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Consumer Speaks
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Deal or No Deal:
M&A opportunities for the consumer industry

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Sam: Welcome to Consumer Speaks, a Deloitte podcast series where you'll hear perspectives and insights on emerging topics impacting the consumer industry. I'm your host, Sam Loughry, the leader of our consumer industry Audit & Assurance practice. Today, we'll discuss the impact of the current economic situation on the consumer industry and how organizations are approaching mergers and acquisitions opportunities. We are joined by Jason Menghi, Deloitte & Touche LLP's national Private Equity leader for the Audit & Assurance practice, Bhuvy Abrol, Deloitte Consulting LLP's Private Equity and Alternatives practice leader, and Pawan Kapoor, leader in Deloitte Consulting LLP's M&A practice. Thanks for joining us, guys. Jason, let's start with you. Tell us what you're seeing in the current market related to private equity.

Jason: Thanks, Sam. So private equity firms really had a difficult decision to make when COVID-19 first hit. Reflect back to March or April time frame, private equity executives really had no idea what permanent impact this would have on their business. So, the immediate reaction on their part was "let's make sure that our portfolio companies from a liquidity perspective are healthy." And the decision that they had to make was do they take the capital that they've generated through the years and make an additional investment to help their portfolio companies through these difficult times or do they take the capital and invest it into new portfolio companies? That was a very difficult decision for all private equity firms. We have seen a lot of retailers really struggle through COVID, and we've seen some of the retailers, actually really large retailers, file for bankruptcy. We also know that the consumer business was already struggling as a result of the phenomenon of online retailers. With that being said, this really is a classic example where private equity firms can play a really important role in the recovery. They can really bring a lot of capital to the table, they can preserve jobs, they can help restructure debt, they can help with a variety of other liquidity measures, helping portfolio businesses in the consumer space navigate through these difficult times. But one thing is for sure, we know that private equity firms really are going to try to take advantage of this market dislocation and particularly focus on taking advantage of the bankruptcy market. We've actually seen a lot of our clients and a lot of large private equity firms start to think through and raise capital for new distress debt funds.

Sam: Jason, you said you're seeing private equity firms raise new funds. Do you expect this will continue given the state of the economy?

Jason: I do, depending on the size of the firm. We have clients that are in the small private equity space, certainly in the middle market, and then also the mega private equity firms. We find that almost all of them are raising capital right now. We think that private equity is actually a desired investment class, so they have no real issues of raising capital. Now, obviously, if you're the mega-sized private equity firms, it's quite a bit easier to raise that capital, just given the brand and the name recognition. But today, we're seeing about a trillion and a half dollars of dry powder out there that private equity firms have to deploy into investments. And really the decision is as simple as what I opened up with was, do you take that capital and invest it in an existing portfolio company, or do you buy a new business? And that's really a complicated decision depending on the type of the firm that you are, because obviously the investor group may lean one way versus the other.

Sam: Yeah, 1.5 trillion, that's a real impressive number. Jason, they talk about this as dry powder. Can you explain what you mean by that?

Jason: Sure, the way I think about dry powder and often explain it is the capital that is raised from investors that comes into the private equity funds that is available to deploy to additional investments. Those dollars could be deployed into existing portfolio companies, they'll often refer to as add-on investments, or it could be deployed into new investments, new portfolio companies that come in to the fund for the very first time. Over the last several months, we've really seen an uptick in the size of the funds being raised. As dry powder continues to grow, we think it will continue to grow even throughout 2020 and into 2021. We really do believe that this is a really strong environment for private equity to invest in. We all know that in difficult times, private equity firms really like to take advantage and invest in an uncertain market. And we have seen through other downturns historically that private equity firms have generally done really well in investing in downturns and when they've come out of it actually end up really with nice gains with those investments.

Sam: Let me turn to Pawan. Pawan, can you provide us with some overall background on the consumer industry deals and how COVID-19 has impacted the deal flow for the consumer industry?

Pawan: Sure, Sam. When we look at, on a YTD basis, M&A activity and consumer industry dropped about 25% in volume and 50% in value terms. What we're seeing is truly an evil of two extremes. We have consumer staples on one hand, that's seeing an unprecedented surge in demand as consumers are loading up on essential goods, and on the other hand is discretionary products that are witnessing steep decline in sales, particularly because of what happened in the beginning of the pandemic with closure of malls, restaurants, travel, retail, and other channels. In the scramble of responding to all these challenges, M&A deal-making took a backseat. We did see some activities, such as companies inviting minority investments to overcome near-term liquidity issues, alliance partnerships to devise alternate route to consumers, mainly through the last-mile delivery services, and there were some distress sales, but not a whole lot.

Sam: Now that we've been dealing with the pandemic for over six months, Pawan, what should we expect going forward with mergers and acquisition strategies?

