# M&A AND FASHION: IF THE DEAL FITS. . . BUY IT!

## PART ONE

*DOUGLAS HAND**

Over the course of the last three decades, the fashion industry has undergone enormous change. Formerly, the industry was characterized by high fragmentation and smaller, family-owned enterprises. Companies sold to wholesalers rather than directly to consumers. More recently, increased consolidation and growth have led to the creation of massive international luxury corporations. The e-commerce revolution has freed many brands from reliance on wholesalers. As a result of these factors, today, fashion and apparel is one of the largest sectors of the global economy.[1]

Increased globalization and advances in technology, manufacturing and distribution have changed nearly every aspect of the industry, especially the attitudes and appetites of consumers themselves.[2] Indeed, while today's Americans spend nearly the same amount (adjusted for inflation) on apparel as they did in 1965, they buy nearly twice as many articles of clothing.[3] Amidst all of this transformation, many fashion

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1. *See* GUILLERMO C. JIMENEZ & BARBARA KOLSUN, FASHION LAW: A GUIDE FOR DESIGNERS, FASHION EXECUTIVES, AND ATTORNEYS XV (2010) [hereinafter FASHION LAW]; *see also* Scott C. Hemphill & Jeannie Sulk, *The Law, Culture, and Economics of Fashion*, 61 STAN. L. REV. 1147, 1148 (2009).

2. *See generally* Vertica Bhardawaj & Ann Fairhurst, *Fast Fashion: Response to Changes in the Fashion Industry*, 20 INT'L. REV. OF RETAIL, DISTRIBUTION & CONSUMER RES., 165, 173 (2010).

3. FASHION LAW, *supra* note 1, at 6.

companies[4] have undertaken strategic mergers and acquisitions ("M&A") to consolidate risk and capitalize on opportunities.[5]

M&A has historically proven enormously successful for the world's leading fashion companies,[6] which, by most critical accounts, have been able to successfully exploit their size without diminishing the value of their brands.[7] Smaller companies have also turned to M&A to improve brand awareness and gain market share.[8] Companies seeking to grow through M&A have "chosen vertical integrations in order to strengthen their positions inside the pipeline; others have implemented horizontal growth by acquiring competitors or companies with related product lines."[9] Private equity funds and entrepreneurs have also been involved in acquiring fashion companies, with mixed levels of success.[10]

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4. In this Article, we use the term "fashion companies" generically to refer to fashion and apparel businesses, which may take on any number of legal entity forms.

5. *See, e.g.*, Kali Hays, *Mergers Could Be the New Trend in Luxury*, WWD (Apr. 3, 2017), http://wwd.com/business-news/mergers-acquisitions/mergers-could-be-the-new-trend-in-luxury-fashion-10855930 [https://perma.cc/ST2N-VTE2]; Vicki M. Young, *Study Predicts More Megadeals; Rebound in Valuations Ahead*, WWD (May 22, 2017), http://wwd.com/business-news/mergers-acquisitions/study-predicts-more-mega-deals-rebound-valuations-ahead-a-t-kearney-retail-consumer-mergers-acquisitions-10891405 [https://perma.cc/ST2N-VTE2]; Luisa Zargani, *Global M&A Activity Up 30% in 2016*, WWD (Mar. 10, 2017), http://wwd.com/business-news/mergers-acquisitions/global-ma-activity-up-30-in-10841891 [https://perma.cc/P8VP-XEBJ].

6. *See generally* Jennifer Hirshlag, *Marriages Made to Profit*, WWD (Sept. 11, 2006), http://www.wwd.com/beauty-industry-news/financial/marriages-made-to-profit-524616 [https://perma.cc/2ZBG-HFMF] (discussing mergers and acquisitions among fashion accessory brands); *see also* FASHION LAW *supra* note 1, at 7.

7. *See* BARBARA ROVETTA, GROWTH THROUGH ACQUISITIONS: THE CASE OF FASHION INDUSTRY (2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=292580 [https://perma.cc/TM8U-7X4D]. Some companies have had greater challenges implementing a multi-brand strategy. *Id.* at 13–16.

8. *Id.* at 12; *see also* Lisa Lockwood, *Analysis: Sell or Go It Alone*, WWD (July 6, 2011), http://www.wwd.com/markets-news/ready-to-wear-sportswear/staying-independent-vs-selling-out-3701351 [https://perma.cc/E4Y3-PW8Z].

9. ROVETTA, *supra* note 7, at 18; *see, e.g.*, Elizabeth Paton & Chad Bray, *Michael Kors to Buy Jimmy Choo in $1.2 Billion Deal*, N.Y. TIMES (July 25, 2017), https://www.nytimes.com/2017/07/25/business/dealbook/jimmy-choo-michael-kors.html.

10. *See, e.g.*, Evan Clark & David Moin, *Retail's Private Equity Legacy: Big Debt, Big Problems*, WWD (May 10, 2017), http://wwd.com/business-news/financial/retail-private-equity-legacy-big-debt-big-problems-bankruptcy-chapter-stores-malls-10884150 (describing how several private equity-backed retailers have recently faced liquidation and restructuring (such as The Limited and Gymboree) and/or heavily leveraged (such as Neiman Marcus)); William Louch & Paul Hodkinson, *3i Lost £45 million on Agent Provocateur*, FIN. NEWS (Mar. 3, 2017), https://www.fnlondon.com/articles/3i-lost-45-million-on-agent-provocateur-20170303 [https://perma.cc/A5YL-W3K5] (discussing how London-based private equity firm 3i Group lost £45 million on its investment in Agent Provocateur); Vicki M. Young, *True Religion Bankruptcy: A Harbinger for*

This Article will focus on the specific aspects of M&A that are unique to the fashion industry.[11] Part One provides a high-level discussion of the M&A process within the fashion industry and some of the distinctive valuation metrics that go into determining targets, then turns to some of the challenges of due diligence. Part Two of this Article outlines transaction structures and describes the negotiation and documentation process, as well as the elements that go into a successful closing. The Article concludes with an exploration of the post-closing goal of achieving the synergy-driven results that motivate the M&A process.

