

US Internet Retail Industry Update

Omni-Channel Retailers Drive Strategic M&A

EXECUTIVE SUMMARY

The internet retail industry has been a particularly hot topic of discussion over the past several weeks, with investors speculating whether Alibaba's recent IPO filing will be the largest in US history.

MarketLive's E-Commerce Index suggests that performance within the industry continues to support the hype, reporting 18.4% YOY revenue growth for internet retailers during Q1 2014.

This comes following a year of strong performance for internet retailers in 2013, on the back of improving economic conditions and a continued shift in consumer behavior toward online purchases; which now constitute 5.8% of retail sales in the US.

M&A activity was down for internet retailers during 2013 compared to the two prior years, with 52 closed transactions during the year, but still significantly greater than the industry's 10-year average of 43 annual transactions. Q1 2014 M&A activity signals a rebound from the prior-year period, driven by strategic acquisitions by retailers building their omni-channel sales and marketing capabilities.

Strategic acquisitions should continue to drive strong M&A demand in the internet retail industry during 2014, and sustain favorable valuation multiples for acquisition targets.

Industry Performance

- Internet retail sales in the US have grown at a Compound Annual Growth Rate (CAGR) of 13.5% since 2008, from approximately \$140 billion to \$263 billion in annual sales in 2013; compared to only 2.8% annualized growth in total US retail sales.
- Internet retail sales have expanded from 3.5% of total US retail sales in 2008 to an estimated 5.8% of total US retail sales in 2013.
- Internet retailers finished 2013 with another strong Q4, posting an estimated 16.0% YOY growth on top of 15.6% YOY growth in Q4 2012.
- Stock prices for publicly traded companies in the T&H Internet Retail Index have increased 26% in the last 12 months; compared to a 15% increase for the S&P500 Retail Index and a 17% increase for the S&P 500 as a whole.

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FY End	Retail Sales (\$B)			% Change Year-Over-Year		
	31-Dec	Total	E-Commerce	% of Total	Total	E-Commerce
2005		3,690,152	90,876	2.5%		
2006		3,874,085	112,484	2.9%	5.0%	23.8%
2007		3,999,256	135,204	3.4%	3.2%	20.2%
2008		3,946,406	139,989	3.5%	-1.3%	3.5%
2009		3,630,408	143,282	3.9%	-8.0%	2.4%
2010		3,841,454	166,522	4.3%	5.8%	16.2%
2011		4,136,352	193,904	4.7%	7.7%	16.4%
2012		4,350,278	225,313	5.2%	5.2%	16.2%
2013*		4,532,858	263,330	5.8%	4.2%	16.9%
2017 P		5,325,000	385,550	7.2%	4.1% CAGR	10.0% CAGR

* Estimated

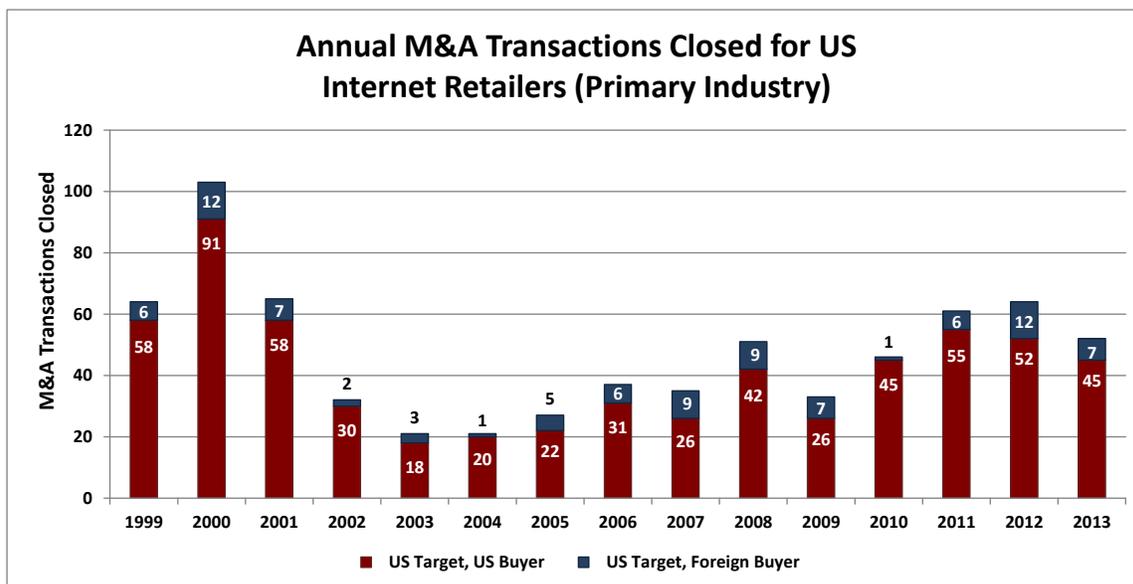
Source: US Census Bureau Quarterly Retail E-Commerce Sales, Forrester Research and Tully & Holland Estimates

