PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 7:
AMAZON, WAYFAIR AND THE CHANGING RETAIL LANDSCAPE

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

Todd Kinney: Hi. I'd like to welcome our listeners to another episode of BDO's Private Equity Perspectives podcast. My name is Todd Kinney, and I'm a director in the private equity practice in New York City. I'm pleased to have two guests with me today. Natalie Kotlyar, who's the national leader of our Retail and Consumer Products Practice, and Richard Baum, who is the founding partner of Consumer Growth Partners and a very good friend of mine personally in the PE industry. Richard, I think you're one of the first folks I met 15 years ago when I started at BDO. And I value our relationship personally and the relationship between our firms. It's great to have you.

Richard Baum: I'm glad to see you're still in the business.

Todd: Let's jump right into it, Richard. I know it's going to be exciting. So, I'm going to throw the first question over to you. If you could, tell us a little bit about your firm and what you're doing and what you're trying to accomplish day to day.

Richard: So, thanks, Todd. I appreciate being on the panel here. So, my firm, as Todd mentioned, is Consumer Growth Partners. We are a private equity firm, and we have an exclusive focus on investing and advising firms that are in retail and what we describe as non-perishable brand and consumer products. On the investing side, we generally are looking for companies with a minimum of three million dollars in EBITDA. But on the advising side, we like to identify companies who have a transaction in their future that are either, for a variety of reasons, not ready, willing, or able to take in an outside equity investor. And we work with them to either improve their performance, get them better positioned, or scaled down. And then at the time that they are ready, we have the option of going out and raising capital for them or retaining an M&A firm to do that job.

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Todd: Perfect. Perfect. Natalie, I obviously already introduced you as the national leader of the Retail and Consumer Products Practice, but maybe you can bring our listeners up to speed on yourself and what you do at the firm.

Natalie Kotlyar: Absolutely. Thank you, Todd. So, first and foremost, I am a practicing audit partner, and I do work with clients every day. I believe that keeps me focused, in touch with what's happening in the industry. And in addition to that, I also lead the Retail and Consumer Products industry group, where I develop thought leadership, I work with partners across the country, and I ensure that our clients get the best in-class service.

UN-AMAZONABLE [3:14]

Todd: All right. Well, let's jump into it. And I think as we all know, Amazon has really been disrupting the retail industry, so why not start with Amazon? BDO's recent Retail CXO Holiday Survey, I believe, found that 36 percent of industry execs view Amazon as their largest competitor. So, I guess, Natalie, I'll throw this out to you first, and then Richard. Other than competing on price, what do you think retailers can do more effectively to compete against Amazon?

Natalie: Well, Todd, that's a really great question. I mean, we are now living in the Amazon era, and everyone is either joining or competing against Amazon. We saw it on Prime Day, which was a huge success for Amazon, lots of other retailers jumped on the bandwagon and had their own version of Prime Day and had their own version of sales and promotions. But getting back to your question, outside of price, one of the things that retailers can do to compete with Amazon is staying relevant with their customers. And what I mean by that is offering something more than just a product, whether it's buy one product and donate a product, whether it's sharing their life story on their website. Anything that will resonate with the consumer and will touch and engage the consumer will certainly differentiate them. One of the other things that we see a lot is providing a customer experience or an in-store experience, something that is difficult for Amazon given the fact that they are primarily an E-commerce company. Hands-on experience, whether that be an in-store event offering something as virtual golf, testing out a video game, or something as simple as having a cosmetics event or a cosmetics party.

But I think one of the strong distinctions between retailers and Amazon, Amazon has excellent customer service. But what other retailers can focus on is providing product customer service. And what I mean by that is really giving expertise and recommendations on certain product, how you bundle product to create the most advantageous purchase for the customer. And this certainly plays a big role in the high-ticket items. And the last, but not least, is the key component to competing against Amazon is really to understand your customer. And Amazon understands each segment of their customer base: what makes them tick, how they like to buy, what contributes to their decision. And they're an expert in targeting and communicating with their customers in their own language. The key for retailers is to really understand how to touch their customer, whether it's through advertising, social media, influencers, text, or a combination of all of those factors. Retailers are more nimble, and they're able to adapt quicker. And I think that that is a key factor of how to approach our customers.

Todd: All right. That's some fantastic insight, Natalie. Thanks. Richard, to you this time. How has the Amazon effect changed the way in which your firm evaluates investments in the retail and consumer product space?

