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Where the M&A Money Is

By Evan Clark

Spring is the time when shorter skirts and warmer temperatures can induce amorous impulses — and so it is in the business of fashion, where players on the mergers and acquisitions scene are starting to come out of winter's freeze.

Potential acquirers, though, might spend a few more months playing the field as price tags on targets drop and the consumer and financial markets settle down.

But the bankers and consultants who act as the industry's matchmakers see plenty of opportunities for further consolidation this year and next.

"Retailers throughout the world are dusting off old books, reviewing the competitive U.S. retail landscape and evaluating potential opportunities," said Ian Sugarman, a director in the consumer investment banking group at Citigroup Global Markets. "That goes across the board in every segment of retail. These conversations are happening today."

Sugarman described the M&A landscape as a "generational opportunity" where the dollar is at an historical trough, retail stocks are near the lows of previous economic slowdowns and retailers are better positioned so they're more desirable than in the past.

All this adds up to an opportunity to buy more for less.

There is also some pent-up demand in the system given the lack of activity.

Global retail M&A deals announced in the first quarter were valued at \$19.75 billion, down 68.6 percent from a year earlier, according to Dealogic. Within that category, the value of apparel and shoe store deals dropped 45.6 percent to \$2.74 billion, while department store deals decreased 21.9 percent to \$1.79 billion.

The value of U.S. retail deals fell 87.1 percent to \$2.68 billion in the first quarter.

Suitors calling on Seventh Avenue and the nation's retailers, though, are now more likely to look like the boy next door than the downtown Wall Street type who was making everyone's heart thump last year.

In the lexicon of deal making, this means "strategics," or companies looking to augment their current businesses, are going to beat out private equity groups that can no longer afford to borrow as much money thanks to the credit crunch.

"Strategics will replace private equity funds as major buyers of retail and apparel businesses over the next year," said Peter J. Solomon, founder and chairman of his eponymous investment banking firm.

Private equity's interest helped prop up retail shares, he said, noting stocks are down now that financial buyers are expected to play a smaller role in the M&A market.

"Strategic buyers will be very aggressive," said Solomon. "They don't require as much financing and the financing they require they can get more easily than most other people."

It isn't just strategic and private equity firms playing the field, however. Two other types of buyers are increasingly on the hunt for fashion companies: sovereign wealth funds and the ornately named special purpose acquisition companies, or SPACs.

The first is the strong silent type with vast pools of money derived from foreign governments and little transparency.

The second is a bit more eager, and is often a small group of people with experience in fashion who put in some of their own money and raise cash from others on the promise of making an acquisition.

All of these players are venturing into an economic scene that brings both risk and rewards.

Job losses are stacking up, consumer confidence is falling and turmoil in both the housing and credit markets recall the Thirties.

"These difficulties are going to put more and more pressure on players in the space, which either have weak positioning, weak financials, weak management or strategies that are not responsive," said Paul Charron, former chief executive officer of Liz Claiborne Inc.

"Those are the people who will be the consolidated as opposed to the consolidators," said Charron, who is now a senior adviser at Warburg Pincus and is also working with banking firm Fidus Partners on investments in small- and mid-cap consumer firms.

"There should be some pretty good deals for the strong to make over the next two years," he said.

That means the two sides of the coin, the difference between pressure and opportunity, could be sitting on opposite sides of the bargaining table and be encompassed within the same deal.

Here's a primer on the types of suitors out there.

STRATEGIC Buyers

Not only do companies looking to make strategic acquisitions have the benefit of cash flows and open lines of credit, they have more than purely monetary reasons to wheel and deal.

When a retailer buys a competitor, it not only buys market share, but also the opportunity to save money by merging back office functions such as accounting. They can also get more bang for their advertising buck.

Similarly, vendors taking on new brands can reduce overall costs and use their larger presence to increase their clout with stores.

"If you're a strategic with a relatively strong balance sheet, you're in a better position to compete against a financial buyer," said William Detwiler, partner at Watch Hill Partners. "You probably don't have to rely as much on the credit markets to finance your deal."

