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WEBINAR Briefing

Consumer Behavior and the Retail Market

From the Privcap webinar:
"The PE Opportunity in Consumer and Retail"

Richard Leonard
Angelo, Gordon & Co.

Tricia Patrick
Bain Capital

The PE Opportunity in Consumer and Retail

E-commerce, social media, and the Internet in general have infringed on ways that consumers buy goods and even food. Richard Leonard of Angelo, Gordon & Co. and Tricia Patrick of Bain Capital compare notes on how they've changed their investment and operational strategies in consumer and retail businesses.

The Panelists

Richard Leonard
Managing Director,
Angelo, Gordon & Co.

Tricia Patrick
Principal,
Bain Capital

→ BIO

Leonard joined Angelo, Gordon as a member of the firm's private equity and special-situations area. Previously he was a managing director at Bruckmann, Rosser, Sherrill & Co. and began his PE career at J.W. Childs Associates and Audax Group. Leonard also was a financial analyst and associate at Dillon, Read & Company. He received an A.B. degree from Harvard University.

→ BIO

Patrick joined Bain Capital in 2004, and she is one of the senior leaders of the firm's North American private equity consumer, retail, and restaurant business. Previously she worked in the private equity group at Goldman Sachs & Co. She received an MBA from Harvard Business School and an A.B. from Harvard College.

David Snow, Privcap: Tricia, can you paint a picture of the pace of change that is happening right now in the consumer and retail market and how this compares to an earlier market cycle?

Tricia Patrick, Bain Capital:
E-commerce and Web-enabled commerce has seen a massive shift in the last 10 years.

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Macy's was 100 years old before it hit $1B in sales. Wal-Mart was 35 years old. And once Wal-Mart hit that billion in sales, they took off from there. But Amazon was able to build a business that was $1B in sales in just five years.

We tend to make five-year investments. Of course they're not all five years—they're as short as three years, sometimes as long as eight or 10 years. But given the amount of dynamic change, an Amazon can come into existence within your investment period. You need to be incredibly cognizant of what could come and what dynamic changes can lie ahead when you're investing in retail today.

Richard, do you agree? Can you talk about the pace of change and what's notable in today's market?

Richard Leonard, Angelo, Gordon: I completely agree that the pace of change is at a faster tempo than it has been historically. There's the old saying, the more things change, the more they stay the same. So we never historically could stand still, and it really is a question of using different tools to stay in touch with our consumers.

And as investors, we've looked at a lot of the traditional hard-line and soft-line retailers as a very challenging space—mostly because of the disintermediation from the Internet. And as a result, we've focused more on food. Our restaurant and supermarket investments are really a defensive position, because those are experiences that are harder to get on the Internet.

Patrick: There are still really interesting places to invest, but picking your spots is what we need to do every day in this market. E-commerce is not just a channel shift. It changes price transparency. It enables a longer tail of retailers to get to market, which makes for interesting investments. And then it enables consumer engagement. If you can use the Web as a tool to engage new customers, you might have the ability to grow a brand, for instance.

We've invested in two brands in the last year: Canada Goose, a luxury outerwear business, and Toms Shoes, the pioneer of the one-for-one model. In both of those cases, we think there's opportunity to use the Web to reach more customers more quickly.

Is there a sector or a type of business that has shown vulnerability to disruption recently where that sector, even recently, was viewed as being relatively safe or stable?

"We definitely do a lot of store visits. And my colleagues will tell you that visiting 100 restaurants in a chain in a span of a few weeks is a challenge.... You definitely see the dark underbelly of the good things they're doing. And invariably there are things that don't work."

–Richard Leonard, Angelo, Gordon & Co.

Leonard: I don't know if anyone would say that mall-based specialty retail was historically viewed as safe and stable, but it's become a lot more challenging. People talk about the demise of the mall, and that is probably an exaggerated narrative, because malls will continue to be important and powerful retail centers. But there won't be a lot more of them built, and those in marginal markets will have increased vacancy rates. So what does that mean if you're investing in a business where you're counting on unit growth? It's more challenging to say that you're going to do that if it's going to require opening hundreds of small-footprint specialty retail [locations].

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I would love to hear about the state of the consumer market in the United States. What's your macro overview?

Patrick: We focus a lot on consumer segments because all consumers are not created equal in the U.S. Not everybody has the same spending power.

Sixty percent of Americans are still worse off today than they were before the recession in 2007. On the other end of the spectrum, luxury consumers—more driven by the state of the financial markets rather than the state of gas prices or employment levels—have been really strong. So when we look at any given business, we're spending a lot of time figuring out who we're selling to.