Richard: So, it absolutely has, Todd. And as Natalie said, every company that you have to deal with today is either competing with or joining Amazon in one way or another. So, one of the first things that we look at with regard to a new investment is whether or not the company is what we call "un-Amazonable," meaning that Amazon is not going to be the company that's going to put this company out of business, put our target out of business regardless of what they do. A lot of the things that Natalie mentioned in terms of how you compete against Amazon are some of the things that we look at. But also at the same time, you have to understand what is Amazon's soft underbelly. They are very, very good. They're better than anyone when it comes to price and convenience of ordering something online. I'm not sure I would agree entirely with Natalie when she said they offer excellent customer experience. We happen to think Amazon offers terrible customer experience. Did you ever try to call Amazon and ask them a question about a product?

Todd: I have not.

Richard: Well, you can't get through. There basically is no number you can call. There is no human that you can talk to if you have questions. So, if you have product questions, if you have assortment questions, you're kind of left on your own. So, companies that are able to create what Natalie called a great customer experience online is a wonderful way to compete. And whether it's telling your story, whether it's having a website that really kind of reflects your brand's DNA, if you're offering a collection of merchandise, that is a great way to compete against Amazon. Amazon is primarily a product-based business, single item-based business. So, if you're looking for a collection of—whether it's an apparel collection or not, you can't really find that on Amazon. By the way, I guess it's not to be forgotten that Amazon still represents a relatively small percentage of the amount of money that's spent at retail. Probably upward of magnitude maybe 15 percent, if that much. So, something like 80 to 85 percent of what consumers purchase is in-store, and if you read the popular press and even the fake media, you'll quickly see that Amazon is going to go to 100 percent, stores are going to 0. We might call that fake news. Because there still are lots of reasons why people go to bricks and mortar. And we like the

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model of companies who are omni-channel, or even today, uni-channel where they have both brick-and-mortar and online.

Todd: Well, I think the "un-Amazonable" is going to start trending, Richard.

Richard: I could use a trend.

RETAILERS' REACTIONS TO SOUTH DAKOTA V. WAYFAIR [9:49]

Todd: You could use a trend. Yeah. All right. Well, obviously, in addition to the disruption Amazon is causing, another factor likely to impact the industry is the recent Wayfair decision. Certainly, it would be good to get both of your perspectives. I think the decision basically gives states greater power to require out-of-state retailers to collect sales tax on sales to in-state residents. At first glance, maybe this will level the playing field between online and brick-and-mortar retailers, at least when it comes to sales tax, I would think. But let me throw it out to both of you. Natalie, can you kind of share your thoughts on the topic?

Natalie: Absolutely. And I do agree. I think it certainly does level the playing field, but only to a certain extent. I think that there's going to be some benefits that will—some people will benefit, and other people will get hurt. In the past, customers would visit brick-and-mortar locations to touch the product, feel the product, look at the various colors, really get a sense for that product, and then go back home and order that online, whether it be for convenience purposes or pricing. And I think that today with the Wayfair case, that may change slightly. One of the reasons customers would go to order online would be to save the sales tax, especially on significant purchases. In fact, the BDO survey showed that 51 percent of online shoppers considered sales tax before making a purchase. Having said that, I think it will have some impact, but primarily for the larger purchases.

Todd: All right. Richard, I guess same question. With a focus on the lower middle market, what do you think the implications of the Wayfair decision are?

Richard: So as Natalie said, it definitely levels the playing field between bricks-and-mortar and online sellers. But I think the playing field was already fairly level. I think the impact on companies that we see, which tend to be lower middle market companies. They actually, at least the online ones, may be hurt by it because they have so little margin generally, if they're trying to compete against Amazon, that whatever that tax differential was, that sales tax differential, has now been eliminated. I still think, although we know that sales tax does enter into a purchase decision, you have to remember that sales taxes are widely variable, and they go all the way up to—if you're fortunate enough to live in New York, you're paying 8 percent or something close to it. So I think the question that consumers have to ask is, "Is it worth it for me to spend all the time, go to the store, park my car, maybe pay for parking, spend all the time which I have to value at something, and then come home, order it online, and I guess I get to save 8 percent?" One of the ironies, I think, in our world, is that we have these things called tax-free weekends, and they generate a lot of money. A lot of sales occur on tax-free weekends, and that's because retailers advertise tax-free weekend. But if a consumer ran an ad that said, "This weekend, everything in our store, 5 percent off," which might be the sales tax of many states, do you think anyone would show up?

Todd: Probably not.

Richard: Probably not. Right. So, in some ways, I think it's a bigger deal than people are making of it.

Todd: Our discussion with Natalie and Richard will continue after we take a quick break with BDO's own Katherine Gauntt. Katherine is a senior manager in the Southeast region, where she advises clients on state and local tax issues.

