Company Participants

- Dana Telsey, Chief Executive Officer and Chief Research Officer
- David DiFusco, Partner, Tax Leader
- Michael Halen, Senior Consumer Analyst
- Stephen Wyss, Partner, Consumer Industry Leader

Presentation

Michael Halen {BIO 18797919 <GO>}

Welcome to BI & CohnReznick's joint webinar on the Consumer Industry Now Through The year 2020. Some quick administrative notes. This webinar will be recorded and available for playback. You can access the replay via the link that you signed up on. At the bottom of slide window, you can adjust the volume and maximize your screen. Feel free to ask questions by submitting one to the right of the slides. We'll address any client questions at the conclusion of the presentation. And a copy of the slides and a transcript will be distributed in the post-event email.

So, quickly Bloomberg intelligence, for those of you that are not familiar, is Bloomberg's research arm. We cover about 135 industries and 1,800 plus companies. We have about 280 Research Analysts across the globe and our research can be found on the terminal.

Stephen Wyss

With that welcome everyone. As Michael said, Bloomberg Intelligence & CohnReznick Consumer Industry 2020 Briefing. My name is Stephen Wyss, and I am Consumer Practice Leader at CohnReznick and I have the pleasure of moderating today's discussion with our senior panel of speakers. CohnReznick is a national accounting, tax and advisory firm, with a specific practice relating to consumer. And I am based here in New York and I welcome you all. With me today, we have been Dana Telsey, CEO and Chief Research Officer of Telsey Advisory Group; Michael Halen, Senior Restaurant and Package Food Analyst with Bloomberg Intelligence; and my colleague, David DiFusco, New York Tax Practice Leader at CohnReznick. Thank you all for joining me today and thank you to our friends at Bloomberg Intelligence for hosting us.

Today, we're going to discuss some interesting topics that we see impacting to all the retail and consumer goods, not only today but in the future. We will talk about consumer trends, the impact of technology on the consumer landscape, the M&A environment in consumer products, and of course the impact of the Tax Cuts and Jobs Act on the consumer industry.

With that, let's start with you, Dana, what are you seeing as key consumer trends that you expect to have a lasting impact?

Dana Telsey {BIO 1491802 <GO>}

Thank you. Thank you so much for having me today. Thank you, CohnReznick for partnering on this, and thank you -- and for hosting it and thank you, Bloomberg for hosting it. Also I'm delighted to be a part of this panel. I think it's a very timely and very topical what we are discussing today in terms of consumer trends. If you go to the slide deck as you can see, you mentioned the key word about what are the key trends. We've got a key right there. As we look out at the landscape and think about the key trends, the consumer space today is shifting at such a rapid pace. We've never seen the pace of change so accelerated. Let's go through some of the key trends and we will touch on some of the themes of each.

Number one is about demographics, with the shift to millennials really changing the spending behavior of consumers. It's going be very interesting to see the evolution of these millennials, and especially as they age, they do become even more like their babyboomer parents, having kids, buying homes, requires some of those mindsets, but also the way they're influenced and the way their spending patterns evolve is different, and we will talk more about that.

Number two, we're seeing omni-channel. It's changing consumer priorities and shopping patterns. One of the most interesting elements of holiday season 2017 was the fact that there was a more integrated perspective with bricks and mortar and digital being more integrated today than we've ever seen before. Companies know how to manage it better, the sales associates know how to work with it better, consumers know how to manage it better. And I think the shift toward physical and digital, not either/or but both, continues into the future.

Number three, looking at new technologies, driving traffic and certainly offering enhanced shopping experiences, whether it's buy online, pickup in store, whether it's ship from store, whether it's technologies like Magic Mirror, we're now seeing technology impact traffic patterns and traffic flows. The data that companies have available to them, in order to manage consumer shopping patterns, and know how to appeal to consumers, know how to communicate with them, certainly is allowing shopping experiences to be more meaningful, because today instead of the customer going to the store, the store is coming to the customer also.

And speaking of using that word experiences, consumers are demanding experiences and services over goods. When you think about the growth rate of experiences and services, as compared to goods, we've seen an compound annual growth rate in excess of 4% for service growth, as compared to just under 4% for goods growth. And what we're seeing is that brands today aren't just selling goods, but they're also selling their experience -- the experiences.

What does the brand mean? I've always believed that a brand has to say what it does and do what it says, it matters. And lastly personalization and globalization are key drivers in the landscape. And what we mean by that is there's always an individual identification factor that's helping to change that consumer -- the consumer landscape. Today you can go to an American Eagle, and all of a sudden have patches monogrammed on your denim jeans, and its your jeans. It's not any one else's, it's yours. And this personalization factor creates uniqueness, and also allows consumers to have their own items that are just relative to them.

Globalization works makes -- the world's big and small for everyone, because today what's trending in Australia, can become popular in the UK and then can also matter in Columbus, Ohio and other places throughout the United States. The world happens to the big and small at the same time, and when I think of what makes companies great and what are the skill sets that they need to have today that differs from the past, number one, is about product innovation. If you don't have newness in product and you're not able to innovate, then you're not going to have a repeat customer.

