

M&A Practice, Retail Practice

The next normal: Retail M&A and partnerships after COVID-19

Now is the time to think about retail M&A after the coronavirus crisis. Five trends could unlock opportunities for retailers, brands, and investors to shape the next normal.

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As a global pandemic, COVID-19 poses mind-boggling health and humanitarian challenges, and the economic impact on lives and livelihoods of the efforts to contain the virus is the strongest in a century.

Retail is one of the sectors most affected by COVID-19, in both positive and negative ways. Grocers, pharmacies, and e-commerce marketplaces are sustaining consumer access to essentials—food, medication, toiletries, and selected “at home” categories—while striving to protect customers, employees, and suppliers.

At the same time, store closures and sharp declines in discretionary consumer spending have crippled nonessential retail (other non-food, apparel, fashion, and luxury products). Many retailers have already had to make tough choices, including temporarily or permanently closing doors, furloughing employees, and more.

Despite this challenging environment, analyses of past crises have shown that there is still potential for value creation through M&A across industries; for further detail, please see the recent cross-industry article, “The power of through-cycle M&A.”

This article examines trends that are likely to create M&A and partnership opportunities that may enable retailers, brands, and investors to shape the next normal postcrisis.

Impact of COVID-19 on the retail sector

Across the globe, consumers plan to reduce short-term and mid-term spending, especially in nonessential categories. Consumer intent, of course, varies by individual economic situation and outlook. For more detail analysis of consumer sentiment, please see McKinsey’s global survey of consumer sentiment during the coronavirus crisis.

We expect the impact of the crisis on consumer behavior to create or accelerate five trends in the retail sector that will have lasting impact.

Shift to online and digital purchasing. As shelter-in-place orders proliferate and potentially extend, and consumer anxiety about infection persists, consumers across age groups have already shifted spend to online channels. The longer the crisis lasts, the greater the likelihood that online and omnichannel purchasing will become the next normal. While this shift is pronounced in grocery and other essential categories, the channel shift within apparel, fashion, and luxury (AF&L) brands and retailers has not come close to making up for the lost brick-and-mortar sales as our recent article on the impact of COVID-19 on the sector demonstrates.

Across both AF&L and food, drug, and mass-merchandise (FD&M) players, the shift in consumer spending to online will pose a question about the future—and purpose—of their brick-and-mortar locations. Driving unique in-store experiences will become even more critical than it has been to drive traffic, facilitate the omni-experience, and improve profitability.

Healthy, safe, and local. One of the biggest challenges facing retailers is the need to protect customers and employees from contracting or spreading COVID-19. Concerns about health and safety have never loomed larger for stakeholders across the value chain. The retailers with the highest degree of touchless automation, both in stores and in warehouses, may enjoy a clear competitive advantage, as they face lower risk to consumers, employees, and their overall operations. Increasing focus on improving health, paired with increased demand for fresh food could drive longer-term habits focused on healthy lifestyle and nutrition.

Shift to value for money. As in any economic downturn, a postcrisis downturn will probably lead consumers to demand value for money across retail sectors. This is already happening in essential categories, as private-label sales at grocers

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and pharmacies are increasing, and pricing and promotion strategies are emphasizing value. In the AF&L sector, recent analysis indicates bifurcation of the market with respect to price positioning.

Flexibility of labor. The COVID-19 crisis underscores the need for more flexible resource allocation that deploys labor across a broader range of activities. This could accelerate the move toward more agile and dynamic resourcing from stores to distribution centers to corporate offices. It could drive new models of collaboration between retailers and their stakeholders to address scarce capabilities and enable the labor pool to move more fluidly in order to meet demand across priority activities.

Loyalty shock. Scarcity of products has spurred trial of new brands, as customers trade up and down. In Asia and the United States, but less so in Europe, we have seen store and brand switching due to proximity, availability, ease of use, and safety considerations, creating opportunities for new habit creation. In the United States in particular, many consumers stated they have tried store or generic brands for the first time, with many saying they were satisfied with the product and would purchase again.

