Shopping for deals in the consumer sector

In June *unquote"*, in association with Pinsent Masons, assembled a panel of leading figures in the private equity consumer sector to discuss recent developments in this rapidly changing segment

Left to right: David Torbet, Bowmark Capital; **John Harper**, Inflexion; **Tom Leman**, Pinsent Masons and **Anne Hoffmann**, CBPE Capital

THE RETAIL and consumer sector remains one of the most important and largest areas for private equity investment. Indeed, according to *unquote" data*, the consumer sector has accounted for 27-29% of total deal volume in the UK since 2012, and up to 39% of total deal value in 2014.

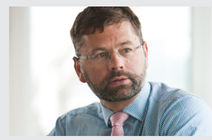
Some of the industry's leading figures within the private equity consumer sector were brought together in June by *unquote"*, alongside Pinsent Masons, to discuss the sector's continued viability and to find out how best to approach this constantly evolving space.

Tom Leman, Pinsent Masons: Given the consumer sector's reliance on personal spend, how stable is the consumer market expected to be over the next five years, and what does this mean for private equity investing?

David Torbet, Bowmark Capital: On the macro view, it is looking more stable. There has been modest growth in real household income, which provides relative stability, but I am not sure if that leads you into a stable deal environment. You need to be cautious of saying consumers have more money, therefore, it is a good time to do consumer deals; companies will still need to work hard to persuade consumers to spend money.

The panel

Tom Leman
Partner,
Pinsent Masons



John Harper,
Investment Director,
Inflexion Private Equity

Anne Hoffmann
Partner,
CBPE Capital

David Torbet
Investment Director,
Bowmark Capital

Tommy Seddon
Vice President, Origination,
UK & Ireland
The Riverside Company

Anne Hoffman, CBPE Capital: There is always a lot of talk about GDP and employment levels, and most people act on perceived view of wealth; how the media perceives the nation's wealth, rather than the reality.

Tommy Seddon, The Riverside Company: Most macro signs say we are in a healthier place economically. However, the middle-ground offerings are still suffering where perhaps they should not be. What this means is that brands are very important. Brands are where people can assign value, whether that be luxury brands of preferred discretionary choice; or the discount segment giving the consumer more perceived 'bang for their buck'.

John Harper, Inflexion Private Equity: This has always been an active space for private equity so, yes, there will continue to be lots of opportunities across the retail, consumer services and leisure markets. It is a big part of the economy and it is growing. The leisure sector is changing, but it remains an important sector – it is what people do with their free time.

Having been through the recession, we can now see which businesses have survived, for example, discount retailers. And we can see which management teams have managed well, enabling us to better focus on winners and losers. The main note of caution is increased competition, especially in restaurants. Today it is becoming increasingly difficult to find and open new sites.

TL: The financial downturn has caused major change to the UK high street, with retailers looking to decrease store portfolios as online becomes a serious aspect of the consumer market. How has this shift impacted the way in which you approach consumer companies?
AH: It is interesting to see how high streets have developed – many have been taken over by a vast number of discount retailers and gambling shops. Those towns that have attracted more differentiated offerings, such as delis and boutique shops, have done well. This shows high streets need to be doing something different. Most high streets have become so similar you can almost predict which shops will be there.

JH: The high street is constantly in a state of change; for example, the rise of the retail park – there will always be that dynamic.

DT: There will be more losers than winners when it comes to the high street because of the continued move to online. The high streets that survive and thrive will be those that recognise it is about retail as a leisure pursuit, using events such as markets, pop-ups and festivals to create engagement with the consumer in a way that online cannot.

Westfield, for example, has been able to create that level of engagement successfully because it can control everything on site, it is not dependent on councils and planning committees.

AH: For our investment in Côte, one big area we were attracted to was transformability of the concept outside London; many concepts work in London that will not work across the rest of the country. Outside London and the south-east, the downturn was more severe and discounters have done well because of this. They have educated the consumer that value reflects price and quality. This shift also shows that brands do not have the power they used to; consumers are willing to try alternatives.

