WWD

Fashion M&A Update: Now Is the Time to Buy

Allan Ellinger, founder and senior managing partner of MMG Advisors, sees the current market as ripe for making acquisitions.

By WWD Staff on November 11, 2020

Allan Ellinger
Courtesy image.

As several European countries and U.S. cities such as New York brace for a second-wave of COVID-19, businesses are working hard to maintain cash flow and not get saddled with too much debt. From an M&A perspective, now is a good time to consider selling a business.

But is it also a good time to buy?

In the second of a two-part series on the topic, Allan Ellinger, founder and senior managing partner of MMG Advisors, an investment bank focused on middle-market retail and fashion companies, explains why this is an ideal time to sell and to buy a business — given current market conditions.

WWD: Is this an opportune time to consider acquiring a business?

Allan Ellinger: My partner, Andy Postal recently shared with WWD readers our view that this is a good time to consider selling your business. And now I am being asked whether this is also a good time for acquirers to consider buying a business. So, the question is: can this be both a buyer's and a seller's market simultaneously?

The answer is yes — this may be a very opportune time to consider an acquisition. The current bankruptcies and consolidation at retail, tight credit markets, the rapid move to digital, weak balance sheets, disruptions in the supply chain, a lack of generational succession and a potential increase in cap-gains taxes are among some of the reasons the industry is ripe for deals.

MMG Advisors has recently engaged with numerous companies with significant financial resources seeking advice on whether this is a good time to consider an acquisition. We strongly believe that acquiring a business early in a recovery cycle is a way to maximize a return on investment. Additionally, interest rates are very low. For public companies, acquisitions may be the means to achieve the growth required to support or enhance stock valuations as it is often faster and cheaper to "buy It, than build It."

For financial buyers, this is a time to put funds to work that have been sitting on the sidelines through the COVID-19 period. For private strategics, this may be a time to find accretive add-ons that expand distribution, mitigate risk by product diversification or adding a brand. We are already seeing an increase in the aggressive acquisitions of distressed or bankrupt companies, an uptick in the IPO market and an increase in the number of Special Purpose Acquisition Companies (SPACs) being created.

WWD: What are the factors that should be considered in creating a buy-side strategy?

A.E.: Successful acquirers know the wisdom of the adage that "if you don't know where you're going, any road will get you there." The key to a successful acquisition program is to invest the time at the outset to develop a clear strategy that is based on your company's financial capability, careful targeting, and the development of valuation metrics and deal structure that your company is prepared to deploy. Some of the factors to be considered are: 1. How do you define the type of company to target? 2. What are the financial resources available to deploy? 3. Who will we need to sign-off of on the deal, i.e., lenders, stockholders, an investment committee, licensors, government authorities? If so, what will they require for consideration of a proposed transaction?

WWD: How do you go about identifying targets? Do I need outside advisers?

A.E.: Identifying targets starts with a clear understanding of the strengths, weaknesses and risks associated with the buyer's business. What attributes are desired to make the buyer a stronger company? Is the buyer a mature company in need of a growth vehicle? Is the buyer a traditional wholesaler that wants a direct-to-consumer capability? Does the buyer want to add brand equity either through acquiring a brand or through acquisition of a license portfolio or key license? Is the objective to add new distribution or product capability to reduce concentration risk?

The answers to these questions will help focus the process. Professional help can assist in the process, help to maintain objectivity, assist in the identification of target companies, assist in valuing the target company to mount an offer and the development of deal structure as well as projecting the transaction's financial impact on the buyer's balance sheet. Selecting appropriate targets involves articulating where strategy meets financial capability. There will always be trade-offs. Once you know what you are looking for, you can proceed to discuss valuations and how transaction structure can help achieve a buyer's objectives.

WWD: What metrics should I consider in valuing a business?

A.E.: There are a variety of metrics that are utilized in valuing businesses. For traditional businesses, earnings before interest, taxes, depreciation and amortization or EBITDA is a common basis for valuation. Multiples of EBITDA to be applied to a business are subject to a number of considerations. Generally, companies with brands command higher multiples than licensed companies, which in turn command higher multiples than private label companies. Concentration, tier of distribution, continuity of earnings all are factors contributing to value. Multiples also are highly dependent on growth — both historical, and most importantly, projected future growth.