Retail M&A during and after the COVID-19 crisis

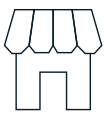

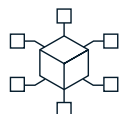

Before COVID-19, we observed four primary deal archetypes, though this sector did not see as much

deal activity as other sectors. Analysis of more than 900 global retail M&A deals over the last ten years suggested the following archetypes (Exhibit 1):

1. **like-for-like acquisitions**, that is, the purchase of direct competitor, who plays in the same categories and/or channels and serving similar consumers, with the goal of gaining scale and unlocking cost synergies
2. **category or channel expansion**, that is, buying into a new category or channel with the goal of improving growth exposure and/or broadening the product offering to the consumer
3. **new business models and/or adjacencies**, typically deployed in a bid to vertically integrate up or down the value chain with the purpose to increase scale and/or control in the supply chain to strengthen the specific value proposition of the retailer
4. **capabilities**, that is, targets that offer new platforms, tools or know-how and talent (typically back end, not consumer facing) to enhance value proposition and service to the end consumer

Historically, archetype 1 (in which the retailer or brand buys a like business, usually to gain scale or share) drove most of the deal value. However, since the 2008 recession, we have seen “new business model” acquisitions (archetype 3) gradually increase over time. Deals to acquire new channels

Analysis of +10 years of retail deals indicates four key M&A and partnership archetypes.

	 Retailer or brand buys a like business	 Retailer or brand buys into a different channel or extends up or down its value chain	 Retailer or brand buys new business models or adjacencies	 Retailer or brand buys a capability
Description	Acquirer and target have a similar business model, channel and category presence, offering and similar value proposition	Acquirer and target have different (and/or complementary) routes to market	Acquirer and target have different business models (eg, subscription) and/or occupy different parts of the value chain; area with the most growth in volume of deals	Acquirer buys a target that offers a new capability, typically not consumer-facing (eg, tech, software, artificial intelligence and/or advanced analytics)
Objective	<p>Food, drug, and mass: Typically a scale, geographic expansion or regional roll-up, where synergies are captured</p> <p>Apparel, fashion, and luxury: Gain further share in a category/ customer segment or extending into a new price point or geography</p>	Largely a network play to become omnichannel and capture growth in other channels; includes buying up or down-stream to secure its supply chain or distribution network	Transform or diversify the business, likely to get ahead of growth in adjacent segments or related businesses	Typically a 'learning' play, or to improve profitability by impacting commercial levers (eg, loyalty, payment) or supply chain (eg, "Last mile" or micro-fulfillment)
Example	Global grocer acquires global grocer to create one of the largest food retailers worldwide	Global multi-category eCommerce retailer acquires brick-and-mortar food retailer, expanding into fresh produce and brick-and-mortar for the first time	Regional drug store/ pharmacy chain acquires health insurance payor	Regional grocer acquires retail analytics company
% of total 2008–19 deal spend	65–75	10–15	10–15	5–10

Note: Archetypes are not mutually exclusive, i.e. companies may acquire a single target who delivers across more than one archetype.

or categories (archetype 2) and capabilities (archetype 4) have also increased, but not as aggressively. Analysis of the impact of total returns to shareholders (TRS) across deal archetypes finds shareholders responding most positively to archetypes 1 and 4. Across the more than 600 (non-AF&L) deals we surveyed, TRS for archetype 1 deals increased 2 percent, and TRS for archetype 4 deals increased 6 percent post-announcement. The other archetypes saw lower value creation, potentially

reflecting questions about the wide variance in P&L economics of the e-commerce channel and new business models.

Given changes in consumer spending across channels as well as persistent concerns about health and safety, and despite the weaker economic outlook, we expect retail M&A activity to accelerate as the crisis stabilizes. Consolidation of smaller players, acquisition of new business models, and

capability tuck-ins (such as archetypes 1, 3, and 4) are likely to increase as financially sound retailers and industry stakeholders uncover opportunities. Within this context, players have new license to rethink their M&A strategy.

