Numerator

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Accounting for Consumers in M&A Decisions

ACCOUNTING FOR CONSUMERS IN M&A DECISIONS

As investors navigate a series of tumultuous world events, M&A activity in the consumer space has slowed (-16% in volume, -32% in value in 2022)[1]. Investors are becoming more choiceful, and the underlying drivers of demand side performance are becoming increasingly important to understand the sustainability and growth potential of an acquisition.

While traditional data sources can offer helpful information about the revenue trajectory of a brand, sales trends and other traditional KPIs can be misleading in the absence of the underlying context and health of a brand's consumer.

In our latest perspective, Numerator emphasizes the significance of robust, first-party consumer data in assisting consumer goods companies and investment firms during the deal sourcing stage and due diligence.

1. CONSIDERATIONS IN DEAL SOURCING FOR CONSUMER PRODUCTS
2. THREE CONSUMER PRINCIPLES TO BRAND DUE DILIGENCE
3. CONSOLIDATING INSIGHTS TO MAKE THE RIGHT INVESTMENT

Source: Numerator
[1]pwc Global M&A Trends in Consumer Markets: 2023 Outlook

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1 CONSIDERATIONS IN DEAL SOURCING FOR CONSUMER PRODUCTS

Understanding the consumer universe is a crucial first step for large portfolio companies and buy-side firms to establish an effective strategy for growth and value creation, even before identifying specific targets. An effective consumer-driven strategy requires understanding the headwinds and tailwinds created by changing consumer habits.

LIFESTYLE FLUX BRINGS EMERGING TRENDS

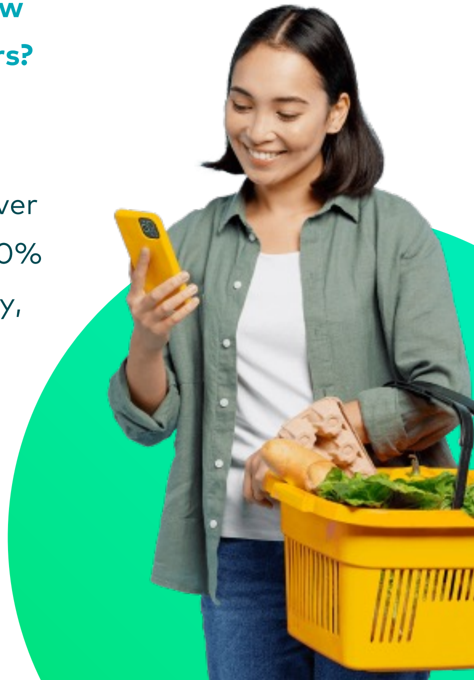
Identifying trends begins by recognizing moments of lifestyle and population flux, which, though initially small, can escalate into significant behavioral shifts in consumer preferences.

For instance, consider the recent adoption of GLP-1 medication to support weight loss. A seemingly innocuous medication initially used for type-2 diabetes has now shaken up how consumers approach health & wellness, and investors are keen to understand what the long-term implications are for various food categories.

The implications for GLP-1 usage are substantial for some brands should adoption grow. Numerator research suggests packaged foods and alcohol beverages are more at risk to potential volume reduction among GLP-1 weight loss users, while categories like nutrition bars are likely to see increases in purchasing.

When new innovations tangibly influence consumer lifestyles, investors and strategy teams should ask themselves: **"What new opportunities have arisen that will grow in the next 5 to 10 years? Where are there new gaps in our existing portfolio?"**

Furthermore, anticipating changes in the population makeup over the next decade is essential. With the US census revealing an 80% and 104% growth in Hispanic and Asian households, respectively, since 2000, leaders should keep in mind the impact of ethnic lifestyles across acculturation levels on the categories they purchase to ensure future-proofing.



