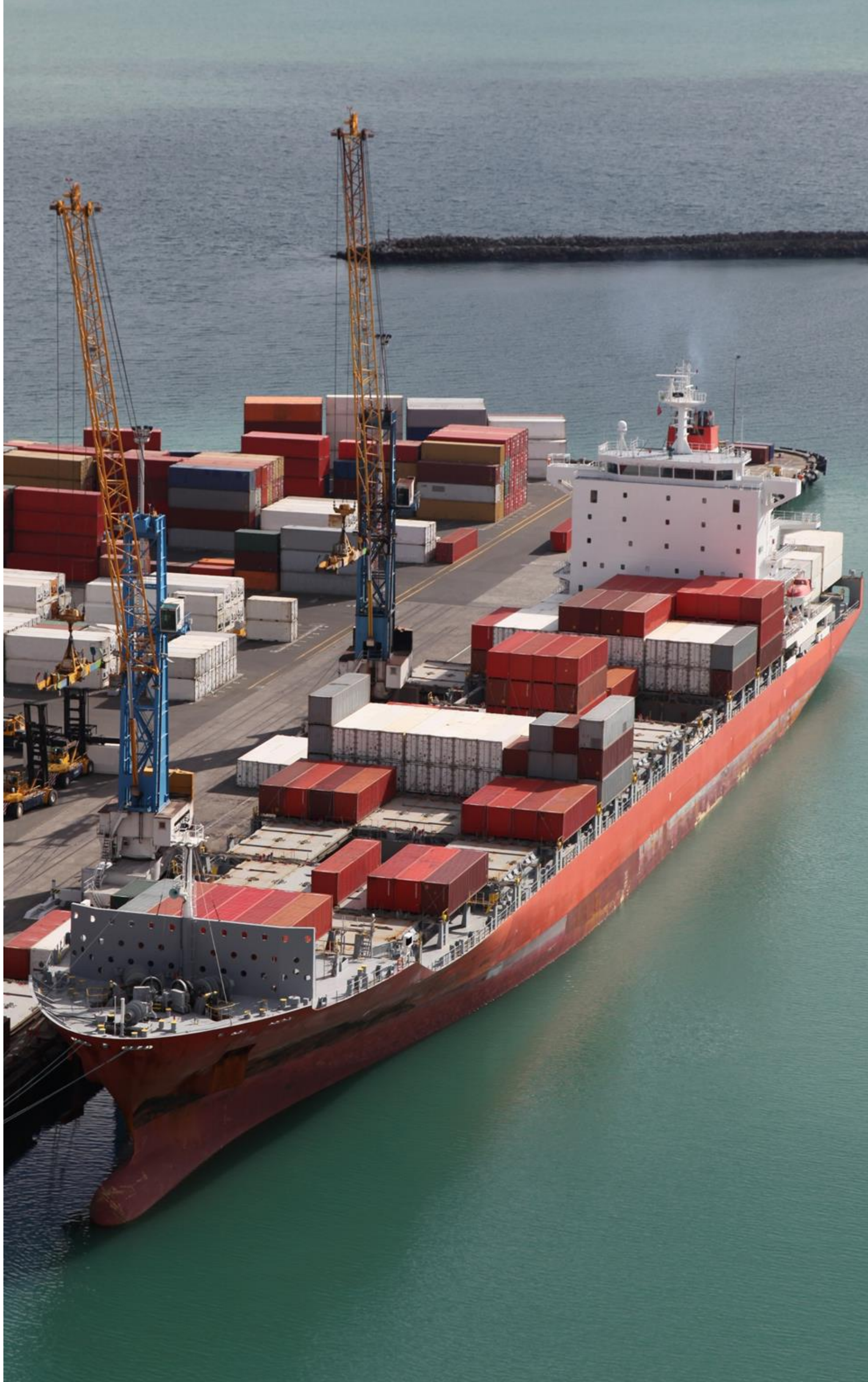
RICHTER CONSULTING

Consumer Products

Supply Chain Challenges
COVID Update

SPOTLIGHT: ASIA

June 4, 2021



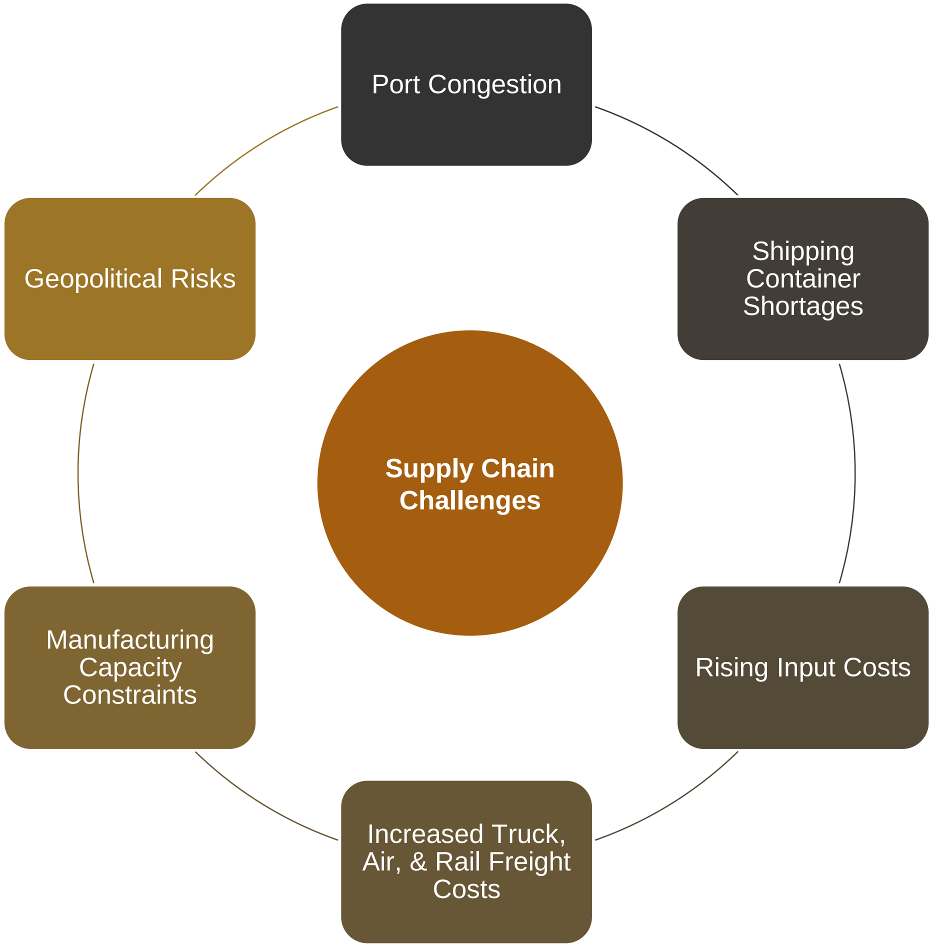
Supply Chain Challenges

Pent-up consumer products demand remains at elevated levels as the vaccination campaign continues and the economic effects of the pandemic generally subside. Global supply chains are under pressure to keep pace with widespread pandemic-related headwinds, as consumer product companies strive to fulfill demand on a timely and cost-effective basis from overseas vendors, primarily located in Asia.

Supply chain participants are facing numerous challenges in the late-stage COVID environment, including congestion at major US ports, container shortages, rising input costs, increasing truck, air, and rail freight costs, manufacturing capacity constraints, and geopolitical risks.

These sourcing challenges may directly impact EBITDA margins, liquidity needs, and brand equity.

Stakeholders need to anticipate and assess the related EBITDA/CF and potential business disruption impact of these supply chain challenges and develop mitigation strategies.