Number two was about speed. And speed in developing product, and speed in delivering product. That development and delivery helps you maintain your market share and also increase it. And then data, the data to learn about what to produce, what consumers prefer and not just having data for the sake of having data, but how do you learn from it, what knowledge does it give you to make a retailer and to make a brand bigger.

So those are some of the key trends. And just following up on that, take a look at the demographic shifts. Millennials are impacting retail spending. You're seeing a millennial generation today that is larger than the baby boomers and watch out because Gen Z is coming, and they're also going to have more influence. We're seeing buying power today and into the future where the millennials are going to have greater buying power than their parent. And part of the reason for that is they are going to be the generation that inherits the most wealth.

They are going to be inheriting the most wealth from babyboomer parents. And when you think about savvy, frankly think about what the millennials and how they grow up. They are the first generation to go up -- to grow up that are consumer savvy. They text instead of face-to-face phone calls, and face-to-face meetings. They basically learn about brands and learn about trends through social media. Bloggers today are the new celebrities and basically the new arbiters of what matters.

In the past it may have been TV, it may have been newspaper, magazines and radios, but there is a new way to reach generations. And you know what, Gen Z has even a newer way Instagram and Snapchat can make brands, can make product categories grow or shrink. The influencers out there, like I mentioned about the bloggers. I know many C level. Executives at many retail establishments, that now talk to bloggers on a daily basis in order to see what's trending. That compares to what babyboomers -- what their influencer were, which typically has been traditional advertising.

And then distribution channels. For millennials there isn't one channel, there is all channels. And I think you're seeing that with Gen Z also. With babyboomers it was traditionally in store. They had to make a set time, had to create a destination and basically use a part of what may have been discretionary time in order to spend it on purchase patterns. And we're seeing the shopping experiences today differ. Babyboomers required customer service. It was do it for me. When you think of millennials, millennials are interactive. They want convenience and they want to be connected. And so therefore what we see is access versus ownership. Take a look at how the economy is changing.

We are seeing productivity growth require automation, given the fact that the average annual growth rate of the US labor force is less than US population. So non-traditional work like becoming an Uber driver isn't considered work. Hotel occupancy rates are at or near their all time highs, yet there is an average decline in room rates. The reason why Airbnb, the access of Airbnb, the access of Uber and the sharing economy is where the millennials, that's how they live, and that's how they experience life.

Unlike babyboomers, who are all about ownership. It was a right of passage, certainly a right of evolution to own homes, to buy cars, to buy luxury goods. And the world is evolving, today where today what certainly is valued is time, time and experience. When you think about what we seeing in the omni-channel world, -- I am sorry did you have a question?

Stephen Wyss

I did, actually Dana, wanted to interject real quickly because that's a lot of really great information. Yeah, to your point there was an interesting article on Bloomberg.com yesterday, called the death of clothing, and that highlighted the change in consumer spending habits, with consumer spending on apparel at just 3% of their total expenditures, compared to 18% on experiences. And I guess in going through the items that you noted, wanted to get your opinion or thoughts on, how do apparel, specifically retailers and consumer companies better compete with experiences?

Dana Telsey {BIO 1491802 <GO>}

So couple of things. I read that article, and I think one of the interesting things that we have been also talking about is, it used to be that women for the most part, bought apparel for four reasons, to wear to work; to wear on the weekends; to wear to the gym; and wear to a party. And today there is only two reasons. Wearing to a party, because work, -- and work weekend and gym are all integrated. How do you make an apparel an experience that's part of what we mentioned with American Eagle, make it special and personal. Are you going to make a fashion show? Are you going to have a sales associate be able to interact with you personally?

Everyone -- no longer are words used in order to communicate, pictures are. So how are you as a sales associate going to deliver pictures to the consumer to make them come to your store. Create that experience of a must-have now, with limited quantity, limited edition that's made just for you, and you can also have designers there. Having designers there makes you feel like wow, this is customized for me. And that was very good article. I read it yesterday.

Stephen Wyss

It was. That so good if you're an apparel manufacturer or retailer.

Dana Telsey {BIO 1491802 <GO>}

Got to be different. When you think on page 4, about omni-channel it is the key to customer engagement. 90% of returns are occurring in store, 70% of online sales touch a physical store. Companies are learning faster, how to become omni-channel retailers. And I think as more retailers begin to report their results, we're going to hear about the advancements that they've made in omni-channel initiatives. And the retailers and the landlords are partnering together with new technologies in order to enhance shopping patterns and traffic patterns.

Take a look at for example Sephora, and the Beauty Bag where consumers can view their saved shopping lists, their buying history and has workshops that can teach you. Teaching matters. When you think about other changes that have gone on in our industry, I don't anyone will forget, where they were on June 16, when it was announced that Amazon buys Whole Foods. It shocked the grocery industry and shocked the retail industry. And I think the reason why they wanted to be able to expand in urban markets. They wanted to be able to have access to more food vendors. They wanted the supply chain and quicker delivery capabilities, and that is what the stores allow you to do.

