Retailers are being driven to perform in an ever-evolving digital environment, proactively hedge against margin erosion, and continually re-evaluate capabilities in the face of a transforming landscape. COVID-19 accelerated transformation in an already volatile retail landscape, and from that emerged a tale of two retailers – the leaders who had invested in products, services, and capabilities – and the laggards, weighed down by their fixed assets and debt, unable to rapidly address change.

Current macroeconomic trends are creating an environment prime for M&A as an accelerated path to transformation for retailers... They can take advantage of access to capital, recent bankruptcies, and increased relevance of digital, through M&A, to accelerate growth and stay ahead of the competition.

...while the same trends are creating opportunities for retailers to shift from “survive” to “thrive”. Portfolio rationalization and liquidity events can help lagging retailers gain financial flexibility to strengthen core offerings and invest in enhanced capabilities.

In addition to “buy”, “partner”, or “sell”, margin improvement can be a step in the journey to help retailers shift into a growth-oriented mindset and free cash flow for re-investment. Improving an organization’s cost structure towards sustainable, competitive margins can position a retailer as a competitive threat and target for investment.

To emerge as a leader through a period of disruption and opportunity, retailers must evaluate how M&A strategy fits into their value proposition and long-term strategic goals. When considering which route to take, companies should consider several factors, such as channel growth, defined optionality, enhancing digital capabilities, and need for market localization.
Introduction

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness...”

– Charles Dickens, “A Tale of Two Cities”

COVID-19 created a tale of two types of apparel and discretionary retailers – leading retailers, poised to weather the storm, capitalize on technology investments, and take market share – and lagging retailers, whose fixed asset base and debt would ultimately prove detrimental.

As noted in our perspective, “A New Formula for Retail Recovery and Growth,” US discretionary retailers faced a plethora of profitability challenges in early 2020: increasing discrete expenses such as rent and wages; declining foot traffic; reduced overall spend on apparel; and heightened competition due to solid incumbents, 3rd party services, and a relative lack of diversification. These challenges existed before COVID-19 but were exacerbated by the rapid onset of the pandemic.

Leading discretionary retailers were already investing significantly in innovation before COVID-19. Investment focused on products, services, capabilities (e.g., enhanced digital presence), while also re-evaluating existing assets (e.g., footprint rationalization). When it became clear that consumer purchasing was altered by the pandemic, these proactive players with agile delivery models and enhanced digital capabilities thrived. The retailers proved that they could move with speed and conviction to activate digital investments and put their downside scenario plans into action – ultimately positioning them to “weather the storm”.

Exhibit 1: A case study of two athletic apparel brands – one who proactively pursued new technologies and innovation, and one who grew by scale.

<table>
<thead>
<tr>
<th>Year</th>
<th>Retailer #1</th>
<th>Retailer #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>16%</td>
<td>15%</td>
</tr>
<tr>
<td>2015</td>
<td>16%</td>
<td>13%</td>
</tr>
<tr>
<td>2019</td>
<td>14%</td>
<td>8%</td>
</tr>
<tr>
<td>2020</td>
<td>11%</td>
<td>4%</td>
</tr>
</tbody>
</table>

Digital Innovation Approach

Retailer #1: Integration into core offerings and customer experience; growth by scope expansion

Retailer #2: Bolt-on businesses and growth primarily driven through scale
On the other hand, lagging retailers who were surviving quarter to quarter – or did not have the margin profile to invest proactively in innovation adequately – failed to rapidly address the accelerated change in consumer demands, leading to immediate diminishing profitability¹.

**Exhibit 2:** Leading and lagging retailers hit a “K-shaped” revenue curve; retailers that had made the necessary investments in capabilities pre-COVID experienced a boom, while retailers that were behind the curve continued their downward trend. Sample set of 50 public apparel and discretionary retailers, with annual revenue >$1B.

M&A deals, which had already been in decline in the retail sector, fell to the wayside or were paused due to the market uncertainty at the onset of the pandemic. In the six months following the pandemic, roughly 1,900 global deals across all industries were canceled, renegotiated, or disputed, including several high-profile deals in the retail sector³. As the economy rebounds and consumer sentiment begins to strengthen, the time is right for apparel & discretionary retailers to consider leveraging M&A for growth. The challenges faced due to COVID-19 can suddenly become new opportunities for these retailers by leveraging strategic M&A to position for growth, further fuel innovation, and double down on differentiation to serve the whole consumer, not just the “shopper.”
The global health crisis posed unprecedented challenges to all industries, notably to retailers. For apparel and discretionary retailers, these challenges represented opportunities to emerge as either a leader – or a laggard. Our analysis identified three macro trends retailers can take advantage of through M&A and margin improvement strategies to accelerate growth and stay ahead of the competition.