Source: Numerator

THE OMNICHANNEL IMPERATIVE FOR TREND DISCOVERY

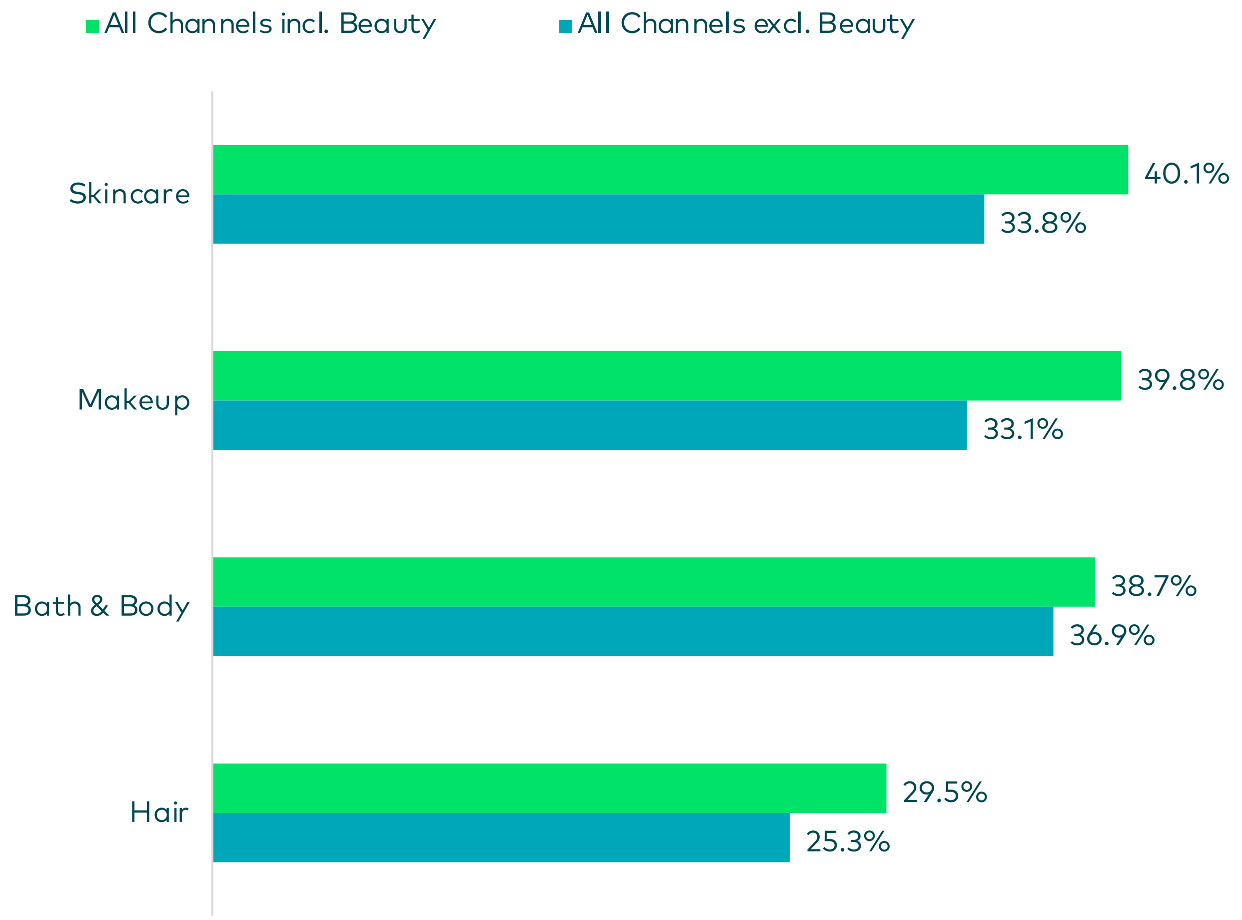
Another important consideration when looking for trends is that the data supporting it must be holistic and robust. By adopting an omnichannel view into consumer purchasing, investors and strategy teams can be confident in identifying investment opportunities across sectors.

The beauty industry serves as a prime example. Over the past three years, beauty faced one of its largest declines due to COVID-19. Anticipated headwinds for categories such as makeup and skincare due to reduced beauty occasions have been proven to be temporary, with both categories now exhibiting faster growth than hair and bath & body products in 2023– *but this is only true if the beauty channel is included.*

The beauty channel, **contributing over $1.5 billion of growth** separately to makeup and skincare, has propelled both categories to exceed their absolute dollar values from 2019, with a 26% increase for makeup and a notable 56% increase for skincare. Investors need to ask whether their data sources cover the wide array of retailers consumers shop at to capture the full picture.

PERCENT VALUE ($USD) CHANGE VS YEAR AGO

Latest 52 Weeks Ending Q2'2023

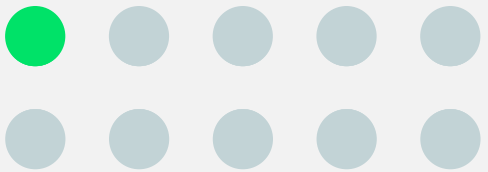


Source: Numerator

12,000
emerging brands

yet only

1 in 10
grow sales consistently



ADD CONSUMER PERFORMANCE MEASURES FOR EMERGING BRANDS

Gaining insight into emerging categories and brands from a consumer perspective is indispensable. Simply put, validation is possible only for what is visible. While a brand's corporate financials may provide an overview of business health, they fall short in breaking down the drivers of growth and the retailers contributing to its success.

