CORPORATE
BOARD MEMBER®

2008 SPECIAL SUPPLEMENT

Board Focus on M&A

A Closer Look at Consumer Business Trends for 2008

A Slow Year for Consumer Business M&A

Private equity and strategic buyers dominate the broad consumer business industry, where, despite the threat of a recession, the luxury goods sector is expected to fare well.

Lindsey Alley
Managing Director
Houlihan Lokey

Jeff Bakutes
National Consumer Business Industry Leader
M&A Transaction Services
Deloitte & Touche LLP

Alan Behr
Partner, IP and Technology Transactions Group;
Leader, Fashion and Luxury Goods Practice
Alston & Bird LLP

What is your take on the general M&A outlook for the consumer business sector for the coming year?

Lindsey Alley: In looking at the M&A environment in the consumer business sector from a broad perspective, we are finding that discretionary consumer product companies generally fare poorly as we approach a possible recession. The question really is, will there be a decline in the overall economy?

In a challenging market, both private equity groups, as well as entrepreneurial and public companies, will often see valuations decline–to the extent that they will hold off on selling. Whereas in a good market, with strong brands and discretionary spending, valuation multiples are significant. And so over the last three or four years, there have been some very high-profile deals in the discretionary consumer sector that have gotten done with attractive multiples. But we expect that trend to decline pretty substantially over the next 12 to 18 months.

On the flip side, in the staple consumer sector, with the food industry being perhaps the best example, we see a fair amount of activity despite a struggling economy. In fact, analysts suggest that some of the best stock performers in a tough market are classic food companies such as General Mills, Wrigley, and Kellogg. There tends to be decent M&A activity in these staple consumer sectors that are need-based, rather than luxury-based.

On the retail side, our expectation is that, in general, the sector will be negatively affected across the board in 2008. We think restaurants will significantly underperform. Certainly the vast majority of retail concepts are more discretionary versus staple oriented.

The only sector that will continue to perform well, both in terms of general economic performance and M&A activity, is luxury goods. There will be significant, high-profile transactions within luxury goods across all categories: retail, consumer, and personal care. A luxury brand such as a Louis Vuitton, Chanel, or Tiffany will continue to perform well and will see a lot of interest from the private equity and strategic community over the next 12 to 18 months. There's still a lot of money out there, so the negative impact of a possible recession is mostly focused on the middle-market consumer, as opposed to the high end of the market, at least for the next year to 18 months.

Alan Behr: Much of the luxury market enjoys a certain immunity to all but the most brutal economic trends, such as a 1930s-type crisis. The luxury market will likely continue to be robust in many ways, and M&A activity will continue to take place. That is because markets undergo market-based shifts regardless, to a very large extent, of the surrounding economic conditions, and most of the major luxury brands have moved from one narrow sector into providing a variety of goods. That goes for retail as well. Remember, Harrods started as a green grocer, and most other department stores started out as simple dry-goods merchants. We can take those to be early examples of product diversification. So we will likely see a continued, relatively good performance in the luxury goods market compared to the rest of the consumer goods sector. I say a relatively good performance, because even if you have a lot of money, you might just conclude that you don't need that second yacht.

Jeff Bakutes: I agree. One additional point is that many times, when companies want to resuscitate their stock prices, consumer businesses will dispose of their noncore assets and undergo product rationalization. That will most likely continue, which will obviously add to deal volume and activity. Looking ahead throughout 2008, it's going to be a slower M&A market, and we're just going to have to wait and see how things develop in terms of the economy and marketplace.

If we enter an economic recession, which industries within consumer business will be most greatly affected?

Behr: We have a low savings rate in the United States, which is sometimes cast as a sign of consumer confidence. Countries with high savings rates show a certain amount of pessimism with regard to the economy and government, so the argument goes. If you have a low savings rate and a recession hits, you're going to cut back on your luxuries first, especially if you are not in a higher income bracket. That includes passing on Friday nights at the Olive Garden and putting off home renovations, if they are not critical. So if the economy worsens, we should expect to see prudent decisions to trim expenses, which will cut across many income brackets, to a certain degree. That being said, everyone at some point has to change a light bulb or fix a leaky sink. Eventually, some of those expenditures must be made.

