TULLY & HOLLAND
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U.S. Internet Retail Industry Update

Omni-Channel Retailers Drive Strategic M&A

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EXECUTIVE SUMMARY

Every year, more time-strapped consumers are lured by the convenience and low prices offered by online retailers. Based on data sourced from the US Census, an estimated 7.4% of retail sales were online in 2015 compared to 4.3% a mere five years prior, making the internet retail industry one of the fastest-growing industries in the United States.

E-commerce sales continue to grow at a blistering pace. U.S. online sales on Cyber Monday 2015 saw a 12% year-over-year increase, climbing to a record $3 billion in one day. Meanwhile brick and mortar sales at U.S. stores open on Black Friday actually fell from $11.6 billion in 2014 to $10.4 billion in 2015, according to the retail researcher ShopperTrak.

The low start-up costs and effectiveness of e-commerce fuel the high number of industry operators anticipated to rise 18.4% per year on average to total 176,505 companies in 2015. Online shopping in the U.S is expected to grow nearly 45 percent over the next five years, according to Forrester Research.

M&A activity was slightly down with 48 closed transactions for internet retailers during 2015, but still greater than the industry's 12-year average of 45 annual transactions. Strategic acquisitions should continue to drive strong M&A demand in the internet retail industry during 2016, and sustain favorable valuation multiples for acquisition targets.

Industry Performance

- Internet retail sales in the US are expected to grow at a Compound Annual Growth Rate (CAGR) of 11.7% from 2006 until 2020, from approximately $112 billion to $527 billion in annual sales in 2020; compared to only 2.4% 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 7.4% of total US retail sales in 2015.

FY End	Retail Sales ($B)			% Change Year-Over-Year	
31-Dec	Total	E-Commerce	% of Total	Total	E-Commerce
2006	3,874,085	112,484	2.9%		
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%
2014	4,628,755	306,850	6.6%	2.1%	16.5%
2015*	4,692,845	349,200	7.4%	1.4%	13.8%
2020 P	5,400,000	526,576	9.8%	2.4% CAGR	11.7% CAGR

** Estimated*

Source: US Census Bureau Quarterly Retail E-Commerce Sales, Forrester Research and T&H 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 US eCommerce to enjoy a double-digit year-over-year growth rate in 2016. While online buyer growth approaches maturation, the continual shift in wallet share will drive the projected 10% compound annual growth rate (CAGR) of online retail spending over the next five years. By 2020, the online spend per buyer will reach $2,500, a 7% annual increase from 2015.

- **The number of industry operators is growing at an alarming rate.** The number of industry operators is expected to outpace industry revenue growth over the five years to 2015, rising at an annualized rate of 18.4% to 176,505 companies. Because of the industry's low barriers to entry and few skill requirements, companies can easily enter this growing industry. Platforms such as Shopify now allow people with minimal technical skills to develop and maintain a storefront. Such platforms are estimated to increase the share of self-employed operators in the industry from 79.6% in 2010 to 86.1% in 2015.

- **Pricing is no longer a differentiator in the world of perfect information; retailers will need to leverage semantics to enrich product data/sell solution bundles to protect margins.** The advent of mobile apps providing easy access to competitive pricing information puts retailers at risk of ending up as showrooms for Amazon.com. This is especially true in categories like toys, electronics, or even diapers – where Amazon.com offers a broader selection, typically lower prices, and two-day free delivery for Prime customers at $99 a year. The only way around this is to sell bundled solutions.

- **The top success factor for this industry is the ability of operators to control stock on hand.** To profit from trends, operators need to be able to control stock on hand to ensure that they have an adequate amount of popular items. According to IBIS World report, the other key success factors include the ability to quickly adopt new technology, provision of superior after-sales service and possession of a loyal customer base.