When we expanded our US panel to 150,000 static households, we unlocked a 47% increased visibility of brand performance at more retailers to surface the impact of new and niche brands at more stores. This expansion led to the identification of over 12,000 emerging brands[1], revealing that **only 1 in 10 emerging brands demonstrated consistent growth over a four-year period.** Diagnosing *why* consumers are not driving growth consistently is important to determine stability.

As mentioned earlier, omnichannel visibility is crucial for understanding category trends accurately. This requirement is equally applicable when pinpointing target brands. Among emerging brands displaying consistent growth over four years, they were 46% more likely to have achieved consistent penetration gains through non-traditional channels[2].

Source: Numerator
[1]Brands with total sales less than $100m and not owned by a manufacturer worth over $100m
[2]Non-traditional defined as all channels excluding Food, Mass and Drug.

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2 THREE CONSUMER PRINCIPLES TO BRAND DUE DILIGENCE

Establishing a foundation for understanding consumer interactions with the target acquisition unveils a pathway to growth and aids in shaping an understanding of the potential valuation. To navigate this intricate landscape successfully, investors and business leaders should focus on three fundamental principles:

- **Brand Net Value**
- **Brand Strength**
- **Brand Future**

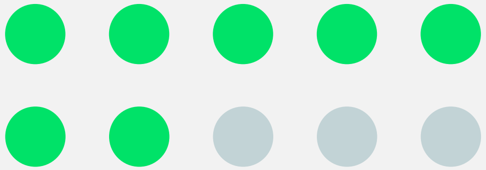
By adopting this framework, teams can effectively determine whether the brand they acquire possesses the incrementality, equity and longevity required to drive long-term value creation.

Source: Numerator

Among the top 100
fastest growing CPG brands in 2023

↓

7 in 10
dollars of brand growth were incremental to the category



Source: Numerator

BRAND NET VALUE

Before you invest in a brand, knowing how it interacts with your portfolio and the category is a crucial step in driving value creation.

If the brand's volume primarily comes from within your existing portfolio, there is a risk of cannibalization and reduced topline portfolio growth. However, not all cross interaction is detrimental. If cross purchasing within your portfolio contributes to premiumization, the benefits of such interaction could outweigh detractors, especially if premiumization aligns with the brand's value proposition. However, the net value to your portfolio may only be the value of the difference in price, not any sales from the new brand.

Ensuring a comprehensive view of a consumer's purchase journey across brands is essential to guarantee an incremental investment.

However, understanding cross brand interaction is just one part of the incrementality equation. Category growth is also important as brands that provide little absolute growth to the category and sources from other brands could create strong headwinds in crafting future sales propositions in driving distribution at retailers.

Among the top 100 fastest-growing CPG brands in 2023, 7 in 10 dollars of brand growth originated from either new category shoppers or existing shoppers spending more in the category. The remaining 3 in 10 were sourced from other brands.

Conducting thorough analyses of the sources of a brand's volume, along with those of its competitors, can determine whether the brand is truly bringing net new value to the table.

BRAND STRENGTH

Loyalty to a brand can come in many forms, and it is quantified through several methods. Each method helps capture specific aspects of brand health and by knowing how to drive them, investors and strategy teams can know how to generate long-term value from each consumer.

Consider the following measures to track:

1. **Consumer sentiment** to understand perception of the brand value and fit with the investment thesis.
2. **Consecutive repeat rate** to determine overall brand health and retention.
3. **Customer lifetime value** to quantify and budget marketing programs focused on acquisition and retention.

Source: Numerator

Consumer sentiment is crucial in determining a brand's overall strength in relation to competitors. Measures such as brand perceptions and purchase intent are heavily relied on to understand brand equity strengths and vulnerabilities.

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Numerator research found it is imperative to capture sentiments from all purchase-verified buyers to ensure the most accurate and precise representation of your brand.

When we asked about repurchasing a fast-growing energy drink brand through our purchase-verified sample compared to a traditional survey sample, the differences were stark.

