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2021 Looks Promising for Retail Exits — If Investors Don't Get Too Greedy

Activity is up, but valuation expectations could curtail deals

BY RICHARD COLLINGS | MAY 24, 2021

M&A in retail is expected to be robust this year as the economy rebounds.Courtesy SOPA Images, NurPhoto, Juan Camilo Bernal/Getty Images

What a difference a year makes.

Twelve months ago, following mass store closures across the U.S. during the pandemic, most of the chatter around retail was about who was filing—or likely to file—for bankruptcy. Soon thereafter, the acquisition of bankrupt U.S. retailers abounded, from the purchase of apparel retailer Brooks Brothers by Authentic Brands Group to the sale of department store banner JCPenney to Simon Property Group and Brookfield Asset Management.

In the meantime, Covid-19 also disrupted deals negotiated just prior to the outbreak. In May 2020, for example, Sycamore Partners and L Brands called off a deal that would have given a majority stake in L Brands' Victoria's Secret banner to the private equity firm for $525 million. The one-time lingerie behemoth then announced it would close 250 stores.

Now, unable to find another buyer or offer it liked, L Brands is instead opting to spin off Victoria's Secret as a public company.

Retail insiders say this expectation of high valuations among sellers could curtail even more merger and acquisition activity in 2021. The alternative, as Victoria's Secret demonstrated, is to go public via an initial public offering (IPO) or a special purpose acquisition company (SPAC).

But, they say, we can still expect a robust climate for retail exits in 2021.

"We are hard-pressed to find a better time to monetize than now," said David Shiffman, co-head of financial advisory firm PJ Solomon's global consumer retail practice.
He cited the low cost of capital, the willingness of debt and equity investors to lend and transact and the large amount of committed capital private equity is holding as key factors.

"We are bullish as a firm on the U.S. economy, macro trends and on the reemergence of the consumer," Shiffman added, noting progress on vaccinations.
In fact, retail sales are proving to be even better than originally expected as the pandemic recovery continues.

As a result, private equity firms may even choose to hold on to portfolio companies for a few more months and then market those banners off improved sales figures, said Mary Ann Domuracki, a managing director at investment bank MMG Advisors.

First quarter transactions up

So far this year, research shows increased appetite for exits.
In the first quarter of 2021 alone, some $8.5 billion worth of retail transactions involving U.S. companies were signed. That's the most Q1 activity since 2014, when $12.4 billion worth of deals were executed, according to law firm White & Case, which compiled the data in partnership with M&A insights tool Mergermarket.

Notable acquisitions so far this year include the leveraged buyout of arts and crafts retailer Michaels Stores for about $5 billion by private equity firm Apollo Global Management.

In addition, private equity firm Hellman & Friedman struck a deal in May to take home decor superstore At Home Group private for $2.8 billion (although activist shareholder Honest Capital is opposing the transaction because the purchase price is too low).

More recently, marketing and branding firm Authentic Brands added yet another piece to its sprawling retail empire after buying outdoors brand Eddie Bauer from private equity firm Golden Gate Capital.

These deals highlight ongoing opportunities in pandemic-era trends of outdoor activities and home improvement—and the appetite among private equity firms for retailers as the recovery continues.

The price is too damn high

Meanwhile, intriguing assets remain up for grabs, such as athletic goods maker Adidas' exploration of a sale of footwear brand Reebok.

There are a handful of potential buyers kicking the tires on potential targets, such as VF Corp., the parent of North Face and Timberland (and which bought Supreme last year for $2 billion), as well as PVH Corp., the parent of Calvin Klein and Tommy Hilfiger. And, per industry sources, we can add conglomerates such as G-III Apparel Group and Hanesbrands to that list. And, yes, Authentic Brands and Simon Property Group are in this race, too.

But strategic buyers are also being selective about the quality of the brands and the categories they play in—and they're holding the line on price.