- **In a crowded market, internet retailers will have to seek new ways to reach consumers.** Most notably, internet retailers use social media to their benefit. Online retailers are harnessing the power of Facebook, Twitter, Instagram, Pinterest and other social media sites. Social ecommerce sales are expected to grow from $10 billion in 2012 to $30 billion by 2015.

- **Consumers continue to use their mobile devices, which include smartphones and tablets, to make purchases at an increasing rate.** Consumers are increasingly leveraging their mobile internet connections to purchase items on the go, enhancing the ease and convenience of online shopping. According to Criteo's latest State of Mobile Commerce study, nearly 30.0% of US e-commerce transactions are now mobile.

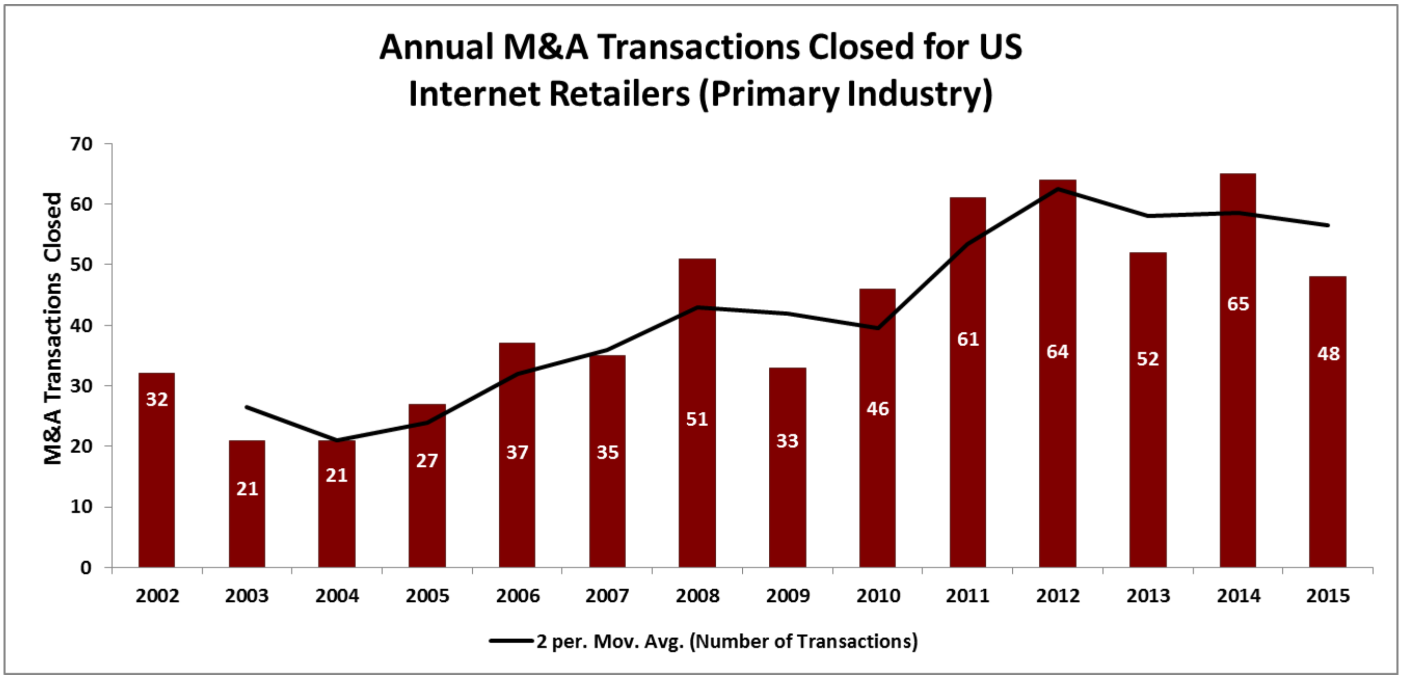
- **A vast majority of the US population regularly buys online irrespective of their income levels.** According to Forrester, 69% of the US online population regularly buys products online, with clothing, consumer electronics, and computers generating about a third of all online shopping dollars in the US. By 2019, Forrester projects that the music category, which drove eCommerce growth more than 15 years ago, will be nearly all digital.

