Athletic Gear, Inc Acquiring Mercury Athletic

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INTRODUCTION

Active Gear Inc (AGI) is a privately held footwear company, operating in a mature highly competitive industry. The industry is marked by low growth with stable profit margins. Each segment has competitive tendencies for consumer marketing based.

John Liedtke, the head of business development for Active Gear, Inc is currently thinking whether to acquire Mercury Athletic, Footwear division of West Coast Fashions. Inc. Active Gear. Recently, a group of Chinese contract manufacturers created pressure to boost capacity utilization favoring larger firms. AGI's small size was a competitive disadvantage. Lidtke was aware that acquiring Mercury Athletic Footwear would bring many advantages to the company such as doubling revenue, increasing market presence among other benefits. We will analyze whether mercury is an appropriate target for AGI.

INDUSTRY BACKGROUND

Athletic and Casual Footwear industry characteristics:

- Mature
- Highly competitive
- Low growth
- Stable profit margins

Even though it has an overall stability, it can be very volatile due to the changing fashion trends. It is estimated that within the fashion sensitive part of the industry the life cycles of fashion trends tend to be short lasting about one season. The goal of each individual firm within this industry is to exploit each fashion trend. The casual segment competes for style, price, and general quality. The athletic segment competes for brand image, type of engineering, performance and price. North American and European footwear companies used independent manufacturers to produce their shoes located in China.

ACTIVE GEAR, INC. (AGI)

AGI was founded in 1965 and focuses in producing golf and tennis shoes. In 2006 AGI had a revenue of $470.3 million, 42% of revenue being composed of athletic shoes, and an operating income of $60.4 million. AGI's footwear was sold by more than 5700 North American sores including wholesalers and independent distributors. What set AGI apart is that they did not sell through discount retailers.

MERCURY ATHLETIC FOOTWEAR

Mercury Athletic footwear focuses on distributing branded athletic and casual footwear focusing on the youth market; sports enthusiast and associated X-Games subculture. This sets apart mercury from typical footwear company giving them a competitive advantage. Mercury's prices stay in the midrange due to the fact that they are a well-known company. Mercury stays up to date with fashion trends due to their media monitoring and interaction such as alternative music, television, film, and clothing. They are also involved in different sponsorship ranging from music festivals to sports.

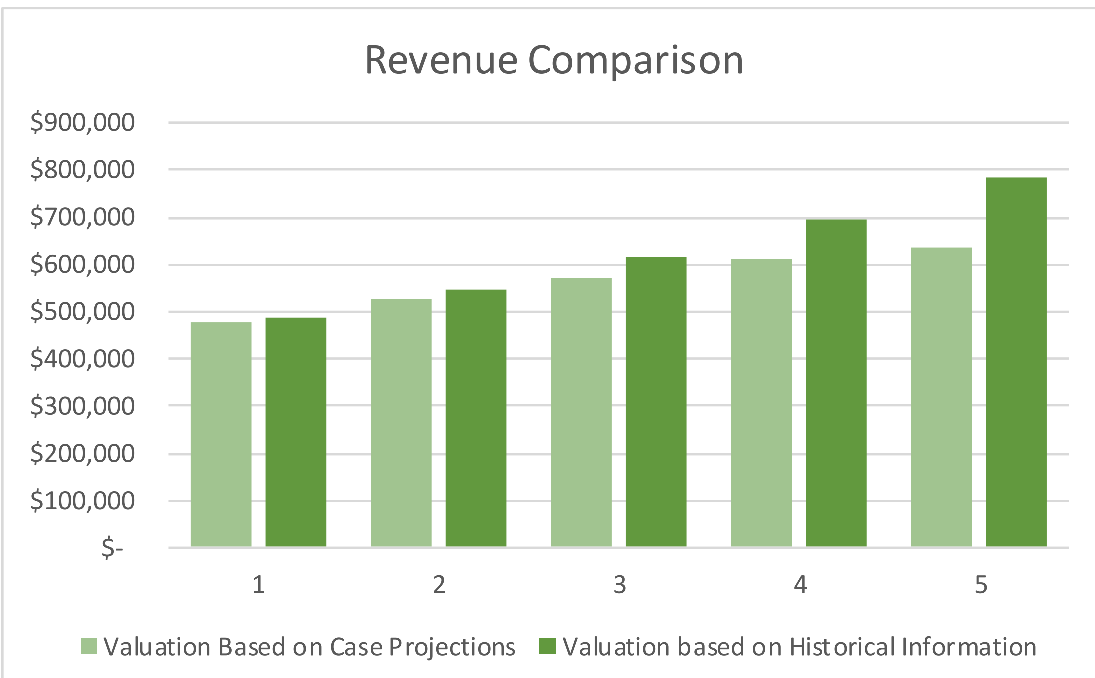
Mercury men's casual segment consistently generates the highest profit. Their ability to generated high profitability is attributed to efficient marketing and distribution strategies. Finally, they developed an operational infrastructure to effectively adapt to changes and customers' expectations.

