Private Equity Goes Retail

By Richard Kennedy and Richard Baker[1]

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The past few years have brought record-setting merger and acquisition activity in just about every industry across the board. Private equity firms, known for their pioneering efforts in creating exceptional returns, have been the most active investors in this frenzy. Due to increased competition with hedge funds and institutional investors, private equity shops have been pushed to search high and low in order to meet investor expectations.[2] So while creativity with respect to deal structuring and sourcing has become essential for survival in the private equity business, there has also been a natural progression towards more complicated and risky transactions. The retail sector, an industry segment originally seen as risky territory, has increasingly come under the spotlight during this phenomenon. Ripe with a number of struggling public companies—most of which have significant real estate holdings—it is no surprise that private equity has shown a greater interest in this sector.

Private equity's fondness for retail companies can be partially explained by the changing industry dynamics: Category-killing dominance of discount giants such as Wal-Mart, Home Depot, Costco and Best Buy has left the retail industry littered with struggling competitors with few growth opportunities. This has struck private equity firms as an ideal opportunity to purchase predictable yet stagnant cash flows at affordable multiples. These cash flows can be used to service debt-heavy capital structures while new owners work to make their acquisitions more efficient. Greater efficiency is usually achieved by unlocking hidden value on the company's balance sheet as well as by implementing a disciplined operating strategy.[3]

One method for unlocking value has revolved around implementing a targeted real estate strategy, where considerable cap rate compression and escalating real estate values have provided lucrative returns. With many of these struggling retail chains, the level of rents afforded to certain locations would never support the actual market valuation of the underlying real estate if the real estate were placed on sale. Consequently, the value of this real estate is often not properly reflected in the company's public valuation.

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1 Richard Baker is Vice Chairman of National Realty & Development Corp, and President/CEO of NRDC Real Estate Advisors and NRDC Equity Partners.

2 As of June 2006, Private Equity Firms have provided investors with a 10-year and 20-year average annual return of 11.4% and 14.2%, respectively. This compares with 6.6% and 9.8% for the S&P 500 for the same time periods. Colvin, Greoffrey & Charan, Ram. "Private Lives". Fortune. November 27, 2006.

3 Worden, Nat. "Why Private Equity Shops Retail." www.thestreet.come/markets/natworkden/10217150. April 13, 2005.

As we will see later in this article, there are several strategies used to unlock this hidden value.

On the other hand, acquiring firms can also achieve efficiencies by implementing regimented operating strategies within their target firms. In order to implement change in a short period of time, these firms bring with them disciplined operational focus, usually leading to improved cash collections, sourcing strategies and merchandising. These changes often bring about reduced overheads, improved margins and a reduction in working capital.[4] Private equity firms happen to be particularly effective at implementing these changes because of their sense of immediacy.

One such investor group that has made the headlines by utilizing both strategies is NRDC Equity Partners ("NRDC"), formed as a coalition between principals Robert and Richard Baker of National Realty & Development Corp., and Bill Mack and Lee Neibert of Apollo Real Estate Advisors.[5] What follows is a general outline of the retail privatization business as well as some strategic insights from NRDC's Richard Baker.

A Niche is Created

Private equity firms bring with them something that most real estate specialists lack: the ability to successfully digest even the largest of targets. This bodes well for the publicly-listed retail sector, where it is not uncommon for firms to have multi-billion dollar market capitalizations. This, among other reasons, has led to an almost exclusive domination by private equity in the field of retail privatizations. Retail conglomerates—who largely grew through acquisitions in the 1990s—are currently focusing on developing their core brands rather than evaluating expansion opportunities.[6] For instance, Federated Department Stores, the nation's largest owner of department stores, has notably been scaling back on non-core holdings in order to deploy narrower operating strategies.[7] It is important to note, however, that while retail chains have largely shied away from acquisitions in recent years, there are instances where they have decided to partner with private equity firms at the acquisition table. In May 2006 for example, a syndicate comprised of retailer Supervalu Inc. and private equity firm Cerberus Capital Management purchased Albertson's for $9.7 billion, making for the largest acquisition the sector has seen. Nevertheless, private equity firms are increasingly seen as the dominant force on the acquisition front in this industry.

