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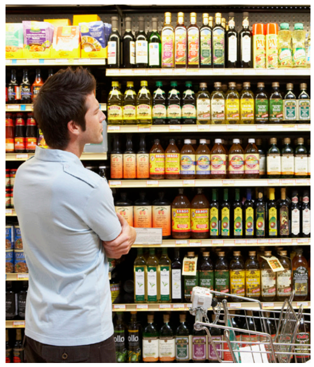

The next wave of M&A in US retail

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Consumers are not the only ones who open their wallets as the economy pulls itself out of a recession—corporate dealmakers also return from the sidelines to invest in M&A to drive growth, and there is good reason to believe the coming wave of M&A in retail will be bigger than the last. With far-reaching implications that could shift the overall industry structure and the competitive position of nearly all players—whether acquirers, targets, or bystanders—an understanding of this M&A trend should be top of mind for all retail executives. Are you ready?

An emerging wave of M&A

Each of the past three US economic recessions has been followed by a clear wave of M&A activity. In fact, as M&A has recovered after the past three recessions—in 1982, 1991, and 2001—year-over-year growth in the dollar volume of M&A has averaged 70 percent per year for three years, and similar patterns can be seen in M&A in the retail sector. Recent activity in the retail space clearly shows M&A activity picking up—the third quarter of 2010 saw the most active retail M&A market since the third quarter of 2008, before stock markets fell.[1] In the past month alone, Wal-Mart Stores bid for a stake in South Africa's Massmart, and Gymboree announced a $1.8 billion buyout bid from Bain Capital. Marketplace dynamics suggest conditions are right for recent activity to build into a significant wave of transactions over the next few years.

For one thing, firms are finding that traditional drivers of organic growth are not sufficient. Consumer spending is not what it was; one well-publicized effect of the recent downturn was a material increase in the consumer savings rate. It reached a low of about 1 percent in early 2008 but has ranged from 3 percent to 5 percent over the past year.[2] While consumers have recently started to open their wallets a bit more, most forecasts expect disposable-income growth, a key driver of consumer spending, to remain 50 percent to 60 percent lower than prerecession levels over the next five years. As such, retailers cannot count on consumer spending to drive overall growth as it has in the last decade.

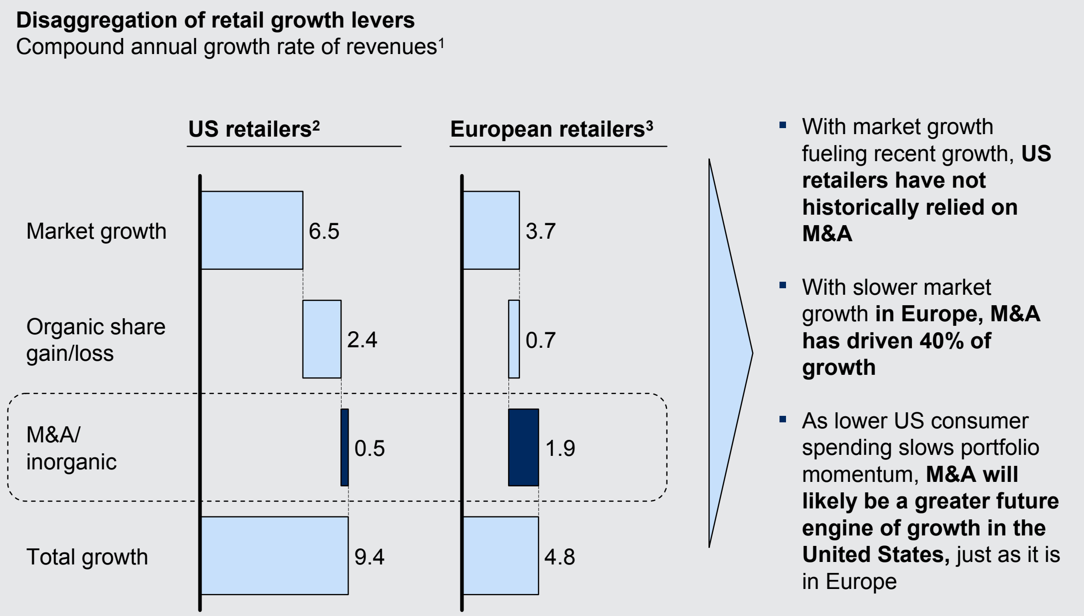
The ability of retailers to grow organically through store expansion is also becoming more and more limited. Over the past 25 years, the amount of formal retail space in the United States has grown four times faster than the overall population; today, the US market has 20 percent more retail space per capita than Canada and more than twice the space per capita of Australia, France, or Germany.[3] Not surprisingly, this apparent overbuilding has begun to catch up with the US retail industry. Most major retailers continue to project that new-store openings will remain well below prerecession levels. (Exhibit 1)

