



Consumer Products and Retail

IS TURNBULL THE NEW BLACK?

Since becoming Prime Minister in September, Malcolm Turnbull is riding a wave of popularity. Whilst his style may be more grey, rather than the monochrome world of black and white politics, it could be said that he is the “new black” in the political world right now. The Government’s announcement of the \$1 billion innovation spend to drive an “ideas boom” in Australia should be welcomed by retail start-ups and entrepreneurs. However, retail legacy businesses and incumbents should also welcome this news, as Australia needs to attract and retain the world’s best talent to help drive our local retailers competitive success overseas. Recognised innovators in Australian retail, “Shoes of Prey”, has recently announced they have attracted a further \$15.5m of funding to drive its translation and mass-customisation to the US through its partnership with Nordstrom.

Early indicators of increasing business and consumer confidence are evident, but few retailers would say their expectations are anything other than stable for 2016. However, the new prime minister effect – fresh ideas; new approaches; reinvigorated thinking – should help stimulate economic growth across the board, from reliance on the resources sector to the broader economy, including retail. Albeit conditions are expected to remain weak for retail in Western Australian and parts of Queensland.

With the dollar’s depreciation making it harder for importers to maintain their margins, we may all soon be facing the reality of fewer discounts and higher prices. Anecdotally, most retailers are of the view they are unable to pass on all of the increase in costs to the consumer. The recent Black Friday sales, could be a good indicator for Christmas. Established in the US, starting on the day after Thanksgiving, Black Friday was typically in store discounts however extended to Cyber Monday for online sales. We saw in the US and Australia the discounts applied to both retail channels over the entire weekend – typically ranging from 20 to 40%. Struggling retailer, Dick Smith, has commenced a “mammoth clearance” to clear its unwanted and out-dated inventory, offering some discounts of up to 80%. Dick Smith’s focus on securing foot traffic means a strong Christmas performance will be key to avoid inventory issues, particularly during the typically quieter months in the New Year. Given competitors, such as Harvey Norman, JB Hi-Fi and the department stores, have posted better results in the lead up to Christmas, they will enjoy a head start.

However retailers will have wanted to hold out as long as possible to start their Christmas sales – which is usually dependent on the Department stores. However many Christmas sales have already commenced in early as the first week or so of December.

On the positive side, most retailers are predicting this year as a good, but not great, Christmas trading period. During the last 12 months, retailers across the board, including Department Stores, have “upped the ante” in terms of an omni-channel approach across e-commerce, and mobile (which now accounts for over 50% of all online sales).

We have also seen heightened levels of M&A activity in 2015:

- The number of transaction are up 20%
- Over 32% involved an international acquirer

We expect this trend to continue in 2016 and we discuss this, and how to manage the volatility of the dollar in this edition.

Gayle Dickerson
Sydney Head of Consumer Products and Retail



State of the market

RECENT RETAIL DATA, WHICH IN SUMMARY SHOWS...

\$\$\$↑
3.9%

Revenue up 3.9% in October 2015 compared to October 2014.



Growth driven by food retailing, household goods retailing and department stores.

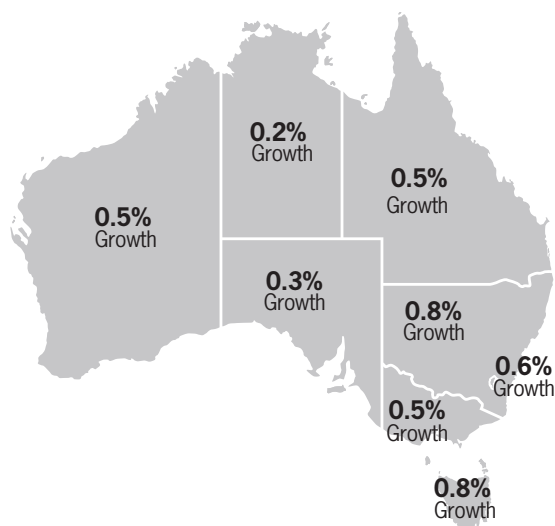


Decline in cafes, restaurants & takeaway food services and clothing, footwear & accessories.