It's a network. So I think what this acquisition does, it shows that physical needs digital and digital needs physical. And I think we're going to be on the precipice of more acquisitions of big buying small and digital companies and physical companies partnering together. And when you think about the technology that's a part of it, I mean look at the in-store technology with wireless now. Magic Mirrors where interactive mirrors allow consumers to see outfits. They share their looks via our social media, take a look at logistics with RFID, that's been a topic of conversation for years. And finally, now is becoming meaningful to optimize the accuracy of inventory and help to manage margins.

And most important is big data, which allows consumer -- which allows companies to understand their customers in order to better match products to demand, and as a result helps drive sales and manage margins to rise higher. You were mentioning experiences and they are important. Three different categories of experiences on page number -- slide 11, on experiential retailers, whether it's services like Drybar and getting your hair washed and blown, whether it's Restoration Hardware, you can go to pick out furniture. And also if you've been to the Restoration Hardware in Chicago, you can also -- it's hard to get a reservation, go to one of the best restaurants in the city.

And when you speak about entertainment, whether it's an activity, whether it's an experience, it is growing in terms of consumer wallet share. Take a look at Punchbowl, so Punchbowl Social, Topgolf and what is going to movie theater now, wine, dine and recline. You have to check out those, iPic movies theaters where it's a first-class experience of being able to eat great food, see a movie in a terrific environment where there is nearly 2 million members that become a part of iPic, and it becomes part of a social experience. And so iPic which just went public the other week, I think there is -- we're going to see more iPic movie theaters and it's attracting more consumers given the experience that it offers.

It's part of that entertainment experience, it's aspirational and it's social, all at the same time and it is truly differentiated.

Think about fitness, health and wellness matters and whether it's SoulCycle, whether it's GoodLife Fitness or Pure Barre, now people are getting to know each other and meeting each other basically through health and wellness. It's certainly increasing traffic to other retailers, and that's why you're seeing it in different locations too. So experiential like Drybar, entertainment like iPic, fitness like SoulCycle, that's where we see consumers gravitating. And what this all means for the future of retail? I think it means personalization, localization and customization. It's about ization.

One day we will have 3D printing with virtual dressing rooms. But right now, speed matters to get instant gratification. You have a global reach where the flow of information, spans the globe and if there is a cross broader knowledge of brands and service and experience are married together. And married together in experiences like the iPic theater, in services like Drybar, and I think brands matter where, when and how matter, and we're at the beginning of a change in how consumers are allocating their dollars.

Stephen Wyss

That's some really great stuff, Dana.

Dana Telsey {BIO 1491802 <GO>}

Thank you.

Stephen Wyss

A couple of questions. What I found really interesting, on the technology side, how do you see the appetite for spending on all of this wonderful technology by retail and consumer companies that are already facing challenging times of declining revenues, in many instances, and tighter margins. Is there a willingness to make significant capital investment in these areas?

Dana Telsey {BIO 1491802 <GO>}

I think the allocation of CapEx dollars has shifted. It used to be that for many companies CapEx allocated to technology was around 10% or under of their CapEx budget. And what it is today? Today it can be around 40% of their CapEx budgets. So I think technology is integral. I think store bases are being refined to the most productive units. And I think the willingness to learn how do use technology is greater than ever before. So whether it's conversational commerce, mobile applications, focused automation, we're only at the beginning of where technology is taking us.

Stephen Wyss

And how do you think this evolve model that we're looking out to 2020, that focuses on experience and technology, how do we see it impacting prices for consumers and eventually margins of the companies? Do you see -- is there an indication that consumers are more willing to pay higher prices for these better experiences and interaction with technology?

Dana Telsey {BIO 1491802 <GO>}

I think we have seen part of that shift. I think we've seen that shift, when you think about experiences, and what consumers are willing to pay for, they are paying for personalization, they're paying for community engagement. We are not seeing the same amount of spend as you mentioned earlier in apparel. What you are seeing that spend being on is you're seeing it on areas that, for example, can be aspirational, experiential, social and what's an affordable luxury, that's what becomes meaningful. That's why when I mentioned earlier, what the iPic theaters are doing, or what we're seeing with SoulCycle, those are where we're seeing consumers allocate time and allocate their dollars.

Stephen Wyss

Excellent. And one last question I had for you Dana, from your perspective, what do you think has the advantage? You've have noted a bunch of companies on the technology slide, Kohl's, Neiman Marcus, Nordstrom and Walmart, large companies. And then in the next slide, really a lot of these I think coming, smaller companies, iPic's a great example. Who has the advantage in the evolving marketplace, and who is going to perform better, if you had to place a bet? Is it the nimble, smaller, innovative companies, or the larger companies that have much more capital to spend and invest?

Dana Telsey {BIO 1491802 <GO>}

Nimble companies always can move faster. What's going to happen is, I think you're going to see a consolidating market in some instances, whilst Walmart bought Jet.com, why did you see PVH go buy digital companies also. We are now seeing a melting of the two. Smaller matters, they can teach the larger companies, but certainly we're seeing those nimble companies be able to take share.

Stephen Wyss

Excellent, thank you so much, Dana.

Dana Telsey {BIO 1491802 <GO>}

Thank you.

