How retailers create value through LBOs

Theoretical Framework and Case Study of SMCP's buyout by KKR

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Abstract

This Thesis aims at studying the role of Private Equity and LBOs in value creation within the retail industry, and more specifically on the factors that contributed to economic and social value creation in SMCP's buyout by KKR. The paper is divided into two differentiated parts. The first section is initiated with an overview of the retail sector, its market trends and transaction activity. It is then followed by a description of the PE landscape as a whole and within retail. Lastly, the drivers, rationale, and computations of the different economic and social metrics used for the central case study of the Thesis are introduced. The second part focuses in the profound study of SMCP's buyout by KKR, started in 2013 and exited in 2016 (sale to a strategic) and 2017 (sale of the remaining minority investment trough IPO). The deal analysis is completed with the decomposition and comparison of these value creation metrics with empirical studies currently in literature regarding returns in the broader international PE industry.

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INTRODUCTION

The PE industry has been highly topical and controversial over the past decades, especially with regards to its impact on target companies. The debate about whether PE firms enhance post-buyout performance of their acquired companies is still nowadays very active. Experts on the industry support a wide variety of opinions concerning this subject. The most critical with the PE industry object that LBO's heavy reliance on debt financing, its short-term view (3-5 years) at the expense of long-term performance and its intense focus on boosting investor returns, have negative effects on a firms' performance, employment, and wages. Hence, they argue that LBO's allow only PE funds to keep most of the value created while leaving the target company and related stakeholders with little improvements (if any) with respect to their prior circumstances. By contrast, PE defenders argue that PE firms do, indeed, generate economic efficiencies through financial, governance, operational and strategic levers, and by doing so, they improve the firm's general performance.

This debate has been even more controversial within the retail industry, given that in the last decade, numerous brick-and-mortar stores have closed due to a number of different factors, including failed LBOs the resulted in bankruptcies. In fact, according to a study of the Center for Popular Democracy; 597,000 people working at retail companies owned by PE firms and hedge funds have lost their jobs in the last 10 years due to bankruptcy filings and store closures.

While extensive research in the past has proven that buyouts can create real value in portfolio companies and even increase the employment level, there is little research that explains how initiatives are taken on an individual company level by PE funds. The objective of this thesis is, therefore, to fill this gap and show how PE investments (within the retail industry in particular) can generate high returns to the fund without compromising the value creation for all other stakeholders. In order to address this question, this Thesis has been split into three sections. The first section, "Theoretical Background", presents the current landscape of the retail and PE industries, together with the key financial concepts, metrics and frameworks required to analyze value creation in companies. The second section has a more practical approach, as it presents and analyzes the real case study of SMCP's buyout by KKR. This case will prove helpful in order to better understand how the drivers and actions taken to create value affect both company and fund. Finally, the conclusions extracted from both the literature review section and the case study are presented.

SECTION I - LITERATURE REVIEW

The first part of this Thesis aims at introducing the last decade's landscape in the retail and PE industry, and presenting the financial concepts and metrics needed to fully grasp the intention of this paper developed in Section II: to profoundly study the economic and social value creation and its drivers used by KKR in SMCP's buyout, starting in 2013.

Firstly, the fabric of the apparel retail sector is introduced, followed by the trends and dynamics that have been shifting and continue to shift the industry at present date, namely channel and consumer behaviour shift, the importance of emerging markets, and technological disruption. In line with the financial base of this paper, the current M&A and financial environment of the sector is presented.

This section then focuses on introducing the history and evolution of the PE industry and its drivers. After, the risk-return profile of the asset class and the current themes and situation are explored (i.e. dry powder, covenant-lite loans). This point is concluded with a closer look of the intrinsic risks of conducting LBOs in the retail industry.

Then, the structural and managing procedures of PE funds and its fundamentals are briefly explained. This is followed by the two central pieces of this section: the decomposition of the different economic value creation levers in an LBO traditionally identified, and the presentation of the metrics and method used for measuring and comparing economic and social value creation, to be executed in the second section of this Thesis.

Closing the Section I of this Thesis, a brief glimpse of the current COVID-19 crisis and their consequences in both the retail and PE industry are outlined.

1. Overview of the retail industry

a. Market outlook

The global retail market is a €22.6tn sector that includes the sale of products and related services through multiple offline and online channels. Main products include food and beverages, apparel, electronics and appliances, health and personal care, home and furniture, hobbies, music and books and others. For the purpose of this paper, we will focus in exploring the apparel category.

Figure 1: Retail market size by category (%)
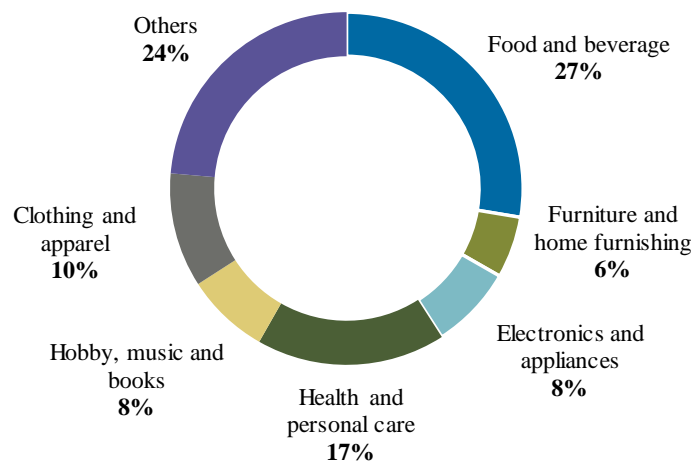
Source: PYMNTS.com

The increase in consumer spending, which typically accounts for two thirds of a country's GDP, together with the increasing penetration of online shopping, especially via smartphones, are the main drivers of the retail market, which is expected to continue growing at a CAGR of 4.4%.

Figure 2: Global retail and e-commerce sales (€tn)
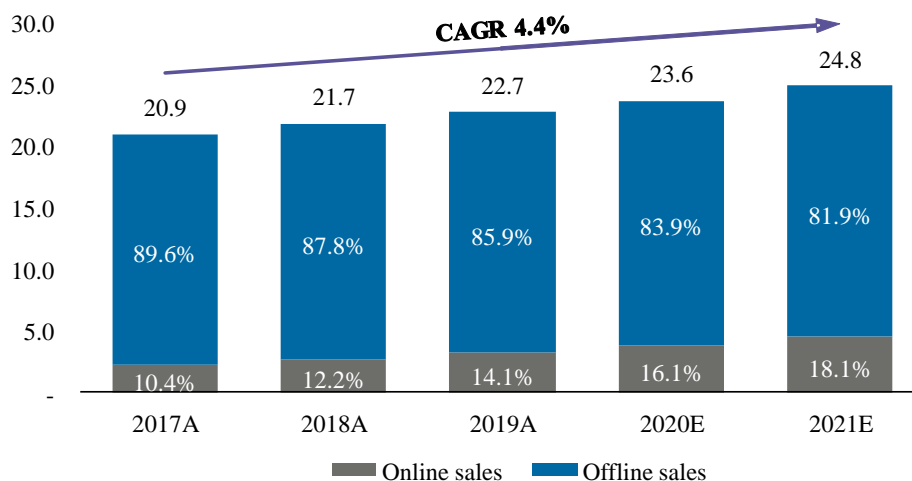
Source: eMarketer

Apparel retail

The global apparel market represents around 10.5% of the total retail market. It is a €2.39tn industry that comprises all the brands and retailers that produce clothing, footwear and accessories. The overall market has been growing annually at a CAGR of 4.5% since 2010 and is expected to keep growing at a slightly lower rate of 3.5 to 4%[1]. Growth has mainly come from online sales, which have been growing at double digit rate, and sales in emerging markets, especially in the Asia Pacific region.

Figure 3: Evolution of apparel retail market size, 2010-2019 (€bn)
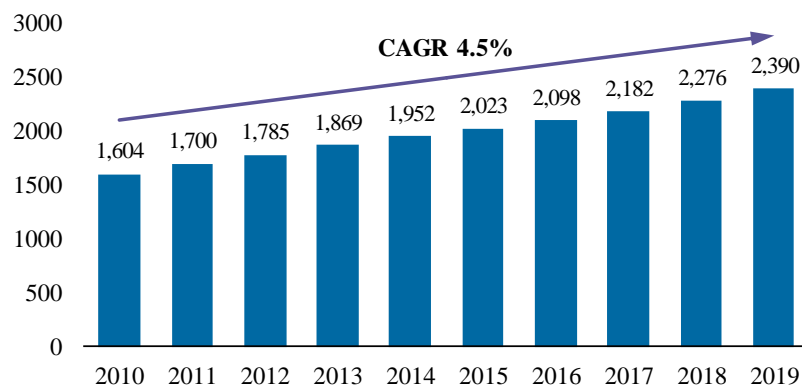
Source: Statista; Euromonitor

Clothing is the largest segment of the market, followed by footwear and accessories[2]. Within clothing, women's wear makes the greatest contribution, followed by men and children. Geographically, Asia is has the largest volumes followed by Europe and North America. The three continents account for an aggregate of 86% of global sales. In terms of channels, ever increasing online sales represent 20% of total turnover. Finally, pricing segmentation can be divided into mid and entry-price (with a combined share of 90%), and luxury/premium (~10%).

Figure 4: Apparel market segmentation by product, channel and geography, 2019 (%)
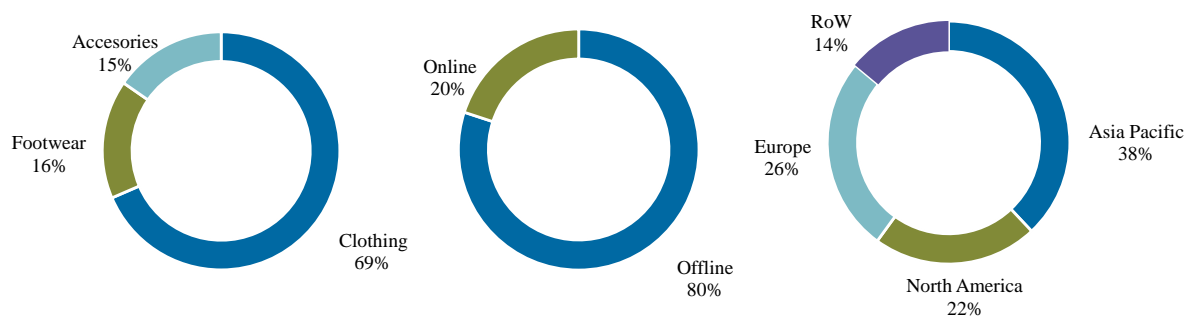
Source: Statista; Euromonitor

[1] According to McKinsey Global Fashion Index (MGFI)
[2] This segment includes bags, suitcases, hats and scarves among others

The apparel industry is a highly competitive and rather fragmented sector with many different players involved. Players range from brand owners to purely online retailers and mass merchants, such as hypermarkets and department stores.

Figure 5: Types of players present in the apparel industry and examples

Player Type	Description	Examples
Mass Merchants	Retailers offering several brands in physical stores (potentially with associated e-commerce), such as discount or department stores. They often also offer own brands as part of the assortment	
Online players	Retailers offering several brands in a purely online store. Like Mass merchants, they often also offer own brands within their assortments	
Brand Owners	Firms developing and owning the brand name, but not necessarily owning manufacturing capabilities. Brands are sold through owned specialty stores and e-commerce as well as through mass merchant stores	

Source: McKinsey & Company; Gereffi & Frederick, 2010

With regard to market share, as of 2019, Inditex (Zara) is the biggest apparel player with €26bn in sales, followed by Fast Retailing (Uniqlo) with €19.4bn and H&M with €19.3bn.

b. Trends and dynamics

Over the last decade, the retail industry has undergone a significant transformation resulting in the appearance of defining trends such as channel shift, shift in consumer behaviour, emerging markets increasing share and technological disruption.

1) Channel shift

The internet has been the main driver of the retail industry, resulting in an increasing shift from traditional brick-and-mortar stores to online sales. Today, internet means represent 5-15% of total retail revenues in most relevant markets, and the share is much higher in categories like apparel *(Figure 7).* In the last decade, this has resulted in what is popularly known as the "retail apocalypse", which refers to the closing of numerous brick-and-mortar stores due to factors including overexpansion, rising rents, bankruptcies resulting from failed LBOs, changes in consumer habits and the rise of e-commerce, mostly in the form of competition from juggernaut companies such as Amazon.com and Walmart.

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Figure 6: Net store openings/(closings) by retail category in the USA, 2007-2017

(stores in thousands)
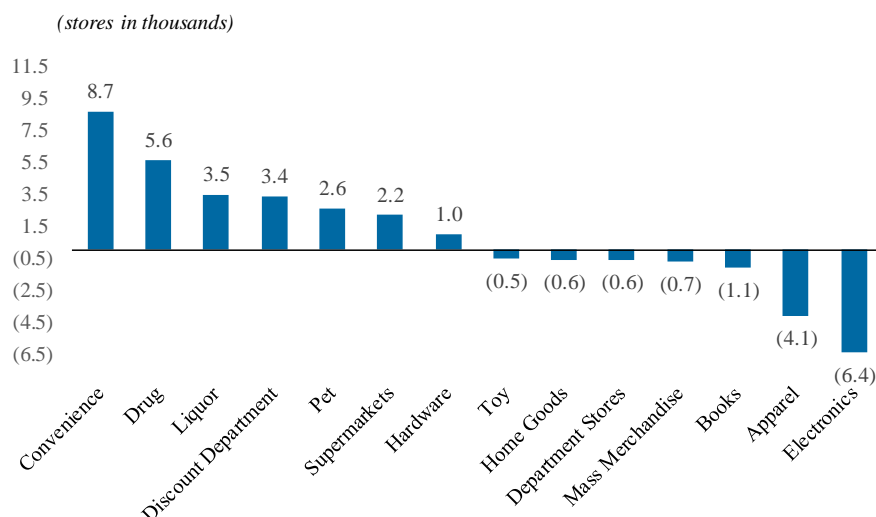
Source: Nielsen

Furthermore, taking a glance at bankruptcy filings in the last years, we can also see that most retailers in bankruptcy, or currently on the brink of it, sell apparel. In 2019, 10 of the 16 major retail bankruptcies in the USA were filled by companies that mostly or exclusively sold apparel and/or footwear, such as Forever 21, Barneys New York and the US arms of Diesel and Roberto Cavalli.[3].

We believe this ecommerce adoption will not slow down anytime soon *(Figure 7)* due to multiple drivers favouring it, such as busier consumer lives, increased consumer access to the internet and expansion of B2C last-mile delivery companies.

Figure 7: Evolution of Internet share of total sales, 2012-2023E (%)
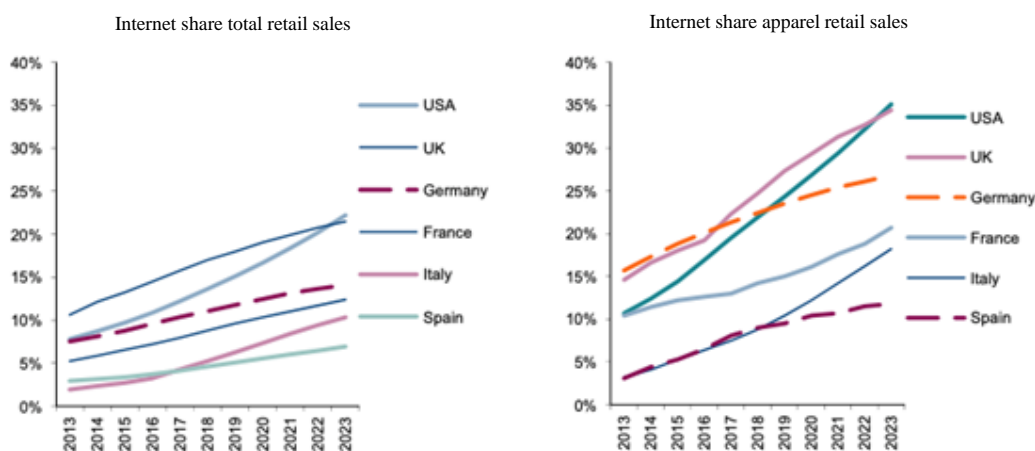
Source: Euromonitor, Exane BNP

[3] Thomson Reuters

Finally, within online sales, mobile is rapidly becoming the main channel for online shopping. Smartphone and tablet penetration, 4G and the falling cost of mobile data have contributed to consumers increasingly using mobiles more than "traditional" desktops to perform their online shopping. This channel-within-channel shift is forcing retailers to adapt their online platforms to become "mobile first" in web and mobile apps launch and design.

2) Consumer behaviour shift

The emergence of new communication and distribution channels (mobile, social media, chats) and devices (tablets, smartphones, wearables) have changed the habits, behaviours and expectations of consumers. Today's consumers are used to getting what they want, when and where they want it. Power has shifted from retailers to consumers, who are now more price sensitive and demand higher levels of service, particularly convenience and immediacy, prompting retailers to develop new strategies.

Omnichannel retailing

Customers nowadays want convenience, which means being able to simultaneously use multiple channels, devices, and platforms to browse, purchase and return products. In response, retailers have gone from selling only through physical stores or purely online to selling from integrated platforms that combine the best of both online and offline shopping *(Figure 8)*. This new phenomenon is known as "omnichannel retailing". Within apparel, forecasts suggest that nearly 100 percent of growth in the market will be omnichannel in the next three years.[4]

Figure 8: Retail sales growth by channel, 2012-2021E (%)
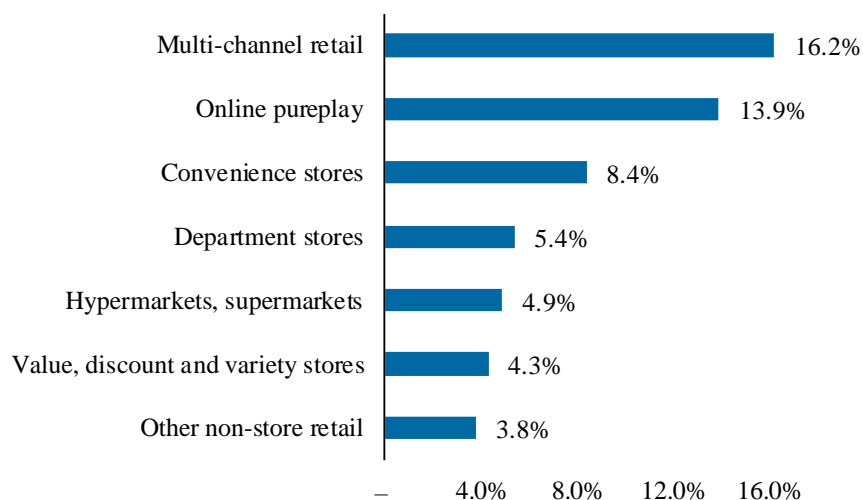
Source: Dufry, GlobalData

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4 McKinsey & Company: The State of Fashion 2020

As part of this integration between the online and offline channels, retailers are implementing new formats such as "Buy online, pick up in-store (BOPIS)" and other combinations of online and traditional retail that facilitate and improve the shopping process and customer experience.

Furthermore, broader consumer trends such as the decline in car ownership among younger urbanities have contributed to a growing trend to shop locally This consumer preference for local shopping is leading retailers to rethink their store network and to open smaller shops and pop-ups in areas outside the traditional department stores. For example, in the USA, Nordstrom has opened small shops called Nordstrom Local that hold no inventory but provide styling services, fittings as well as in-store pick up and return of products. Some digitally native brands have also found local neighbourhoods more appealing for their flagship stores.

Fast fashion

Present consumers are also demanding more newness and immediacy, therefore forcing retailers to improve flexibility in design and speed to market in order to be able to rapidly satisfy fashion trends. This 'need for speed' is partly driven by social media accelerating the movement of fashion trends to the masses, and by industry leaders using analytics and customer insights to better meet customer needs and increase responsiveness.

Figure 9: Year-over-year sales growth of fast fashion 5vs total market, 2013-2019
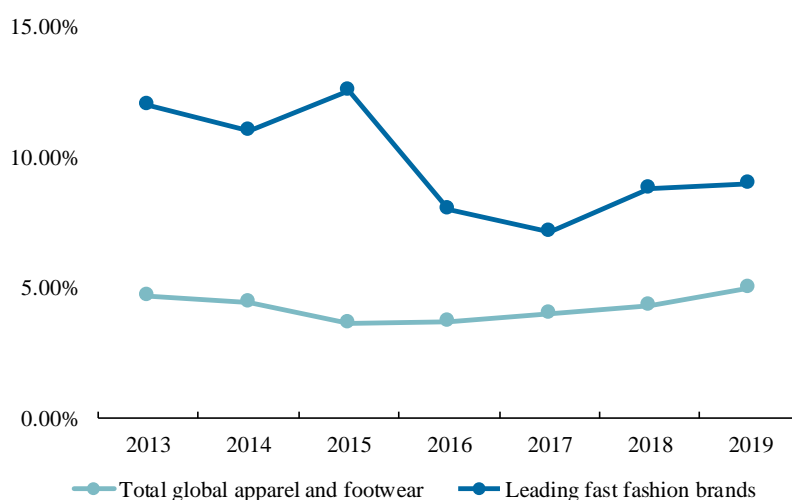
Source: Annual Reports, Statista

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5 Calculated using the average of the three biggest fast-fashion players: Inditex, H&M and Fast Retailing

In this mentioned new "fast-fashion" industry, Inditex has been the leader for decades, being able to design and introduce collections to stores in a minimum of three to five weeks' time thanks to its responsive supply-chain. Other fast-fashion players such as H&M, Uniqlo and SMCP in the mid-price/luxury segment, are also shortening design room to stores times and increasing the average number of collections per year. In this line, fast fashion players have grown at higher rates than the overall market *(Figure 9)*.

Fair fashion

On the other side of "fast-fashion", the rising consumer awareness for sustainability, fair trade and eco compliance is also putting pressure on retailers in this matter, while increasing the demand for ethical and sustainable brands as well as increasing sales through second-hand markets. Brands have already started taking action. For example, Zara and H&M have pledged to use 100% sustainable fabrics by 2025 and 2030, respectively. E-commerce players have also taken steps towards satisfaction of these new moral imperatives. For instance, the multi-brand retailer Asos introduced this year a search filter for recycled fabrics, while Zalando has expanded its sustainable product offering.

3) **Emerging markets**

Geographically speaking, over the past 10 years, growth in the apparel industry has come from emerging markets, especially from the Asia Pacific region, with China accounting for 38% of global apparel industry growth across segments. Indeed, last year (2019), China overtook the US as the largest apparel market in the world.

Moreover, there are specific brands that have been extremely successful in China. Luxury players such as LVMH and Gucci have already been in the market for years, having first opened stores in the 1990s. Mass-market players have also prioritised China as a core part of their business models: China now accounts for 5% of H&M's global revenues, while Inditex has over 600 stores across the country, making up over 8% of its store network.

However, retailers are now turning their focus towards other smaller, high growth regions beyond China such as India, Southeast Asia, Brazil, Russia and UAE & Saudi Arabia. These countries are expected to experience the highest growth in the apparel market due to their sharp and somewhat consistent GDP growth while increasing internet adoption and smartphone penetration.

Figure 10: Fashion industry sales expected growth by region, 2019-2020 (%)
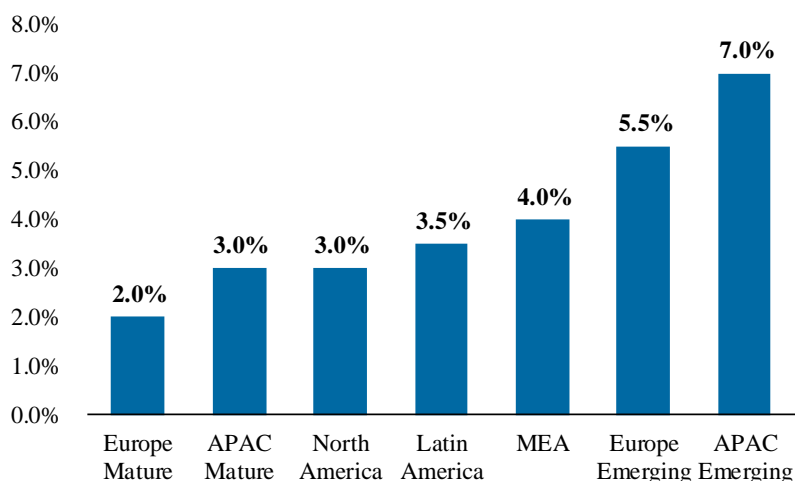
Source: McKinsey Global Fashion Index (MGFI)

4) Technological disruption

Innovation and technology have always been key drivers behind the growth and disruption in the any industry, and so is the case in the retail sector. In addition to traditional physical and online stores, new mobile channels (mobile devices, branded apps, social media) and services (mobile payments, e-coupons, located-based services) have transformed and continue to transform the consumer buying process.

Although the biggest technological disruption in the last years has come from online channels, physical stores are the ones expected to be more affected by emerging technologies. Indeed, early adopters have already started using in-store technologies such as free Wi-Fi, tablets, interactive screens, augmented reality, virtual mirrors/fitting rooms, digital signage, intelligent self-service kiosks, 3D printing, QR codes and mobile or automated payments. Zara for example, launched in 2018 its first self-service checkouts, allowing customers to skip the queue and buy for their items via do-it-yourself kiosks. Another good example of such disruption is menswear store Ministry of Supply, founded by MIT graduates, who developed a platform with the ability to create a custom garment on-demand in 90 minutes.

c. M&A activity

The continuously disruptive and changing global retail market has had its impact on M&A activity and consolidation within the apparel retail industry. The sector has generally followed cross-industry M&A global trends: increasing volumes in the last decade, fuelled by favourable economic conditions and profiting from low interest rates in western and developed countries. All in all, the four major trends and dynamics presented above, in conjunction with the mentioned positive conditions, has encouraged apparel retailers to engage in increasing

number of transactions up until 2020. As for the rationale for the rising activity, IMAP (International M&A Partnership) mentions few but pronounced factors in both buy and sell side, which are indeed completely aligned with the previously mentioned trends.

Figure 11: Recent M&A rationale in apparel retail, until 2020

Agent	Rationale
Bidder	▪ Vertical integration between manufacturers, wholesalers and suppliers to reduce costs of fast fashion ▪ Geographical expansion to emerging markets ▪ Strategic expansion to new product type, segment, local niche or urban groups ▪ Leverage of franchise or brand image which the current owner is unable to exploit ▪ E-commerce retailers for accelerated technological capabilities and boost online sales, rather than inhouse platform development
Target	▪ Costs of compete in fast fashion trends are too high (excessive number of collections needed and more sales periods) ▪ Ability to sell at historically high and even record valuation levels and realize return to shareholders ▪ Brick and mortar assets carve outs as part of a transition to omnichannel operations

Source: IMAP; Fashion & Apparel, 2017

Figure 12: Trend-driven acquisitions examples and timeline (value in €mm)
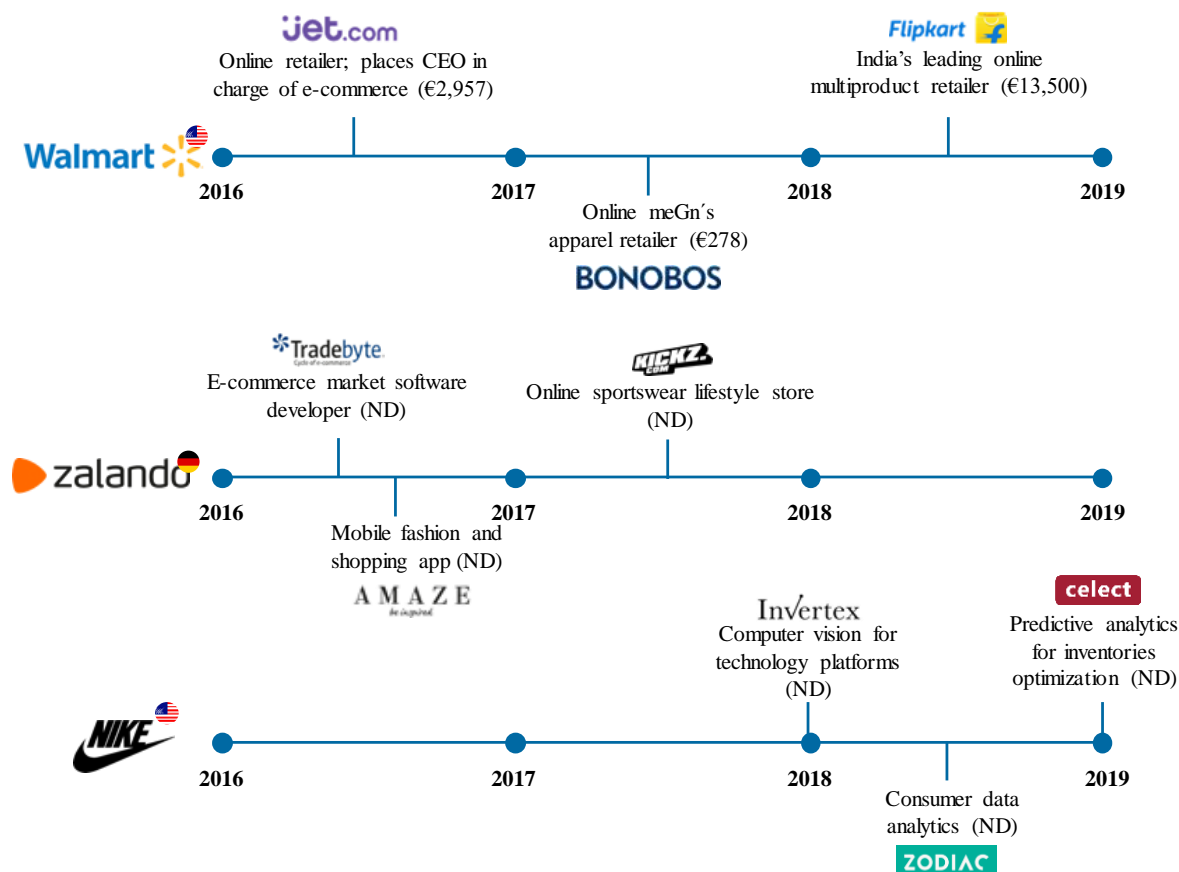
Source: Thomson Reuters, IMAP; Fashion & Apparel, 2017

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Companies within the apparel retail industry have been growing more and more outside its traditional markets, which in some cases has been translated in several acquisitions with similar rationale and in a very short span of time *(Figure 12)*. Mass merchants like Walmart, for instance, have been betting big on e-commerce and all the capabilities associated with it, moving far from its historically wholesale brick-and mortar activities. The American retailer has even expanded internationally to India with a pure e-commerce megadeal. On the other hand, pure online players like Zalando have preferred to strengthen their digital niche for a further penetration. Finally, brand owners like Nike have been acquiring e-commerce companies to improve its direct to consumer sales as well as digital capability companies to enhance its app/website user experience.

While fast paced technological disruption and constant innovation have certainly changed the face of the apparel industry, transaction activity continues to be, as mentioned, very closely related with global M&A and dependant on macro trends. Moreover, transactions carried out by financial sponsors also fall in line with standard cross-industry PE activity vis a vis total M&A figures (between 10 and 25 % of total activity in the last 20 years). Geographically, this ventures also follow general M&A trends, with around half of all deals taking place in the USA, and a consistent aggregate of c.85% being completed in North America and Europe.

Figure 13: Apparel and global M&A, sponsored volumes and apparel deal count[6]
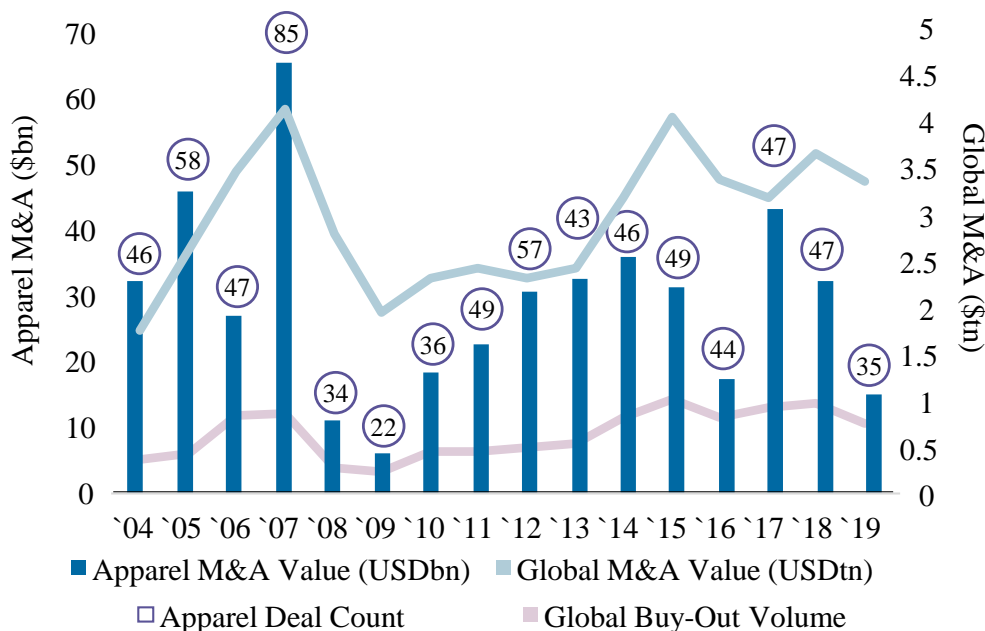
Source: MergerMarket, Wall Street Journal, J.P. Morgan, Dealogic

[6] Apparel M&A Value and Deal Count: includes all Apparel and Clothing deals with a transaction value of more than $100mm; Global M&A Value, includes only deals with a transaction value of more than $250mm

Of growing importance to the apparel retail sector is the amount of add-on deals. Add-on can be defined as acquisitions undertaken in order to either form new line of business or to expand capabilities in an already existing business line (Loos, 2006). Examples of pure add-on M&A are very frequent in any apparel-related transaction *(Figure 14)*, especially in those firms trying to build prominent omni-channel capacities. Indeed, according to Pitchbook, around 30% of all add-on transaction are part of a broader buy and build strategy, in which the bidder plans to engage in more than one investment to complement its core activities. For the past decade, add-ons as part of a broader 5+ deal count strategy accounted for a consisted c.20% of all add-ons by any company, across-sectors.

