Consumer and retail

Sector coverage · Consumer and retail · interview preparation summary

INT.BC.4.a · Consumer and retail

Classify a consumer or retail company by what it sells, how it reaches the shopper and how it earns its return, and say what that implies for margins, capital needs, cyclicality and operating leverage.

A coverage banker opens any consumer conversation by saying what the company sells, how it reaches the shopper and how it earns its return. Those three answers set its growth, its capital needs and how far it moves with the cycle. Consumer divides into five groups: food and beverage, personal and household goods, apparel and luxury, retail and e-commerce, and leisure. The first three own brands and sell through wholesalers, retailers or their own stores. Retail and e-commerce sell other people's products. Leisure sells meals and experiences from fixed sites. Brand owners typically earn gross margins of 35% to 80% and spend heavily on advertising, so profit depends on the brand holding its price and its volume. Retailers earn thinner gross margins, often 20% to 40%, and make their return by turning stock quickly through a leased estate. Returns follow a simple identity. ROCE = EBIT margin × capital turn. A brand owner with a 12% margin and a turn of 1.25 and a grocer with a 3% margin and a turn of 5 both earn 15%, so comparing margins across groups misleads. Supplier terms count as capital, because a grocer funded by payables needs little of its own. Demand type matters next. Staples such as food, household and personal care are bought habitually and hold volume in a downturn, although shoppers may trade down to private label. Discretionary goods such as fashion, homewares, dining and travel follow confidence, real income and credit, and tend to fall faster than they recover. Luxury sits between, because wealthy buyers are steadier but tourist and aspirational demand is not. Cost structure then decides how far profit moves. Stores, plants and brand support are largely fixed, so a small fall in sales cuts profit by several times as much. Growth should be split into price, volume and mix. (1 + sales growth) = (1 + price) × (1 + volume) × (1 + mix). Growth that is all price is weaker than it looks, because shoppers eventually buy less. The channel is the last question, since wholesale gives scale with less control, direct and online give margin with more cost, and franchising gives royalties with little capital. A banker classifies first because the answer fixes the metrics, the valuation multiple, the buyer list and the financing.

WORKED EXAMPLE: THREE CONSUMER COMPANIES, THREE ECONOMIC MODELS

Three invented companies are on a coverage list. Brannoch Foods makes packaged sauces for grocers, with sales of 800m, gross profit of 320m, operating costs of 200m (150m of it fixed), depreciation of 30m, stock of 100m and capital employed of 600m. Calderwick Stores is a discount grocer with sales of 2,000m, gross profit of 400m, operating costs of 300m (240m fixed), depreciation of 30m, stock of 120m, payables of 260m and capital employed of 500m. Fenwood Lifestyle is a fashion brand with its own stores and website, with sales of 400m, gross profit of 240m, operating costs of 200m (150m fixed), depreciation of 15m, stock of 90m and capital employed of 200m. Classify each, compare their returns, and test a 5% fall in sales with gross margin held. Convention: costs of sales equal sales less gross profit, a 365-day year, year-end figures, variable operating costs fall in line with sales, ignore tax.

Answer: Brannoch, Calderwick and Fenwood earn return on capital of 15.0%, 14.0% and 12.5% from margins of 11.25%, 3.5% and 6.25% and turns of 1.33, 4.0 and 2.0. A 5% fall in sales cuts EBITDA by 11%, 17% and 24%. Fenwood is the most exposed, with 205 days of stock and the highest fixed costs relative to profit.

> **Interview tip:** Say what the company sells and how it reaches the shopper, then give margin and turn together rather than margin alone, and finish with one sensitivity such as a 5% fall in sales and what it does to EBITDA.

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Read the metrics a consumer specialist checks first, including like-for-like sales, price, volume and mix, gross margin, advertising, stock days, store returns and cash conversion, and say what normal ranges look like.

