Case 28: Salty Sole Shoe Co.

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CASE COMPETITION
SILVER MEDAL WINNER

Case Question

- Your client is a large retail-focused private equity firm that owns Salty Sole, a leading designer of junior women's footwear, primarily targeting the 14 – 22 year old age group. Salty Sole was purchased last year by the private equity firm expecting to realize substantial profits upon sale in 2012 by increasing the company's EBITDA. The situation, however, is that due to a current recession, annual profit has only grown modestly post the acquisition and is not on track to generate the double-digit returns that the private equity firm originally anticipated.
- *How can the company increase profitability and achieve the private equity firm's return on investment objectives?*

7

Quants.

6

Structure

Creativity
Acct.
Micro.

Case tracker

- **Industry:**
  Retail Apparel
- **Level of Difficulty:**
  Medium
- **Case Format:**
  Improving profitability
- **Concepts Tested:**
  - Creativity
  - Accounting
  - Microeconomics

Fit Questions

Spend first 15 min on fit

- Tell me about a problem you faced in your professional life, how you resolved it, and what the results were.
- Tell me about a time when you worked in a contentious or high-stress situation and how you handled it.

Guide to interviewer

- **The case primarily tests an understanding of profitability and profitability growth strategies**
- Begin by reading the case question and asking the interviewee to take a few moments and then explain how they would like to proceed in the client's problem
- After they present a framework for solving the case, if they have not already done so, ask the interviewee what he/she believes the primary components of costs are for a business like this.
  - **Answer:** materials, distribution (labor / transportation / taxes), sales force labor

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Clarifying answers and handout guide

Clarifying answers to provide

Industry Characteristics/Market Economics

- Client is the market leader in junior women's footwear in the U.S. only.
- Apparel industry is characterized by cyclicality due to economy and consumer preferences.

Client Characteristics

- Client designs and distributes footwear to discount retailers (think Kohl's) and is considered mid-priced.
- Client outsources all manufacturing on a fixed-contract basis (i.e. manufacturing costs with outsourced providers fall under Fixed Costs for simplicity).

Competitive Dynamics

- Client follows a "me-too" strategy and follows fashion rather than inventing it then offering lower prices than name brands (i.e. not subject to fashion risk).
- Client competes on the basis of trendy fashion and value pricing.

Guide to handouts

- After asking the case question, the interviewee should draw a framework that outlines the basic concept that profit is driven by revenue (price and volume) and cost (fixed and variable)
- **Exhibit 1** – Hand out after interviewee presents his/her framework.
  - What observations can be made from this chart?
  - Interviewee should point out that the company experienced significant growth during the pre-recession years, but a decline and only gradual pick-up following.
  - Interviewee should pick-up on the fact that the change in net sales is not due to increased discounts/allowances (remains 1% throughout years).
  - On the cost side, interviewee should note that variable costs remained flat at 50% and fixed costs remained flat
- **Exhibit 2** – Hand out when discussing revenue / increasing volume.
  - Note that the "casual" footwear market is used as a proxy for the junior women's category in which the client competes and is the market leader.
  - What observations can be made from this chart?
  - Candidate should note that the client is already the market leader with greater than 35% share and that the industry is not projected to grow.

Key elements to analyze

Costs

- Using **Exhibit 1**, have a quick discussion about the company's cost structure.

Revenue

- Once interviewee determines that cost is not the issue, have a discussion on the components of revenue – price and volume.

Notes to interviewer

- Fixed: Interviewee should note that fixed costs are not extremely high (about 23-25%), but could be an area for improvement. Ask how interviewee would reduce fixed costs? **Answer:** renegotiate contracts, find cheaper manufacturing partners, etc.
  - State that in-fact fixed costs cannot be adjusted based on the company's research.
- Variable: Interviewee should note that variable costs are approximately 50% of sales. Ask how interviewee would think about reducing variable costs? Answer: reduce labor/sales force, use technology, renegotiate / volume purchase materials
  - State that variable costs are currently at the lowest possible rates based on market research.