Phillips-Van Heusen Corp. is a good example of how economic conditions need not be perfect to close a big deal.

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PVH reached an agreement to buy Calvin Klein in late 2002, when financing was tight, and in doing so dramatically changed its business.

Emanuel Chirico, PVH's chairman and ceo, said last month that acquisitions were still the company's "first priority."

"Chaotic times are the times when good companies do acquisitions that can really fuel growth going forward," said Chirico. "It'll start to flush out over the next three to six months."

BLANK CHECKS

Special purpose acquisition companies raise money for the explicit purpose of making a deal within a set time period. If nothing comes along or no deal goes through, the shareholders get their money back, including the funding put up by the people running the show.

SPACs, also known as blank check companies, have already begun to make themselves heard in the marketplace.

Endeavor Acquisition Corp., founded by Jonathan Leddecky, reeled in American Apparel in December.

The clock is ticking for others.

Such is the case with Global Brands Acquisition Corp., another SPAC, run by Joel Horowitz and Lawrence Stroll, of Tommy Hilfiger fame, and John Idol, ceo of Michael Kors Inc. (which Stroll owns with Silas Chou). In December, the company raised \$287.5 million with the goal of sealing a deal within two years. The three also have \$5 million of their own money on the line.

Their initial target will be a company in the branded consumer segment specializing in apparel, specialty retail, footwear or accessories.

Also working with a two-year time frame is NRDC Acquisition Corp., which raised \$384 million in October. Richard Baker, ceo, is also chairman of Lord & Taylor.

SOVEREIGN WEALTH FUNDS

Fed by oil revenues and vast pools of foreign currencies, governments are becoming increasingly active on the investment scene through their own funds. Witness Istithmar, the Dubai fund, which owns Barneys New York, Loehmann's and a host of other companies in various fields.

Such sovereign wealth funds could pump over \$1 trillion into the global equity markets and \$1.5 trillion into the debt markets over the next five years, according to Deutsche Bank Research.

Most expect to see further investments by foreign governments in the fashion world.

In part, it's just economics, said former Gucci Group chief Domenico De Sole; a matter of who has capital and who can use it.

"The reality is there's a huge amount of money in those funds," said De Sole recently. "You'll see more and more."

Assets under the management of sovereign wealth funds jumped 18 percent last year to \$3.3 trillion, according to a report by International Financial Services London, a group that promotes UK financial businesses. That number is expected to rise to over \$10 trillion by 2015.

"In recent years, there has been a gradual shift from passive to active investment strategies," said the report. "This involves taking active control of companies through mergers and acquisitions or acquiring minority stakes."

The funds often have little transparency and enough money to swoop in with a dramatic purchase should it be appealing enough.

PRIVATE EQUITY PLAYERS

Despite the credit crunch and so much uncertainty in the financial markets, it would be wrong to discount private equity players in the M&A arena, even if their stars are on the wane right now. Private equity firms that can make strategic buys and pair them with existing businesses in their portfolio could still be a force.

"The strategic private equity would probably be the most aggressive group," Jack Hendler, president of Net Worth Solutions Inc., which helps connect buyers and sellers. "They're probably the most aggressive group paying a real multiple."

They, like the other players on the hunt, might also be beneficiaries of the retail weakness this past winter.

"The shakeout in this industry is really just beginning," said Hendler. "We're starting to see indications of stressed situations, where companies are going to need stronger partners. The margins are off, the sales are off, they're not getting the support they need."

There are also others with a track record in the industry who are looking for deals that aren't necessarily awash with dollar signs, though the potential is there.

"We're creative operating investors," said Jeffrey Aronsson, who cofounded Aronsson Group and is the former CEO of Donna Karan International and Marc Jacobs.

Last month, the Aronsson Group took a stake in Ginny H, the fashion label by Ginny Hilfiger, and is helping the designer build her business. The investment firm also has a stake in Matthew Williamson's business.

"There are a lot of people out there with big checks," said Aronsson. "We're invited in because there's a need within the company that we can do something to fulfill. In this equation, capital is of secondary importance. The primary focus is their need for expertise, hands on support and relationships."