Another force at work is the greater financial wherewithal of potential acquirers. Many leading retailers currently find themselves cash-rich. At this point, the leading players in many retail subsectors collectively hold cash balances that surpass the total market value of all midsize retail players, and the top ten US retailers overall currently have almost $25 billion of cash on their balance sheets.[4] In addition, several retailers have considerable debt capacity to fund deals. Wal-Mart alone is estimated to have more than $10 billion of borrowing capacity before its leverage ratios would risk tipping it into a lower debt rating.

1 Thomson Reuters; Bloomberg.
2 Bureau of Economic Analysis.
3 MVI; John Wiley & Sons; International Council of Shopping Centers; press search; Burt P. Flickinger.
4 Compustat; McKinsey Corporate Performance Analysis Tool.

Exhibit 1

M&A is expected to become a more significant lever for delivering topline growth in US markets as organic growth levers soften



1 Time frame differs by company, based on availability of data, spanning 1999 to 2008.
2 Based on 21 large retailers.
3 Based on 12 large retailers.

Potential acquirers might also get a boost from attractive capital market conditions. Share prices are currently below historical valuations in eight of ten major retail subsectors. In several subsectors—apparel, office and electronics, discount/club, and drug—forward-looking valuations are 25 percent or more below 20-year averages.[5]

Finally, a private-equity "overhang" will likely boost M&A activity, with upward of $90 billion of buyout capital estimated to be committed to firms that have traditionally sought retail deals. After focusing inwardly on managing current portfolio companies through the downturn (and being constrained by extremely tight debt markets), private-equity players appear ready to start spending soon. Given the pressure that private-equity funds will increasingly feel to invest money that they have been slow to deploy in the past couple of years, we believe many funds will put capital to work in the near future, reinvigorating the deal pipeline.