Taking learnings from the last recession, retailers that can continue to make organic and inorganic investments through a down cycle typically outperform competitors over the long term. Companies that outperformed during the last recession participated in 10 percent more deals and in larger deals (approximately 1.8 times higher median) than companies that did not outperform.

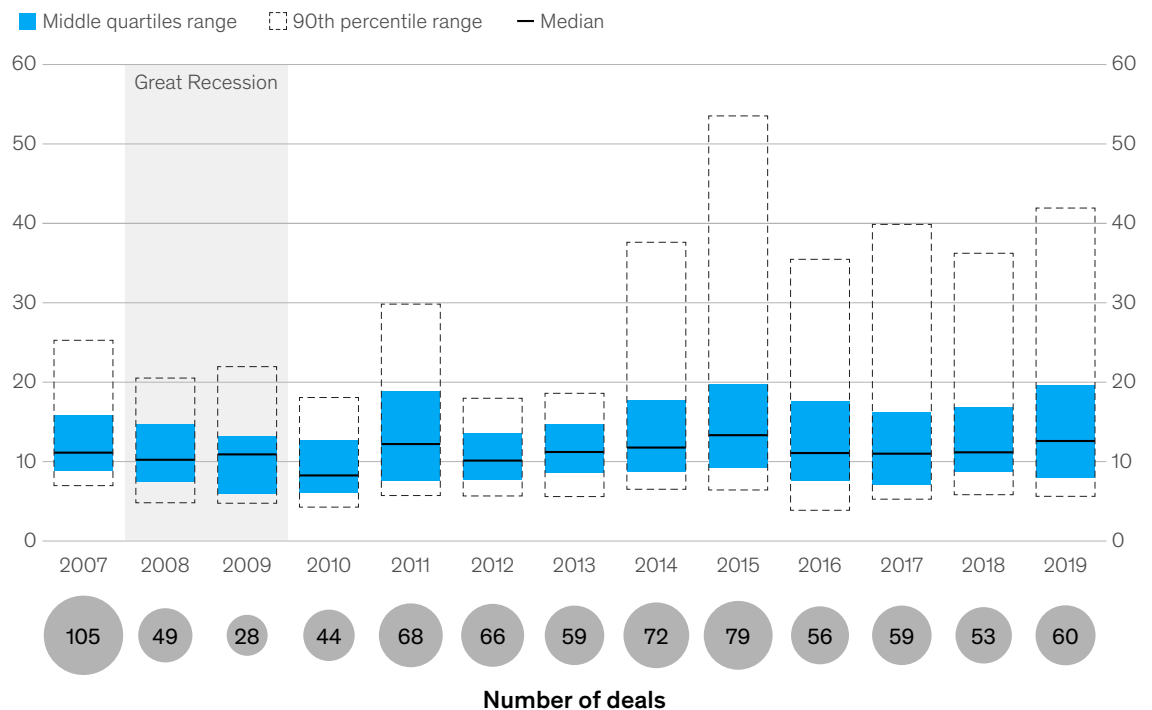
Analysis of the financial crisis in 2008 also indicates that companies that take M&A action early may also benefit from more favorable valuations at first (Exhibit 2).

In the new COVID-19 context not all retailers will be equipped to pursue M&A. The most likely are the leading ecosystems and larger FD&M companies with strong e-commerce positions that focus on essentials or well-performing brands, play in subsectors less affected by the crisis, and enjoy some combination of relatively low financial leverage, access to investment-grade debt, and a cash-heavy balance sheet.

Exhibit 2

Analysis of transaction multiples indicates deal volume and valuation falls and remains depressed following an economic crisis.