- **Electronic products comprise the largest segment sold online.** Computer hardware, software and supplies, along with TVs, DVD players and related items, comprise the largest product group sold online. However, strong growth from other product segments has decreased this segment's share of total industry revenue to 18.4% of the total. Clothing, footwear, accessories and jewelry are also popular goods to buy online, with this segment accounting for an estimated 18.2% of industry.

- **Industry wages continue to remain constant as a percentage of sales.** According to IBIS World report, wages are expected to account for a mere 5.4% of industry revenue at $15.2 billion in 2015, reflecting a 12.4% increase over the five-year period and staying constant as a share of revenue.

M&A TRANSACTIONS

M&A activity for US internet retailers was quieter during 2015 than it has been in recent years. Internet retailers were involved in 48 closed M&A transactions during 2015, compared with 65 closed transactions in 2014 and 52 closed transactions in 2013. Although 2015 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 12 years.



Source: Capital IQ, Internet Retailers (Primary Industry)

Recent M&A activity involves a few big companies; however, the vast majority of them are startups. Recent trends suggest a significantly more active year for deal making ahead in 2016. Niche e-tailers represented a particularly popular segment for both strategic and financial buyers during the second half of 2015. There are at least 9 transactions including those of 1-800 Contacts, Inc. and Gilt Groupe, Inc. that were announced towards the end of last year and early this year that are expected to close in the first quarter of 2016.

Most Recent M&A Transactions Closed for US Internet Retailers

Announcement Date	Target	Buyers/Investors	Segment
01/08/16	Retail Innovation Group, Inc.	LeftLane Sports, Inc.	Sports Goods
12/3/15	eBags, Inc.	Willowridge Partners, Inc.; Saints Capital	Accessories
10/9/15	Pickleball Paddles Plus	Olla LLC	Sports Goods
9/21/15	Amagi, Inc.	Anthem Vault Inc.	Precious Metals
9/15/15	Central Vending Co., Inc.	Canteen Vending Services, Inc.	Food & Beverage
8/26/15	Vintage Blades LLC	The Grooming Network	Beauty Supplies
8/20/15	United States Medical Supply, Inc.	H.I.G. Capital, LLC	Healthcare
8/19/15	VEGAS.com, LLC	Remark Media, Inc. (NasdaqCM:MARK)	Travel
8/19/15	Elite Vending Company, LLC	Five Star Food Service, Inc.	Food & Beverage
8/17/15	zulily, LLC	QVC, Inc.	Fashion
8/10/15	Of a Kind, Inc.	Bed Bath & Beyond Inc. (NasdaqGS:BBBY)	Fashion
8/10/15	Auto Customs LLC	Truck Hero, Inc.	Auto