Key Risks & Mitigating Actions

Risks	Specific Issues	EBITDA/CF Considerations	Mitigating Actions
Port Congestion	▪ LA & Long Beach ports (32% of US container imports) significantly delayed due to labor shortages and surge in consumer spending.	▪ Protracted lead times; ▪ Inventory stockouts; ▪ Lower inventory turns; ▪ Customer retention risk.	▪ Supply chains should be assessed for (i) diversion to less congested ports, (ii) alternative modes of shipment (i.e., air freight), and (iii) use of multiple node distribution model to minimize domestic lead times; ▪ Review inventory management (MRP) and purchase plans to mitigate CF constraints.
Container Shortages	▪ Unprecedented container price increases; ▪ Trade imbalance with Asia.	▪ Ability to pass freight costs to customers and/or share costs with carriers; ▪ Longer lead times stressing W/C; ▪ Margin compression due to ↑ container costs.	▪ Diversifying freight forwarders and sourcing agents; ○ Emphasis on majors with better access to containers and stronger customs relationships; ▪ Lock in freight rates via contracts; ▪ Alternative modes of shipping if margins permit; ▪ Consider nearshoring as a longer-term solution.
Rising Input Costs/Inflationary Pressures	▪ Significant cost ↑ in commodities/RM such as lumber, steel, plastics, semiconductors; ▪ Input shortages.	▪ Manufacturing disruptions; ▪ Greater margin pressure if unable to pass increased costs to customers; ▪ Higher inventory cost base; ▪ W/C impact if cost increases lead to stretched payables/receivables.	▪ Hedging instruments (i.e., forwards/futures and options) to limit the volatility of input costs; ▪ Potential product reformulation to lower cost; ▪ Vendor consolidation/migration to lower-cost/tariff-free jurisdictions and price increase renegotiations; ▪ Ensure contracts include price escalation clauses; ▪ Ensure costing reflects projected input cost ↑.
Freight Increases	▪ Driver shortages; ▪ Increased fuel costs and intermodal freight rates; ▪ ↓ air cargo capacity and ↑ air freight rates.	▪ Increased add-backs; ▪ Potential significant liquidity impact as freight payables have limited terms; ▪ ↓ margin if DDP (delivery duty paid) terms.	▪ Consider alternative modes (i.e., air freight, rail) and increase RFPs; ▪ Negotiate freight overrides or "ex-factory" terms; ▪ Assess inventory valuation and ensure costing incorporates projected freight increases.
Manufacturing Capacity Constraints	▪ Pandemic-induced demand; ▪ Labor shortages; ▪ Input shortages; ▪ Manufacturers' leverage.	▪ Increased vendor prices; ▪ Higher risk of GM erosion from customer discounts & returns; ▪ Potential short shipments leading to penalties & cancellations.	▪ Vendor consolidation and increased order levels to improve negotiating leverage and ensure adequate supply; ▪ Contractual clauses to lock in vendor pricing and pass-through cost increases to customers.
Geopolitical Challenges	▪ Tariffs; ▪ Economic policy; ▪ Ethical sourcing.	▪ GM impact dependent on ability to negotiate tariff absorption by vendor and/or pass through to customer; ▪ ↓ EBITDA/CF if limited ability to migrate sourcing to non-tariff countries.	▪ Supplier diversification to non-tariff countries and explore nearshoring options; ▪ Negotiate price increases/cost ↓ to offset tariff impact; ▪ Closely monitor changes in tariff regulations.

Port Congestion Likely to Persist Into Q3/21

Congestion at major ports resulting in disrupted supply chains

- Pandemic-induced demand resulted in longer lead times, with ~40% of container ships arriving on time in March vs. ~70% in the prior two years (WSJ, May/21);
- The two largest West Coast ports, LA and Long Beach (32% of US container volume), are experiencing the most significant delays, with ~2-3-day delays commencing in Nov/20 and peaking at ~8 days in Feb/21. While delays have begun to subside, the two ports continued to operate at 10% to 15% above normal capacity through May/21 (Port of LA, May/21);
- Port issues were exacerbated by pandemic-related labor shortages as absenteeism rose and social distancing requirements took effect. This was coupled with reduced trucking and rail capacity due to similar labor issues (JOC.com, Mar/21, Cushman & Wakefield, Apr/21);
- Finished goods storage space is becoming scarce as merchandise is waiting to be shipped, worsening the already critical capacity crunch (Freightos, May/21);
- A recent National Retail Federation survey indicates that 98% of retailer respondents have been impacted by delays throughout the supply chain. More than two-thirds also reported significant recent shipping costs increases. (NRF, Apr/21);

Port congestion has impacted several industries, including:

- **Apparel:** *"Imports surged again in April and are expected to rise further in May and beyond, likely meaning port congestion will continue to pose a challenge at least through the end of the second quarter"* (Steve Madden Chairman & CEO, Apr/21);
- **Fitness:** *"A lot of merchandise is coming from Asia, which has just really jammed up the ports in a way that was largely unanticipated and is causing supply chain issues for many companies, including Peloton."* (Peloton Chairman & CEO, Feb/21);