Other retail sales relatively unchanged

RETAIL TURNOVER



DETAIL BY INDUSTRY GROUP - RETAIL TURNOVER

CAFES, RESTAURANTS & TAKEAWAY



0.6%↓

FOOD RETAILING



0.6%↑

HOUSEHOLD GOODS RETAILING



1.1%↑

CLOTHING, FOOTWEAR & ACCESSORIES



0.1%↓

DEPARTMENT STORES



3.5%↑

OTHER RETAILING



0.0%

Source: ABS October 2015 retail turnover (seasonally adjusted) growth by state

RETAIL & CONSUMER PRODUCTS DEALTRACKER

FINANCIAL YEAR 2015 UPDATE

In this Dealtracker – Financial Year 2015 Update, we have reviewed recent M&A activity in the retail and consumer products sector.

Despite tough trading conditions for Australian retail and consumer product businesses, M&A transaction levels have grown year-on-year, with 87 transactions taking place during FY2015, up from 69 transactions the year prior.

KEY INSIGHTS:

At Grant Thornton we are seeing more private business owners seeking to realise the value of their business and exit the industry due to growing pressure from international participants and a weakening Australian dollar. While many of these owners have been biding their time, waiting for trading performance to return to pre-GFC levels (prior to pursuing a sale), many now realise that those conditions are unlikely to return and low growth and high competition is here to stay.

Unless Australian retailers are willing to invest and reinvent themselves to become more relevant to today's discerning consumer, now may be the optimal time to pursue a transaction and unlock the value of your investment. We expect the level of competition in Australia to intensify, as new global entrants enter our market by either buying Australian businesses, setting up their own stores, or targeting Australian consumers through their online offerings.

Those businesses acquiring are doing so due to the need to seek alternative growth strategies in the face of stagnant organic growth. The majority of recent deals are occurring with strong branded businesses with international expansion opportunities, which are gaining particular interest from private equity.

Approximately one-third of transactions involved an international acquirer, a trend which we expect to increase, driven by a decline in the AUD:USD making in-bound acquisitions (particularly from the USA) more economical.

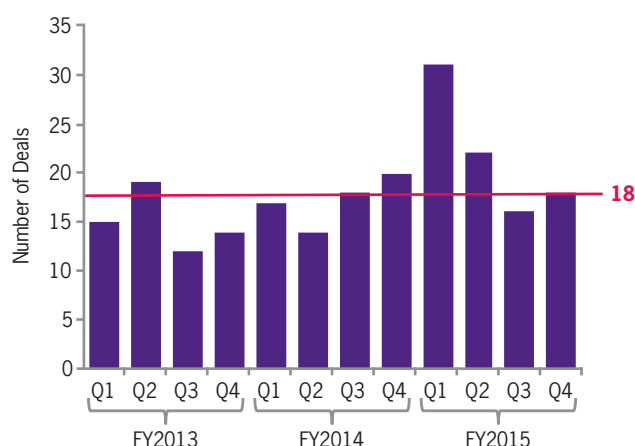


9%
of FY2015 transactions involved private equity

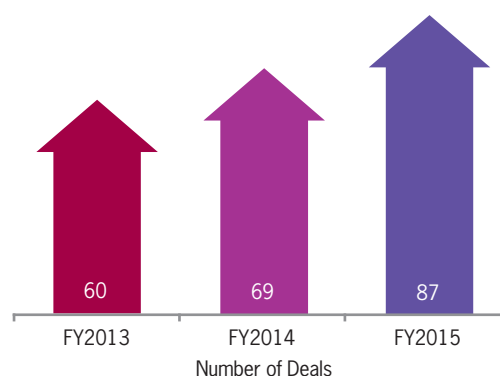


32%
of FY2015 transactions were cross-border conducted by an international acquirer

