

RETAIL

The impact of debt on retail businesses

CONSUMER MARKETS



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Glynn Davis
Editor

Business and finance journalist writing for a wide variety of magazines and newspapers including *The Financial Times*, *The Guardian*, *The Grocer* and *Retail Week* covering mainly the retail and leisure sectors. Previously worked on a number of business magazines before writing a book on the late 90s internet start-up gold rush. Initially spent five years working in the City, predominantly within fund management for BZW and Capital International.

Glynn Davis – Editor

Having worked in the City during the late 1980s and more recently plied my trade as a business journalist, it has been interesting to watch the private equity house phenomenon and to see how it has made a significant impact on the retail industry through ‘take private’ deals.

So, when asked by KPMG in the UK to be involved in producing a report looking into the effects of this trend on the retail sector, it was an opportunity too good to pass up. The objective of the report has been to find out whether a company with debt is managed any differently from one that is free of such obligations.

It has involved speaking to the Finance Directors of a number of prominent retailers – Debenhams, Mosaic, New Look and Jane Norman – along with senior bankers from Barclays and Bank of Scotland. From the interviews has come a perspective on exactly how, if at all, the running of these companies has altered as a result of taking on the responsibility of servicing debt.

What follows are summaries of the interviews, providing practical examples of how each company is now run, along with a focus on the specific managerial aspects important to that business. What comes through in the report is that despite the definite differences in how each company is now managed, the fundamentals of running a retail business remain the same. Helen Dickinson, head of retail at KPMG and David Madoc-Jones a partner in KPMG’s debt advisory group, comment further on the findings at the beginning and end of the report.

However, the buy-out phenomenon is providing some useful guidance and pointers on how to run a retail business – regardless of whether that business is listed or private – and hopefully some of these are highlighted in this report.



Helen Dickinson
Head of Retail, KPMG

Regularly quoted in the media on retail sales trends and other sector issues, Helen has overall responsibility for leading and developing KPMG's retail practice in the UK including development of multi-disciplinary value propositions focused on the sector. Her clients include Ottakars, Liberty, Zara, QVC, Jane Norman, Robert Dyas and Etam.

Helen has responsibility for the compilation of figures for the British Retail Consortium-KPMG Retail Sales Monitor and comments, each month, on the underlying trends. Helen also writes a weekly column in Marketing on retail sector issues.

She is a Fellow of the Institute of Chartered Accountants in England and Wales and is based in London.

Helen Dickinson – KPMG

With debt running at a higher level than has historically been the case, Helen Dickinson, head of retail at KPMG, initiated this research into what impact it is having on the retail sector.

“The private equity houses have invested in retailers because they believed retail assets were undervalued so we've sought to assess whether in private hands, and with debt to service, these ‘buy-out’ companies are managed very differently in order that their true value can be realised,” says Dickinson.

What stood out from the findings was that irrespective of the ownership structure of a business, the retail fundamentals remain the same: getting the right product in the right place at the right price and at the right time. This is dependent, as always, on management's ability – the success of many of these transactions is down to an established track record.

However there is a difference in the way such management teams achieve their objectives. “What the research shows is that, within a buy-out there is a strong focus on managing for cash, which is very different to the way a quoted company is run, as it tends to be much more profit centric”, according to Dickinson.

Many of the retailers interviewed give practical examples of how they manage this on a day-to-day basis – whether it is marking down slow-moving stock more quickly to sell it through, increasing capex return criteria or managing suppliers differently.

This ability to focus on cash, in perhaps a different way, is predicated on quality management information which enables retailers to ‘pull the right levers’ where necessary and the banks to get what they need to support their funding decisions.

The research does show that these businesses do operate differently and that there are lessons to be learned on how to recognise inherent value.

“But what has created this value?” she asks. “It is not a function of the level of debt. Could it be that operating without public scrutiny gives a retail business a better chance to realise its shareholder value?”



Chris Woodhouse
Executive Director, Debenhams

Currently Finance Director of Debenhams Limited following a buy-out backed by CVC/TPG and Merrill Lynch Global Private Equity.

