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M&A Activity, Divestitures and Initial Public Offerings in the Fashion Industry

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EXTRACT

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1 INTRODUCTION

This dissertation analyzes the implications of mergers and acquisitions, divestiture activities and initial public offerings in the fashion and leather accessories industry. It contains four independent empirical studies and covers a large fraction of corporate finance-related activity in a business segment that has been widely disregarded in previous research. The purpose of this introduction is to give a short overview on macroeconomic trends and industry-specific characteristics of the apparel industry. We will also briefly introduce our four research objectives and some of the key findings of our following studies.

Generally, the apparel business segment has seen extensive shifts in industry dynamics over the course of the previous decades. High labor costs in established Western countries and decreasing costs of global logistics have triggered a wide-spread outsourcing of manufacturing activities into low-cost developing countries. This has rendered a great deal of workers in developed countries unemployed. The subsequent reductions in manufacturing costs and mass production have also given way to the strong proliferation of clothes in the low-price segment (Abernathy et al. (1995)). Still, European and North American apparel companies play leading roles in the up-scale and luxury fashion sector where the main emphasis is rather put on product quality, individual features and exclusivity than price competition (Glasmeier et al. (1993)).

Aggregate demand has further shifted from traditional developed to emerging markets such as China, India, the countries of the Middle East and Russia where increases in economic wealth and personal prosperity in particular fuel the aspiration for clothing and related products. An empirical study by KPMG (2009) has shown that individuals in these countries are especially prone to the consumption of luxury goods and upscale fashion, resulting in strong growth rates and steadily increasing market shares of these business segments.

In addition, distribution characteristics have changed on a large scale due to the fashion industry's strong affiliation to product sales via the internet and web-based applications. Gertner and Stillman (2001) have shown empirically that apparel products are among the best-selling items for online distribution in the United States. The acquisition of internet retailer Net-A-Porter.com by Swiss luxury conglomerate Richemont in 2010 has further underlined the importance online distribution nowadays carries for fashion and accessories companies.

The fashion industry is now both a multi-billion dollar business sector as well as a fast-growing market segment. According to recent international trade statistics of the World Trade Organization, the apparel and textiles industry has accounted for $527bn or 4.3% of the world's trade volume in 2009 while growing at an impressive CAGR of 5.0% over the course of the years 2000 to 2009 (WTO (2010)). Given the fact that even more upcoming economies are gaining access to fashion and luxury products, it is reasonable to believe that the apparel industry is facing many years of sustainable growth in the near future.

Besides these favorable macroeconomic developments, the industry itself has changed due to consolidation and alternating customer demands. Many companies that headed the fashion "zeitgeist" of a certain era have become irrelevant and have been replaced by fashion houses and designers that were able to better understand current lifestyles. The fast-paced rhythm of the two collections-driven business model is a distinctive characteristic that differentiates the fashion segment from other industries with more long-term oriented product life cycles. Fashion businesses are therefore forced to implement permanent innovation and adaptation to their ever-changing industry dynamics.

Like many other industries, the fashion segment has seen a tremendous amount of M&A activity in previous decades. The luxury goods sector which also includes many luxury fashion brands has become especially concentrated with the four European conglomerates LVMH, PPR, Compagnie Financière Richemont and Swatch Group now being the predominant worldwide players. In the leather accessories segment, Mariella Burani Fashion Group has acquired a large portfolio of handbag and similar leather product manufacturers. On a remarkable note, all of these companies are located in Europe.

Nevertheless, the upper mid-price fashion segment has also witnessed the rise of large brand collectors such as Phillips-Van Heusen, Iconix Brand Group and Liz Claiborne that are mostly located in the United States. Two of the most prominent recent deals conducted were the takeover of Tommy Hilfiger by Phillips-Van Heusen Corporation in March 2010 ($3.0bn) as well as the acquisition of outdoor footwear manufacturer The Timberland Company by VF Corporation in June 2011 for a consideration of $2.0bn. These mid-price fashion conglomerates also constitute multi-billion dollar businesses and have participated frequently in the takeover market to support their external growth strategy.

Still, the fashion industry exhibits a very heterogeneous business structure. While the above-mentioned conglomerates and some solid, stand-alone companies such as Polo Ralph Lauren and Hermès International are steadily increasing company sizes, there are also a great deal of small, single-brand businesses that are privately owned and closely associated with central personalities such as their founder or present creative director. Since many of these small businesses are attractive takeover candidates due to their company heritage and strong market awareness, future mergers and acquisitions are to be expected.

On the contrary, divestiture activities in the fashion industry are rather scarce and often related to either corporate refocusing programs or seller companies in situations of financial distress such as NexCen Brands and Tropical Sportswear. In Germany, the decline and subsequent bankruptcy of luxury ladies' fashion house ESCADA AG caught media attention during the first decade of the 21st century. ESCADA divested several of its non-core segments over the course of this period. In our clinical paper we concentrate on a particular divestiture process that heavily contributed to the company's demise.