The subsequent apparel related deals have been selected given their recent closing, volume, significance in the sector or similarities with the case study of this Thesis, presented in Section II.

Figure 14: Selected apparel related deals

☐ *Strategic*   ☐ *Financial Sponsor*

CVC and PAI, each owning a 33% stake in the Spanish retailer Cortefiel, agreed to buy out the remaining 33% stake of private equity firm Permira, valuing the company at over €1bn. The deal allowed the retailer to repay 40% of its outstanding debt. The group owns the brands Cortefiel, Springfield, Women's Secret, Pedro del Hierro and Fifty Factory as a leading European Retailer.

Perry Ellis International agreed to be taken private by its cofounder and the lead backing of Fortress Investment Group. It is the latest major taken private transaction in the apparel retail industry. The acquisition, according to its acquirors, gave Perry Ellis the flexibility to better execute its long-term strategy and manage its brands such as Rafaella, Cubavera.

The bankrupt wholesale retailers Sears was acquired by ESL investments (a hedge fund run by Sears Chairman) for around €4.6bn. This has been one of the largest, most controversial and talked about deal in the retail industry in recent years. The new owners advocated for a new focus on robust digital platforms and an integrated ecosystem between its two main franchises Sears and Kmart.

€2,957

Walmart

Acquired

jet.com

2016

Jet.com, an online e-commerce business that allowed users to show online from various retailers, agreed to be acquired by Walmart for around €3bn. Being one of the biggest deals in the last decade in the apparel industry, Jet was intended to refocus on a traditionally hard to reach niche for Walmart: the urban millennial consumer. The deal is a perfect example of the impact the industry's dynamics have on its M&A market.

Source: Merger Market, Fox Williams, Thomson Reuters, Business Insider, IMAP Fashion and Apparel 2017

2. Overview of the PE industry and its environment

a. Definition and history

Academics and practitioners define Private Equity depending on a specific conglomeration of private asset classes within alternative investments. Bance (2002) for instance, includes hedge funds, commodities or even interest rates and currencies (as long as the transaction includes private capital). Others refer to a more traditional definition, focusing in a conglomerate of Leverage Buyout funds, Venture Capital and Mezzanine Funds (Loos, 2006). But more broadly, Private Equity can be defined as an asset class consisting of equity and debt securities not quoted on a public exchange. Private Equity investments are more usually active and controlling in nature, with a strategic and value-adding focus that requires highly specialized skills by the investment manager/s.

Organized PE activity can be traced back to 1946 with the formation of the American Research and Development Corporation (ARD) (Loos, 2006), a publicly traded closed-end American company founded to attract private institutional investors and provide capital to business managed by veterans of the World War II. Although other similar initiatives were formed parallelly, and under increasing concern of a lack of new business formation, the U.S. Congress passed the Small Business Investment Act in 1958, which facilitated formation of public investment vehicles (with benefits such as tax credits). These vehicles, though, also limited the characteristics of the companies the SBICs licensed firms could invest in and their compensation structures. This inevitably resulted in the natural formation of Limited Partnership Venture Capitals during the 70's, which solved both investment profiles restrictions and compensation issues. The 70's decade was characterised by a somewhat limited attraction of investors, who deemed a non-increasing volume in market activities and start-up investing as too risky. The latter events and a favourable U.S. labour reform up to the 1980's (Fenn, Liang, 1996), pushed a majority of Private Equity holders to focus on a more mature, stable and secure businesses to invest in and an abundant funds inflow, hence signalling the birth of Leverage Buy-Outs.

In the scope of the literature and case study of this Thesis, we will more specifically focus on the mentioned Leverage Buy-Outs (from now on, LBO), which can generally be defined as a *transaction in which a group of private investors, typically including management, purchases a significant and controlling stake in a public or non-public corporation or corporate division using significant debt financing , which it raises by borrowing against the assets and/or cash flows of the target firm* (Loos, 2006).

The evolution of LBO centred Private Equity can be divided in four distinct eras differentiated by broad market sentiment, underlying tendencies of the PE industry, deal volume and number of PE transactions and signature events that shaped the sector.

Figure 15: Distinctive eras of the PE industry (activity in $bn)[7]
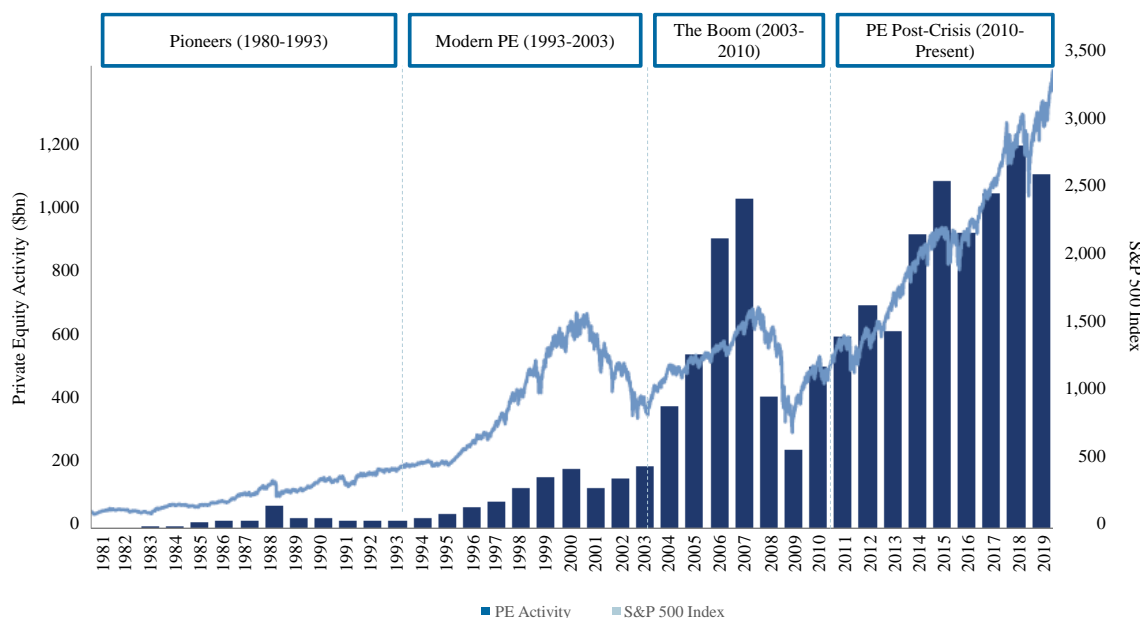
Source: Thomson Reuters SDC, Goldman Sachs

- **Pioneers (1980-1993):** "…in 1980s, Private Equity was a place for mavericks and outsiders…" (The Economist, 2014). The first era of LBO transactions was marked with initial staggering return deals and the posterior emergence of the junk bond market and skyrocketing returns. LBO volumes consisted an average of 4.2% of total M&A (Thomson SDC) in an economic period distinguished by a stock market more favourable than past decades, after a dramatic reduction in interest rates posterior to the inflation abating Volcker monetary policies. The most notable deal of the period was the famous RJR Nabisco buyout by KKR in 1989 ($30.2bn).

- **Birth of Modern Private Equity (1993-2003):** "…companies that would once have tuned up their noses at an approach from a PE firm are now pleased to do business with them" (The Economist, 2004). The second era begun classifying PE as an asset class and comprised the first industry specialized funds. In the midst of global trends such as the tech boom and the emergence of cross border megadeals, stock markets were quite supportive of IPOs and M&A activity (of which PE comprised and average 2.4%, Thomson SDC) up until the burst of the Dotcom bubble (2000-01). Major buyouts included TRW by Blackstone ($4.7bn) or Borden by KKR ($4.6bn).

- **The Boom (2003-2010):** "…with returns that triple the S&P 500, it is no wonder PE firms are challenging the public markets for supremacy" (USA Today, 2006). The third era was distinguished by landmark fund raising, transactions and valuations rise until Global Financial Crisis (2008). The LBO market benefited from an increasing volume of high yield debt issuance fuelled by CLO structures. Consequently, leverage in buyouts significantly rose until the violent cycle-ending events like the Lehman Brothers bankruptcy and the banking bailout. PE deals summed up an average 9.9% of global M&A volume (Thomson SDC). Signature mega transactions included buyouts like TXU by KKR ($44.4bn) and HCA by BofA, Bain Capital and KKR.

- **PE Post-crisis (2010-present):** the current era clearly features an emergence of new players (Infra Funds, SWFs[8]…) and variety of investment themes (add-on, secondary, P2P), rising valuations, and record-breaking levels of fundraising ($1.47tn in 2019, Pitchbook) and dry powder. LBO percentage in global M&A volume is steadily increasing from 16% in 2011 to a record 26% in 2017. Economic environment is marked by low interest rates and central banks constant liquidity support. Landmark deals include the buyouts of FirstData by KKR ($39.4bn) and Heinz by 3G Capital ($27.3bn). This may well change after the COVID-19 present crisis, as explained later.

Figure 16: Historically prominent PE players, funds raised 2010-2018 (in $bn)[9]

THE CARLYLE GROUP	KKR	Blackstone	APOLLO
$98.7bn	**$69.4bn**	**$81.4bn**	**$50.3bn**
TPG	CVC	BainCapital	ARDIAN
$42.6bn	**$52.1bn**	**$98.7bn**	**$52.4bn**

Source: Preqin

b. Why investors turn to PE

Risk-return profile

In the last four decades, investors have poured more and more capital into private equity, searching for excess returns that other asset classes may have been unable to deliver. The validity of this fact though, does not come without high risks associated with the PE industry.

Empirical study of the risk-return profile of PE investment is to say the least, controversial. Since the transactions are private, as its name suggests, some academics argue that it might be difficult to measure possible excess returns vis a vis the amount of risk taken by fund managers, portfolio companies and investors alike. However, under the hypothesis of somewhat efficient markets, the continuous growth of PE funds seems to suggest that investors do think its return-risk profile is still worth their capital.

Uncountable papers present different measures to try and capture PE returns and its embedded risk. Bruining, for instance, (1992) proposes alternative measures to IRR to classify successful MBOs (i.e. Cash Flow Ratio, Return on Equity). He goes on to conclude that these types of transactions do result in higher profits than any other asset class, especially the ones exited after 3 or 4 years. Parallelly, numerous academics have tried to dive into the "real" embedded risk of this type of deals, arguing that the sole fact of increased leverage does not necessarily mean higher raw risk-taking. Jensen (1986), Green (1992) and Bruining, Herst, Robbie and Wright (1993), all in their respective studies, mention the presence of huge incentives for management to take risk reducing management turns to secure their packages and lock in returns. Appointing functional specialists, decreasing contracting out, increased autonomy or more direct lines of communication intra-company are some examples.

In the last decade, the focus has turned to "Public Market Equivalent" (PME), a measure that takes all the cash flows between investors and fund and discounts them using a return on the relevant stock benchmark (usually the S&P 500), net of fees. The measure is somewhat less favourable to PE and is deemed by most to be the right metric when capturing fund performance. In one of the most recent and notable academic studies on the industry, Harris, Jenkinson and Kaplan (2015) show that PME figures statistically demonstrate an excess return of 3% (PE versus S&P 500) up until 2006, and an approximately flat PME relative performance in the years 2006-2015. These academics even suggest investor's need to tackle the fees structure proposed by PE firms in order to claw back to pre-2006 returns and reach a certain

resemblance to European PE, where excess returns post-crisis have been more consistent, at least until 2020.

Figure 17: Net IRR by geography of buyout funds vs benchmark indexes (%)
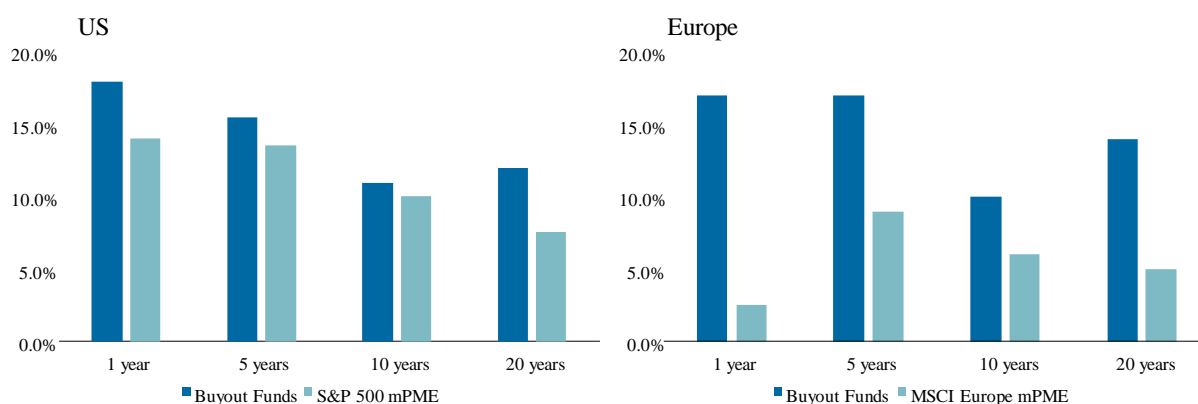
Source: Cambridge Associates Private Investment

In fact, the industry has struggled to keep up with the bull market up until 2020. In the most recent reports, empirical evidence shows that U.S buyout funds have yielded lower annualized returns than the S&P 500 Index (2019).

Figure 18: 10-year annualized PE IRR for US and Europe
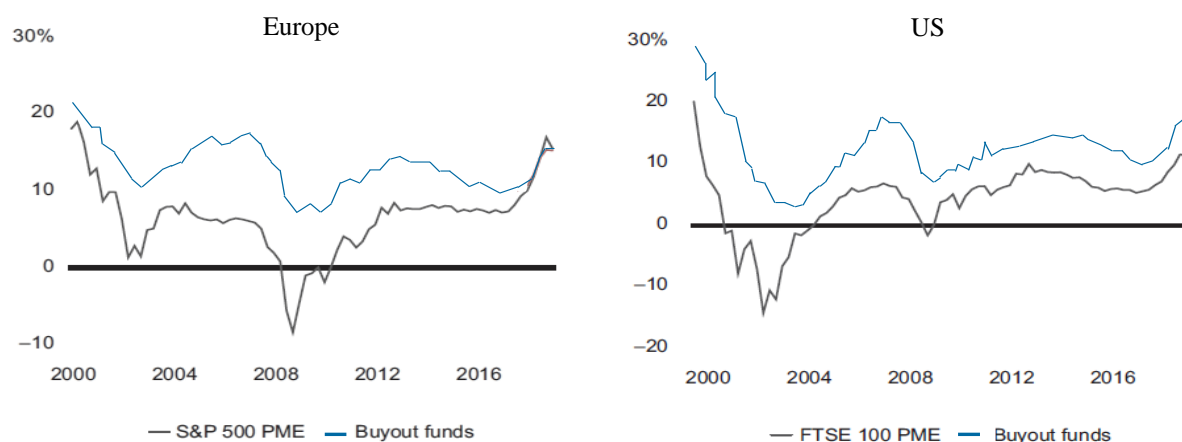
Source: Bain & Company

This seemingly staggered performance is extremely characteristic in the US, where long term rising company pricing combined with the most thriving public markets narrow the gap for excess return opportunities. In Europe, though, were markets have had deep struggles in recent years, excess PE returns are highly visible and present a clearer opportunity for European investors *(Figure 18)*. Indeed, independently of the empirical studies mentioned and according to Preqin (2018), investors place "High Absolute Returns" and "High Risk-Adjusted Returns" as their top two reasons for allocating capital in private equity, and with a higher percentage than similar asset classes such as Hedge Funds, Growth or Venture funds. This shows evidence

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that the marketplace still believes in this asset class as the most balanced risk-return profile to secure excess returns. Diversification and the lower correlation with traditional asset classes are the next top reasons investors cite to invest in private equity.

On the other hand, the additional risk embedded in PE is obviously significantly greater than that of the traditional asset classes. Although some may support the early views presented by Bruining, Herst, Robbie and Wright (1993) (in which managers tend to drastically reduce risk), empirical evidence shows a huge return dispersion amongst different PE funds, which offer a much wider range than that of the traditional asset classes, as seen in the figure below.

Figure 19: Annual returns dispersion of US private equity and mutual funds by performance percentile, 2013-2018 (%)
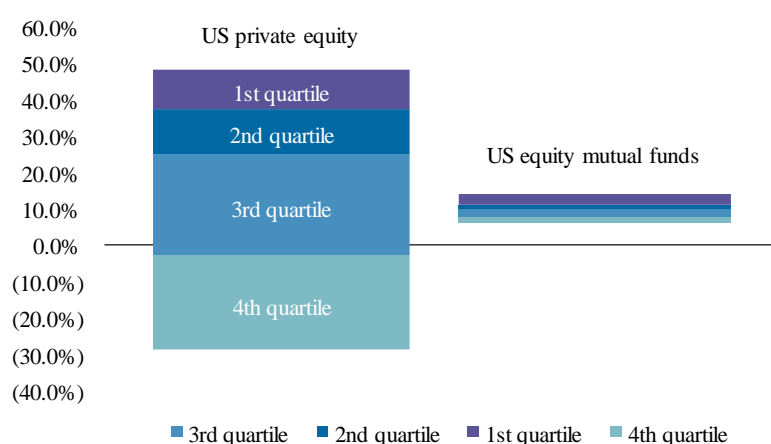
Source: McKinsey Global Private Markets Review 2019

All in all, the phenomenal growth of fundraising and globalization of the industry indicate that investors deem the PE industry is still worth investing. This compelling market view had already been continuously argued in recent years given rising valuations, record holdings of dry powder, and an investor base pendant of possible recessions and its consequences on covenant lite obligations (as later mentioned in this Thesis). In the current 2020 environment, these fears may have been confirmed, not without presenting themselves with more opportunities, as explored later.

Figure 20: Investors views on alternative assets performance expectations, 2018-2019 (%)
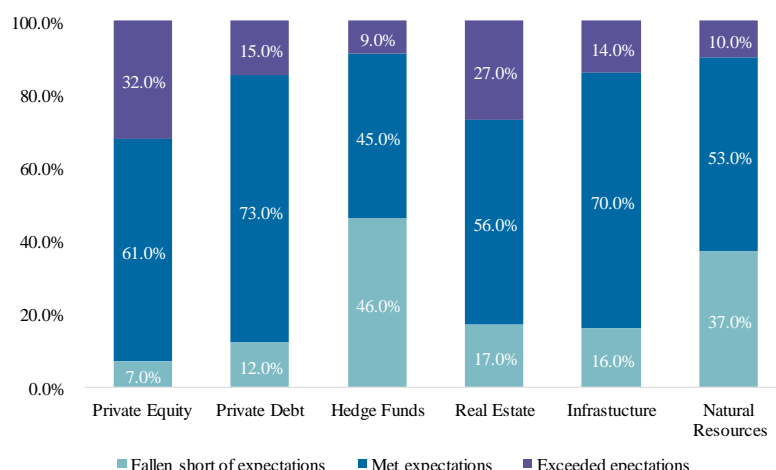
Source: Preqin

Overall, Limited Partners (from now on, LPs) have been satisfied with the performance of their investments in PE versus other alternative asset classes. In fact, Private Equity is placed first in satisfactory expected returns in front of other private capital placement options such as Debt, Hedge Funds, Real Estate or Infrastructure for 2018-19 *(Figure 20)*.

Fundraising, volume and dry poder

A positive evolution of risk-return perception by investors, convergence of returns and expectations, and positive market and economic conditions have naturally resulted the great momentum of the global PE industry up until now. Capital raising has more than quintupled in the past 20 years (although it remains still a niche market when compared to listed equities), with an all-time record $797bn raised in 2017 and a constant $700bn+ each year raised for the past 4 years[10]. Aggregate capital raised in 2014-2018 ($3.4tn) is almost double of the amount raised post crisis in 2009-2013 ($1.7tn), and it shows no signs of slowing down. A consistent range of 40 to 60% of all funds raised are collected by traditional private equity buyouts funds.

[10] Includes all type of Private Equity funds: Buyouts, Real Estate, Growth and Venture, Infrastructure, Natural Resources and others

Figure 21: PE funds raised worldwide ($bn)[9]
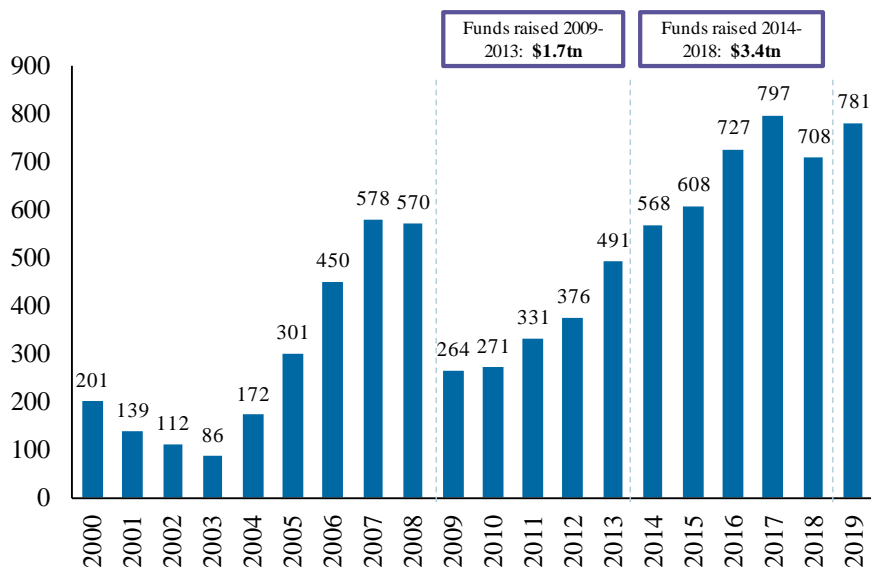
Source: Preqin

Positive recognition from investors has been boosted by a decent economic outlook and supportive monetary policy for the past decade. Slower-than-usual but steady economic growth and historically low interest rates across the major PE markets have eased and flexed debt funding for deals, drawing firms to raise more and more capital and more frequently than before. Indeed, these factors and the return of a seemingly controlled covenant-lite leveraged loans market (which is discussed later in this Thesis) have boosted deal volumes. This has been reflected in the gaining share up to a quarter of all transactions (strategic and non-strategic) in the overall M&A market (*see PE Post-Crisis era description*).

Figure 22: Private Equity annual announced deals volume ($bn)[11]
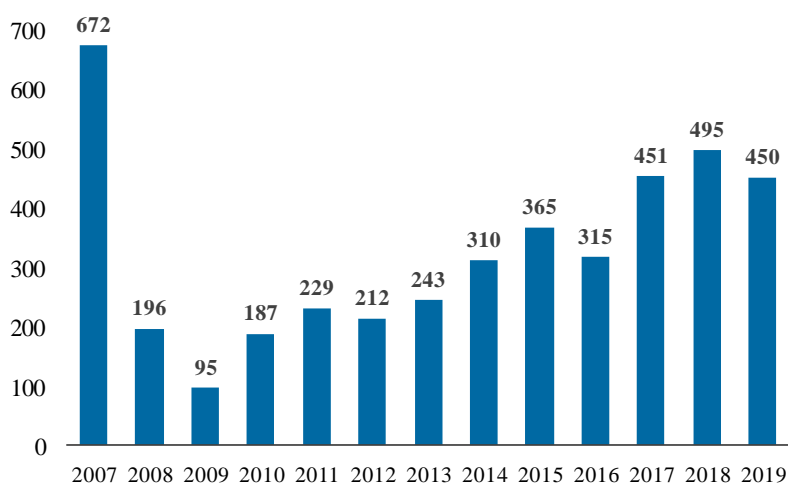
Source: Bloomberg

[11] Includes all deals through December 26 of each year. Includes minority and majority purchases, takeovers and buyouts by PE and VC firms for the selected period

Additionally, the amount of dry powder (committed capital by LPs still to be deployed) has also repeatedly reached record levels in the past years. As of the end of 2019, the aggregate amount of yet-to-use capital amounted to almost $1.8tn. Again, a consistent 40 to 60% of all dry powder is in hands of traditional buyout funds each year. These favourable and mostly positive years for the sector are in question at present, given the major economic shocked caused by COVID-19, which may change the industry's landscape, as briefly presented later in this Thesis.

Figure 23: Total PE dry powder ($bn)[10]
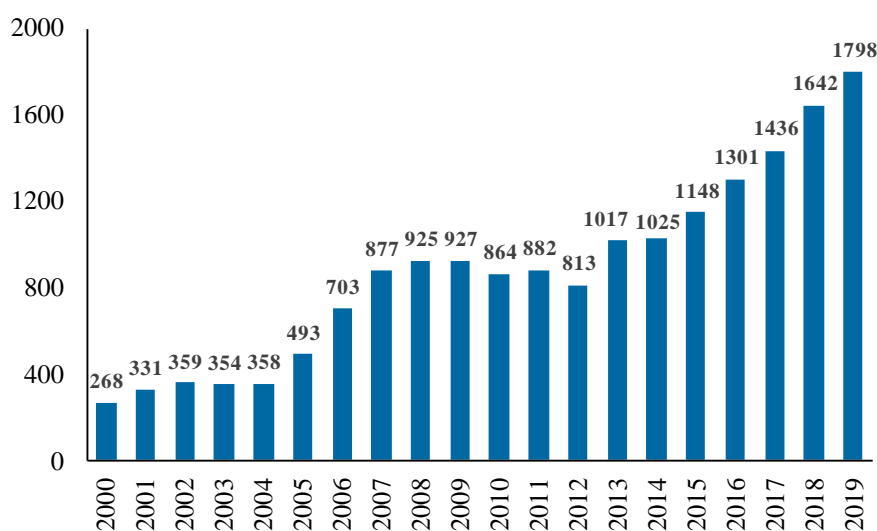
Source: Preqin

Overvaluation and leverage

Nevertheless, the positive figures presented also bear notable risks. Steep growth in fund raising and concentration in mega funds (almost half of global fundraising consistently allocated to these managers) fuelled by GPs and LPs sentiment to not miss out on favourable market conditions, has inevitably caused more competition for the same opportunistic assets. This, combined with thriving public markets in recent years up until 2020 and of underperformance of other alternative asset classes, have poised PE purchase prices up. Consequently, it is increasingly difficult to gain significant profits and the traditionally targeted 15-25% IRR. Regardless of multiple expansion, leverage or operational enhancement as profits power drivers, entry prices have resulted in a burden that many believe is surely going to derive in disappointing returns going forward. As of early-2020, average acquisition multiples were at record levels across industries in the main two PE markets (US and Europe), and were even higher than average pre-crisis levels.

Figure 24: Acquisition EBTIDA multiples, US and Europe
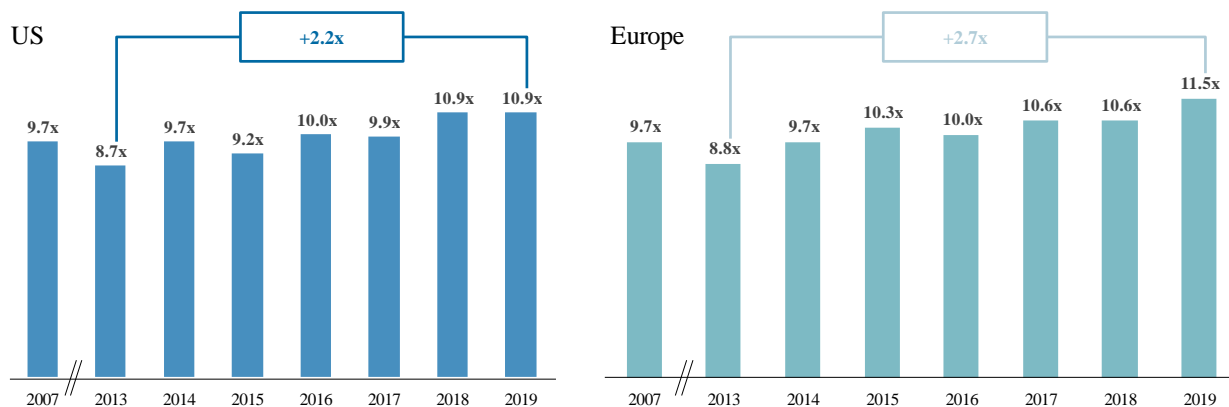
Source: S&P Global Market Intelligence

Complementarily, the desire of investors and managers to not miss out, combined with spikes in assets under management and increased competition, may draw these managers to make less thought-through investments. This again may point to a probable decrease in returns in the upcoming years. Inevitably, these factors and the possibility of exiting fast due to extraordinary valuations had derived in a shortage of the holding periods of portfolio companies up until the current crisis. The median holding number of years had gone from an all-time record of 5.9 years in 2014 to 4.5 years in 2019, following a continuously falling trend similar to that of the pre-crisis era (in which holding periods fell to a whopping 3.2 years in 2008).

Scarcity of opportunistic large assets has not been the only talked about risk in the Private Equity sector (probably not an issue anymore given current circumstances). Although in a seemingly controlled manner (below pre-2008 levels), average leverage in deals has shown a growth dynamic. Given the mentioned pricing challenges, basic ratios such as Net Debt / EBITDA have experienced a surge in the major PE markets. The remembrance of a recent Global Financial Crisis though, has inclined investors to close deals with slightly larger equity contributions as a % of the total value, somewhat offsetting some of this increasing leverage risk. These leverage levels have been found to have slightly different trends in the US and Europe. In Europe, a tighter regulatory environment has kept, for the past two years, the mentioned Net Debt / EBITDA ratio just under 6x. This represents a significant increase from a reduced 4.9x in 2013 but is still far apart the 6.6x levels observed in 2007 (according to S&P Market Intelligence). Of more concern in the region is the dramatic rise of the percentage of debt composed by the so-called Covenant-Lite loans, as later explored in this Thesis.

The dynamic for leverage levels is also upward in US PE deals since the Global Financial Crisis until 2020. In the American market though, the proportion of deals with Net Debt / EBITDA of 6x of more has dramatically increased in the last 5 years to levels even higher to those pre-

2008 *(Figure 26)*. A search for higher returns and a more relaxed regulatory environment could be two of the main reasons for this disparity (call to mind that a 6x ratio is the usual trigger for regulators to more profoundly examine a company top to bottom).

Figure 25: Share of US leveraged buyout market, by leverage debt (as of year-end, %)
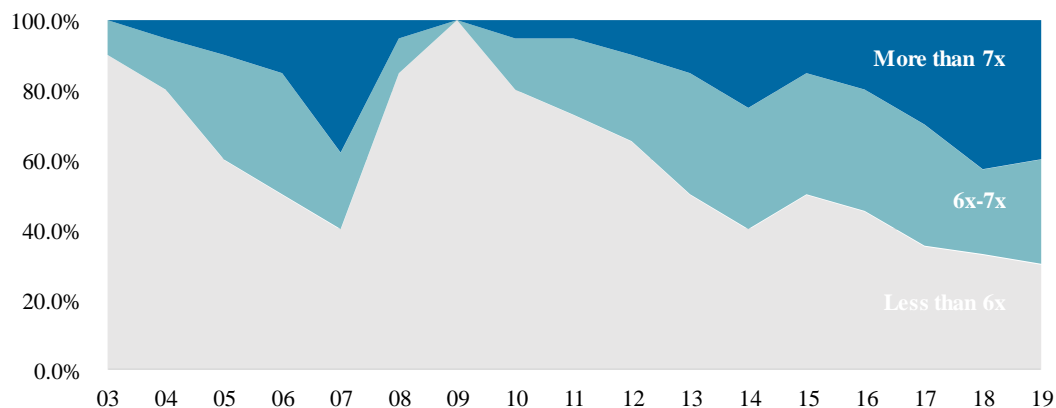
Source: Thomson LPC

Still and all, the most frequent controversy in past years has evolved around the rising % of the so-called Covenant Lite loans in the debt structuring of PE transactions. Covenant Lite loans are loans given out with few or nonlegal clauses that enable investors to take control if a company turns a corner in lower than expected financial performance. The presence of these clauses supposedly protects debt holders from a more probable default ensuring they keep their principle value. Offerings lacking these covenants became the norm in the years preceding the financial crisis. As previously mentioned, these obligations are almost business-as-usual in Europe, with c.90% of leveraged loans being covenant lite. In the US, this proportion is slightly lower and has seemingly stabilized at c.80%. This could be explained by the previously exposed difference in leverage ratios of deals between geographies: a lower ratio is perceived as less risky, hence giving European investors more access to the covenant lite market. The outcome of this trend still needs to be seen and will be closely related to macroeconomic evolution, monetary shifts, and the scale of the dramatic economic consequences of the current COVID-19 crisis.