AUSTRALIAN DEAL ACTIVITY BY QUARTER



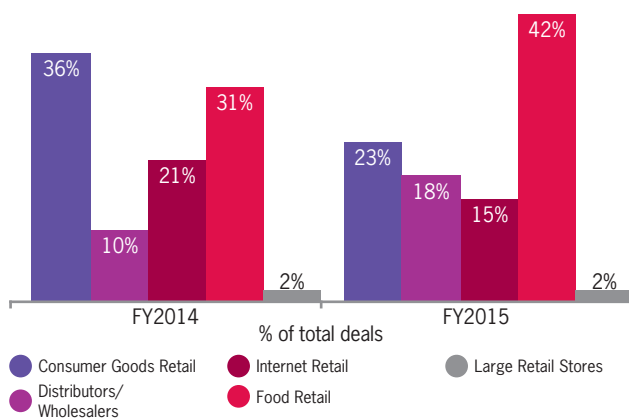
AUSTRALIAN DEAL ACTIVITY BY FINANCIAL YEAR



FY13 – FY15 TRANSACTION MULTIPLES BY TARGET SIZE *

Revenue Range	Number of Deals	Median EV/ EBITDA
Less than \$20 million	9	4.6x
Between \$20 million to \$50 million	8	6.2x
Between \$50 million to \$100 million	7	5.3x
Between \$100 million to \$200 million	7	8.7x
Between \$200 million to \$500 million	6	10.5x
Over \$500 million	4	10.9x
Total	41	
Median		7.4x

RETAILERS – DEAL COMPOSITION FY14 VS FY15



KEY INSIGHTS:

Investors have been attracted to the food sector with food retailing accounting for 42% of all transaction in FY2015. Food retail is generally considered to be one of the most resilient sectors due to lower levels of discretionary spend.

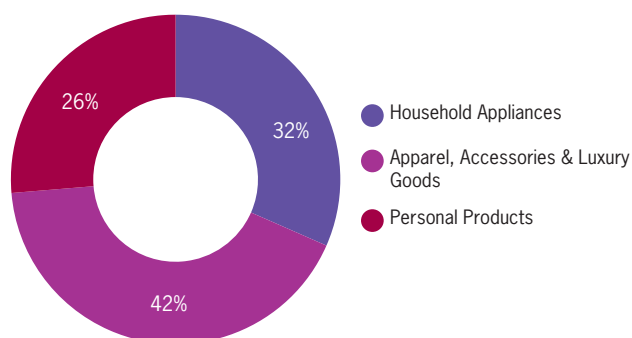
We believe food retail will remain a strong sub-sector for deal flow driven by investors seeking to capitalise on changing consumer lifestyle patterns and growing demand for convenient eating options.

KEY INSIGHTS:

Internet Retail transactions accounted for 15% of total retail and consumer product deals during FY2015, down marginally from 21% in FY2014. This remains relatively high considering online sales in Australia still only accounts for 6-8% of total Australian retail turnover, however many of these transactions have been driven by the need to increase scale as margins have been compressed.

We expect growth in online transactions to stabilise over the coming years as retailers realise that digital channels are not necessarily generating the returns initially expected due to the high costs to maintain and the rampant price competition.

CONSUMER PRODUCTS – DEAL COMPOSITION



KEY INSIGHTS:

The adjacent table outlines the current forward earning multiples of Australian listed retail and consumer product businesses.

Whilst multiples vary somewhat between the respective sub-sectors, those businesses with a strong differentiator and brand, offering a unique customer value proposition, to a niche customer segment are achieving the highest valuation outcomes.

With a growing number of privately held businesses expected to be taken to market over the next 10 years, we believe those who undertake a well researched and systematic pre-sale grooming process are best positioned to achieve a successful sale outcome.