## I. STRATEGIC DEVELOPMENT: THE PROCESS BEFORE THE PROCESS

### *A. Synergies*

Regardless of the industry category or structure, most mergers and acquisitions share a common objective: the combining of two companies worth more together than separately—or in M&A parlance, achieving synergies.[12] While in theory achieving synergies is reasonably simple, historical trends show that roughly two-thirds of mergers will fail to achieve the anticipated financial success projected by principals and investment bankers.[13] As one senior financial professional stated,

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*Fashion Brands?*, WWD (July 6, 2017), http://wwd.com/business-news/financial/true-religion-bankruptcy-raises-questions-fashion-brands-restructuring-leveraged-balance-sheet-private-equity-nine-west-vince-nydj-10940002 [https://perma.cc/JXV7-3KJ5] (discussing how several private equity-backed retailers face bankruptcy). *But see, e.g.*, Scott Deveau & Alex Barinka, *Canada Goose Soars in Debut After IPO Puts It Atop Luxury Peers*, BLOOMBERG (Mar. 16, 2017), https://www.bloomberg.com/news/articles/2017-03-16/canada-goose-soars-in-trading-debut-with-peak-luxury-valuation [https://perma.cc/2KFA-G3FK] (describing how Bain Capital acquired a majority 70% stake in Canada Goose in 2013 when it was valued at $250 million and by March 2017 the company had increased to a market value of $1.72 billion); Andrew Roberts & Anne-Sylvanie Chassany, *Can Private Equity and Fashion Look Good Together?*, BLOOMBERG BUSINESSWEEK (Apr. 22, 2010), https://www.bloomberg.com/news/articles/2010-04-22/can-private-equity-and-fashion-look-good-together [https://perma.cc/6Y4L-B95R] (mentioning how Apax Partners sold Tommy Hilfiger for $3 billion, quintupling its investment in four years).

11. Accordingly, many of the particular elements of the targeting and valuation process as well as M&A law and procedure, which are present in any deal context, will not be covered in this Article.

12. STANLEY FOSTER REED & ALEXANDRA REED LAJOUX, THE ART OF M&A: A MERGER ACQUISITION BUYOUT GUIDE 26 (2nd ed., 1995) (defining "synergy" as the value of the combined companies is greater than the sum of their parts—one plus one equaling three).

13. PAUL A. PAUTLER, THE EFFECTS OF MERGERS AND POST-MERGER INTEGRATION: A REVIEW OF BUSINESS CONSULTING LITERATURE 5 n.6 (2003),

"failure starts right at the beginning," as acquirers get excited about an opportunity and cast any notion of strategy to the side.[14] For an acquirer in the fashion industry in particular, formulating and implementing the right M&A strategy and sticking to it can mean the difference between a successful investment or acquisition and a financial failure.

The evaluation of strategic development for a fashion company needs to be viewed with an eye towards maximizing revenues (which itself is a project largely dependent on an ever evolving, entitled, and fickle customer base), and/or minimizing costs while simultaneously managing and incentivizing the eponymous or lead designer and existing management team, as applicable.

The strategic development process begins as a highly introspective one, given that finding the right fit requires the fashion company to first determine its own strengths and weakness. Potential acquirers should ask themselves: "What do we lack that can be supplied by an acquisition?" and "What strengths or assets, human and material, do we have that are transferable to the merger or acquisition?"[15] The sources of revenues for fashion companies typically come from one of three fairly distinct sources: (1) wholesale sales to retail stores and online e-commerce retailers;[16] (2) direct retail sales (via directly owned retail stores or e-commerce sites);[17] and (3) ancillary royalty and/or design services revenue from licensing, franchising or collaborations.[18]

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http://www.clarityperformancealliance.com/postm&areview2003ftc.pdf [https://perma.cc/H26L-FB47].

14. *See* Robert J. Aiello, & Michael D. Watkinds, *The Fine Art of Friendly Acquisition*, HARV. BUS. REV. (2000), https://hbr.org/2000/11/the-fine-art-of-friendly-acquisition [https://perma.cc/XY2L-N9PF].

15. At any point during this process of introspection, the parties may discover that the potential sale or acquisition is simply not worth pursuing. For example, following a lengthy period of negotiation and due diligence, Aldo Group and Camuto Group halted plans for the sale of Camuto Group's footwear and accessories business to Aldo Group. The parties acknowledged their complementary strengths and expressed that they look forward to exploring other opportunities with one another in the future. *See* Chantal Fernandez, *Aldo Group Calls Off Camuto Group Acquisition*, BUSINESS OF FASHION (Oct. 20, 2017), https://www.businessoffashion.com/articles/news-analysis/aldo-group-calls-off-camuto-group-acquisition [https://perma.cc/TNC2-WSCB]; Vicki M. Young, *Aldo and Camuto Put the Brakes on Acquisition Plan*, WWD (Oct. 19, 2017), http://wwd.com/business-news/mergers-acquisitions/aldo-group-camuto-group-stop-acquisition-11031789 [https://perma.cc/8S7T-469A].

16. This is the traditional business of fashion houses from Acne Studios to Zadig & Voltaire.

17. Traditionally, direct retail sales are the purview of large fashion companies, such as the Gap and J.Crew, and a growing segment for smaller fashion companies, such as Steven Alan and Theory. It is worth noting that a direct-to-consumer trend has emerged in recent years with smaller fashion companies seeking to eliminate intermediaries and offer consumers higher quality products at a lower price point.

The sources of costs typically associated with fashion companies are: (1) raw materials (fabric, leather, and finishings); (2) production costs; (3) shipping and associated costs; (4) marketing, public relations and advertising; (5) sales; (6) and retail store and e-commerce operations. A company looking to make an acquisition needs to determine which of these resources it is seeking to gain and which it can provide.