Alley: As far as specific sectors in consumer business, sporting goods will take a hit, along with lawn and garden equipment and housewares and accessories. Those are the types of categories that will be significantly impacted by a recession, for the reasons that have been stated. Household products and cosmetics may be less affected as they are a little less discretionary and more need-based.

Bakutes: Specialty apparel, department stores, and similar retailers will certainly be impacted the most. When you look at the holiday sales season, weakness in the retail sector was fairly widespread, and I expect that will continue in 2008.

Behr: Mass-market, big-box retailers have been able to hold on to margins in recent years by shifting production to China and, to a certain extent, by using online facilities that, in many cases, are more cost-effective than traditional storefronts. Those changes have been assimilated into the market and there is no way to repeat that benefit, so they'll have to take their current numbers as their respective starting points and ride the wave with them.

Alley: On the restaurant side, we tend to see the middle get squeezed. So in a challenging economic environment, you see high-end restaurants such as Morton's not as affected as, say, Applebee's, because many consumers will choose to eat at a quick-serve or fast-casual restaurant as opposed to a full-service establishment. So it will be interesting to see how the fast-casual concepts, which aren't quite fast food but are somewhere between fast food and full service, fare. What we're expecting to see, and what we've seen in previous recessions, is that the McDonald's of the world do all right. The luxury steakhouses, unless we have a deep recession, also tend to do all right. But everybody in the middle gets squeezed.

Behr: I agree. It's been a number of years since the last U.S. economic recession, and quite a bit has happened in the market since then. There has been a shift in point of production and, more recently, an increase in online activities, as well as an interesting and perhaps disturbing alteration in our society: a greater imbalance between the high and the low ends. That middle position, which we've always valued as the central core of the American experience, is more challenged than before to maintain pace. Companies selling into that classic middle-American market may therefore have the biggest struggle in a downward-trending economy due to that proportional weakening. We can contrast that with the comparative ease with which the higher end of the salary scale has moved further upward, effectively immunizing itself from all but the worst catastrophe. Rich individuals may suffer in a bad economy, and everyone can cut back here and there, but the group will do just fine long term.

Do you expect online spending to continue to increase, and will that be affected in any way by a downturn in the economy?

Behr: People shop online for things that are fairly commoditized–things they don't have to see and touch in order to buy. It's all about convenience. When I send Christmas presents to family members in Florida, it's easier for me to click on Barnes & Noble's website than it is to walk into my neighborhood Barnes & Noble and ask the clerk to ship them.

Alley: I don't follow the online retail industry as closely as I do the bricks and mortar or consumer segment, but in doing some research I found that online holiday sales in 2007 totaled $29 billion, up 19% from 2006. In fact, 2007 was Amazon's best holiday season in its 13-year history. The busiest day of the year was no longer the Friday after Thanksgiving (Black Friday), but something dubbed Green Monday, which is the second Monday in December. Green Monday has also eclipsed the Monday after Thanksgiving, known as Cyber Monday.

We'll continue to see explosive growth in online spending. It may slow down from 19%, but it really is taking market share from the brick-and-mortar stores, and I think it is out of necessity and potential cost savings. Online sales will be somewhat immune from the effect of the overall economy, more so than the brick-and-mortar stores.

Bakutes: I agree. So much of the news and information the younger generation receives is either via cell phones or

the Internet, which should continue to drive online shopping. I have three sons and, half the time, if not more, they are choosing to buy something online, as opposed to saying, "Let's go to the mall or to the store to shop."

Behr: That's a good point, because the younger generation, especially, has trained itself to do its consumer research online, the way my generation was trained to watch television commercials. It's much easier to bring Dad over to the computer and ask him to consider a purchase than it is to get him to drive to the mall. The benefit for an online company, especially in categories such as consumer electronics and things that do not need a lot of inspection or trying on, is that, other factors being equal, there is a real incentive for Dad just to click "yes" and move on.

Unemployment rates hit a two-year high in December. How do you see that affecting consumer business in the coming year, particularly with regard to layoffs?

Alley: I think the most significant numbers will come from the specialty retailers and their suppliers. But the state of employment in the vast majority of the states where our clients are is pretty good. It's pretty robust. There are plenty of people looking for opportunities and good talent for retail. There's not a dearth of employment activity in the retail space, and we're not seeing retailers significantly reducing their workforces, other than for the retailers that are closing. Probably the most extreme example is The Bombay Company, which essentially liquidated 550 stores nationwide and terminated a fairly significant number of employees. So we're seeing fewer layoffs in the going concerns. Instead, what you're more likely to see is that the mid-tier and lower-tier retailers that fail in this environment will essentially liquidate, and that's where there will be significant elimination of employment.