RECENT TRADING MULTIPLES BY SUBSECTOR

	Number of Companies	FY2016 EV/EBITDA Projected
Apparel Retail	7	7.8x
Apparel, Accessories and Luxury Goods	4	7.2x
Computer and Electronics Retail	4	6.8x
Department Stores	1	4.5x
Distributors	7	7.4x
Food Retail	4	8.1x
General Merchandise Stores	2	7.0x
Home Furnishing Retail	9	8.3x
Household Appliances	5	6.8x
Internet Retail	5	7.0x
Personal Products	5	12.9x
Speciality Stores	2	5.7x
Restaurants	3	9.5x
Average		8.1x
Median		7.6x

NOTABLE MID-MARKET DEALS

- L Capital, an Asian-based private equity fund backed by French luxury fashion group LVMH Moët Hennessy, acquired an 80% stake in Australian swimwear brand, Seafolly for \$100 million in December 2014. The strategic investment will be used to fund the company's international expansion and movement into new products, including a skincare range. Seafolly's management believes the funding will greatly assist in growing sales from \$120 million per annum to a target \$500 million in four to five years time. Private equity fund L Capital typically invest as minority shareholders in companies generating greater than \$100 million in revenues to assist company's with extending product range, strengthening internal operations and initiating international operations.
- SurfStich Group continues on its acquisition trail with the acquisition of Surf Hardware International for over 7.5 times FY16 forecast EBITDA. The acquisition comes only weeks after SurfStich acquired a selection of action-sports content providers, including film producer, Garage Entertainment and magazine publisher, Magicseaweed. The acquisitions support SurfStich's strategy of becoming an online destination for its customers to connect, engage and transact. SurfStich Group operates as an online retailer in the Asia Pacific, Europe, and North America.
- Four months after acquiring Pacific Brands' Brand Collective business, Anchorage Capital Partners acquired children's footwear retailer Shoes & Sox for \$20 million. Anchorage, which is most well-known for its recent investment and sale of Dick Smith, is a specialised private equity firm that focuses on operational turnarounds and special situations investments. Shoes & Sox is a leading independent children's footwear specialist employing around 200 staff across 24 stores. Brand Collective owns a number of iconic Australian brands including Volley, Grosby and Julius Marlow, and has exclusive licences for leading international brands including Superdry, Clarks, Hush Puppies and Mossimo. The business sells through a combination of leading department stores and discount department store chains, as well as around 50 branded retail sites and several company owned websites. Brand Collective also owns the Shoe Warehouse chain of discount footwear stores.
- Iconic Australian swimwear label JETS has recently been acquired by PAS Group, the company behind fashion brands such as Review, Metalicus and Yarra Trail. JETS sells swimwear and activewear through local and international department stores, independent boutiques and online.
- Retail Food Group continues on its acquisition trail in an attempt to become Australia's largest coffee player by acquiring Gloria Jeans for \$160 million. Retail Food Group currently runs approximately 800 stores across Australia and Internationally under brands such as Michels Patisserie, BB's, Esquires, Coffee Guy and Cafe2U. The business, based in Southport, Queensland, is also the franchisor and owner of Brumby's Bakeries, Pizza Capers, Crust and Big Dads Pies brands.

OTHER NEWS

- European based Fabbrica Italiana Lapis e Affini ('FILA'), an international manufacturer and wholesaler of art materials, is currently seeking to acquire Australian stationary businesses generating turnover in the EUR 20 – 30 million range. Potential targets would be companies specializing in school products, such as crayons, markers and pencils, but also in stationary products for teenagers and professional office use. FILA's CEO believes consolidation in the sector worldwide will become a reality in the few next years. The field is extremely fragmented as it is made of small and medium family companies that will need to join forces to compete on an international level.
- Dusk, the Australian candles and gift seller, is expected to be put up for sale next year, the Australian Financial Review reported. According to the report in the paper's Street Talk column, Dusk's owner, Catalyst Investment Managers, is refurbishing stores and is likely preparing the company for sale. There are no current sale plans but unnamed sources noted that a trade sale is the most likely exit for Catalyst. Dusk has 95 stores and is believed to have earnings of just under AUD 10m (USD 7.34m). Catalyst acquired Dusk along with Adairs, the Australian sheets and towels business that was listed in May.
- Merger Market reports that the pet food and services sector in Australia is poised for further consolidation as smaller privately held businesses become prey to large chains. The flurry of activity in the sector is driven by growing population of domestic pets in Australia and the increasing level of money being spent per pet. The larger chains including Petbarn and PetStock are targeting economies of scale, in the currently highly fragmented pet industry, in an effort to offer more products at cheaper prices.