Interested buyers will always be constrained to some degree because regardless of how much money there is to invest, and no matter how willing the capital markets are to lend, the sky is not actually the limit when it comes to risk and leveraging the balance sheet with debt as a multiple of cash flow, especially as it pertains to retail.

For example, the more that debt is leaned upon to finance an acquisition, the more it will cost to service or pay the interest on that debt, both in relative and absolute terms.

In the case of private equity, on the other hand, using less debt means such firms will have to front more of the cash to pay for the deal, which can limit eventual returns when they sell or take the company public.

An investment banker, who asked for anonymity because such conversations are confidential, pointed out in some cases, legacy businesses are seeking 14 times Ebitda (earnings before interest, taxes, depreciation and amortization, which is a measure of cash flow), which is likely to make most strategic investors and private equity firms balk.

That may discourage bargain hunters and forestall some transactions, like we saw with Victoria's Secret. In fact, a source at a potential acquirer noted the lingerie brand is well-known by consumers, but is nevertheless a "fixer upper" that will require significant investment.

Bankruptcy on the wane

But it's another story when there are bargains to be had.

In a reversal from 2020, the default rate, along with bankruptcies in the retail sector, is expected to continue to plummet—at least as far as corporate debt issuers are concerned, according to David Silverman, a retail analyst at credit rating agency Fitch.

The shrinking list of banners that remain in danger of default include apparel chains Men's Wearhouse, J.Jill and Talbots, as well as online jewelry retailer Blue Nile and brand licensing group Iconix, which owns labels such as Joe Boxer, London Fog and Rocawear.

But while Chapter 11 filings will certainly be lower in 2021, activity is expected to pick up as the year proceeds, resulting in asset sales, according to Murali Gokki, a managing director at consulting firm AlixPartners.

Private equity firms in particular will be on the lookout for attractive assets they can buy out of bankruptcy, but they will continue to be selective, he said.

The most recent example is the sale out of bankruptcy of Paper Source, a seller of greeting cards and papers, to hedge fund Elliott Investment Management, the owner of bookstore chain Barnes & Noble.

The public markets

For strategic investors who won't back down on valuation, the most likely exit is an IPO or SPAC.

"As a whole, the public markets are incredibly robust," Shiffman said.
In fact, publicly-held companies have been able to achieve valuations in many cases that the private markets can't afford to pay, he said, while declining to comment on any specific names.

Apparel retailers such as Abercrombie & Fitch, which is trading near its five-year high of about $42 per share, are achieving market capitalizations not seen in years.

Sporting goods retailer Academy Sports and Outdoors and crafts retailer JoAnn both opted for an IPO in recent months, for example.

Academy has an enterprise value of about $3.6 billion, a multiple of about six times its adjusted Ebitda of approximately $600 million for the fiscal year ended Jan. 30, according to public filings. While the multiple is relatively low for a sporting goods chain, the share price is roughly double where it traded in November.

That's a sign that even troubled retailers such as Academy, which was marked as distressed by credit agencies through much of the pandemic, can attract investors and achieve healthy valuations via the public markets.

And as in the case of Michaels and At Home Group, it demonstrates confidence in retailers tied to the home and outdoor activities.

SPACs

In addition to IPOs, SPACs are another path retailers may take to access the public markets.

As Gokki pointed out, SPACs are in a unique position because they are already sitting on a pile of cash and have immediate access to the public markets, so they don't have to line up debt or investors to finance deals.

Domuracki said the retail sector has not participated in many SPACs, although they've played a role in beauty, wellness and tech,

But there's an outside chance we may see a few such transactions later this year.

Two such "blank check" vehicles looking for consumer -or retail-related businesses include KKR Acquisition Holdings I Corp., which was formed by former Gap CEO Glenn Murphy and private equity firm KKR, and Good Commerce Acquisition Corp., led by former Gap CEO Art Peck.

In all, it's a promising albeit mixed bag of potential outcomes.