KATHERINE GAUNTT TALKS SOUTH DAKOTA V. WAYFAIR [14:01]

Katherine: Hello, my name is Katherine Gauntt, and I'm a senior manager in BDO's Atlanta office. I work with clients on state and local tax issues specifically as they relate to sales and use tax. Today, the most significant issue in the state and local tax world is the Supreme Court's decision on South Dakota versus Wayfair. To put it simply, the Court's ruling has effectively allowed the states to collect sales and use tax from companies that make sales in those states, even if that company has no other presence, physical or otherwise, within that state's borders.

In tax terms, this new standard is called an economic nexus standard because the mere act of making sales at a certain threshold within that state is sufficient to create nexus. Overnight, this decision has changed many businesses' thinking from, "I don't have to collect sales tax because I do not have physical nexus," to, "How can I comply with all of the state and local jurisdictions where I deliver my products and services?" Naturally, e-commerce retailers, states, and consumers all responded to the ruling with questions and concerns.

However, many stakeholders will have to wait for clearer guidance, but the individual states and, potentially, Congress have yet to release guidelines with respect to threshold for sales dollars and transaction counts. Almost half the states that impose a sales and use tax have economic nexus standards similar to those of South Dakota's. So, it's reasonable to expect that most, if not all of the remaining states that impose a sales and use tax, will follow South Dakota's lead.

Texas, Ohio, and New York are all currently very proactively working to create those respective guidelines. In terms of how

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the Wayfair decision relates to private equity, the ruling may have a massive impact on private equity owners of e-commerce companies that do business in multiple states.

There are three main aspects that private equity owners of e-commerce businesses need to consider post-Wayfair. First, e-commerce companies should examine where and how much business they're doing in each state. They need to understand their footprint. If a private equity firm acquires an e-commerce company, the buyer should fully understand where that company's sales took place over the past three years as some states might apply these new standards retroactively. Keep in mind that the buyer may be facing different rules in different jurisdictions. There may be different thresholds. The laws and policies of each state should be researched thoroughly for the application to that specific e-commerce retailer. Retailers that understand how their products are sold through the states will be best prepared to comply, while those that don't will need to quickly create a system to track activity so that they can become compliant with the law.

E-commerce needs to understand how the products they sell in each state are treated in terms of taxability. Different products can be characterized by that state in different ways. And services especially, which are sold via e-commerce, can be characterized in multiple ways, and those ways will have different tax outcomes. There are also certain commodities and certain consumer types having special exemptions. So, companies need to examine each and every consumer type and commodity to see if exemptions might exist for them. When you're looking for an e-commerce company to acquire, consider a detailed due diligence process to determine that target's footprint, and therefore, assess its potential tax risk. The due diligence process can offer insight into how much should be held in escrow as part of the deal and how long that escrow should be held.

Buyers must also keep in mind that the escrow amount, as well as the time that it's held by the third party, should be longer than usual because the law is not fully developed. The factors and risks pertaining to state and local taxes where the target operates add an additional level of scrutiny and an additional level of risk that could be uncovered in the due diligence process. Going forward, it will be interesting to see whether Congress decides to weigh in and offer clear guidance on how the state should be collecting sales tax and at what thresholds.

Another development to watch will be whether certain companies will steer away from doing business within certain states because they enact strict economic nexus standards or their taxability on products is broad. While the full impact of the Wayfair decision is yet to be determined, retailers and their private equity owners should begin considering potential options and strategies to comply effectively. And once the guidelines do come out, they'll be better prepared to act accordingly. Thank you.

RETAIL'S NEW RECKONING [19:10]

Todd: And now, back to our conversation with Natalie and Richard. I think it would be a glaring omission not to discuss the demise of retailers such as Toys R Us, for sure. BDO's Retail in the Red report noted that for the first time since 2009, the total number of US stores dropped as of the second half of 2017. Pretty alarming. So, some say the downturn is due to Amazon, and I think others are pointing to private equity owners potentially placing too much debt on their retail companies. So again, Natalie, I'll come to you first. Are there any recommendations you would give to a retailer that needs to become more competitive?