MANAGING CURRENCY RISKS AGAINST THE GREENBACK

GAYLE DICKERSON & LACHIE SWANN



With the Australian dollar (AUD) languishing against the greenback, it's no surprise that retailers and wholesalers know the spot rate to the nearest decimal point.

The dollar has dropped more than 20% of its value over the past year, directly impacting profit margins. The pressure is on as the cost of bringing product into Australia increases.

HOW HARD WILL THE LOWER DOLLAR HIT RETAILERS?

When the Australian dollar held parity with the US dollar in 2010-11, many retailers didn't pocket the benefit. Instead, they passed on the majority of them to consumers, and some saw costs blow out due to the margin buffer.

While the Australian dollar hovers around the 65 to 75 US cents mark, conditions will be challenging for many retailers and wholesalers, especially those who aren't vertically integrated or who don't have a niche offering. Such businesses will need to ensure management is both efficient and lean; focus on products that resonate with consumers and look at re-pricing with less discounting.

While offshore online sales are, in reality, only a fragment of total online sales in Australia, growth in this segment will likely slow, as overseas products are not as cheap as they used to be. Those retailers with omni-channel customer relationships through mobile, click and collect, and online will benefit as consumers refocus their attentions on the domestic market.

PUTTING THE BIGGER PICTURE TO ONE SIDE, HOW CAN RETAILERS MITIGATE THE RISK OF CURRENCY EXPOSURE AND HOW HAVE THEY RESPONDED?

To answer this question we need to look first at how the world responded to the global financial crisis. Since then, many unconventional monetary policy settings by central banks have been introduced, aimed at averting a global depression. With over 600 rate cuts globally (that's one every three trading days), multiple quantitative easing programs and bailout packages failing to deliver on economic growth forecasts since 2008, central banks are still unable to return to conventional policy settings.

In Australia, interest rates have been lowered to unprecedented levels to accommodate the transition from the weakening mining investment boom to a domestic-led recovery. In line with this monetary policy bias, the Australian dollar has also declined, falling as much as 15% this year alone. The drop has been volatile and swift, putting enormous pressure on import prices and margins in a very short space of time.

Typically, retailers approach each year by forecasting sales, considering potential currency volatility and then setting a budget level to determine profit margins and prices. In 2015, retail importers have seen their purchasing power drop by 15%, forcing many to raise prices in an effort to maintain margins while risking market share as a result. For others that manage long-dated pricing agreements, the currency movement has directly diminished profit margins.

To summarise, there isn't a one-size-fits-all approach to managing currency risk, but understanding the answers to the questions below will help you select the best solution. External expertise, from accountants, financiers and specialists like AFEX, can provide support to help you determine an efficient approach that suits your needs.

To help you analyse the best hedging strategy for your business, consider the following questions.



QUESTIONS TO ASK

- Does my international payments strategy match my business goals (market share, marketing initiatives, growth strategy, competition, industry maturity)?
- Do I have a level that I set my pricing and profit margins from (budget level)?
- How often should I review this level?
- Do I have the ability to reprice?
- What effect will re-pricing have on my client relationships?
- Is there a timing misalignment between my international payments program and local pricing agreements?
- How can I plan for more AUD weakness if the US Federal Reserve raises the cash rate this year?
- How accurately can I forecast purchases?
- Do I set the same budget level for all stock (even if they have different margins)?
- Are my product margins considered premium or price-driven?
- Should I manage risk differently for premium and price-driven products?
- Do I hold stock or sell-by-order?
- What are the market conditions ahead in the currency pairs that I'm exposed to?
- What forward coverage do I have? Is it sufficient for my business?
- Are there other levers, such as extending supplier terms, to help improve working capital?