Noteworthy Industry Trends and Developments

- **E-commerce sales in the US have exhibited uninterrupted year-over-year growth during each of the last 10 years.** During this time, the only two years when annual sales did not increase at a double-digit growth rate were 2008 and 2009, when the US economy was in a recession.
- **Internet retail sales channels are expected to post strong growth moving forward.** Forrester Research projects that internet retail sales will grow at a 10.0% CAGR through 2017, increasing the proportion of retail sales made through e-commerce channels to 7.2% of total retail sales. Other projections from various research firms range from between 7.1% and 14.0% estimated annual sales growth during this period.
- **Consumers continue to use their mobile devices, which include smartphones and tablets, to make purchases at an increasing rate.** IBM reports that 16.6% of online sales came from mobile devices during Q4 2013, up from 11.4% of online sales during Q4 2012. This trend has been driven by the penetration of tablet devices in the US consumer market. There are now 88 million active tablet users in the US, a 57% increase from last year. Forrester Research projects that by 2017, \$31 billion in retail sales will be made using mobile devices.
- **New retail sales tax legislation is expected to impact the performance of internet retailers.** Research from Ohio State University found that households reduced spending on Amazon by 10% after sales taxes on internet retailers were introduced in their state. The effect was even more pronounced for larger transactions, as purchases of items priced at \$300 or more fell by 24%. The adverse effects on sales volume stem from new legislation eroding the pricing advantage Amazon sustained when it wasn't required to collect state sales taxes.
- **Online product returns constitute a significant challenge that internet retailers will have to address.** Retail strategy consulting firm Kurt Salmon reports that internet retailers offering free shipping promotions and lax return policies are driving high merchandise return rates. They found that online consumers return 20% to 30% of apparel and other soft good purchases, and just below 10% of hard good such as home products and toys. Steve Davis, CEO of Rue La La, said that dealing with e-commerce returns cost his company \$5 million last year.
- **In a crowded market, internet retailers will have to seek new ways to reach consumers.** Most notably, internet retailers have driven the first uptick in US catalog distribution since 2007. Bonobos began using catalogs last year to reach customers, and found that 20% of new customers placed orders after receiving a catalog, while spending 50% more on purchases than customers that had not received a catalog. Pat Connolly, CMO of Williams-Sonoma, explains that customers look through catalogs to get ideas and inspiration, and that businesses that use them as an effective marketing tool are able inspire in customers a desire for products that they previously did not even know they wanted.
- **Social media networks are emerging as a rapidly growing online sales channel.** Booz & Co. projects social commerce sales will increase 93% per year, to \$14 billion by the end of 2015.
- **A new pricing structure used by shipping companies is expected to substantially affect freight costs.** Last week Fed Ex announced that it will shift its shipping prices to reflect the size of the item being shipped rather than its weight; and UPS is expected to follow suit. Bill Ashton, VP of Operations for online apparel retailer Modnique.com, estimates that the new pricing structure will increase overall shipping costs by approximately 30%.
- **The distinction between retail channels will continue to blur as retailers shift toward omni-channel strategy.** Bain & Co. recently noted that it's becoming increasingly difficult to track "online sales" as a mutually exclusive category. Retailers are now using multiple sales channels to generate a single transaction (i.e. an item ordered online and picked up in-store). As competition heats up across all channels for retail sales, it is becoming increasingly important for pure-play internet, brick-and-mortar and catalog retailers to develop omni-channel sales and marketing strategies to reach and service customers in differentiated ways.

M&A TRANSACTIONS

M&A activity for US internet retailers was quieter during 2013 than it has been in recent years. Internet retailers were involved in 52 closed M&A transactions during 2013, compared with 64 closed transactions in 2012 and 61 closed transactions in 2011. Although 2013 marked a short-term decline in deal activity for the industry, it remained comfortably above an average of 43 transactions closed annually over the past 10 years.