Previously non-executive Deputy Chairman of Halfords following a buy-out backed by CVC

Previously Commercial Director and Deputy Chief Executive of Homebase Ltd where a threefold improvement in operating profit was achieved prior to its sale to GUS

Before this, Chris held posts as Finance Director of Birthdays Group Ltd, Group Finance Director of Albert Fisher plc (a publicly quoted turnaround) and Finance Director of Superdrug

He is a qualified FCA, was voted Finance Director of the Year 2002/03 and is an associate member of the Association of Corporate Treasurers

Chris Woodhouse – Debenhams

Since a consortium of private equity houses bought Debenhams for £1.7 billion in December 2003, one of several areas of focus of its new management team has been to generate cash to reduce the company's levels of debt.

External debt represented around two thirds of the total borrowing required to fund the deal, according to Chris Woodhouse, which is a similar level to what he managed at the two previous 'take-private' deals that he has been involved in – Homebase and Halfords.

An established track record

As finance director at both these retailers, Woodhouse was a key part of the team – together with chief executive Rob Templeman – that turned around the fortunes of both businesses. He helped the private equity backers on each deal achieve sizeable returns with Homebase sold to GUS and Halfords gaining a listing on the main market.

As with Debenhams, the heart of these deals was cash generation in order to pay down the levels of debt. "People in private equity look at cash flow generation in order to service the debt and the banks lend on the levels of cash flow coming into the business. Fund managers in the City have less appetite for lots of debt and place more importance on a company's price/earnings (PE) ratio." says Woodhouse.

Although the team's track record has made it easier to attract debt finance from lenders, Woodhouse believes that high levels of available banking finance combined with the strong consumer markets has inevitably led to a situation of debt finance chasing a limited number of transactions.

Since retail businesses require little investment (for the likes of R&D and manufacturing plant) Woodhouse says it is a good cash generative sector but the downside is that it is 'susceptible to swings in trading'.

At Debenhams, Woodhouse is confident that the fleet-of-foot management team and the operational structure that has been implemented, provides the business with the ability to react to changes in the market and, crucially, helps to ensure it continues to generate cash.

A 'hands on' approach has generated returns

The management team honed its cash generative model at Homebase and Halfords and has shown itself adept at quickly finding ways to boost the levels of cash flowing into the business.

One method is to focus on the stock turn in order to reduce the levels of product held within the business. At Debenhams this has been reduced by £35 million since the buy-out. The supplier base has also been consolidated and better terms negotiated, with the result that the initial 700 companies have been reduced by 150 and the survivors given the carrot of greater volumes.

“ We weeded out any stock lines that did not justify their place ”

Any assets that are surplus to requirements have also been sold. Management also freed up further capital through sale and leasebacks.

This focus on cash generation also extends into the handling of capital expenditure. The company has introduced a high hurdle rate of between a 25 percent and 30 percent return on investment, with the result that it is now much easier to decide which projects will receive funds.

“We’re choosy about what projects we put money into; so many things simply don’t even get considered. This makes many people’s lives a lot easier as we don’t spend hours wondering if a project will increase sales by 2 percent or 2.25 percent,” he says.

“ You need to start as quickly as possible because for a short period there is a higher level of risk in the business ”

Woodhouse believes strongly that in any buy-out situation it is vital to find the ‘quick wins’ to generate cash and ‘de-risk’ the business.

Flexibility of debt structure is a necessity

The effectiveness of this acute focus on cash has enabled Debenhams to have already repaid £150 million of its debt and restructure its capital base. “If you build up a lot of cash then it is inefficient to also maintain a high level of debt, so you need to re-finance the business.”

“ The chosen option must be sufficiently flexible to undergo a re-structure at a later date.”

The creation of a suitable structure is a critical part of any leveraged buy-out. There is likely to be little difference in pricing of different banks but the structures will be very different.

Focus on cash cascades through the business

Long before any re-structure is even a glint in the eye of management, it is essential that they strive to ensure they are in touch with the operational aspects of the business through effective forecasting software that can prompt fast-paced decision making.