TL: With consumers more open to trying alternatives to established brands, what can newer brands do in


Tom Leman, Pinsent Masons

today's market to attract loyalty, especially if brands are expanding – how do you retain a brand's 'soul'?
JH: In terms of restaurants, you can reach 20 outlets without any impact on the brand's soul, but often groups fail by the time they reach to 60 sites because the founders have not been as close to the roll out.

It depends where the asset goes – if it goes to private equity or it is listed, the continuation of management is the secret to keeping it going. But if it goes to corporate, there have been many examples of that brand's soul being eroded.

DT: What is the soul of a business? Essentially, it is the company's ethos, and some have made promises around size to prevent being labelled as a soulless corporate. Innocent was the case study for not being a big corporate business, but then it sold out to Coca-Cola and compromised its identity. On the other hand you have brands such as Nando's, which has a strong brand promise to deliver cheap, good fast food, and it can continue to deliver at any size.

TS: Retaining the soul of a brand when expanding can be a very difficult transition. Because of that we avoid pronounced fashion risk; if something thrives on being edgy and it is bought by private equity it might suffer.

In consumer, the reach through to the consumer is key. We invested in a gelato ingredients producer in Italy – MEC3 – which is selling to the gelato parlour making the end-product on a daily basis. We need that person to think the MEC3 gelato cone is only as good as his ingredients; that it is the best. Keeping the spirit of that business was crucial. We ensured the family members are still around. We brought an element of know-how on the day-to-day business; looking at pricing, sales strategy and so on, while always maintaining the core values established by the founders – 'made with passion' – that has to remain the case; we do not tinker with that.

AH: There is a difference between product and services in terms of branding. With product, you can retain basic principles regardless of how big the company gets; Gü is a good example of this. But it is much harder with services, as it is about how people feel. The brand's culture has to be cascaded through the business.

TL: Is it about ideas? Pret has done a great job of keeping going with new ideas – going for new trends where they are not always the first adopters.
DT: Compare that to Innocent; both Pret and Innocent are about being organic and healthy; Innocent was much more vocal about its ethics. Both have sold out but Pret has not lost its step, whereas Innocent has lost its innocence.

JH: Simple Skin Care is an interesting example of a corporate making the company more effective. I was invested in the company when I was at Duke Street and at the time it was a UK-only brand. We did some testing in the US and predicted it would work. After being bought by a corporate the company is now double the size in the US than it is in the UK; corporate ownership is not always a negative.

TL: This highlights the importance of finding the right backer to internationalise consumer companies – that private equity may not always be the best way of globalising a business. How do you decide which is the best way to expand overseas?
AH: The digital revolution has made internationalising much easier; you do not need a physical presence if you are selling a product, as a virtual presence can give you a clear sense of how that product will be received.

It is easy to assume geographic proximity means it will be the same culturally but you cannot assume that a nearby market is the same in Europe or the US. For our investment in sofa.com, for example, we started selling into the Netherlands and we had to think about product dimensions; about the average consumer being taller and what modifications would be needed for the product.

DT: The basis for going overseas has to be a clear understanding of what your brand stands for in its home market. You really need to know why people are buying your product before you attempt to break foreign markets.

JH: If you are exporting brands into new territories, the internet can help. But a lot of it is down to management and often a different skill set is needed. It takes longer and it costs more than anyone expects. And there is no reason that the brand will translate.

Around 80% of Inflexion's current portfolio has international sales. To support our efforts in internationalising our portfolio companies, we have opened offices in Brazil, India and China, simply to accelerate growth; no investments are made out of these offices but our in-country teams are heavily involved in sourcing and assessing add-on investments within their region.

TS: We have expanded our investment in Finnish children's wear brand Reima into China. Reima has a localised strategy for China because it is a tough market. L'Occitaine, for example, had to localise its offering for China because its core brand proposition in the Western markets is all about the romanticism of Provence, but Chinese people living in cities have moved from living on farms in one generation, so that story does not sell. The localisation of a brand story is critical – but it is hard work – you really need people on the ground.

TL: After expanding a company into new territories, how do you then treat your UK presence – how do you ensure it is not neglected and is it a sensible time to review your UK store portfolio?

JH: We are generally cautious of having too much space in the first instance. The issue is that it is very difficult to get out of leases in the UK.