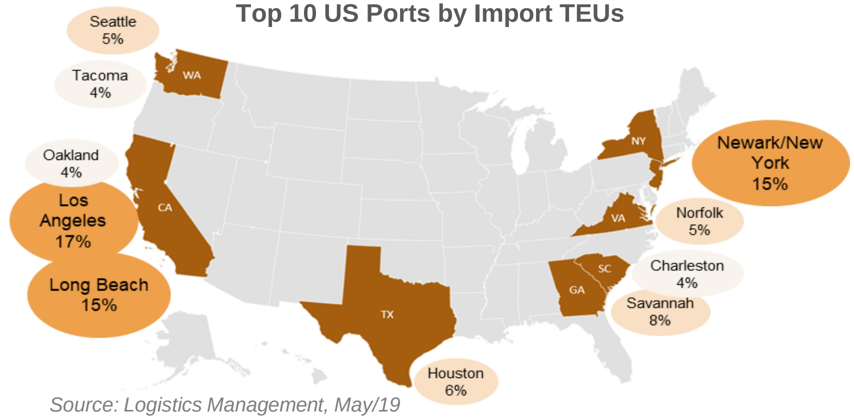
Signs of Improvement

- *"There are signs that port congestion is beginning to improve. But import levels are still elevated, and it's still taking longer than normal for facilities to process containers."* (Supply Chain, May/21);
- *"In the past 8 weeks, the number of anchored ships at the LA port decreased by two thirds and the velocity of containers flowing through improved by 20%"* (Port of LA, May/21);

Outlook

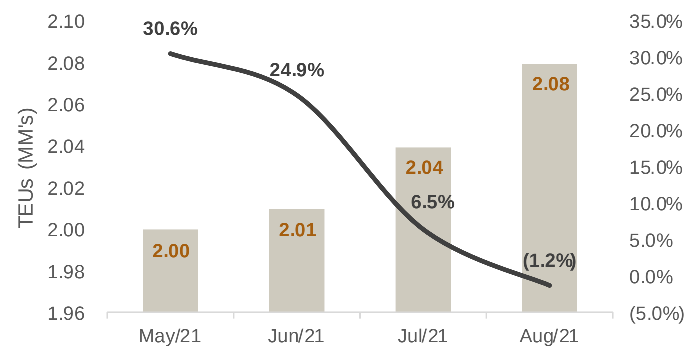
- A return to normal depends on when demand subsides and import volume growth moderates. However, import volumes are forecasted to remain well above 2020 through Aug/21 (MH&L, May/21);
- While port congestion is likely to improve significantly in Q2/Q3, governmental and environmental challenges coupled with limited available land around major ports could result in more chronic delays (MH&L, May/21).

Top 10 US Ports by Import TEUs



Source: Logistics Management, May/19
Note: % of 2018 total US port twenty-foot equivalent units ("TEU")

Retail Import Volume Forecast



Source: MH&L (May/21)

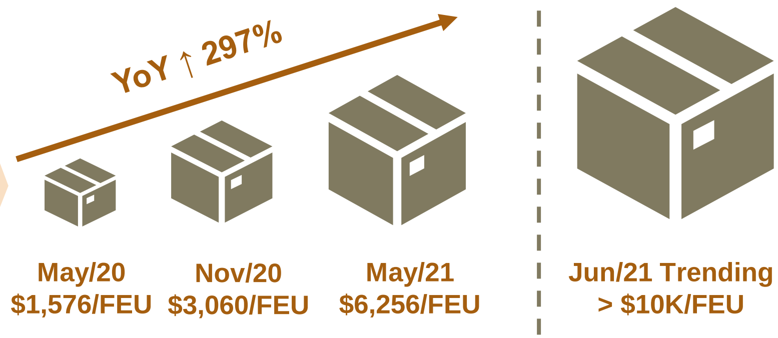
EBITDA/CF Considerations

- The backlog has resulted in protracted lead times, stockouts and customer discounts, straining cashflows and negatively impacting EBITDA and potentially brand equity;
- To mitigate these negative impacts, supply chains should be re-examined for (i) diversion to less congested ports, (ii) alternative modes of shipment (i.e., air freight), and (iii) use of multiple node distribution model to minimize domestic lead times;
- Inventory management and buying plans (MRP) should be reassessed to ensure appropriate, longer order lead times and adequate safety stock levels are maintained.