Along with M&A activity, the fashion industry has also witnessed some high-profile initial public offerings in recent years. Prada's $2.1bn offering in June 2011 on the Hong Kong Stock Exchange was one of the largest fashion IPOs so far. With Tom Tailor Holding AG's 2010 offering, there was also a prominent German IPO during the preparation of this dissertation. The ongoing discussions about possible IPOs of Italian fashion houses Versace and Salvatore Ferragamo show that equity offerings are still an integral part of the fashion industry and appear as an attractive option for change of control processes.

Despite these enormous changes in industry structure and dynamics, there is only a very narrow literary base of corporate finance research on the fashion industry. One of the most prominent exceptions is the acclaimed case study on once highly successful US footwear manufacturer L.A. Gear's failure by DeAngelo et al. (2002). Königs and Schiereck (2008) further examine shareholder wealth effects for luxury goods M&A transactions which also include luxury fashion and leather accessories deals. This study, however, leaves out low- and mid-price fashion transactions and also considers non-fashion merger activity in segments such as jewelry, alcoholic beverages and wristwatches.

Bhattacharyya and Nain (2011) explicitly reference the apparel segment in their empirical study of horizontal mergers in various industries as an important example for strategic consolidation efforts in order to create high buying power towards suppliers. Finally, Mitchell and Mulherin (1996) investigate takeover and restructuring activity in different industries following exogenous shocks between 1982 and 1989. They confirm that consolidation in the apparel industry during this period was mainly driven by the emergence of foreign competitors and the reduction of trade barriers while giving a rather pessimistic outlook on M&A profitability for this particular time period. None of these studies, however, exclusively focuses on the apparel segment. Therefore, only little insights on long-term industry dynamics and value drivers are given.

To the best of our knowledge, a conclusive overview of corporate finance-related issues on the fashion and accessories industry has not yet been given. The research objective of this dissertation therefore is to shed a light on a variety of topics that revolve around the key factors of success of fashion companies. There are also undisputedly important aspects within the fields of marketing, sales, logistics and organization that determine corporate success in the fashion industry. For the sake of coherence and sharp focus, however, we dedicate this dissertation solely to matters of corporate finance and governance.

We divide our analysis into four central research questions. First, we take a look at short-term shareholder wealth effects that are generated by M&A deal announcements in the fashion and leather accessories industry. In a second step, we analyze the long-run operating performance of merging companies and their non-acquirer peers. Our third analysis concentrates on divestiture activities in the fashion industry with the help of a clinical paper on ESCADA's belated disposal of its non-core segment PRIMERA. Finally, we illustrate the long-term stock price performance of fashion initial public offerings and investigate shifts in the systematic risk exposure of apparel companies issuing equity.

In light of the ongoing consolidation in the fashion industry, we start our analysis with the following first research question: How do investors react to the announcement of an M&A transaction in the apparel industry? As an appropriate measure for shareholder wealth effects, we apply standard short-term event study methodology as outlined inter alia by Serra (2002), Binder (1998) and MacKinlay (1997). Since many target firms in our data sample are privately held companies with little or no publicly disclosed information, we rather concentrate on bidder stock price reactions. While most previous studies find highly positive and statistically significant abnormal returns to target shareholders, results for bidder companies vary across different industries and time periods.

Using a data set comprising 192 M&A transactions conducted between 1994 and 2009, we find positive and significant abnormal returns to bidding shareholders of fashion companies. Cross-sectional regression analysis reveals that wealth creation is highly positive especially for smaller bidding firms and first-time acquirers. Furthermore, there is a significantly negative correlation between abnormal returns and both acquirer market capitalization as well as multiple bids during the observation period. We therefore conclude that M&A deals conducted for the purpose of diversifying the high risk exposure of small, single-brand fashion companies are generally welcomed by equity investors.

On the other hand, the negative reaction to multiple bids and transactions of larger companies can most likely be attributed to arguments of the free cash flow (Jensen (1986)) and hubris hypotheses (Roll (1986)). These theories view M&A activity as a means to squander excess cash resources and to increase firm size as well as management reputation rather than corporate profitability. The same applies to transactions that have been conducted during bull markets with high cash availability as opposed to carefully-assessed strategic deals executed in times of economic downturn or even recessionary periods.

Having analyzed the announcement effects of fashion M&A transactions, we pose our second research question: How do these positive short-term reactions translate into more long-term oriented merger success? Generally, it would have been possible to evaluate long-run performance by using a buy-and-hold return event study as applied in studies such as Bouwman et al. (2009) and Agrawal et al. (1992). Due to a number of companies that conducted various deals, however, test results of a corresponding analysis would have been seriously biased due to the presence of many confounding events.

Instead, we measure long-term M&A success by comparing pre- and post-merger operating profitability, leverage and growth ratios for merging firms and their non-acquiring peer group companies. Following the methodology of Barber and Lyon (1996), we use several accounting ratios and a matched-firm approach to find abnormal operating performance. We use the same data sample as in our short-term event study, but have to eliminate 32 of the 192 original transactions due to the non-availability of sufficient accounting data.