Source: Capital IQ, Internet Retailers (Primary Industry)

M&A activity during Q1 2014 signals a rebound after a year of relatively low deal activity. Internet retailers announced 22 M&A transactions during Q1 2014, compared with 12 transactions announced during Q1 2013. M&A activity during 2013 was quieter due in part to the high number of deals closed before the end of 2012, as owners cashed in on investments prior to changes in the tax code. Recent trends suggest a significantly more active year for deal making ahead in 2014.

Online contact lens retailers represented a particularly popular segment for both strategic and financial buyers during the beginning of 2014. Vision Direct, 1-800 Contacts and Coastal Contacts were each acquired during Q1 of this year.

2014 Selected Recent M&A Transactions

Announcement Date	Target	Buyers/Investors	Segment
04/22/2014	Collectable Diecast Inc.	Vertana Group LLC	Toys
03/26/2014	Simplexity, LLC	Wal-Mart Stores Inc. (NYSE:WMT)	Electronics
03/11/2014	Elan Guides, LLC	John Wiley & Sons Inc. (NYSE:JW.A)	Education
03/10/2014	Portero, Inc.	Circa Inc.	Accessories
03/03/2014	CourseSmart, LLC	Vital Source Technologies, Inc.	Education
02/27/2014	Coastal Contacts, Inc.	Essilor International SA	Optical
02/24/2014	Branders.com, Inc.	BEL USA LLC	Diversified
02/14/2014	Altrec Inc.	TruSnow.com	Apparel
02/11/2014	Vision Direct Inc.	GetLenses Limited	Optical
02/10/2014	FUZE Online, Inc. and Generis Group, Inc.	AccountNow, Inc.	Electronics/Telecom
02/01/2014	Konarqui Internet Services, LLC	Luggage & More	Travel Accessories
01/23/2014	Global Custom Commerce, Inc.	The Home Depot, Inc. (NYSE:HD)	Household Products
01/13/2014	ideeli Inc.	Groupon, Inc. (NasdaqGS:GRPN)	Apparel
01/13/2014	AutoNationDirect.com, Inc.	Autobytel Inc. (NasdaqCM:ABTL)	Auto
01/09/2014	Replay Photos, LLC	Lulu Enterprises, Inc.	Photographs
01/07/2014	Discount Ramps.Com LLC	Rotunda Capital Partners, LLC	Industrial Supplies
01/07/2014	1-800 CONTACTS, Inc.	Thomas H. Lee Partners, L.P.	Optical
01/07/2014	The Winetasting Network	TSG, LLC	Food & Beverage

Source: Capital IQ, Internet Retailers (Primary Industry); M&A Deals Announced, Closed or Effective