Shipping Container Shortages → Significant Price Increases

Trade imbalances with Asia are causing container shortages & increased freight costs

- While the pandemic has changed consumer shopping patterns (i.e., shift to online, increased demand for home goods), shipping capacity has failed to keep pace. This imbalance has resulted in a shortage of containers in Asia for exports to the US;
  - As China rebounds from the pandemic, the trade imbalance with the US has been significantly exacerbated, leading to China exporting three containers for every one imported;
  - *"The Global Shipping Alliance suggests that 'shipping lines are refusing outbound bookings because they want to expedite return of the containers to the Far East.' Bookings are now being accepted based on profitability and strategic importance, and as a result, **many small to medium shippers are being sacrificed.**"* (Forbes, May/21);
- This imbalance has significantly inflated container rates, with Drewry's composite World Container index indicating a YoY cost increase of ~ 300% from May/20 (to an average of $6,256/FEU in May/21, with recent prices rising to in excess of $10K/FEU).



*Drewry Composite World Container Index per FEU**
** FEU = Forty Ft. Container Equivalent Unit*

> *"The gross margin decrease was primarily due to high in-bound freight costs reflecting a worldwide shortage of shipping containers and other supply chain constraints. The higher freight costs will persist."*
>
> *- CFO, Lifetime Brands, May/21*

Global container shortages likely to last until 2022

- Despite slight improvements, given the strong recovery in China and consumer demand showing no signs of abetting, container shortages are projected to remain at least through 2H/21;
  - *"I would say that we're seeing somewhat positive momentum towards an improvement in the constraint we've been having with containers and availability. **It's not where we need it to be, but it's showing some improvement**."* (CEO, Hooker Furniture, Apr/21);
- Freight carriers and lessors of shipping containers expect shortages (and related price increases) to likely persist into 2022;
  - *"Our expectation is that the horizon looks like a minimum **through the end of this year and likely well beyond that**."* (CEO, CAI Global Transportation, Apr/21).

EBITDA/CF Considerations

- EBITDA impact subject to the ability to pass increased freight costs to customers and/or negotiating shared costs with freight carriers and vendors;
- Companies should consider switching freight forwarders, with an emphasis on larger players having better access to containers, and lock in freight rates to the extent possible;
- Alternative modes of shipping should also be considered if margins permit (i.e., air freight);
- Consider nearshoring as a longer-term solution, if feasible.

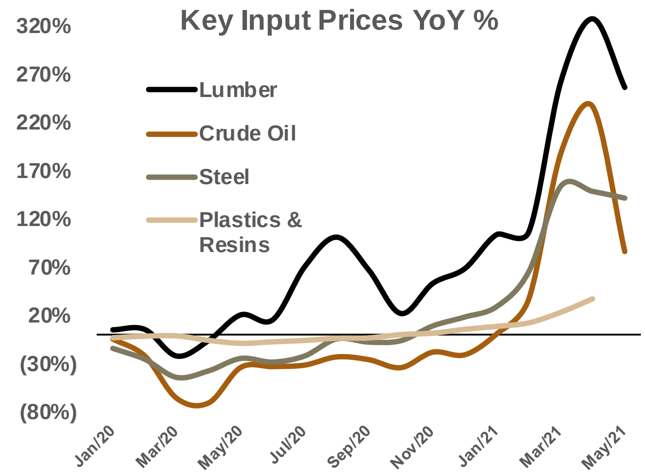
Rising Input Costs Stressing Supply Chains

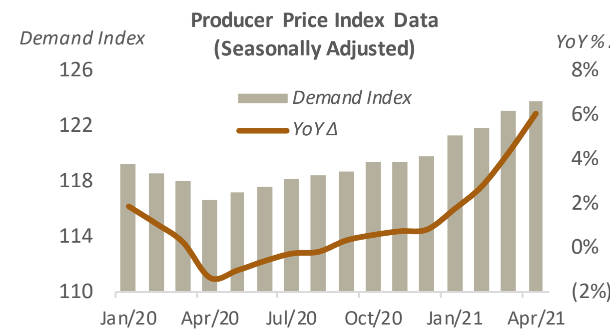
Commodity prices have surged over the past year

- Sizeable corporate and consumer demand spanning several product categories is fueling a rise in raw material/commodity and labor costs. The increases have not only affected the products themselves, but packaging materials as well (i.e., plastic, aluminum, and paperboard);
- Affected inputs include lumber (↑ ~87% YTD), steel (↑ ~42%), crude oil (↑ ~36%), plastics & resin (↑ ~25%), semiconductors, corn, soybeans, sugar, copper, iron ore, rubber, and chemicals, among others (NASDAQ, NYSE, FRED Economic Data/US Bureau of Labor Statistics, Bloomberg May/21);
- The effects of elevated consumer demand are apparent when looking at Producer Price Index commodities, which reflect producer price increases of 4.2% March YoY and represents the largest increase since 2011 (Consumer Brands Association, May/21, US Department of Labor);