Bakutes: We're probably going to see declining sales leading to store closings because certain markets are saturated. Take Talbots, for example, which has announced that it is getting out of its children's and men's divisions, and Pacific Sunwear, which is closing 154 stores. It remains to be seen how unemployment will impact the consumer business sector.

Behr: I agree, though I want to add one caveat, which is that we live in a world where brands are everything. The stories that brands tell about themselves are critical, partially because of the electronic media and partially due to evolutionary reasons. A lot of closings are not strictly economically driven, but are due to branding issues and consumer preferences that are trend-driven.

What were some of the most influential or interesting consumer business deals last year?

Bakutes: The largest deals in the consumer business sector in 2007 were take-private transactions by private equity investors. However, the sector has been, and will continue to be, dominated by strategic buyers. The deal that stands out to me as far as deal size, difficulty in the credit markets, and other issues all occurring at the same time, was when Bain Capital and various other acquirers were looking to buy Home Depot's supply business.

Other examples of megadeals in the sector included KKR's purchase of Dollar General for $6.9 billion and Warburg Pincus's purchase of Bausch & Lomb for $3.67 billion. On the other hand, there were numerous strategic deals that were completed as a result of companies seeking top-line growth, geographical expansion, and new product innovation.

Alley: One deal that I'm following is IHOP's acquisition of Applebee's. IHOP CEO Julia Stewart has been a hero for this iconic brand. Now IHOP has bought Applebee's, a struggling bar-and-grill chain, and has promised the market that it will refranchise about 500 restaurants over the next several years, and it is trying to do so when the restaurant is not performing well. So that is clearly a deal that is the most talked about in the restaurant industry, and it's one everybody is watching extremely carefully. If Stewart can't pull it off, the results could be disastrous.

Switching over to another acquisition, Coca-Cola acquired Energy Brands, which makes Vitaminwater. Coke is determined to create a new business within this energy-infused water sector. It got into the water business with Dasani and has done a great job with that brand. I'll be interested to see what it does with Vitaminwater and whether it will be able to create a category that people think about when they think about soda and bottled water. Will Coke be able to take energy-infused waters to a new level, as well?

Behr: 2008 will be an interesting and, in many ways, challenging year, as will, I think, the rest of the decade. We are undergoing an evolutionary process caused by a change in media and, of course, a change in generations with buying power. The result will be change in the economic environment.

As far as cross-border activity, do you see more or less foreign interest in the broad consumer business sector?

Alley: I see significantly more interest from foreign buyers across all three U.S. consumer sectors. We've started to see significantly more interest in retail, particularly luxury retail. There was a very high-profile auction process this year for Barneys, and there were two foreign businesses that were interested. It was fascinating, given that it concerned an iconic luxury brand in the United States and the two final bidders were both from overseas.

As governments have generated income and are looking to put their money to work, they've taken a very interesting approach, particularly in the Middle East, toward using that money almost in a private equity sort of way to invest in the United States. They've opened up to a combination of infrastructure investments and consumer investments. These consumer investments, one could argue, are trophy products for them, similar to what the Japanese were doing in real estate in the 1980s. So we've seen a lot of foreign interest, and I expect that to continue, especially for anything priced more than $250 million.

Behr: I agree there will continue to be a lot of foreign investment interest in the United States as a place for growth and as a place that perhaps understands more aggressive business tactics. The United States is also a favored safe harbor for cash. I do wonder whether we will see a negative impact once, as is inevitable, the dollar recovers from its rather exhausting freefall, from something like 85 cents for a euro to a $1.53, as of the date of this conversation. So I would add that, as a caveat, I continue to see borders becoming less consequential; if there's a good deal available, people will take a plane or just pick up the phone and exercise their privilege to strike while the iron is hot.

Bakutes: I agree, we're seeing significantly more interest from foreign buyers in terms of M&A activity in the United States. We see it in the consumer business sector, but really we see it across various industries, primarily due to declining market valuations and less competition from private equity investors who are not able to actively pursue the same types of deals completed over the last couple of years due to changes in the credit markets. As Alan indicated, the fall of the U.S. dollar has given rise to a lot of interest from foreign buyers. I expect that to continue in 2008.