Natalie: Absolutely. And I think before I address your question, I think many of the retailers that are filing for bankruptcy—and as we see, many of them are coming right back out of bankruptcy primarily due to over-expansion in a relatively quick period of time. And now looking at their fleet of stores, analyzing the performing and the under-performing stores, looking at the profitability, and really to determine what is the right number and, of course, the right location for these stores. That would probably be my biggest recommendation for retailers to really understand your fleet of stores, where you should be, which locations, and how many stores there. Some of the others are pretty elementary, such as keeping inventory clean and fresh, not to overbuy. Obviously, that would reduce markdowns and promotions. Ensure that you're partnering with the right vendors that will give you proper quality, good lead time, and of course, advantageous pricing. And then on the banking side, it's really important to partner with the right either banking or investment firm, private equity, someone that really understands your business and the cyclical nature of your business and wouldn't overreact when there is a dip in your business.

Todd: Gotcha. Gotcha. Richard, I guess same thing. Maybe I'll ask you in two parts here. One, kind of what are your thoughts on private equity's business practices in this scenario? And then, two, maybe you can comment on how firms like yourself in the lower middle market are using leverage versus some of the larger PE firms.

Richard: Sure. So, let me just begin—I just want to kind of respond to Natalie's comment kind of from a 30,000-foot perspective about what is causing a lot of the bankruptcies that we're seeing.

Todd: Sure. That'd be great.

Richard: So, I think there's—there are different buckets of this. So, there's a bucket of stores that, if they went away tomorrow, nobody would care. And that's because they've become totally irrelevant. Probably two of the best examples are Sears and K-Mart, which are going through a long and lengthy, I would call it, hospice experience if anything else. And we know they're going to

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die. It's just a question of when, and when they do, it'll be a shock to everybody. But it's like your 105-year-old grandmother dying. So that's one group. Then there are a group of stores that were—and these tended to be much larger transactions where it was done by private equity large firms who, frankly, just didn't do their due diligence. Toys R Us is probably a great example because at the time that you make these LBOs, leverage buyout transaction, you're doing it based on a forecast of the business. And obviously, they were forecasting a pretty rosy future for Toys R Us, and so that's how they were able to justify all the debt that got put on it. But for years before Bain & Company and others invested in Toys R Us, both Wal-Mart and Target were taking huge chunks of market share away from Toys R Us. And Toys R Us really never ever figured out how to stem that. And so that, I would literally put at the front of the large private equity firms.

So smaller private equity firms and smaller companies that are bought by private equity firms are much more conservative in their approach to leverage. So, it is more normal to put two to three times leverage on a company, which would mean two to three times EBITDA as opposed to five to six, which were considered, in retrospect, extraordinary and obviously got to those numbers because the projections of what sales and profit would be never materialized. And so one of the reasons is that when you've got a small company, a relatively small mistake can have a relatively large impact. So by its nature, you need to be conservative and only put the debt on the business that you think that the company can actually support at the time, not based on what you're expecting out of some future performance for the company.

WHAT'S NEXT FOR RETAILERS [25:03]

Todd: Makes sense. Makes sense. Thank you. So, at every point in our podcast series, we get to the crystal ball question where we ask you to let us know your thoughts on where the industry may be going over the next year or two. So, Natalie, again, first to you. Why don't you tell us what your forecast is for kind of the consumer and retail industry in the next year or so?

Natalie: Well, I expect that we're going to continue to see significant growth in e-commerce as evidenced by the success of Amazon's Prime Day. And with consumer confidence still relatively high, I expect that we are going to have a strong back half of the year, especially as it pertains to back to school and holiday season.

Todd: All right. Richard, you're on the hot seat. So, what do you foresee for the retail industry and especially for private equity investors in this space?

Richard: So again, I'm not going to address the short term because I'm not an economist.

Todd: Right. You're not?

Richard: And even they don't get it right some of the time. But I think as Natalie points out, online commerce led by Amazon has really taken most of the growth that we've seen in retail in the last year or so, and we expect that to continue. And so, in that regard, private equity investors have to take into account what's happening in online commerce. If they're going to be successful, you cannot ignore it. You have to make sure that your companies are either positioned well to compete against Amazon or to join Amazon. I mean, the Amazon Marketplace - and more recently they've got Wal-Mart with their Marketplace - are becoming very valuable channels of distribution. There are some drawbacks, but by and large, all of the companies that we invest in are trying to generate more revenue and as much of that dropping to the bottom line as possible.

Todd: Fantastic. Well, I enjoyed the conversation this morning. Again, Natalie Kotlyar with BDO and Richard Baum with Consumer Growth Partners, thank you both for your time and your insights. I enjoyed having you as guests, and I look forward to working with both of you in the months and years to come. So, thanks so much for joining us today.

Natalie: Great. Thank you.

Richard: Thanks, Todd.

Todd: All right. Thanks. And thanks to the listeners. We'll catch up with you on the next podcast.

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