Figure 26: Average deal proportion of debt and equity, % of debt that are covenant lite loans, 2013-2019 (%)[12]

US

Europe

% of cov-lite loans

US chart values — % of debt contribution (top) / % of equity contribution (bottom):
2007: 67.0% / 33.0%
2013: 63.0% / 37.0%
2014: 62.0% / 38.0%
2015: 58.0% / 42.0%
2016: 57.0% / 43.0%
2017: 56.0% / 44.0%
2018: 58.0% / 42.0%
2019: 57.0% / 43.0%

Europe chart values — % of debt contribution (top) / % of equity contribution (bottom):
2007: 66.0% / 34.0%
2013: 58.0% / 42.0%
2014: 57.0% / 43.0%
2015: 57.0% / 43.0%
2016: 50.0% / 50.0%
2017: 56.0% / 44.0%
2018: 52.0% / 48.0%
2019: 53.0% / 47.0%

Legend: ■ % of equity contribution ■ % of debt contribution —— % of cov-lite loans

Source: S&P Global Market Intelligence

Meanwhile, there has been a divergence of opinions among academics, practitioners, investors and regulators on the possible routs and consequences of this trend. On the loan underwriting side, some argue that debtholders are not the best suited to run troubled companies, and so they should not be put in charge under any circumstance, subsequently eliminating all power transfer covenants. Additionally, the huge increase in number of PE deals and a maintenance of low interest rates can increase interbank underwriting competition, resulting in a loss of bargaining power vis a vis PE firms. This apparent caution-less lending can then be profited from in a parallel resurgence in the CLO market, in which lenders sell securitized tranches of the mentioned Cov-Lite loans to 3rd investors.

On the investment side, managers and practitioners frequently argue that rising levels of equity more than make up for the apparent riskiness of Covenant Lite loans. Additionally, they suggest that the lessons learned in the crisis have pushed them to engage in more sophisticated and effective risk management, consequently making more secure investments and running portfolio companies in a more risk averse manner, which is currently about to be challenged.

On the regulatory and policy making side, the range of views can widely vary, and valid points can be found in any extreme. Mark Carney (Bank of England Governor and President of the G20 Committee for Financial Stability) for instance, suggested in 2018 that the evolution of what he calls "careless lending", accompanied with a volume rise in CLOs, is worrisome and

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[12] Average equity contributions for LBO transactions, including rollover equity; covenant lite loans include all new issue institutional loans which are covenant lite

could be comparable to the mortgage market bubble. In the other hand, analysts such as Ruth Yang from Standard & Poor's have a more optimistic approach: she believes that considering the consistently low levels of leveraged loans default through the post-2008 cycle, the rise in the volume of Covenant Lite obligations might signal an increasing strengthening of the underlying businesses. She also believes that more measured risk-taking by managers inherently make portfolio companies more worthy of cheap credit.

As mentioned, the evolution of this issue is being closely observed and all market agents are wary and intrigued to see its outcome in the upcoming months and years.

Exit trends

The presented factors and other resulting dynamics also influence the method through which funds exit their investments. In brief, firms tend to search for the highest bidder while being aligned with the company's future objectives set during their tenure. This is normally accomplished through a public floating, a sale to a strategic buyer, or a sale to another financial sponsor (secondary buyout).

The share of exit methods has been relatively stable overtime, with strategic sale accounting for over half of the divestment processes. In the last 5 years, however, there has been a consolidating trend regarding both public offering and secondary sponsors exits. In the last lustrum, public markets have experienced growing scepticism regarding private equity backed IPOs. Some PE funds have heavily relied on leverage effects and a 10-year long multiple expansion to squeeze profits at exit, theoretically leaving a more open window for operational weaknesses.

This has been especially penalized by the market, with several PE-backed IPOs underperforming during the first months or even years after the listing (recent examples include beer chain BrewDog, luxury car maker Aston Martin, or discount retailer Poundland & Dealz). In consequence, a fear that public investors non-appetite might diminish a portfolio company's valuation has evolved. This has tilted managers to more frequently look at sponsor-to-sponsor or strategic related exits to lock in profits, causing a jump in the percentage of secondary LBOs and a decrease in IPO exits. Moreover, the recent market volatility (2020) might also discourage the public offering as an exit method, given the amplification of the reasons above.

Figure 27: Global buyout-backed exit value by channel ($bn)[13]
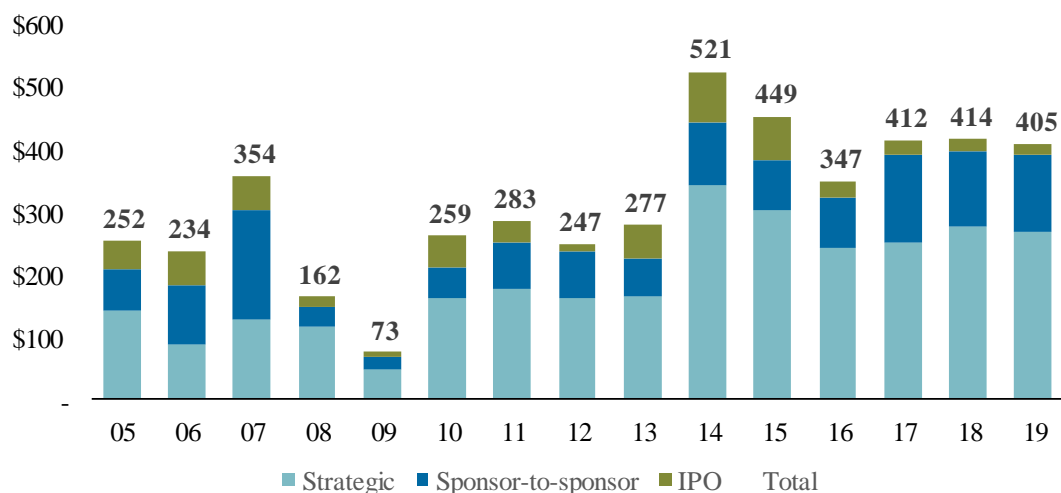
c. PE in the retail apparel industry

Riskiness of the sector

The retail industry has always been an attractive sector for private equity investors due to low leverage levels, the possibility of using the store properties as debt collateral and the ability to easily create enterprise value through four straightforward levers: (i) polishing the core value proposition (ii) boosting digital and e-commerce channels, (iii) expanding both domestic and international stores through franchise and other models and (iv) ensuring operational excellence and tight cost control. However, as already commented, over the past 10 years there has been significant changes across retail that have had major implications for PE investors looking for value in the sector. While the previously mentioned levers are still relevant today, it is becoming much harder to create sustainable value growth, especially for mid-players with no clear differentiation.

Strong evidence of this trend can be seen in the already explained "retail apocalypse", with the recent flood of retail bankruptcies (many resulting from failed LBOs) in the US, increasing from one in 2012 to reaching levels not seen since the Global Financial Crisis and most probably to be highly increasing during 2020.

[13] Bankrupcies excluded; IPO value represent offer amount and not market value of company

Figure 28: Retail Bankruptcies in the US, 2008-2018[14]
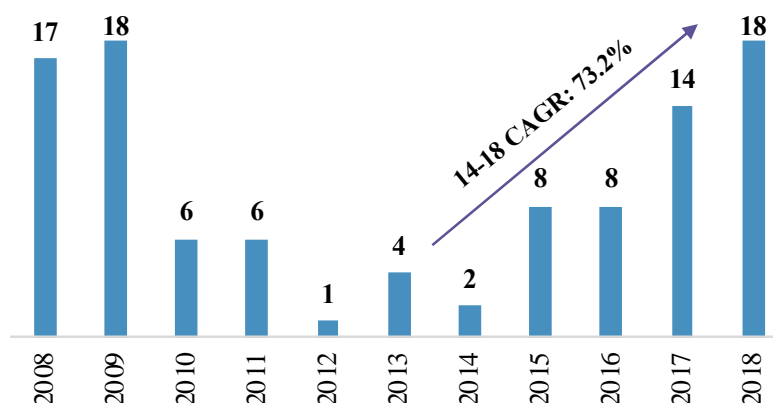
Retail LBO transactions, and more specifically traditional public-to-private LBOs, are now almost non-existent; with only five transactions occurring within the last three years *(Figure 27)*. We also see that the increase in the number of retails bankruptcies since 2015 matches perfectly with the increase of private equity transactions between 2009 and 2012 (taking into account that average holding periods within the industry range between 3 and 5 years).

Figure 29: Retail PE Transactions in the US, 2008-2018[13]
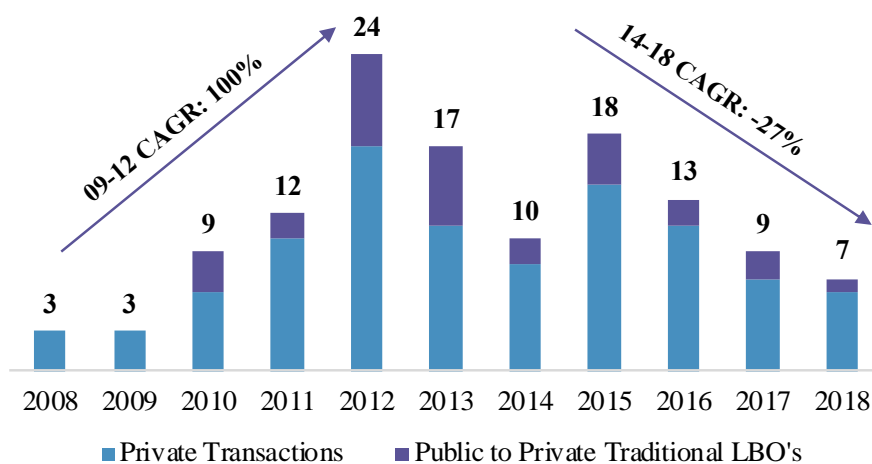
PE funds have become highly selective with their acquisitions and are buying fewer retail assets. Credit markets have been unreceptive to traditional retail as well, particularly for mall-based retail. Financial investors have pivoted towards consumer and service-oriented businesses, especially those focused in millennial shoppers, clothing & accessories, beauty, and personal care categories (PJ Solomon, 2019). Also, some traditional retail-focused private

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[14] Reflects retail companies based in the US, excluding restaurants, automotive dealerships and tech-enabled retail service providers and any transaction of less than $100m

equity firms have moved to "earlier stage" propositions, leveraging their retail acumen to make more venture-type investments. Within apparel for example, according to McKinsey & Company, VC investment have risen steadily from $43.5mm in 2007 to $560.6mm in 2018

Finally, another factor that has increased the risk profile for investors in retail is the fact that they can no longer reliably look for the IPO market as an exit strategy, which has tapered dramatically since the 2008 recession. The agent behind this decline has been a medley of public equity investors fearful of the transformation of the retail marketplace, coupled with fewer LBO's exiting to public markets. Since the Financial Crisis, there have been two to four traditional retail offerings per year and nearly a third of retail IPOs have been for e-commerce companies.

Valuations, returns and leverage levels

In terms of public market sentiment, P/E and EV/EBITDA multiples of the S&P 500 for the last 5 years grouped by sector shows that the consumer sector (includes retailing) has traded above the S&P 500 average.

Figure 30: S&P 500 5-Year Average P/E and EV/EBITDA multiples by sector[15]

5-Year P/E

Sector	Value
Energy	25.71
Consumer	19
Utilities	17.11
IT	16.99
S&P 500	16.71
Materials	16.5
Industrials	16.41
Heatlh Care	15.86
Communications	13.39

5-Year EV/EBITDA

Sector	Value
Energy	16.92
Health Care	14.09
Consumer	13.48
Materials	12.55
S&P 500	12.50
IT	12.35
Industrials	12.19
Utilities	11.61
Communications	11.06
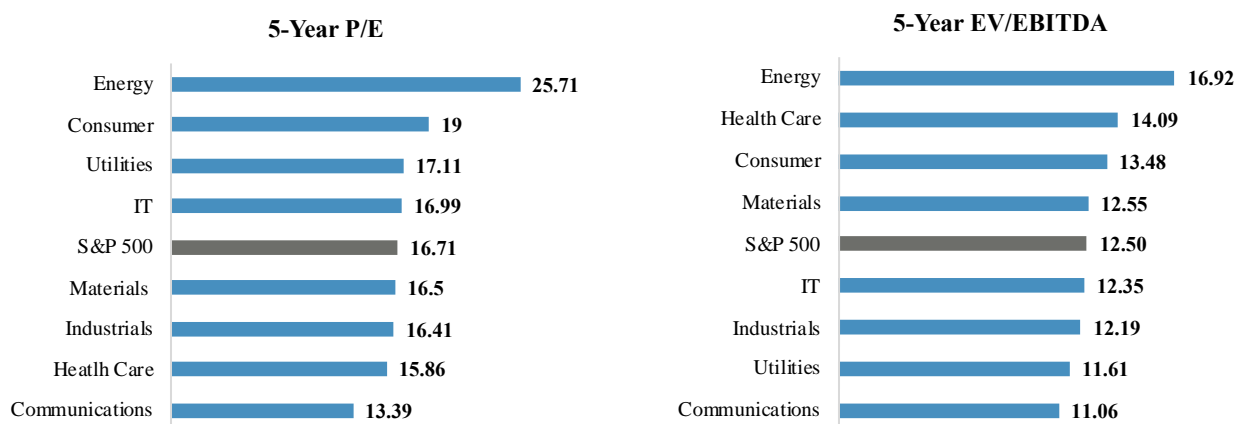
Source: Bloomberg, Siblis Research

Within consumer, and more specifically retailing, there is performance differences based on product and business models. Consumer and service-oriented businesses, internet & e-commerce companies, apparel & accessories, and personal products categories tend to have higher trading multiples than other categories such as specialty retailers or mass merchandisers, due to its higher margin performances *(Figure 29)*.

[15] Consumer includes both consumer discretionary and consumer staples sectors

Figure 31: Consumer and retail trading multiples by product and business model

Performance by product

Performance by business model

	P/E	EV/EBITDA		P/E	EV/EBITDA
Recreational Products	14.7	12.6	Internet & e-Commerce	20	15.6
Consumer Services	23.1	8.2	Discount Retailer	16.8	11.5
Household Products	14.8	11.7	Specialty Retailer	12.2	9.8
Apparel	23.8	11.9	Mass Merchandiser	15.3	7.4
Personal Products	21.6	14	Grocery & Pharmacy	11.6	9.4
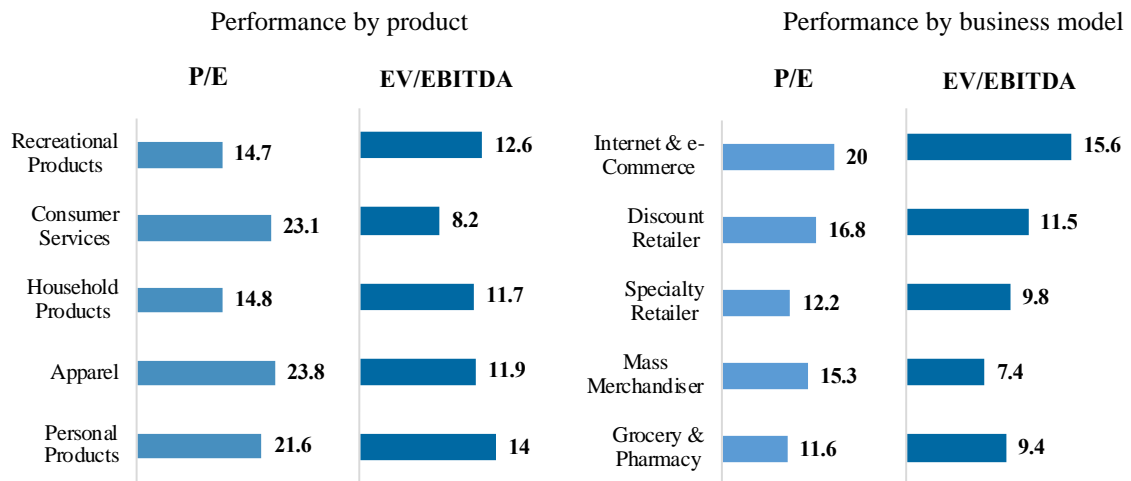
Source: Fifth Third Capital Markets

Looking at valuations of historical retail M&A and PE deals, in terms of business model, it is again perceived that value is to be found in the edges, with the luxury and value/discount sectors offering strong performances and digital pure-plays offering the greatest EV potential, especially in luxury pure-plays. On the other hand, mid-market retail players with the lowest valuation levels are responsible for many of the retail failures.

Figure 32: Valuation of selected retail deals across the last 10 years in the UK, US, EU
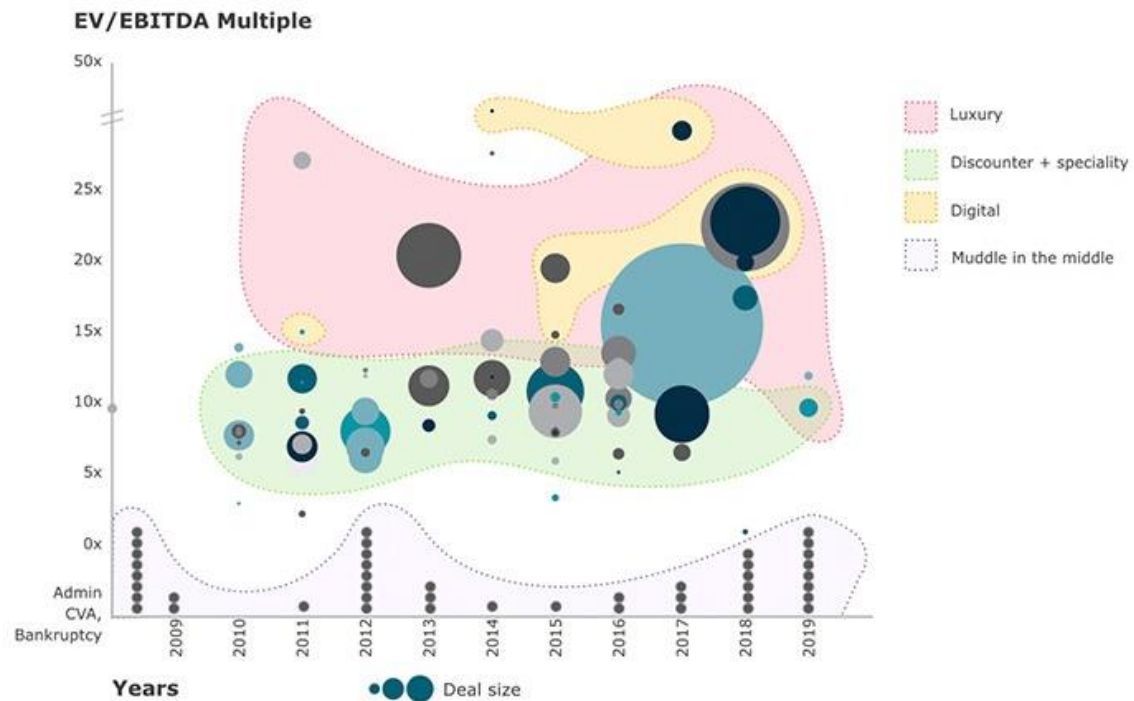
Source: AlixPartners

Additionally, brand value is found to have had a strong impact on market valuations as well, especially in the apparel retail category. When evaluating the EV/EBITDA multiple over the last five years there is a valuation gap of between 50% and 110% in favour of established

branded companies (Inditex, H&M, Nike) versus retailers selling either non-branded or third-party branded products (Walmart, Costco, Nordstrom). This gap is even higher when compared to the luxury fashion sector, which typically represents the apex of brand value. Indeed, the EV/EBITDA multiple for the top three luxury apparel companies (LVMH, Hermes, Kering) is 20.6x, almost 2 times higher than branded retailers and 3.5x higher than non-branded retailers.

Figure 33: Evolution of branded vs non-branded retailers EBITDA multiples, 2013-2018
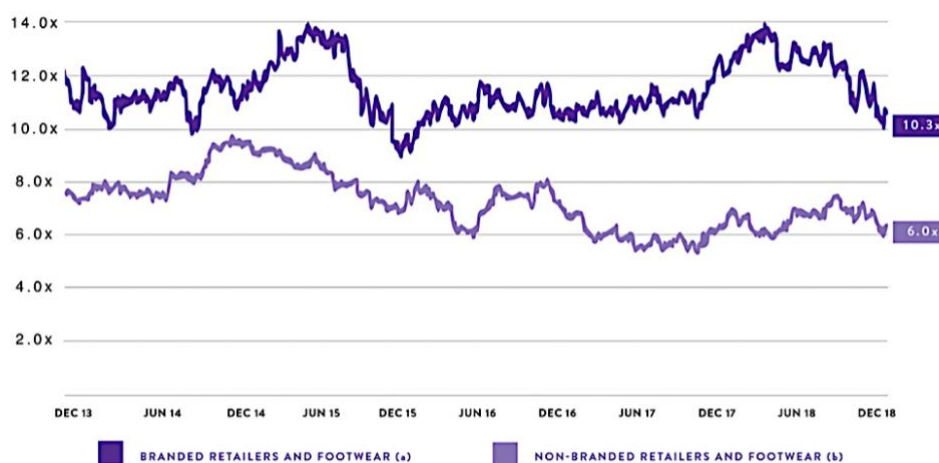
Source: Capital IQ

In terms of returns, the consumer and retail sectors have been slightly below the PE industry average, historically speaking. Pooled MOIC[16] for fully realized buyout deals in the last decade shows the consumer industry has experienced, in average, cash on cash returns around 2x, 20 bps below the PE average.[17]

Figure 34: Pooled MOIC for fully realized buyout deals, 2010–2018
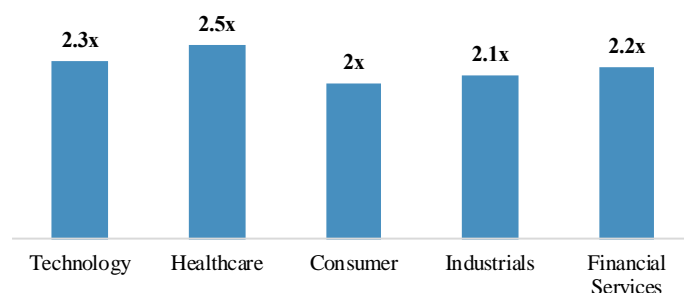
Source: Bain & Company

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[16] Money On Invested Capital
[17] Note that CoC returns are not significant of compounded rates of return, but only an "order of magnitude" reference

However, within the consumer industry, the consumer discretionary sector, and more specifically the Apparel & Accessories sector, has and is expected to continue experiencing, the highest returns. Indeed, according to Deloitte's Private Equity and Investors Survey, on average, funds expect an IRR from their investments in apparel & accessories ranging from 21% to 30%.

Figure 35: IRR expected from new retail investments, 2019 (%)
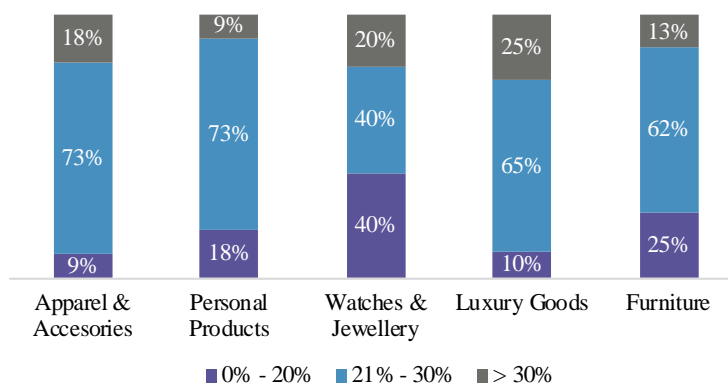
Source: Deloitte's Private Equity and Investors Survey 2019

Finally, when it comes to leverage levels, historical ND/EBITDA ratios of middle market retail LBOs for the past 6 years show that leverage levels have remained quite consistent around 6.0x, aligned with the average of the LBO industry.

Figure 36: Middle market Retail Industry LBO Leverage Levels, 2014-2018
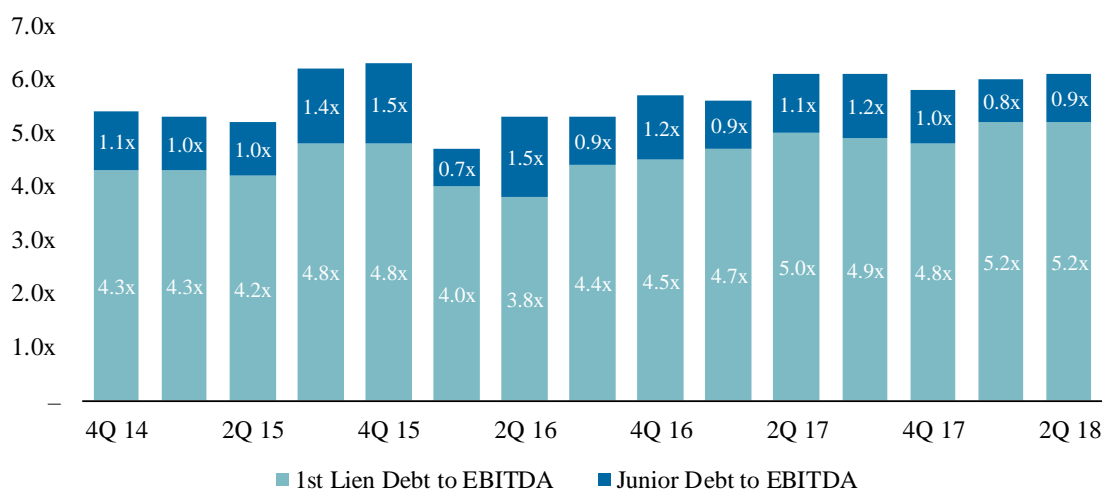
Source: Fifth Third Capital Markets

3. LBO theory and value creation

a. Introduction to PE structuring fundamentals

This Thesis has already presented a brief historical evolution of the PE industry as a whole, and further defined Leveraged Buy-Outs as a transaction in which a group of private investors, typically including management, purchases a significant and controlling stake in a public or non-public corporation or corporate division using significant debt financing , which it raises by borrowing against the assets and/or cash flows of the target firm (Loos, 2006).

Further, it can be added that the controlling stake is normally purchased by Buyout funds, allowing the managers and investors of these vehicles to restructure the target's financial, governance, and operational characteristics to drive value creation. The post-buyout capital structure typically consists of 50-75% debt and 25-50% equity (Zeisberger, Prahl & White, 2017).

The completion of the firstly presented definition denotes that an LBO investment does not only depend on the single target's characteristics and potential. Furthermore, the players and contributors surrounding a fund, most likely to invest in more than one company, need to be aligned, therefore constituting the key drivers for each investment.

Fund structure and LPA

A private equity fund is a concentration of investors' capital constituting a single investment vehicle, managed by one or more investment professionals. Most of the funds are committed for 10 to 12 years by Limited Partners (LPs), which outflow the capital needed to investment managers whenever they are to make an investment (capital call). The vehicle is normally constituted in a *close end* manner, meaning it is not usual for an investor to sell its stake in the fund, nor it is expected for the fund to liquidate its position before the agreed termination period.

Firstly, a PE firm composed by investment professionals drafts an investment proposition they believe can deliver substantial returns, which does not include much specificity on the assets or details of investment, but rather general lines on selection criteria such as sector, capitalization of the target company, or geographic area of investment. After revision from potential investors (SWFs[18], Pension Funds, Insurance Funds, HNWI[19], etc.) these may decide

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[18] Sovereign Wealth Funds
[19] High Net Worth Individuals

to sign a Limited Partnership Agreement (LPA), by which they commit a specified amount of capital to the fund, often contributing around 99% of the funds. Upon signing of the LPA[20] , a Limited Partnership is constituted as per the structure below. LPs are indeed not liable beyond the contribution of capital and are also limited in any active decision-making regarding investments or day-to-day managing portfolio companies. Hence, they are de-facto passive investors in the fund until its closing or distribution of returns.

The firstly mentioned PE firm is most frequently the contributor of both the General Partners and the fund's investment manager. General Partners are a set of investment professionals that effectively decide, after extensive due diligence, which investments to make or overlook in accordance with the signed LPA. This task usually falls under the shoulders of a select group comprised by the most senior and experienced professionals in the PE firm, constituting an Investment Committee. Under current standards, GPs normally contribute 1% to the fund's capital, in order to further ensure alignment of interest (colloquially called as to "*having skin in the game*"). The investment manager/s, in turn, is one or more of the PE professionals ensuring the correct workings of daily activity of the fund and its companies, while charging a small yearly fee to the fund's entity

Figure 37: Limited Partnership PE Fund Structure and Economics
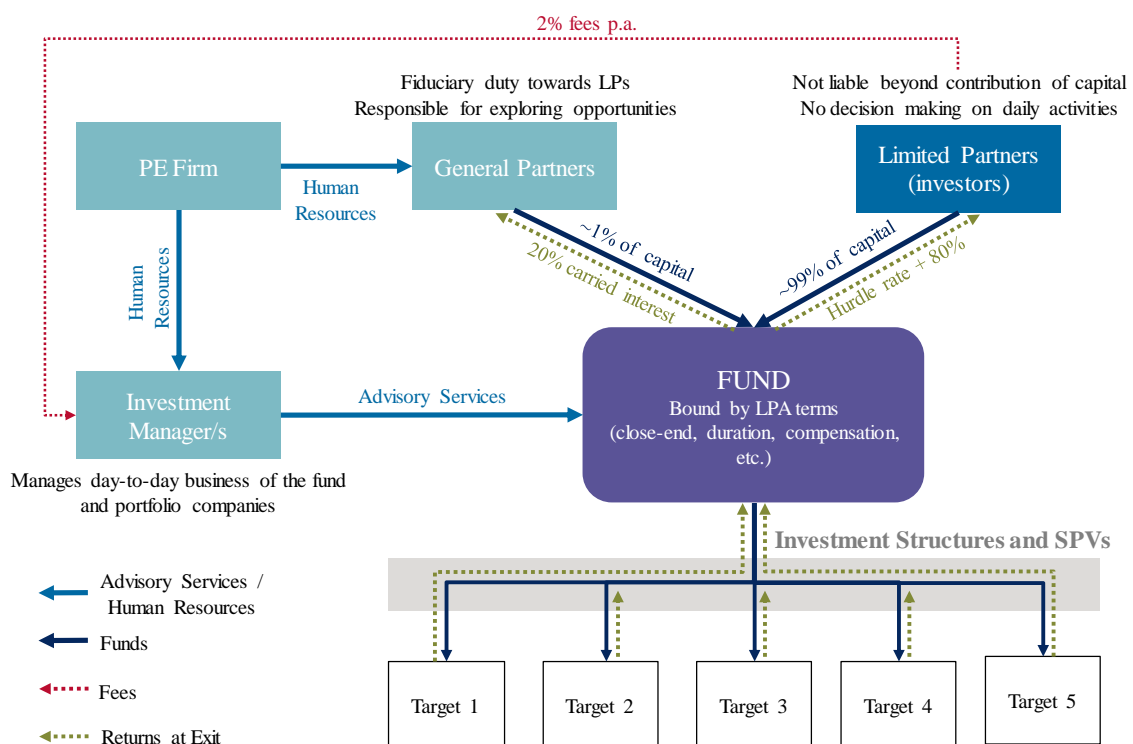
The Limited Partnership Agreement (LPA) lies at the centre of all fund and deal documents. The LPA normally contains all necessary binding guidelines for the terms and procedures between the different parts of the partnerships with regards to organisational aspects, partners and capital commitments, capital calls, subsequent closings, limited liability terms and distribution and carried interest (Zeisberger, Prahl & White, 2017).

Regarding the profile distribution of the mentioned LPs, Public Pension Funds have historically been the main global contributors of committed capital, according to Preqin. Geographically, the largest contributors have been by far American investors, with over 60% of the global funds. Additionally, relative allocation of LPs capital to PE versus all other asset classes has been around 12% in the last decade. This though, ranges widely between types of LPs, and can generally vary between an average 3% target allocation of insurance companies' capital, to a maximum target of 16% for SWF, according to McKinsey[21]

Figure 38: Amount of capital by % of LPs contribution in funds
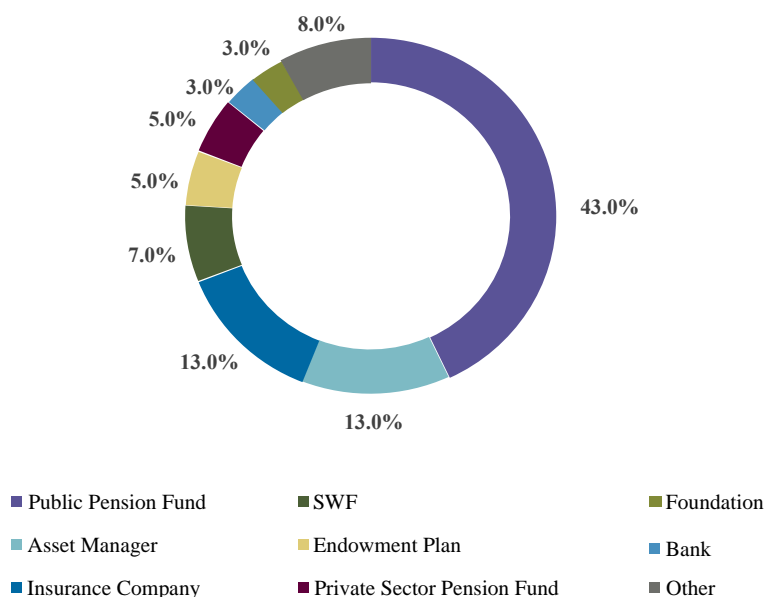
Source: Preqin Private Equity Online, 2017

Fees structure and carried interest

Compensation and economics in a PE fund usually follow the so called "2&20" rule. This common practice establishes that LPs finance Investment Management activities with a 2% p.a. fee on committed capital (or deployed capital after the investment period of the fund).