Metrics tell a banker whether headline growth is good growth, and each consumer group has a few that come first. Like-for-like sales count only stores or channels open in both periods, at constant currency, so they strip out new space, acquisitions and exchange rates. Like-for-like sales growth = (1 + transaction growth) × (1 + basket growth) − 1. A rise driven by price on falling transactions is weaker than one driven by traffic. A brand owner splits organic growth into price, volume and mix in the same way, and volume is the figure that shows whether shoppers are really buying more. Gross margin is read against the group, and typically runs 20% to 30% for grocers, 35% to 50% for food and household brands, 50% to 65% for fashion

brands and higher for beauty and luxury. Advertising and promotion is often 8% to 15% of sales for a branded staples company, and a company that cuts it to lift profit may be borrowing from future sales. EBITDA margins typically run 15% to 25% for branded staples, 4% to 8% for grocers and 8% to 15% for specialist retail, before the effect of lease accounting. Stock days = stock ÷ cost of sales × 365. Grocers typically hold 20 to 35 days, while fashion and homewares may hold 100 to 180, and stock growing faster than cost of sales often signals markdowns to come. For a store estate, four-wall EBITDA, which is store profit before central costs, drives the roll-out case. Cash-on-cash return = four-wall EBITDA ÷ net investment per store. Paybacks of two to four years are common, a new store usually takes a year or two to mature, and the figure should be read with the sales it takes from nearby stores. Cash conversion = (EBITDA − capex) ÷ EBITDA. Separate maintenance capex from growth capex before judging it, because a low conversion in a roll-out may be a choice and not a leak. For online businesses, read contribution per order, customer acquisition cost and repeat rate by cohort. Leverage should be quoted lease-adjusted, as net debt plus capitalised rent over EBITDAR, since a retailer's rent is a debt in all but name. The usual mistake is to quote total sales growth, which hides price, new space and acquisitions.

WORKED EXAMPLE: READING MARLOWE AND PIKE, A HOMEWARES RETAILER

Marlowe and Pike is an invented homewares retailer. Last year it had 120 stores, sales of 480m, a gross margin of 41.5% and stock of 96m. This year it opened 15 stores, which together sold 30.4m, and the 120 older stores sold 489.6m. Total sales were 520m, gross margin was 40.0% and stock is 130m. Shelf prices rose by an average of 3.5%. Each new store costs 1.5m net and is expected to earn four-wall EBITDA of 0.36m a year once mature. Test the quality of the growth, the stock and the roll-out. Convention: cost of sales is sales less gross profit, a 365-day year, year-end stock, prices apply to comparable stores.

Answer: Total growth of 8.3% is made of 2.0% like-for-like and the rest new stores, and the like-for-like figure is all price, because comparable volume fell 1.4%. Stock days rose from 125 to 152, about 23m of extra stock, while gross margin fell 1.5 points. New stores earn 24% cash-on-cash and pay back in 4.2 years. The quality of growth is lower than the headline.

> **Interview tip:** Never quote total growth alone. Split it into new space, like-for-like and price, take price out to find volume, and tie stock days to margin before you give a view.

INT.BC.4.c · Consumer and retail

Choose and defend the valuation approach for a consumer company, matching the multiple to the model, keeping lease accounting consistent, and selecting trading and precedent sets that support a range.

A coverage banker chooses the multiple to fit the business model and then defends the peer set. Branded staples are valued on EV/EBITDA, P/E and free cash flow yield, because earnings are steady and the brand is the asset. They usually trade above retailers and above commodity food makers, and the premium is explained by pricing power, growth and cash conversion. Fashion and luxury brands are better valued on EV/EBIT or P/E, since depreciation of stores and systems is a real cost. Retailers are valued on EV/EBITDA or EV/EBITDAR, and the treatment of leases must match on both sides of the ratio. EV (post-lease) = equity value + net debt + lease liabilities. Post-lease EV must be divided by EBITDA under IFRS 16, which removes rent, and EV without leases must be divided by EBITDA after rent. Mixing the two bases is the most common error, and it makes a lease-heavy retailer look cheap or dear by the size of its leases. High-growth online businesses with little profit are valued on EV/sales or EV/gross profit, but only alongside contribution margin, cohort payback and a believable path to profit. Franchisors and restaurant groups depend on the mix between owned and franchised sites, and franchisors typically earn higher multiples because they need little capital. A discounted cash flow suits staples best, though the terminal value should rest on a normalised margin and not a peak. Normalise earnings for one-offs, calendarise to a common year end, and look at the next twelve months as well as the last. A trading set should share the sub-sector, growth, margin, geography and size, and it is better to use six close peers than twenty loose ones. Precedent transactions add a control premium and often synergies, so they sit above trading values. Equity premium and EV premium are not the same, as leverage dampens the second. EV premium = equity premium × equity value ÷ EV. A single acquired brand often earns a scarcity premium, because buyers cannot create a brand and must buy one. Present the range as a football field, and say which method you trust most and why. The usual mistake is applying one sector-wide multiple to companies whose growth, margins and lease burdens differ.

