

Deal Size, Valuations on the Rise in Retail

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Not only is the retail mergers and acquisitions market continuing to heat up, but the megadeal is back on the table.

Certainly there's enough money out there for both deal size and valuations to balloon.

Chris Meyer, director at McKinsey & Co., said private equity firms have as much as \$100 billion that could be invested in retail.

"It's a big number," he said. "The funds are feeling pressure to put that money to work."

And growth is the order of the day.

"If you believe that growth in consumer spending is going to be muted versus what it was during the last decade, retailers are going to figure out how to compete in what is essentially a share war," Meyer said. "Folks are going to pay a premium for those assets that have some real growth potential in them."

It's hard to compare one deal with the next on overall size — retailers have a varying number of stores, different management teams, brands and so on. To level the field, bankers look at multiples, which typically are determined by dividing a company's enterprise value — the value of its stock and debts minus cash on hand — by earnings before interest, taxes, depreciation and amortization for the previous 12 months.

In specialty retail, the \$3 billion acquisition of J. Crew by TPG Capital and Leonard Green & Partners equated to about nine times EBITDA, while Gymboree Corp. went for about eight times, according to Thomson Reuters. That means that Aéropostale Inc., one of several companies that has been said to be a buyout candidate for months, is still attractive from a valuation perspective. Its stock is trading at a multiple of 4.12 times, so a buyer could pay current shareholders a healthy premium and still come in below the range established by the other deals in the sector.

There are plenty of companies with relatively low valuations in the sector. Gap Inc., for instance, trades at a multiple of 4.62 times. In February, Sears Holdings Corp. chairman Edward S. Lampert revealed that he had bought 5.8 percent of the company, or 35 million shares. (For more on current multiples across retail, see chart at right.)

All the action is being spurred by a number of factors. The recovery is on surer ground, stock prices have come roaring back and financing is easily available. So observers believe multiples are bound to head up, as will the size of the deals.

“I don’t see any reason why there isn’t a \$5 billion to \$10 billion deal out there,” said David Shiffman, investment banker and managing director at Miller Buckfire & Co. “Because of the Fed policy, as it relates to interest rates, money is incredibly cheap and we’re back to seeing financial packages that look like they did pre-crash. Absolute levels of leverage are beginning to creep up as well.”

Just look at AT&T Inc., which last week secured a \$20 billion bridge loan from J.P. Morgan to acquire T-Mobile.

“Deals like that excite the marketplace,” Shiffman said.

And the market had already proven to be rather excitable. So far this year there have been 53 retail buyouts in the U.S. totaling \$9.31 billion — well ahead of the \$1.61 billion in deals seen a year earlier, according to Dealogic.

“I don’t think there’s been a better time, really, for the M&A market,” said investment banker Elsa Berry, head of Houlihan Lokey’s cross-border consumer coverage. “It’s a unique time. Never before have you seen companies pile up so much cash. If you’re a public company sitting on a ton of cash and you’re not deploying it somehow, shame on you. You know what happens to those guys, they’re not independent for long.”

Companies across the spectrum are on the move. Walgreen Co. inked a deal to buy Drugstore.com, Revlon Inc. bought the Sinful Colors brand and Nordstrom Inc. acquired online private sale firm HauteLook Inc. for \$270 million. In Europe, LVMH Moët Hennessy Louis Vuitton agreed to buy Bulgari for \$6 billion and has been slowly amassing a stake in Hermès, which now stands at 20.2 percent.

Still, big deals can bring big challenges and the market still seems far from the days when rumors of a \$100 billion buyout of Home Depot seemed credible enough.

To make a big deal work, the target company has to be in expansion mode to be worthwhile.

“There are still a number of companies to consolidate,” said Gilbert Harrison, chairman of Financo Inc. “One of the problems that you have to take a look at if you’re going to look at any of these companies seriously is, ‘What is the growth rate?’ If the company can’t continue to grow at 12 to 15 percent a year, there’s going to be a greater difficulty in getting payback. The bigger the company is, the harder it is to do that.”

And not all fashion mergers are Master of the Universe stuff.

Middle-market apparel producers — who usually count their sales in tens of millions of dollars, not hundreds of millions — are also busy consolidating, buying up friends and enemies as they cope with changing retail realities.

“They used to say, ‘I’m in Macy’s and J.C. Penney.’ Now they’re saying, ‘I’m in T.J. Maxx and Burlington [Coat Factory] and Stein Mart and the regionals,’” said Jack Hendler, president of Net Worth Solutions Inc. “There’s an overabundance of production. They’re looking to buy because they lost volume over time. Organic growth really does not exist unless you’re some mega-brand, a Polo, a Calvin [Klein], a Nike. Anybody else has extreme difficulty getting more shelf space and the only way they can do it is by making an acquisition.”

Hendler said more of the smaller companies need to be absorbed, making for larger, stronger vendors that can work more effectively with retailers.

“There are still companies that are clearly doing well and have found a niche and have an identity and keep remodeling and keep reenergizing their product categories,” he said. “Some of them have recognized that they’re unique, but are also getting tired of the difficulty in the market place. A number of healthy companies with real EBITDA [earnings before interest, taxes, depreciation and amortization] are looking for acquirers.”

Already some buyers and sellers have connected. In January, Kellwood Co. bought contemporary sportswear brand Rebecca Taylor and Perry Ellis International Inc. acquired Rafaella Apparel Group Inc. from Cerberus Capital Management.

The Rafaella deal includes \$80 million and 106,564 warrants to purchase Perry Ellis stock. That makes for a multiple of about six times.