These activities include operating costs such as salaries but can be requested for an increase in case of special costs (additional advisor hiring, for example) if specified in the LPA. The 20% rate refers to the percentage of the remaining exit funds that GPs are compensated with, after distributing back initial capital to LPs (net of fees), the agreed upon Hurdle Rate (around 8% annually of invested capital) and the so called GP "catch up" (around 20% of the hurdle rate amount). The remaining 80% is of course distributed back to LPs. This conforms a much organized and stipulated distribution waterfall that needs to be complied with in line with the terms of the LPA. Furthermore, this distribution can be executed after the pre-agreed closing of the fund ("All capital first" distribution) or individually after each exit ("Deal-by-deal" distribution) *(Figure 37)*. For the purpose of this Thesis a deal-by-deal distribution will be applied in the case study in Section II, in order to observe the case's individual returns.

Target financing, types of debt and investment structure

In order to finance the purchase of a stake in the target companies, the fund needs to raise additional capital to equity in debt markets. As already mentioned, it is usual for the deal to be funded by around 50/50 debt/fund equity, although this ranges widely between sectors, geographies, size of the target company and expected volatility of its cash flows. While each buyout has a particular debt structure of its own, academics and practitioners alike normally classify the different types of debt that may be raised into three types:

- **Senior Debt:** typically accounts for around 30-50% of the whole borrowing structure. Lenders are normally financial institutions working in a syndicate. It is the shortest term and cheapest source of debt (it is usually issued with a low floating rate vs LIBOR or SOFR but can be easily swapped to fixed rates) and it is (or was) secured against specific company assets. Hence, it is the most senior tranche in the debt structure and normally has/had the most restrictive covenants. It frequently has tranches that can be periodically amortized but can also have bullet repayment tranches. As seen previously in this thesis, the senior debt market in LBOs has been experiencing huge growth in the so called "covenant-lite" loans, which has reached a share of as much as 90% of the leveraged loans volume in Europe in recent years. Complementary to this type of debt, most buyouts negotiate a credit revolving facility with one of the lenders of the mentioned syndicate, with a slightly lower floating cost than the most senior tranche, and usually used to solve needs of working capital in the target company.

- **Junior Debt:** with at least one grade less seniority than senior debt, junior debt usually accounts for most of the remaining borrowing structure. Instruments and issuers vary widely to satisfy the needs of the buyout fund. Second Lien loans are the most senior of the bulk, with similar characteristics than senior debt, but with less covenants, longer term and second priority to all collateral securing the latter type. Investment grade and high yield bonds are another two usual common instruments used and are junior to second lien loans. They have a fixed coupon, are publicly traded and unsecured, and frequently have event trigger or incurrence covenants.

- **Others and remarks:** the last frequently used debt class is Mezzanine. Normally lent by specialty funds, it is junior to high yield bonds, and is usually issued when the company has no easy access to the bond market or needs interest to be repaid as late as possible. It hence does not publicly trade and has the highest amount of interest. This interest is normally captured in a Pay in Kind manner. This means interest is aggregated to the principal until final repayment of all debt is due in 10-12 years. Additionally, Mezzanine lenders may require equity sweeteners (equity stake of the target company at exit) also called semi-equity instruments, and consequently it is seemed as a middle way instrument between debt and the fund's equity. Needless to say, each buyout is extremely complex and is dealt by professionals engaging in financial engineering in debt and legal structure to maximise profits. Consequently, debt products and their underwriting characteristics are almost infinite in options (callable bond options, tailored covenants, uni-tranche structures, rate swaps embedded instruments, etc.), not explored in this Thesis. An applied example of debt structure, covenants and repayment schedule is presented later in the case study of this Thesis.

Given the multiple tranches of debt and its potential complexity, lenders normally require a certain type of investment structure, commonly composed by separate SPVs[22] to enforce the contractual rights of their covenants and their seniority order. The different vehicles engage in intercompany loans down to the "BidCo", which is the entity purchasing the target company *(Figure 39, as detail of "Debt Investment Structure" in Figure 38).*

[22] Special Purpose Vehicle

Figure 39: Example of PE Investment Structure and SPVs
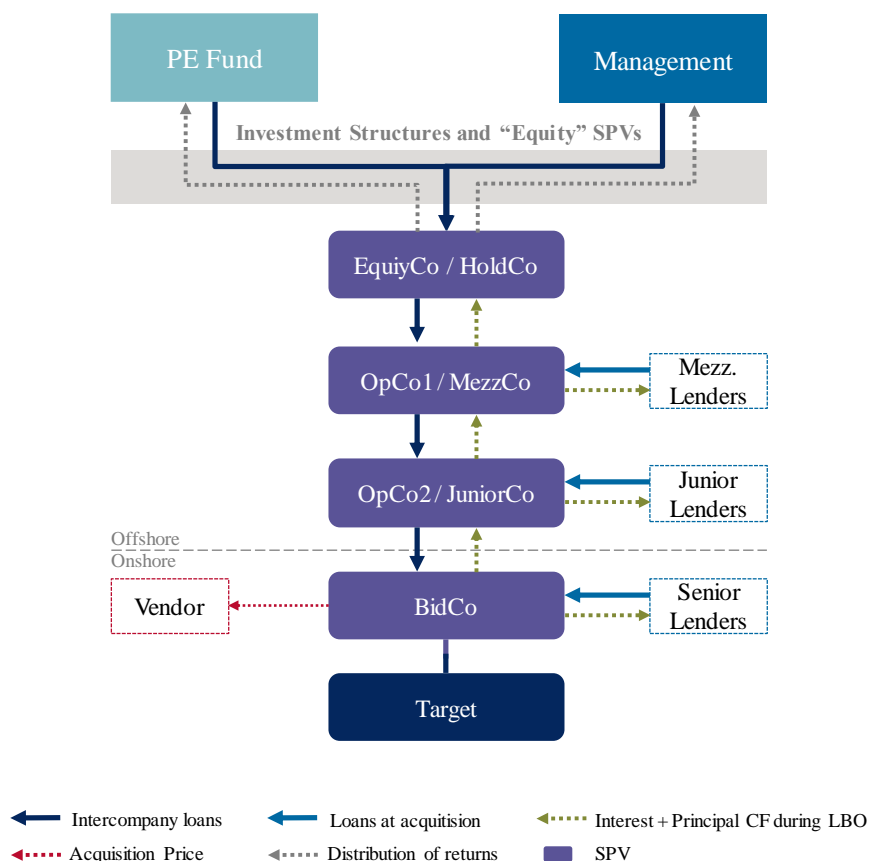
Structural subordination is hence achieved with claims on the cash flows and assets of the target company being conditioned on the satisfaction of the previous senior SPV lenders (starting at the BidCo), and all the way up to the HoldCo or Equity Holding Company *(Figure 39)*.

Additionally, PE funds take significant advantage of these structures by forming each of the entities offshore (i.e. The Cayman Islands) to optimize regulatory and tax treatment of the investment. General financial engineering looks to establish these SPVs following criteria for easy access of lenders to collateral and to reduce risk that debt is treated as equity and interest as dividends for tax purposes.

Furthermore, should the buyout have additional equity capital than that of the original fund (management, co-strategic investors, co-sponsor investors), it is usual that each of the equity capital flows to the target be conducted in a separate "Equity SPV". This helps adapt different needs that LPs, management, the fund itself, and other equity contributors may have. Intercompany loans would then flow from this "Equity SPVs" to the HoldCo, which are obviously structurally junior to any "Debt SPVs" *(Figure 39)*.

An applied example of equity co-investment and debt structure will be presented and explored in the framework of the case study of this Thesis.

Types of LBOs

It is important to distinguish between different types of LBOs depending on the management's involvement.

- **MBO (Management LBO):** acquisition of the company with the management as equity capital contributors (with an implied "management package" as economic incentive). Usually carried out when GPs prefer for the management to stay in charge, if they are in line with the fund's objectives.

- **MBI (Management Buy In):** acquisition of the company by the fund and introduction of a new executive team in the target company with their respective equity contribution and management package.

- **OBO (Owner Buy Out):** the majority shareholder ousts any other shareholders (with the collaboration of the fund) with an equity contribution and a negotiated package with the PE firm.

- **LBU (Leverage Build Up) / Add-on acquisitions:** a company already under an LBO process acquires another (normally to expand capabilities or geographically) using debt.

Once again, the basic standard concepts have been presented but the options and names may be endless, depending on the management involvement in the buyout, their package or role in the company, and the fund's interactions with the different stakeholders of the target.

Critical factors to successful LBOs

While not strictly related to structuring of a PE deal, the screening of buyout opportunities by GPs is central to an investment professional's job as it constitutes the root decision for potential value creation. Although there is plenty of academia and practitioner content in this topic, most experts point out that each target is unique and has different exploitable characteristics that may adapt even in a framework of one same LPA. Nevertheless, some general rules seem obvious across all funds. These criteria, however, may substantially change, expand or simplify overtime in line with the evolution of the PE industry and all its players. As an example, the ideal traits of LBO candidates according to leading PE firms published in two very distinct times for the industry are presented below.

Figure 40: Characteristics of an ideal LBO candidate according to KKR (1989), Ardian (2019)

KKR 1989	**ARDIAN** 2019
Financial	1. Buy a strategic value asset cheap (as possible)
1. A history of demonstrated profitability and ability to maintain above average profit margins	2. Incur on limited leverage on acquisition
2. Strong, predictable cash flows to service acquisition financing cots	3. Have a clearly defined equity story shared with management
3. Readily separable assets or businesses which could be available for sale if necessary	4. Align interest with not only top management but also N-1/N-2 managers
Business	5. Avoid anticipated technology or marketing disruption businesses
4. Strong management team	6. Strong FCF
5. Well-known brand products and strong market position	7. Avoid highly concentrated customer base businesses
6. Status as low-cost producer within the industry creating competitive advantage	8. Not subject to prolonged cyclical swings
7. Potential for real growth in the future	9. Ability to generate increase in strategic value to attract trade buyers
8. Not subject to prolonged cyclical swings	10. Assessment of ability to sell and right time to do it
9. Products which are not subject to rapid technological change	

Source: Company documents, Kaufman and Englander (1993)

Exit Strategies

Bypassing the management of the asset itself, the second half of the fund's life is centred around searching for a profitable sale of each of the acquired targets and distributing the cash derived from it. Usually, this process is executed 3 to 7 years after the fund has invested in a specific target. If the target has not gone bankrupt in the mentioned period (c. 6% of all LBOs, 1970-2006, according to Loos, 2006), the most common and widely practiced exits and its pros and cons are presented below (Zeisberger, Prahl & White, 2017).

Figure 41:Exit strategies and considerations

Path	Advantages	Disadvantages
Sale to strategic	1. Full exit 2. Often pay a premium (due to existence of synergies 3. Pay in cash	1. Less sophisticated buyers, prolonging process 2. They require a majority stake
Sale to PE fund (secondary LBO)	1. Ample dry powder available 2. Can "warehouse" a target until an alternative exit	1. Sophisticated and demanding buyers 2. Minority stake may reduce pool of potential investors in the future, at full exit
IPO	1. Generally, potential for higher returns 2. Access to future liquidity 3. Often preferred by management 4. High profile exit	1. Lock-up[23] period 2. Risks of going to market 3. Uncertainty of returns 4. Strain on management time
Dividend Recapitalization[24]	1. Returns cash to LPs 2. No new shareholders 3. Does not dilute equity stake	1. Partial exit 2. Value of investment unknown 3. Not a high-profile exit

Source: Mastering Private Equity, Zeisberger, Prahl & White, 2017

b. Drivers of value generation in LBOs

Value generation in buyouts has typically been analysed from the angle of the equity investors, i.e. in terms of appreciation of the equity value of the holding company over a certain period of time. When looking at the different causes that generate value, a classical approach is to mathematically decompose the equity value into four fundamentals: market multiple, margin, revenue and net debt. This leads to the following equation:

$$Equity\ value = Market\ multiple \cdot Revenues \cdot Margin - Net\ Debt$$

Based on this equation, Gottschalg distinguishes between two main classes of value generation. The first type of value generation is associated with changes in valuation. Such changes usually come from market or industry appreciation or alternatively from the timing of business cycles. Since these changes can occur without modifications in the fundamental business of the

[23] Period in which insiders (like management) are not allowed to sell the stock after the IPO
[24] By which the portfolio company is recapitalized with additional debt, with the purpose of returning all or most proceeds of the issue to LPs and keep operating the target for an extended period

company, this type of generation is typically referred as "value capturing". In the equation above, this value captured is represented by the market multiple.

The second type of value generation is directly linked to changes in the financial performance of the target company such as improvements in revenues and margins, or the reduction of capital requirements. This type of value generation is typically referred as "value creation". The fundamental drivers of such value creation emerged with the first US buyouts in the mid-1970s and its use of financial engineering techniques to profit from tax shields resulting from the highly leveraged acquisitions.

Another early driver emerged through corporate governance, which involved the active involvement of investors and had the intention to mitigate agency conflict with measures such as incentive realignments (Lowenstein, 1985). However, during the second wave of buyouts in the late 1980s, LBOs started to become more associated with operating and productivity improvements (Baker and Wruck, 1988; Kaplan, 1989).

Finally, starting in the 90's, strategic redirection emerged as a key driver of value creation through market expansions, complexity reductions, and others. Additionally, strategic improvement was strengthened in the 2000's as a differentiator between PE firms, and a fundamental criterion for GPs and target companies to look for managers and potential investors, respectively. In the equation above, all these changes in financial and operating performance have an impact on revenues, margin and net debt.

Berg & Gottschalg also analyse value generation based on the phase of the buyouts where it takes place. They distinguish between three phases: acquisition, holding and divestment. The acquisition phase incudes the negotiation process and the due diligence process. It is in this phase when two of the most value determinant decisions are taken: the acquisition price and the structure of the buyout, such as the level of leverage. Indeed, much of the value generated during a buyout is said to be "front loaded", i.e. determined by decisions taken during the acquisition phase (Baker and Montgomery, 1994). During the holding period, all the financial, operational, strategic and organizational levers included in the initial business plan are implemented. It is also in this phase when the resulting operational improvements are realized. Finally, in the divestment phase the exit mode and the exit valuation are determined and returns to investors are ultimately realized.

Overall, the above-mentioned drivers of value generation can be mapped as follows:

Figure 42: Value creation drivers and levels
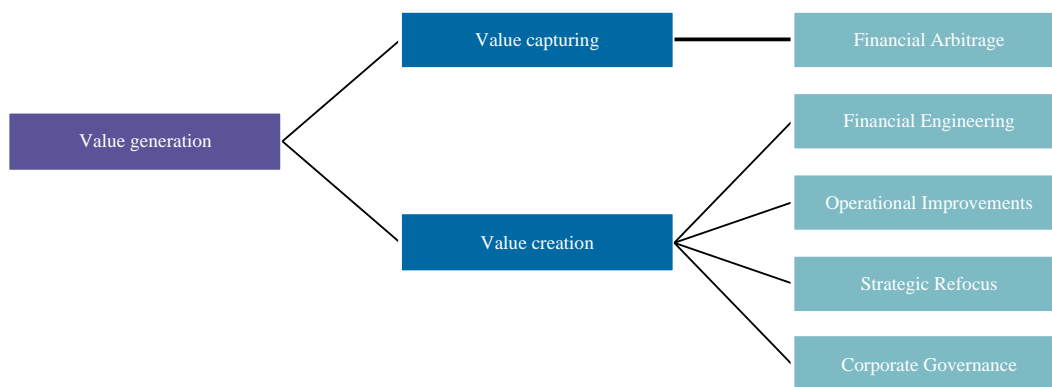
Financial arbitrage

Financial arbitrage (also known as multiple expansion) refers to the ability to generate returns from differences in the valuation multiple between the acquisition and the exit independent of the changes in the underlying performance of the company. Financial arbitrage in buyouts typically comes from the ability of the fund to identify mispricing opportunities and take advantage/suffer from the market environment, and from the negotiation capabilities of the fund to buy low and sell high. According to Bain & Company, multiple expansion has been the main driver of returns in the US and Europe in the last decade, leading to nearly half of the increase in enterprise value *(Figure 40)*. However, with multiples being at record highs and the deteriorating macroeconomic conditions, this spread between entry and exit multiples has already started to diminish.

Figure 43: Enterprise value for US and Western European buyouts invested, 2010-2019
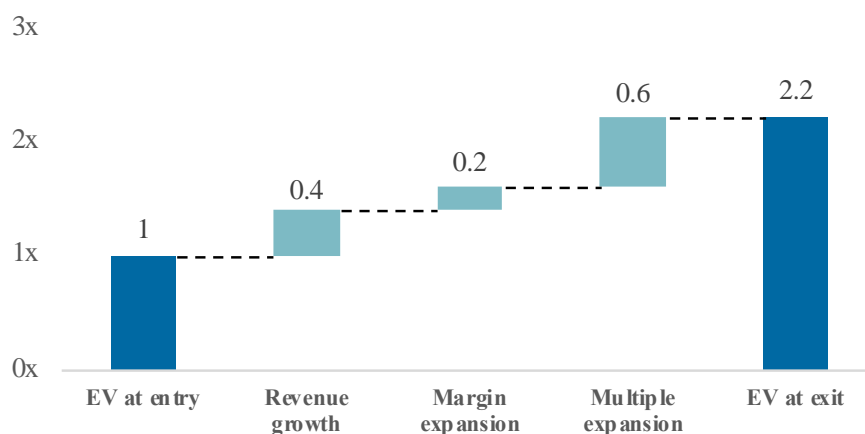
Source: Bain & Company

Financial Engineering

Financial levers are focussed on optimization of the portfolio company's capital structure and minimizing the after-tax cost of capital using leverage and improvement of access to financing and liquidity for the target.

In this financial context, in the first instance, portfolio companies tend to benefit from the financial expertise of the PE funds, who typically assist the management in negotiating terms, especially those related to debt financing, that the portfolio company would not be able to get on as stand-alone basis (Kaufman and Englander, 1993). Secondly, this same financial knowledge is applied to improve the portfolio company complex capital structure and to find the optimal equity-debt mix (Anders, 1992).

Capital structure optimization starts with the selection and combination of the different options of debt tranches, already presented earlier in this Thesis *(see pages 43-44).* These can be combined in an infinite number of creative ways to best suit the target company and the fund running it. For example, the use of unitranche debt (also known as strip financing), where the acquisition is financed through multiple tranches of capital, such as subordinated debt, preferred stock and common stock, has become quite popular in the last decade (Champan & Klein, 2011).

As a consequence of this high debt raised, tax savings represent an important source of value creation in buyouts. The increase in debt and the legal SPV structure allows for high tax-deductible interest payments, providing a tax shield that positively impact on cash flows (Kaplan, 1989). Furthermore, the step-up in book value of purchased assets and the consequent application of accelerated depreciation procedures may also have value increasing effects (Baker and smith, 1998). Some researchers though, argue that this tax advantage is typically almost entirely offset by the higher cost of the debt (Long and Ravenscraft, 1993).

Other methods for achieving a more efficient capital structure and lowering the cost of capital include the conversion of traditional assets into new sources of financing, especially when the portfolio company has a substantial amount of capital tied in non-cash fixed assets. In this context, additional capital can be raised through the securitization of those assets into collateralized loan obligations (CLO) and assets-backed securities (ABS). Sale and leasebacks can also liberate substantial amounts of capital.

Operational Improvements

Operational levers are focused on optimizing operating margins and cash flows through improvements by readjusting the configuration of the company's resources while leaving its strategic positioning unchanged.

Several studies show that the first profitability gains in buyouts in the late 1980s were associated with cost cutting and margin improvements. Cost savings typically come from a

tighten control on corporate spending (Anders, 1992) and the initiation of cost reduction programs. In this context, the outsource of non-core activities and the reduction of overheads expenses play a key role in improving the overall efficiency. Cost savings through employment reductions are also highly topical and controversial. However, while these employment reductions are typically observed in the short-term, the effect tends to cancel out and even reverse in the long-term (Amess, Firma, and Wrights, 2014).

In addition to eliminating unnecessary costs, it is also quite common to increase the company's capital productivity and/or reduce its capital requirements. One typical way to achieve this is to make a more efficient use of corporate assets (Bull, 1989). There is evidence that buyouts achieve cost savings through the improvements of working capital management and the rationalization of assets. Indeed, researchers have found that by streamlining and tightening inventory control and accounts receivables management, post-buyout working capital is sharply reduced (Holthausen and Larcker, 1996). Industrial engineering practices such as Six Sigma and Lean Enterprise are typical practices used in this context. Also, another common method for improving capital management is through the acceleration of the collection of cash. In practice, this can be achieved by enforcing payment terms, shortening payment periods for customer and prolonging payment periods for suppliers (Niemeyer and Simpson, 2008).

Parallelly, companies also adopt stricter capital expenditure regimes that involve the reduction of capital expenditures and the divestment of under-utilized assets (Magowan, 1989). This leads to and an increase in overall operating performance and factor productivity while it provides additional cash flows to pay down debt (KKR, 1989).

Strategic Refocus

Strategic levers are focused in redefining key strategic variables such as operating markets selection or which products to compete with. They usually involve changes in pricing, customer service, product quality or distribution channels**.**

Regularly, buyouts lead to corporate refocusing along with an overall reduction of complexity. The main reason behind focusing on the core business is that many empirical studies have demonstrated that firms with many unrelated and diversified business units tend to underperform (Rumelt, 1982). Is for this reason that complexity reduction levers are found in many buyouts (Phan and Hill, 1995). Evidence shows that this reduction translates in an increase in the post-buyout firm value (Kaplan and Weisbach, 1992). As expected, and as we

have already mentioned in operational levers, there is also strong evidence of asset sales and divestment or outsourcing of non-core operating after a buyout (Aslan and Kumar, 2011).

Another typical strategic lever is what in the mid-1990s became increasingly common and is known as "buy and build" strategy. A "buy and build" strategy starts with the acquisition of a core company in a rather fragmented industry, followed by a succession of acquisitions with the objective of creating a market leader and benefiting from economies of scale and multiple expansion (Wright, 2001). These deals are also referred to as "add-on" deals. While buy and build strategies have been around for a long time, they have become very popular in the recent years due to its clear path to value when market multiples are at record levels *(Figure 39)*.

Figure 44: Total global add-on deals by sequence for platform company, 2003-2008

| % of add-ons that are 4th or later | 21 | 22 | 31 | 29 | 31 | 30 | 29 | 31 | 33 | 33 | 33 | 32 | 32 | 33 | 30 | 26 |
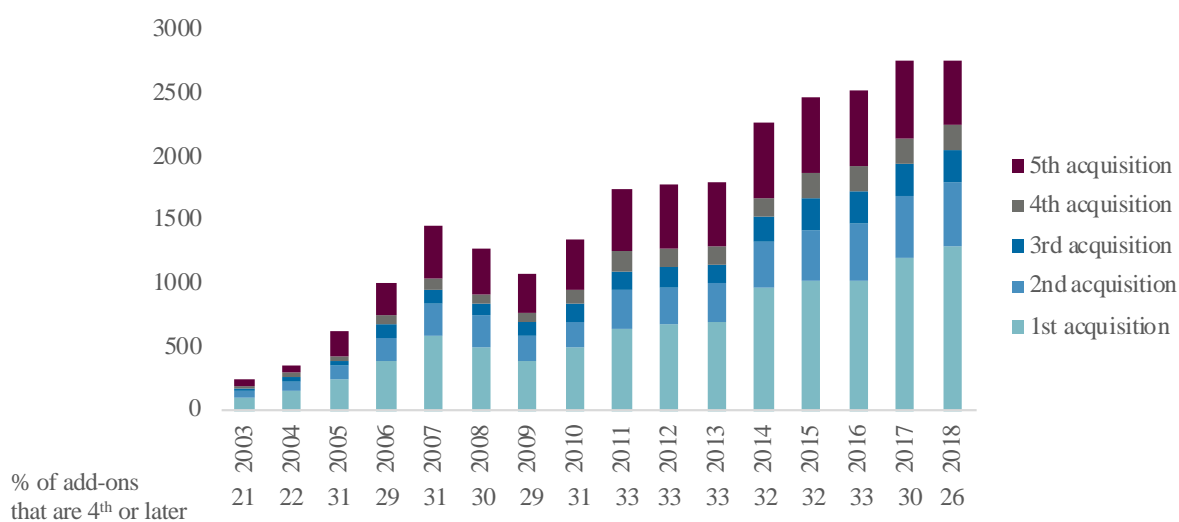
Source: Bain & Company

Finally, growth and market expansion are also very important components of strategic value creation, typically representing between 20 and 30% of the IRR (Boston Consulting Group). Indeed, when looking at specific strategic levers within the retail industry, internationalization is one of the main levers adopted by investors to grow their asset value (as seen in the case study of this Thesis). Digital strategy is also becoming a relevant topic for retail companies seeking faster growth, synergies opportunities and to pursue an omni-channel strategy (Deloitte Private Equity and Investors Survey 2019).

Corporate Governance

Governance levers are focused on changing the organizational and administrative structure. Although not having a direct effect on the bottom line, they support value creation through the three previously described financial, operating and strategic levers. Governance levers can be divided in two main categories related to: (i) reduction of agency costs, (ii) mentoring.

The most distinguished value creation driver in buyouts is the reduction of agency costs (Wrights, 2001), which can be achieved through two main sub-drivers. Firstly, through the high level of debt used in many buyouts, which plays an important role in forcing managers to efficiently run the company to avoid default. It reduces managers discretion over corporate expenditures and limits possible non-value maximizing behaviour, hence reducing risk-taking, as presented before. Several empirical studies have shown that, indeed, expenditures decline following a leveraged buyout (Bull & Kaplan,1989). Another positive effect of debt is the extra governance from financial lenders, which have strong incentives to monitor the actions of the management to ensure its debt is repaid. In this context, debt covenants and repayment conditions act as a sort of operating budget to which management is tied (Baker & Wruck,1989).

Secondly, through the increase in incentive alignments between manager and shareholders through what is known as a carrot and stick mechanism. Buyout firms provide incentives (the "carrot") in order to align the interest of all parties involved and to reduce the agency conflict after the buyout. Managers are encouraged or forced to lock a part of their capital into the company (the "stick") and increase their share in equity ownership of the company to a significant level. This change in status from managers to co-owners increases their stake in any value-increasing or decreasing action and therefore incentivises them to look for efficiency gains and intelligent strategic moves. In this context, buyouts also incorporate monitoring and controlling mechanisms to further increase the possibility of reducing the agency costs.

Another frequent lever associated to the PE industry is the parenting advantage it provides by implementing common services in monitoring, mentoring and learning. Thanks to this, portfolio companies can benefit from open and direct interaction between their managers and their counterparts in buyout firms as well as from the interaction with the network of contacts in various industries and especially in the financial and consulting markets typical from PE funds. This parenting effect also affects corporate culture. Indeed, several researches have also reported on a change in corporate culture following a buyout, especially in those pre-buyout family-owned firms. This can also contribute to the restoration of the entrepreneurial spirit, which is typically positively associated with performance improvements (Wright, 1996).

c. Measurement of value creation and returns in LBOs

After introducing the main drivers of value creation in an LBO transaction, this section will present the standard metrics used to measure them. Creation of value can be widely understood as a better outstanding situation after exiting the investment that the one in place

before the deal. Generally, this situation is purely measured in economic terms. Indeed, in the case study of this Thesis, there will be a profound study of the drivers and end result of economic value creation for the main investor (KKR Fund). Additionally, an alternative set of non-economic centred measures will be explored, with the purpose of demonstrating whether or not SMCPs buyout resulted in socially related benefits such as compensation increases, employment levels or personnel training.

Company

At the company level, although there is not a clearly defined way to asses value for the firm, one of the most accepted theoretical measures is the Return on Capital Employed (ROCE) and its spread with the Weighted Average Cost of Capital (WACC). The rationale is that for a company to create value, it must generate more return than the cost of doing business, or alternatively, the required minimum return perceived by its investor base. The ROCE does indeed measure the operational profit the company is able to extract from the investing in its assets given all of its capital providers (both shareholders and creditors), while WACC expresses the cost of capturing this capital, or else the opportunity cost these investors incur in while providing capital to a given company.

$$ROCE = \frac{NOPAT}{Capital\ Employed}$$

$$WACC = k_e \cdot \frac{E}{D+E} + k_d \cdot (1-t) \cdot \frac{D}{D+E}$$

The ROCE-WACC approach is a very simple one but has some imperfections. On one hand, ROCE relies solely on the accounting return on all the capital base, and so it can be very vulnerable to accounting manipulations that may boost it at a company's liking. Also, it does not measure the asset's capacity to generate cash flows. As presented earlier, cash generation is as important as profitability during an LBO, given the amount of leverage being incurred and the drawing down of debt needed to accomplish the projected returns. On the other hand, a single measure of WACC makes it difficult to reflect the rapid dynamics of the capital structure an LBO faces overtime from entry to exit.

Another widely used indicator is the Economic Value Added (EVA), which is complementary to the first one and is computed as the ROCE-WACC spread multiplied by the capital employed.

$$EVA = (ROCE - WACC) \cdot Capital\ Employed$$

Both previous measures are sensitive to somewhat subjective assumptions, as the totality of the WACC computation is in fact dependant on the market's perception of the company's debt and equity risk. The WACC hence embeds every possible issue of the market's perception of the company (efficiency/inefficiency of markets, possible bubbles or overselling of the sector, emotional trading, etc.) as well as the as the obvious impossibility of pricing in "black swan" events (as it has been demonstrated recently).

Because of the latter market perception factor, it seems logical to search for a metric with the ability to measure the value of the overall company looking solely at the entry purchase price and exit value of the company's operations (or enterprise value), be it perceived by the public or private markets. This third and final measure for the company value draws apart from a perception of "intrinsic" measurement of value creation using ROCE and WACC and focuses on the willingness to pay of actual investors pre and post LBO.

<u>Shareholders, PE fund</u>

As already mentioned, returns for shareholders are typically analysed from an equity perspective. In this context, a widely used academic tool, but not used by PE funds, is to simply compute the Return on Equity (ROE) and compare it with the cost of equity. Value for shareholders is created when its return on invested equity is higher than the opportunity cost of investing in similar assets (COE). This same concept will be computed as Net Capital Gain as the main measure for value created for equity investors, in the case study of this Thesis.

$$ROE = \frac{Net\ Profit}{Equity}$$

However, when it comes to indicators used in the PE industry, the most widespread ones are the Internal Rate of Return (IRR) and Cash-on-Cash multiple (CoC). While the ROE is merely and accounting measure centred around profitability, the IRR and CoC focus on cash flow generation to the investment fund or its contributors. The IRR represents the rate of return that equals the NPV of the total cash flows to zero. On the other hand, the CoC multiple simply evaluates the ratio of inflows to outflows, not taking into account the time-value of the investment. In addition to that, the CoC multiple also excludes potential extra equity injection by the Fund into the company, as well as any intermediary proceeds. As such, the CoC multiple has little sense financially speaking, and is widely seen as a mere tool for presenting results simply or to less-sophisticated investors. The IRR is hence the most common indicator in PE (Wright, 2005). Another widely used measure, and similar to the CoC, is the Times Money (TM). This measure is very similar to the CoC in that it does not account for compounding or

any sort of time effect on the fund's cash flows. Its computation differs from CoC in that the Net Capital Gains of the equity investment are the numerator, instead of the final equity value.

$$IRR = \sum_{i=0}^{n} \frac{CF_i}{(1 + IRR)^i} = 0 \qquad CoC = \frac{Final\ Equity\ Value}{Initial\ Equity\ Value}$$

While being the standard performance measure in the PE industry, the IRR cannot be used as a sufficiently good proxy for value creation, given that it does not compare to the cost of capital or any other opportunity cost measure, and it assumes that all intermediary entry-exit cash flows are re-invested at the same IRR rate, which is highly unlikely.

Additionally, to not being an ideal value creation measure, the IRR itself is very controversial as a widely used performance metric in the industry. The mentioned reinvestment assumption is the first argument made against it. Secondly, the IRR fails to account for the cost of holding on to capital, in the form of cash or very liquid assets, that LPs incur in the time that passes between the LPA signing and the capital call. The third main argument against IRR is the different computations funds may use when aggregating the performance of all the target companies. The absence of an agreed or standard method of calculation for aggregated IRR can make the comparison between different fund's performance a challenge for prospective investors. The last issue commonly brought up in relation of the use of IRR is the absence of an agreed benchmark or common metric for comparing the resulted profit, given the difficult comparability of LBO investments to any other indexable asset class. These issues are accentuated when computing IRR for the returns of a complete fund.

In this context, there exist alternative measures that try to address the mentioned IRR issues. A rather common metric is the Modified IRR (MIRR) which addresses the reinvestment assumption supposing positive intermediate cash flows to LPs before the full exit are reinvested at the cost of capital or a broad public market benchmark. This, however, can obviously be influenced by a subjective or market dependant view on the cost of capital taken for reinvestment (similar to that presented previously on the ROCE-WACC metric proposition). Another clear advantage of the MIRR is that it accounts that costs that LPs incur in with holding uncalled capital until the investment decision is made. According to Zeisberger, Prahl & White, 2017, the MIRR effectively results in a smoothening of fund's returns, with stellar IRR being drawn down to more comprehensive and logic returns (given the issues with IRR exposed above) and with bottom performances being mildly lifted. This allows for a more accessible comparison between funds, with less outliers and a measure of more realistic returns.

$$MIRR = \left(\frac{Interim\ CF * Reinvestment\ Rate}{Initial\ Investment * Cost\ of\ Capital} \right)^{\frac{1}{n}} - 1$$

An unaddressed problem by MIRR is indeed the inconvenience of comparing it straight to another asset-class benchmark given its unique risk-return profile and the difficulty to accurately and consensually mark to market any investment, if not yet exited.