“The focus on cash runs all the way down from the shareholders and, although it mainly affects the finance and treasury teams, we let everybody know the dynamics of how the deal works. We show them the model and how debt is important. We make sure we get good alignment and keep telling them about it. The VCs certainly keep telling me about it all the time,” explains Woodhouse.

“ Retail businesses are simple: you create a market and manage a supply chain to generate gross margin. So, regardless of whether or not you have debt, for most of the business nothing changes ”

While the capital structure of the business clearly affects its financial modus operandi, Woodhouse points out that it does not detract from the fact that, at heart, Debenhams is a retailer whose simple objective is to sell more products to its customers.



Richard Glanville
Finance Director, Mosaic

Richard Glanville is Finance Director of Mosaic Fashions Ltd, joining shortly before the MBO in 2001. The group operates the Oasis, Karen Millen, Coast and Whistles brands in the womenswear retail sector. Previously Richard has held finance, IT and logistics roles in a variety of retail companies, including Mothercare, Comet and Sears.

“ It’s cash first and profit second. Our actions are based on the consequences on cash rather than the consequences on the P&L. The stock market typically won’t allow you to act this sensibly ”

Richard Glanville – Mosaic

The Baugur owned Mosaic – which operates the Oasis, Coast, Karen Millen and Whistles chains – represents a good example of a retail business that is highly leveraged but whose debt has been flexibly structured to allow it to survive any potential difficult trading periods.

Richard Glanville says that with all ‘very highly leveraged’ companies, a triumvirate of banks, financial backers – in this case Baugur – and management creates a debt structure that it is hoped will take into account all possible future eventualities.

“You run through a three to four year plan that takes into account various scenarios so you can trade very badly for a significant amount of time before you start to hit any trouble,” he says.

Glanville also believes that any prolonged downturn in the retail sector would have a greater effect on the larger players since the performance of the smaller retailers is dependent more on the quality of the buying in a given season than on the economy as a whole. Glanville says you would have to effectively back a long run of losers before you hit trouble.

Established track record

Although in a solid position, Glanville certainly knows the pressure points in the Mosaic business as he has overseen the evolution of its debt structure from the initial ‘take-private’ management buy-out (MBO) of Oasis in 2001, through the acquisition of the business by Baugur, and the purchase of Karen Millen last summer. He is sufficiently experienced to know exactly what is required of the business to pay down its debt.

Such is the management team’s track record that Mosaic was able to take on additional debt for the funding of the £152 million acquisition by Baugur and a further slug for the £120 million Karen Millen purchase.

Even though there is an ‘enormous appetite’ by the banks to lend to retailers, Glanville says they still require management to have a strong track record. Mosaic not only has this – with Glanville and chief executive Derek Lovelock among the seasoned campaigners – but the retail and financial experience of Baugur.

Private status can enable a stronger cash focus

He suggests one of the biggest aids in managing its debt is the company’s private status. Being able to run the company for cash rather than for profit (as you would if it was listed) puts the focus of the business firmly on reducing its debt levels.

One area where this manifests itself is with stock. Glanville says it is much easier for a private company to quickly write down slow-moving lines. Immediately after the MBO, Glanville reduced the 10 weeks of stock Oasis used to hold down to only eight weeks. “We know after only one week if it is not selling so we mark it down. Previously we didn’t do it until mid-season but now we do it in situ to accelerate sales rather than holding onto stock.”

“ If you break your bank covenants then it is a warning of trouble ahead. By and large the banks do not pressure you – provided you deliver. But if you miss your targets then expect them to be in your office every day ”

Reporting procedures are streamlined

Glanville says that with private status he also enjoys easier reporting procedures. This chiefly involves sending weekly sales figures and monthly management accounts to Baugur and a quarterly covenant check to the lending banks. This provides an early warning system for the lenders, which highlights any potential future default on debt repayments.

Helping Glanville to avoid this fate is a healthy focus on cash flow forecasting. It requires the finance team to keep on top of forecasts so the business can react quickly to changes in its cash position. This discipline provides sufficient time to cut back on, say, the marketing budget or reduce capital expenditure if a difficult cash position is forecast.

“It’s common sense really but our finance team has had to change their mindset because, as accountants, they tended to look at the P&L rather than the cash flow,” he says.