A group of would-be competitors in the acquisition of retail chains are Real Estate Investment Trusts (REITs). REITs, however, are essentially prevented from purchasing retail chains because of legal restrictions placed on them: A REIT must have 75% or more of its total assets in real estate, mortgages, cash or federal government securities and must derive its income from passive sources such as rents and mortgage interest. REITs are also restricted from investing capital back into the businesses as they are mandated to distribute 95% or more of their taxable income to shareholders.[8] Finally, REITs are

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4 Currie, Martin. Et al. "Retail Sector Dominates Mid-Sized Private Equity Buyouts." LDC: Press Release. August 2005. http://www.ldc.co.uk/assets/documents/0508_Barometer_National.pdf

5 Background and biographic information of NRDC's partners is provided at the end of the paper.

6 Rosenbush, Steve. "Private Equity Takes Shine to Retail". Business Week. July 5, 2006.

7 Byron, Ellen. Et al. "Federated Is Near Deal To Sell Lord & Taylor Chains". The Wall Street Journal. June 22, 2006.

8 Miller, Normal G. et al. "Real Estate Principles for the New Economy". Thomson.2005 Page 444.

often handcuffed with respect to the amount of leverage they can deploy through their Declaration of Trusts.

With a limited number of competing bidders, private equity investors have made a strong move into the industry, as seen by recent landmark private equity transactions including the Blackstone Group and Bain Capital's takeover of craft-store chain Michaels for $6.0 billion in the July 2006, and the KKR-led purchase of Toys "R" Us in June 2005 for $6.6 billion.

The Transaction Team

As an operating business with a large real estate component, retail deals require a number of specialized skill sets that private equity firms do not typically possess. In fact, deals of this nature usually consist of three parties, all with distinct areas of expertise—operations management, finance, and real estate—with success dependent on the contributions from all three fronts. Incumbent management is often replaced by a strategic executive team with experience in turn-around strategies. Depending on the circumstances, the buyer also often chooses to create a team composed of both new and existing management. The finance expertise on these transactions comes from the private equity investors (represented by a single firm or a syndicate of partners). Private equity professionals have developed expertise in structuring some of the world's most complicated financial transactions, making them a crucial component of the deal team. The last component includes the real estate experts, who take one of two forms depending on the circumstances of the transaction.[9] If the retailer's stores are all profitable, investors usually need only to understand the value of the underlying real estate. In this case, a financing partner is required either in the form of a debt provider or a sale-leaseback specialist. Conversely, if the real estate is more valuable "dead than alive" (meaning its market value would never support its level of rent), a partner is needed to help reposition and/or redevelop the real estate. In essence, this involves executing a variety of more complex real estate strategies. For instance, one might evaluate the underperforming stores, deciding whether to redevelop the sites or to introduce non-retail uses to improve the investment return.[10] Under these circumstances, the private equity firm would likely seek a strategic real estate advisor as a partner.

The Creation of NRDC

An excellent example of this strategic real estate partnership is NRDC Equity Partners. NRDC combines the real estate expertise of Richard Baker's family business, National Realty & Development Corporation ("National Realty") with the financial acumen of his partners at Apollo Real Estate Advisors. For 45 years, National Realty has developed shopping centers in the Eastern U.S., providing the company with a street-level view of real estate, development, and operations. This body of expertise allowed for a natural progression into the acquisition of retail companies when the appropriate opportunity arose. In 2004, National Realty created two new companies, NRDC Real Estate Advisors and NRDC Equity Partners. Together, these two companies provided a platform for acquiring operating companies with a real estate platform and creating value through the use of a targeted real estate strategy. NRDC Real Estate Advisors

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[9] Lovell, Aaron. "What's in Store?" Private Equity Real Estate Magazine. September 2006, Vol 2, issue 7. Pages 40-47.

[10] Bodamer, David & Mizonzhnik, Elaine. "Private Equity Dominates ICSC New York Chatter." Retail Traffic. December 6, 2006.

provides real estate services to retailers and companies in the U.S. and Canada, and NRDC Equity Partners focuses on acquiring such operating companies.