Stephen Wyss

With that I'd like to transition over to Michael and discuss the M&A market, and specifically on the CPG side, what's been going on in a really interesting segment which is packaged foods.

Michael Halen {BIO 18797919 <GO>}

Thanks, Stephen, and thanks Dana. That was great. You are a tough act to follow.

Dana Telsey {BIO 1491802 <GO>}

Thank you.

Michael Halen {BIO 18797919 <GO>}

You got it. So with the CPG arena, specifically packaged foods, which is one of the areas that I cover here at Bloomberg, packaged food stocks have been hot. The Supercomposite Packaged Food Index has been on fire and it's really been boosted by M&A over the last five years or so. 2017 was another strong year. There was 369 deals worth 42.5 billion. It's not quite the record setting year, we had back in 2015 with that Kraft-Heinz deal and a bunch of others, but 42.5 billion really is nothing to sneeze at.

Stephen Wyss

And Michael, I notice that's up over 50% from 2016, despite declining sales across the industry. What are some of the factors that you think are driving that increase?

Michael Halen {BIO 18797919 <GO>}

Yeah. Sales is a big one. So there's been a big shift, similar to retail, as Dana outlined, there's been a huge shift in the eating habits in the last decade. So sales in most center of the grocery store categories have been in decline. Customers don't want processed foods any more or to the degree that they once did. They're seeking cleaner labels, millennials especially want fresh organic produce and healthy proteins. We're seeing them shop at the outer rim of the store and avoid the center of the store completely.

So a lot of these old growth companies the sales are declining. They're searching for growth and they're really being forced to acquire brands to get into the healthier for you category in a meaningful way. And a big part of that is that Gen X and millennials kind of distrust of these big food companies, right. So M&A picked up, demand for organic Campbell Soup in a can was weak. So they bought Pacific, they are maker of organic soup and bone broth in aseptic cartons. General Mills, so their, kind of their store brands declined. So they acquired Annie's to help boost sales and organic growth potential over coming years.

We've also seen a big shift towards snacking and convenience. A lot of these snack brands have been hot. People want to eat on the go. So that's been a big trend for M&A and also to push organic growth in the packaged food sector.

Stephen Wyss

Yeah, the key is seemingly to be on healthy, fresh and new, is what consumers want.

Michael Halen {BIO 18797919 <GO>}

Yeah, without a doubt. And we think that those motivations are going to contribute to a strong first half for CPG M&A. So tax cuts and low borrowing costs, they're going to continue to motivate buyers and sellers following a strong year of deals, as mentioned. So rising interest rates interestingly enough may force acquirers to speed up their timeline. So some companies maybe feel the pressure to act now before the cost of capital moves even higher as the year moves on. And also falling equity values may motivate potential sellers as we've seen volatility come back to the market over the last couple weeks. This could cause -- could motivate some sellers that maybe want to cash in before valuations move even further to the downside.

Stephen Wyss

Michael, you mentioned tax cuts. And I think it's a good time perhaps for our tax expert, David to chime in. David how do you see this new tax legislation impacting M&A decisions from debt versus equity structuring, overall lower tax rates, big picture wise what you think it's going to do to the M&A market?

David DiFusco

Well I loved Michael's teasing the audience with tax, because we know that's what they're waiting to hear about. But if I had to sum up everything I'm going to talk about later in one word, it's going to be modeling. So when I was speaking in 2017, the word I was saying was confusion and opaque because we really didn't know how to value all these tax attributes that are such an important component of any M&A deal. And now we have all this information and we're seeing this flood of deals, due diligence structuring, or what's keeping me up at night is along with burning this new tax codes. But there's certainly going to be an increased tension between buyers and sellers, because of these new depreciation rules.

So you are going to be able to recover a lot of the tax cost of your assets very quickly, and there's always been that struggle between selling stock versus buying assets, it's just going to get enhanced.

But the modeling part of it is going -- there is lot of limitations in this new tax code. So we're seeing interest deductions being limited, we're loss reductions being limited. The international side is I think favorable and fair, and they got rid of some annoying parts of M&A. They're small, but important. For example, they repealed the technical terminations of partnerships. So when you're acquiring a partnership, you have to go through this tremendous compliance burden, everyone had to do.

Stephen Wyss

Like reduced M&A.

Michael Halen {BIO 18797919 <GO>}

I'm excited. And so here is Amazon again. In addition to taking advantage of lower rates in 2017 later in the year, I think some of the M&A was motivated by the Amazon Whole Foods merger. So in addition to all of the benefits Dana outlined, there was also another one. We kind of viewed it as an attack on packaged food manufacturer margins. This gives them more scale and more negotiating power. So it kind of almost makes them not quite to that level, but the Walmart of online, right where Walmart can really pressure their suppliers in terms of price points.