In the case of digital companies, traditional valuation metrics have been replaced by multiples of revenue. As many digital companies have been built and financed to generate growth rather than profits, the valuation of these companies revolves around the growth curve, the cost of generating the growth, the assessment of the return on funds spent (KPIs) and an assessment of the sustainability of the growth. While we do anticipate a convergence of digital companies with more traditional vendors and brands, valuations will have to become more normalized before the trend accelerates.

At the end of the day, beauty may be in the eye of the beholder. What a target is worth to a particular buyer will not only be determined by valuation metrics, but also the purchase objectives and whether a transaction can be structured to increase the likelihood that the buyer's goals can be achieved.

WWD: How are buy side transactions structured? How do earn-outs or earn-ups factor into valuation?

A.E.: Transaction structure can be used to align interests between buyer and seller. Structure can help achieve synergy, and keep key ownership engaged for sufficient time to ensure the attainment of the transaction's objectives.

Earn-outs and earn-ups are provisions designed to give the seller a stake in future performance and reward them for achieving the performance that was the basis for the transaction valuation. Typically, these forms of post-closing consideration are a portion of the purchase price, which is tied to the achievement of projected results agreed upon between buyer and seller at the time of purchase. Properly structured, they provide a powerful incentive to achieve projected results and align interests in hitting targets that were implicit in the valuation of the target company.

Improperly conceived, they can become a source of misalignment and disincentive between parties. The key to these provisions is the financial and strategic assumptions underlying the agreed-upon go-forward plan for the acquired business unit. Typically earn-outs range from two to three years. Successful earn-outs hinge on transparent and timely financial reporting and the ability to easily interpret its provisions.

WWD: What are the key factors in insuring a successful transaction?

A.E.: There are many factors that go into a successful transaction. Assembling the right team is paramount to the success of a transaction. Typically the team would include a deal-savvy attorney, a tax adviser who is often an attorney, the company's accountant, a due-diligence team (which may be the company's accountants), and an investment banker, who, in addition to negotiating the deal, would coordinate all the professionals. Do not skimp on due diligence.

Confirming and documenting what assets you're buying and what liabilities you agree to assume, as well as margins, usable inventory, forward bookings, tax liabilities and contracts will protect you should issues arise post-close. Additionally, the acquirer should assemble an internal team that can help to assess the deal and its viability to the buyer as well as begin planning integration.

One of the most important variables in an acquisition is the marriage of cultures between buyer and seller. All too often this is underestimated in transactions. In many cases, the seller is an entrepreneur who has run his or her own company, only reporting to themselves and has not been part of a larger organization. The melding of management personnel, systems, reporting structures, compensation policies, benefits and the understanding of how each other's businesses operate all combine for a challenging integration.

WWD: How should I plan for integration of the new business? Should this be part of the buy-side process? What are the key issues and pitfalls?

A.E.: We often say it is far easier to buy than to integrate. Successful buyers understand the challenges of integration and plan for it**.** The two primary reasons deals fail post-closing are a lack of cultural fit and alignment, and inadequate and poor integration both organically and operationally.

Integration planning is a vital part of the buy-side process. The buyer should engage with its key departmental management and its outside professionals in formulating an integration plan. Departments that can be picked up at closing need to be identified and integration planned. There will need to be coordination with the seller's organization to ensure an orderly absorption. Some of the integration will require time to be incorporated, such as the seller's ERP system, and will of necessity be governed by a Transition Services Agreement. Depending on the transition structure, other assets of the seller may be left behind and will need to be liquidated or separated.

We believe that due-diligence is far too often a check-the-box, backward-looking exercise. The buyer is purchasing the seller's future, not its past and must devote the time and resources to understand the reality of the seller's future projections. The buyer must also spend the time to evaluate the seller's organization and identify key employees whose continuance with the business is critical. Finally, the buyer must evaluate the seller's supply chain and customer relationships to ensure those relationships continue as projected.

A buy-side transaction is a serious commitment for any buyer and must be met with a disciplined approach. Don't do deals that are too big to hurt you if it fails, especially if it's your first deal. Don't become emotionally connected to a potential transaction. Don't let your ego supersede good business judgment, and know when to say no and walk away, because they'll always be another deal. Remember, once you own it, you can't return it!