

Grant Thornton Corporate Finance mergers & acquisitions

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Grant Thornton Corporate Finance Mergers & Acquisitions

Retail and Consumer Group

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Lifestyle Fashion Retailing

Private equity shops for small lifestyle boutiques

Executive Summary

Retail buyouts continued to make headlines last year, stacking the acquisitions of Claire's, Deb Shops, Avenue, Express, and The Limited onto a long list of transactions completed in 2006. Unique to 2007, however, was a new willingness by private equity to invest in small fashion boutiques. Activity in 2008 will likely be lower, because favorable valuations and ample capital will not be enough to stave off fears of weak consumer spending. Nevertheless, private equity's new interest in retail provides closely held chains with exit opportunities seldom before available.

Industry Overview

Innovative young lifestyle retailers have blossomed and are successfully competing against larger, more mature players. These niche retail concepts tailor their merchandise assortment, store layout/décor, employees and music specifically to their target demographic, to form a closer bond with the customer. We believe two factors have encouraged lifestyle retailing:

- The U.S. clothing and accessories market¹ is large and highly fragmented; the top five specialty chains (The Gap, Limited, Abercrombie & Fitch, American Eagle, and Aeropostale), make up less than 15% of the total U.S. specialty apparel market of \$236.8 billion.²
- Today's consumer is bored, and he or she quests for a new and exciting shopping experience. Quick and creative retailers offering something >

¹Excludes department stores

²U.S. Department of Commerce

Recent fashion retailing transactions

Date	Target	Acquirer	Doors	Description
11/13/07	Best & Co.	FAO Schwarz	2	Children's lifestyle brand and boutique
10/19/07	Boot Barn Inc.	Marwit Capital	31	Western footwear retailer
09/21/07	Calypso Christiane Celle	Solera Capital LLC	34	Women's lifestyle brand and boutique
09/11/07	United Retail Group (dba Avenue)	Pinault-Printemps Redoute	483	Plus-sized women's chain and catalog
08/23/07	BJ Vines (dba Betsy Johnson)	Castanea Partners	55	Women's lifestyle brand and boutique
07/30/07	Intermix, Inc.	Goode Partners LLC	18	Women's luxury boutique
07/26/07	Lucy Activewear	VF Corp.	50	Women's lifestyle brand and boutique
07/26/07	Deb Shops, Inc.	Lee Equity Partners LLC	347	Junior's and Plus
07/09/07	The Limited Stores Inc.	Sun Capital Partners, Inc.	260	Women's
06/25/07	Sheplers Inc.	Gryphon Investors	19	Western lifestyle apparel retailer
06/22/07	Barney's New York	Istithmar	34	Luxury department store
06/13/07	Hanna Andersson	Kellwood Co.	18	Children's multichannel retailer
05/22/07	Stride Rite	Payless Shoesource	300	Various footwear
05/15/07	eStyle, Inc.	Global Retail Partners	20	Children's multichannel retailer
05/15/07	Express LLC	Golden Gate Capital	631	Junior's apparel
04/18/07	Francesca's Collections, Inc.	Bear Stearns Merchant Banking	60	Women's boutique
03/20/07	Claire's	Apollo	3000	Costume jeweler for preteens
02/28/07	Just Add Water	Everything But Water, Inc.	12	Women's swimwear boutique
01/17/07	Moosejaw Mountaineering	Parallel Investment Partners	7	Outdoor lifestyle retailer
01/15/07	Corral West Ranchwear, Inc.	BTWW Retail LP	94	Western lifestyle apparel retailer

different can enter the market and quickly capture share. Recent examples include Lululemon, the yoga-inspired clothing boutique, and Zumiez, which caters to the action sports lifestyle. The most formidable constraint is a shortage of suitable space in enclosed shopping centers.

Recognizing the success of these smaller chains, large retailers have launched their own lifestyle concepts to better connect with the consumer. Examples include Abercrombie & Fitch's Ruehl concept and American Eagle Outfitters' Martin + Osa, both of which target the affluent 25–40 age demographic.

M&A activity

Last year witnessed unprecedented deal activity in fashion retailing. Private equity investors, seeking to acquire unique lifestyle concepts as growth investments, claimed 70% of all transactions. This development is a dramatic departure from 2006, when corporate divestitures, spurred by department store consolidation, drove the market.

Why then would private equity firms, known for acquiring easily leveraged businesses with predictable, sustainable cash flows, invest in fashion retail? We believe several factors explain this trend:

- **An abundance of capital** – Over the last three years, private equity firms raised more than \$400.0 billion for new investment. To put this in context, in the 10 years spanning 1995 to 2004, private equity raised an equivalent amount.
- **Ever-increasing valuations** – Auctions for midmarket companies became ultra-competitive in recent years, driving up price. During 2007, median valuations for midmarket companies topped 9.0x EBITDA, prompting investors to seek lower-priced, nontraditional investment alternatives like retail, despite higher levels of risk.
- **Passion for brands** – Private equity has always had a fondness for consumer brands, believing that brand loyalty lends itself to sustainable cash flows, better margins, differentiation, and barriers to entry. The ascension of branded specialty retail concepts has given rise to a host of new consumer lifestyle brands, and private equity has taken notice.
- **The promise of easy growth** – Unlike other mature sectors, retailers can grow simply by opening more doors. Once an investor buys into the viability of a concept, chains can rapidly expand by signing more leases.
- **Herd mentality** – Well-respected private equity groups like KKR, Bain Capital, Apollo, and Thomas Lee closed enormous leveraged buyouts of public retailers during 2006, blazing a path for smaller funds to pursue middle-market retailers.

Without regard to underlying reasons, the entry of private equity capital into midmarket specialty retail has created unparalleled opportunities for owners to extract liquidity from their investments.

Most fashion retailers acquired in 2007 were relatively small chains (between 18 and 60 doors) that operated in clearly defined niches. Examples range from retailers solely focused on a narrow product offering, such as bathing suits, to boutiques that target particular demographics, such as women between ages 20 and 34, or pure lifestyle concepts, capturing western culture. >

Valuation

Factors that influence apparel sales (and thus valuation) are fashion trends, shifting demographics, consumer confidence, discretionary income, and consumer spending. Notably, consumer confidence has been in decline since August, and many public fashion retailers reported weak comparable store sales and announced store closings. These downbeat economic signs have lowered overall sector valuations. Median multiples for public fashion retailers have declined from their peak in March 2007; they now rest at approximately 5.0x EBITDA.

We believe current lackluster valuations are temporary and represent the market's extreme view of dramatically lower retail profits in 2008. For support, we note that two fashion retailers were recently acquired at valuations in excess of 7.0x EBITDA. The latest was the acquisition of United Retail Group, Inc. (which does business as Avenue) by RedCats USA, the U.S. subsidiary of the French retail juggernaut Pinault-Printemps Redoute. The second was the acquisition of Deb Shops by private equity group Lee Equity Partners. Both transactions closed at a full price despite rather difficult financing conditions.

Conclusion

Private equity groups acquired successful lifestyle retailers at a breakneck pace in 2007, creating new and attractive liquidity options for smaller retail chains. Many of the factors underpinning this trend continue into 2008 – interest in consumer brands, an abundance of capital, and favorable valuations. However, declining consumer confidence and weak retail sales will likely scare off some fair-weather investors and begin to take a toll on M&A activity. Nevertheless, an opportunity exists for differentiated lifestyle retailers with strong growth and profitability to benefit from unusually strong M&A market conditions.

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