Enterprise-value-to-EBITDA¹ ratio for retail and apparel, fashion, and luxury M&A transactions²



¹Earnings before interest, taxes, depreciation, and amortization. ²Transactions announced as of April 9, 2020. Included industries: Apparel retail; Apparel, fashion, and luxury goods; Automotive retail; Computer and electronics retail; Department stores; Distributors; Drug retail; Food retail; Footwear; General merchandise Stores; Home improvement retail; Home furnishing retail; Hypermarkets and super centers; Internet and direct marketing Retail; Specialty stores; Textiles. n = 798. Source: Capital IQ

Smaller, more specialty players are less likely to flourish, as they are more often weakly capitalized and may lack the breadth and depth of e-commerce capabilities—or the financial muscle to build them—required to profit in the short to medium term from shifts in consumer spending. These players may become targets for more resilient competitors.

Private equity (PE) may also play a key role in accelerating M&A activity postcrisis. At the beginning of 2020, the global private-equity industry had an estimated \$1.5 trillion in dry powder,¹ and it likely will be key player in the overall retail M&A landscape.

Implications for food, drug, and mass-merchandise players

Because FD&M retailers are deemed essential in most markets, they have both obligations and often advantages during the COVID-19 crisis. They have a social imperative to improve their productivity to meet broad humanitarian needs, and they are currently some of the few retailers taking in cash, while also seeing firsthand the shifts in consumer behavior, spending patterns, and channel preferences.

We expect FD&M deal or collaboration activity to increase across all archetypes, but especially new business models and adjacencies (archetype 3) and capabilities (archetype 4).

Roll-ups of smaller regional or independent FD&M players (archetype 1) may accelerate in 2021, as these retailers face sustained sales declines driven by consumers shifting to alternative channels or players with stronger omnichannel offerings. This may create opportunities for the largest retailers to expand their geographic reach and generate back-end synergies. It is less likely this will occur in the short term as nearly all grocers have seen a spike in sales that is expected to persist through the end of 2020; potential sales declines driven by pantry unloading may not occur until 2021 depending on how long COVID-19 crisis lasts. In the short term, this roll-up may manifest as purchase of assets, particularly well-priced prime retail locations.

Acquisitions to expand into new categories or channels (archetype 2) may be smart plays for FD&M retailers, especially as they prepare for the next normal postcrisis and face lower in-store traffic. Broadening category footprint, that is, moving into complementary categories, could enhance players' value propositions and increase in-store traffic. Other opportunities in food service may also materialize, as some food service players (for example, quick-service-restaurant players) face financial difficulties. However, this expansion will be tempered by a need to simplify and strengthen supply chains; perhaps only where acquisitions are natural extensions of existing assortment and does not inhibit the agility of the supply chain.

Traditional FD&M and pure-play e-commerce players may move opportunistically into adjacencies (archetype 3) to integrate vertically and strengthen their route to market. Attractive options may include delivery services to capitalize on the anticipated stickiness of e-commerce and omnichannel buying and vertical integration of suppliers to guarantee availability and control over strategic categories. Other downstream opportunities in food service may materialize as some players face financial pressures.

FD&M players may double down on the acquisition of digital capabilities, platforms, and other value-adding bolt-ons (archetype 4) to enhance and transform existing operations quickly, given the relatively strong performance and persistent demonstration of touchless use cases. These deals will capitalize on evolving technology, secure scarce capabilities, and meet postcrisis service needs. For example, we expect that FD&M retailers will increasingly look to invest in automation technology (for both in store and back end), analytical tools and capabilities, e-commerce platform-management opportunities, and last-mile technology tools to pull forward digital transformation. This could also manifest via collaborations with logistics providers.

¹Anne Sraders, "Private equity firms are sitting on \$1.5 trillion in unspent cash, and looking to raise more," Fortune, January 25, 2020, fortune.com.

Implications for AF&L players

The past five years have favored a few AF&L success stories and left a long tail of lower-performing companies. Most AF&L companies (62 percent) saw negative TRS (versus 21 percent of the S&P 500), and only 15 percent of AF&L companies achieved TRS greater than 10 percent (versus 46 percent of the S&P 500).

Today, several AF&L categories (for example, footwear, apparel, and jewelry) are some of the retail categories hardest hit by the crisis. We expect AF&L M&A and partnerships could evolve in three ways postcrisis, accelerating some of the trends described in our latest State of Fashion outlook beyond COVID-19.

