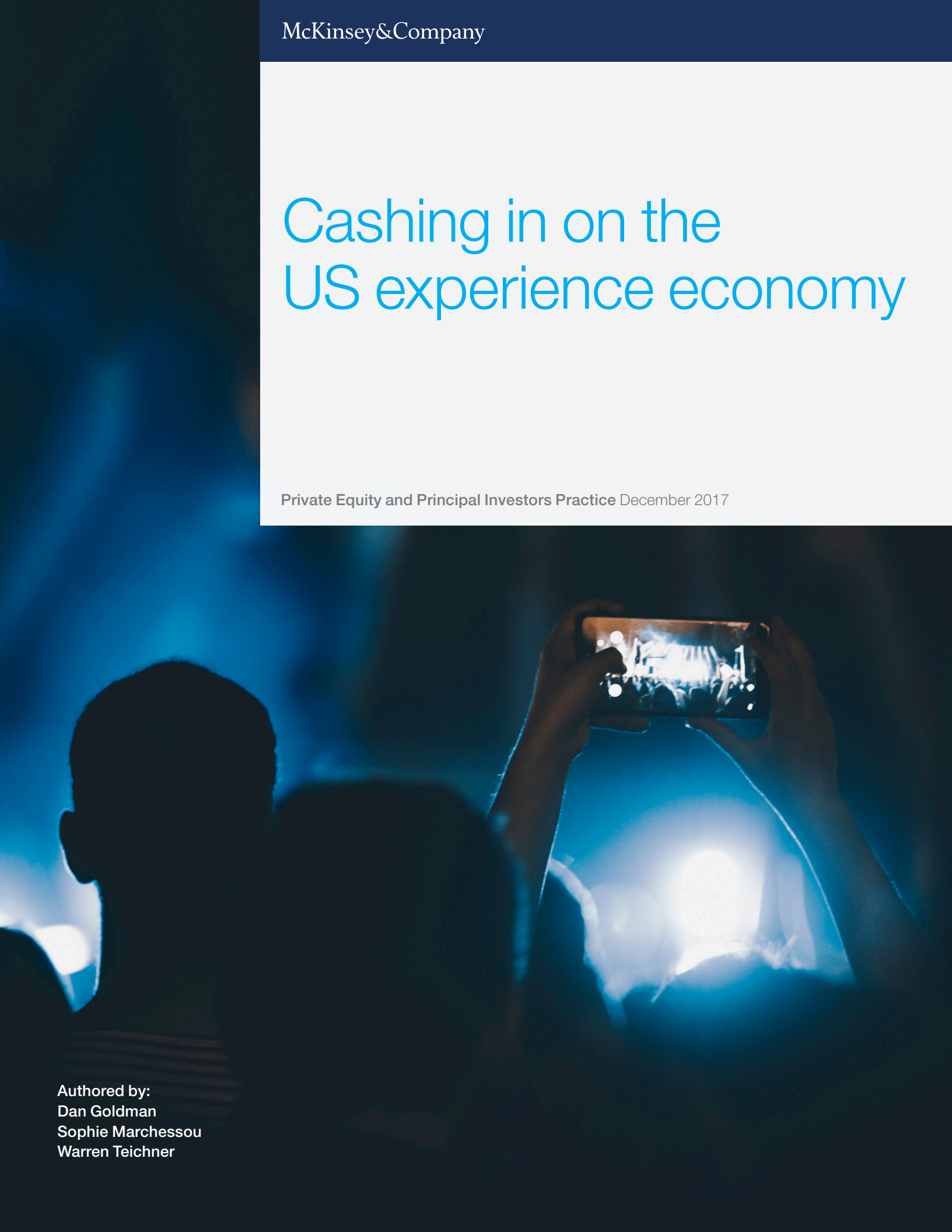


# Cashing in on the US experience economy

Private Equity and Principal Investors Practice December 2017



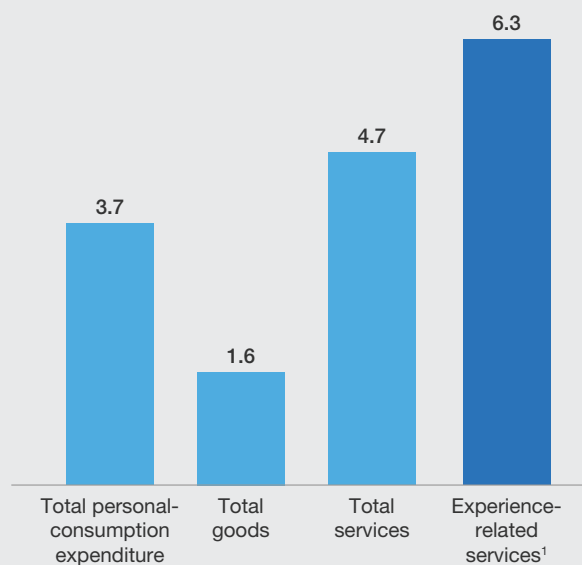
Authored by:  
Dan Goldman  
Sophie Marchessou  
Warren Teichner