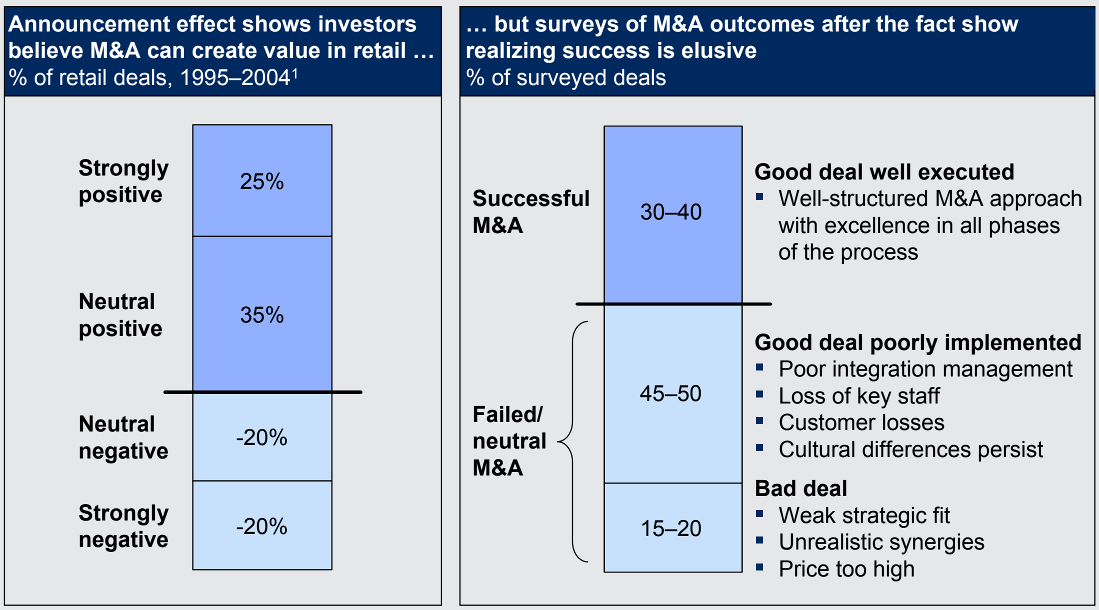
How retailers might ride the wave

Asserting that the market is headed for a new wave of deals, of course, is only helpful insofar as retailers know how to create value through M&A. An empirical study of retail M&A transactions in past decades produces two clear insights. First, the market is convinced that retailers can create value though M&A, as evidenced by 60 percent of transactions generating a positive announcement effect; second, only 30 percent to 40 percent of retailers believe that they have succeeded in ultimately capturing the value they expected when they announced the deal.[6] Through market research and our work advising clients on acquisitions, it has become clear that a combination of a sound investment thesis and effective execution are essential to creating lasting value through M&A (Exhibit 2). The remainder of this article shares our perspective on these two important topics.

5 Bloomberg.
6 Thomson Financial Securities Data; Bloomberg; Compustat; McKinsey research and analysis; the "announcement effect" is defined as the impact on the stock price of an acquirer versus a market benchmark on the day of the announcement.

Exhibit 2

M&A can create value in retail, but success requires combining the right strategy with strong execution



1 Based on announcement-effect analysis of 84 major deals from 1995 to 2004 involving publicly traded retailers with transaction value >$100 million; strongly positive = abnormal positive return >1 standard deviation.

Source: Thomson Financial Securities Data; Bloomberg; Compustat; McKinsey proprietary survey; team analysis

Investment theses of the coming M&A wave

While each deal has a unique strategic rationale, we see four plausible investment theses for M&A deals in the coming wave. Importantly, each of these general theses has a different set of value drivers, which must be accurately understood and quantified as part of due diligence and then captured during post-transaction integration. The following list is in descending order, starting with what we believe will be the most common thesis in this M&A wave:

Financial buyouts. Private-equity-backed deals generated the most transaction value in the last cycle—40 percent of the total. While returns are difficult to determine for individual private-equity deals, the continued presence of firms pursuing retail deals suggests returns have been compelling. Given the capital overhang in private equity, we believe these deals will continue to flourish in the near term—for example, see Bain Capital's recent $1.8 billion bid for children's clothing retailer Gymboree. Furthermore, private-equity firms will increasingly look to monetize current retail investments, which could catalyze other forms of deals as strategic buyers reenter the market.

As an example, earlier this year Apax Partners inked a deal to sell Tommy Hilfiger to Phillips-Van Heusen for about $3 billion. While private equity will maintain a prominent role in the retail M&A space, we think these transactions are unlikely to account for 40 percent of deal value over the longer term, as strategic buyers increasingly take advantage of market conditions to strengthen their positions.

International expansion. International retail M&A transactions represented 23 percent of total deal value in the last M&A wave, but they were the least compelling type of deal as judged by announcement effect (more than 60 percent produced a negative announcement effect). We believe this type of transaction will drive an increasing portion of deals as market growth in the United States becomes more difficult to deliver. Furthermore, we expect these deals will increasingly enhance value as retailers become more sophisticated in their international operations. Some will enter new markets by making an acquisition locally and building on that platform, while others may opt to enter a market by developing a few stores organically in the country and then expanding through acquisition when they are more comfortable operating in the market. Several companies have stated international growth plans that could include M&A—recent evidence includes Wal-Mart's bid for South Africa's Massmart, mentioned earlier, and Target's plan to open 200 stores in Canada.

Scope-of-business expansion. Just over 20 percent of deal value in the past cycle was generated from deals that expanded business scope, with about 50 percent of these deals generating a positive announcement effect. While integration of these deals is usually complex given disparate business models, their potential to open new profit pools results in significant upside when well executed. Although these deals are strategically important, we expect they will be smaller than other types, as many of them will be used to meet consumers' demand for "digital retail" experiences through new channels (for example, online or mobile) and product delivery models (such as the digital download of content). Wal-Mart's recent acquisition of Vudu, a distributor of digital video content, is an example of this type of transaction.

Domestic consolidation. While domestic consolidation was the least-common type of deal in the last M&A wave (18 percent of deal value), it was the most applauded by the market (almost 70 percent positive announcement effect), perhaps because of the inherent opportunity to drive both revenue and cost synergies. We believe current market dynamics support an opportunity for similar results in the coming wave—in particular, companies will be able to strategically combine and consolidate into a larger store "footprint" to benefit from joint operating skills and scale. However, we expect that this thesis will continue to be a small portion of overall deal volume given that considerable consolidation has already occurred in most sectors. Walgreens' $1.1 billion takeover of Duane Reade is a recent example of this type of deal.