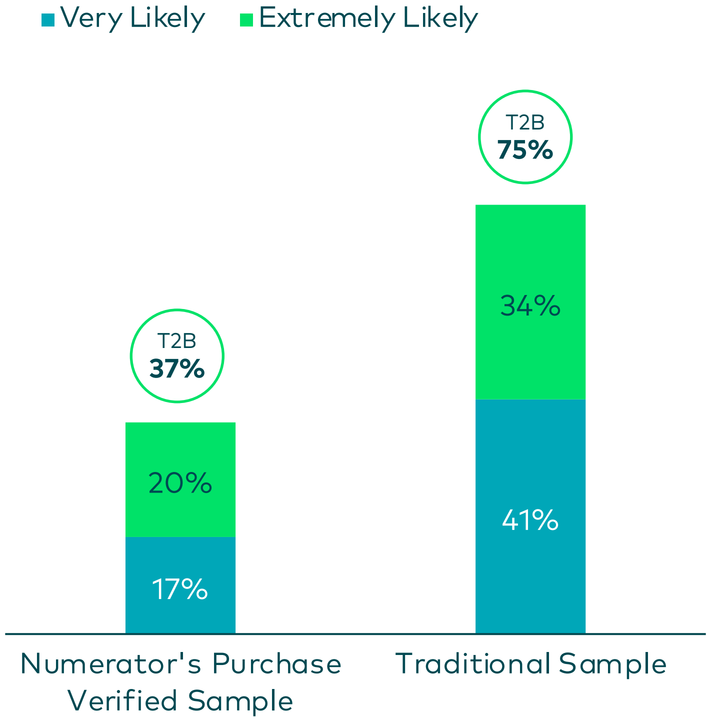
The positive response in likelihood to purchase was a nearly 40-percentage point difference between traditional and verified buyers.

Responses from a traditional survey sample may be inflated due to its composition of both actual buyers and individuals who claim they made a purchase but did not. These biases are negated with a purchase-verified sample, which includes less-engaged buyers who recall their purchases when prompted with a receipt. In traditional surveys, these less-engaged buyers are often classified as non-buyers.

As investors and strategy teams become more reserved with what they invest in, buyer's remorse can be prevented by using a purchase-verified sample that captures how consumers feel toward a brand.

LIKELIHOOD TO PURCHASE

Energy Drink Brand | October 2023



Source: Numerator

Consecutive repeat is the gold standard in measuring brand strength through purchase-based behavior. Consecutive repeat rate is the rate at which consumers are repurchasing a brand at their next immediate category purchase, whereas traditional repeat rate is defined by a repurchase regardless of when it is made.

In our recent whitepaper, we shared two primary reasons why consecutive repeat rates are important to track:

1. Consecutive repeat rate is a stronger leading indicator of market share performance.
2. Loyalty is better defined through consecutive repeat rate.

Additionally, with data capable of stringing together consumer journeys on a trip-by-trip basis, investors and strategy teams gain valuable insights into direct competition for their target. This information empowers leaders to formulate the right strategies to gain market share and drive sales growth effectively.

Source: Numerator

Customer lifetime value (CLV) is a modern measure that calculates a quantifiable value for the financial relationship between a business and a customer by measuring the entire revenue that a customer will likely spend on a business or product over a designated period of time.

Knowing that a consumer spends $300 for three years on your brand can help determine how much to spend to maintain that relationship.

Beyond loyalty to a specific brand, CLV can also measure engagement across a category–does your customer also buy coffee at other retailers–and assess how their coffee-purchase behavior changes over time. Understanding a brand's CLV can help determine what strategy will look like going forward in terms of what product offerings are needed through the journey and opportunities for future cross-sell.

In recent M&A activity, a large CPG manufacturer in the beauty space announced a divestiture of one of their brands to a private equity firm. In diagnosing potential reasons for the brand's disposal, we learned brand penetration was in decline during its time with the CPG manufacturer.

However, our CLV analysis showed that the brand offered a 5.8x return on newly acquired customers in a three-year timeframe compared to single-year households.

This high level of return suggests the brand's ability to drive spend and cross-sell across the categories they play in.

For the new owners, the potential infusion of investments to stimulate penetration growth within reason could lead to a substantial increase in profitable sales, especially if they continue acquiring new customers for years to come.

Source: Numerator

Source: Numerator

BRAND FUTURE

The top brands we see today may not be the top brands of tomorrow. Brand acquisitions, in many cases, occur to build up proper funding and capital to transform the brand's existing base into a platform of new products and messaging to excite growth within just a few years.

But how can you envision what the *realistic* headroom is for the brand? And more importantly, what could the future look like for the brand?