The Public Market Equivalent (PME) is an index-return type measure that has been widely used by practitioners and academics alike in the last years *(Figure 17).* The method assumes that all cash flows resulting from capital calls or interim distributions are replicated into a public market index (i.e. the S&P 500). The dollar-weighted return from the index' theoretical investments is then the PME of the fund. This measure is obviously very much influenced by the election of the benchmark in question. It is worth noting however, that most practitioners do not encourage the comparison of an individual investment or a fund to the an index, as according to Zeisberger, Prahl & White, 2017, it can oversimplify the challenges of investing in PE and can be intrinsically flawed, given the private nature of most investments and the absence of data about them.

Although the various alternative performance and value creation measures presented above can be extremely useful for specific purposes, and solving other metrics issues, the IRR, CoC and Times Money (TM) remain the standard today. In order to ensure both simplicity, comprehension and clear separation of all the value creation factors presented above and its metrics, TM will be used in the case study of this Thesis. TM will be classified into a set of simplified value-creative effects contributing to the final returns of SMCP's LBO to the KKR Fund. This strictly follows the definition and decomposition of economic value creation used by Puche, Braun and Achleitner in their paper "International Evidence of Value Creation in Private Equity Transactions", 2015, allowing for the assessment of the performance of SMCP's investment of KKR vis a vis the rest of the PE industry in a verified and already effectively proven manner.

The proposed approach uses a widely accepted methodology that divides the total value created as a percentage of total capital invested into the following four components: (i) contribution from leverage, (ii) increase in operating cash-flow (measured by increases in its EBITDA proxy), (iii) growth in the transaction multiple; and (iv) a Free Cash Flow (FCF) effect that is estimated by the reduction in net debt over the holding period. EBITDA can be further split into sales and margin contribution. For each of the four sources of value creation, both the absolute value and relative contribution to total value created will be calculated.

First of all, to separate the value created by the leverage effect, the unlevered TM can be calculated using the following formula:

$$TM_U = \frac{TM_L + r_D \cdot \left(\frac{D}{E}\right)}{1 + \frac{D}{E}}$$

The remaining value is then divided and calculated as follows:

- Multiple effect: it reflects the value attributable to the increase in the EV/EBITDA multiple from entry to exit. It is calculated by simply multiplying this change in the multiple by the entry EBITDA and is divided by the Net Capital Gains to compute its TM.

- Combo effect: it aggregates the combined effect of the EV / EBITDA multiple and EBITDA rising simultaneously between entry and exit of the LBO. It is computed multiplying the difference in EBITDA (exit-entry) and Multiple (exit-entry). This amount is later divided by the Net Capital Gains to get its TM.

- FCF effect: it captures the value created from the reduction of net debt during the holding period adjusted by dividends and capital injections. Note that this effect does not capture anything regarding the cash flow of the Company per se, but instead it captures inflows and outflows of the Fund itself. It is calculated by computing the reduction in net debt plus interim dividends, minus capital injections.

- EBITDA effect: it reflects operating improvements that result in a change in the EBITDA between entry and exit and is calculated multiplying the change in EBITDA by the entry EV/EBITDA multiple. This again is later divided by the Net Capital Gains to get its TM. The EBITDA effect can be further split into revenue growth effect, pure margin enhancement effect, and a denominated Combo 2 effect. The revenue factor reflects the value created by increases in company revenues and is calculated by multiplying the change in revenues by the entry margin and by the entry EV/EBITDA multiple. On the other hand, the margin effect reflects the value created from increases in EBITDA margin and is computed by multiplying the change in margin by the entry Revenues and by the entry EV/EBITDA multiple. The final Combo 2 factor reflects the result of both sales and margin improving simultaneously and is computed by multiplying the entry EBITDA multiple by the sales difference and margin difference

between exit and entry. All of the different factors can be later divided by the Fund's Net Capital Gains to get their respective TM equivalent.

Creditors

For the debtholders, value creation can also be defined at the debt level by the difference between the return on debt (ROD) and the cost of debt (COD). The return on debt of any creditor is the same as the cost of debt of the credited. A simplified method, based on Net Capital Gains, will be computed in order to observe the returns of the quasi-equity instrument present in the case study of this Thesis. Although this is not the most ideal of measuring a debt-holder's value creation, it indeed falls in line with the previous measuring practices (centred around TM multiples), and hence giving a common scope to the overall returns of the KKR investment Fund, as shown in Section II of this Thesis.

ESG

Value creation can also be defined at an ESG level into its three levels: environmental, governance and social, with this last one being the most common and easy to measure in an LBOs due to the lack of public and detailed information on the rest. On the environmental side, value creation can be defined based on measures such as emissions reduction (CO_2, waste, etc.), innovation (product innovation, green revenues/R&D/Capex, etc.) or efficiency increase in resource use (water, energy, environmental supply chain, use of sustainable packaging, etc.). As for governance, value creation can be computed using management measures (compensation, diversity, etc.), shareholders measures (shareholder rights, takeover defences, etc.) or simply by looking at the CSR strategy (ESG reporting, transparency, etc.).

Regarding social metrics, measures related to human rights, product responsibility, community and workforce are typically used, with this last one being, not only the most common and easy to calculate, but also the most topical and controversial within LBOs. When looking at workforce related measures, the academic literature is mostly focused on two aspects: employment growth and changes on financial remuneration. Measuring the growth of the acquired company's employment level is the most classical approach (Kaplan, 1989). To calculate the employment growth, the number of employees at entry and exit is compared to see if the target company has increased or reduced its employment level during the LBO period. On the other hand, in order to measure employee remuneration, an average salary per employee is calculated at entry and at exit based on the total costs allocated to workforce and the number of employees. This measure is easy to implement and give good proxies of changes in

remuneration for employees. Finally, employee trainings and money spend on them are also good measures of employee value creation. In the case study of this Thesis, all publicly available information on this issues has permitted a detailed computation of absolute and relative measures regarding employment growth and density, gender ratios and leadership, employees remuneration, and employee training.

4. COVID-19 implications

a. For the retail/apparel industry

Retail is one of the sectors most affected by the COVID-19, in both positive and negative ways. While groceries, pharmacies and e-commerce marketplaces have sustained consumer access to essentials such as food, hygiene or medications, store closures and sharp declines in discretionary consumer spending have harmed nonessential retail such as other non-food, apparel, fashion and luxury products. Indeed, after travel and tourism, the AF&L [25]industry has been the most negatively impacted of all consumer goods and services, with worldwide sales decreasing by 40-60% from February to March.

Figure 45: U.S. monthly retail sales development during coronavirus outbreak 2020 by sector, February 2020 - March 2020 (%)

Category	%
Total retail	-8.70%
Clothing & accesories	-50.50%
Furniture & home furniture	-26.80%
Motor vehicle & parts dealers	-25.60%
Sporting goods, hobby & books	-23.30%
Gasoline stations	-17.20%
Electronics & appliances	-15.10%
Building material & garden equipment	1.30%
Health & personal care	4.30%
General mechandise	6.40%
Food & beverage	25.60%
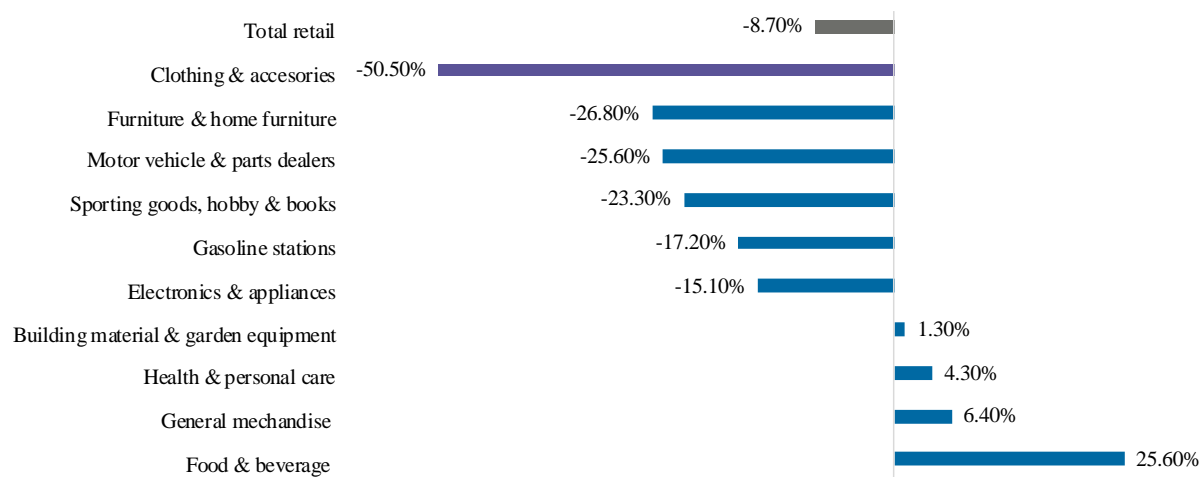
Source: Statista

Subsequently, cash preservation and liquidity have become top priorities among all fashion companies. Current response measures include cost reductions, employee layoffs, working capital optimization and sales pushes (with some companies massively clearing their inventories with discount strategies or emphasizing online sales). Consequently, manufacturers are facing cancellations of orders, which is already causing devastating ripple effects,

[25] AF&L = Apparel, Fashion.& Luxury

especially given that the growth of textile and garment manufacturing sectors plays a fundamental role in the economic maturation of countries under development.

When looking into the future, according to McKinsey & Company global survey of consumer sentiment during the coronavirus crisis, it is expected the impact of the crisis on consumer behaviour to create/accelerate impactful trends for the retail sector.

First, a clear shift to online and digital purchasing is awaited. Due to shelter in-place orders being proliferated and extended, and consumers becoming more anxious about potential infections, customers across age groups have already shifted to online channels. While this shift is noticeable in grocery and other essential categories, the cannel shift within apparel, fashion and luxury retailers has not come close to compensate the lost brick-and-mortar sales. In this context, driving unique in-store experiences will play an even more important role than it has played in the past, in order to further drive traffic, facilitate the omni-channel expedience and improve profitability. Overall, the longer the crisis last, the greater the likelihood of online omnichannel purchasing becoming the next normal.

In addition, as in any economic downturn, the post COVID-19 crisis downturn will probably decrease consumer spending and lead consumers to demand value for money across all retail sectors, i.e. shift to value for money. Retailers will therefore need to adapt through prices and promotion strategies that emphasize value.

Finally, while before the COVID-19 it was observed that the retail sector did not see as much M&A activity as other sectors do, the changes in consumer spending across channels as well as persistent concerns about health and safety, and despite the weaker economic outlook, retail M&A is expected to accelerate as the crisis stabilizes (similar to what has happened in previous recessions such as the 2008 financial crisis). Consolidation of smaller players, acquisition of new business models, and capability tuck-ins are likely to increase in the new COVID-19 context. However, not all retailers will be equipped to pursue M&A. The most likely to engage in deal activity will be the leading ecosystems and larger FD&M companies with strong e-commerce positions that focus on essentials or well-performing brands, which play in subsectors less affected by the crisis, and at the same time enjoy some combination of relatively low financial leverage, access to investment-grade debt, and a cash-heavy balance sheet. Private equity may also play a key role in accelerating M&A activity post-crisis, with the already mentioned $1.5tn in dry powder at the beginning of 2020.

b. For the PE industry

In the case of the PE industry, the current situation can be seen as a double-edged sword. On the one hand, since the start of the shutdown, credit downgrades due to cash flow freeze caused by the shock have been daily routine for credit rating agencies. This has been a huge blow for PE-backed companies, which as presented in the PE environment point of Section I of this Thesis, already walked into this crisis with excessive amounts of leverage. This logically complicates these companies' prospects of refinancing the already high levels of debt. In fact, in the U.S, two thirds of all companies downgraded to the lowest ratings are backed by PE firms (with special damage in those of fund vintages 2016-2018). This has obviously caused PE executives and fund managers to focus on the survival of their portfolio companies. Since the early days of the shutdowns, all hands have been on deck to secure credit lines to ensure, at least, the survival of the fittest companies, to hopefully maintain returns if a recovery is to come, and they manage to keep invested. This, however, is obviously accompanied by spreading credit risks (specially for the junk-rated companies) and controversy around the search for cheaper financing. Across countries and industries, as all other companies are doing, PE-backed enterprises have been tapping all the possible government aid packages, which offer lending at much lower rates, or in some cases, even grant capital. Helping PE portfolio companies considered to have been overleveraged in the past is, to say the least, at issue with a great part of the population. It is hence not preferable for politicians seeking to damage their image at least as possible during these turbulent times. Consequently, lobbying by private capital-linked personalities has not always given the expected cheap-financing results. In countries like Spain and UK, some PE-backed companies have had access to most government programs, although they are not as aggressive as those put in place in the U.S (where access by PE-backed companies has been more limited), especially in southern Europe. In the short run, this continuing struggle will result in the survival of the better capitalized portfolio companies going into 2020. In upcoming years, the last years vintages' returns will be surely damaged, and only deliverable for those who managed to stay invested and wait for the recovery to exit.

On the other hand, every crisis comes with new opportunities. As already mentioned, record levels of dry powder will come useful in a prospect of economic rebound and consolidation in many industries, meaning a generalised acceleration in M&A activity worldwide could well be underway. Nevertheless, this rebound is for now pure hypothesis. This generalisation of higher activity will largely depend on the much-commented shape of the recovery (V, U, Z…), its intensity and its time-to-peak. For now, recent market volatility and cheaper prices (at present going up again) have been difficult to take advantage of, given the extreme deal-financing

conditions for PE or any other dealmaker. The Federal Reserve has acted swiftly to ensure bond markets functioning, ensuring purchase of securities for the even so called "fallen angels" (recently downgraded to junk status). Lower rated bonds, however, are not supported. While the "bazooka" methods have somewhat steadied financing for fortress-balance sheet and strong businesses, this is usually not the case for a potential PE target. Additionally, some investors and politicians argue that the Federal Reserve has much surpassed its mandate in buying the mentioned type of corporate bonds. As said, debt markets still function in a somewhat decent manner, at least for now. The worrisome scenario for PE companies' deal financing (and short-term portfolio refinancing) is a prolonged depression, which would start to wear down monetary and fiscal policy effects. This has already been the case for major policies of the ECB in Europe, consequently making any grim scenario for a proper debt market functioning outside a state's program even more serious in this region. Again, the capital deployment and risk returns-profile of the PE industry going forward will largely depend on the mentioned shape and grade of the recovery, market conditions associated with it, potential monetary and fiscal policy effectiveness, and other assistance of central governments.

In the lines of the arguments above, the main PE activities have also been altered. Deal making continues active, although it seems as only transactions which were very advanced pre-crisis are being closed (KKR purchase of Virider for $5bn (EV), and Wella and Clairol for $4.3bn (EV), or Vista Equity Partners 2.3% stake bet on Reliance Industries for $1.5bn). Fund-raising, on the other hand, is mainly halted, with on the rise vintages' runaway being extended (such as the $15bn target new EQT fund) or expected to extend in the coming weeks.

In the meantime, PE firms with large lending arms (Ares, Apollo, KKR, Blackstone or Carlyle) can still seek returns, as well as fulfilling an essential social purpose. The credit conditions outlined above has banks and traditional lenders being cautious on credit allocations. Reports even point to a partial (and logical) retreat of major lenders in the most troubled companies of Europe. This represents a great opportunity for the mentioned lending arms of PE companies, which have been gaining market share in direct lending in recent years. It does not only provide a possible source of profits (if invested cautiously) away from their traditional PE operations. As seen, troubled companies will struggle to hold on to decent refinancing conditions for the foreseeable future. That means that weaker balance sheet companies, large and small, who will surely need more than present government' aid, can only turn to these funds for comfort. This will be surely met with cries that PE firms undergo vulture-type attitude and investment

proposals. But indeed, these firms are lending and will continue to lend to businesses that nor government, central banks, or even traditional banks, are willing to risk a penny on.

In this line, it is very probable that if this type of credit investment propositions manages to return decent rates, PE firms look to diversify deployable funds to refocus on these activities. This will surely be the case for mega fund firms or firms with already prominent lending arms. All in all, as any other industry, whether in traditional buyouts or direct lending, PE firms will have to pivot their target search to businesses more prepared for the post COVID-19 world (work from home and social distancing adapted, healthcare providers, etc.) while probably entering deals with lower leverage levels than in recent years.

SECTION II - THE SMCP CASE STUDY

The second and last part of this Thesis focuses on the analysis and application of the value creation framework on a real case deal. In particular, the buyout of SMCP by KKR is analysed. The investment started in 2013 and was exited in 2016 and 2017, with a sale to a strategic and a sale of the remaining minority stake through an IPO, respectively.

Firstly, the SMCP Group is introduced, followed by a non-exhaustive due diligence as of 2012 (pre-LBO level), analysing the company at both financially and strategically while identifying the main risk factors of a potential investment. Additionally, a prospect LBO analysis is carried out to explore the viability of the investment at its entry date, under three potential scenarios. This model aims at replicating the expected returns that KKR could have awaited in the moment of acquisition, and hence simulating that the writers of this Thesis were part of the KKR fund investment team.

After detailing and describing the entry process and both of the exit methods (sale to strategic and IPO), this section then focuses on analysing the real returns and value created to the different stakeholders of the SMCP-KKR buyout. A series of limitations and hypothesis, conditional of the analysis, are previously outlined for both computation of returns and value creation.

Once returns to the different stakeholders have been presented, this Section then engages at exploring the central matter of this Thesis: to break down and quantify the value creation of the buyout to the invested Fund by KKR. This is complemented with an intensive strategic rationale and presentation of the drivers responsible for such value creation. This real deal analysis ends in a comparison of the different value-creative metrics and their relative importance with other several LBOs, in accordance with empirical studies currently in literature.

Closing this second part of the Thesis, the social value created during the LBO period, especially at employee level, is studied.

5. Preliminary and pre-LBO analysis

a. SMCP overview

SMCP is a Paris-based apparel group that designs and distributes fashion apparel and, to a minor extent, footwear and related accessories, mainly for women (>90% of 2012 revenues) but also for men. The Group designs, markets and sells its products under three brands: Sandro, Maje and Claudie Pierlot. The company is focused on affordable premium fashion (high quality and on-trend products at a discount vs luxury market) and operates through its own stores (including its Suite 341 multi-brand outlet), as well as concessions in upmarket department stores.

History and changing ownership

Sandro and Maje, were founded in 1984 and 1998 respectively by sisters Evelyne Chétrite and Judith Milgrom. While initially distributed primarily via the wholesale channel, they switched to retail pure player in the early 2000s, opening its first store in 2003 in Paris.

In 2007, former managers of Comptoir des Cotonniers, invested c. €11.16m (25% stake) in the Group to help develop the company further, extending the Group's offering, supporting the establishment of Sandro Homme in 2007 and acquiring Claudie Pierlot in 2009.

In 2010 private equity firm Florac (investment vehicle for the Meyer family) and L Capital (investment vehicle of LVMH) founded the SMCP Group, acquiring 51% stake for c. €112mm, with the rest being held by the founders and the managers. In the following two years, the Group started a professionalization phase, strengthening the management team and adding dedicated brand directors. L Capital and Florac also supported SMCP's first expansion into the US and Asia.

Figure 46: SMCP's history
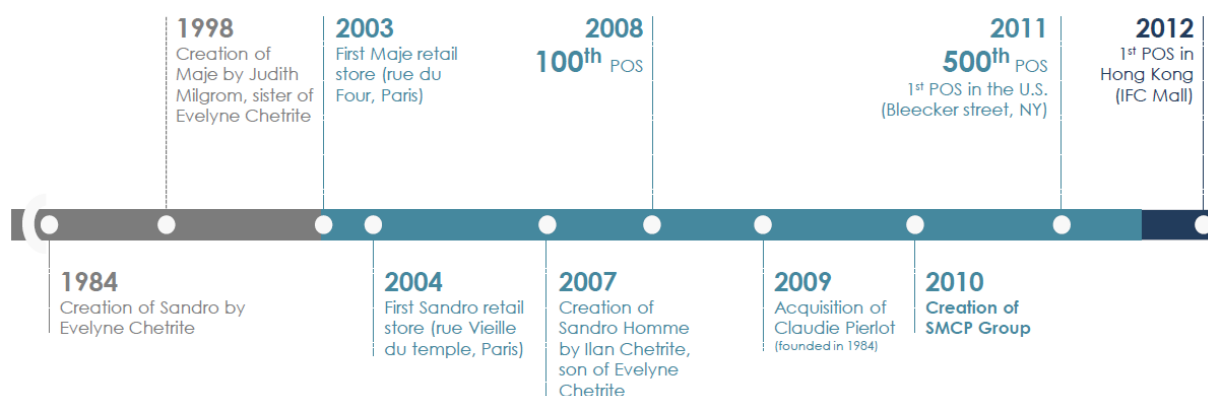
Source: Company reports

Key Financials

As of 2012, the Group has net sales of €339mm, an Adjusted EBITDA of €59.5mm and an EBITDA margin of 17.6%. Within brands, Sandro accounts for most of the revenues, followed by Maje, Claudie Pierlot and Suite 341. Geographically, France represents almost two thirds of the sales, followed by the rest of Europe and North America. Presence in Asia is still almost non-existent. Finally, in terms of channels, although the group launched online platforms in France and the US in 2010 and 2011, respectively, most of the sales still come from physical stores, with online sales currently accounting for only around 2% of sales.

Figure 47: SMCP's sales breakdown by brand, geography and channel, 2012
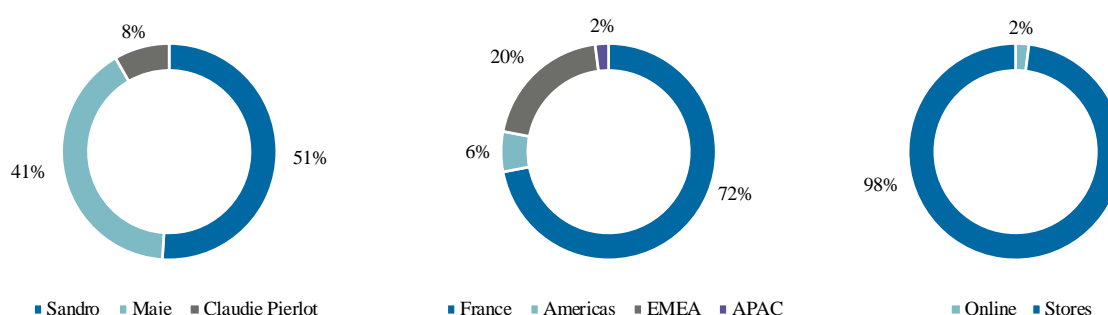
Source: SG Cross Asset Research/Credit

SMCP's revenues and earnings have grown rapidly (at double digit) over the past two years on the back of expansion under the management of Florac and L capital. As shown in the Figure below, in 2012, SMCP's net sales have risen 30.6% to €339mm and EBITDA 36.2% to €59.5mm.

Figure 48: Sales and gross margin, 2011-2012[26]

Fiscal year	2011	2012
Revenue	**259.6**	**339.0**
% growth		*30.6%*
Commissions	(38.9)	(58.0)
% of revenue	*15.0%*	*17.1%*
COGS	(71.4)	(83.0)
% of revenue	*27.5%*	*24.5%*
Gross Profit	**149.3**	**198.0**
gross margin (% of revenue)	*57.5%*	*58.4%*
SG&A	(105.6)	(138.5)
% of revenue	*40.7%*	*40.9%*
Adj. EBITDA	**43.7**	**59.5**
% growth		*36.2%*
% of revenue	*16.8%*	*17.6%*

Source: SG Cross Asset Research/Credit

[26] Due to the lack of detailed financial information, assumptions on FY 2011 include fixed commissions as % of sales of 15%, COGS of 27.5%, tax rate of 33.33% and a depreciation of 70% of CAPEX.

Main growth drivers have been international expansion (opening of first store in the US and Asia in 2010 and 2011 respectively), development of e-commerce and further product diversification into menswear and accessories segments.

In terms of profitability, despite a lower ASP[27] vs luxury, no licenses and a higher level of discounting vs. luxury and best-in-class fast fashion retail, SMCP's gross margin is one of the best in the sector. One of the key reasons for such high profitability is the pure retail model, vs on average 25-30% of luxury sales generated in wholesale (hence not capturing the retail mark-up). However, despite one of the highest gross margins in the market and high sales densities, SMCP has an EBITDA margin broadly in line with mass market retailers and below the luxury goods average. In other words, SMCP opex[28] as % of total sales are much higher than that of peers. We believe the key reason for such a higher opex is SMCP's high exposure to concessions (vs usually a shop in shop model for luxury RTW[29] companies) and affiliates, which comes with very high fees. In fact, commissions represent 17% of the group's net sales as of 2012.

Finally, the leverage profile of the Group is indeed high, as it is amidst a (1st) LBO. As of 2012, SMCP has an adjusted net debt of €357.6mm compared to €305.4mm the prior year. The company's leverage ratios, though, see a clear downward tendency, with both adjusted net debt to EBITDA and senior net debt to EBITDA decreasing *(Figure 48)*. Additionally, the fixed charge coverage ratio shows an upward trend, up from 1.61x to 2.07x. This indicates a broader earnings coverage of the Group's leases, rental and interest expenses, which are mainly on the note raised by Florac and L capital to finance the acquisition in 2010. In addition to the usual seasonal factors, the group is also exposed to financial pressures coming principally from high working capital and capex needs to fund the high growth rate. The Group is currently absorbing €10-15mm pa to meet its working capital requirements, with capex[30] of c.10% of sales, currently running around €40mm above depreciation. Also, dividends distributed in the years 2011 and 2012 have been nearly non-existent.

[27] Average Selling Price
[28] Operational Expenses
[29] Ready to Wear
[30] Capital Expenditures

Figure 49: Summary Financials and Leverage metrics (€mm) (%)[31]
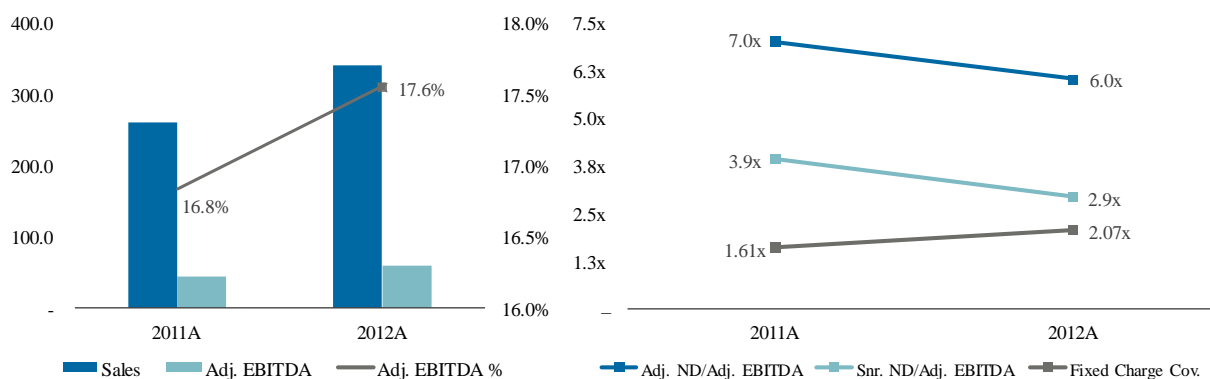
Source: Société Générale Cross Asset Research / Credit and Equity

Complementary and well-established brands

As already mentioned, the SMCP group consists of three brands: Sandro, Maje and Claudie Pierlot. All three brands target the broader apparel and accessories market and are directed towards on-trend and high-quality products at affordable price points. While each brand is run completely separately, with its own in-house creative studio and respective artistic director, as well as sourcing and retail teams, they share many common features. All three brands are based in Paris and take inspiration from the themes of Parisian chic and "joie de vivre". Each brand, though, has its own style, unique identity and key loyalty categories: contemporary, sleek, sophisticated dresses, lace, tailoring and coats at Sandro; bohemian, lace and embroidery, technical innovative materials, creative knitwear and leather at Maje; romantic, feminine, navy colour, Claudine neckline, Parisian touch and bows at Claudie Pierlot. These distinct identities make the brands complementary, as they each address a customer base with a different mindset. Indeed, only 15% of SMCP's customers are common to at least two of the Group's brands.

[31] Due to the lack of detailed financial information, assumptions on FY 2011 include fixed commissions as % of sales of 15%, COGS of 27.5%, tax rate of 33.33% and a depreciation of 70% of CAPEX.

Figure 50: SMCP retail brands comparison

	sandro PARIS	maje	CLAUDIE PIERLOT
Founded	1984	1998	1984
% Revenues 2012	49%	39%	11%
Avg. price point	€210	€205	€192
POS	287	228	82
Style	Contemporary, sleek	Bohemian	Romantic, Feminine
Loyalty categories	Sophisticated dresses, lace, tailoring, coats	Lace and embroidery, innovative materials	Navy colour, Claudine neckline, bows
Men's line	Yes	No	No

Source: Company reports

Price positioning: Affordable luxury market

SMCP Group is positioned in the "accessible luxury" or "affordable luxury" market. This market segment was launched in the US in the 1990s by two brands, Marc Jacobs and Theory, and covers products priced at between €100 and €1,000. The affordable luxury market forms over a third of the luxury market as a whole and is essentially defined by price point rather than product. It is already a sizeable addressable market, both in already developed and developing regions (notably China) and is expected to grow at a faster pace than the rest of the luxury sector. Also, since it is a relatively new segment, there is still no clear global leader as of 2012, with SMCP directly competing with strongly branded luxury groups (LVMH, Kering, Prada and Burberry, among others), as well as high street chains, online luxury specialists and many local and smaller brands. Finally, the fact that within luxury, the French market is regarded as one of several trends' setters, provides SMCP with a competitive edge internationally.

Figure 51: Average entry price for A/W dress comparison
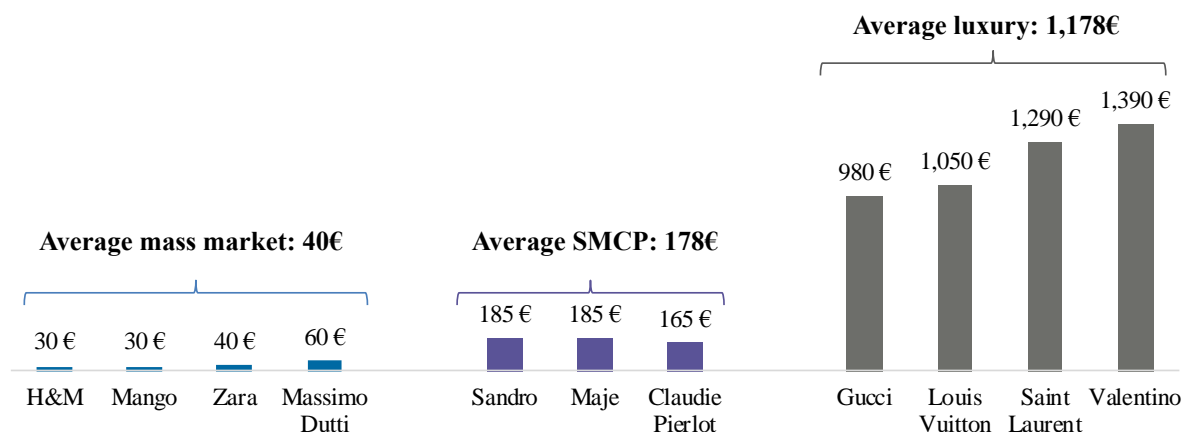
Source: J.P. Morgan estimates, Company data for Autumn/Winter collections (French prices)

Although SMCP's price point is closer to the mass market than luxury (4.5x delta vs 6.6x delta in *Figure 48*), the group is closer to the luxury industry in several ways:

- **In-house creative studios fully internalized for each brand:** SMCP'S in-house creative capabilities are led by independent artistic directors for each brand and supported by experienced teams of designers, stylists and modelers based in their own studios located in Paris.

- **High-end image through a dedicated communication strategy:** SMCP follows a strategy for its brands that projects a high-end image through communication campaigns supported by well-known photographers, models and influencers for each collection. Additionally, the communication campaigns of each brand are presented on multiple media, including photo shoots and films, events and announcements, billboard, collaborations, advertisements in the press and digital initiatives.

- **Global footprint with high-quality locations in key fashion capitals:** As of 2012, the company has a global network of 454 points of sale located in major fashion capitals (including Paris, Los Angeles, London, New York, Hong Kong and Milan). The Group's retail stores are often located in premium high-street locations such as Avenue des Champs-Elysées in Paris, in commercial thoroughfares such as Soho in New York or Paseo de Gracia in Barcelona, and leading positions in prestigious department stores such as Galeries Lafayette in France and Harrods in the UK.

- **Enhanced customer experience and personalized service:** SMCP puts a lot of emphasis on developing strong personal connections with its customers through personalized service by its carefully selected, trained and passionate about fashion sales assistants. To further enhance this personal relationship, there is only one size per item on display and no mirrors in the fitting rooms, encouraging dialogue with the sales assistants, who offer styling advice and act as brand ambassadors.