Since its inception, NRDC has emerged as a major player in the retail industry, having bid on Toys "R" Us, the Pathmark grocery chain and Burlington Coat Factory. In February 2006, NRDC Equity Partners made its first acquisition, taking over Linens 'n Things for $1.3 billion. Now the company is coming off its second acquisition, that of Lord & Taylor (a prominent Manhattan-based retailer) for $1.2 billion in October 2006. Baker says his company's strategy is "to buy and operate retailers with strong names and valuable real estate." He explains that his team evaluates opportunities on two pillars: First, the transaction must offer a valuable real estate component, which allows the transaction team to finance a large portion of the acquisition, reducing the amount of required equity and boosting projected returns. Second, the transaction should also bring about synergistic benefits. The evaluation of the latter pillar is not as straightforward; accordingly, Baker has assembled a team composed of retail industry veterans to help evaluate operating sides of each business while searching for value-creating opportunities with existing assets. As Baker completes more acquisitions he foresees that this aspect of the transaction will become increasingly important.

Lord & Taylor Case Study

In June 2006, NRDC's proposal to acquire Federated Department Store's Lord & Taylor department store chain for $1.2 billion in cash was accepted from amongst several other bids. When the deal closed in October 2006, it yielded NRDC 48 stores across the Northeast and Midwest, as well as a distribution center. Among the stores is the Lord & Taylor flagship store at Fifth Avenue and 39th Street in Manhattan.

When asked what most attracted Baker to Lord & Taylor, he points to three main features. The first was that Lord & Taylor owns and leases a large amount of high-quality real estate with some of these properties valued higher than what their current rent would justify. As he explains, "the first step with any of these transactions is looking at what a retailer owns or what they have full control over versus what they lease." In conducting their analysis, his deal team determined that the chain was ideal for implementing a sophisticated real estate strategy to increase shareholder value.

The second quality of interest to NRDC was Lord & Taylor's high-quality brand name, which presents a possibility for future acquisition synergies. Baker says that his team is currently in the process of evaluating every store and coming up with the right mix for each of the company's major markets: "NRDC looks at weaker stores and decides whether to redevelop the sites or to add in-line space or non-retail uses to boost sagging sales. The goal will be to analyze the profitability of each store, with an eye toward selling or scaling back those with poor sales." This focused real estate strategy will likely result in a reduction of retail floor space at the flagship store, with some of the upper floors converted into office space.

The third major attraction for Baker was the fact that Lord & Taylor possessed a strong existing management team, which he will keep involved during the company's reconfiguration.

Other Strategic Factors

Private equity professionals generally target companies with the intention to fix them, grow them and then sell them in three to five years. The subsequent buyers usually come from competitors within the target company's industry, another private equity firm or the public through an IPO.[11] Baker's anticipated exit strategies seem to vary. In the case of Linens 'n Things, Baker foresees an IPO within the next five years. With Lord & Taylor, however, Baker does not seem to have a defined plan in place. While there is no denying that NDRC will one day look to sell the chain at a profit, Baker insists that NRDC is not just in it for the sites and is intent on operating the retail chain's locations on a long-term basis, as long as it presents the best opportunity. In the meantime, NRDC will continue evaluating its options to refinance and extract capital from the business where possible.

While Baker has seen increased competition into retail by other private equity partnerships, he is not discouraged. He mentions that it is always nice to approach a potential target before it is actually put on the block, thus avoiding a more competitive bidding war. However, he says that his deal team "is neither looking to compete nor not compete, they are just looking for transactions that work." He emphasizes that when considering potential targets, it is important to have an original idea; this provides a competitive edge by allowing his firm to go after things with a creative light. Baker is also quick to point out that although his focus thus far has been on retail candidates, he foresees his firm's business expanding into other industries and other markets. NDRC doesn't appear to be limited by geography, and is actively evaluating opportunities in Canada and Europe. "As long as the transaction brings with it a strong real estate component, it is fair game," he says.

As private equity firms evolve towards more creative and complex transactions, and as the retail industry remains relatively fertile, expect transactions in the sector to continue to make the headlines. Recent retail privatizations have demonstrated that putting together a team of experts in their respective fields is an ideal strategy for tackling these opportunities. For a real estate professional, the business of partnering with a private equity firm to execute on a large-scale real estate focused investment strategy is compelling for many reasons. In Richard Baker's case this has presented an unparalleled opportunity to leverage his expertise in retail and real estate to execute a lucrative strategy on a very large scale.