Shortages and price increases have impacted an array of consumer product categories:

- **Consumer electronics:** *"As we stand today, we face an environment that…includes a worldwide supply shortage of integrated circuit components."* (Universal Electronics CFO, May/21);
- **Storage goods:** *"As it relates to gross margin, like other retailers, we are seeing freight and shipping cost headwinds, along with higher commodity prices. We plan to employ multiple methods to help mitigate the impacts of higher costs, which include vendor negotiations, actively managing our supply chain, along with adjusting our retail pricing and promotional cadence."* (The Container Store CFO, May/21);
- **Home goods:** *"It continues to be a challenged supply chain backdrop. Chemical shortages continue to impact different foam manufacturers"* (Casper CEO, May/21).





Source: NASDAQ, NYSE, Bureau of Labor Statistics

Commodities inflation, along with costs related to supply chain disruptions, have been largely passed on to consumers:

- The Consumer Price Index increased 0.6% in Mar/21 – the largest increase since Aug/12;
- Strong brands have been able to pass through cost increases;
  - Coca-Cola, Unilever, Nestlé, Mondelez and General Mills, among others, recently announced price increases or implied that hikes are anticipated later in the year to offset rising costs (Food Dive, May/21);
- Lesser-known brands appear to be struggling to pass on cost increases due to limited brand equity and intense competition.

Outlook

Moderate inflation is anticipated in the near term due to supply chain disruption, pent-up demand, and base inflations effects.

EBITDA/CF Considerations

- EBITDA impact is largely dependent on the ability to pass the increased costs to customers and/or negotiate vendor cost absorption;
- The use of hedging instruments (i.e., forwards/futures and options) can limit the volatility of input costs;
- In certain cases, product reformulations to include lower cost inputs could mitigate the impact;
- Vendor consolidation/migration to lower cost/tariff free jurisdictions and renegotiations should also be considered;
- Ensure new contracts include price escalation clauses;
- Ensure inventory costing reflects projected input cost ↑.

Truck, Air, & Rail Freight Increases

*"We continue to be operating in a very disruptive environment because of container shortages coming from Asia, port congestion, **trucking shortages** […]. We do expect it to be a difficult supply operating environment for the rest of the year," (Finance chief and business operations president of Newell)*

Driver Shortage: As more drivers retire and younger potential replacements are drawn to higher-paying alternatives (i.e., construction), the current industry-wide driver shortage is likely to remain chronic (IBISWorld, Mar/21);

- To attract drivers, wages have increased significantly – *"Knight-Swift Transportation, the largest truckload carrier in North America […] said last week that its wages for recently certified drivers have jumped by 40% or more in recent months"* (WSJ Apr/21);

Fuel: Retail gasoline prices increased 52% YoY in May/21 (US Energy Information Administration, May/21);

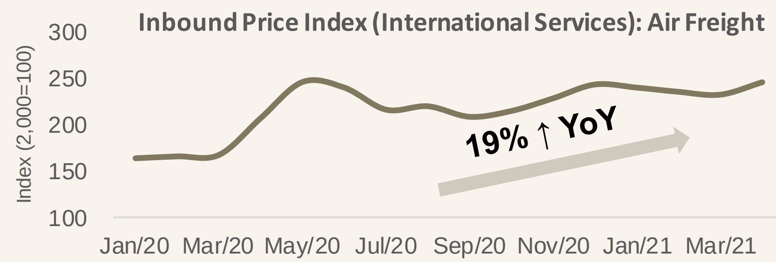
Freight Rates: There were significantly more available flatbed trucking loads for every available truck on the DAT freight exchange network. These trends resulted in 50%+ Apr/21 YoY increases in van, flatbed, and reefer spot rates;

Outlook: As retail inventories expand to satisfy increasing consumer spending, higher freight volumes are forecasted for long distance trucking over the next five years. Strong freight demand and a lack of truck capacity, along with high fuel costs are expected to keep trucking rates high for the near future (IBISWorld, Mar/21).

*"We have a couple of pretty significant headwinds. The biggest one is the freight with ocean rates up over 100%. **Airfreight rates are up close to 200%.**"* (Steve Madden CEO, Apr/21).