Pure retail model

At SMCP, there is no selling via wholesale whatsoever. The Group operates as a retail pure player, with full control over its distribution, a model that enables them to manage its routes to market (product and pricing) and the overall customer experience. With almost 100% revenues generated through its own retail network as of 2012, which includes free-standing stores,

concessions (corners) in prestigious department stores and e-commerce websites, we believe SMCP to be closer to the best-in-class luxury companies, as for most of the peers the wholesale channel remains an important channel for distribution. Even online, SMCP has a very small exposure to wholesale multi-brand platforms, preferring partners that allow the Group to run digital operations and fulfil orders directly (e.g. Harrods.com, Zalando Premium).

Figure 52: Retail sales as % of total, 2012
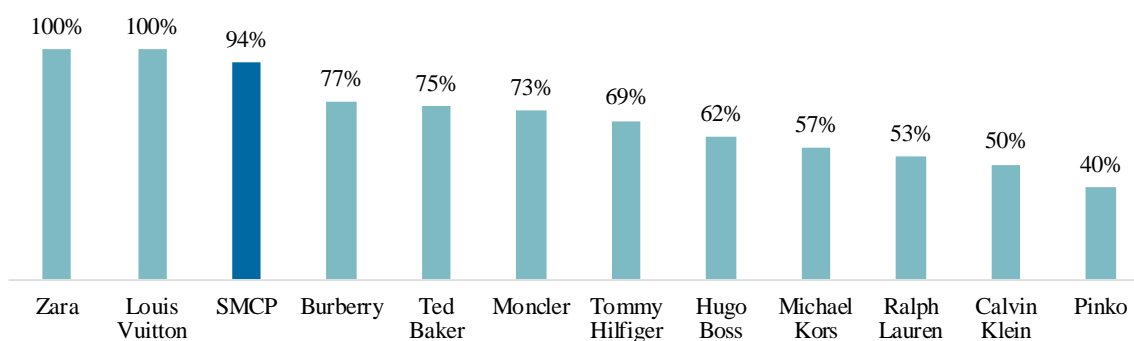
Source: Company data based on third party data, J.P. Morgan

The benefits from running a pure retail model are far reaching, as they enable SMCP to:

1) Maintain direct and full control over the brand image and customer experience, key priorities for SMCP to maintain legitimacy in the premium fashion segment.

2) Keep direct control over pricing and commercial policies, including maintaining a diligent approach to stock management and promotional activity (the lack of a wholesale channel makes this easier, with no risk of third parties quickly moving to an aggressive promotional strategy which would negatively impact retail sales, whilst also damaging brand equity).

3) Design late into the season. At SMCP, both collections at each brand are worked on by the creative team right up until the first drops in store; for instance, the Fall/Winter collection could be worked on up until April, with the first drops beginning in May and running through the summer. A retail- only model extends the time available to finalise collections and so allows the teams to incorporate the latest fashion trends into new products, thereby helping on the all-important newness front (and for the same reasons, the retail model allows for a fast replenishment of best sellers).

4) Lastly, a retail only model provides a significant advantage on omni- channel execution, potentially achieving full integration between the online and offline platforms.

Fast and agile product cycle

SMCP blends the codes and methods of fast fashion. The Group's in-house design, sourcing and procurement processes are highly coordinated allowing delivery of new products to stores within 100 to 120 days as of 2012. This production model is significantly shorter than traditional luxury companies (8 months), and more similar to the one of fast fashion brands such as Inditex, which have a very short (35 to 40 days) period between creation and production ("design to store").

Figure 54: Number of collections per year
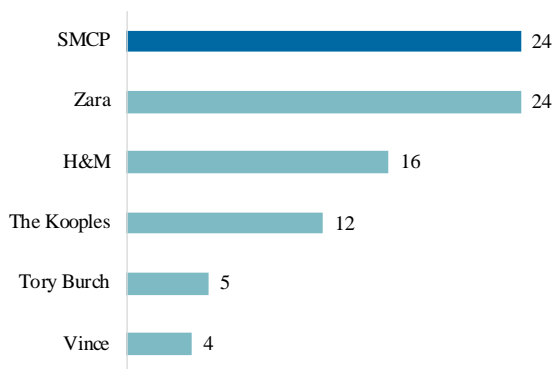
Figure 53: Average number of days between design and store availability

SMCP	24
Zara	24
H&M	16
The Kooples	12
Tory Burch	5
Vince	4

Luxury	270
Accessible luxury	135-365
SMCP	100-120
Zara	35-40

Source: Company reports
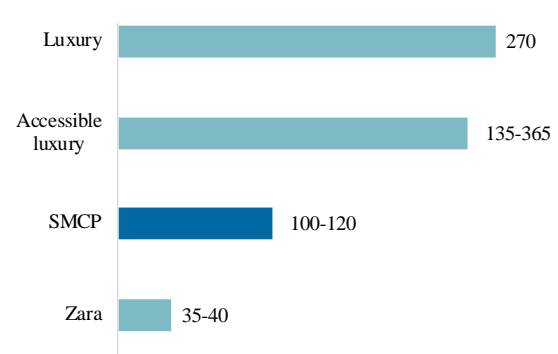
The fast product cycle can be achieved thanks to the Group's agile sourcing and diversified supplier and manufacturer base, which provides a highly flexible design and production calendar. The Group operates through a diversified base of more than 240 suppliers, with the 10 largest suppliers representing roughly one-third of the total supply. Additionally, to improve reactivity, SMCP ensures sourcing is well balanced geographically between short and longer lead-time sources. As of 2012, approximately 70% of the Group production has short lead times and is based in Europe and North Africa, particularly in Portugal, Italy, Spain, Eastern Europe, Tunisia and Turkey. The longer lead times cover the remaining 30% of manufacturing and sourcing costs, with sourcing from Asia Pacific (the most important countries being China, India and Vietnam).

To shorten productions times and ensure fast replenishments of best sellers, SMCP sources a mix of finished (54%) and "cut & make" products (46%), whereby it outsources the manufacturing of the garment but supplies the pattern (done internally) and purchases the fabrics. This is the same model employed by Inditex, i.e. holding fabric inventory ahead of design.

The Group's operating model benefits from a fully integrated global platform and supply chain. Its IT systems operate across all its brands, facilitating replenishment and inventory management, as well as allowing the Group to measure store performance and integrate best practices across its retail network. Furthermore, all three brands share the same European distribution centre, which consists of one large warehouse near Charles de Gaulle airport in Paris. In North America, distribution is subcontracted out, with one warehouse in use in New Jersey. This enables the Group to replenish stocks in less than two days in Europe and within four days in North America, therefore maintaining low inventories in its stores and optimize dedicated sales space.

Overall, the agile product cycle allows SMCP to develop new creations all year long. Each SMCP brand launches two main collections per year, each of them divided into 12 drops in stores, with 25 new products coming to stores every week (out of the 450-500 SKUs[32] designed per collection). Effectively, this means that, every week, 5% of the offering products are refreshed with new ones, similar to category killers such as Zara or Asos and well above most retail and luxury companies.

b. Risk factors

The main and most important, specific, risks that investors (KKR in this case) should consider at investment date (2013) are:

- **Competition risk:** As already mentioned, fashion retail is a highly fragmented and competitive industry, even if SMCP's "affordable luxury" concepts operate in a relatively under-served, fast-growing niche. While recent trends have seen customers opting to trade down from luxury to accessible luxury, or up from the mass market to accessible luxury, it is possible in the future (and also while executing the LBO) that one or both of these trends could slowly reverse. The growth of online retail in all countries implies that all markets are open to a much wider competitive set than was historically the case.

- **Macro risk:** In general, demand in consumer goods (apparel in this case) is linked to macroeconomic conditions in the countries where the Group operates, particularly in France, where the Group has generated 70% of its revenues in 2012. Demand for

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[32] Stock-keeping unit

SMCP's products could be negatively impacted by adverse economic conditions influencing consumer spending or the growth of tourism, which accounts for around 12% of SMCP sales (2012).

- **Fashion risk:** The success of the Group depends on its ability to identify fashion trends, evaluate and react rapidly to changing consumer demands and to translate market trends into appropriate product offerings. The fashion sector is generally characterized by rapidly changing preferences and trends. If the collections offered by the Group fail to respond to consumer preferences, or if consumers would simply rather spend money on other kinds of products, the Group sales could fall along with its profitability and cash generation.

- **Production costs risk:** The raw materials used to manufacture products sold by the Group (mainly cotton, leather, wool, silk and polyester) are subject to availability constraints and price volatility caused by factors such as strong demand for fabrics, political and economic situation in producer countries (particularly in North Africa and Asia), delivery conditions, applicable regulations and other factors beyond the Group's control. In addition, other factors may have a general impact on production costs, such as regulatory changes and salary increases in the regions in which the Group operates, changes in shipping costs, customs legislation, quality requirements, the cost of energy or currency exchange rates.

- **Third-party risk:** SMCP does not own and does not operate any manufacturing plants and consequently it is wholly dependent on third parties to manufacture its products. Production by third-party manufacturers could be disrupted or delayed, temporarily or permanently, because of economic, social or technical problems beyond the Group's control, or could simply not comply with the relevant specifications and quality standards. In addition, and although the company distributes via free-standing stores and concessions, it also operates through a network of local partners internationally and through affiliates in France and Southern Europe. SMCP cannot guarantee that its selected external distribution partners will strictly comply with the Group policies and strategies on distribution, marketing and communication or with the implementation of management and/or sales methods, which could have a negative impact on SMCP's brand and product image, as well as its results. Furthermore, the Group also outsources certain logistics and operational processes to external service providers (including its warehouse located in New Jersey), and hence third-party risks also include logistics.

Finally, all the mentioned above is also applicable to compliance requirements, as the Group cannot guarantee that its suppliers or manufacturers will comply with local labour law or with environmental and ethical standards in the course of their activities.

▪ **Counterfeiting risk:** The apparel and accessories retail market is subject to extensive counterfeiting. SCMP's brands are highly recognizable to consumers and its intellectual rights maybe be the subject of counterfeiting, such as the production of unauthorized imitations, particularly in new markets, like China. A significant presence of such counterfeit products on the market could have a negative impact on its value and image.

▪ **Management risk:** SMCP's success and its future growth depend especially on the results of its senior management and the creative/design team. In the event of the departure or an incident affecting one or more of these executives and key personnel, the Group may not be able to replace them quickly, which could have a material adverse effect on the Group's business, financial condition, results of operations, development and prospects. This risk is especially accentuated in the respective creative departments of Sandro and Maje, which are led by the founders of both brands and are perceived as crucial for its overall well-functioning.

▪ **Online risk:** The Group has recently started investing in marketing and communication in respect of its e- commerce platforms and anticipates further expansion of its online offers in the future (as of 2012). Considering that the e-commerce market is characterized by rapid technological change, there is a risk that department stores could lose their appeal for consumers faster than SMCP can develop its online business, keeping in mind that online represents 2% of sales for SMCP, while 98% is brick-and-mortar based (2012). Additionally, pure online retailers could become more powerful and aggressive within SMCP's space. There is also the risk that multi-channel retailers such as SMCP may be required to invest more heavily in the future in online platforms, for example in websites, apps, personalisation, big data / data science, logistics technology, service (e.g. faster free delivery to customers, ultra-convenient free returns), call centres and/or online help centres, as the online channel grows in importance. Finally, there is also a price alignment risk intrinsic to the online channel. Given SMCP's current strategy of growing it, it is important to take into consideration that the visibility of prices online enables greater transparency between countries, whereas SMCP currently has different pricing for the same products between countries.

The current price index is France = 100, UK =120, US =135, Hong Kong =145 and China =150.

Other more general risks include legal risks (intellectual property rights, regulations, proceedings and litigations, insurance or taxes and changes in tax legislation, etc.) and financial risks (liquidity, interest rates, credit and/or counterparty risk, exchange rates).

c. Expected returns

With the purpose of exploring an investment case for SMCP as of 2012-2013, a complete "hypothetical" LBO model has been constructed. This model aims at replicating the expected returns that KKR could have awaited in the moment of acquisition, and hence simulating that the writers of this Thesis were part of the KKR fund investment team.

To those means, only data that would have been available at purchase date has been used, with all other projections and assumptions intended to be as reasonable as possible given available historical financials and strategic guidance and analysis, as explained below.

Investment Vehicle and Legal Structure

KKR has since 1999 raised separate and dedicated investment vehicles in the Buyout/Corporate PE category in Europe. In the case of SMCP, the investment was carried out through the firm's newest KKR European Fund III (vintage 2008 and size $6.79bn or €4.61bn)[33][34], which is still today active[35] and with an investment thesis focused in Central, Eastern and Western Europe and a variety of sectors. Vintages and details on other KKR European vehicles can be found in Appendices *(A 1)*. KKR European Fund III has a considerably concentrated investor profile. With 15 registered Limited Partners, over two thirds of all investors are American and around 60% are registered as Public Pension Funds. This highlights KKR dependence in American investors even when investing abroad (more fund details can be found in Appendices *(A 2))*.

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[33] Surpassing its fund target size of $6.0bn.
[34] Based on an average $/€ 2008 rate of 1.47
[35] According to Private Equity International

Figure 55: Limited Partners KKR European Fund III distribution (%)

US   Switzerland   Canada   Kuwait   Finland

Investment Firm   Public Pension Fund
Insurance Company   Government Related Investment
Foundation/Endowment   Independent Firm (PE)
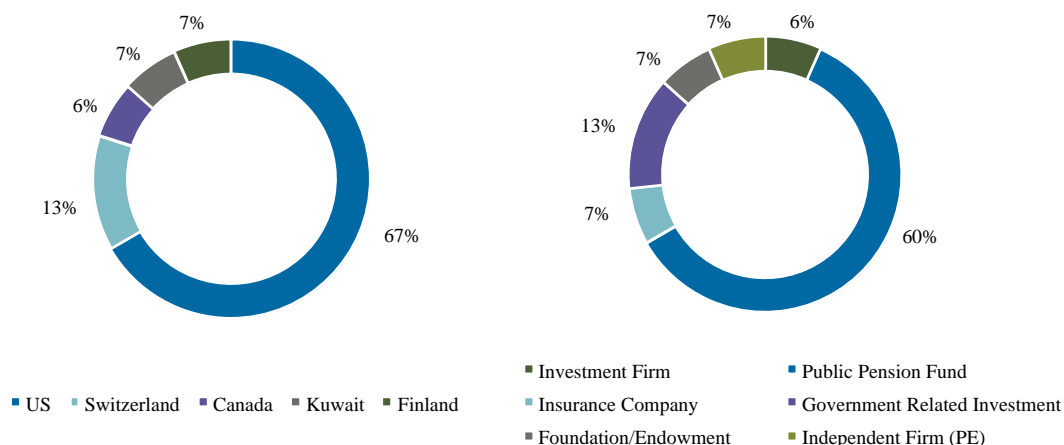
Source: Private Equity International

As for the legal structure of SMCP's investment, the fund formed new societies under the umbrella of KKR Retail Partners, in accordance with the structure below. Parental guarantors of all debt issued (explored in the next points) and the restricted group for covenant compliance and other legal requirements were based in Luxembourg.

Figure 56: SMCP Acquisition and Financing legal structure
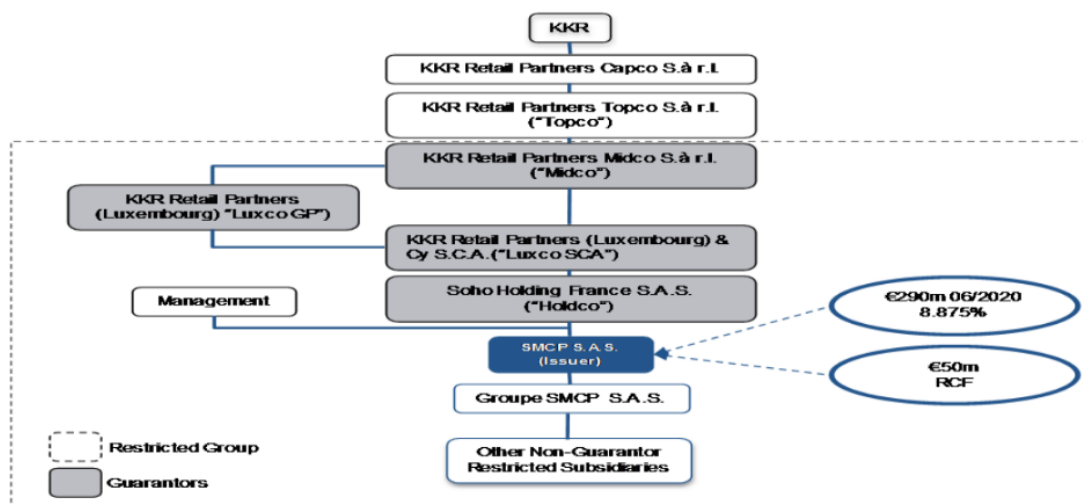
Source: Société Générale Cross Asset Research / Credit

For simplicity purposes and given that exploring the mentioned LBO prospect is not central to this Thesis, advantages due to this legal structure have not been explored when modelling. Consequently, approximate estimated prospect returns might be deemed slightly lower than those expected by KKR, given that benefits such as tax shield consolidation have not been taken into account.

Entry and Debt prospects

Entry details and debt specifications have been considered known for modelling purposes. After all, these details would have been available to the investment team in the final bidding and binding round before the agreed purchase in April 2013 (finalised in June 2013). KKR purchased a 70.2% equity stake for an approximate €410mm.[36] . Managers on the other hand, contributed with the purchase of a 3.2% stake. This amounted to an approximate Enterprise Value of €690mm and a more than 12x EBITDA 2012 multiple. Financing of the acquisition was completed with €280mm of equity from the Fund (together with managers) and a single issue of €290mm of Senior Secured Notes (high-yielding bonds, despite their name). These bonds carried an 8.9% cash interest and expired in 2020. Before the purchase payment termination (in September of 2013), the fund made a preliminary investment in SMCP. This investment was solely constituted by an issue, by SMCP, of €125mm of Convertible Bonds, fully purchased by the societies owned by KKR, in June 2013. These yielded an accrued 8% interest and expired in 10 years (2023). Hence, even if not used for the sole purchase of the 70.2% stake, the total Equity injected as entry capital by KKR amounted to €391.3mm (or 95% of the total equity injection and the convertible bond purchase, with the remaining 5% contributed by management). This represents an initial proportion of 42.6% of the investment in equity. The remaining 57.4% of these uses were indeed the mentioned High-yielding senior bond. Consequently, SMCP Group as a target company had, at entry, a 2 tranche debt structure formed by a 7 year senior bond, a 10 year convertible bond (fully subscribed by KKR), and a €70mm 5-year Revolving Credit Facility paying high spreads on LIBOR (when applicable, see *A 4*).

These proportions of debt/equity (57.4% vs 42.6%) seem slightly modest given the PE environment as of 2012 (see Part I of this Thesis). The high interest rates in the bond issuances (8%+), especially given the near-zero interest rate environment in the eurozone as of 2013, might indicate that the debt market perception for the SMCP investment at that stage was indeed quite risky. This could have impacted the desired optimal leverage level for the acquisition, resulting in a maximum debt proportion with acceptable terms at 42.6%.

Full details of the purchase, entry assumptions, Sources&Uses tables and Debt tranches detail can be found in Appendices *(A 3 to A6).*

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[36] Implicit price derived from data in Registration Document, issued 15 September 2017

Income Statement and Debt Schedule

The Income Statement and Debt Schedule evolution are the central part of the LBO Prospect modelling. Actuals of the two previous years (2011-2012) were available as mentioned earlier in this Thesis.

Projections have been made for up to the fiscal year end 2019 (6 years after entry). Three modelling scenarios have been implemented for selection (Bull, Base, Case), in line with the better and worst financial historical records and their averages (2011-12), personal research in independent channels and strategic outlines given by the Group in the Registration Document of 2017. The model, however, assumes the latter data to be already given in retrospect. For a practical approach, a projection more founded on the historical years has been modelled.

A summary on each of the scenario's main assumptions, resulting Income Statement and Debt Schedule prospects can be found in Appendices *(A 7 to A 10)*. Note that the modelled Debt schedule is very much dependant on the actual debt specifications and covenants (i.e. maximum dividend pay-out ratio of 50%), which as mentioned before, are known at entry.

Debt Covenants prospects

In terms of debt covenants compliance and potential breaches, the prospect LBO modelling confirms the ability of SMCP Group to respect each of the restrictive tranches during the LBO, as indicated in the debt specifications presented before *(A 4 to A 6)*. The only consistent breach is projected to be the one that is not default-triggering[37], which endorses the fixed charge coverage ratio. For the other modelled covenants and Bull and Base case, the limits are comfortably met. Additionally, the high-yielding Senior notes are projected to be eligible for a rating upgrade (given Moody's criteria, *A* 5) in the (possibly) last years of the LBO (2017-2019). In the more pessimistic Bear case, the Group fails to comply with the Senior Secured Leverage Covenant in the first year after investment. The margin, though, is not at all wide, and given the proximity of the breach with the entry date, the non-compliance could be disregarded.

A summary of each of the scenario's prospects of the main covenants compliance and rating evolution can be found in Appendices *(A 7 11)*.

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[37] According to Moody's, reason for which they do not include this ratio as a criteria for upgrade/downgrade of the €290mm Senior Secured Note

Exit and returns

Accounting for all the assumptions and projections already presented, the prospective LBO model proceeds to compute the expected returns in each of the scenarios and for each of the potential exit years. For simplicity purposes, the exit has been assumed to be completed at the same month as the entry, regardless of the year.

As seen in the sensitivity tables below, the longer the LBO period, the lower the variability of the expected returns to the investment Fund. Hence, for the interest of investors, KKR should try to operate the group for as long as possible, if no cornerstone exit option presents itself (assuming of course, that the projections and assumptions made in *A 7* are indeed realized in the future).

Assuming a standard industry exit period of 4 years and an EBITDA iso-multiple exit, LPs would realize between a 28% and 11% IRR return, with a base case internal rate of almost 20%. The base CoC if exited in 2017 would be around 2x. A summary of the base case exit financials and details can be found in Appendices *(A 12)*.

Figure 57: Sensitivity Tables for Prospective Returns (%) (x) (Cases: 1=Bull; 2=Base; 3=Bear)

Fund IRR (Case vs Exit Year)	2015	2016	2017	2018	2019
1	36.5%	35.1%	33.4%	32.2%	31.4%
2	18.5%	22.0%	23.4%	24.5%	24.6%
3	(0.2%)	9.3%	13.8%	16.3%	17.8%

Fund CoC (Case vs Exit Year)	2015	2016	2017	2018	2019
1	1.9x	2.5x	3.1x	4.0x	5.0x
2	1.4x	1.8x	2.3x	3.0x	3.7x
3	1.0x	1.3x	1.7x	2.1x	2.7x

LPs IRR (Case vs Exit Year)	2015	2016	2017	2018	2019
1	30.5%	29.6%	28.4%	27.6%	27.0%
2	15.1%	18.1%	19.6%	20.9%	21.3%
3	(0.6%)	7.0%	11.0%	13.4%	15.0%

LPs CoC (Case vs Exit Year)	2015	2016	2017	2018	2019
1	1.7x	2.2x	2.7x	3.4x	4.2x
2	1.3x	1.6x	2.0x	2.6x	3.2x
3	1.0x	1.2x	1.5x	1.9x	2.3x

GPs IRR (Case vs Exit Year)	2015	2016	2017	2018	2019
1	138.5%	112.0%	92.9%	80.6%	71.9%
2	62.0%	73.7%	70.6%	66.5%	61.3%
3		22.3%	43.0%	47.8%	48.2%

GPs CoC (Case vs Exit Year)	2015	2016	2017	2018	2019
1	5.7x	9.5x	13.9x	19.2x	25.8x
2	2.6x	5.2x	8.5x	12.8x	17.6x
3	(0.1x)	1.8x	4.2x	7.1x	10.6x

[38]
Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model

[38] Assuming a 2&20 fee and carried interest structure, 8% Hurdle Rate, a distribution waterfall on a deal-by-deal basis, 100% devolution of managing fees at exit, 97% entry capital contributed by LPs and 3% of entry capital contributed by GPs

6. Transaction details

a. Deal rationale and initiation

As already presented in the history of the Group, the company was in 2012-13 in the midst of a "first" LBO, initiated in 2010, under the control of LF Capital, a Joint Venture formed by LVMH investment arm L Capital and French PE firm Florac. Beginning in 2010, the group notably profited from a deep professionalization of operations, good management leadership, dedicated brand directors and international expansion.

In January 2013, both the controlling investor LF Capital and the remaining shareholders (management and founders) started and auction process under the guidance of financial advisors Edmond de Rothschild, J.P. Morgan and legal advisors Leonardo&Co. The sale served a dual rationale. Firstly, it provided LF Capital an exit to its 2010 investment, which was clear was going to yield high returns given the evolution of the Group. Secondly, SMCP indeed needed further capital to keep up with its expansion and professionalization plan. An experienced cornerstone and controlling investor, with knowledge of the sector, was hence sought by both management and founders.

The sale process started with nine publicly known bidders, as shown below, and was drawn down to four possible purchasers a after two months. The final and binding round of offers were submitted by PE groups Eurazeo, The Carlyle Group, KKR, and Chinese conglomerate Swire. Although details of each of the binding offers are not public, the abundance of players surely pumped up the final price.

Figure 58: Bidders for SMCP purchase
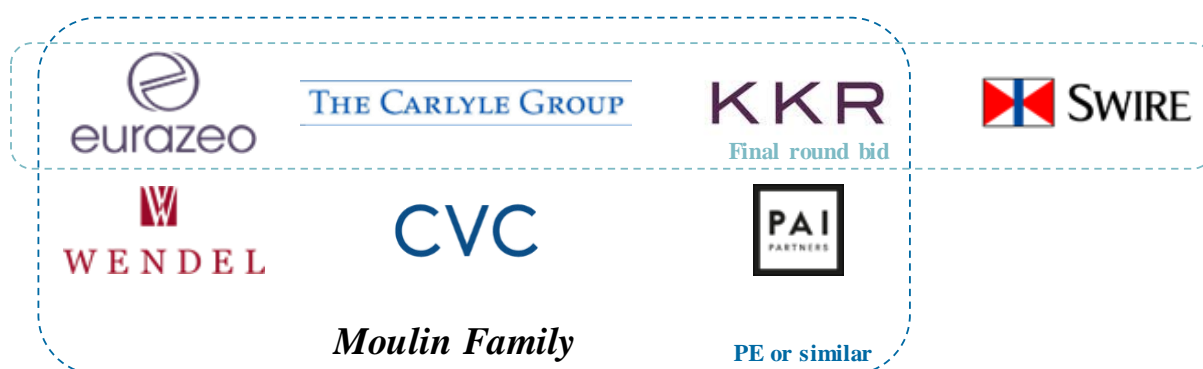
Source: Reuters

The sale was finalized in April 2013, with KKR emerging as the strongest bidder. Details of the KKR LBO entry terms have already been presented in the Prospect point in this Thesis and

are further detailed in Appendices *(A3 to A6)*. In short, KKR purchased a 70.2% equity stake for an approximate €410mm[39] . Managers on the other hand, contributed with the purchase of a 3.2% stake. This amounted to an approximate Enterprise Value of €690mm and a more than 12x EBITDA 2012 multiple. Financing of the acquisition was completed with €280mm of equity from the Fund (together with managers) and a single issue of €290mm of Senior Secured Notes (high-yielding bonds, despite their name), details of which can be found in the references mentioned. Before the purchase payment and control transfer (in September of 2013), the fund made a preliminary investment in SMCP. This investment was solely constituted €125mm of Convertible Bonds issued by SMCP, fully purchased by the societies owned by KKR, in June 2013. All in all, the above terms amounted to a proportion of 42.6% of the investment in equity. The remaining 57.4% of these uses was indeed the mentioned high-yielding Senior bond. The slightly modest Debt/Equity proportions might indicate that the debt market perception for the SMCP investment at that stage was indeed quite risky as already described.

With the terms above, LF Capital locked in an approximate 2.7x CoC in an investment period of less than 3 years, which equates to and IRR of c. 45% [40]. Further details and assumptions on ownership terms, ownership evolution, and transaction highlights can be found in Appendices *(A 13)*.

b. Exit 1 – Sale to Shandong Ruyi

After vastly consolidating the business in line with the purposes mentioned from management and founders in the 1st LBO exit (professionalization, international expansion, etc.), KKR sought its own investment exit in early 2016, with again a less than 3 years holding period of the Group. In words of the own Group, "…the company began exploring a dual track process (IPO and strategic investment) to raise capital to pay down a portion of debt, reduce cost of borrowing and allow KKR to sell part of its stake…". In this regard, KKR and its advisors on the process[41] even filed the necessary documents for an IPO in the Paris Euronext in April 2016. A few days later, though, a deal was reached with Chinese retail conglomerate Shandong Ruyi[42] for a sale of a controlling stake. Shandong Ruyi and its co-investors

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[39] Implicit price derived from data in Registration Document, issued 15 September 2017
[40] Based on the following assumptions, as seen in Appendices 13: shareholding at LF Invest entry is 51% for the latter and 49% for managers and founders. This 49% is proportionally split between managers and founders in line previous shareholding (2007-2010), as seen in Appendices. Equity Value at entry of c. €200mm according to Fashion Network, which implies a c. €102mm for a 51% stake. Exit amount of c. €278mm based on a 73.8% purchase (KKR and management) for €409.6mm as shown in Appendices 3.
[41] Bank of America Merrill Lynch, UBS, Bredin Prat (legal)
[42] Advised by J.P. Morgan, Latham Watkins (legal)

purchased a combined c. 81.5% stake in the Group amounting to a share purchase amount of €949.4mm (and an implied Equity Value of €1.17bn). KKR sold its remaining 69.7% stake down to 9.6% (it had previously sold a 0.45% stake to incoming CEO Daniel Lalonde in April 2014 for c. €1.9mm). Executives from the LF Investment LBO[43], which still held a combined 7.1% of equity, completely sold their stakes, while founders' stake was significantly reduced to a combined 6.7%. CEO Daniel Lalonde and other managers did not sell their respective shares.

In line with the stated purpose of the sale, the Group, under the control of Shandong Ruyi, immediately redeemed the €290mm high-yielding bonds issued under KKR control for the acquisition in 2013[44]. The €125mm of Convertible Bonds, fully subscribed by KKR, where assumed by the new structure. Additionally, the Chinese conglomerate redeemed and cancelled the €70mm Revolving Credit Facility *(A 3)* and restructured the Groups capital structure. In May 2016, it issued two sets of bonds for €100mm and €371mm, expiring in 2022 and 2023, respectively. It also approved a new RCF[45] for around €70mm.

As for KKR, the total amount of inflows in this "first stage" exit, corresponding to the sale of most of its equity stake, was c. €700.6mm. Recall that the €125mm Convertible Bond was still to be redeemed. Further details and assumptions on ownership terms, ownership evolution, and transaction highlights can be found in Appendices *(A 13)*.

c. Exit 2 – IPO

It is not publicly known if a Public Offering a year after the majority sale in 2016 was one of the terms of the deal made between KKR and Chinese conglomerate Shandong Ruyi. Nevertheless, given that the PE firm indeed was in the verge of executing that offering before such deal, it seems highly likely. This would effectively facilitate the complete exit of KKR, which as mentioned remained a 9.6% holder of the Group. In October 2017, SMCP began trading in the Paris Euronext exchange with an initial price of €22 per share. The complete offering amounted to almost €542mm, of which €127mm was capital increase in shares, €261mm was sold by Shandong Ruyi and €148mm were distributed to KKR in exchange of their last held stake. The remaining €5.9mm were sold by several managers. Post-IPO,

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[43] Frederic Biousse and Elie Kouby
[44] For which they incurred in early redemption penalties amounting to €17.8mm, as seen in Appendices 13
[45] Revolving Credit Facility

Shandong Ruyi's stake was drawn down to a controlling 57%, while main managers and founder's share was mostly stable. The resulting free float of the firm was over one third of its shares.

With the proceeds of the capital increase and the Shandong Ruyi minority public sale, and as part of the restructuring, the Group redeemed the totality of the previously mentioned 2022 bonds and around 30% of the 2023 bonds, with a combined penalty of €19mm for early redemption. Additionally, a new RCF of €250mm was agreed to replace the last one.

Regarding the KKR last holding % of shares, they were exited for the amount mentioned. As for the €125mm of outstanding Convertible Bonds, they had a trigger convertibility clause in the event of an IPO, as well as 30 days prior to redemption in 2023. There is no public information confirming these bonds were converted as the first of such events happened. However, given the assumed priority of KKR to exit as soon as possible to maximize returns, and for simplicity purposes, it has been supposed that the mentioned bonds where converted, and the underlying shares sold on the open market at IPO. Further details and assumptions on ownership terms, ownership evolution, and transaction highlights can be found in Appendices *(A 13).*

7. **Value creation under KKR**

   a. **Assumptions and limitations**

Exploring the value creation and returns of the actual SMCP LBO by KKR is, as repeatedly mentioned in this document, the central matter of this Thesis. In this line, this exploration firstly regards the overall return to stakeholders in the presented KKR European Fund III and the Group's key managers. In a more detailed way and vital to the question posed, the value creation to the Fund is broken down in a series of factors. These factors are then compared in relation with a series of criteria as per the guidelines described below. Finally, social value created metrics are computed and explored, when available. In accordance with these objectives, some general assumptions, sources and limitations to the findings need to be mentioned

Actual LBO and return to stakeholders

- **Entry and Debt Structure Specifications**, for actual returns computation purposes, have remained the same as those presented in point 4c (Expected Returns) and are detailed in Appendices *(A 3 to A6)*. This is due to the previously mentioned consideration: the entry and debt terms are indeed known in the Prospect LBO modelling and are hence the same as the actual LBO terms.