This philosophy also applies to private equity and other financial acquirers—buying companies that fit within the acquirer's scope of expertise is preferable, both for the acquirer and the target. The success of Apax Partners, a private equity firm with a consumer retail focus, which exited from its Tommy Hilfiger investment in 2010 (quintupling its investment in four years), is a good example of industry knowledge leading to desired results.[19] Other examples of recent private equity acquisitions abound and include, among others, Apax Partners' September 2017 acquisition of British luxury e-commerce group matchesfashion.com for approximately £800 million, the Carlyle Group's February 2017 acquisition of Italian luxury sneaker company Golden Goose Deluxe Brand for an undisclosed amount,[20] Crescent Capital Partners' February 2017 acquisition of Australian swimwear brand Tigerlily for $46 million[21] and Palamon Capital Partners January 2017 acquisition of Swedish sock design company Happy Socks for $81.2 million.[22]

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Popular direct-to-consumer fashion companies include, for example, Warby Parker, Reformation, Cuyana, The Arrivals, Everlane, Leonard and Church, Tamara Mellon and Away.

18. As the economic climate in retail continues to evolve, shorter term collaborations are growing increasingly popular in lieu of longer-term licensing and franchising arrangements. Collaborations allow fashion companies to negotiate one-off or limited capsule collections with other retailers or manufacturers, among others, and avoid the multi-year and otherwise more rigid obligations inherent in a traditional licensing or franchising agreement. Vera Wang, Calvin Klein and Kenneth Cole, to name a few, have all effectively implemented collaborations in recent years.

19. *See* Roberts & Chassany, *supra* note 10.

20. *See* Luisa Zargani, *The Carlyle Group to Acquire Golden Goose Deluxe Brand*, WWD (Feb. 2, 2017), http://wwd.com/business-news/mergers-acquisitions/carlyle-group-to-acquire-golden-goose-deluxe-brand-10775256 [https://perma.cc/N4PT-UEP6].

21. *See* Patty Huntington, *Billabong Sheds Tigerlily in $46 Million Deal*, WWD (Feb. 22, 2017), http://wwd.com/business-news/mergers-acquisitions/billabong-sheds-tiger-lily-46-million-dollar-deal-10815307 [https://perma.cc/V9DP-VPX3].

22. *See* Vicki M. Young, *Happy Socks Acquired by Palamon Capital Partners for $81.2M*, WWD (Jan. 16, 2017), http://wwd.com/business-news/mergers-acquisitions/happy-socks-acquired-palamon-capital-partners-81-2m-mergers-acquisitions-accessories-hosiery-10751755.

*B. Cautionary Tales*

Being actively involved in the business of fashion has often been a necessary key to success. Even a disciplined institutional investor with only slight knowledge of the fashion industry may find the intangible assets of a fashion company difficult to value; misjudge the lasting appeal of the brand; make poor judgments in operating (or choosing who operates) the brand; or choose the wrong design talent. Recent cautionary tales abound.

Men's Wearhouse acquired competitor JoS. A. Bank for $1.8 billion in 2014, creating one of the largest men's apparel chains in the United States under the new holding company name "Tailored Brands, Inc." ("TBI").[23] As part of its post-acquisition strategy, TBI eliminated JoS. A. Bank's well-known "buy one suit, get three" deals in 2015. The company has experienced severe losses ever since. While there was significant improvement in TBI's financial results in the second quarter of 2017,[24] it remains to be seen whether the acquisition is finally paying off or the uptick is a final fleeting sign of life pre-death.

London-based private equity firm 3i Group acquired luxury lingerie brand Agent Provocateur for approximately £40 million in 2007.[25] Although 3i Group injected additional investments into the brand and even implemented a debt restructuring to save its initial investments, the brand entered bankruptcy protection and was sold off in early 2017.[26] 3i Group attributed the loss to a mix of declines in Russian consumer spending, the inconsistent execution of its recent store expansion program, and the discovery of accounting issues.[27]

LVMH Moët Hennessy Louis Vuitton ("LVMH") had struggled with Donna Karan International ("DKI") since acquiring the brand in

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23. *See* Phil Wahba, *Buying Jos. A Bank Has Been a Catastrophe for Men's Wearhouse*, FORTUNE (Dec. 10, 2015), http://fortune.com/2015/12/10/jos-a-bank-mens-wearhouse-results/; Austen Hufford, *Men's Wearhouse Continues to Be Hurt by Jos. A. Bank*, WALL ST. J. (Feb. 16, 2016), https://www.wsj.com/articles/jos-a-banks-same-store-sales-drop-32-1455627723.

24. Press Release, Tailored Brands, Inc., Tailored Brands, Inc. Reports Fiscal 2017 Second Quarter Results (Sept. 7, 2017), https://ir.tailoredbrands.com/press-releases/detail/1822 [https://perma.cc/C9SG-LAB4].

25. Louch & Hodkinson, *supra*, note 10.

26. Samantha Conti, *Four Holdings Buys Ailing Agent Provocateur*, WWD (Mar. 2, 2017), http://wwd.com/business-news/mergers-acquisitions/four-holdings-buys-ailing-agent-provocateur-10828884/ [https://perma.cc/7MGX-ZWRH].

27. Louch & Hodkinson, *supra*, note 10. *See* Vicki M. Young, *supra*, note 10 (describing how private equity firms over-leverage retailers, putting them on a slippery slope to bankruptcy).

2001.[28] In 2015, Ms. Karan exited as lead designer of her eponymous brand, pointing to her strained relationship with LVMH and telling The New York Times that "Vuitton ha[d] given [her] the cold shoulder."[29] The next year, LVMH sold DKI to G-III Apparel Group for a disclosed enterprise value of $650 million, essentially breaking even in what was perceived to be a "rare admission of failure on the part of LVMH."[30]

### *C. Growth Strategies*

One potential strategy for growth is market intensification or, as it is sometimes called, horizontal integration. Market intensification is accomplished by buying out companies that are in direct competition and share the same product lines and markets. Adidas's acquisition of Reebok in 2005 is a classic example of such a transaction,[31] with more recent examples including the $49 billion merger between eyewear giants Luxottica Group and Essilor of France in 2017[32] and Net-a-Porter Group's 2015 £936 million merger with yoox.com.[33] Market intensification transactions can allow a company to gain market share and may have additional synergistic benefits. Often this strategy is about infusing a tired brand with that ephemeral but critical component of "cool." For example, accessible luxury retailer Michael Kors Holdings ("Michael Kors") acquired U.K.-based luxury footwear company Jimmy Choo in July 2017 for £896 million as part of its larger strategy to update Michael Kors with a more international, "upmarket aura" following an extended period of languishing profits.[34] That said, having two former competitors exist under one roof can be fraught with challenges—like having two peacocks in the same pen. Managers run the risk of undermining the "core values on which the brand(s) have

28. *See* Vanessa Friedman, *Ivanka Trump's Manufacturer Just Bought Donna Karan Label from LVMH*, N.Y. TIMES (July 25, 2016), https://www.nytimes.com/2016/07/26/business/dealbook/lvmh-sells-donna-karan.html.