Could you each give a brief recap of the trends you expect to shape consumer business M&A in the next 12 months?

Alley: I think the theme of 2008, and hopefully just 2008, is a blah M&A market for consumer business. In general, I expect consumer business M&A to be down over 2007. The theme of 2008 will be distressed M&A and turnarounds–sort of a hangover from some of the transactions that got done between 2004 and 2007, when there was too much leverage or too high a price paid. This will be the year of the workout. There will be a lot of nontraditional M&A activity and restructuring in this general space, especially in retail.

Behr: I would support that. It will likely be a challenging market for the foreseeable future, and there will be an increase in deals resulting from distress situations. That being said, the process never moves in a straight line, and inevitably, the next turn comes. At that point, I think we'll see a resurgence in brand-awareness-based consumer M&A deals, as the public refocuses its branding interests. That can either concern brands at the source level, from goods supplied to retailers, or brands that are retailers themselves. Increasingly, retailers have become more powerful. Those with the most raw power in revenue are likely to be retailers who are their own design and manufacturing sources, such as Gap. That will very likely continue even after this period is ridden out.

Bakutes: I think 2008, as previously indicated, will be a slow year for M&A activity in general, and consumer business probably won't be any different. It is possible that some of the very highly leveraged deals that got done over the last few years could certainly run into problems going into 2008. As a result, we could see distressed situations. Some companies are sitting on the sidelines waiting for opportunities to acquire particular brands that they might not have been able to acquire previously because of high valuations. Therefore, I think it's going to be more of a wait-and-see-type situation as things move forward in the markets. It's difficult to predict an outcome, but I don't think it's going to be a robust M&A market by any means.

Sponsors

CORPORATE BOARD MEMBER MAGAZINE

Corporate Board Member is the leading information resource for senior officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. The bimonthly publication provides readers with decision-making tools to deal with the corporate governance challenges confronting their boards. *Corporate Board Member* further extends its governance leadership through an online resource center, conferences, roundtables, and timely research. The magazine maintains the most comprehensive, up-to-date database of directors and officers serving on boards of publicly traded companies listed with the New York Stock Exchange, NASDAQ Stock Market, and American Stock Exchange. Headquartered in Brentwood, Tennessee, with editorial offices in New York, *Corporate Board Member* is published by Board Member Inc. and is the sister publication of *Bank Director* magazine, a leading information resource for officers and directors of financial institutions. For more information, visit www.boardmember.com.

Deloitte.

Deloitte's Merger & Acquisition Services professionals provide comprehensive, strategically focused tax, accounting and advisory services to both financial and corporate buyers. Our global network of over 3,000 M&A specialists from DTT member firms and our 30 years of deal experience set us apart from the competition. Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

HOULIHAN LOKEY

Houlihan Lokey, an international investment bank, provides a wide range of services, including mergers and acquisitions, financing, financial opinions and advisory services, and financial restructuring. In 2007, the firm was ranked the No. 1 M&A advisor for U.S. transactions under $1.25 billion and the No. 1 M&A fairness opinion advisor by Thomson Financial. In addition, the firm was ranked the No. 1 restructuring investment banking firm by TheDeal.com's Bankruptcy Insider. Established in 1970, the firm has over 800 employees in 13 offices in the United States, Europe and Asia. Each year we serve more than 1,000 clients ranging from closely held companies to Global 500 corporations. For more information, visit www.HL.com.

ALSTON+BIRD LLP

Founded in 1893, Alston & Bird has offices in Atlanta, Charlotte, Dallas, New York, Washington, D.C., and the Research Triangle in North Carolina. Our 800 attorneys provide a full range of services to domestic and international clients conducting business around the world. The industry knowledge and regulatory capacity of the 270 corporate attorneys bring critical value to client relationships. The BTI "Masters of the Deal" list, a survey of law firms' corporate relationships, ranked Alston & Bird 5th among U.S. law firms.

Alston & Bird has been ranked by FORTUNE magazine as one of the "100 Best Companies to Work For" for nine years in a row, including placement in the top 25 for seven consecutive years, four of which were in the top 10. The recognition speaks to the culture of the firm and the environment in which we practice law.