- **Detailed Actual Realized Debt Schedule and Covenants Compliance** details where not publicly available. Consequently, they both have been modelled in line with the debt terms and their details outlined above. This could differ from the actual debt repayments that the Group incurred in, given possible accrual of interests or arrangements with debtholders that are not publicly available. Nevertheless, the modelled schedule is compliant with the terms above and its effect on returns at exit is the same, regardless of possible differences of the unavailable information (debt principles and accrued interests remaining at exit are known).

- **Actual SMCP Group Statements, Stakeholder Monthly Cash Flows, and Exit and Returns** minor assumptions can be found in the notes of the detailed Appendices *(A 14 to A 20)*.

Breakdown of value created

- **Method source and comparison study:** as explored in Section I of this Thesis, in order to apply a previously explored and validated method, the value creation breakdown of

the SMCP Group LBO has been computed in conformance with the academic paper: "International Evidence on Value Creation in Private Equity Transactions" by Benjamin Puche, Reiner Braun and Ann-Kristin Achleitner (Technische Universität München, Centre for Entrepreneurial and Financial Studies). This paper was published as a part of the "Journal of Applied Corporate Finance" in its Volume 27, number 4, in Fall 2015. The text follows a strict calculation method and breakdown, outlined and explained in the first section of this Thesis, applied and recalled below. The use of this method allows for easy separation of value creation factors and comparability with other LBO transactions, as explored later in this document. Recall that Value Creation has been presented as the Net Capital Gains to the investors of the company. In this case, we explore the value created to the KKR Fund invested in SMCP Group (KKR European Fund III).

- **In order to adapt to the mentioned paper methodology, one important variation to the actual LBO was made.** The computation of the breakdown in accordance with the mentioned study requires that the company registers its exit inflows at a single date. In the case of SMCP, as detailed in the Appendices and already presented, KKR exits its investment in two phases, with a 0.45% stake intermediate sale to an incoming manager in the interim of the LBO. To comply with this condition, both inflows of the strategic majority sale in 2016 and minority sale at IPO in 2017 have been assumed to be simultaneous as per the date of the firs sale (strategic sale). In the case of the intermediate minority sale, this has been included in the FCF effect, and has been treated similar to a dividend for TM calculation purposes. This entails the following limitation of this Thesis findings.

  1) **Holding period** given the assumption above, the resulting holding period for TM calculation purposes is 34 months, or 2.83 years. Indeed, the actual holding period until exit was some months longer. This can limit comparability and end TM calculation purposes. Nevertheless, note that the bulk of KKR stake's, and its controlling condition, is sold in line with the mentioned holding period, making this Thesis calculation's plausible *Grosso modo.*

  2) **Exit data:** because the single exit date for calculation purposes has been assumed at April 2016, the exit financial data needed for the breakdown is that of fiscal year 2015 (EBITDA, Sales, Balance Sheet). Given that SMCP's fiscal year ends on the 31st of December, and the unavailability of quarterly financials,

2015 data is in effect the closest actual financials to the single exit date. The optimum condition to perform the breakdown would indeed have available 1Q 2016 financial data for the Group. This simplification, while imperfect, complies with the broader objective of the value creation breakdown.

- **Convertible Bonds treatment:** additionally, to the above, the study does not give details on how to treat quasi-equity instruments or side investment such as the one made by the KKR fund prior to LBO entry (full subscription of a Convertible Bond issued by SMCP). To account for the Net Capital Gains of this prior investment, a separate TM computation has been added as per the waterfall presented later in this Thesis.

Further detail and assumptions on Breakdown of Value Created can be found in Appendices (*A 21 and A 22*).

b. Overall return to stakeholders

Before analysing the amount of net value created to investors and its breakdown into factors, the returns to the different investors that contributed capital both at a Fund and management level have been calculated. Using the actual financial data as well as exit and intermediate transaction details (as presented in *A 13* to *A 20)*, a monthly cash flow to the different stakeholders has been computed. Using this net flow evolution, monthly, annualized and Cash on Cash returns can be computed for each stakeholder from their respective entrances in the Group until exit (recall for instance that pre-KKR managers still had stakes in SMCP up until its sale to Shandong Ruyi, as detailed in *A 13*).

- **Founders:** it is of essence to recall, that unlike many other MBOs, founders, which are also managers of SMCP, did not contribute extra capital in any of the phases the Group went through (as presented in *A 13*). This absence of capital commitment makes a return calculation non-existent for these stakeholders. However, the monthly stakeholders cash flow evolution does include the inflows the founders receive for their progressive stake sales in each phase. In this sense:

  1) **Evelyn Chétrite** Sandro Founder, received a total sum of €150.7mm between the years 2007 and 2017 (€5.6mm in June 2007 at Frederic Biousse and Elie Kouby buy-in, €19.5mm in September at LF Invest entry, €46.6mm in June

2013 at KKR entry, €79mm in April 2016 at KKR exit), and still held a 3.2% stake of the Group post-IPO in October 2017.

2) **Judith Milgrom,** Maje Founder, received a total sum of €148.7mm between the years 2007 and 2017 (€5.6mm in June 2007 at Frederic Biousse and Elie Kouby buy-in, €19.5mm in September at LF Invest entry, €51.3mm in June 2013 at KKR entry, €72.3mm in April 2016 at KKR exit), and still held a 2.9% stake of the Group post-IPO in October 2017.

▪ **Managers:** publicly available information and implied calculations were used to derive the monthly net cash flows and returns of three of the major managers involved in the KKR investment, even for those who entered the company before the PE firm's entry and were ousted during the buyout.

1) **Frederic Biousse:** co-CEO from 2007 to 2014, who entered the company alongside Elie Kouby with a joint capital injection of around €11.2mm. He exited this investment gradually in each of the phases of the company (as presented in *A 13*). He fully exited in April 2016 with the sale to Shandong Ruyi, after 106 months, and having received a total sum of €67mm, exclusively from the gradual sale of his equity stake. This amounts to an annualized IRR of 42.2% and a CoC of 12x.

2) **Elie Kouby:** co-CEO from 2007 to 2014, who entered the company alongside Frederic Biousse with a joint capital injection of around €11.2mm. He exited this investment gradually in each of the phases of the company (as presented in *A 13*). He fully exited in April 2016 with the sale to Shandong Ruyi, after 106 months, and having received a total sum of €59.5mm, exclusively from the gradual sale of his equity stake. This amounts to an annualized IRR of 43.6% and a CoC of 10.66x. This larger IRRs than fellow co-CEO, despite a smaller CoC and same holding period, is due to the timing of his equity stake sales.

3) **Daniel Lalonde:** CEO of SMCP Group from April 2014 and appointed by KKR after buying a 0.45% stake from the fund (at around €2.5mm). In the scope of this Thesis he did not exit his participation in any of the presented phases but would have had a 3.1x CoC and 75.9% IRR given the equity valuation of the company at IPO.

4) **Other managers:** due to the lack of public information, the only conclusive data on the bulk of the other managers shows an aggregate investment of €13.6mm at KKR's entry, in June 2013, and no selling of this 1.7% stake. Again, based on the valuation at IPO, these managers would have had a CoC of 1.95x for an IRR of 39.5%.

▪ **KKR:** given the entry data presented in the LBO prospect (*A 3*) and the monthly cash flows of the fund (Convertible Bonds subscription in April 2013, majority stake purchase in June 2013, and sales in April 2016 and October 2017) the overall fund accomplished an annualized IRR of 33.8%, which a CoC of 2.6x, accounting for the total holding period until full exit, at IPO.

Figure 59:Summary of stakeholders returns46

Managers	c. Monthly IRR	c. Annualized IRR	c. CoC	Holding Period
Frederic Biousse	3.0%	42.2%	12.00x	106 months
Elie Kouby	3.1%	43.6%	10.66x	106 months
Daniel Lalonde (if exited at IPO)		*75.9%*	*3.09x*	*42 months*
Other managers (if exited at IPO)		*39.5%*	*1.95x*	*52 months*
KKR Retail Partners	**2.5%**	**33.8%**	**2.60x**	**52 months**

Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Exit&Returns")

At a more specific level, the model shows, under some assumptions, the returns to LPs and GPs for the Fund's investment. Note that there is substantial difference between the overall return of the fund as computed above and the return to LPs under the below waterfall distribution. The Fund's return is indeed calculated in a monthly manner, and hence it should be more accurate. The distribution waterfall to GPs and LPs, though, has been computed assuming distribution on a deal-by-deal basis, but after the LBO is fully exited. The gap in time between the first exit (in which KKR sales a majority stake) and the full exit at IPO amounts to approximately 18 months. Consequently, the waterfall's results are more illustrative than exact. Nevertheless, these assumptions yield an illustrative IRR of 20.8% for LPs and 71.2% for GPs, with a CoC of 2.3x and 10.3x, respectively.

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46 Holding Period until full exit

Figure 60: Waterfall distribution of KKR investment fund, deal-by-deal basis (€mm)[47]

Assumptions			Distribution	
KKR Retail Partners Equity	391.4		**Total Distribution**	1,016.4
LPs commited %	97.0%		*Total Fees*	33.9
Amount LPs commited	379.7		*Total LPs commited*	379.7
GPs commited %	3.0%		*Reimbursement of initial capital*	413.6
Amount GPs commited	11.7		**Left to distribute**	602.8
Management Fees % (yearly)	2.0%		*Hurdle rate profit*	150.3
Management Fees amount (yearly	7.8		**Left to distribute**	452.5
Hurdle Rate	8.0%		*Carried interest to GPs*	37.6
Carried Interest	20.0%		**Left to distribute**	415.0
Years to exit	4.33 years		*Distributed to LPs*	332.0
			Distributed to GPs	83.0

c. Expected LPs CoC	**2.3x**		c. Expected GPs CoC	**10.3x**
c. Expected LPs IRR	**20.8%**		c. Expected GPs IRR	**71.2%**

Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Exit&Returns")

c. Breakdown of value created

After presenting the different stakeholder's return, the central matter of this Thesis is to explore the breakdown of value creation to the main investors (that is, the KKR Fund) as detailed in Section I of this Thesis, based on the Net Capital Gains of their investment and its drivers.

Figure 61:Value creation breakdown (TM x)
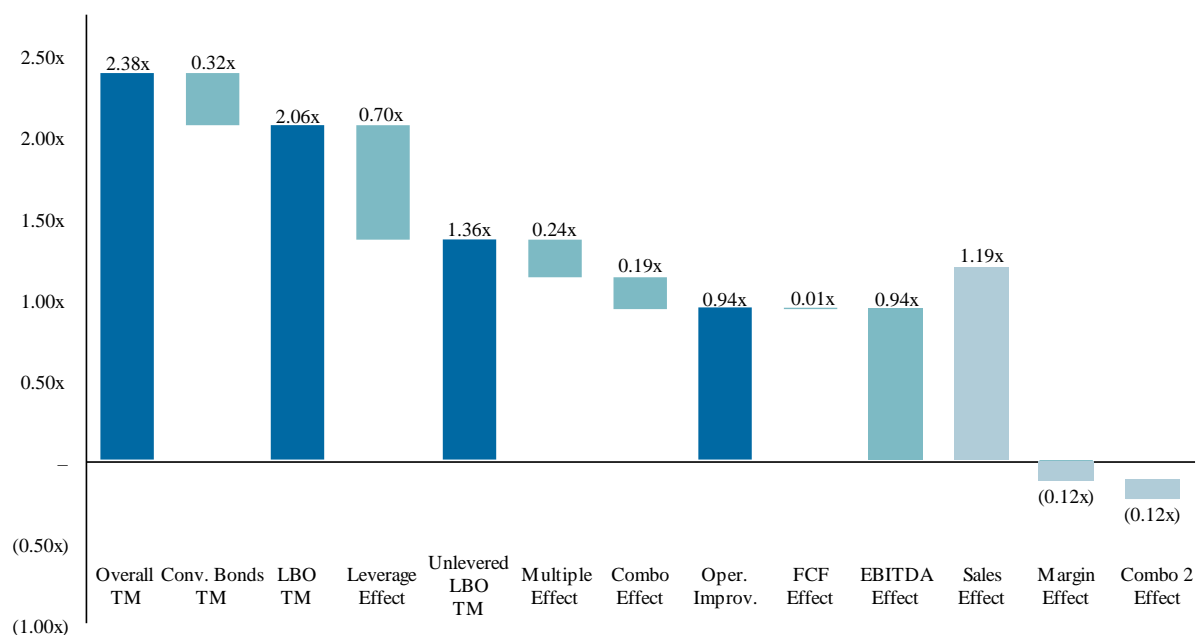
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

[47] Assumptions: 97% of the necessary capital for the deal commited by LPs (€379.7mm), 3% commited by GPs (€11.7mm in aggregate); 2% per annuum management fees, 8% hurdle rate and carried interest of 20%

Applying the mentioned calculations *(A 21 and A 22)*, the above waterfall has been derived. Note that an extra factor, not present in the reference study, has been added, for the reasons presented in point 6a. of this Thesis. The findings of this calculations conclude that an Overall TM of 2.38x was reached in the KKR LBO of the SMCP Group. The primary debt investment in Convertible Bonds account for a modest 0.32 TM, or 13.4% of the total Net Capital Gains. The LBO itself is responsible for the remaining 86.6% or 2.06x TM of value creation. This is divided into Leverage, Multiple, Combo, Free Cash Flow and EBITDA Effects, as described in Section I, and as resulted in the table below.

Figure 62: Value creation breakdown and weights (TM x) (%)

Item	TM	% of Overall TM	% of LBO TM (excl. Conv)
Overall TM	**2.38x**	**100.0%**	na
Convertible Bonds TM	**0.32x**	**13.4%**	na
LBO TM	**2.06x**	**86.6%**	**100.0%**
Leverage Effect	0.70x	29.4%	33.9%
Multiple Effect	0.24x	9.9%	11.5%
Combo Effect	0.19x	7.9%	9.1%
FCF Effect	0.01x	0.2%	0.2%
EBITDA Effect	0.94x	39.6%	45.8%
Sales Effect	*1.19x*	*49.8%*	*57.5%*
Margin Effect	*(0.12x)*	*(5.1%)*	*(5.9%)*
Combo 2 Effect	*(0.12x)*	*(5.1%)*	*(5.8%)*

Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

Convertible Bonds effect

The Convertible Bonds effect reflects the Net Capital Gains of the full subscription by KKR of the mentioned bonds issued by SMCP some months before the acquisition. As already mentioned, this label is unique to this transaction, given that the reference paper gives no details on quasi-equity treatment. In this sense this effect is treated more like a strictly debt instrument: it is computed dividing its Net Capital Gains by its principal amount (as detailed in *A 22*). Recall that the 8% interest is accrued until conversion, which is executed after the trigger event, at IPO of the Group in October 2017.

Figure 63: Value creation breakdown - Convertible Bonds effect (TM x)
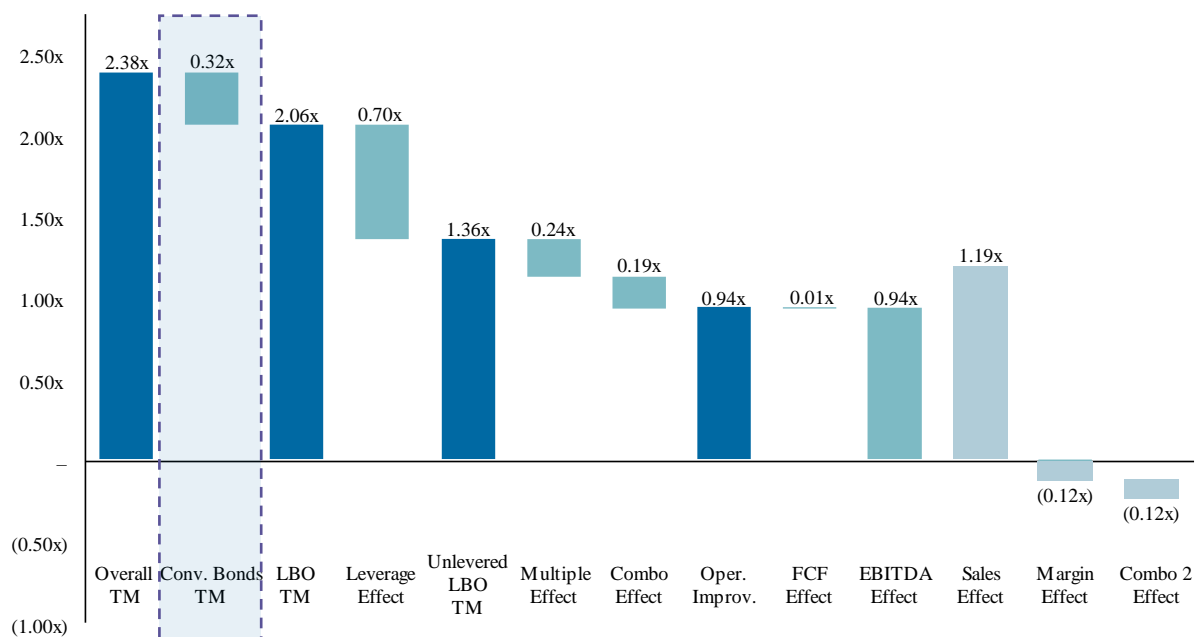
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

As seen in the figure above, the Convertible Bonds Effect TM amounts for a 0.32x of the 2.38x of Value Creation. This amounts to a 13.4% of the overall Net Capital Gains. This leaves 2.06x TM of the value created attributable to the LBO per se. There are no strategic drivers tied to the convertibles returns, other than the timing on the investment, the terms of the bonds, and the full subscription and trigger conversion events imposed by KKR.

Leverage effect

The Leverage effect reflects the fact that the Fund purchases the company with the use of equity and a €290mm Senior Note issue, which is to be redeemed during or at exit of the LBO. These bonds carried an 8.9% cash interest and expired in 2020. In the case of SMCP's LBO, and as detailed in the Debt Schedule *(A 17)*, the principle of these bonds is not redeemed in the interim. This results in a relatively high average Fund D/E, given that as mentioned in the first lever, Convertible Bonds are treated apart from the LBO value creative process. Initial fund D/E is over 100%, while exit is significantly reduced to nearly a quarter given the rise on equity value, nevertheless, this causes an average D/E of 64.2% for the assumed 2.8 years holding period (given the single exit assumption). Recall that the leverage effect is computed by subtracting the Unlevered LBO TM to the LBO TM. Details of this computation can be found in Appendices *(A 21 and A 22)*.

Figure 64: Value creation breakdown - Leverage effect (TM x)
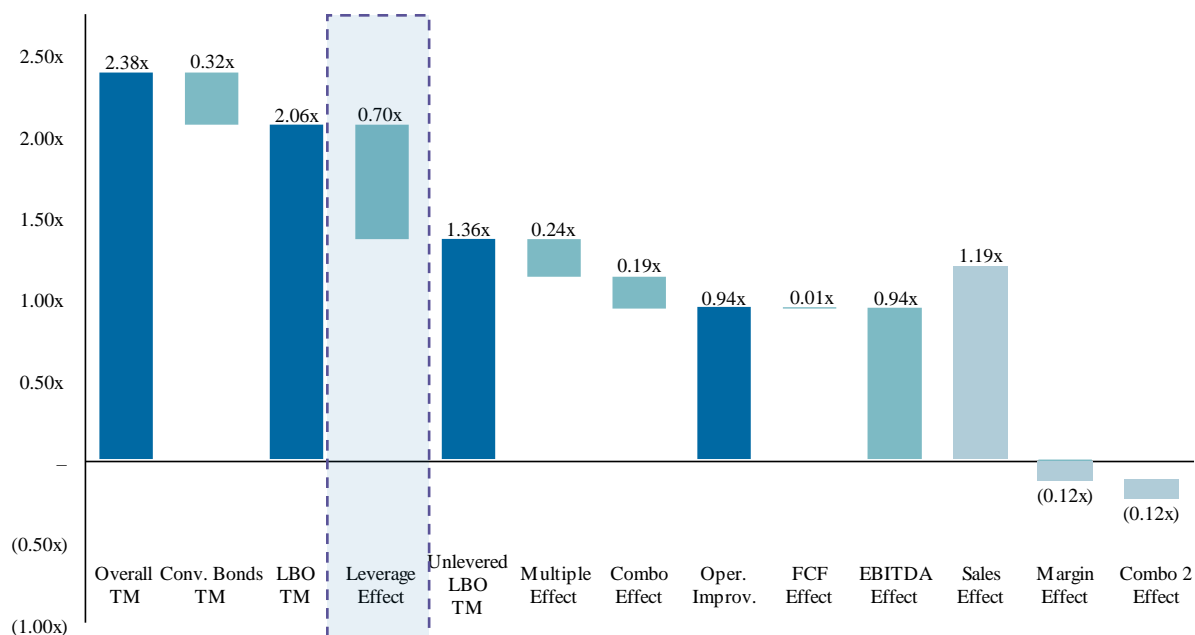
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

As per the waterfall above, the Leverage Effect TM amounts for a 0.70x of the 2.38x of Value Creation of the remaining 2.06x of the LBO Net Capital Gain. This accounts for around 30% of the Overall gain and almost 34% of the value created during the LBO. Vast experience is needed in order to optimally arrange debt terms in an LBO to maximize the value creation of this effect. An excess of leverage can lead the target company to financial distress, while too little acquisition debt will put a roof in the TM earned in this effect. In the case of SMCP, as mentioned earlier in this Thesis, it is probable that the perception of riskiness in the investment resulted in a high 8.875% of interest of the main Senior issue. More debt would undoubtedly have meant higher interest. In this regard, a controlled amount of leverage, as the one executed, could have been prudent, but could have certainly been a limit factor to the Leverage Effect in terms of value creation, given that the company does not seem to be in much financial distress during the LBO. After accounting for the Leverage effect, this leaves a TM of 1.36x remaining for the market factors (multiple expansion) and operational improvements.

Multiple effect

The multiple effect reflects the value attributable to the increase in the EV/EBITDA multiple from entry to exit, commonly known as multiple expansion. It is calculated by simply multiplying this change in the multiple by the entry EBITDA and is divided by the Net Capital Gains to compute its TM.

Figure 65:Value creation breakdown - Multiple effect (TM x)
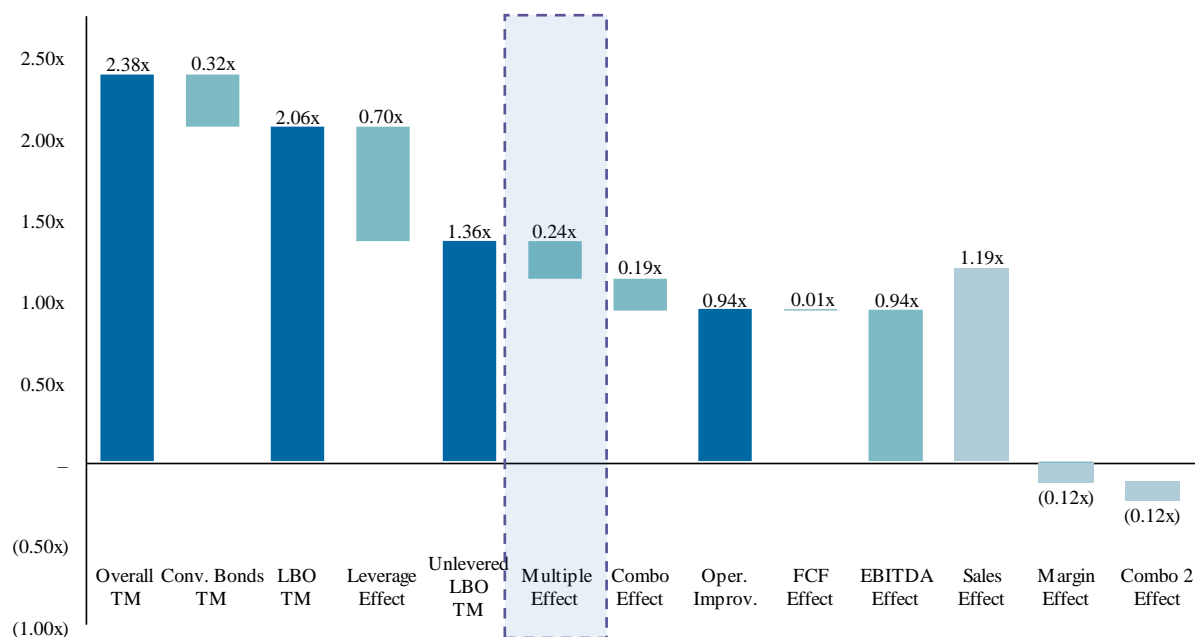
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

SMCP was purchased in 2013 for an approximate EV/EBITDA multiple of 11.6x. The majority stake was sold by KKR in 2016 at around 13.9x multiple[48] *(A 21)*. This implies a 2.3x multiple expansion and a resulting TM Multiple Effect of 0.24x. This comprises a 9.9% of the overall Net Capital Gains and 11.5% of the value created to the Fund only from the LBO.

Having a positive Multiple effect TM has a lot to do with timing the market. Given that retail is a relatively highly cyclical sector, this becomes even more crucial. The purchase of a target company when asset prices are historically high might mean a secure value destructive multiple effect. For conservatism reasons, most models run on an iso-multiple basis (as has been done for the Prospect LBO model of this Thesis). Multiples evolution can be substantially different by subsector, geography and other factors. Although multiples had generally gone up post-2008 and during SMCP's LBO, the evolution was not as stable in European retail as the one presented in Section I of this Thesis regarding the retail market.

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[48] Both multiples do not include the amount used in investment of fully subscribing the €125mm of Convertible Bonds. Both multiples are computed with financials from the previous complete fiscal year, ended in December 31st : 2012 for the entry multiple and 2015 for the exit multiple

Figure 66: European transaction EV/EBITDA multiples in retail (x)
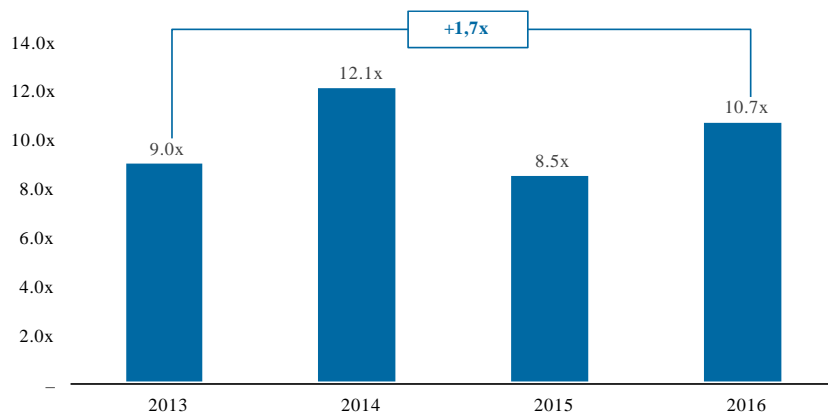
Source: EY study, based on data from Capital IQ and Bloomberg

In the case of SMCP, it was both purchased and sold at high multiples when compared to general retail European transactions. Nevertheless, KKR did profit from the upward trend in these multiples across the sector in Europe, as seen in the figure above.

Combo effect

The Combo effect is reflective of the simultaneous effect of the EV / EBITDA multiple and EBITDA rising between entry and exit. It is computed multiplying the difference in EBITDA (exit-entry) and Multiple (exit-entry). This amount is later divided by the Net Capital Gains to get its TM.

Figure 67: Value creation breakdown - Combo effect (TM x)
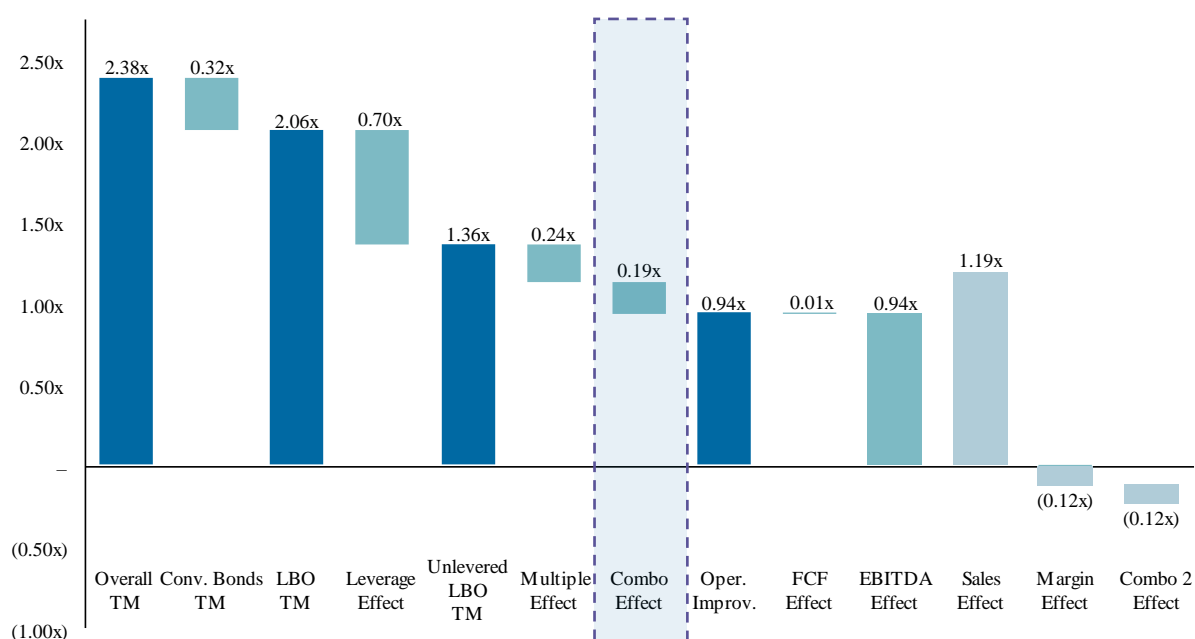
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

In the case of SMCP, both the multiple (as seen in the previous lever) and EBITDA increased during the LBO controlling period (€59.5mm in 2012 and €106.5mm in 2015, previous to the April 2016 exit). This results in a Combo effect of 0.19x TM, accountable for 7.9% of the overall gain and 9.1% of the LBO value creation to the Fund.

Although this factor is presented as being external to operational improvements, the EBITDA component in it certainly makes it dependant on the latter. Its intrinsic multiple component though has pushed the authors of the reference document to include the Combo effect in the scope of the "Market effects", rather than in the Operational Improvements. The drivers of multiple variations have already been presented, while EBITDA increases/decreases drivers and causes will be presented in the upcoming effects presentation.

FCF effect

As explained in Section I of this Thesis, the Free Cash Flow value creation effect captures the net cash flow movements of the investment parties of the operation. In KKR's case, this factor accounts for the interim redemption of debt issued at entry, the possible dividend pay-outs, and any capital injection made during the LBO, all being flows from the Fund as a condition. As mentioned in the Assumptions and Limitations of the applied method, the 0.45% sale from KKR to incoming Group CEO Daniel Lalonde has also been included in this factor. Consequently, note that the FCF effect does not capture the potential improvements of Free Cash Flow of the target company. It is hence calculated by computing the reduction in net debt plus interim dividends, minus capital injections and adding the mentioned intermediate minority sale. It is divided by the total Net Capital Gains to compute it as TM.

In the case of the SMCP LBO by KKR, recall how interim flows are null (as per *A 21*), except for the included intermediate sale. This results in the FCF effect being of practically null impact, with a TM multiple of 0.01x. This equates to less than 0.2% of both overall gains and LBO value created.

Figure 68: Value creation breakdown - FCF effect (TM x)
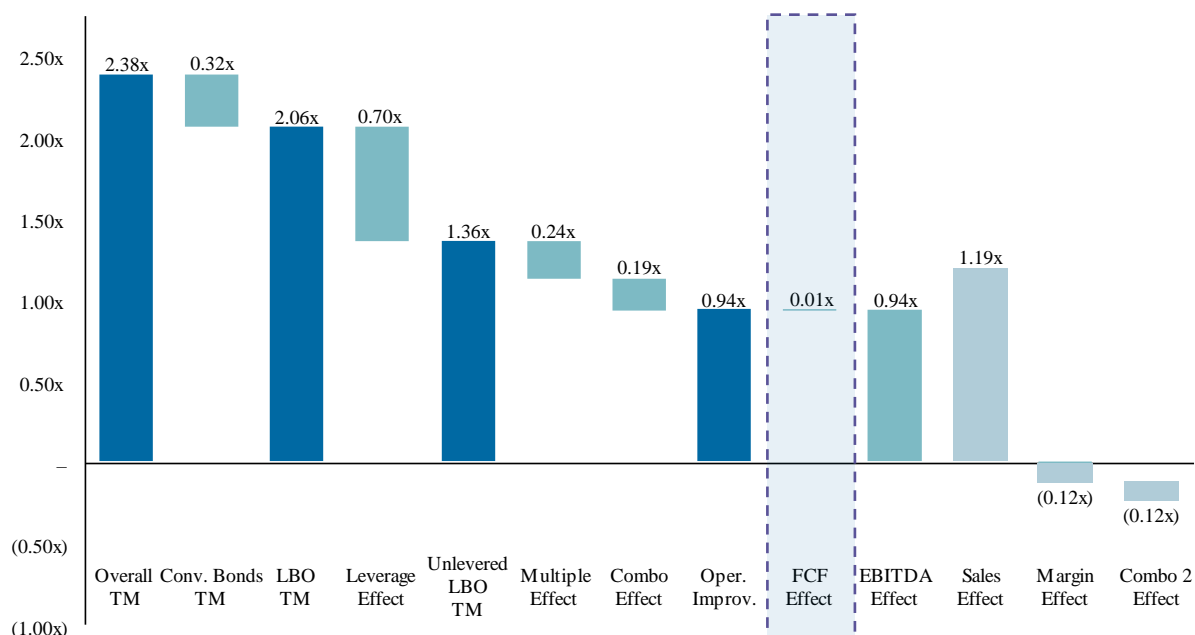
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

EBITDA effect

The EBITDA effect reflects the operating improvements that result in a change in the EBITDA between entry and exit and is calculated multiplying the change in EBITDA by the entry EV/EBITDA multiple. The EBITDA effect can be further split into sales effect, margin affect and the combined effect of both margin and sales effect.