CONTRIBUTORS

SIMON TRIVETT

Simon Trivett is the National Head of Consumer Products and Retail at Grant Thornton Australia. Simon has broad experience in the retail and consumer markets built up over 22 years. His experience in accounting and consulting is pragmatic and commercial. Simon can bring a fresh approach to problem solving and dealing with issues.
simon.trivett@au.gt.com

GAYLE DICKERSON

Gayle Dickerson is a Partner in Financial Advisory at Grant Thornton, specialising in helping retailers and wholesalers formulate strategies for growth while mitigating risks. Gayle leads our Sydney retail industry team and currently sits on the Board of the Australian Sporting Goods Association (AGSA) and the talent network of the National Online Retail Association (NORA). She is regularly invited to present on industry issues and contribute to thought leadership.
gayle.dickerson@au.gt.com

JONATHAN BUCCERI

Jonathan Bucceri is a Manager in Grant Thornton Australia's Consumer Products and Retail team. Jonathan specialises in advising clients on acquisition, fund raising, divestment and financial modelling assignments.
jon.bucceri@au.gt.com

LACHIE SWANN

Lachie is the State Manager, Victoria for Associated Foreign Exchange (AFEX). During his career, Lachie has helped ASX200 companies develop risk management strategies to improve business performance. He specifically supports businesses aiming to align business objectives with their risk management policy and this has led to the development of valuable relationships across Australia. With more than 10 years' experience across Financial Markets, BPO and IT consulting, Lachie's diverse industry background enables him to recognise and solve business problems with commercial outcomes. In previous engagements, Lachie has run foreign exchange workshops with the Council of Textile and Fashion Industries of Australia (TFIA). More recently Lachie has worked within the retail sector designing and implementing risk management strategies.
lswann@afex.com



Publication team acknowledgement
Angela Spowart and Paul Gooley

Our national retail team

Simon Trivett
National Head of Consumer Products and Retail
T 03 8663 6001
E simon.trivett@au.gt.com

Gayle Dickerson
Sydney Head of Consumer Products and Retail
T 02 8297 2706
E gayle.dickerson@au.gt.com

Lorena Sosa
Associate Director
T +61 2 8297 2548
E lorena.sosa@au.gt.com

Adam Pitts
Partner
T +61 3 8663 6186
E adam.pitts@au.gt.com

Michael Catterall
Partner
T +61 2 8297 2535
E michael.catterall@au.gt.com

Angela Spowart
Partner
T +61 2 8297 2605
E angela.spowart@au.gt.com

Peter Thornely
Partner
T +61 3 8663 6229
E peter.thornely@au.gt.com

Kim Batcheldor
Partner
T +61 2 9286 5666
E kim.batcheldor@au.gt.com

Michael Skinner
Partner
T +61 3 8320 2330
E michael.skinner@au.gt.com

Louise Worsley
Partner
T +61 2 9286 5604
E louise.worsley@au.gt.com

GRANT THORNTON OFFICES

Adelaide

Level 1
67 Greenhill Road
Wayville SA 5034
T +61 8 8372 6666
F +61 8 8372 6677
E info.sa@au.gt.com

Brisbane

King George Central
Level 18, 145 Ann Street
Brisbane QLD 4000
T +61 7 3222 0200
F +61 7 3222 0444
E info.qld@au.gt.com

Cairns

Cairns Corporate Tower
15 Lake Street
Cairns QLD 4870
T +61 7 4046 8888
F +61 7 4051 0116
E info.cns@au.gt.com

Melbourne

The Rialto, Level 30
525 Collins Street
Melbourne VIC 3000
T +61 3 8320 2222
F +61 3 8320 2200
E info.vic@au.gt.com

Perth

Level 1
10 Kings Park Road
West Perth WA 6005
T +61 8 9480 2000
F +61 8 9322 7787
E info.wa@au.gt.com

Sydney

Level 17
383 Kent Street
Sydney NSW 2000
T +61 2 8297 2400
F +61 2 9299 4445
E info.nsw@au.gt.com



www.grantthornton.com.au

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