## The time may be right for private equity to reach for experiences.

In recent years, faced with the choice of buying a trendy designer jacket or a shiny new appliance or of attending a show, consumers increasingly opt for the show and, more broadly, for experiences with their friends and families. In fact, over the past few years, personal-consumption expenditures (PCE) on experience-related services—such as attending spectator events, visiting amusement parks, eating at restaurants, and traveling—have grown more than 1.5 times faster than overall personal-consumption spending and nearly 4.0 times faster than expenditures on goods (Exhibit 1).

### Exhibit 1 | Consumers are shifting spending from goods to experiences.

Average annual personal-consumption-expenditure growth, 2014–16, %



<sup>1</sup>Experiences include the following BEA service categories: membership clubs, sports centers, parks, theaters, events, museums, casino gambling, food service, accommodations, air travel, package tours, and foreign travel by US residents.

Source: US Bureau of Economic Analysis, McKinsey analysis

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Despite these healthy tailwinds, over the past three years private equity hasn't meaningfully increased its investment activity in experience-related services. In fact, from 2015 to 2016 the number of transactions related to restaurants; to hotels, resorts, and cruise lines; and to movies and other forms of entertainment decreased (Exhibit 2).

The relatively limited number of investments in these spaces probably doesn't reflect a lack of interest. Many investors understandably wonder if the current trend—choosing experiences over goods—is sustainable. And even for those private equity firms that do believe these changes in consumer behavior are here to stay, deals have tended to be small, perhaps because, historically, many experience-based businesses have been local mom-and-pop or regional operations. Yet while many experience players are still relatively small, an increasing number have proven business models and strong consumer pull, so they could potentially be rolled or scaled up rapidly with a capital infusion, strategic guidance, a digital infrastructure,

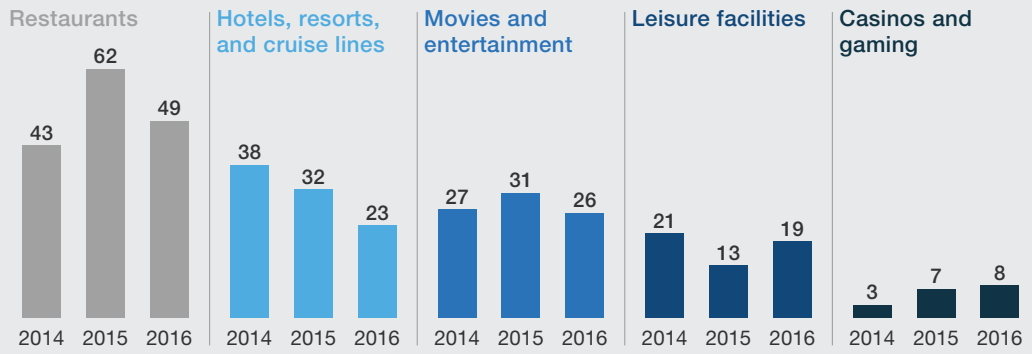
and customer analytics. In addition, services often are not as cyclical as some would expect: many consumers see them as affordable indulgences, not major expenditures. Furthermore, our analysis of the underlying drivers of the trend indicates that it is indeed here to stay.

### Experiences are king

Consumers of all ages are opting for experiences, with millennials leading the charge. A McKinsey consumer survey found that the average millennial outspends the average Gen Xer and baby boomer on entertainment- and fitness-related memberships, for example (Exhibit 3).