This squeezing of cash involves managing the cash flow more efficiently by only paying suppliers when it has to and renegotiating to extend the payment terms. It has also become more proactive in chasing payment from its concessions partners and overseas franchises.

Capital expenditure has also been simplified by only considering the return on investment (ROI), which must be achieved within a two-year timeframe. “Instead of complicated tools we just go on when we’ll get the cash back as we want quick paybacks. In quoted companies it is often done using a discounted cash flow model but when you are highly leveraged you don’t have that luxury,” says Glanville.

That the company has grown its Coast chain from 30 to 140 stores in the three years since the MBO is proof that this ROI criteria and the debt within the business does not constrain capital expenditure.

“ The debt does not affect people below me but a consciousness of cash does permeate throughout the company ”

Glanville says this is evidence that much of the business runs the same regardless of any debt on its balance sheet. Glanville also suggests that the cash management disciplines within the business are instilled in all staff by the targets that they have to meet, rather than by an understanding of why the targets are in place.



Alastair Miller
Managing Director Finance
and Services, New Look

Appointed CFO of New Look on 18 January 2000. Currently has responsibility for finance, systems, property, human resources, company secretariat and investor relations. He joined New Look from the RAC where he was group finance director from 1995. Previously a finance director within the BTR group and a management consultant with Price Waterhouse, having qualified as a chartered accountant with Deloitte Haskins and Sells, now part of PricewaterhouseCoopers LLP. He is also responsible for environmental issues and the policy for corporate social responsibility.

“ The quoted players have become more disciplined with their capital structures having seen the strong performances of the ‘take-privates’ ”

Alastair Miller – New Look

Although debt levels have increased markedly within the retail sector over recent years there are a number of industry-specific factors that have helped its most highly leveraged constituents manage their debt liabilities.

Alastair Miller of New Look, which was taken private in a £700 million deal in April 2004 with the support of private equity firms Apax Partners and Permira, believes these factors are not always appreciated.

“Historically, there has been a mismatch between the low ratings offered to retailers by the City and the views of the private equity investors. A lot of people failed to recognise the cash generative nature of retail,” he says. “The venture capitalists have strict investment models to follow and have demonstrated over the last few years that high levels of return within retail are a reality. This in turn has started to correct the mismatch in valuations.”

Volatility in the sector is manageable

He disputes the argument that the degree of trading volatility inherent in the industry gives retailers an inconsistent backdrop from which to repay their loans. “Yes we suffer volatility at the macro level from interest rates and consumer spending but is the sector any worse off than any other?” he asks.

The deflationary environment, which has been prevalent in the clothing sector for some time, has also offered some protection against the impact of volatility. “It has been that much easier to persuade the consumer to increase purchase volumes when prices are falling,” he says.

He also believes that, unlike many other sectors, retailers have at their disposal a number of tools to enable them to react quickly and/or mitigate any unforeseen volatility. Among them is the possibility of postponing capital expenditure, deferring maintenance on property, considering lower cost shop-fits as well as re-negotiating supplier terms.

“It’s the speed of response that is important. Of course any retailer would be reluctant to delay expenditure on new stores but if needs must, it will produce the desired result because the lead times are so short,” he continues.

More sophisticated approaches are now commonplace

Although it is the retailers that have gone private who have taken on the vast majority of debt, it is also starting to appear on the balance sheets of quoted operators. Some public players now adopt a much more sophisticated approach in planning and communicating the return of cash to shareholders and this is beginning to be recognised in enhanced multiples by the City.

“ The VCs knew all the banks and put together an auction – we had three syndicates competing to be lead arrangers ”

Miller says the two private equity houses masterminded New Look’s debt structuring exercise. What’s important within the structure is to try to ensure the management team is sufficiently incentivised and that the private equity houses anticipate a return that fits within their business parameters.

During the buy-out stage, Miller recalls that since the management team was effectively both a buyer and a seller of the New Look business, the private equity houses were very much in the driving seat. However, nowadays Miller says he has frequent dealings with both the VCs and the banks. On the treasury side, he says his communication with the banks also includes negotiating the likes of foreign currency hedging, letters of credit and merchant retail services.