Difficulty Finding Air Cargo Carriers: Companies without precommitments or the willingness to pay premiums are struggling to find carriers to move their cargo (Freight Waves, May/21);

Freight Rates: As global air cargo volumes are up ~78% April YoY (CLIVE data services, Apr/21), prices have also significantly increased (19% Apr/21 YoY, per Bureau of Labor Statistics);



Source: Bureau of Labor Statistics

Outlook: Despite high air freight rates and shortages, conditions should improve significantly once air travel resumes and airlines add capacity.

*"Total **US weekly rail traffic** was 523,309 carloads and intermodal units, **up 26.9 percent** compared with the same week last year"* (Association of American Railroads, May/21).

Increasing Rail Demand: Although rail freight has been relatively inexpensive compared to other options, recent higher demand and fuel costs are beginning to put pressure on intermodal freight rates;

- *"Domestic intermodal demand continues to be strongest off the West Coast, […] Union Pacific instituted a $1,500/container surcharge on low-volume customers […] in late April."* (Journal of Commerce, May/21);
  - Union Pacific has instituted a further surcharge in June 2021 on lower volume, non-core customers due to container shortage concerns for core customers through the upcoming peak season (Journal of Commerce, Jun/21).

EBITDA/CF Considerations

- Critically assess add-backs;
- Analyze inventory costing and assess inventory valuation;
- Potential significant liquidity impact as freight subject to limited terms;
- ↓ margin if DDP (delivery duty paid) terms, consider freight overrides or "ex-factory" terms with customers;
- Consider alternative modes of freight (i.e., air freight, rail) and increase RFPs.

Leverage is Shifting to Vendors as Asian Factories Near Capacity

Pandemic-induced demand

- Pent-up consumer product demand, aided by record savings fueled by government stimulus checks and lack of travel, combined with pandemic-related labor shortages, is resulting in capacity constraints for many overseas manufacturers;
  - *"Consumer spending […] grew at a 2.3% pace in the fourth quarter. Stimulus money contributed to savings, ballooning to $4.12 trillion from $2.25 trillion in Q4/20. Economists estimate households have accumulated at least $2 trillion in excess savings during the pandemic."* (Reuters, Apr/21);

Labor shortages

- Asian manufacturers are facing labor shortages as factory work is increasingly considered unattractive;
  - *"Young people aren't willing to work on factory floors"* (Director, Midea, a leading home appliance manufacturer in China, Apr/21);
  - *"Surging raw-material prices and a shortage of workers have pinched smaller Chinese manufacturers, including many that sell their products to the US. While many have passed their higher costs on to overseas buyers, the pain is so severe at some manufacturers that they are finding it hard to raise prices enough to make up the difference."* (WSJ, Jun/21);
- Factory employees in alternative sourcing countries have experienced COVID-related absenteeism, exacerbating labor shortages and constrained production levels in the continent;
  - As COVID cases surge in Vietnam and India, shipping ports are experiencing labor shortages;
    - *"India's devastating COVID-19 crisis is threatening operations at some of its biggest ports, raising concern the [disruption] could trigger shipping delays that reverberate through global supply chains."* (Bloomberg, May21).

Input shortages

- Factories have also been dealing with shortages of commodities and other raw materials, contributing to the limited production capacity of manufacturing facilities;
  - *"Nio Inc. will temporarily halt production at one of its factories in Anhui province because of a semiconductor shortage, becoming the first high-profile Chinese carmaker to succumb to the chip snarl that's silenced the factory lines of auto manufacturers globally."* (Bloomberg, Mar/21);
  - Semiconductor shortages have caused supply disruptions in many consumer products categories, including automotive, electronics, and appliances: *"The production capacity for certain chips has been nearly fully utilized, reaching at least 98%."* (Deputy GM of CCIC Research Centre, May/21).

- Constrained capacity and customer demand has forced vendors to prioritize their customer base and order pipeline;
- Companies are increasingly facing penalty and discount demands from customers due to late shipments;
- While pandemic headwinds are beginning to subside, pent-up demand and record consumer savings are anticipated to continue to fuel spending, likely leading to **chronic factory capacity constraints well into 2022.**

EBITDA/CF Considerations

- Monitor production and delivery dates vs order commitments;
- Higher risk of QC issues leading to GM erosion from customer discounts & returns;
- Potential short shipments leading to penalties & cancellations;
- Vendor consolidation and increased order levels to improve negotiating leverage and ensure adequate supply.

