Daniyal Mehdi - 1003017371

Nadia Shaban - 1003108807

Syed Ahmad Salman - 1002994076

RSM433 Case Analysis

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Berkshire Partners: Bidding for Carter's

1. How does Berkshire Partners create value? Why could Carter's be attractive to a private equity buyer? (3 points)

Berkshire Partners have a number of ways to create value in the private businesses they invest in. After taking an equity position in a business, Berkshire plays the role as a strategically supporting management in various forms. The private equity firm helps the business prioritize key objectives and create a business plan. In doing this, Berkshire partners reviews the organizational design and capital structure of the business. They also help train and develop key managers while leading the integration process after making an acquisition. Berkshire is involved differently in every acquisition the company has made. About half the acquired companies do not need much attention of Berkshire's management team, however, there are some which need a lot of attention from the private equity firm, depending on which stage the business is in and whether or not Berkshire can create a meaningful impact. Unlike many private equity firms, Berkshire prefers to initiate an IPO during the middle stages of its ownership to stay involved with the management and try to help the company grow.

Carter's is an attractive investment for private equity buyers. This is largely because it is a consumer products company and is a strong brand with previous success that can be leveraged across multiple industries. The brand was present in department stores, had national chains and specialty stores. Through the 150 retail outlet stores Carter's operated, customers were also able to purchase their products at large discounts. Furthermore, in 2000, Carter's new brand, Tykes, struck a lucrative deal with Target and was growing consistently at 9.5% for the past 8 years. With earnings increasing by 22.1% during the same time period, Carter's was on a great path. It would be a great opportunity for an investor to help with the business's growth while reaping the benefits alongside it.

2. Why is Investcorp selling? (2 points)

Investcorp acquired Carter's after which it enjoyed a period of sustained growth with the business. They maintained a 9.5% growth rate, and increased EBITDA by 22% in 8 years. After aiding in Carter's growth for over 5 years, Investcorp wanted liquidity. With a variety of investors funding them, the lack of greater returns makes it harder for Investcorp to raise further financing to fund the business. Therefore, with the IPO market at a standstill, Investcorp aimed to 'generate a win' for their network of investors through the sale of Carter's.

3. How much cash flow will Carter's generate in the next five years (2002-2006), based on management estimates? How realistic are the management forecasts, in light of Carter's historical performance? (4 points)

	2002	2003	2004	2005	2006
EBIT	$ 67,600	$ 87,300	$ 109,800	$ 133,500	$ 140,175
Tax	$ 27,040	$ 34,920	$ 43,920	$ 53,400	$ 56,070
NOPAT	$ 40,560	$ 52,380	$ 65,880	$ 80,100	$ 84,105
Depreciation	$ 20,000	$ 21,100	$ 21,800	$ 24,400	$ 28,100
Capex	$ 19,500	$ 21,000	$ 21,500	$ 22,500	$ 22,500
Change in NWC	$ 91,794	$ 25,984	$ 29,596	$ 34,020	$ 3,143
Free Cash Flow	**$ (50,734)**	**$ 26,496**	**$ 36,584**	**$ 47,980**	**$ 76,562**

Judging by their historical performance, the Free Cash Flows from these projections seem to be slightly farfetched. This is largely because Carter's enjoyed a 9.5% growth rate from 1992 to 2000, however, management is projecting revenue growth rates of around 15% for each year from 2002 to 2005. Such a rapid increase is unlikely, especially due to the risks and costs associated with the acquisition. Integration of management, creation of synergies, adapting according to the company's culture and the restructuring of the company will take time. Therefore, it may not be very realistic to forecast such high growth so soon.

4. What should the Berkshire team bid using the management forecast? Make an assumption about an appropriate capital structure and do a valuation. Compare with trading and transaction multiples of comparable firms. (6 points)

We recommend that Berkshire submit a bid of $513million as an enterprise value for acquiring Carter's. This comes from $153.2million in equity and $360million in debt. We assume the Goldman Sach's staple financing combined with Berkshire's thoughts regarding the equity position being at 25% and our target leverage being at 75%.

In order to calculate the cost of equity, we were able to look into the asset beta for the industry average and leveled it using the target capital structure for Carter's. This resulted in an equity beta of 3.61. The market premium was 5% and the risk free rate was calculated through 10 year treasury bonds and was found as 5.2%. This led us to calculate the cost of equity as 23%. Hence, we were able to calculate Carter's WACC as 10%.

WHen we use the WACC alongside the management projections we are able to calculate the enterprise value for Carter's. The terminal value that was calculated through the terminal growth rate of 1.5%.

When using comparables we must look deeper into the valuation method. We used EV/EBITDA for multiples of Nike, Jones Apparel, Tommy Hilfigure and Liz Clairborne - we know that the industry average multiple was about 7.1. We can then calculate an implied enterprise value of $556million (using EBITDA for 2001E). This values Carter's at a higher value and is relatively similar to using management projections.

5. Make your own forecast. What bid would you recommend? (2 points)

Due to the fact that revenue is growing at a slower rate than what was forcasted, we recommend a bid of about $128million in equity and $300million in debt. This gives us a total enterprise value of $428million. This differs from the management forecast, yet, both cases still maintain the capital structure that Berksire requires.

6. Given the bid you recommend, what is the expected IRR on the investment for Berkshire? (3 points)

In order to calculate the IRR, we had to make certain assumptions. In the past, we know Berkshire has favoured exits through sales to other companies however there were certain circumstances in which the company could go public with an IPO. If considering an IPO, it was important that the target firm met certain conditions: having a strong brand, displaying strong growth potential, and had a dramatic need for capital. Carter's was able to satisfy all three of these conditions and therefore was an excellent IPO contender - hence, it was easy to assume that Berkshire would remove their responsibility through IPO. Therefore, in our analysis, we assume an exit in the fall of 2001. We then derive an exit value to Berkshire proceeding the IPO. In out analysis we computed the present value of the exit value using 2001 fall data (= $626million). The PV of the exit value was about $590million this will yield a net return of $162million. The IRR we calculate for Berkshire is 38%.