WORKED EXAMPLE: VALUING PENHALLOW HOME ON A CONSISTENT LEASE BASIS

Penhallow Home is an invented homewares retailer. EBITDA after the lease accounting change is 180m, of which 70m is the rent that the change removes. Net debt excluding leases is 150m, lease liabilities are 420m and net income is 50m. Trading peers are on 6.0x EV to EBITDA after rent and 11.0x P/E. Recent precedent deals were struck at 7.0x EBITDA after rent. Value the equity three ways and explain which figure you would trust. Convention: the multiples are applied to EBITDA after rent and net debt excludes leases, so lease liabilities are not deducted.

Answer: On EBITDA after rent of 110m, trading peers give an equity value of 510m, P/E gives 550m and precedents give 620m. Applying the multiple to the 180m figure without lease liabilities would overstate equity at 930m. A range of 510m to 620m is defensible, with the trading value as the floor and the control price at the top.

Interview tip: Say first which basis the multiple is on and state that numerator and denominator match on leases. Then give the range, name the method you trust most, and say what would move you up or down.

INT.BC.4.d · Consumer and retail

Explain what drives M&A, equity and debt capital markets activity in consumer and retail, name typical buyers and sellers, say what IPO and bond investors ask, and propose pitch ideas with leverage capacity in mind.

Consumer activity is driven by a few repeating motives, and a coverage banker brings an idea that fits the client's position in them. The first motive is portfolio reshaping. Large groups sell slow-growth or non-core brands and buy into faster categories such as health, premium and local brands, so carve-outs and disposals are a steady source of mandates. The second is scale. Buyers in food, drinks, beauty and household goods pursue overhead and procurement savings, which lenders and boards accept, while revenue synergies are discounted. The third is sponsor activity, such as take-privates of retailers whose property or cash flow is undervalued, buy-and-build in fragmented categories and exits of brands that have grown. The fourth is distress, as weak retailers and restaurant groups restructure, sell stores or enter administration. Typical buyers are strategic groups, sponsors, family holding companies and, for digital brands, groups that want a customer base. For an IPO, investors ask whether growth is durable, using repeat purchase, like-for-like sales, full-price sell-through and gross margin, and then ask how the brand compares with listed peers. Staples and quality brands can list in uncertain markets, while fashion and discretionary names usually need steady trading and a firm market. Sponsors then sell down through blocks, subject to lock-ups. Bond investors in staples look for stable cash flow and moderate leverage, and typically accept more debt than for cyclical retailers. Retailers should be judged on lease-adjusted measures. Lease-adjusted leverage = (net debt + capitalised rent) ÷ EBITDAR. Fixed charge cover = EBITDAR ÷ (interest + rent). Rating agencies and lenders also look at stock quality and the share of freehold property, which can be pledged or sold. Pitch ideas follow from these points. They include a portfolio review and carve-out, a bolt-on programme, refranchising for a restaurant group, a sale and leaseback of freeholds to cut debt, a dual-track sale and IPO for a sponsor-owned brand, and a refinancing ahead of a maturity. Check the effect of each on leverage after rent, since a sale and leaseback lowers headline debt but adds a fixed charge. The usual mistake is to present an idea without showing what it does to leverage, cover and the equity story.