29. *Id*.

30. *Id*.

31. *See The adidas-Reebok Merger*, CASESTUDYINC.COM (Jan. 8, 2010), http://www.casestudyinc.com/Case-Study-Adidas-Reebok-Merger [https://perma.cc/RX38-3D3G].

32. *See* Chad Bray & Elizabeth Paton, *Luxottica, Owner of Ray-Ban, in $49 Billion Merger with Essilor*, N.Y. TIMES, https://www.nytimes.com/2017/01/16/business/dealbook/luxottica-essilor-merger.html.

33. Chad Bray & Vanessa Friedman, *Yoox to Merge with Net-a-Porter in All-Share Deal*, N.Y. TIMES (Mar. 31, 2015), https://www.nytimes.com/2015/04/01/business/dealbook/yoox-group-agrees-to-merge-with-net-a-porter-in-all-share-deal.html.

34. Paton & Bray, *supra* note 9.

built their identity."[35] Thus, anticipating the challenges unique to each acquisition and having a post-acquisition integration plan in place is critical.

Another potential strategy is a product extension acquisition. Such a transaction involves the acquirer purchasing another company that sells different-but-related products in the same market. Think swimwear and underwear; luggage and accessories; or fragrance and cosmetics. This allows the acquirer to add a product to a company's existing line of products that can be sold in its present geographic area or to its present customers.[36] A product extension acquisition or merger can be of particular value to companies that have seasonal business as well as to companies which are entrenched in a particular market.[37] Also, to the extent the acquirer plans on extending into the related product line under its own label, acquiring a brand already in that product line speeds up that extension (and, potentially permits the acquired company to extend into the acquirer's product core competency under the guidance of the acquirer). For example, Coach Inc., traditionally a leather goods company, acquired designer footwear company Stuart Weitzman for up to $574 million in January 2015 and rival handbag and apparel maker Kate Spade Inc. for $2.4 billion in May 2017.[38] Coach Inc. changed its holding company name to the more wide-ranging "Tapestry Inc." in the process, with chief executive officer Victor Luis explaining the desire to not be limited to any specific product category.[39] On a smaller scale, in October 2017 Lacoste Group acquired an 80% stake in Tecnifibre, a French company specializing in tennis and squash equipment. Thierry Guibert, chief executive officer of Lacoste Group, stated that the acquisition would facilitate the development of technical equipment by the Lacoste brand.[40]

Market extension is another strategy that fashion companies consider. In a market extension, a company extends its geographical reach by acquiring a company that sells the same products in different markets.[41] Market extensions can increase efficiency by reducing

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35. *See* Rovetta, *supra* note 7, at 16.

36. REED & LAJOUX, *supra* note 12, at 24.

37. *See, e.g.*, Rovetta, *supra* note 7, at 27–28.

38. Vanessa Friedman, *Coach Inc. is Dead. Long Live Tapestry.*, N.Y. TIMES (Oct. 11, 2017), https://www.nytimes.com/2017/10/11/fashion/coach-inc-rebrands-tapestry-american-fashion-group.html.

39. *Id*.

40. *See* Jennifer Weil, *Lacoste Acquires Sporting Equipment Maker Tecnifibre*, WWD (Aug. 31, 2017), http://wwd.com/business-news/mergers-acquisitions/lacoste-acquires-sporting-equipment-maker-tecnifibre-10968953 [https://perma.cc/W5WT-UVEA].

41. REED & LAJOUX. *supra* note 12, at 21.

operational costs. Recent examples of market extension transactions include Canadian retailer Hudson's Bay Co.'s ("HBC") $2.9 billion acquisition of Saks Inc. in 2013 and $250 million acquisition of Gilt Groupe in 2016, each of which gave HBC greater access to the U.S. market.[42] Any company considering a market extension needs to analyze the intended growth markets based on what matters to those consumers, versus its existing customers. Brands don't necessarily translate in all markets.[43]

Vertical integration, whereby a company purchases a customer or a supplier, is a strategy employed by many companies looking to "achieve economies in purchasing, sales and distribution."[44] One means of vertical integration is a vertical backward integration in which a company is buying a "current or potential supplier."[45] A vertical integration "can mean increased sales for the acquired supplier entity," as well as increased profits for the company, which will be able to purchase raw materials at a more competitive price. In particular, it is common for large luxury fashion companies to acquire their suppliers. Chanel alone has purchased multiple silk companies and invested in feather providers, glove-makers, milliners, cashmere producers and tulle and lace suppliers.[46] Other examples include LVMH's purchase of a tannery and Hermès watch division's purchase of a supplier.[47]

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42. Vicki M. Young, *Hudson's Bay Is No Stranger to Making Acquisitions*, WWD (Mar. 15, 2017), http://wwd.com/business-news/mergers-acquisitions/hudsons-bay-no-stranger-to-making-acquisitions-timeline-nrdc-gilt-galeria-kaufhof-10844011 [https://perma.cc/7LK9-RLGA]. A similar example is the February 2017 acquisition of L.A.-based, young fashion brand Nasty Gal by British online retailer Boohoo Group for $20 million dollars, which is expected to give Boohoo Group greater access to the U.S. market. Shan Li, *Nasty Gal, Once a Fashion World Darling, Is Now Bankrupt. What Went Wrong?*, L.A. TIMES (Feb. 24, 2017), http://www.latimes.com/business/la-fi-nasty-gal-20170224-story.html [https://perma.cc/TQ4C-HPL4].