“ As a plc you worry less about cash flow as you’ve more headroom. It might sound a bit obvious but many businesses that are not so highly geared are much more profit-centric rather than cash flow driven ”

A stricter focus on cash

On a more day-to-day basis, Miller says managing the debt New Look is carrying has manifested itself in the introduction of a much stricter focus on cash flow. He is keen to stress that it is not a question of cash or profit. He feels that a much stronger balance of focus has been introduced between cash flows, the profit and loss account and the balance sheet. This represented a significant shift from the ways things were done historically within the business.

This caused them to rework their reporting indicators, tools and processes. Miller admits that before any new systems of reporting could be fully effective in the New Look business, he had to bring in a change of culture: “It was a big step because departmental managers now have cash flows as well as budgets to deal with.” This process involved explaining to the top 120 managers what a highly leveraged structure is and that debt repayments have to be made to pay off the loans.

“ The management of cash has become a much more exact science ”

“There is a greater need to analyse the drivers of cash movements and understand fully all the component parts,” he says. He cites the opening of a new store as an example. Breaking down the component inflows and outflows (eg shop fit, property costs, staff costs, stock build up etc) and assessing the precise timing of each is critical.

What a significant increase in debt has not changed within the business is its continued growth. Miller does not believe that taking on high levels of debt “necessarily” affects the operational running of a retail business but that such businesses must be much more aware of the cash flow implications of what they do.

He says, “Clearly like for like sales continue to be just as important to us as they always were (i.e. giving us growth without a cash requirement). This combined with the roll-out of new stores, where the payback period can be very short, has enabled us to generate enough cash to re-invest in the business **and** repay some of our debt.”



Ian Findlay
Finance Director, Jane Norman

Ian Findlay became Finance Director of Jane Norman upon the MBO in January 2003. Previously he held senior finance positions in a FTSE 100 company.

“ As a family-owned business we had a roll out strategy but the buy-out certainly gave us the impetus to carry it out quicker ”

“ Certainly the level of debt (versus profits) going into some deals looks high but I'd hope that the management teams are comfortable with it ”

Ian Findlay – Jane Norman

A highly leveraged buy-out is likely to have minimal operational implications on a well run business, whereas for a retailer that is deemed to be a ‘recovery story’ it will likely have a heavy impact across the whole of its operations.

This is the view of Ian Findlay, who says the family-owned Jane Norman was so well run that after its £70 million buy-out in early 2003, it has largely been “business as usual”.

“We’ve expanded the key teams such as buying and merchandising and IT but made no significant changes to any operational aspects. The basic business is the same because it was already at the top of its game with the highest margins in the fashion industry and there was no fat to cut out. If it’s not broken then why fix it?” he asks.

With the bulk of its activities remaining the same, Jane Norman somewhat dispels the widely held view that taking on a heavy debt load radically alters the way a business is run. Unlike many other buy-outs, it was not predicated on a new management team being drafted in to make dramatic change and overhaul the operational elements of the business.

Rapid growth has been self funded

What did change was that the deal gave management the impetus to push ahead with growing the business. So in the two years since the deal was completed, the company has grown rapidly from 46 outlets to 88 – comprising 38 standalone shops and 50 concessions in department stores.

Findlay is quick to point out that this roll-out is self-funding – from cash generation – and that the debt the company took on was used purely to fund the buy-out from the founding family.

Needless to say, the deal also changed the financial structure of the business. “Prior to the buy-out, Jane Norman had not borrowed a penny in its 50 year existence but now we’re very highly geared,” says Findlay.

Management must be comfortable with debt levels

Although Jane Norman is highly leveraged, Findlay suggests it is only the management in a business that really knows what levels of cash a company is capable of paying back and that they would only do a deal if they were comfortable with the levels of debt that they were taking on.

Findlay says he is ‘very happy’ with the repayment schedule at Jane Norman and that the senior bank debt was reduced significantly by the end of 2004.