So what we've seen now is some of the food manufacturers feeling this pressure to gain scale, so they can protect their margins against Amazon and Walmart. We saw a couple of very historically conservative companies, McCormick and Campbell Soup paid very steep multiples and really stretched their leverage ratios to purchase RB Foods and Snyder's-Lance respectively. So Campbell's bought Snyder's at almost 20 times EBITDA just months after acquiring Pacific Foods. Their leverage ratio's almost at 5 times right now. And McCormick, they paid 7 times sales and 19.6 times adjusted EBITDA for RB. And listen, it's a great asset. They really wanted to get into hot sauce which is a very high margin business. RB was run very lean, it's got very impressive EBIT margins. It fits the portfolio. It allows them to get into hot sauce in a more meaningful way immediately versus try to grow that Zatarain's brand over the course of the years.

But this company has typically been under a turn of leverage and their leverage jumped to 4 times EBITDA after this deal. So we think this Amazon threat is really going to continue to motivate bigger transactions in the near future.

Stephen Wyss

I think it's interesting in looking at the Amazon threat, in package foods, and when you look at it from the strategic perspective, it seems -- it's greatly impacting the value of brands, and saving them for strategics. How is Amazon interact or I guess play in the space of private label? Where you're seeing the private label?

Michael Halen {BIO 18797919 <GO>}

Yeah, so we think that motivated the deal as well, right. Whole Foods has some great private label brands and Amazon controls their "shelf space" right. When you search something they can put their private labels up on top, and like every other retailer they love private label, because the margins are much higher, and it also causes -- gives them a reason, gives people an attachment to a certain store, right. As customers like Up & Up brand, toilet paper or paper towels, they're going to go to Target because that's the only place that they can get them. And kind of the same thing with Amazon. This is a quick and easy way to get into private label with brands that a lot of people know and really love. So yeah, I think that was also a big piece of that, Amazon and Whole Foods, yeah.

Stephen Wyss

You see the effect in supermarket and retail, and the emphasis that seems to be -- being placed on developing better product label options and really investing in private label certainly from the supermarket perspective, but even across the board and looking at fashion apparel, looking at retailers that want to have their own brands exclusivity. So I think the ripple effect from Amazon throughout is pretty interesting.

Michael Halen {BIO 18797919 <GO>}

Yeah, it's definitely caused some waves in packaged food here in the last six months. But -- as they've been doing in retail for years now. So just quickly some of the companies that we watch and cover that are interested in and potentially could do a pretty good-sized deal in the first half year are Kraft Heinz, Conagra, Hormel & Pinnacle are all names that we view as on the hunt. So Kraft Heinz, according to our colleague, Ken Shea is looking for a transformational deal. And they have deep pockets of Berkshire and 3G that help make it happen. Conagra, a name we have has been busy, and they're going to continue to be. They purchased a lot of snacking and healthier for you brands as they completely transform their portfolio to more hot on the trend -- on-trend brand. And they still have $1 billion tax asset burning a hole in their pocket. So we expect them to continue to be aggressive.

They're also seeking larger synergistic deals if they can find one. Once again, it could help them against the Walmarts and the Amazons of the world. Hormel is under-leveraged and they brag about a nice pipeline of global multicultural and healthy protein based brands. So companies that can maybe help them boost scale in their core businesses. And finally Pinnacle Foods, who's done a great job of transforming under-managed iconic brands has more than 2 billion of capacity to make a deal in the Health and Wellness category.

David DiFusco

Michael I loved that you're talking about tax again. And when you're talking about deferred tax asset, that's why we saw such an interesting earnings season, because companies with deferred tax assets were taking these massive hits because the corporate rate's going down, that assets worth a lot less to them. On the exact opposite side, companies that had massive -- not losses, which generally allows the deferred tax assets, but instead had a lot of depreciation in their physical plan had a deferred tax liability. Well, that's not going to be as expensive to them. And some of those companies took those earning benefits and translated them into bonuses for their employees. Whether that's sustainable we will see. Nobody really knows. I think if you are really cynical it's just a one-time political play but the bottom line is corporate tax rate has gone down and companies are going to do something with that differential. Whether they put it into other M&A, or whether they give it to their employees or whether they return it to their shareholders, obviously nobody knows.

Stephen Wyss

Point, David.

Michael Halen {BIO 18797919 <GO>}

Yeah, that would be part of -- it's kind of been a PR spin with a lot of companies talking about how they're -- what good they're going to do with the cash. But we think a lot of them are going to continue to return cash to shareholders. With that, the second half kind of remains a question mark in our view. So rising interest rates could become prohibitive. We've seen a lot of these deals be accretive in year one or early in year two. As interest rates rise, that may not be the case. You can see on the chart to the right here, median US packaged food net debt to adjusted EBITDA has now surpassed the peak of '08-'09. So some balance sheets are stretched. And there are fewer strategic buyers out there looking for a big transformational deal. McCormick and Campbell Soup, who we already mentioned are going to be limited to smaller bolt-on deals to their recent M&A activity.

J. M. Schmucker as I said that they will limit themselves to smaller deals as their pet food business continues to struggle. If you remember they acquired big hot pet brands a few years back, in dry food, dry dog and cat food, has really struggled mightily over the two years since. Ken Shea expects General Mills, Tyson and Hershey and Kellogg to seek smaller deals due to their historical conservatism and/or the need to integrate recent purchases.

