Berkshire Case Study and Report

Berkshire Partners: Bidding for Carter’s

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Agenda

- Cash flow generated by Carters in the next five years (2002-2006)
- Assess management forecast
- Realism of management forecast
- Sensitivity analysis
- Berkshire team Bid

Company Overview

- Carter’s was founded in 1865 in Needham, Massachusetts.
- Over the course of 136 years in the highly competitive apparel industry, the company became the largest branded manufacturer of toddler and baby apparel in the United States and also a leading maker of young children’s clothing.
- Dividing its market into five segments—layette (i.e., newborn), baby sleepwear, baby playwear, young children’s sleepwear, and young children’s playwear—the company sought to outfit children for the first six years of life, “from birth to bus.”

More Information about Carter's

Current Situation

- Berkshire Partners was considering a
- leveraged buyout (LBO) of the William Carter Co. under GS's staple financing.
- From 1992 to 2000, the company increased revenue at a CAGR of 9.5%. and EBITDA grew at a rate of 22.1%.
- Analysts attributed much of the company’s growth to improved brand recognition, a lower cost structure, expansion into the discount channel, and the movement of some manufacturing operations offshore.

Growth Strategy

- Capitalize on the leading market position.
- Diversify distribution channels
- Continue to extend Carter’s into the two- to six-year-old playwear market.
- Increase operating efficiencies

Management Projection

Year	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
EBIT	55100	67600	87300	109800	133500	140175
TAX	22040	27040	34920	43920	53400	56070
NOPAT	**33060**	**40560**	**52380**	**65880**	**80100**	**84105**
Depreciation	20,000	21,100	21,800	24,400	28,100	29,505
GROSS CASHFLOWS	**53,060**	**61,660**	**74,180**	**90,280**	**1,08,200**	**1,13,610**
CAPEX	20500	19500	21000	21500	22500	22500
CHANGE IN WORKING CAPITAL	-12080	12358	14071	16027	18423	7117
GROSS INVESTMENT	**8420**	**31858**	**35071**	**37527**	**40923**	**29617**
FCF	**44,640**	**29,802**	**39,109**	**52,753**	**67,277**	**83,993**

Assessment of Management Forecasts

- Despite improvements in areas such as cost structure, expansion of discount channels, and offshore operations, Carter's historical performance only generated a compound annual growth rate (CAGR) of 10.4%. Based on the company's historical performance, the projected revenue growth of 14.7% is unrealistic
- The management has recognized that the projected growth is due to the new Tykes brand, but it is uncertain if the other major segments of the company can maintain similar growth. The effectiveness of the four growth strategies is unclear, and it is uncertain how much more growth can be achieved through these strategies.
- The enterprise value based on the management estimates should be around $873.782M, and this results in a value of equity of $513.782M. When we compare the trading multiples, we realized the comparable trading multiple is 7.41x and we multiplied this multiple by the forecasted EBITDA of 2001 to get the value of Carter’s at $539.106M, and $179.106M of equity value correspondingly. The EV based on management estimates is much higher than that of based on the comparables, which is consistent with our opinion of management being delusional.

Assumptions

The risk-free rate, 5.2%, is obtained from the 10-year U.S. Treasury bond yield, and we used a risk premium of 5%.

Berkshire believed that the equity portion of the firm should be at least 25%,we assume a reasonable target leverage ratio to be 75%

Using 2000 EBIT and tax expenses, we arrived at an effective tax rate around 40%

We took the average of the fully drawn cost of three debts proposed by GS to arrive at a total debt of $360M

WACC Calculation

The cost of debt is calculated using the proposed capital structure by Goldman Sachs.

The cost of Equity is calculated using the CAPM model where Beta is the average of the given company Betas and the market rate of return is 10%

The Equity and Debt ratio is taken from the proposed ratio by Carter's.

The **WACC** value comes out to be **10.28**%

Additional Assumptions

Revenue growth rate by averaging the historical data and management projection (growth rate = (10.4%+14.7%)/2 = 12.55%

The terminal growth rate is 2%, which is a normal rate for a firm that already established its position in the industry and still seeks means to expand. This rate also corresponds to the average U.S. GDP growth

Company Valuation(using own assumption)

Years	2001	2002	2003	2004	2005	2006
EBIT	$ 55,100	$ 62,015	$ 69,798	$ 78,558	$ 88,417	$ 99,513
TAX	$ 22,040	$ 24,806	$ 27,919	$ 31,423	$ 35,367	$ 39,805
NOPAT	$ 33,060	$ 37,209	$ 41,879	$ 47,135	$ 53,050	$ 59,708
Depreceation	$ 20,000	$ 22,510	$ 26,024	$ 29,932	$ 34,243	$ 39,126
Gross CF	$ 53,060	$ 59,719	$ 67,903	$ 77,067	$ 87,293	$ 98,834
CapEx	$ 20,500	$ 23,073	$ 25,968	$ 29,227	$ 32,895	$ 37,024
Change in OWC	$ -12,080	$ 10,224	$ 11,508	$ 12,952	$ 14,577	$ 16,407
Gross Investment	$ 8,420	$ 33,297	$ 37,476	$ 42,179	$ 47,472	$ 53,431
FCF	$ 44,640	$ 26,422	$ 30,427	$ 34,888	$ 39,821	$ 45,403
PV of FCF	$ 44,640	$ 23,965.53	$ 25,018.59	$ 26,012.57	$ 26,923.24	$ 27,835.49
Sum of PVs	$ 1,74,395					
Terminal Value						
Terminal Value in 5 years	$ 5,59,309.86					
PV of TV	$ 3,42,900.95					
Enterprise Value	$ 5,17,296.37					
Value of Debt	$ 3,60,000.00					
Value of Equity	$ 1,57,296.37					

Conclusion

- When we took both historical performance and management projection into account, we obtained an enterprise value of \$516.91M, and an equity value of \$156.91M. Given equity bid equals enterprise value less than debt, we would recommend an equity bid of \$156.91M.
- Using the equity bid of \$156.91M and FCF from 2002 to 2006, we arrived at an expected IRR of 43%. We used more conservative assumptions for the revenue growth rate than the management estimates.
- I think such a high IRR is really attractive to Berkshire, and Berkshire should definitely bid on it, since Carter’s WACC is at a level of 10.28%. The investment return is higher than the cost of capital, so it’s very likely that Berkshaire will exit this investment profitably and successfull

THANK YOU