“ It would hit us but not as much as having the wrong products in our stores. It is in our hands, not the economy – for us it’s all about product, product, product. ”

Findlay is confident of the company’s strategy and believes that it will not suffer from any future downturn in consumer spending. Jane Norman is helped by its flexible supply chain, which ensures that it only holds limited amounts of stock. Any slow-moving lines can therefore easily be offloaded through its normal half-yearly sales and via its concessions when a department store chain has its own sales and promotions. This high stock-turn obviously helps with cash generation, which is the crucial factor in any leveraged buy-out.

To aid this process, Findlay says it is essential that a strong cash flow model be implemented. This helps to ensure an understanding of the short and medium-term cash requirements and provides an early warning for when to ‘pull the right levers’ to temporarily reduce the outflow of cash.

However, Findlay admits that there are limited levers to pull at Jane Norman and that reducing spending on marketing is not one of them: “To date our carrier bags and our shop windows have been the main part of our marketing and advertising strategy.”

“ When you go from private with no debt to private equity-backed with significant debt, the information flow becomes more structured. There are also more formalised budgeting procedures and cash flow forecasting ”

More structured reporting processes

Although the structure of the finance department has remained the same after the buy-out, Findlay says the deal has brought extra reporting responsibilities. Although all the required data and analysis was previously available within the business, it was in a less formal structure to that now demanded by its private equity backer and lending bank.

Findlay admits to few changes having been required on the accounting front and says the company’s operational management information (that varies little from that of a quoted retailer) remains very much the same as they did pre-buy-out.

Findlay says he has tried to engender a ‘business as usual’ culture at Jane Norman by making people generally aware of the company’s debt liabilities but avoiding frightening them. “If you get into a lot of detail then it can be quite daunting for non-finance people so we just keep everyone focused on beating their budget and then they’ve nothing to worry about,” he says.



Kevin O'Sullivan
Relationship Director, Retail
and Wholesale Team, Barclays

Kevin has been a manager with Barclays Bank for 15 years during which time, he has worked in a wide variety of roles ranging across both sales and risk management. Four years ago he joined the bank's Retail and Wholesale Team where he now looks after the team's food and drink customers

“ With a leveraged deal you need cash coming through the door and you have it in fistfulls in the retail sector ”

Kevin O'Sullivan – Barclays

Helping to fuel the growth in the number of leveraged deals in the retail sector is the willingness of the investor community to take a higher risk in order to maintain the returns that they have been enjoying of late.

Kevin O'Sullivan says: “Investors such as pension funds and insurance companies have been prepared to accept the same sorts of returns as before but on a more highly leveraged basis.”

Such have been the increased levels of activity by the private equity houses, putting such deals together for a hungry pack of investors, that O'Sullivan says the Barclays Leveraged Finance team is working closer than ever with the Retail and Wholesale team and this has helped the bank grow its market share in this area.

Level of debt does not impact susceptibility to downturn

Looking to the future, O'Sullivan expects consumer spending to slow down: “We expect some slowdown but it is not the death knell for the retail sector. It is inevitable that some companies will suffer but no more than in any other sector. And I don't think leveraged buy-outs (LBOs) are any more susceptible to a downturn than other retailers.”

This is because he believes they will benefit from having an established track record in cash generation, which will act as a good defence against an economic downturn. O'Sullivan cites private equity backed Debenhams as a good example of a retailer that has successfully generated cash without requiring a growth in top-line sales.

“Retailers have been good at de-leveraging, look at Debenhams and Bhs/Arcadia, and overall we think they are sensible in the amount of debt that they have taken on.”

He even goes as far as to suggest that many retailers regard upward only rentals as a bigger debt issue than that of borrowings from the banks: “Rent is effectively off-balance sheet gearing and retailers' perception of the key debt issue they have to deal with is rent.”

The sector's cash generation record is now established

The ability to generate cash – despite increasing rental levels and a continued deflationary retail environment – has proved attractive to both private equity houses and lending banks with the result that the retail sector is no longer regarded as quite the risky investment that it once was.

The ability to extract as much cash as possible from a business is largely down to the quality of the management team and how effectively they can operate the supply chain. To this end, O'Sullivan recommends that retailers in a leveraged business focus strongly on cash generation and make themselves fully aware of the implications of their actions on the company's cash flow.