**Historically low-interest rates**

Although COVID-19 has caused vast uncertainty within the market, interest rates have been historically low⁴, providing an opportunity to finance growth or capital at a lower cost. Given the expected Fed action around interest rate increases in 2022, the current rate environment is expected to shift in the near future, making now the time to take action. With the macroeconomic opportunities presenting upside, companies can consider buying or selling based on a variety of factors including their current debt ratio, cash on hand, and overall balance sheet strength.

**Buy-Side:** With the ability to finance at lower rates, retailers interested in pursuing strategic acquisitions can secure funding with heightened confidence that associated debt costs will not increase in the immediate future. In 2020, issuance of investment-grade bonds in the US hit $73B in a week, 21% higher than the previous weekly record set in 2013. The influx of relatively inexpensive capital into the retail industry resulted in the highest debt to sales ratio for this group of peers over the last 5 years – and their balance sheets are primed to be acquisitive.

**Sell-Side:** Retailers are refining their focus given new consumption behaviors in a post-COVID world. As such, divesting a non-core business is an attractive option. Retailers are also searching for the new frontier of growth; with online channels growing at double digits and brands emerging from the pandemic as clear winners (and laggards), rebalancing the brand portfolio is worth a detailed examination. Through divestitures, sellers can obtain necessary capital and focus their effort and energy on core operations to proactively anticipate an evolving retail landscape.

**Recent retail bankruptcies**

The average *Net Debt to EBITDA* ratio for US retailers increased by ~26% between 2017 and 2020. According to Moody’s, debt default levels in retail and apparel will continue to remain well above the levels of the past 12 years, and the market can likely expect continued bankruptcies as retailers emerge from the pandemic with debt-filled balance sheets and a lack of liquid assets.⁵ After a period of heavy bankruptcies⁶ and increased debt to capital ratio⁷ brands and assets are often not residing in their optimal long-term "homes"; we expect to see more disruption and opportunity to capitalize on this via M&A. The retail industry faces a profitability crisis as retailers face pressure to continually adapt to shifting consumer behavior, deliver personalized experiences for consumers, seamlessly navigate supply chain challenges, and simultaneously combat inflation. Distressed retailers can seek new partnerships, address SG&A costs, or explore top line alternatives for selected categories to capture value quickly.
“A lot of the companies that find themselves in a distressed situation were eventually going to get there anyway, they were just kicking the can down the road.”

– Mickey Chadha, Vice President, Moody’s

Creditors are becoming increasingly wary of distressed borrowers and as a result may tighten their lending practices. Further, adding more debt to already heavy balance sheets will likely prolong retailer bankruptcies rather than avoid bankruptcy altogether. In this scenario, retailers should explore selling/divesting their businesses when they are “in the driver’s seat” to identify a more vital partner to help turn around the business and reduce liabilities instead of waiting until the bankruptcy is the only option. When examined from a forward-looking lens, there are likely winner and loser lines within each portfolio. After a period of disruption, it is essential to take a deep look at the future growth profile of each given the new state of the consumer and the next horizon of possible scenarios that are going to unfold. This exercise and the resulting action will result in the more effective deployment of capital, increased operational focus, and a more lucrative overall valuation for the core, higher-growth categories.

Relevance of digital/e-commerce

Retailers are continually looking to differentiate themselves from their competition and meet customers in an increasingly digital world as customers have shifted their focus to shopping online. As a result, retailers offer customers a more personalized and digital experience leveraging innovative technology across the value chain, such as virtual showrooms, QR codes, automated check-out, contactless payment, etc. Retailers are also investing in distribution capabilities to provide a fast and seamless shopping experience for customers who prefer to shop online. This push by retailers puts pressure on the market collectively to continue innovating and expanding into digitalization.

Buy-Side: Acquisition may represent an effective way to rapidly build digital capabilities, rather than trying to “go it alone” and struggle to enhance digital capabilities in an appropriate timeframe. Potential targets for buyers looking to improve their digital-friendly capabilities include online-first retailers, DTC brands, targeted software companies to manage consumer data, and more. Beyond acquisition, partnerships or alliances with third-party providers may be an attractive option. For example, “buy now, pay later”

According to a recent Deloitte survey of PE investors in fashion and luxury, 64% of respondents will invest in disruptive technologies to benefit from potential synergies and pursue an omnichannel strategy, compared to 57% in 2020.

Sell-Side: Small and/or struggling retailers may want to explore a sale to gain the required capital to pursue aggressive growth without capital to build capabilities. This can be seen across PE deals the last few years, where US-based retailers have been acquired to provide financial flexibility to strengthen omnichannel offerings and further invest in retail and digital platforms.

If you’re a distressed retailer or a struggling retailer, you can’t make a mistake, so you’re probably going to be gun-shy, and your competitors are going to pass you by...It’s survival of the fittest, and the fittest are the bigger [retailers] that have been executing and have the financial wherewithal to be innovative, be creative [and] make acquisitions.