Pawan: Yeah, that's an interesting thing to reflect at this point, and we feel that where we are with regards to the pandemic, companies have generally adjusted to the new normal and they are starting to think about what the future of M&A looks like for them. We recently polled about a thousand U.S. executives, about 750 from strategic corporations and 250 from private equity firms, about their current and future M&A plans.[1] And it's interesting to note that about 57% of them indicate that there'll be taking an offensive route to M&A. What they want to do is leverage the disruption caused by the pandemic to accelerate transformation of their business models. What we're going to see is a typical predator-prey kind of situation, where some companies will come at this offensively while others will be defensive. In general, we think that there are three big drivers for M&A in the coming quarters. One would be acquisition of emerging brands that will feed the ongoing pursuit for growth in the consumer industry. We're seeing a lot of portfolio divestitures/ portfolio adjustments by strategic players that will present tremendous opportunity for private equity firms to create value. There will be some opportunistic transactions driven off continued financial struggles for some players.

Sam: Pawan, would you say smaller serial acquisitions are a winning investment strategy for consumer companies?

Pawan: Absolutely. So, based on our study we did on hundreds of public consumer product companies that were collectively involved in over 2,000 transactions over the last decade, the small serial acquisition strategy has outperformed on all major financial metrics.[2] Small serial acquisition strategy is successful we think because of three primary reasons. One, acquiring frequently and acquiring small allows buyers to explore and selectively extend into new profit pools and be the first mover, which is a big deal in consumer industry. It also allows buyers to look for brands, capabilities, or intellectual property they want to acquire and scale without paying premium for unwanted assets, so there's a limited risk on each bet you're putting, if you're acquiring small and are focused. In almost every small transaction, we see the value is predicated on scaling the acquired business profitably and achieving growth without damaging the core of what makes that business successful. And we've seen that serial acquirers have gotten really good at following a balanced playbook where they integrate cautiously and don't rush into making the acquired business look just like the existing business.

Sam: Let me get some perspectives from Bhuvy. Bhuvy, it looks like there are still plenty of M&A opportunities available for consumer companies. What about the other side? Whenever there's a transaction, there must be a seller. Do you think we'll see more organizations look to dispose of certain businesses?

Bhuvy: Absolutely, Sam. Like Pawan said earlier, portfolio adjustments, divestitures are imminent based on what we have been expecting even before COVID-19. If you look back between 2011 and 2015, there were roughly, I believe, about a hundred consumer companies that divested parts of their portfolio. We have been expecting and expect a similar, perhaps even larger trend this time around. PE ownership can turn around these divested assets and create tremendous value. This is something we certainly are seeing an uptick in across consumer and other spaces, and there are a lot of promising brands out there today that could be of great interest for strategic, as well as private equity buyers.

Sam: When is the right time to pursue these options?

Bhuvy: As Jason stated earlier, from an exit standpoint, strategics are evaluating their porticoes, but you think about what is being done on the other side. There are a lot of cash-rich strategies that are out there, there are also a lot of new fundraisers by a lot of private equity firms. And Sam, you had asked Jason the question to explain dry powder. All this capital has to get deployed. Otherwise, many of the private equity funds have to return back to the investors, so they are literally jumping at the bits to invest in the right assets where they do see value creation and realization opportunities. I think that the time is now, frankly, and there's a lot of that uptick that I mentioned that we're seeing already.

Sam: Bhuvy, back to the sellers, if they're thinking about or contemplating an exit strategy, how should they package their portfolio companies?

Bhuvy: That's a great point. First thing is that, for sure, there'll be a lot of diligence done by the buyer because the buyer, whether they're a corporate or a private equity, they're really going to want to try to get even deeper because right now the biggest unknown, which has not been there before, is the impact of the pandemic on the top line and the customer sentiment, the consumer sentiment. So be prepared, I would say, for a fairly strict and in-depth diligence from most buyers. At the same time, many corporates are experienced in this, but I would say that really positioning yourself as a prepared seller where the private equity funds, while they're hunting for assets, they also are looking for a good process. And in certain cases, they might want to engage earlier based on their own research on what brands or what parts of certain businesses might be coming on the market, and having the basics ready, really defining the deal perimeter, having a view on TSAs[3] and if you're ready as a seller to provide them, which for what duration. Obviously, the buyers will do their diligence, but having advised so many buyers over the last 20 years, the more prepared a seller, I've just noticed that the process tends to go a lot more efficiently. I'm happy to speak more, but we might be running out of time. If there's anybody who wants more information, you'll have our contact to come back to. So back to you, Sam.

Sam: Bhuvy, despite the pandemic, it's pretty clear that M&A activity is thriving and can be an important part of many organizations' strategies to remain competitive. Jason, Pawan, Bhuvy, thanks for being here and sharing your insights with our listeners. I'm Sam Loughry. Thank you for listening to Consumer Speaks, sponsored by Deloitte's Audit & Assurance practice. For more information, please email sloughry@deloitte.com or visit our website, deloitte.com. Until next time, take care.

Endnotes

1. https://www2.deloitte.com/us/en/pages/mergers-and-acquisitions/articles/m-a-trends-report.html.
2. https://www2.deloitte.com/us/en/insights/industry/retail-distribution/cpg-m-and-a.html.
3. Transition Service Agreement