“Cash flow has to come higher up the agenda for a leveraged business so more resources – chiefly in the finance department – will need to be committed. Although it is more a finance/treasury issue the whole board must buy into it,” he says.

Quality information for the bank is crucial

Should any management be lacking in the area of cash flow handling, then they are likely to be quickly dealt with. For all parties involved in backing a leveraged buy-out, visibility about performance is crucial and the key tool is relevant financial data.

“ From the transactions we see, cash flow skills come very quickly to management, and one of the key strengths of a private equity house is to identify the strengths of a management team and to make corrections quickly where necessary ”

O’Sullivan says that for a business with insignificant debt, the lending banks could rely on as little as its interim audited results but for a leveraged retailer he says they would need some Key Performance Indicators (KPIs) at least quarterly, if not monthly.

For LBO deals, Barclays uses a number of KPIs that are cash flow based and include the debt service coverage ratio (that indicates the ability of a retailer to service the interest and debt repayment obligations from the cash flow generated).

“We are often lenders where, in the absence of more tangible assets such as freehold buildings, cash flow is the only source of repayment. We therefore have to understand the cash flow movements of the business and will always focus on debt service ratios,” explains O’Sullivan.

“ It’s in no-one’s interest to see these covenants breached so we give them some margin for error. There has to be room for slippage ”

Such ratios will be included in the banking covenants of any LBO and act as an early warning that a company is having difficulty meeting its obligations. They should, however, be configured to provide management with some room for manoeuvre.

At the other end of the performance scale, the banks will also put in place incentives for retailers who make repayments ahead of schedule and reduce their levels of borrowing, including reductions in the cost of borrowing.



Graeme Shankland
Head of Integrated &
Acquisition Finance,
Bank of Scotland

Graeme Shankland joined Bank of Scotland in 1990 following spells with Deutsche Bank AG and Clydesdale Bank Plc. He helped launch Integrated Finance in 2000, a business that provides debt and equity capital to finance buy-outs in the UK. He has worked on many retail transactions including Arcadia and Edinburgh Woollen Mills.

“ We broke the mould and a number of industry commentators suggested at the time that the transaction was over-gearred – although the leverage multiples look conservative in relation to current market appetite ”

Graeme Shankland – Bank of Scotland

Bank of Scotland (BoS) has been active in the retail sector and enjoyed significant gains through its Integrated Finance (IF) business from providing almost the entire funding for the purchase of Arcadia by Philip Green in 2002.

Graeme Shankland, Head of Integrated & Acquisition Finance at BoS Corporate Banking stated that they funded a number of retail transactions during 2002 but valuations have since moved northwards and it is now a sellers market. IF uniquely provides both debt and equity for acquisitions and effectively acts as principal in support of incumbent management.

BoS focuses on ‘operational deals’

Shankland states that there has been a strong appetite across the private equity and banking market for cash generative retail businesses in two distinct categories.

The first is asset rich retailers capable of securing off balance sheet asset based financing and with non-core disposal opportunities. Typically, cash flow can be enhanced through efficiencies in supply chain management and control of capital expenditure.

The second category is niche operators offering growth strategies through a roll out programme. This latter opportunity is more complex to finance, requiring further injections of debt and equity throughout the lifecycle of the deal. It is therefore not suited to all investors as cash flow may not be available to amortise debt or to provide any yield on the equity investment.

The IF business tends to back ‘operational deals’ where value is created through improvements in the running of the business. The prime example of an operational deal that has enabled the prepaying of debt ahead of schedule is Arcadia.

High profile deal fuelled further activity

Shankland says the deal was completed at a time when banking capacity for retail transactions was limited and its success kick-started the subsequent flurry of activity. The appetite for retail deals has developed significantly since then.

BoS initially underwrote the whole of the £800m of debt as well as taking a minority investment alongside Philip Green’s family. This commitment was held over the bank’s year end and the important Christmas trading period, before a proportion of the banking was syndicated in the traditional manner.

“ The beauty of the deal for BoS is that although the debt has been prepaid, it now receives an attractive annuity stream from dividends ”

Such was the level of operational improvement that Green and his team have since been able to implement at Arcadia that the debt has been fully repaid well ahead of the five year timetable.