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

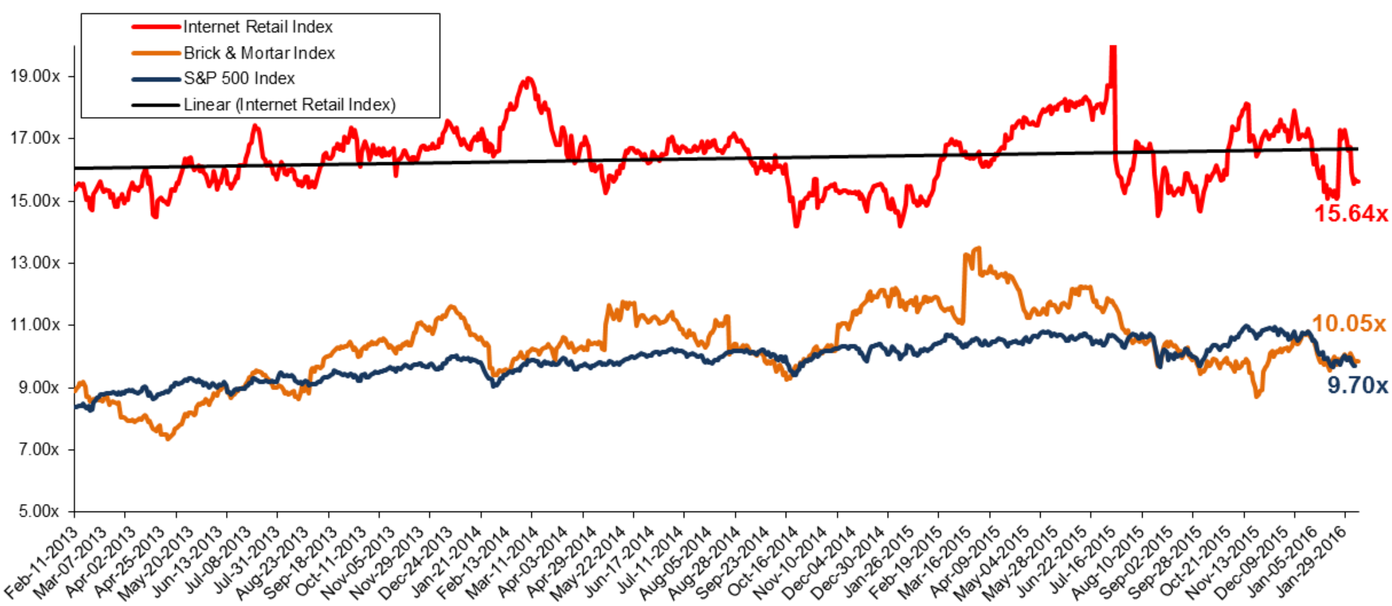
PUBLIC COMPS & VALUATION

Valuations for publicly traded companies in our Internet Retail Index remain relatively strong, trading at 15.6x EBITDA, which is slightly below the three year average of 16.4x EBITDA. Despite the recent pull back, internet retail valuations have been steady over the past three years due to increasing growth expectations and strong margins. Analysts estimate an average of 12.5% revenue growth for the Internet Retail Index companies in FY 2016.

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. Analyst expectations of Brick-and-Mortar Index companies are bleak with an average revenue growth of 0.6% in 2016 on an average 4% EBITDA margin, resulting in a trading EBITDA multiple of 10.05x.

It is important to note that Netflix, which currently trades at 101.8x EBITDA, makes up 9.5% 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 and average EBITDA multiplier is 16.4x.

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



Source: Capital IQ

As of 2/12/2016

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, BAMM, HZO, KIRK, ZLC, DXLG, BONT, NWY, DEST, BBW, SCVL*

Tully & Holland Conclusions

Driven by a need to create a retail environment where online and in-store shopping are a seamless experience for consumers, retailers are expected to make “bolt-on” acquisitions of e-commerce providers beginning later this year and into next. Retailers have no choice. The stock market is looking for faster growth at a time when major firms are at best eking out single-digit gains in same-store sales. And consumers’ rapidly changing demands are forcing companies to adapt, or fall behind. Consolidation is one of the few options left.

Another prominent trend in the industry seems to be acquisitions of early stage start-ups. Big brick and mortar retailers follow their online counterparts, and are placing their bets on innovative product search and mobile-based technology start-ups that enhance the customer experience.

- For instance, Wal-mart Stores Inc., has added 14 technology companies to its e-commerce war chest in the last four years with the most recent one being a product discovery technology company called Luvocracy. However, they still lag behind the mighty online giants such as Alphabet, Inc. and Amazon.

On the other hand, Pinterest recently acquired mobile shopping and discovery service The Hunt and image-focused search app Pext. These start-ups can help consumers find and buy products they’re likely to be interested in.

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 2016.

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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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