We certainly still believe value is an important reality for most U.S. consumers after living through the last recession. And you can see that in our investment in Bob's Discount Furniture, which is growing quickly precisely because it provides that value to consumers.

Leonard: Our portfolio very much mirrors that approach. At the moment, our two grocery store brands—Kings Food Markets and Balducci's—are focused on the high-end prepared foods. That really appeals to the consumer who has disposable income to spend, either entertaining their friends, or they want to have a family dinner but they don't have the time to sit down and prepare a chicken or what have you.

On the other side of the spectrum, we have an investment in Benihana, a well-known Japanese restaurant chain. And in that demographic, we actually skew a little bit lower in terms of income, and it's more of a special-occasion restaurant. And you really have to recognize who you're targeting and where you're trying to grow, because the most important decisions that we make are where are we going to build the next 10 restaurants? And we have a tremendous amount of data that we try to use to make those bets properly.

People are not out there spending the way they were before the recession. They're being a little bit more conservative, deleveraging. They're not accessing home equity lines to go out and buy expensive toys the way that they were. So things are better, but not great.

What are some of the most important items of due diligence that you have to get right before you invest in a consumer-facing or retail company?

Leonard: I would separate that into two broad categories. One is a company where things are really humming, and you're presumably going to pay a high multiple for a high-performing company, and the growth is going to come. The other is a fixer-upper. They have different challenges and different questions.

With a fixer-upper, you have to focus on the core bedrock, and as we try to change this thing and fix it up, let's make sure we don't throw the baby out with the bathwater. And that applies to the high-growth situation, but it's probably more critical in the fixer-upper. In high-growth businesses, you're trying to improve and build infrastructure, but you're probably not going to monkey with the basic nuts and bolts of the business too much. In the fixer-upper, you know that you have to change something fundamental. And when you do that, you're making a pretty big bet, and you just want to make sure that you're not pulling the wrong lever. So you do a lot of work up front, talking to consumers to make sure that you don't make

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changes that are going to scare away the only thing that's keeping the company afloat.

On the high-growth side, we are certainly focused on consumer research and understanding net-promoting scores. That's probably the most important piece of research that we do.

Patrick: Consumer research is important no matter what type of investment we're making. And in the world of retail, just walking the stores, seeing what consumers do in their real environment, seeing how engaged they are, is massively important. And we do that on every deal we get serious about.

We also spend a lot of time trying to get to know management. A team that knows their business, believes in their brand, and is able to execute every day is incredibly important. We don't run businesses; we partner with management teams.

In the Canada Goose research, we went in thinking this brand should stand for something differentiated. It is the warmest jacket. People wear it on Arctic expedition trips. The consumer research really held that up.

Leonard: We definitely do a lot of store visits. And my colleagues will tell you that visiting 100 restaurants in a chain in a span of a few weeks is a challenge. And when you go in, you're actually ordering off the menu. And you can gain 10 pounds in one diligence trip, as grim as that is. You definitely see the dark underbelly of the good things they're doing. And invariably there are things that don't work.

To what extent can a private equity firm tap into a social media or a similar campaign to revive a tired brand, or bring a brand or a product or service to a new set of consumers?

Leonard: We certainly used it at Benihana. It's both people signing up for our email program where they opt in, but it's also through other social media, which are more of a pull than a push. Any company that is successful today has to have that. Benihana is 50 years old, but we've been very effective in generating interest on social media and in the mainstream media around our passport club or our birthday club, and not too many days go by before you see we're in the press. And the difference being, in mainstream press, you put it out there and it goes out there once. But with the social media, it can echo and you can get people talking about a topic for weeks as opposed to days.

Patrick: Social media, done well, can be a really interesting tool in your marketing toolkit. Where you're pushing to consumers and engaging with them and telling them how to think about your brand in an authentic way. But it also should just be a place where you listen to your consumers. You can listen to what people think is going right or wrong with your brand or your products or your most recent product launch.

Leonard: We also use it as a way to follow up on customer complaints, whether it's somebody who had a bad experience that we can rectify, or it's someone where there's something fishy about the complaint. And so you follow up on it, and if you can prove that it is not legitimate, then you can take it down.

Patrick: At Bob's Discount Furniture, we focus on the Web presence to see where people might have had a bad experience, and then find that consumer and try and fix it. But it's always hard to get great consumer data, and we certainly track net promoter scores at our companies and try and figure out if they're improving over time or not. But there's always selection bias in whoever you're getting to fill out that phone survey or Web survey or calling the number on the bottom of their receipt. ■