THE ACQUISITION

The acquisition of Mercury Athletic holds several embedded advantages and disadvantages to Athletic Gear, Inc (AGI). Upon acquiring Mercury Athletic, AGI is expected to experience the following pros and cons:

Pros

AGI's smaller size, when compared to its competitors, puts it at a disadvantage. Acquiring Mercury will help AGI grow in size. This growth in size will be a result of capturing existing customers, utilizing Mercury's production lines and assets. AGI is expected to see an increase in debt-capacity upon the acquisition. Not only will AGI grow larger, but we expect to see both economies of scale and scope. Suppliers are demanding larger quantities that AGI cannot satisfy currently. The acquisition will help AGI meet these demands. Another advantage is the diversification of risk. AGI will be controlling different target markets and demographics simultaneously. Reducing Mercury's current DSI down to 42.5 days will create synergies for the firm.



Cons

Mercury Athletics' EBIDTA margins show poor performance among its peers. Poor margins impacting AGI's high performing financials would be a potential disadvantage. The different variety of product offerings may pose a disadvantage by hurting or conflicting AGI's brand image.

ANALYSIS

Cost of Equity

To obtain the cost of equity, which is an essential step to further obtain the Weighted Average Cost of Capital (WACC), we calculated the following:

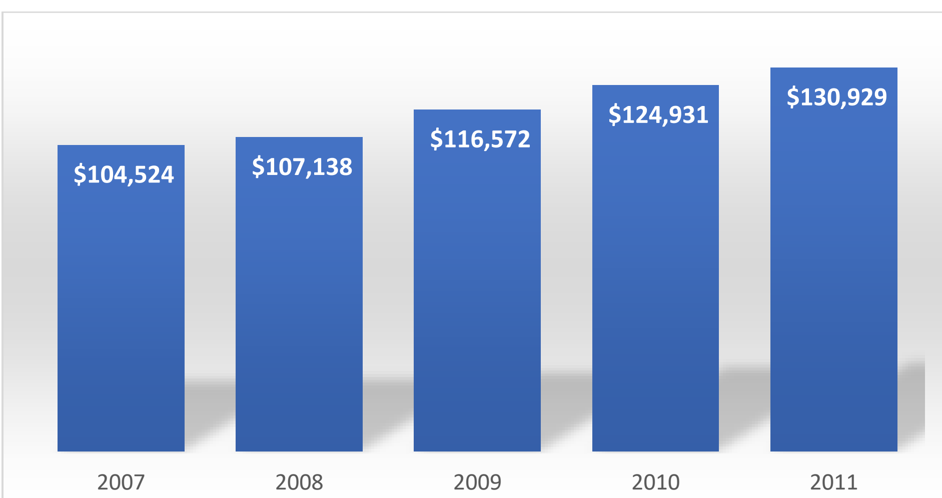
Using data on public footwear companies for March 15, 2017; we calculated the asset beta of each company. After collecting several asset betas of different companies, we derived the mean to obtain an estimate for the analysis. The asset beta that we have derived was: 1.3688.

After obtaining the asset beta, we calculated the equity beta that is essential for the Capital Asset Pricing Model. The equity beta included our calculated asset beta and the average debt-to-equity ratio of all public footwear companies (March 15, 2017). We were able to obtain an equity beta of 1.57. Estimating the beta by using averages was recommended since it is acceptable to derive betas of industry-related companies. Yet, we attempted to use a few inputs that were averaged from public companies to reduce error.