43. *See* David Aaker & Erich Joachimsthaler, *The Lure of Global Branding*, HARV. BUS. REV. (Dec. 1999), http://hbr.org/1999/11/the-lure-of-global-branding/ar/pr [https://perma.cc/3ATC-BQGQ] ("Honda means quality and reliability in the United States, but in Japan, where quality is a given for most cars, Honda represents speed, youth and energy.").

44. REED & LAJOUX. *supra* note 12, at 22.

45. *Id*.

46. Astrid Wendlandt, *Chanel Snaps Up Four Companies to Secure High-End Silk Supplies*, REUTERS (July 22, 2016) https://www.reuters.com/article/us-fashion-chanel/chanel-snaps-up-four-companies-to-secure-high-end-silk-supplies-idUSKCN10222T [https://perma.cc/9XP4-KGN6].

47. *See* Joelle Diderich, *Hermes Watch Divisions Acquires 32.5% in Supplier*, WWD (Sept. 29, 2011), http://www.wwd.com/business-news/mergers-acquisitions/herms-watch-division-acquires-325-percent-in-supplier-5236804 [https://perma.cc/3NSY-HEH4]; Miles Socha, *LVMH Invests in Crocodile Tannery*,

Alternatively, vertical forward integration involves "buying a current or potential customer."[48] Examples of this can be seen in Li & Fung's past acquisition of and investments in smaller fashion houses.[49] More recently, in July 2017 eyewear manufacturer Luxottica Group acquired Brazilian optical retail chain Óticas Carol for €110 million, allowing Luxottica Group to significantly expand its control over its retail presence in Brazil.[50] Whether a company is buying up or down the supply line, there are many advantages to vertical transactions, including greater quality control, inventory control and distribution.

### *D. Culture & Other Considerations*

While the decision to acquire or merge with a company is often centered on increasing the bottom line, other equally important considerations, such as cultural differences, are often ignored.[51] Accordingly, another key component to the strategic development process is planning for ways to preempt and manage culture and personnel issues, particularly in light of ever-increasing globalization.[52]

One concern is whether the transaction will cause top management to be spread too thin, and how this will affect the rest of the management structure and the existing core business. Personnel issues are not always easily overcome, and in the fashion industry, where human capital plays an integral role in the company's success or failure, anticipating potential issues and strategizing in advance as to how they will be managed and overcome is crucial. For fashion companies, losing an eponymous designer can be catastrophic.[53] In addition to the exit of Ms. Karan from her eponymous brand discussed earlier, Jil Sander famously

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WWD (Oct. 9, 2011), http://www.wwd.com/business-news/mergers-acquisitions/lvmh-invests-in-crocodile-tannery-5274560 [https://perma.cc/GM5A-BMUJ].

48. REED & LAJOUX. *supra* note 12, at 22.

49. Li & Fung acquired Fishman & Tobin and Crimzon Rose and invested in the Hang Ten brand. All were theretofore customers of Li & Fung's massive production capabilities in Southeast Asia. *See* Kate O'Keeffe & Nisha Gopalan, *Li & Fung Company Makes $340.7 Million Offer for Hang Ten*, WALL ST. J. (Dec. 20, 2011), https://www.wsj.com/articles/SB10001424052970204879004577109522134639522; Michael Wei & Frank Longid, *Li & Fung Goes on an Acquisition Spree*, BLOOMBERG BUSINESSWEEK (Aug. 25, 2011), https://www.bloomberg.com/news/articles/2011-08-25/li-and-fung-goes-on-an-acquisition-spree [https://perma.cc/9ACD-B5ZZ].

50. *See* Alessandra Turra, *Luxottica Group Acquires Brazilian Óticas Carol*, WWD (July 6, 2017), http://wwd.com/accessories-news/eyewear/luxottica-group-acquires-brazilian-oticas-carol-10940880 [https://perma.cc/6Q2W-P23K].

51. *Id*. at 67 ("Many mergers and acquisitions have gone awry because the buyer ventured into an unknown industry, paid too high a price, forecasted too bullishly, or did not recognize the importance of the target's people.").

52. Rovetta, *supra* note 7.

53. Rovetta, *supra* note 7, at 16–17.

exited from her eponymous brand (for the first of three times) a mere four months after it was acquired by the Prada Group in 1999.[54] The brand suffered significant financial setbacks as a result. If the designer is going to remain with the company, there must also be a plan to manage the company's relationship with the designer.[55] If the designer had previously enjoyed an enormous amount of autonomy, a shift in the management structure can lead to friction.[56] If the target's management and/or design team does not share the same ideas as the acquirer with respect to how to grow the business, this can undermine the success of the post-acquisition process and in turn have a detrimental effect on the bottom line.[57]

## II. VALUING THE DEAL

Emmanuel Chirico, the chairman and chief executive officer of PVH Corp. ("PVH"), once stated: "[G]reat brands are expensive. It's OK to pay huge premiums for a great brand, but make sure you're actually buying a great brand."[58] The buyer and seller in any M&A deal will have opposing goals regarding the valuation of the target. In order to determine whether a potential transaction is worthwhile, companies and investors must determine how much the company being acquired is worth *to them*. Several established valuation methods are analyzed below.

### *A. Overview of Valuation Methods*

The replacement value method asks the question: "What will it cost the buyer to duplicate the target right now?"[59] Such an evaluation

54. *See* Douglas Hand, *Think Tank: Douglas Hand on the Challenge of M&A for Namesake Brands*, WWD (Jan. 23, 2016), http://wwd.com/business-news/mergers-acquisitions/douglas-hand-challenges-mergers-namesake-brands-10320585 [https://perma.cc/VBY9-NAQP].

55. *See infra* Section II.B.ii.

56. Amy M. Spindler, *Editor's Notebook; Is There a Designer in the House?*, N.Y. TIMES MAG. (Nov. 5, 2000), http://www.nytimes.com/2000/11/05/magazine/editor-s-notebook-is-there-a-designer-in-the-house.html?pagewanted=all&src=pm ("Designers, who once owned their own companies along with a business partner, are now answering to such higher powers."); *see also* Roberts & Chassany, *supra* note 10 ("Perhaps the biggest obstacle to successful deals is the fact that many family-run businesses are unwilling to cede control to financial investors.").