Stephen Wyss

So when you mention pet and Smuckers struggle on the dry food the other side of that has been significant growth in alternatives and new, fresh, organic, pet and there seems to be a lot of popularity there, how do you guys see that as a category going forward? And do you expect it to continue to grow and attract more interest from more difficult consumer product companies in terms of potential M&A? What are your thoughts?

Michael Halen {BIO 18797919 <GO>}

Yeah, we're going to see more premiumization. So you have seen Smucker kind of improve that segment results over the last quarter to by debuting Natural Balance, a premium pet food, because people like to consider their pets their children, right? So they don't want to serve their kid's artificial flavors or packaged foods. People view the same way as for their pets, right? So we continue to see premiumization as the best route for a lot of these companies, but also remember we're -- what are we, nine years into a recovery and the economy is doing well. Consumers are feeling kind of bullish. So maybe they have more money to buy premium pet food, right? So if the economy turns, maybe that -- it could really kind of shift back towards a little bit of dry pet and dog foods.

Stephen Wyss

(inaudible) I think it's almost in a psychological way, treating your pets better is an experience that makes you feel better. So from the experience side, you see willingness to spend premiums to make yourself feel better, which I think is pretty interesting trend. And so thank you on that, Michael. Speaking of interesting trends I have seen many times the word tax comes up. David gets very excited and we'd like to turn the discussion over to David to talk about the impact and the tax legislation, as we all know, changes have some complex and confusing components, but perhaps David, you could start with a brief overview of the key changes.

David DiFusco

Great, thank you, Steve. So if I was going to summarize the Tax Cut and Jobs Act, we're looking at lower statutory rates and we're also looking at lower effective rates or cash tax outlay. Now whether that's all going to go into premium pet food, I'm not sure, Michael but we can only hope. So one of the -- I mentioned some of the positives with regard to the rates. But we're seeing a pass through taxation, a new deduction there. I mentioned depreciation, international, then negatives, I mentioned a few of them, but the one you got the Tri-state region up in arms was limitation of the state income tax deductions, and that's being limited to $10,000. It really is going to change the way the individuals calculate their itemized deductions, and whether people do or not going to -- remain to be seen and what the impact of that is on real estate, on charitable deductions, all that, it's going to be really, really interesting. I mean, I think people are going to be talking about taxes for the next 12 to 15 months, and nothing gets me more excited than people talking about taxes.

Stephen Wyss

I think to your point, David, when looking at the potential impact of that alone, in what are considered to be blue states, I mean those on the East Coast or West Coast, perhaps we could see consumer spending habits in those particular geographic areas change as a result of this. So this could have -- and it's too far to look out for the crystal ball, but that discretionary spending in certain areas of the country may shift, and companies may need to pay attention to that and look after that.

David DiFusco

I agree. The tax rate changes for the corporation, look at that 21%. Now I used to tell my students all the time, it was really painful to have one of the highest corporate tax rates in the world. Now I don't have to complain about that anymore. The individual rates have gone down tremendously as well. We -- looks like we are missing the table, but I can fill in the highlights on it. We have the old 25% rate coming down to 20%. The old 28% rate coming down to 24%. Those are real, real changes. And at the top we have the 39.6% rate. Not only is the rate coming down to 37, but it's a much higher bracket. So you really get into that at over $500,000 for a single and $600,000 for married family jointly.

The pass-through deduction, I really think is huge for the consumer industry. Because initially, it's predecessor, which was Section 199 was a manufacturing deduction. But this is so much broader than that. And you don't really necessarily need to manufacture anymore, which we know a lot of our clients in the space don't. So what we're seeing is, this is a corollary in my mind to the cut in the corporate tax rate. Now we are trying to get to a -- we're allowing this pass-through deduction and in essence, you could eliminate 20% of your income if this is where your income is coming, from a pass-through business. 80% of that 37% gets you all the way down to 29.6. Not exactly the 21%, but a nice giveaway. And in essence what we're saying is non-corporate owners of pass-through businesses are going to be allowed a 20% deduction of their qualified business income, with respect to that trader business in the United States.

So 199 and all its predecessors were always very favorable towards US activity, nothing's changed here, but the big difference is that income really doesn't include the investment income or what they are calling specified service trader businesses. So a lot of businesses that are reputationally run and unfortunately, Steve that U and I's accounts. We're not in there. Architects, engineers are, not exactly sure why they -- what led to that difference. Maybe we don't lobby well enough, right. But -- and the deduction is being driven in essence limited by W2 wages, or a combination of W2 wages and qualified property, but with consumer companies having very large payrolls, this could be something really exciting.

Now there is a planning opportunity there. To the extent, there are services embedded in some of what the companies are doing and obviously, we don't have all the explanations through the regulations of how this is going to work, we're seeing some clients talk about separating their service and non-services businesses. So they can take advantage of a deduction like this.

Stephen Wyss

And I think it's a really interesting point, as Dana was talking about earlier in the evolution of retail and consumer interaction and the greater importance placed on services. So services along with a typical retail component. Certainly, to your point, David, those companies that are -- whether it's SoulCycle or others in the space that have both a service component as well as a sales and retail sales component, should pay attention about how the structure stays going forward.