Lessons learned on how to create value through M&A execution

So what does this impending wave of M&A mean for individual retailers? We believe that the implications will be meaningful regardless of a retailer's ingoing aspirations for M&A. To ride this wave successfully, retailers must pay close attention to five key lessons:

Define the role of M&A in the corporate strategy. First, retailers should have a plan in place detailing the ways in which M&A could support or challenge their existing strategy. This is an important step for all retailers and should include developing a perspective on how M&A is likely to change the competitive landscape and market dynamics. For those with acquisitive aspirations, it should also include an assessment of the role of M&A in executing corporate strategy. Firms that are more likely to be takeover targets should work to define and capture ways to maximize the value a takeover would generate for shareholders.

Key questions for a retailer in either position might include: How is M&A likely to change the subsectors in which we compete? How could a potential target benefit from our company's distinctive assets and capabilities, and what assets and capabilities could our company gain from a potential deal?

Develop an M&A thesis and related value drivers. For retailers that see M&A as a potential growth driver, it is important to identify a sound investment thesis to guide deal sourcing and evaluation. The important idea here is to determine the three to five levers that will drive value, and thereby justify any purchase premium, within that thesis. Such levers might include economies of scale or unique assets in supply chain or distribution (say, "fresh" supply chain in grocery, digital media distribution) or acquiring new formats to reach customer segments or shopping occasions not currently served (for instance, small box or urban stores, online capabilities). This step is crucial because it provides tight "guardrails" for deal sourcing and screening, and it helps filter out transactions that do not align with the company's M&A strategy.

Get the operations of M&A sourcing and screening right. Retailers should be proactive and develop deal teams and transaction playbooks ahead of any opportunity. Identifying and evaluating targets should not be a haphazard process; rather, companies should follow a tight and structured approach that balances a comprehensive risk assessment (that is, traditional due diligence) with a focus on the three to five priority value drivers identified earlier. This process should reveal "keystone" issues—the make-or-break sources of value that, if lacking, undo the deal rationale. For example, if a key reason to do a deal involves gaining new customers, the majority of analysis in the diligence phase should focus on understanding as much as possible about the target's customer pool and confirming that the pool is as valuable as it first appeared. This analysis should go beyond looking at the average customer to understand individual customer segments, trends in shopping behavior, how these customers view the potential acquirer, the size and strength of any loyalty programs, and so on.

Focus implementation on key value levers and rigorous performance management. Integration planning starts well before a deal closes—as the likelihood of a transaction increases so too should the rigor of integration planning. Again, firms should focus on the keystone value drivers and in that context look beyond traditional synergies (for example, economies of scale in sales, general, and administrative expenses) to levers such as cross-channel revenue opportunities, customer-life-cycle-management synergies, or even growth derived from moving up the value chain, as Wal-Mart did via its acquisition of Vudu. Preparation is crucial, and we recommend staffing integration teams with top performers from both sides of the newly combined company. Firms should plan to move quickly and pursue 70 percent, or "good enough," solutions as long as they can be 100 percent implemented. They should set aggressive targets and track operating, process, and financial metrics. Finally, acquirers must address cultural challenges head-on and deal with them by substantially investing in communications.

Play offense even if on defense. Even retailers that have no plans to pursue M&A will need to prepare for a changing environment. Bystanders should update their strategies to align with the new retail landscape. To prepare for the possibility of becoming a takeover target, management teams should identify the top two or three value-creation levers that an acquirer might latch on to, and they must determine actions that can be taken to maximize the value of these levers. To initiate this process, a company could perform internal due diligence to gain a perspective on how private-equity firms or strategic buyers might view the business.

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The retail M&A market is moving, and this movement will go a long way toward shaping who wins and who loses in tomorrow's retail marketplace. Have you thought through the implications for M&A on your subsector? Is your team clear on your company's current posture on M&A—are you a buyer, seller, or bystander? Are you ready to act—either offensively or defensively—as the M&A wave confronts you? And are you confident about how to identify and capture maximum value when you do act? These are questions all retailers should be asking, and we welcome the opportunity to engage in conversation and share our perspective.

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