Another retail transaction backed by BoS was the secondary buy-out of Edinburgh Woollen Mills (EWM), which Shankland says has also recently paid down its debt ahead of time. However, this was a more conventional leveraged deal with a group of banks providing capital alongside BoS in the senior and mezzanine strips. In common with other successful private equity backed retailers, EWM now has the opportunity to recapitalise and release value.

Regardless of the deal type, BoS engages in the expected stringent levels of due diligence and commissions third party reports (market, accounting, pensions, management, insurance and legal) from the usual sources.

In addition, IF secures independent advice on potential retail targets from experienced operators from within its own network of Non Executive Directors. Shankland explains that IF will lead the transaction process, resulting in short lines of communication where management and vendors can speak directly to the sole funder.

“ Retail is detail and management teams in leveraged retailers need to be constantly aware of unit performance, stock margins and cash flow unlike public companies where the focus tends to be more on like for like sales ”

Retail is detail

For all the companies in which BoS invests, it sets out a detailed specification of information requirements focusing on the Key Performance Indicators. Shankland says the Arcadia team provided a detailed business plan and followed this up with concise management information on a regular basis as they delivered on their strategy.

He warns that such has been the success of the Arcadia deal that there is a risk that people may think it is easy and that it can be simply replicated. “Philip and his team have an exceptional track record and their achievements at Arcadia are outstanding. The complexity and difficulty is often glossed over.”

Although there has been an increase in debt multiples across the retail sector over the last two years, predominately from the increase in MBO activity, Shankland says that appetite is cooling down and leveraged multiples in the UK have now peaked. However, he believes that despite the more aggressive debt structuring across the market in recent years, the broad portfolio is holding up well and has benefited from significant de-gearing.



David Madoc-Jones
Partner, Debt Advisory
Services, KPMG

David is a Partner in KPMG's Debt Advisory Services group and has extensive experience across a wide range of debt products. He joined KPMG in 1999 from Bank of America, where he had focussed on leveraged finance, corporate restructuring and leisure sector financing. Whilst at KPMG, David has advised a range of corporate and private equity clients raising and refinancing debt capital across a variety of sectors. Retail clients of the Debt Advisory Services group have included Tesco, Kesa, MFI, Maplin Electronics, Change Capital/Robert Dyas and Virgin Entertainment.

David Madoc-Jones – KPMG

“Lenders have traditionally been somewhat wary of high levels of debt in the retail sector but the number of leveraged retail transactions over the past 18 months has demonstrated that they are willing to back the right story,” says David Madoc-Jones, a partner in the Debt Advisory Services group in KPMG's Corporate Finance practice.

So what is important to lenders?

Lenders understandably focus very hard on the cash-flow generated by the business, recognising that many (though not all) retailers have limited tangible assets to provide collateral to support the debt.

Retail is largely a cash business so, provided that the reporting systems are effective, lenders can see what is going on in the business and track the cash that they need to pay their interest and repay the principal.

Higher debt levels do add a level of risk to the business. The ability in a retail business to take rapid action when performance is below par provides lenders with comfort that there is enough flexibility in the way the business is run to protect its cash-flow.

The management team holds the key to delivering success. Lenders will always set great store on the quality and experience of the team leading the business. As the number of leveraged retail transactions has grown, a pool of senior executives with experience of operating in a cash-focussed leveraged environment is starting to emerge and lenders will continue to assign high value to those skills.

In the end, successfully managing high levels of debt in a retail business hinges on management's ability to make the business a success. As Madoc-Jones says: “If the business is going well, the only debt problem will be figuring out how best to repay and then ensuring the capital structure remains appropriate for the business's future goals.”

Contact details

Helen Dickinson

UK Head of Retail, KPMG
Tel. 0207 311 8255
Fax. 0207 311 8258
helen.dickinson@kpmg.co.uk

David Madoc-Jones

Partner, Debt Advisory
Tel. 0207 694 3039
Fax. 0207 311 8806
david.madoc-jones@kpmg.co.uk

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