57. *See infra* Section II.B.ii.

58. *See* Vicki M. Young, *Men's Wear CEO Summit: The Power and Pitfalls of the Acquisition Game*, WWD (Apr. 7, 2011), http://www.wwd.com/menswear-news/retail-business/mens-wear-ceo-summit-the-power-and-pitfalls-of-the-acquisition-game-3576392?full=true [https://perma.cc/S5WC-YG6N].

59. REED & LAJOUX. *supra* note 12, at 132.

includes adding together the cash costs of all hard assets, such as land, and soft assets, such as intellectual property ("IP"). In the fashion industry, where the brand itself constitutes a key asset, there are many drawbacks to the replacement value method. As a consequence, it is rarely used with any degree of persuasiveness. For example, the replacement value method may not take into consideration the length of time it may take to develop a popular brand or assemble good design and management teams that work together. While the replacement value method does include the soft assets of the company, it still can inaccurately portray the company's worth.

Another valuation method is comparative ratios. In a comparative ratio valuation, the company in question is compared to similar companies that are currently trading in the market but not involved in a merger or acquisition.[60] Certain financial information of the comparable company, such as its earnings or sales, forms a ratio with its market price; once the ratio of a comparable company is determined, the company in question is valued according to that multiplier.[61] This method is not always used in fashion transactions as one may get different multiplier values depending on which financial data is used for comparison, and in the fashion industry there are many different metrics to consider (e.g., direct to consumer sales, wholesale account sales, licensing royalty revenue, franchise sales). Therefore, when evaluating the company, weighting or prioritization is necessary and this judgment call makes the method less objective and precise.[62]

The discounted cash flow ("DCF") method is a frequently used approach to the valuation of a company. In a DCF analysis, a company is worth its estimated cash flows, or the revenue it is expected to earn for a certain period of time into the future, less the appropriate discount rate.[63] Two important factors comprise the discount rate: the time value of money and risk. The first takes into account that by investing in a company, an investor gives up "the use of her or his money for a period of time, [and] . . . must defer consumption or forego a return on the invested sum [until] . . . the investment is repaid."[64] The discount rate also indicates the risk that may accompany a particular investment or the

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60. Rutherford B. Campbell, Jr., *The Impact of Modern Finance Theory in Acquisition Cases*, 53 SYRACUSE L. REV. 1, 15 (2003).

61. *Id.* ("For example, if the present trading price of [X company] is two times its total revenues, then under this methodology one might claim that the fair value of [a similar company, Y, also] should be two times [its] total revenues.").

62. *Id.*

63. *Id.* at 6.

64. *Id*. at 9.

"volatility or variability of possible outcomes" inherent in that company.[65]

One drawback to the DCF method is that in a constantly changing and evolving economy, where new products and ideas for engaging fashion consumers emerge daily, it can be difficult to estimate future cash flows.[66] Few industries undergo such constant and drastic changes as the fashion industry. As Coco Chanel once remarked, "Fashion should slip out of your hands. The very idea of protecting the seasonal arts is childish. One should not bother to protect that which dies the minute it is born."[67] These changes can have a drastic impact on the value of a company, particularly ones that are narrowly focused in producing particular goods. For example, private equity firm TowerBrook Capital Partners acquired True Religion in 2013 for $835 million. The premium denim company filed for bankruptcy reorganization in July 2017, with critics citing that the brand failed to adapt as its "signature large stitching and flashy logos plastered on t-shirts [fell] woefully out of style [with] many younger shoppers."[68]

Among the three methods, is there one that is preferable? Are some better suited to different kinds of acquirers or acquisition strategies? What would motivate an acquirer to choose one over another?

### *B. Due Diligence Process*

It is only through targeted due diligence that an acquirer can obtain the data points necessary to make an informed projection of the target's post-acquisition financial performance. As the valuation of a target is

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65. *Id*. at 10.

66. A glance at the risk factor and forward-looking statement disclosure of any public fashion company highlights the challenges of any evaluation method which estimates future earnings. For example, in their 2016 annual report on Form 10-K, Michael Kors notes that any forward-looking statements are qualified by risk factors as varied as global market and competition uncertainties, macroeconomic conditions, consumer traffic, changing fashion and retail trends, dependence on distributors and suppliers, cyber security risks, the continued employment of Michael Kors and executive management, etc. Michael Kors Holdings Ltd., Annual Report (Form 10-K) (May 31, 2017), https://www.sec.gov/Archives/edgar/data/1530721/000153072117000022/kors04012017 10-k.htm#sCD21C047E2D191E85CD643C39398C89A [https://perma.cc/DY6Y-BG6M].

67. Clare Coulson & Justine Picardie, *Is Fashion Too Fickle*?, TELEGRAPH (London) (Oct. 5, 2005), http://fashion.telegraph.co.uk/news-features/TMG3345633/Is-fashion-too-fickle.html.

68. Greg Petro, *True Religion Lost Its Focus On the Consumer*, FORBES (July 26, 2017), https://www.forbes.com/sites/gregpetro/2017/07/26/true-religion-lost-its-focus-on-the-consumer/#1f15bd85cbfb.

dependent upon such projections,[69] due diligence is an extremely important aspect of any M&A transaction. Much more than merely "kicking the tires," successful acquirers approach the due diligence process cautiously, with a plan that includes a variety of actors from inside and outside the company to assess the value of the target.[70]

Due diligence is accomplished by inquiring into all aspects of the past, present, and, to the extent predictable, future of the business to be purchased. However, the due diligence process is not uniform across all companies. Rather, it must be, ahem, tailored to the particular transaction and may vary based on the characteristics of both the acquiring and target companies, including size, maturity, jurisdiction, and whether the target is public or private. In addition, due diligence can be adjusted based on the companies' needs and desires.[71] If the parties are eager to deal, they may substitute extensive representations and warranties in the purchase agreement in place of more comprehensive due diligence.[72]

The parameters for due diligence are usually agreed upon by the buyer and seller during the initial stages of the deal. While some parties will begin to negotiate the definitive transaction agreements governing the M&A transaction concurrently with the due diligence review, other parties will prefer to wait until the review is completed, or at least well under way, before spending the time and money drafting and negotiating long form agreements.