While each brand requires a unique approach to understanding its growth trajectory, three constants should be explored:

1. **Penetration feasibility** to validate brand valuations against realistic household growth targets.
2. **Demographic fit** to understand if existing branding fits within expected population development.
3. **Promotional effectiveness** to estimate trade costs and diagnose base sales health.

Penetration feasibility is a cornerstone in setting up a potential acquisition for success–particularly for fast-growing emerging brands. While many brands claim valuations several multiples off its current worth based on theoretical conditions, few brands share how consumers will follow suit.

A CPG manufacturer in the health space reached out to Numerator to validate whether a target could reach $1B quoted by the brand over a set timeframe. What Numerator found was that for the brand to reach the estimated revenue, **the manufacturer would need to continue the brand's share growth and triple US household penetration– the amount equal to nearly 4.5 times the number of households in New York City– while also maintaining its currently high buy rate.** Only one brand had managed to grow penetration within the CPG health space at that rate since 2017, and the penetration growth was driven by demand during the COVID-19 lockdown. The question Numerator brought forward to the manufacturer was, "Are you prepared to make the necessary investments to acquire that many new consumers?"

Being able to ground aggressive valuations against what has been seen can help investors determine if they have enough (and are willing) to invest the amount of resources required to grow a brand. Key questions to ask as you go through feasibility exercises:

- "Would investments into existing marketing activations and expanded distribution be enough?"
- "What expansion into adjacent categories would be required to reach these penetration targets?"
- "Would investments in large scale innovations & transformations give me enough return to be profitable?"

Source: Numerator

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Demographic fit is a core element in determining a brand's runway for long-term growth. Breaking down a brand by its demographic base and aligning it to larger macrotrends and category trends can determine if there are affinity gaps to close.

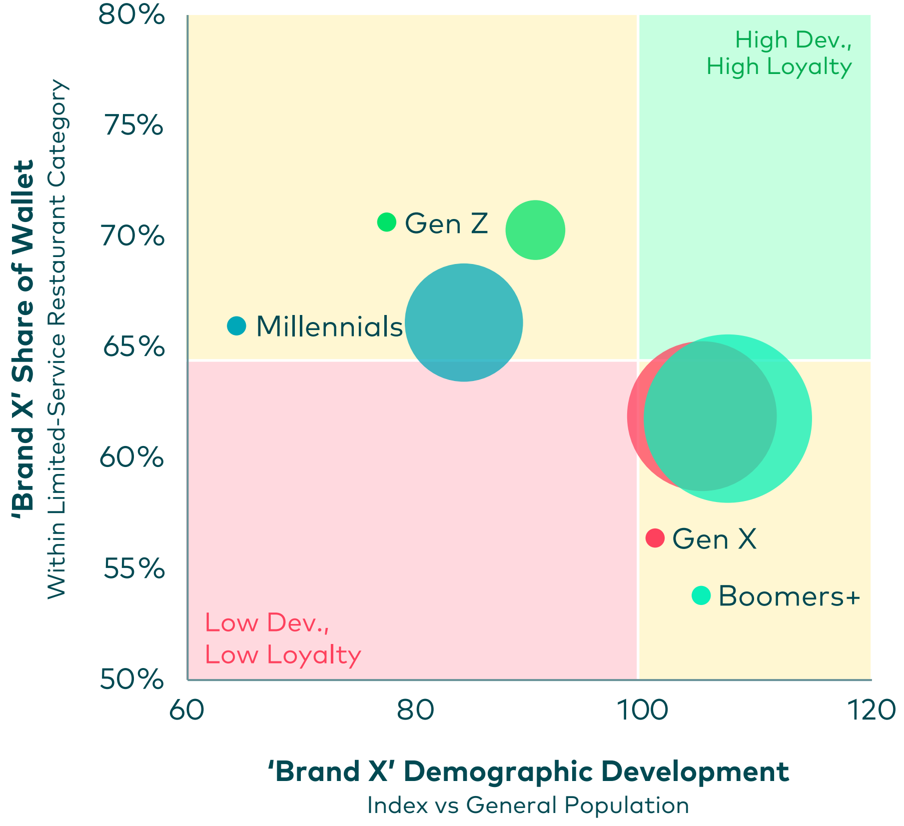
Numerator worked with a world-leading private equity firm to understand the demographic opportunities for an acquisition in the limited-service restaurant space. By leveraging single-source consumer data, the firm learned that the target managed to retain spend among younger consumers but would need to make substantial investments to acquire more of them to drive sustainable long-term growth.