## Exhibit 2 | US transactions by investment firms have declined in some sectors.

Number of transactions, 2014–16

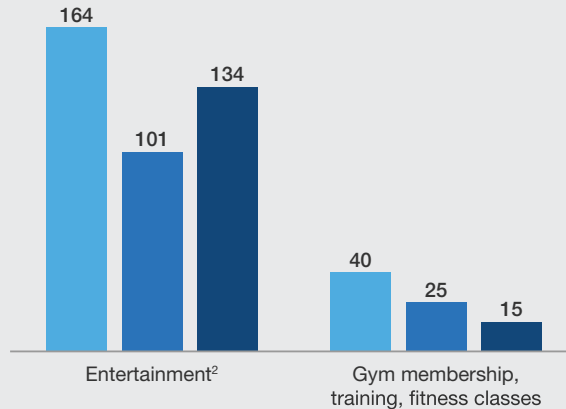


McKinsey&Company | Source: Capital IQ, May 25, 2017; McKinsey analysis

## Exhibit 3 | Millennials spend more than Gen X and boomers on experiences.

Spending on experiences,<sup>1</sup>  
\$ reported in average month

■ Millennials ■ Gen Xers ■ Baby boomers



<sup>1</sup>Respondents were asked “Approximately how much do you spend in an average month on the following types of purchases or expenses? (Enter amount to the nearest dollar.)” Results are mean \$, including responses of those who spent nothing.

<sup>2</sup>Such as eating out, movies, and sporting events.

Source: McKinsey Millennial Survey, May 2016

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The fact that millennials are now the largest spending cohort, and that the cohort of higher-income consumers is growing as well, creates greater confidence in the sustainability of the trend. To understand the underlying drivers of this shift in consumer spending behavior, we see three key factors, which are particularly applicable to millennials but hold true among older consumer cohorts too: a more holistic perspective on what leads to happiness, the growing importance of social media, and an increasing fear of missing out. They are unlikely to dissipate, which suggests that this shift in spending behavior will stick.

**A stronger link to happiness.** Shared experiences with friends and family have a deeper psychological link to long-term intrinsic happiness than buying products does. A recent study conducted at Cornell University found that consumers’ “evaluations of their material goods went down from the time of the initial purchase to the present, but their evaluations of

their experiences tended to go up, indicative of hedonic adaptation to the possessions but something quite different for their experiences.” The research suggested three potential drivers of this behavior:

experiences “are more open to positive reinterpretation, they tend to become more meaningful parts of one’s identity, and they do more to foster social relationships.”<sup>1</sup>

**The quest for “likes.”** Social media also appears to have helped accelerate the growing demand for experiences. Facebook and Instagram likes and creative snaps are now the ultimate social currency for millions of Americans, especially millennials, and the quest for likes requires a constant stream of new shareable content in the form of stories and pictures. Experiences play into this thirst for content because they are more likely to lead to such stories and pictures than the purchase of a new product would be. Even experiences that don’t turn out as expected—say, a long flight delay or rainy football game—eventually turn into shareable stories.

**A fear of missing out.** Keeping up with the Joneses used to be about wanting to own the same expensive products your friends or neighbors did. But with more consumers opting for experiences—whether that means seeing the musical *Hamilton* or visiting Hanoi—and sharing their stories and pictures online, people feel peer pressure to join in or keep up. This anxiety is so deeply embedded in the social fiber of millennials that they have given it a nickname: FOMO. The term was even added to the *Oxford English Dictionary* back in 2013.

### Assessing investment options

When investors try to capitalize on these trends, they should base their evaluation of potential experience-related targets on several key criteria (Exhibit 4).

**Exhibit 4 | Investors should consider several experience assessment criteria.**



- Loyalty and advocacy
- Multiple revenue streams
- Day-part utilization
- Strength of real estate
- Barriers to entry
- Portability to new markets

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To start, the target needs to show that it is more than just a cool, one-time experience and that it can generate loyalty and word-of-mouth advocacy with a core group of consumers. Such loyalty requires companies to create a longer-term form of consumer allegiance through reward programs, educational or community events, leagues or competitions, or the ongoing ability to create innovative new experiences. “Escape the room” concepts, for instance, would falter if they didn’t reinvent their rooms every few months; otherwise, patrons would visit once and never return.

Next, strong concepts generally have multiple revenue streams—for example, admission fees, food and beverage sales, and league or membership dues. Along these lines, they should prove that they can operate at a high level of utilization by generating sales across different days of the week and times of day. Concepts that appeal to multiple consumer segments (such as adults, families, teens, and corporate-event planners) typically perform well on this dimension.

<sup>1</sup> Thomas Gilovich and Amit Kumar, “We’ll always have Paris: The hedonic payoff from experiential and material investments,” *Advances in Experimental Social Psychology*, 2015, Volume 51, pp. 147–87.

Other critical areas usually include the quality of the real estate. Do the adjacent businesses attract similar target consumers? Does the location have sufficient traffic across all key parts of the day? Is it visible from the street, with ample parking nearby, or close to public transit? The magnitude of barriers to entry—such as whether the business has a proprietary model, or “secret sauce,” that can’t be copied easily—is also important. Finally, investors must determine whether they have sufficient evidence that the target’s business model can be extended to new markets or scaled in these markets through acquisitions.