– Charlie O’Shea, Analyst, Moody’s
Strategic Buy-Side & Sell-Side M&A considerations: A framework

Beyond macroeconomic trends, organizations must reflect internally and define how planned M&A (including strategic partnerships) fits with their value proposition and long-term strategic goals.

In addition to “buy/partner or “sell,” a third approach may be a more sustainable, attractive option for retailers—margin improvement. Expansion of margins can enable an organization to move from “survival mode” into a growth-oriented mindset with sustainable, competitive margins. Eventually, improving the organization’s cost structure can ultimately free cash flow for reinvestment and position a retailer as an attractive buyer (by creating a platform for growth) or target (by increasing the company’s value).

Our analysis outlines four primary considerations organizations should consider when assessing whether to buy, sell, or expand margins to optimize their portfolio. After defining a variety of factors and paths, the outcome is clear — regardless of buy- or sell-side opportunities, retailers should continually be evaluating opportunities to streamline costs, generate capital, and drive sustainable profitability.

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Retailer position</th>
<th>Buy-Side opportunities</th>
<th>Sell-Side opportunities</th>
<th>Margin improvement</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product portfolio strategy</td>
<td>Overweight in a category / offering / format</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>Buying brands/ companies can be a fast and reliable option for companies wanting to diversify into different product offerings and/or markets</td>
</tr>
<tr>
<td></td>
<td>Broad or unfocused portfolio</td>
<td>Medium</td>
<td>High</td>
<td>High</td>
<td>Selling a non-core brand/business unit can create a more focused portfolio and provide additional capital to reinvest in the remainder of the business</td>
</tr>
<tr>
<td>Financial health</td>
<td>Low debt to EBITDA ratio</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
<td>A strong financial position enables a retailer to seek expansion/growth via inorganic means</td>
</tr>
<tr>
<td></td>
<td>High debt to EBITDA ratio</td>
<td>Low</td>
<td>High</td>
<td>High</td>
<td>Retailers may consider margin improvement or sale as attractive options to obtain/free up cash, vs. traditional means (e.g., debt financing)</td>
</tr>
<tr>
<td>Digital/eCommerce capabilities</td>
<td>Ability to invest and drive digital maturity</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>Acquiring an existing digital player, getting acquired to gain financial flexibility, and/or building digital capabilities in-house are all viable options for retailers looking to expand their digital capabilities</td>
</tr>
<tr>
<td></td>
<td>Limited investment ability and low digital maturity</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>Non-digitally focused retailers tend to focus on other priority initiatives to improve profitability (e.g., marketing campaigns, loyalty programs)</td>
</tr>
<tr>
<td>Brick &amp; mortar footprint</td>
<td>Subscale store footprint</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>Retailers can pursue footprint expansion by acquiring other retailers with stores capabilities in geographic markets where they do not currently play</td>
</tr>
<tr>
<td></td>
<td>Over extended store footprint</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>Retailers can consider rationalizing their brick &amp; mortar footprint to strengthen their cost structure and emphasize a more online presence</td>
</tr>
</tbody>
</table>
Tale of two retailers | A time to thrive vs. survive
Conclusion

**FUEL GROWTH TODAY:** Evaluate how your organization’s overall financial health is influencing its ability to fulfill long-term strategic priorities. Don’t wait for another “once in a lifetime” event to drive action – focus immediately on how to obtain the necessary capital to concentrate on fueling growth.

**DO SOMETHING:** Look beyond “survival” mode to take action. Perform portfolio analysis and assess value realization options to capitalize on current opportunities in the market driven by macroeconomic conditions.16

**MAINTAIN MARGIN TO REINVEST:** Focus on profitability and drive continual improvement to arrive at sustainable, competitive margins. Utilize increased cash flow and profitability to reinvest in opportunities to propel further growth through digital channels or store and fulfilment capabilities.

**CLOSE THE GAP ON DIGITAL:** Define a digital strategy with a forward-looking lens to assess if there are gaps in capabilities, and build / buy / partner to address gaps. Invest into digitalization and innovation, or risk losing share to competitors who have.

**SERVE THE WHOLE CUSTOMER:** Pursue opportunistic M&A or partnerships to advance and strengthen areas of differentiation. Leverage strategic M&A – divestitures included, to position for growth, fuel innovation, and double down on differentiation to serve the whole consumer – not just the retail part.
Endnotes

2. CapIQ data, top US Public Retailers >$1B in annual revenue
5. https://ycharts.com/indicators/us_5year_cd_rate
9. CapIQ data, top US Public Retailers >$1B in annual revenue
12. Yahoo Finance, Retail Dive (confidential retailer)
13. https://fred.stlouisfed.org/series/ECOMPCTSA#0
15. Gartner, Enterprise IT Spending for the Retail Market
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