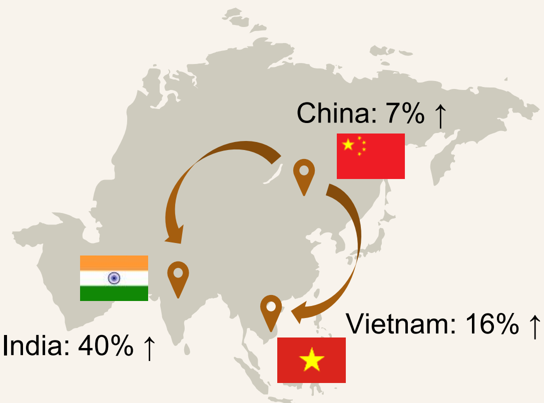
Geopolitical Trade Tensions Contribute to Supply Chain Disruptions

Tariffs Environment

- The Biden Administration has continued the previous administration's tariff policy on Chinese imports, with US companies bearing the brunt of the tariff-related expenses;
  - *"US importers absorbed > 90% of additional costs resulting from the 20% US tariff on Chinese goods"* (CNBC, May/21);
- In response, US companies have diversified their supply base to non-tariff jurisdictions, including India and Vietnam, which have seen a surge in production capacity and expertise;
- While the diversification has been critical in addressing the tariffs, many companies are now facing supply disruptions due to (i) recent COVID surges in India and Vietnam, (ii) related travel restrictions within Asia, hindering intracontinental sourcing, and (iii) related labor shortages at production facilities and ports, which has led to a temporary return of production to China;
  - *"...if supply chain (in India and Vietnam) is disrupted for an extended period, we could see 20% - 30% further export growth in China to continue into next year"* (CNBC, May/21);

China's export growth has significantly slowed in the six-month period ended Mar/21 due primarily to tariffs.

India had the highest export growth in the comparable period, among non-tariff countries.



- Despite the recent diversification, many companies continue to source certain raw materials from China (i.e., Chinese cotton shipped to Vietnam to be used in garment manufacturing). The intra-Asian input flow has also been impacted by container shortages, further exacerbating sourcing delays;
  - *"We are seeing an increased flow of components, raw materials and semi-finished goods that are being shipped between countries in Asia, before the finished products are shipped out to other regions"* (MSC, Apr/21).

Economic Policies

- As China looks to increase domestic spending and decrease exports via policy reform, supply chains will be further strained to fulfill global demand;
  - *"Expanding domestic consumption is a priority in China's 'dual circulation' economic strategy first highlighted by President Xi Jinping in May, which also called for a reduced dependence on foreign markets."* (Reuter's, Apr/21);

Ethical Sourcing

- The US has recently imposed import bans on products from specific regions in China due to forced labor concerns. These have primarily impacted cotton as Xinjiang province, under fire for potential human rights violations, is the source for 87% of China's cotton crop (~20% of the world's supply);
- Chinese exporters are under severe scrutiny due to these sanctions, which are not just limited to cotton, but include seafood and other agricultural products.

EBITDA/CF Considerations

- GM impact dependent on ability to negotiate tariff absorption by vendor and/or pass through to customer;
  - Must assess tariff environment and exposure on an ongoing basis to address any imminent changes in policy;
- ↓ EBITDA/CF if limited ability to migrate sourcing to non-tariff countries and if unable to circumvent other geopolitical risks;
  - Explore nearshoring options and assess related cash flow impact.

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Turnarounds

- Business & operational assessments
- Integrated 13-week CF forecasts
- Comprehensive sensitized projections
- Crisis/liquidity management & monitoring
- Working capital management
- Cost saving opportunities
- Covenant & loan amendments
- Strategic alternatives
- Lender group management
- Address stakeholder sensitivities

Operational Performance & Improvement

- Management team assessment
- Revenue diagnostics
- Customer & product profitability
- Fixed/variable cost analyses
- KPIs and benchmarking
- Supply chain management
- Capex requirements
- Post-acquisition synergies
- Plant consolidation
- Reporting systems

Transaction Advisory

- Financial and operational diligence
- Corporate carve-outs/asset divestitures
- Integration advisory
- Working capital and liquidity, including maintenance/growth Capex
- Support contract negotiation and transaction structuring

Forensics & Litigation Support

- Financial misrepresentations/gaming
- Revenue recognition/pre-billing issues
- Related party transactions
- Changes in accounting policies
- Forensic investigations
- Damages quantification

ABL Diligence

- Pre-funding diligence
- Borrowing base assessment
- Risk-based focus
- System assessments

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