Private equity firms exploring this space will see solid investment opportunities abound as consumers show increased interest in a broad range of experiences. In particular, spending for events, activities, travel (except for package tours), and restaurants all increased significantly faster than overall PCE expenditures over the past few years (Exhibit 5).



### Events and activities

The fastest-growing consumer experiences include events and activities: spending on spectator sports, amusement parks and related activities, live entertainment, membership clubs and sports centers, and movie theaters all rose faster than overall personal-consumption expenditures did. Collectively, these open up several potential investment avenues for private equity investors.

Amusement park–related activities and games rank among the fastest-growing types of experiences. They cover a wide spectrum of operators, from traditional amusement parks and family-fun centers to adult-oriented camps to specialized activity centers that focus on everything from go-cart racing to trampolines to laser tag. In addition, consumers are enjoying a plethora of newer immersive activities, including escape-the-room games, scavenger-hunt adventures, haunted houses, and even wreck or anger rooms (where people pay to destroy everything in the room, such as plates, appliances, and computers).

Consumers also continue to seek evening entertainment in the form of live performances. While concerts, festivals, and plays typically present higher barriers for traditional investors, private equity firms can look to more retail-orientated entertainment businesses, such as comedy clubs, piano bars, acrobatic performances, and dinner shows with themes like medieval tournaments or murder mysteries. Many have the potential to flourish in midsize and smaller cities, which often have fewer homegrown options.

A large segment of consumers wants to work up a sweat during experiences, so expenditures on membership and sporting clubs are growing strongly. Specialty concepts are outpacing traditional gyms; consumers are willing to spend big on an ever-growing number of exercise-based experiences, from competitive spinning to high-intensity strength and cardio-interval training to yoga and Pilates classes to endurance and obstacle-course races and even to flying-trapeze workouts.

### Restaurants

Healthy tailwinds are boosting the restaurant industry: food-service expenditures are growing at 6.4 percent a year (compared with overall yearly PCE growth of 3.7 percent). “Eatertainment” and “drinkertainment” offer an even more intriguing opportunity to take advantage of both the activity and the food service. A wide range beyond traditional offerings has emerged. Some of the new ones have already benefited from private equity investment.

Several higher-end, adult-focused businesses combine sports with more expensive food and drinks than traditional gaming venues typically offer. Premium bowling and bocce, for example, give consumers the opportunity to compete and eat in style. Other concepts pair driving ranges, golf-based games, arcades, or even table tennis with upscale food and beverages.

Sports and games aren’t the only food and drink possibilities: several other experiential restaurant and bar concepts are increasingly popular. A handful of craft-beer locations, for example, are starting to leverage technology to transform patrons into their own bartenders. Customers are kitted out with radio-frequency-identification (RFID) wristbands as soon as they walk through the door. They can swipe these wristbands (which are linked to their credit-card tabs) to unlock craft-beer taps around the bar, pouring their own suds and paying by the ounce.

### Travel

In addition to shifting spending toward local events, activities, and restaurants, consumers have been splurging on travel. A foreign-travel boom has lifted expenditures by 6.6 percent a year, while spending on domestic hotels and motels has increased at an annual rate of 6.0 percent. Spending on packaged tours has increased at a slightly lower rate than overall PCE—but one higher than spending on goods.



In summary, American consumers are consistently voting with their wallets to buy experiences rather than products. A more holistic perspective on what leads to happiness, the influence of social-media sharing, and a rising level of FOMO drive this trend—and, we expect, will continue to do so, offering attractive opportunities for potential investors. Private equity firms looking to capitalize on this trend need to identify experience operators that have real staying power with consumers and the brand strength to expand into new markets.

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#### Dan Goldman

Associate Partner, San Francisco  
[Dan\\_Goldman@mckinsey.com](mailto:Dan_Goldman@mckinsey.com)

#### Warren Teichner

Senior Partner, New Jersey  
[Warren\\_Teichner@mckinsey.com](mailto:Warren_Teichner@mckinsey.com)

#### Sophie Marchessou

Associate Partner, New Jersey  
[Sophie\\_Marchessou@mckinsey.com](mailto:Sophie_Marchessou@mckinsey.com)

#### Alex Panas

Senior Partner, Boston  
[Alex\\_Panas@mckinsey.com](mailto:Alex_Panas@mckinsey.com)

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