To ensure a smooth due diligence process, the acquirer usually will expect a covenant from the seller permitting the buyer adequate time and access to complete due diligence.[73] Such a covenant is often found in the term sheet or letter of intent ("LOI"), if such a document is executed in connection with a transaction, and, in any case, in the definitive transaction documents. In the event that significant due diligence has been performed by the acquirer prior to the execution of the transaction agreements, the parties will negotiate the inclusion of a closing condition that the acquirer's post-signing due diligence has been completed to its satisfaction. The target does not want the acquirer to have the right to walk away from a deal based upon an arguably insignificant due diligence finding.[74] Conversely, the acquirer wants the comfort of a due diligence "catch-all" that enables it to terminate the definitive

69. REED & LAJOUX. *supra* note 12, at 375.
70. *See* Aiello & Watckins, *supra* note 14.
71. REED & LAJOUX, *supra* note 12, at 378.
72. *Id*. at 379.
73. *Id*.
74. *Id*. at 395.

agreements in the event that facts are uncovered that are detrimental to the target's value.[75]

Important first steps in any due diligence review are to ensure that the target was legally formed, is in good standing and has the necessary power and authority to enter into the definitive agreements. The acquirer must also be satisfied that the target is not in violation or breach or in default under any existing agreement or law to which the target is bound. Additionally, careful due diligence needs to be performed to determine the target's capitalization (including reviewing the target's stock ledger and, in the case of a stock deal, locating and taking possession of all share certificates). The acquirer needs to be certain that the number of shares whose favorable vote is required for any aspect of a transaction can be correctly calculated and, in the case of a stock deal, that all of the outstanding shares of stock are being transferred.

An acquirer also typically performs a lien and litigation docket search of public records in order to determine if any of the target's assets are subject to a security interest or the target is subject to any pending litigation. Any such liens or litigation can greatly affect the valuation of the deal.

Acquirers should review the target's commercial and other material contracts. The rationale for and structure of the deal will dictate which contracts (and particular provisions of such contracts) are crucial to its success. For example, backward vertical integration and market intensification transactions will have different objectives and, consequently, will require a focus on different documents in the diligence process.

In addition to representations and warranties about many aspects of a target's business, including active litigations—and even potential future litigations, potential defaults under existing contracts, IP rights, products liability, environmental liabilities, and unpaid taxes, a target is generally expected to make a representation and warranty that there are no undisclosed liabilities not reflected on the target's balance sheet. The acquirer will require an indemnity from the target for any breaches of such representations and warranties. This protection notwithstanding, the acquirer should also review the due diligence materials to confirm, to the best extent possible, that the seller's representations are true. It is preferable for the acquirer to know about a latent liability and to factor it into a reduced purchase price, if not into the decision to undertake the acquisition at all, than to bring an indemnity claim against the seller post-closing.[76]

75. *Id*. at 380, 393, 395.
76. *Id*. at 461–62.

The due diligence process is typically organized by way of a due diligence request list which would usually include, among other things, the following list of areas and documents to be reviewed:

- all financial statements reflecting past operating and financial performance;
- market studies/reports on company's product and relative profitability of the company's various classes of products and business segments compared to companies of similar size in the industry;
- key intellectual property (e.g., design patents, trademarks, trade names and copyrights);
- leases, title documents to real estate and personal property;
- license and collaborative agreements;
- supply and sales agreements;
- employment and consulting agreements, as well as any design services or independent contractor agreements, agreements with labor, pension, profit sharing plans and insurance policies;
- ownership of company's securities-trace title of present owners of corporation;
- product backlogs, purchasing, inventory and pricing policies;
- and market and product studies (i.e., contact major customers to determine their level of satisfaction).

### i. IP Due Diligence

A comprehensive and accurate IP review is particularly critical in the case of fashion industry transactions. IP is usually the seller's most valuable asset.[77] Due diligence review in a fashion transaction should investigate all trademark, copyright and design patent registrations, domestic and foreign, to verify ownership and to ensure there is no potential litigation that may arise over the use of the brand name or the designs. This should happen both where such IP is currently being used and in potential expansion markets. Needless to say, the fees associated with legal review in multiple jurisdictions can escalate as multiple law firms typically need to be engaged to complete a detailed review.

The IP review must also cover common law IP rights to the extent registration is not permitted or was simply not undertaken by the target. In the case of unregistered trademarks, which are usually limited to names used for particular products rather than the brand name itself,

77. *See* FASHION LAW, *supra* note 1, at 25–26.

trade dress or other IP that is not registered, date of first use, evidence of that use, and proof of secondary meaning should be obtained and reviewed for accuracy.[78]

ii. Designer Diligence

As mentioned previously, an integral consideration for an acquirer of a fashion company, and a component that differentiates the fashion M&A due diligence process, is the need to determine what role the eponymous or lead designer and design team will play in the future of the company after the transaction is consummated.[79] A head designer—particularly in a smaller fashion house, but in many cases in larger ones as well—not only designs the merchandise, but may also have decision making authority as to licensing, what markets the merchandise is sold in (i.e., couture, ready-to-wear ("RTW"), contemporary), what types of raw materials are sourced, and where merchandise is sold (e.g., some designers may want to sell only to the highest end retailers, which may result in significant negotiation between the parties).[80] Whether an eponymous or lead designer stays or leaves after the transaction is consummated thus plays an integral role in the future of the brand, both from a design perspective and an image perspective.[81] Accordingly, when applicable, the acquirer will almost always meet several times with the eponymous or lead designer and design team to discuss the future of the to-be-acquired company as part of the due diligence process.[82]

Losing an eponymous or lead designer can diminish the value of the brand and, as a result, cause a potential acquirer to pay less for the brand than it would have paid if the designer had remained.[83] For example, LVMH would likely have been able to command a higher price

78. REED & LAJOUX. *supra* note 12.

79. *See* Rovetta, *supra* note 7, at 9, 11.