Purchases of brands or retailers (archetype 1). Strategic acquirers and PE investors may look to revitalize or own and license longstanding brands that become distressed but are believed to retain strong brand value. Strong brands that acquirers can leverage to build out unique business models may be especially attractive targets. As with FD&M, in the short term, some of this could manifest as asset sales, particularly as challenged brands and retailers look for injections of cash.

Further consolidation into existing or new “brand houses” (archetype 1). Relatively cash-safe AF&L players and PE or other private investors may look to combine multiple brands in a portfolio and give them creative autonomy, while realizing cost benefits from jointly negotiated rents, wholesaler terms, and back-office cost synergies.

Partnership with small players (archetypes 2–4) **and platform and marketplace consolidation.** The combination of an expected downturn and below-expectation performance in recent deals to exit direct-to-consumer (DTC) brands (for example, Casper IPO) could lead to more cautious funding of AF&L-focused DTC players, at least in the short term. This may open the door for strategic purchases of high-growth-oriented brands and retailers that have the digitally focused operations

and consumer bases required for growth. Brands and multibrand players could also look to take smaller platforms in house to enhance consumer reach and digital capability. Overall, we expect the crisis to lead to further consolidation of marketplaces and platforms.

Next steps for retailers

COVID-19 and the onset of an economic slowdown may well reshape the landscape of retail deals and partnerships. We encourage retailers to take four steps now as they contemplate M&A and partnerships going forward, grounded in the three C's of excellent M&A strategists (competitive advantage, capacity, and conviction).

Define the next normal—and your competitive advantage. The first step to redefining M&A and partnership strategy is to understand what the next normal means for each brand and retailer. The new reality will depend largely on how core consumer segments, including behaviors and spending habits, have been impacted by COVID-19. Where are the growth spaces today and where will they be in the future? Where are consumers spending money—which categories and/or channels? How have their tastes, preferences, or concerns changed, driving new opportunities for differentiation or shaping new habits? In this context, how have previous competitive advantages changed and what new advantages have emerged? Identifying the opportunities for growth in the next normal—and which areas can be accelerated via partnerships and M&A—will be the first step to reshaping M&A strategy.

Assess capacity to execute acquisitions and partnerships. A realistic assessment of balance-sheet strength and ability to make acquisitions independently (that is, while debt markets are slowed or frozen), as well as ability to secure financing in the postcrisis environment, will be a key input to evolving M&A strategy. Understanding

what targets (and what size targets) are feasible to acquire now versus later should inform how areas of exploration are prioritized. For players with limited cash availability or challenging financial health, partnerships with other players to pool financial resources while addressing strategic priorities could be considered (for example, sourcing collaborations).

Build conviction through identification of key areas of exploration within the M&A and partnership market and think through value creation up front.

Retailers should generate data-backed perspectives about market trajectory, new-normal scenarios postcrisis, and the risks of further disruption. Shortlisting top-priority areas and securing executive and board commitment to M&A will accelerate decision making as markets thaw and potential targets are discovered. In the post-COVID-19 tight credit market, we expect that synergy capture expectations, and track record, will matter to investors, which makes it even more important to think through synergy ambitions and value-capture plans up front. We also envision that a potential economic crisis will make it more important to carefully think through how a deal can help to sharpen and/or reposition the joint entity's value proposition(s) to better service customers' needs.

Explore opportunities to strike new deals and partner with healthier players. Players without the cash and financial health to pursue acquisitions should identify potential assets to liquidate or potential partnerships to shore up the balance sheet until the crisis passes. The implications of COVID-19 are just as high for potential sellers as they are for potential acquirers.

The retail sector cannot escape the economic impact of COVID-19. But, despite the difficult economic outlook, we expect retail M&A activity to accelerate as the crisis stabilizes, creating opportunities for financially sound players to acquire or partner with less advantaged players. Now is the time for retailers to think about M&A postcrisis. This calls for defining their role in the next normal, reevaluating financial health, segmenting the M&A market, and contemplating new deals and partnerships.

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