For the risk-free rate, we opted for selecting the 10-year treasury rate. The reason behind not selecting a rate with a longer maturity is because long maturities of 20-years may not be considered risk-free. 10 years seemed to serve as a median and is more likely in the footwear industry. The equity market risk premium (EMRP) was estimated at 5.00%.

Using the Capital Asset Pricing Model (CAPM), the cost of equity was calculated at 12.6%.

Change in Net Working Capital Accounts



Weighted Average Cost of Capital (WACC)

The firm's capital structure is composed of 20% debt and 80% equity. Our estimated cost of debt is at 6%. Yet, the after-tax cost of debt is 3.6%. The after-tax cost of debt accounts for interest tax shields that create value. With a corporate tax rate of 40%, we were able to retrieve a WACC of 10.80%.

Discounted Cash Flow Analysis (DCF)

After calculating the Weighted Average Cost of Capital (WACC), we conducted a discounted cash flow analysis. Using the base care scenario assumptions, we consolidated the numbers under one account. For instance, all the segments were combined under consolidated revenues. After adding back non-cash items, we retrieved our EBITDA. Subtracting increases in net working capital accounts, capital expenditures and taxes (40%), led to the firm's unlevered free cash flows. The discount statistic that we opted for was the calculated WACC (10.8%). The DCF analysis resulted into positive discounted cash flows, totaling at slightly under $99,000.

RECOMMENDATIONS

The purchase offer of Mercury is was calculated using EBITDA Multiple totaling $326 million. The purchase price was divided by the WACC of 10.8% and Terminal Growth of 2% giving a terminal growth of $3.7 billion. The acquisition offer based on synergies created an additional $41.5 million through Women's Casual, revenue growth, and expanding presence with key retailers and distributors.

Sensitivity Analysis

$3,709,693	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%
7%	$ 5,021,100	$ 5,439,525	$ 5,934,027	$ 6,527,430	$ 7,252,700	$ 8,159,288	$ 9,324,900
8%	$ 4,351,620	$ 4,662,450	$ 5,021,100	$ 5,439,525	$ 5,934,027	$ 6,527,430	$ 7,252,700
9%	$ 3,839,665	$ 4,079,644	$ 4,351,620	$ 4,662,450	$ 5,021,100	$ 5,439,525	$ 5,934,027
10%	$ 3,435,489	$ 3,626,350	$ 3,839,665	$ 4,079,644	$ 4,351,620	$ 4,662,450	$ 5,021,100
11%	$ 3,108,300	$ 3,263,715	$ 3,435,489	$ 3,626,350	$ 3,839,665	$ 4,079,644	$ 4,351,620
12%	$ 2,838,013	$ 2,967,014	$ 3,108,300	$ 3,263,715	$ 3,435,489	$ 3,626,350	$ 3,839,665
13%	$ 2,610,972	$ 2,719,763	$ 2,838,013	$ 2,967,014	$ 3,108,300	$ 3,263,715	$ 3,435,489

By providing Women's Casual to discount retailers will boost growth for Mercury's least profitable segment to a segment that will generate an additional $4 million per year. Our assumption of a high growth rate is typical for a business in its early stage of expansion. Considering Mercury's Women's Casual segment has negative operating income in 2006 would experience fast growth due to AGI established position within the footwear industry. The growth will fuel the revenues new creating free cash flow.

Women's Casual					
Revenue	$ 36,802	$ 37,538	$ 38,289	$ 39,055	$ 39,836
Less Operating Expense	37,265	33,784.2	34,459.9	35,149.1	35,852.1
Operating Income	**$ (463)**	**$ 3,754**	**$ 3,829**	**$ 3,905**	**$ 3,984**

CONCLUSION

With Active Gear being one of the more profitable firms in the footwear industry the question to acquire Mercury is solely based on value creation sustained through synergies. The only downside of the acquisition of Mercury will expand AGI Days Sales Inventory to from 42.2 to 51.8. Mercury provides AGI an amazing M&A opportunity to expand the company and double revenue growth.