Notes to interviewer

- Price: Interviewee should ask if pricing has remained constant over time or if the company has adjusted its pricing to reflect lower consumer discretionary income.
- Ask what considerations the interviewee would have when considering adjusting price?
  - Answers should be price sensitivity / elasticity, cost structure, brand equity (dilute brand through price decrease but compete with more upscale brands if increase).
  - State that pricing has remained constant at an average of $25/unit. The company has determined that it would not be prudent to adjust pricing based on industry research. Interviewee can now determine the number of pairs of shoes sold for later in the case.

Key elements to analyze

Revenue (cont' d)

- Now that the interviewee has hopefully zeroed-in on the fact that the issue is volume, ask how many units must be sold by 2012 in order for the private equity firm to achieve a 20% return on the investment in Salty Sole Shoe, which equals approximately $300 million sale value (give this number). Note that interviewee should *ignore* discounts/allowances for simplicity.

Notes to interviewer

- Interviewee should determine that if the sale value needs to be $300mm in 2012, then EBITDA will need to be $300 / 6.5 = $46.15 (round up to $50 million).
- The formula to determine how many pairs of shoes must be sold to reach that EBITDA level is as follows:
  - $50,000,000 = $25*v – (.5 * 25 * v) – 15,000,000
  - $65,000,000 = 12.5v
  - V = 5,200,000 pairs of shoes
- Interviewee should note that this is more than double the 2008 and 2009 volume levels.
- Ask what the interviewee would want to know to determine if this volume is feasible? Answer: market size / share.

Market Size

- Show the candidate Exhibit 2 when he/she notes that market size/share would be helpful.
- Candidate should note that the client is already the market leader with greater than 35% and that the market size is not projected to increase.
- This should lead to the conclusion that the client can increase volume by stealing share and/or new products in other categories.

Solution and recommendations

Solution & Recommendations

- The interviewee should zero-in on the fact that since cost-structure is fixed and price is also fixed, volume is the only real way to increase profitability.
- However, volume must more than double in order to achieve the growth desired by the private equity firm for a 20% return, which could be difficult given recession and the fact that the industry as a whole isn't growing.
- Interviewee should recommend potentials strategies for achieving that volume growth while outlining the risks of each: 1) Volume: new products / geographies / distribution channels (international?); increase marketing to steal share; acquire growth (brands); adjust product mix to higher-margin products. 2) Price: add value / features. 3) Risks: Capacity, cannibalization if new products.

Bonus/Guide to an Excellent Case

- An excellent interviewee will quickly identify that volume is the issue by ticking through the parts of the profitability equation.
- An excellent interviewee will also ask about product mix and question the 50% gross margin. Interviewer should note that it's assumed that all products have the same margin, but that's a great question.
- An excellent interviewee will also note that since the company is not projected to have to adjust discounts / allowances, then it probably has a good product that is highly-valued by customers and/or this may be aggressive projecting.

Exhibit #1: Clients Financial Estimates 2006 - 2012

Salty Sole Financial Estimates
($ in millions)

	2006A	2007A	2008A	2009E	2010E	2011E	2012E
Sales	50.00	65.00	60.00	61.00	62.00	65.00	70.00
Less: Discounts/Allowances	(0.50)	(0.65)	(0.60)	(0.61)	(0.62)	(0.65)	(0.70)
Net Sales	$49.50	$64.35	$59.40	$60.39	$61.38	$64.35	$69.30
% Increase / Decrease	*20.0%*	*30.0%*	*(7.7%)*	*1.7%*	*1.6%*	*4.8%*	*7.7%*
Cost of Goods Sold	24.75	32.18	29.70	30.20	30.69	32.18	34.65
Fixed Costs	15.00	15.00	15.00	15.00	15.00	15.00	15.00
Total Costs	39.75	47.18	44.70	45.20	45.69	47.18	49.65
EBITDA	$9.75	$17.18	$14.70	$15.20	$15.69	$17.18	$19.65
Sale Multiple	6.50x	6.50x	6.50x	6.50x	6.50x	6.50x	6.50x
Purchase/Sale Price		$111.64	$95.55	$98.77	$101.99	$111.64	$127.73
Return on Investment							2.7%

Note: Acquisition occurred on December 31, 2006.

Exhibit #2: Market Size and Share