David DiFusco

Right. Well you remember me saying modeling. So here is something you have to model. This is from pass-through businesses, which does not include corporations. So do you want to take advantage of this through a pass-through, or do you want to take advantage of a lower corporate tax rate to a corporation, a lot of decisions to be made.

This is also tremendous for companies in the space that are going to have a lot of PP&E, that they're going to put into play in 2018. So we have a bonus depreciation and we also have this 179 deduction and they are starting to look a lot like each other because in essence, you're getting a 100% deduction, the bonus depreciation, the rate on that is changed over the years. We went from a 50% reaching now to 100%. The 179 is in essence for smaller businesses, ones that are putting in place, investing $3.5 million of spend. So a lot of ordering has to go into that. You want to take your 179 first, and then worry about your bonus depreciation, we're certainly advising clients in that area.

Stephen Wyss

And I think this ties into what Dana was discussing earlier. We were talking about the decision to invest in technology, decision to invest in new brick-and-mortar or renovations to brick-and-mortar. David, do you see this as potential to spur additional investment, given these new depreciation tax laws?

David DiFusco

Well, Michael, would it not be amazing if we went back to brick-and-mortar after all this, after everything Dana was telling us about online. And it could well be. I mean, you have to be careful about it, the building itself is not going to qualify under this. But and a building, if you've done right through cost aggregation is just a shell. And then think of all the improvements that have to be put inside of it to really make it work, especially for the savvy consumer of today and all that probably is going to be deductible.

One of the issues become state tax, remember I'm talking about best state taxes today, but this 179 deduction that we've talked about, not recovered by most of the states where the bonus depreciation is. So even if you are getting your federal taxes down, you still might have a state tax bill for all that. Again it's just going to have to be some more modeling. There -- especially in states like New York, California with fairly high corporate tax rates.

International has been -- seen -- probably, I think the greatest amount of changes. And the big-ticket item was this mandatory income inclusion. It's finally happened. We've talked for years and years and years, about how to get those billions and billions of dollars of earnings that were offshore back to the United States. We found a way to do it. So really interesting tax rate, is -- if it's in the form of -- if the assets from that deferred income were held in the form of cash or accounts receivable, the rate is 15.5%. For other types of assets, it's down to 8%. This is a massive tax bill.

So fortunately they didn't make everyone have to pay it upfront. So coming real soon, when you are filing your first return or extension for it, you have to make your first payment but you get to spread it out over eight years. I think that was very nice. I have never seen anything like a eight year tax bill. But companies are really scrambling now to figure out how much this is. These are numbers that they really haven't had to crunch in the past and there are a lot of things that have to be thought about.

There is two other provisions in, and I could spend the next six hours talking about taxes, but I won't. But there's these concepts called GUILTY and BEAT, two acronyms in the international tax paid.

I met with some government officers. They absolutely love these acronyms. So I'm happy somebody is having fun with the tax code. But it is really was to attack all those perceived and potentially real way that people are getting around paying the US taxes. So we have talked so much over the last couple of years, your headline -- Bloomberg headlines were about companies that had all this IPO offshore and then were getting -- generating tremendous earnings from it in what were considered tax havens.

So that's not really going to work anymore. It is -- it has to be taxed in the United States now. There's always been this anti-deferral provision called subpart F. This is a new part of it. That income is going to be taxable in the United States, but at a much lower rate. So yeah, it really is a win for everyone. Finally, the money is going to come back and companies are going to go good. It's at a lower rate. I used to put on those books, Michael, that you got to see these massive deferred tax liabilities for things that were going to come back or companies were saying no, no, we are never going to take it back, we're permanently reinvested. Well, now they don't have to be permanently invested. They can bring the money back and invest it in the United States.

Stephen Wyss

Do you see, David, from a big picture perspective, past the initial -- I guess shock and implementation, how is it going to change the way consumer companies and retail companies view international expansion? Do you think it will spur more investment overseas or will it perhaps change it in the other direction?

David DiFusco

If you can get your international rate down to 10.5%, why wouldn't you do that. So it really is export friendly. So if we can -- if companies can do that, there is a big compliance burden to it. There is a lot of calculations have to go in to place, but that's what tax departments do. I think it will definitely spur some of that.

I mentioned a couple of the limitations and I'll go through them fairly quickly. But what we're seeing now is a limitation of those NOLs, and it's interesting, they got rid of the corporate M&A, excuse me AMT, which was a mechanism for that in the past. We don't have the corporate AMT anymore, but we have the same sort of limitation, albeit it's even larger, because now you can only offset 80% of your income where before it was 90%, and I think this is another one of those things that maybe take some of those headlines out of news, because a lot of companies now have to pay taxes, because you are not allowed to offset all your income with the losses, either ones generated in the current year or carryovers. So -- and then for the individuals there is a limitation and you can only use losses up to 500,000, married and filing joint in the year, 250,000 for single. If you limit it to that you are just creating a carry-forward. What's interesting there carry-forwards used to be limited to 20-year period, now they're indefinite.

The UK had a similar system. I think, it's fair because, why -- if a company actually generates a loss, why shouldn't it be able to use that loss regardless of what it is.