Our analysis shows a significant drop in operating performance following the remaining 160 sample transactions compared to both pre-merger company financials as well as peer group firm performance. On the contrary, post-merger financial leverage significantly increases for merging companies. At first sight, this is not a surprising finding, since firms generally gain higher debt capacities following M&A activity due to larger company size, lower default risk and higher bargaining power in bank negotiations (Ghosh and Jain (2000)).

Nevertheless, cross-sectional regression analysis shows that post-merger debt ratios have a significantly negative influence on operating performance. We conclude that some merging companies have increased their leverage beyond the optimal point of indebtedness which puts additional distress on companies that are already engaged in costly post-merger integration activities. Finally, pre-merger cash availability and the general stock market climate again are negatively correlated to post-merger accounting performance. These findings give a mixed outlook on the general advantageousness of fashion M&A activity.

In case a company decides on a corporate restructuring or the anticipated synergies from an acquisition do not materialize, it might be beneficial to sell off parts of the business or a certain brand. Our third research question therefore is: What are the consequences of a divestiture in the fashion industry? Mostly due to the fact that our identified seller company data sample is rather small in order to draw reliable inferences from an empirical analysis, we illustrate the implications of divestiture activities by means of a clinical paper.

German luxury couture house ESCADA AG rose to international success and high reputation in the two decades following its foundation in 1976, reaching almost €1bn in annual sales volume at its peak. The company also supported its growth strategy by various mergers and acquisitions, joint ventures as well as licensing agreements in non-core segments such as affordable mid-price ladies' ready-to-wear fashion, kids wear, leather accessories, cosmetic products, sunglasses and jewelry, creating a widely-diversified brand portfolio.

As the company's profitability started to deteriorate at the end of the 1990s, management under founder Wolfgang Ley decided on a refocusing on ESCADA's core competencies in the luxury apparel segment. While most of the company's non-core activities were sold off subsequently, management adhered to PRIMERA AG, ESCADA's largest mid-price fashion segment that included four brands and accounted for roughly one quarter of the group's revenue in fiscal year 2000/2001. During the following decade, management insisted on its disposal plans for PRIMERA without initiating a divestiture process until the company finally faced serious financial distress at the end of 2008.

Since management itself proclaimed the lack of synergies between ESCADA's core business and the PRIMERA brands while independent broker reports at times consented on a very lucrative value range for the PRIMERA business of up to €200m, the prolonged disposal hesitation appears in stark contrast to the rational behavior hypothesis that is commonly cited in corporate finance research. Based on pertinent behavioral finance literature and publicly disclosed announcements of ESCADA management, we argue that psychological phenomena such as loss aversion, status quo bias and mental accounting exerted a tremendous influence on the reasonable decision to divest the subsidiary. In the absence of an efficient market for corporate control, management was able to delay the divestiture and thereby lead the company into bankruptcy.

Finally, we put forward our fourth and last research question: How do initial public offerings of fashion and leather accessories companies perform in the long-run and what are the key drivers of successful offerings? Numerous empirical studies such as Chang et al. (2010) and Brav and Gompers (1997) have analyzed long-term buy-and-hold returns and consistently found a significant underperformance of newly issued stocks compared to corresponding benchmarks across various industries, geographic regions and time periods.

Building on a data set comprising 207 fashion IPOs conducted between 1990 and 2007, we find that offerings are clustered during periods of high stock market valuations. In addition, IPO stocks experience an average price jump of 20.5% (commonly referred to as "money left on the table") from the offer price to the closing price at the end of the first trading week. Despite these very positive initial returns, issuing companies significantly underperform corresponding equity indices by up to 31.5% for a 36-month post-IPO holding period.

While long-term underperformance is often attributed to investor sentiment and asymmetrical information, we argue that there is a more rational explanation for the seemingly poor stock price development. We find that a large fraction of issuing companies intended to use their offer proceeds for investments in both internal and external growth opportunities. An analysis of pre- and post-IPO company financials confirms that capital expenditures as well as total assets and sales volumes significantly increase following fashion offerings.

We build our analysis on the theoretical model of Carlson et al. (2004) who argue that SEO companies use their offer proceeds to turn risky real options such as a potential M&A investment into lower-risk assets in place. When we analyze the development of post-IPO company betas, we find a considerable reduction of systematic risk. In the context of the risk-return spectrum, this confirms our hypothesis that the weak stock price performance of issuing companies is in large parts driven by a general risk reduction that is due to the realization of real options in company portfolios. This finding evokes a more optimistic outlook on IPO performance in the fashion business segment.

In summary, this dissertation gives a broad variety of insights into the dynamic environment of the fashion and leather accessories industry. We empirically investigate both short- and long-term implications of mergers and acquisitions, divestiture activities as well as initial public offerings in this business segment. On an academic level, we expand the existing corporate finance literature by novel findings on a specific, fast-growing industry that has been widely disregarded in previous scholarly works. Nevertheless, this dissertation also represents a helpful manual for various practitioners within financial institutions, venture capitalists and, not least, fashion and leather accessories companies. Based on our empirical findings, they should be able to draw significant inferences that will help them to understand the key drivers of success in the fashion industry and to make meaningful and sustainable strategic decisions.