WORKED EXAMPLE: REFRANCHISING PITCH FOR BRINDLEMOOR GRILL

Brindlemoor Grill is an invented restaurant group with 100 company-run sites. Each sells 2.0m a year and earns site EBITDA of 15% of sales. Central costs are 6m and net debt is 120m. The group trades on 8.0x EBITDA. You propose selling 50 sites to franchisees at 7.0x their site EBITDA, with the group keeping a royalty of 5% of their sales. Show the effect on EBITDA, margin, leverage and value, and say whether the idea is worth pitching. Convention: ignore tax, costs of the sale and any change in central costs, use all proceeds to repay debt, and keep the 8.0x multiple.

Answer: Selling 50 sites at 7.0x raises 105m, cuts EBITDA from 24m to 14m, lifts margin from 12.0% to 13.3% and cuts leverage from 5.0x to 1.1x. The effective multiple on the 10m of EBITDA given up is 10.5x, above the group's 8.0x, so equity rises by 25m, from 72m to 97m. The idea is worth pitching, with attention to franchisee quality.

Interview tip: Show the effect on EBITDA, margin, leverage and value, and then compare the effective multiple on the earnings given up with the multiple the market gives the group, rather than the headline multiple on the sites.

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Identify the cycles, risks and accounting traps in consumer and retail, and run a compact end-to-end analysis of a company from growth quality through earnings quality and leverage to a view.

Consumer earnings move with a few forces, and a banker should know which one is driving a company before pitching. Real household income, employment and credit set demand, and discretionary categories fall faster than staples. In a squeeze shoppers trade down to private label and discounters, which hurts mid-priced brands most. Input costs such as grains, cocoa,

packaging, freight and wages reach cost of sales with a lag. Companies recover them through price, but each rise risks volume, so a 10% rise in a cost that is 30% of sales needs about a 3% price rise to restore gross profit before any lost volume. Fashion and fad risk, weather, exchange rates and dependence on a few large retailers add further swings. Stores and wages are fixed costs, so retailers carry the most operating leverage. The accounting traps follow the same lines. Supplier finance programmes move trade payables into a bank-funded balance that is not shown as debt, so payable days that rise sharply deserve a question. Payable days = payables ÷ cost of sales × 365. Trade promotion and rebate accruals can be released to lift profit, and a brand can ship more to retailers than they sell through, which flatters sales until stock is cleared. Adjusted EBITDA is another trap when restructuring or store closure costs are added back year after year, because a cost that recurs is an operating cost. Capitalised software or marketing, thin stock provisions and optimistic goodwill carrying values complete the list. Lease accounting raises EBITDA without changing cash, so use EBITDAR or lease-adjusted leverage. A compact end-to-end analysis follows an order. First classify the company and split growth into price, volume and new space. Then check margin against input costs and mix, then working capital against sales, then adjusted earnings against cash. Next restate leverage with supplier finance and leases as debt, and value on a consistent basis. Close with the idea the analysis supports, such as a disposal, a refinancing or a warning to the client. The usual mistake is to accept the company's adjusted figures and its headline leverage without rebuilding them.

WORKED EXAMPLE: END TO END ON HALDEN BEAUTY

Halden Beauty is an invented prestige skincare brand selling through department stores and its own website. Sales were 600m against 540m last year, and price and mix added 6.0%. Gross margin was 62% against 64%. Reported EBITDA was 90m against 84m, and the company shows adjusted EBITDA of 108m after adding back 18m of restructuring, which it has also added back in each of the last two years. Receivables were 150m against 110m, stock 120m against 90m, and trade payables 90m against 60m, of which supplier finance is 40m against 15m. Capex was 30m and net debt excluding supplier finance is 270m. Analyse growth, cash, earnings quality and leverage, and say what you would tell the client. Convention: cost of sales is sales less gross profit, a 365-day year, ignore tax and interest.

Answer: Halden grew 11.1%, with volume up about 4.8% and gross margin down two points. Stock days rose from 169 to 192 and receivable days from 74 to 91, and underlying cash flow is about minus 5m once the 25m rise in supplier finance is stripped out. Leverage is 2.5x on the company's basis but 3.4x on reported EBITDA with supplier finance as debt. A fair EBITDA of about 99m lowers EV at 12.0x by 108m.

