



Grant Ringshaw

## Shopping spree.

**The retail sector has been a rich source of deals for private equity firms. Grant Ringshaw explains the appeal and details why it is essential for owners to find the right partner.**

The ownership of the UK high street has changed dramatically. In the past six or seven years, private equity houses, specialist banks and a collection of high-profile entrepreneurs have been on a spending spree, snapping up scores of retailers.

The range of acquisitions has been broad, covering large groups, such as supermarket chain Somerfield and department store chain Debenhams – which, after being taken private in 2004, plans to return to the stock market this year – to fastgrowing mid-market store groups such as Fat Face and Jane Norman.

So why has the retail sector become so attractive to the private equity community? For years the retail sector had been seen as too risky by private equity firms. But that started to change in 2000, argues Andrew Ware, head of lead advisory at BDO Stoy Hayward. He says investors recognised that the benign economic environment was set to create a massive increase in consumer spending: “There was a lot more growth to come around the sector than there probably had been for some considerable time. Suddenly the dynamics started to look quite good.”

One of the main attractions of retailers for private equity investors is that they can be fantastic cash generators. This makes them particularly well-suited to leveraged deals. Private equity firms often use long-term debt and preference shares as part of a financial structure to “gear up” a transaction. These are paid off over the long term by using a company’s cash flows, an approach which leads to an increase in value of the equity.

### If you’ve seen one...

But retail deals are much more than financial engineering. “The attraction is that retail tends to be cash-generative. But it is also very modular – so if you want to grow a chain and you have a proven model, you literally open exactly the same thing and do it again and again,” says Shani Zindel of ISIS.

“Private equity firms can help owners run their businesses in a slightly different way, so it makes them more cash-generative and more efficient,” says Jackie Naghten, a former brand director of Arcadia, which owns Top Shop, who now runs her own consultancy, Brandnewventure, and is retained by Clearwater Corporate Finance to advise on retail and consumer brands.

Often, niche retailers are family-owned and, while successful, many have seen their growth rate plateau. This is when a good private equity backer can really help grow the business, bringing not just finance, but also a wealth of sector and transaction knowledge, the shared experience of fellow investee companies, high-quality industry contacts and potential new management.

This was exactly the case with Americana, the wholesaler and retail firm whose brands include Bench and Hooch and in which ISIS invested in 2003.

“The ISIS team brought a lot of passion to the business and they were not afraid to speak their mind,” says David Brock, the chairman of Americana. “They understood what we were trying to achieve and the issues that drive the business. They really worked well with our management team.

**“The ISIS team brought a lot of passion to the business and they were not afraid to speak their mind. They understood what we were trying to achieve and the issues that drive the business. They really worked well with our management team.”**

David Brock, Americana

ISIS had a strong track record in our space and we were aware of the work they had done. Some venture capitalists that we met didn’t display the same level of understanding of our sector.”

Another factor that has helped drive retail deals is the strength of management in the UK retail sector. “There has been a kind of rebirth of the retail entrepreneur,” argues Ware. He says that recent years have witnessed a small army of youthful retailers, often trained by larger firms, emerging to strengthen or lead the management of smaller store chains.

For smaller chains, the injection of new management expertise can be key to driving the next phase of growth. “The challenge is about managing the risk. So it is about making sure you have the right management team in place to deliver the growth,” says Zindel.

### High street on a high?

Last year, the private equity industry was active in the retail and consumer markets sector, completing 66 deals worth £5.5bn and involving 66,000 staff. So are deals set to continue in the sector and when should companies look at gaining private equity funding?

Ware believes the focus in 2006 is likely to be on mid-market transactions rather than the big retailers. Naghten, in turn, argues that buyout firms are likely to be most interested in health and beauty retail, retailers of premium products, such as organic food, and those serving more affluent customers in the 40-50 plus age bracket. Paul Herman, a director at Cavendish Corporate Finance, adds that branded businesses that "stand away from 'me-too' offerings" will remain attractive.

Given the slowdown in retail sales in the first few months of 2006, the structure of deals may also be set to change. Ware expects to see more owners "partially de-risking their positions by selling part of their stake to bring in third-party funding". Naghten believes some entrepreneurs are setting up retail businesses specifically to grow them rapidly to five to 10 stores then seek private equity funding: "There is a greater understanding of how private equity operates and the need for firms to get in under the radar."

But, as Herman points out, timing is key for owners looking at private equity funding: "It is a fine line between taking private equity investment too early and achieving a poor valuation, or taking investment too late and losing out on an opportunity that could have been exploited through additional management resources."

## A GUIDE TO VENTURE CAPITAL

With 1,600 companies turning to the industry for funding each year, private equity plays a major role in the UK economy.

Private equity funding can be used to meet a range of needs. These include providing financial backing for a management team looking to buy a company or for a management buy-in by a team from outside an existing business.

Private equity firms can also provide development capital, enabling a company to expand or make acquisitions, and replacement capital, where personal wealth tied up in a business can be realised without the need for an outright sale.

A good private equity firm brings not only finance, but also a wealth of expertise and relevant contacts in a sector. Private equity investors typically take a seat on the board, improve corporate governance by appointing an independent chairman and aim to bring expert advice and input on strategic issues.

However, most private equity firms choose not to get involved in the day-to-day of running the business.

One of the major advantages of private equity funding is that deals can be structured to incentivise key managers. Under a typical management buyout, the private equity firm will provide between 40% and 50% of the total funding through a combination of taking an equity stake, long-term debt and preference shares. Management teams are typically asked to make a cash investment. However, the deal is often structured so the value of their investment grows rapidly if the company is successful. This is achieved by using "gearing", or leveraging up the cash-flows of the business.

Ultimately, private equity firms will look to realise their investment. Options include floating the company on the stock market and selling the company to a trade buyer or to another private equity firm in a secondary buy-out.