80. *See, e.g.*, Ginia Bellafante, *Front Row; Jill Sander is Divorcing Prada. After Next Month's Fall Women's Collection in Milan, She Plans to Leave Her Signature Company.*, N.Y. TIMES (Jan. 25, 2000), http://www.nytimes.com/2000/01/25/style/front-row-jil-sander-divorcing-prada-after-next-month-s-fall-women-s-collection.html; Eric Wilson, *The Long Fall of the House of Blass*, N.Y. TIMES (Dec. 25, 2008), http://www.nytimes.com/2008/12/25/fashion/25BLASS.html [https://perma.cc/2NUE-DM8B].

81. *See generally* Spindler, *supra* note 56.

82. *See, e.g.*, Michael J. De La Merced & Liz Alderman, *For Bulgari, LVMH Deal Paves Way to Growth*, N.Y. TIMES DEAL BOOK (Mar. 7, 2011), http://dealbook.nytimes.com/2011/03/07/for-bulgari-lvmh-deal-paves-way-to-growth/ [https://perma.cc/M6SE-YZST].

83. *See, e.g.*, Eric Wilson, *Question for Prada: Now What?*, N.Y. TIMES (Jan. 25, 2005), http://www.nytimes.com/2005/01/25/fashion/25lang.html (noting the diminished value of the Helmut Lang brand after the designer left, and the possibility for the Prada Group to sell).

for DKNY in its 2016 sale to G-III Apparel Group had Ms. Karan not exited the brand in the prior year. The importance attached to an eponymous or lead designer may also depend on the level of control such designer actually possesses over the day-to-day operations of the company, both in terms of design and in terms of management and operations. Some designers may be the creative force, but delegate extensively to a highly effective design team, which understands the look and feel of the brand and could therefore replicate the brand's aesthetic going forward.[84] Some designers may also delegate management and operations functions to a trained team, which could similarly ease the transition of the business to the acquirer.[85] Accordingly, losing an eponymous or lead designer who wears all of the hats in the company will likely have a far more deleterious impact on the company and the brand than losing a designer who has delegated effectively and serves as a more general creative influence.[86] Stuart Weitzman's near-term retirement was contemplated by both parties during the sale of his eponymous label to Coach Inc. in 2015.[87] As a result, when Mr. Weitzman stepped down as lead designer the following year, he remained actively involved in the selection of the newly-appointed creative designer and design team and there was no deleterious effect to the brand as a result of the transition.[88]

Discussing the future direction of the company with the eponymous or lead designer is another critical step for acquirers. While this is considerably more important in the event that the designer is expected to remain with the company, it may also be relevant in situations where the designer is expected to exit. An eponymous designer may, for example, seek to limit the use of their name to certain categories of merchandise or dictate the channels of distribution, regardless of whether they remain or exit.[89] Because licensing/franchising and brand extension have

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84. *See, e.g.*, Wilson, *supra* note 80.

85. *See, e.g.*, *Jones Apparel to Acquire Majority Stake in Stuart Weitzman*, APPAREL MAGAZINE (June 9, 2010), https://apparelmag.com/jones-apparel-acquire-majority-stake-stuart-weitzman [https://perma.cc/KBG5-YEVL].

86. *Compare* Bellafante, *supra* note 81 (Jil Sanders leaving after the Prada Group acquired a 75 percent stake), *with* De La Merced & Alderman, *supra* note 83 (Bulgari recognizing its need for stronger management).

87. *See* Neil Weilheimer, *Exclusive: Stuart Weitzman Talks to FN About Calling It Quits After 50 Years*, FOOTWEAR NEWS (Mar. 20, 2017), http://footwearnews.com/2017/business/designers/stuart-weitzman-celebrity-red-carpet-shoes-retirement-328770/ [https://perma.cc/YM3T-JUPJ].

88. *Id*.

89. William Lozito, *Tommy Hilfiger's $3.38 Billion Acquisition Biggest Deal Ever in Apparel Naming and Branding*, NAME WIRE (Mar. 16, 2011) http://www.namedevelopment.com/blog/archives/2010/03/tommy_hilfigers.html ("[W]hat is really interesting is that PVH is trying to ensure that control of Tommy

become such potent profit-raising strategies for fashion companies, such potential limitations should be discussed with the designer as part of the due diligence process.[90] If, for example, part of the acquirer's growth strategy is to turn a company that sells only RTW into a lifestyle brand, an eponymous designer must be willing to license their name to many categories of goods. Alternatively, if the acquirer wants to take a couture brand and create a RTW and contemporary line, they must ensure the designer is in agreement.[91] Eponymous designers may consider their brand an extension of themselves and, as a result, may be less willing to execute these potentially highly lucrative strategies due to a perceived negative impact on their reputation.

Another important due diligence consideration is how the company will be managed and who will maintain control over strategy. An eponymous or lead designer may demand a certain amount of control over the business in order to remain with the company. Such a demand might not suit an acquirer with a definite strategic vision for the brand that would be subject to the designer's influence.[92] Furthermore, even if the designer relinquishes control of certain aspects of the company, care must be taken to ensure that the designer will work well within the new management structure.

## CONCLUSION TO PART ONE

This constitutes the end of Part One. Part Two of this Article will go on to outline transaction structures and describe the negotiation and documentation process, as well as the elements that go into a successful closing, and conclude with an exploration of the post-closing goal of achieving the synergy-driven results that motivated the M&A process in the first place.

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Hilfiger himself rests with them. PVH is seeking 'ironclad' ability to control the name, and not just the trademarks. Hilfiger is staying on as 'Principal Designer and Visionary' for the Tommy Hilfiger brand but he has been quietly acquiring smaller brands, leading to the worry on the part of PVH that Hilfiger may have plans to create a breakout, competitive brand name.") (emphasis omitted).

90. *See* REED & LAJOUX. *supra* note 12, at 397.

91. *See generally* FASHION LAW, *supra* note 1, at 83–86.

92. *See, e.g.*, Wilson, *supra* note 84 (noting how Helmut Lang's stubbornness in working with seemingly inferior fabrics, despite lower costs, contradicted the Prada Group's desire to bring the brand into profitability).