Background and biographic information of NRDC's partners

Robert Baker

Robert C. Baker is the Chairman and Chief Executive Officer of National Realty & Development Corp., based in Purchase, New York. Mr. Baker has been an active developer and owner of real estate for the past 45 years and has developed and presently owns approximately 75 shopping centers located in 14 states, as well as a number of office buildings and industrial buildings, comprising approximately 16 million square feet. National Realty & Development Corp. remains one of the largest privately owned development companies in the United States. He is considered an expert in land acquisition, construction, financing, and management. Mr. Baker is a graduate of Yale University and Yale Law School. The Nathan Baker Professorship of Law at Yale University was established by Robert Baker in honor of his father. He has recently funded the Dean's Discretionary Fund at Yale Law School and is a member of the Yale Law School Executive Committee.

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[11] Colvin, Greoffrey & Charan, Ram. "Private Lives". Fortune. November 27, 2006.

Mr. Baker has served as Secretary of the New York State Dormitory Authority. He was the Executive Director of Gerald Ford's election campaign for New York State in 1976. Mr. Baker is a Trustee of the Guggenheim Museum where he is a member of the Real Estate and Development Committee. The committee is presently charged with exploring the expansion of the Guggenheim Museum at one or two international locations. Mr. Baker is a member of the Board of Trustees of Johns Hopkins Medicine and serves on the Facilities and Real Estate Development Committee, which is developing plans for a 1,400,000 square foot twin medical tower.

Richard Baker

Richard A. Baker is President and Chief Executive Officer of NRDC Equity Partners and NRDC Real Estate Advisors. Mr. Baker is Vice Chairman of National Realty & Development Corp., a privately owned real estate development company owned by him and Robert C. Baker. National Realty & Development Corp. owns and manages approximately 20 million square feet of shopping centers, office buildings, business parks and residential communities throughout the United States. Richard Baker sits on the board of Hudson's Bay Company, Lord & Taylor, City and Suburban Bank and Brunswick School. In addition, Richard is Chairman of the Board of Lord & Taylor. Mr. Baker is a graduate of Cornell University and serves on the Dean's Advisory Board of the hotel and real estate program.

Bill Mack

Mr. Mack is a Founder and Senior Partner of Apollo Real Estate Advisors and is the President of the corporate general partners of the Apollo Real Estate Funds. With 40 years of experience in the U.S. real estate industry, he is recognized as one of its leading figures. Mr. Mack is also a Senior Partner of the Mack Organization, a national owner of industrial buildings and other income producing real estate investments. Mr. Mack serves as non-executive Chairman of the Board of Directors of Mack-Cali Realty Corporation. He has been a Director of Mack-Cali since the 1997 merger of the Mack Organization's office portfolio into Mack-Cali, one of the largest publicly traded real estate investment trusts in the United States. Mr. Mack is a Director of Wyndham International, Inc., and Vail Resorts, Inc., as well as various boards related to Apollo's investment portfolio. Mr. Mack also serves as a Trustee of the University of Pennsylvania, as an Overseer of the Wharton School of Business, as Vice Chairman of the Board and as an Executive Committee Member of the North Shore Long Island Jewish Health System, and as a President of the Solomon R. Guggenheim Foundation. Mr. Mack attended the University of Pennsylvania's Wharton School of Business and received a B.S. in Business Administration from the New York University School of Business.

Lee Neibart

Lee Neibart has been a Partner of Apollo Real Estate Advisors since 1993. From 1989 to 1993, Mr. Neibart was with the Robert Martin Company, most recently as Executive Vice President and Chief Operating Officer. Robert Martin was a real estate development and management firm with a portfolio of approximately seven million square feet of commercial real estate. Mr. Neibart is a Director on various boards relating to Apollo's investment portfolio. Mr. Neibart also serves on the Advisory Boards of both The Enterprise Foundation and The Real Estate Institute of New York University. He is also a past President of the New York Chapter of the National Association of Industrial and Office Parks. Mr. Neibart graduated with a B.A. from the University of Wisconsin and an M.B.A. from New York University.