TS: We tend to avoid businesses that are heavily exposed to bricks and mortar. We prefer businesses with predominantly online sales, plus these businesses tend to be borderless. Being exposed to onerous leases can be tricky.

DT: We now spend more time assessing a retail estate in detail. The 'tail risk' is getting more significant and we are seeing more store portfolios with longer tails of underperforming stores.

TS: For those expanding their property portfolio there are far more tools available; mapping footfall, mapping the consumer journey to the completion of sale, and so on. Measurement in this area is much more sophisticated.

JH: There can be a big difference in location; leases have become more flexible in secondary locations – there is a big disparity between primary and secondary locations.

AH: In the UK, discount gyms have picked up a lot of the big box empty space and the market is hardening again. Demand has returned for empty space. In the mid-2000s, a lot of these spaces were car dealers or vacant – gyms have come in and done well. Prime-A retail units in top UK towns have been consistently buoyant despite problems elsewhere.

TL: Indeed, discount and budget focused offerings have been quick to take up empty space and have grown impressively over the last seven years. Will these offerings continue to grow, given the entirely different procurement model, and should private equity be investing in these types of retailers?

DT: Budget is often the wrong terminology; in many cases the business model is based on creating demand for end of line or clearance stock and because of that, they need to

> *"The digital revolution has made internationalising much easier; a virtual presence can give you a clear sense of how a product will be received"*
>
> **Anne Hoffmann,** CBPE Capital

be all over the sourcing. TK Maxx has a great model, but fundamentally will come under strain as it grows; there is only so much stock in circulation. The pound shops have had to go from sourcing overstock to changing the size of products to fit in their pricing limit. In these types of models you need to think about the stability of your supply of product.

TS: They do have more sophisticated procurement systems. We do not tend to look towards discount segments – they can be very destructive to brands.

JH: Look at gyms; they have stripped the offering right back and have worked out what people want. It is the same with

Left to right: Anne Hoffmann, CBPE Capital; **David Torbet**, Bowmark Capital; **John Harper**, Inflexion; and **Tom Leman**, Pinsent Masons

airlines – consumers do not want these extra services, they just want to pay sensible prices for what they are buying.

TL: What is the best way to use online in terms of social media engagement?

TS: With our investment in Bike 24, we are selling to very sophisticated consumers, who you could not access with a physical store; it would not make sense to hold a wide range of very expensive inventory at each store, so social media engagement is important. We monitor what is being said about our brands; we want to engage without being overbearing.

Also, the increased demands of online are important. People have an expectation of online, they will not suffer poor websites, even on discount sites consumers need a quick and clear proposition, especially when you are competing with the likes of Amazon.

AH: You need to embrace social media and ensure the right messages are out there. When addressing complaints, for example, it is about giving the right customer experience. Be prepared to embrace social media and cover all bases in terms of physical and digital; the crossover from both sides. The optimum model loves both sides.

JH: One theme that is essential is consistency, for example, for restaurants there are peer websites; you have to be confident operations are working properly. It used to be that complaints were much more localised – that is not the case anymore.

DT: There is an element of social media that is dysfunctional, so you need equal focus on managing negative feedback and misinformation, as much as promoting positive messages. I question how well star-rated systems actually work, because they reduce a vast range of qualitative views to a score out of five.

TL: Finally, during the downturn, several banks turned away from lending against consumer deals – have they returned? How are alternative lenders approaching the sector?

JH: Yes, there is debt in the sector but there is a split among lenders; some are more cautious and lending on modest multiples. Unitranche has done well in this space; it is well suited to the roll out model.

On the consumer side, take travel and leisure companies, they have been able to raise large sums of debt. Center Parcs, for example, has been able to tap into a new market of international lenders because it has constant cashflow. We have also seen this in restaurants; Yo Sushi is financed at 5x earnings – that is a lot for a business with leaseholdings.

DT: Traditional lenders are more cautious; they still have memories of the downturn but alternative lenders do not have that. In this sector you do need to expect a level of volatility and need a financing structure that can cope. For us, financial leverage is not a major part of the investment strategy for consumer deals. ■

■ *This article has been sponsored by Pinsent Masons*

Pinsent Masons