Current research has shown that Gen Z is driving development of limited-service restaurants as a way to save money, which could provide natural tailwinds for the investor who decides to purchase the brand.

Additionally, while demographics are typically based on census-based definitions, looking at consumers through psychographics (e.g. households who care about sustainability or households that enjoy hiking) can help to determine whether a brand will fill a lucrative need state within the current portfolio.

GENERATIONAL OPPORTUNITY QUADRANT

Latest 52 Weeks Ending 12/31/2022



Source: Numerator

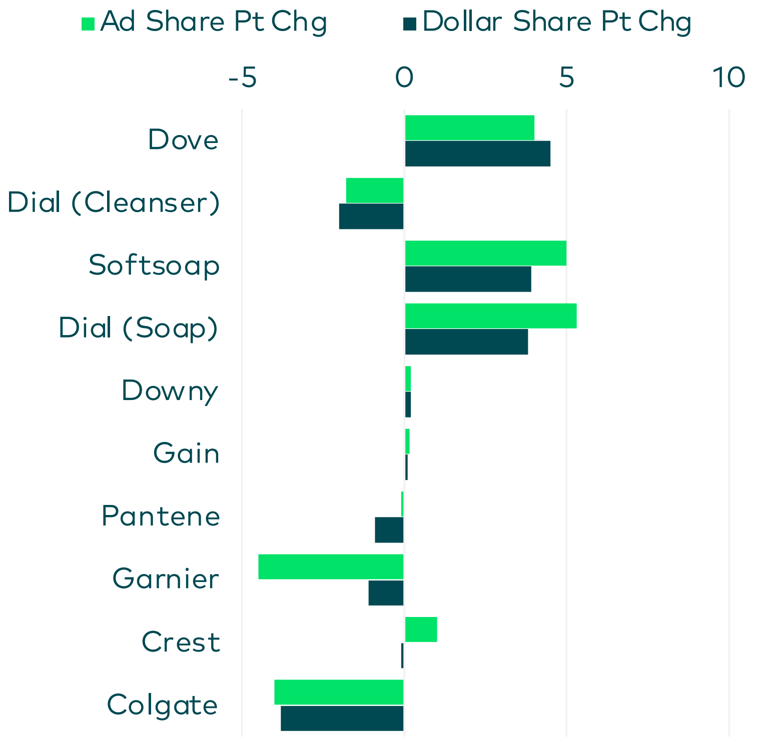
Promotional effectiveness can be a forgotten part of the due diligence process, but those that are able to breakdown how a brand is promoting can find themselves in a better position post-acquisition. The reason is that trade spend is one of the highest costs on a brand's P&L– nearly 9 in 10 brands spend over 20% of gross revenue on trade promotions[1]. And those promotions have tangible impact on the market.

Numerator found that [9 of the top 10 essentials brands] observed a positive relationship between growth and decline of promotional share and market share. However, promotionally driven revenue and share gains come with potential implications on margins and long-term sustainable growth. Investors should look at two core areas:

1. Utilize promotional data to map the promotional landscape of offers being done by the brand in context to other competitive brands and historically. By folding promotional data into existing data sets and models, investors can identify whether a brand is overpromoting or is inflating short-term sales.

2. Understand if promotions are driving incremental spend. If a brand is promoting but is only subsidizing its consumer base, the value proposition of the brand will erode. By identifying households that purchase the brand on and off promotion, investors can determine whether adjustments to the brand's trade strategy are necessary post-acquisition and how costs could change.

PROMOTIONS TO MARKET SHARE RELATIONSHIP
Latest 52 Weeks Ending 12/31/2022 vs Year Ago



Source: Numerator
[1]Salesforce CG-Insights Report

3 CONSOLIDATING INSIGHTS TO MAKE THE RIGHT INVESTMENT

In the dynamic consumer goods and investment landscape, leveraging consumer data for M&A decisions is essential.

Modern, robust consumer data equips executives in consumer goods companies and investment firms with insights to identify emerging trends and properly evaluate brand performance for potential acquisitions.

Investors and strategy teams will need to make sure that as they look to find the next bet for sustainable growth, they ask themselves and their data vendors the following:

- Does my investment strategy fit with the long-term trends of consumers?
- Do I have the level of consumer visibility I need from a channel and brand level?
- Will underlying consumer interactions with the brand on a trip-by-trip standpoint support its topline sales trends?
- How am I evaluating my target acquisition from a consumer incrementality, equity and potential standpoint?

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