands and introduce them to new customers.

For example, high-end menswear seller Bonobos has had incredible success creating comfortable, good-fitting men's clothing in dozens of colors, encouraging shoppers to find their fit and stock up. The model has helped Bonobos become the largest U.S. apparel brand ever built online. In 2011, the company expanded into the brick-and-mortar space, creating showrooms called Guideshops that help customers select the right fit before buying. And Nordstrom recently invested $16 million in Bonobos to sell its merchandise on Nordstrom.com and inside 20 Nordstrom stores. Bonobos has Web sales of $15 million, according to Internet Retailer estimates.

Custom suit maker Indochino has taken a similar approach, recently opening limited-time pop-up stores in cities around the globe. In 15 minutes, customers are measured, pick out their fabric and pay—roughly $500—and in three weeks, the suit arrives from China. Indochino has 40,000 customers in 60 countries and its revenue has doubled year over year since it was founded in 2007.

Clearly, there is significant room to grow luxury concepts by diffusing them to aspirational customers across a range of more accessible price points and formats. But it's important to separate the experience and quality of these diffusion concepts from the core luxury brand to avoid alienating high-end consumers. For example, Vera Wang at Kohl's couldn't be further from Vera Wang's high-end wedding dresses, and Missoni was so popular at Target that it shut down the mass retailer's website, but this has not tarnished Missoni's reputation in luxury circles.

Retailers to watch: St. John Knits, Christian Louboutin, Burberry and Intermix ❖

AUTHOR

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