> **Interview tip:** Give the order of the analysis aloud: growth quality, margin, working capital, cash, adjusted earnings, leverage, then valuation and advice. Say which numbers you rebuilt and which you took as given.

INT.BC.4.f · Consumer and retail

Name every material consumer and retail sub-sector and, for each, say what drives demand, how it makes money, which first metrics a specialist reads, what is most often misread and how the product groups meet it, then use the map to open an answer.

Consumer divides into nine sub-sectors, and any answer begins by naming the one the company belongs to. Food and beverage makers sell packaged products to grocers, so demand is habitual and the model is plant based, with volume, gross margin against inputs and the private label gap first, and the trap is price hiding falling volume, which draws bolt-ons and bonds. Personal and household brands sell beauty, care and cleaning products, so demand is habitual and the model is high margin and light on capital, with organic growth, advertising ratio and share first, and the trap is growth bought with promotion, which suits portfolio M&A. Apparel and footwear brands sell seasonal ranges through wholesale, stores and online, so demand follows taste, with full-price sell-through, stock days and wholesale concentration first, and the trap is one hot season taken for a lasting brand, which shapes sponsor sales and IPOs. Luxury houses sell scarce, high priced goods mostly through their own stores, so demand follows wealthy and tourist spending, with price against volume and tourist share first, and the trap is aspirational buyers who leave in a downturn, so scarce assets draw strategic buyers. Grocers and everyday retailers sell necessities on thin margins, so demand is steady and profit comes from buying terms, with like-for-like sales, gross margin and stock days first, and the trap is profit resting on supplier terms, which makes lease-adjusted leverage the key test. Specialist and department store retailers sell homewares and clothing from leased sites, so demand follows confidence and fixed costs are high, with four-wall profit, like-for-like sales and markdown rate first, and the trap is an average hiding weak stores, which brings restructurings. E-commerce and direct brands sell online, so demand depends on winning and keeping customers, with acquisition cost, contribution per order and cohort retention first, and the trap is a blended acquisition cost flattered by organic customers, which tests IPO and growth equity pitches. Restaurants and food service sell meals through owned or franchised sites, so demand follows visits and spend per head, with same-site sales,

prime cost and franchisee health first, and the trap is revenue lifted by buying back sites, which supports refranchising. Leisure and consumer services such as gyms, cinemas and travel sell access from fixed sites, so demand is discretionary and operating leverage is high, with utilisation, churn and spend per head first, and the trap is joiners masking leavers, which suits sale and leaseback. Practice differs, because some firms treat luxury within apparel or place food service with leisure, so say which grouping you use. In an answer, name the sub-sector first, then the driver of its profit, then the two or three numbers that prove it.

WORKED EXAMPLE: THREE CONSUMER COMPANIES READ AS A MAP

Three invented companies are on a screening list. Lumera Direct sells skincare online and spent 9.0m on marketing this year to win 100,000 new customers, of whom 40,000 came without paid marketing. A typical order is 60 with a contribution of 24 after the costs of fulfilment, and customers place five orders in their lifetime. Asterley Maison is a luxury house with sales of 400m up 12%, of which price added 10%, a gross margin of 70% and operating costs of 200m (160m fixed and the rest varying with sales). Tourists account for 30% of its sales. Tidewell Fitness runs gyms with 25,000 members paying 30 a month and monthly churn of 3%. Name each sub-sector, give the first metrics and test the misread. Convention: 12 months a year, order and costs in £, ignore tax.

Answer: Lumera has a blended acquisition cost of 90 but a paid cost of 150 against lifetime contribution of 120, so its paid customers lose 1.8m in total. Asterley's volume grew only about 1.8%, and a 25% fall in tourist spending would cut operating profit by 22.5%. Tidewell needs 750 joiners a month to stand still, since its average member stays 33 months.

> **Interview tip:** Open with the sub-sector, then the driver of profit, then the two or three numbers. Finish with the one trap you would test, such as paid against blended acquisition cost, price against volume, or joiners against leavers.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.