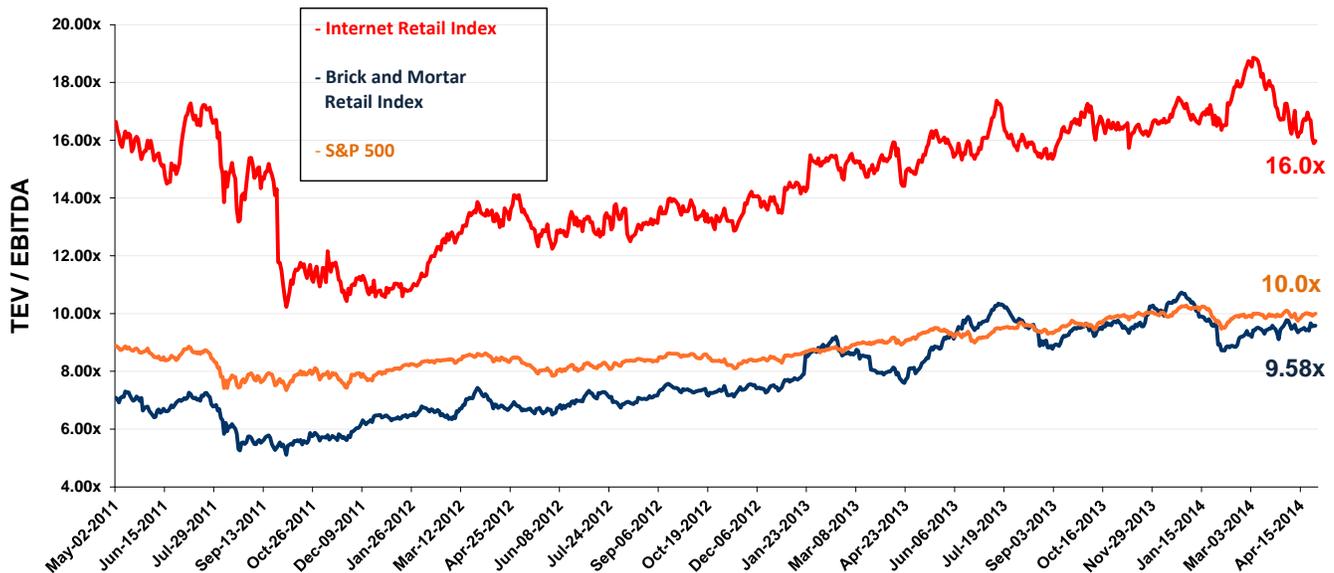
PUBLIC COMPS & VALUATION

Valuations for publicly traded companies in our Internet Retail Index remain relatively strong, trading at 16.0x EBITDA, despite having pulled back off a high of 18.9x EBITDA in March 2014. Prior to the recent pull back, internet retail valuations rose steadily from 10.6x EBITDA in January 2012 on increasing growth expectations and strong margins. Members of the Internet Retail Index generate on average 14.3% LTM EBITDA margin and analysts estimate an average of 10.5% revenue growth for these companies in FY 2014.

Internet retailers continue to trade at a premium to both our Brick-and-Mortar Retail Index companies and S&P 500 companies, due to superior consensus growth expectations. These estimates and valuations are consistent with investor sentiment that internet retail sales growth will continue to outpace and cannibalize brick-and-mortar retail sales moving forward. Analysts expect a 2.9% average revenue growth rate for Brick-and-Mortar Index companies in 2013 on an average 4.5% EBITDA margin.

It is important to note that Netflix, which currently trades at 54.1x EBITDA, makes up 10.8% of our market cap-weighted Internet Retail Index; and has a significant upward effect on the aggregate EBITDA multiplier. Currently, the Internet Retail Index's non-weighted, median EBITDA multiplier is 12.8x.

TOTAL ENTERPRISE VALUE / EBITDA Multiples T&H RETAIL INDEX - LAST THREE YEARS



Source: Capital IQ

As of 4/29/2014

Internet Retail Index Constituents: FLWS, NILE, EBAY, IACI, NFLX, OWW, OSTK, PETS, PCLN, SFLY, STMP, PRTS, EXPE, LINT.A

Brick-and-Mortar Retail Index Constituents: TUES, WMAR, CACH, BAMB, HZO, KIRK, ZLC, DXLG, BONT, NWW, DEST, BBW, SCVL

Tully & Holland Conclusions

Many retailers are developing their omni-channel strategies and capabilities internally, and are reaping the benefits of recent market developments. This is exemplified by the success Bonobos has enjoyed with its new catalog; as well as the sales boost that traditionally brick-and-mortar retailers, such as Target and Macy's, enjoyed via their e-commerce channels in states where new taxes eroded Amazon's pricing advantage.

Retailers are also using M&A to integrate omni-channel capabilities more quickly and with lower risk than developing them internally:

- In January 2014, The Home Depot announced its acquisition of Global Customer Commerce; which operates the #1 online window coverings retailer in the world, *Blinds.com*. The acquisition allows Home Depot to enter the rapidly expanding online window coverings market through an established platform that would have otherwise been challenging to replicate or compete with. Management at Home Depot expects that they will be able to leverage the platform to develop "best-in-class capabilities for selling customizable and configurable products online."
- In March 2014, international pre-owned jewelry wholesaler Circa acquired Portero, a premier online shopping destination for pre-owned, authenticated luxury accessories. The acquisition of the online retailer allows Circa to develop and integrate an online sales channel as well as to access a new segment of customers.

As competition in the online retail market intensifies; a proven online sales platform, an established customer base, and effective customer service mechanisms will be premium assets for retailers building omni-channel strategies and capabilities. We expect to see strategic acquisitions of this nature drive a robust M&A market and favorable valuation multiples through the duration of 2014.

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ABOUT TULLY & HOLLAND

INVESTMENT BANKING SOLUTIONS FOR CONSUMER PRODUCT COMPANIES

Founded in 1992, Tully & Holland, Inc. is a leading US investment bank that provides merger & acquisition advisory services and private placements to consumer companies with special emphasis on multi-channel marketers, retailers, food & beverage companies, and consumer product manufacturers/distributors. Tully & Holland's Managing Directors have a combination of deep industry knowledge and sophisticated financial experience enabling them to develop innovative solutions for each client's needs.

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