When we talk about M&A activity, but some of the guidance I'm looking out for there was a provision in the code that limited the utilization of the losses, when you acquired a company. Well the reason that was important is because eventually those NOLs ran out under the carry-forward limitation provisions. Do they now, yes, they soon will find out. But that could make some of that M&A valuation a lot more valuable.

Another limitation here is the business interest expense. So now I'm going to contradict myself, Steve. I mean we know so many of these deals we did were leveraged, and here's a limitation to that. That number it's interesting because it's going to change. It's 30% of adjusted taxable income and that's now a new word in our lexicon. And the definition of that word changes. So through 2021 it's earnings before interest, taxes, depreciation, amortization, i.e., your EBITDA. So it's a fairly robust number and then after that, it's earnings before just interest and taxes. So much smaller number. So that 30% of a smaller number. Yeah, you are going to have a limitation on interest expenses.

Now again the carry-forward becomes indefinite. So we're not looking at limitations on that. But so much of the deals we're looking at Steve, the modeling is net present value. So when you're pushing some of these deductions way out in time obviously their value goes very down.

Stephen Wyss

You think it's going to have any impact on M&A world in terms of amount of debt, amount of equity, how -- I guess how the potential investors or buyer look at the balance sheet?

David DiFusco

Certainly, it's just going to have to be layered into everything. We saw on the private equity side, they've made a change to the carried interest rules. It wasn't nearly as draconian as is everybody was worried about, and maybe it was because of this interest deduction limitation. So it could be stifling. It would be interesting to see a world where debt isn't the primary driver in these deals, but with lower tax rates companies should have more dry powder in the form of after tax earnings.

Stephen Wyss

Good stuff.

David DiFusco

Then just wrapping up on a couple other items. So the 199 A, we saw is now replacing that 199, which was domestic production. There's going to be new audit assessment rules, which could be leveled at the partnership level for the first time ever. This is going to make sure the IRS doesn't have to go after the individual partners. They can go after the partnership itself. R&D expenses are often important to this industry, new bottling, new packaging, all of that can fall into R&D if you look at it correctly and do the proper analysis, but there might be some capitalization that has to go on in 2022. And that's it for taxes.

Stephen Wyss

Yeah, I think the key takeaway there is modeling, I think in terms of needing to look at your operating business and how tax is impacted differently in the future as well as investments that you are making and potential acquisitions, the models have changed, then you got to change the way you look at things.

Well we do have a Q&A question coming in, feel free everyone to join in and just click in your question. So this question here , not surprisingly it's tax question.

David DiFusco

That's all everyone wants to talk about.

Stephen Wyss

Because it's pretty enlightening. So the question is on the personal tax effect on consumers, what do you see the material impact of the child tax spread increase have on consumer spending, will tax saving show up in withholding savings or be tax refunds at the end of the year?

David DiFusco

Well, it is tax geek. I am not allowed to say anything about consumer spending because I really don't know. But hopefully, right, I really believe there will be more money in more people's pockets after this is all done with the exception of that Tri-state area where all those state taxes they used to deduct are now limited to $10,000. So it really depends on where you live. We're going to see low withholding rates. So people should see almost immediately their after tax paychecks going up. With regard to the child tax credit. Yeah, I have no reason to think that won't -- the mechanism for that won't be the same in the form of a tax refund. But you can start filing your tax return now. So for individuals and you do it early in the year, you get that tax refund upfront.

Stephen Wyss

All right great. And we have time for one more, so I am going to be greedy and take it. And it's for Dana. So I also cover restaurants and so millennials have really helped that casual chains grow over the last few years. And part of that was that they were seeking the experience over things as you mentioned Dana. But now with millennials maybe coming of age and starting to move out of their parent's basements and buying houses and starting families, how do you see that impacting near term consumer spending?

Dana Telsey {BIO 1491802 <GO>}

I think if anything, as millennials age and as they grow up, and basically have more spending needs, it's whether spending needs from having families like you mentioned, whether it's spending needs because of -- whether it's work environment, but also travel. I mean what we're seeing with these experiences and building the community, the lifeline that's out is different than what it was in the past. So it is services that do make the difference. So I think if anything, the fact that these millennials have the dollars that they see work and the ability to be an expert is different than their parents do, as they are trying more things, I think that spending power is there, and also as brands and companies essentially are focusing more on the wants of these consumers and have more knowledge of what to create for them there is a lot of optimism surrounding consumer spending. It's the brands that need to innovate in order to capture their attention.

And that's why, as you mentioned the experiential element and a lot of it's surrounding food. Food is the new luxury, health and wellness is the new luxury, there is a lot of changes in spending patterns that are out there. So it's what we had chatted about, whether it's the entertainment items, the fitness items, they are new priorities today.

Stephen Wyss

Excellent, thank you very much, Dana.

Dana Telsey {BIO 1491802 <GO>}

Thank you.

Stephen Wyss

And thank you to all, to all who listened in. And we do see some additional questions, unfortunately without time to get you. But our contact information has been provided in the slide deck. Please feel free to reach out to us via email or give us a call. We're happy to answer any questions you may have. That concludes our presentation for today. Thank you so much for joining us.