The Figure below shows that most of the value created in the overall SMCP operation (c.40% of the overall return/value created) came from the EBITDA effect, which was fully driven by top line growth (positive sales effect), since margins did, indeed, worsen (negative margin and combo 2 effect). The resulting TM multiple equates to 0.94x, accounting for a 45.8% of the exclusive Net Gains of the LBO.

Figure 69: Value creation breakdown - EBITDA effect (TM x)
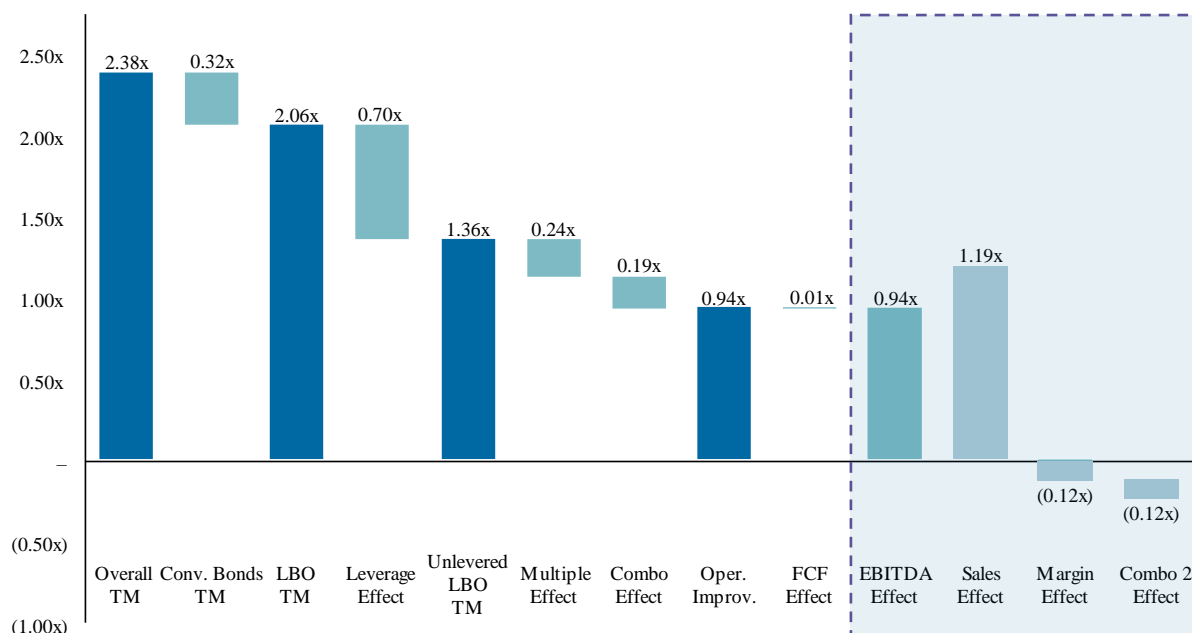
Source: PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

As already mentioned, this EBITDA effect can be further split into sales, margin and combined effect. Below, each of them individually are analysed, with the main drivers and initiatives taken by KKR that improved/worsened them.

- *Revenue growth effect*

The sales or revenue growth effect reflects the value created by increases in company revenues and is calculated by multiplying the change in revenues by the entry margin and by the entry EV/EBITDA multiple. Revenue growth of SMCP under the 2012-2015 LBO period enjoyed a very strong growth trend, with sales increasing from €339mm in 2012 to €675mm in 2015, in excess of 20% per year on average, driven by a combination of sustained store roll-out and LFL (including also the contribution from fast growing e-commerce as discussed below).

Figure 70: SMCP's net sales evolution and growth drivers, 2012-2015 (€mm, %)
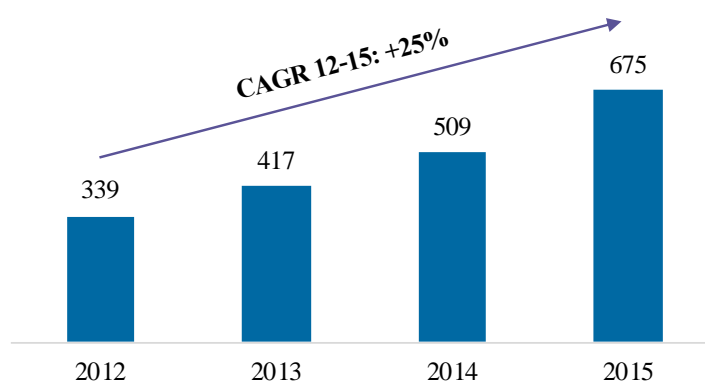
Source: Company data

SMCP expanded its network rather quickly, with an average of c.90-100 DOS openings p.a during the 4-year period, broadly evenly split by brand and mainly focused on the Western European, North American and Chinese markets. The majority of these openings were done internally by the group, with a combination of free-standing stores and concessions.

Figure 71: SMCP's POS evolution, 2012-2015
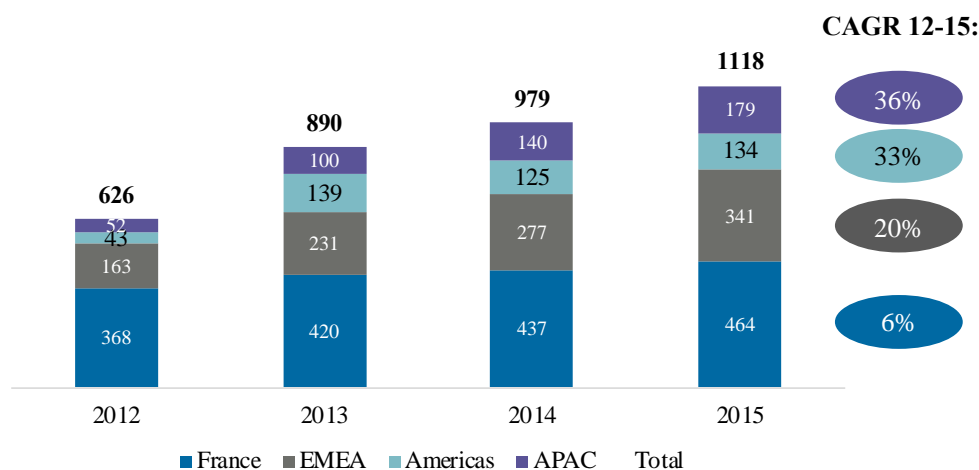
All in all, the sales effect equates to TM of 1.19x, being by far the largest contributor of value creation to the Fund. This figure accounts for 49.8 of the total value added, including the Convertibles investment, and a 57.5% contribution to the buyout itself. When looking at the main initiatives that drove this enormous sales effect, we have identified 3 main drivers: international expansion, development of e-commerce and diversification into menswear and accessories.

International Expansion

SMCP main source of growth was its international expansion. Considering that the Group was already strong and had a deep store presence in its core French market (c.70% of total sales in 2012), KKR focused on growing on those markets with high growth expectations where the group was already present, but its penetration was still low. These markets were China, North America and Western Europe (mainly UK, Spain, Germany and Italy), with China being the most important. China was a relatively new market for SMCP when KKR acquired it in 2013, with the first point of sale opened that same year and sales that were almost insignificant. Since then though, the Group expanded fast (triple-digit CAGR) and by the end of 2015 it had 90 POS generating c.10% of total group sales.

Figure 72: China sales, 2012-2015 (€mm)

CAGR 12-15: +175%

| 2012 | 2013 | 2014 | 2015 |
| 1 | 5 | 21 | 59 |
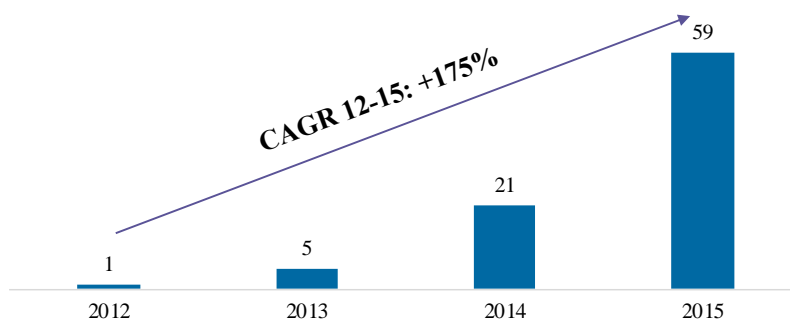
Source: Company data

In Western Europe, sales experienced strong growth too (32% CAGR), accounting for 28% of SMCP total sales in 2015. In North America, Sandro and Maje also developed strongly between 2012 and 2015, with slightly lower growth rates than in Western Europe and with sales that represented c.12% of total sales. In addition to the markets just discussed, three relatively important markets in which KKR played important role in expanding were South Korea, Australia and Middle East (UAE, Saudi Arabia and Kuwait), in which they operated with key partners (ID Look Limited, Higgovale, and Al Futtain respectively).

Finally, and parallelly to the international expansion, KKR consolidated SMCP's strong position in France. SMCP outperformed the French apparel sector during the totality of the LBO period, posting high-single- to low-double-digit growth in a stagnant environment (the French Apparel and Accessories market was broadly flat between 2014 and 2016). This was mainly due to store roll-out, and more importantly LFL growth, which was mainly driven by the ongoing development of digital and omni-channel capabilities and increasing penetration of menswear and accessories (both drivers discussed below). As of 2015, the Group had 464 points of sale in France and the market was still responsible for 46% of total sales.

E-commerce Development

SCMP's focus on digital was also one of its most important growth drivers during the buyout period. In 2013, SMCP internalised its e-commerce platform and made digital a strategic priority. Since then, SMCP built the platform by redesigning the e-shops and strengthening the team, notably with the appointment in 2015 of a dedicated Digital & CRM Director, Flavien d'Adiffret (previously at Amazon). As of year-end 2015, SMCP had a Central Global Digital group and digital teams for each business unit (3 brands and 2 regions), including a total of 40 digital professionals in-hose. Additionally, SMCP started to push more significantly internationally, finding new e-partners and landing on Tmall in China. Thanks to all these initiatives, in 2015 digital was the Group's fastest-growing sales channel (86% CAGR), with

online sales of €42mm, which represented a 7% of total revenues. Prior to KKR's buyout in 2012, online sales only represented less than 2% of total sales.

Figure 73: Digital sales evolution, 2012-2015 (€mm)
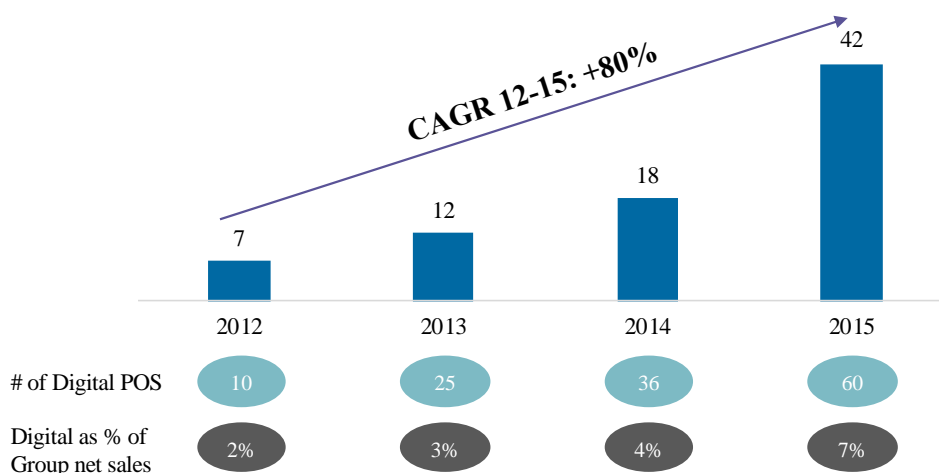
Source: Company data

SMCP's new online scalable platform allowed them, not only to expand its international digital presence, but also to improve the customer experience by enhancing brand content and omni-channel services. For instance, SMCP worked on better integrating its online channel with its stores by reducing delivery times, introducing same day delivery and same day click and collect, as well as e-reservation of products available in store. In terms of penetration, SMCP's online penetration varied significantly by country, with the highest penetration being the UK (19%), followed by the US, Germany, Benelux and France. Below the group's average penetration rate of 10% were Spain and Italy, reflecting the fact that online formed a less important part of the market in Southern Europe. China, APAC, Switzerland and Rest of the World also had below-average online penetration rates.

Diversification into Accessories and Menswear

Under KKR's management, SMCP also started to further diversify its product offering with the production of two new main categories: menswear and accessories.

In the menswear category, SMCP with its Sandro Homme brand, grew at 18% CAGR between year-ends 2012 and 2015 (way above the 3% CAGR of the menswear market), generating sales of €59mm in 2015 (c.18% of Sandro sales and c.8% of total sales). By the end of 2015, the Group had 226 points sales for Sandro Men, split between 104 standalone menswear stores, 103 mixed stores and 19 internet "stores". In order to increase the percentage of menswear sales within Sandro, SMCP implemented initiatives such as store roll-out programmes and new

store concepts, or the enhancement of the marketing and communication, including via social media and influencers.

Figure 74: SMCP menswear and accessories sales evolution, 2012-2015 (€mm)

Menswear   **Accessories**
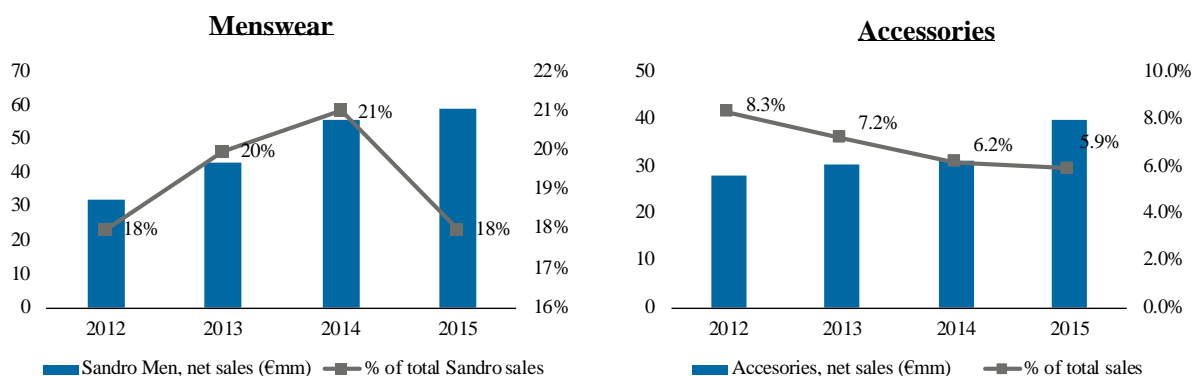
Source: Company data

Within accessories, SMCP also achieved fast growth, with a 15% CAGR over fiscal years 2012 to 2015 (way above the 5% CAGR of the accessories market), achieving revenues of €40mm in 2015 (c.6% of total sales). SMCP set up dedicated business units in each of the three brands including teams with dedicated designers, mainly focused on leather foods (especially handbags) and shoe wear. As for menswear, SMCP carried out different steps to further accelerate sales of accessories in its stores such as the implementation of licenses in certain categories or rolling out accessories' corners in department stores.

- *Margin effect*

The margin effect reflects the value created from increases in EBITDA margin and is computed by multiplying the change in margin by the entry Revenues and by the entry EV/EBITDA multiple.

In this case, when looking at the margin effect, KKR indeed destroyed value. The EBITDA margin decreased from 17.6% at entry in 2012 to 15.8% in 2015. Margin came through particularly in 2014, when it decreased to 14.5%, due to operating deleverage caused by soft LFL, negatively impacted by unfavourable economic conditions. However, in 2015 the Group managed to improve significantly its EBITDA margin. This improvement was driven by: (i) declining weight of commissions due to less concessions and rents as concessions fees in % generally lower internationally compared to France, (ii) operating leverage and (iii) fast expansion of higher margin China and Digital. With regards to the commissions, KKR

managed to decline them, as percentage of total net sales, from 17.1% in 2012 to 13.4% in 2015.

Figure 75: EBITDA and EBITDA margin evolution, 2012-2015 (€mm - %)
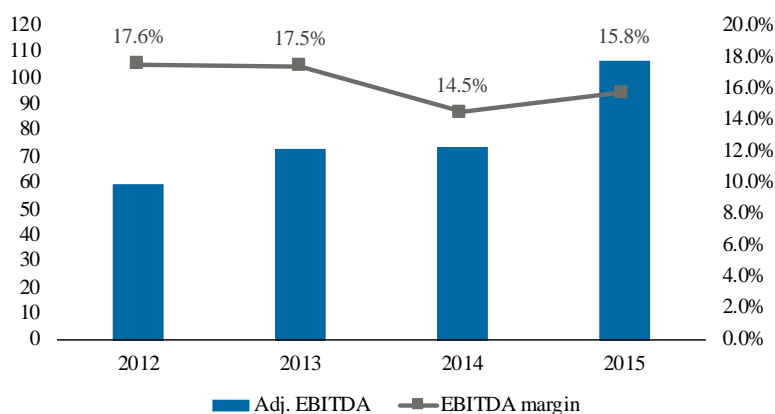
Source: Company data

Once again, SMCP's rather low EBITDA margin compared to the luxury goods average might be a consequence of its still high exposure to concessions and affiliates for its expansion strategy, which comes with very high fees. If corners and affiliates operations were to be excluded, a much higher EBITDA margin would result (c. 21%). The Margin effect TM is negative 0.12x, realizing the value destructive just described. This account for a negative 5.1% and 5.9% of total value creation, and capital gains of the buyout, respectively.

- *Combo 2 effect*

The combo 2 effect reflects the value attributable to the combined effect of a simultaneous increase in revenues and improvement of EBITDA margin. It is calculated by simply multiplying the change in revenues by the change in EBITDA margins by the entry EV/EBITDA multiple, later divided by the Net Capital Gains of the Fund to get the TM multiple.

In this case, although SMCP experienced huge revenue growth and as a consequence, positive sales effect, due to the margin effect being negative, the combined effect of both was also negative. Resulting TM accounts again for a negative 0.12x, contributing negative 5.1% and 5.9% to the overall value creation (including Convertibles) and Net Capital Gains of the buyout, respectively.

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d. Value creation comparison by region, industry, size and exit year

One of the main purposes of applying a validated method to analyse the value creation to the Fund is indeed being able to compare the findings with other transactions. In the case of the reference paper ("International Evidence on Value Creation in Private Equity Transactions") the comparison by region, industry, size and exit year could be done. The comparison though, entails some limitations.

Comparison sample and limitations

The reference paper comprises 2,029 transaction observations as per the figure below. Further classification of the sample is made by region, industry, transaction size and exit year. Note that small cap transactions are those with an entry EV of less than $100mm, while mid-cap are the ones with an entry EV of less than $1bn but more than the first amount.

Figure 76: Sample details, IRR, TM and holding period

	Obs.	Median IRR[49]	Median TM	Median Holding (yrs)
Region				
North America	587	32%	2.8x	4.8
Europe	1,336	35%	2.5x	4.3
Asia	88	36%	2.5x	3.5
Other	18	34%	2.7x	5.8
Industry				
Industrials	726	37%	2.8x	4.5
Consumer Goods	467	32%	2.5x	4.6
Consumer Services	327	34%	2.5x	4.5
Technology	161	35%	2.7x	4.3
Other	348	31%	2.6x	4.3
Transaction size[50]				
Small-cap	1,023	36%	2.8x	4.5
Mid-cap	833	33%	2.6x	4.4
Large-cap	173	29%	2.3x	4.3
Exit year				
1987-2000	274	51%	3.2x	3.4
2001-2008	1,111	36%	2.7x	4.2
2009-2013	644	25%	2.4x	5.2
Total	2,029	34%	2.6x	4.5
SMCP (by KKR)	-	34%	2.38/2.06x[51]	2.83/4.33[52]

Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner)

[49] At Fund level
[50] At entry; Small
[51] 2.38x TM includes Net Capital Gains from Convertible Bonds investment, 2.06x TM excludes the latter
[52] 2.83 if first exit considered, 4.33 at final sale (IPO, October 2017)

- **Comparison imperfection**: an optimal comparison between the sample presented and SMCP would entail a separation of only those sample LBOs that comply with the Group specifications (Region: Europe, Industry: Consumer Goods, Transaction size: Mid-cap; Exit year: post-2008). This would largely narrow the observation but would ensure a higher fit and adequacy of any study. At present, the data used for the reference paper is not publicly available. This means that the mentioned optimal screening of transactions is impossible to elaborate. Therefore, comparison between SMCP and the sample has been made on an individual category basis, as presented below. This entails a certain degree of cross-comparison, meaning for example that when comparing by region, transactions with an industry, size or exit different from that of SMCP have been included.

- **Holding period, TM and IRR**: as mentioned earlier in this Thesis, the reference study requires the determination of a single exit date and single equity entry. As detailed above, SMCP's LBO comprises a two-phase exit and a preliminary Convertible Debt investment by the Fund. As a consequence, when comparing the sample details and SMCP's returns *(Figure 75)*, it can be observed how even with a relatively lower LBO TM (2.06x, excluding the Convertibles investment) and a similar appointed Holding Period (4.33 years) at final exit, the transaction has a seemingly normal IRR. This is a consequence of the assumptions and limitations made for the application of the method of the paper (detailed in 6a). Consequently, TM can be substantially while returning same IRR levels given that the primary or most significant exit is done well before any other median exit dates. In this regard, the method of the study itself is a limitation, as comparing TM multiples does not account for the holding period's impact on returns. Unavailability of a similar study using IRR instead of TM is hence a constraint to the below comparisons. Nevertheless, the reference paper is indeed extremely effective when comparing the % of the derived LBO TM coming from each of the factors, as presented in the figures below.

By region

As outlined in Appendices *(A 23)*, the reference study shows buyout transactions have been more value creative in general in North America and have had similar return levels in Europe and Asia. In terms of the proportional contribution of each of the factors to the gains, American LBOs seem to better squeeze the possible creation out of leverage, probably due to the better conditions of financial markets, stronger economy, and better underlying debt availability.

Multiple effect or expansion effect is substantially higher in Asia due to the large number of the sample's transactions carried out in emerging markets with enormous markets potential. Operational squeezing of value creation is fairly similar in all geographies.

As for the comparison with SMCP, the Group clearly did an outstanding job in creating value through both the EBITDA and Sales effect, vastly surpassing the medians of all geographies *(A 23)*, while using leverage at a similar level than the top performing geography (North America). Narrowing down the sample for a better comparison, the below figure compares the European LBOs, regardless of size, industry or exit year, to the SMCP LBO by KKR. Note that in all TM graphs, the one for SMCP is consistently lower than those of the rest. This, again, is due to a much shorter "practical" holding period (the main inflows happen in 2.8 years), as explained in the limitations of this comparison above. The median IRR for the European sample is 35%, while the Fund's IRR of the SMCP LBO is 34% *(Figure 76)*.

Figure 77: Value creation comparison, Europe.TM and % of factor contribution
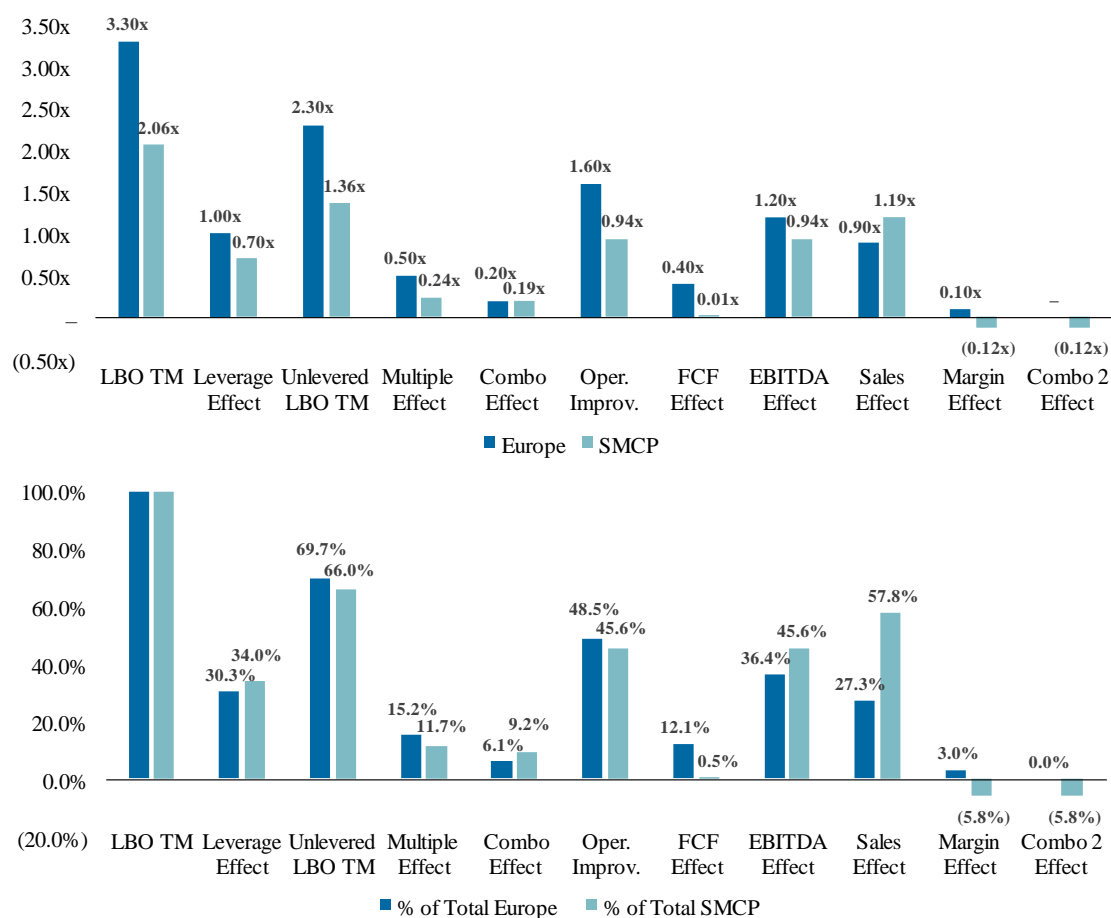
Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

In the above detailed comparison, it can be observed how the Group's transaction is very similar in Leverage, Multiple, Combo and overall Operational Improvements contribution to

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European transactions. There is substantial difference, though, in the distribution of the Operational Improvements percentages *(A 23)*. The sales effect accounts for a 57.8% of the value created in the SMCP LBO, versus a lower 27.3% for its European counterparts. On the other hand, both the Margin and Combo 2 effect are negative for the Group, versus a nearly null contribution in the rest of the European buyouts. This highlights the importance of the measures taken by KKR during the controlling period (2013-2016) to expand the Group's sales and the drivers used to achieve it (international expansion, e-commerce development, diversification into accessories and menswear) presented before.

By industry

The study's industry comparison *(A 24)* demonstrates how industrial and consumer goods buyouts are the ones that create most value for investment funds if measured with TM, being technology the less creative category. Note that only 4 sectors are shown (the ones considered as most relevant by the reference study's authors). Regarding the % contributions of the factors, the study shows a clear tendency of tech LBOs to capture value through multiple expansion (this seems reasonable given that the paper also includes tech-boom pre-2000 transactions into account). Regarding operational improvements, again the sector of SMCP (Consumer Goods) is the one creating the most value through EBITDA and Sales effect.

Regarding the narrower comparison between the Group's sector and SMCP, the below graph reflects on the differences, regardless of geography, size or exit year. Again, it is essential to recall that the consistent lower TM is due to a much shorter "practical" holding period, as explained in the limitations of this comparison above. Also, there is an intrinsic extra limitation to this comparison, given that Consumer Goods indeed includes a varied range of businesses, not necessarily very similar to that of SMCP. The median IRR for the Consumer Goods sample is 32%, slightly lower than SMCP's IRR of 34% *(Figure 76)*.

Figure 78: Value creation comparison, Consumer Goods.TM and % of factor contribution
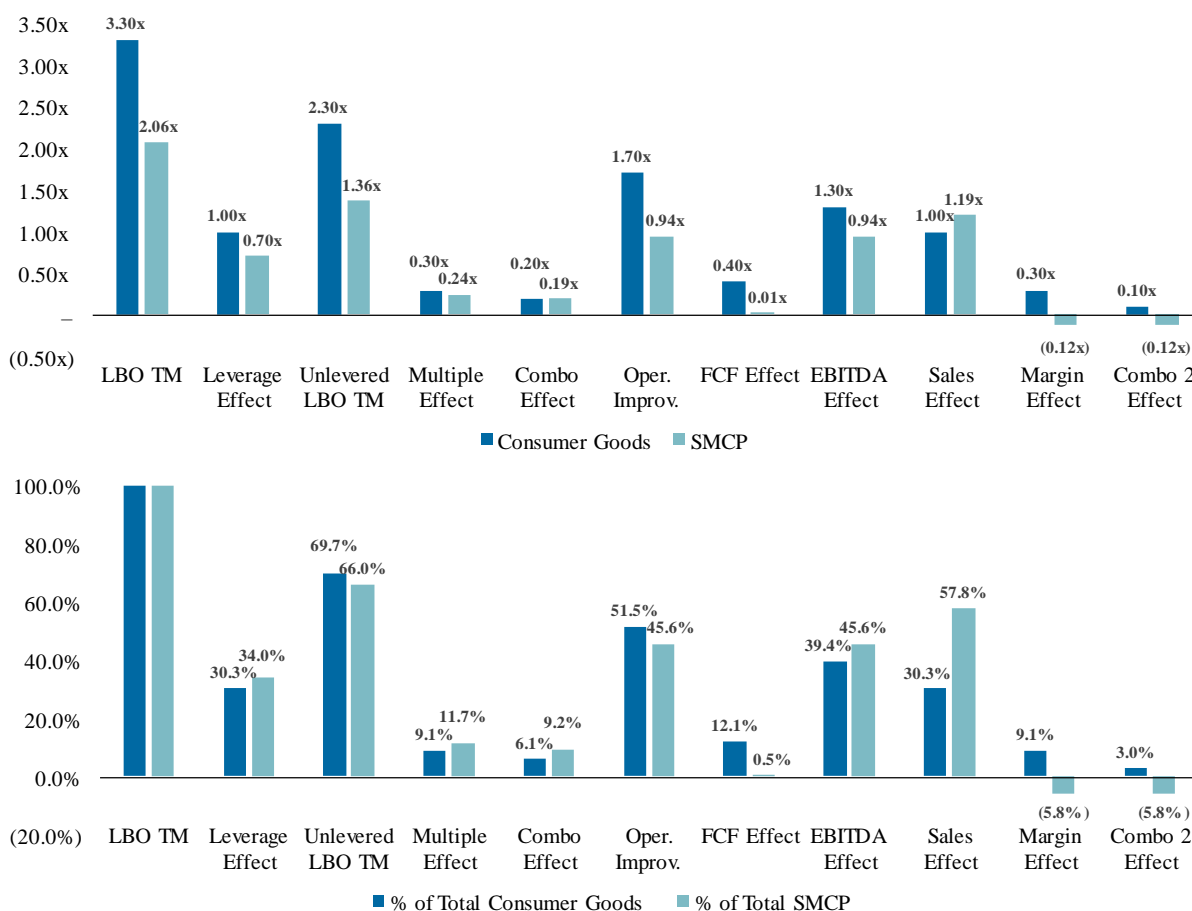
Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

Note how non-operational effects keep the trend present in the geography comparison: a similar use of Consumer Goods buyouts and SMPC of leverage and market factors. Again, since there is no reduction of Debt by KKR, the FCF effect difference is significant. This time around, the effects of all operational factors are more similar in percentage, most probably due to a related business model and underlying macro trends driving each sub-sector. Nevertheless, the substantial Sales effect difference is still observed, again outlining its importance for SMCP.

By size

Unlike the two previous factors, both size and exit year differences are large when comparing the transactions in each category. In the case of the size comparison *(A 25)*, the reference study clearly shows an abundant extra value creation by small versus mid-cap transactions, and between the latter and large-cap buyouts. This is the reason why a significant number of investors turn to the so called "middle market" managers that may offer better returns. In this sense, smaller companies tend to be less scrutinized, and most importantly, they tend to have more room for improvement in operations, management, financing, etc. Regarding the

contribution percentages of each factor, the reference paper demonstrates a larger value creation from leverage in the larger deals, most probably because more secure companies are able to lock down better financing and debt terms while having always access to capital markets in an easy manner. On the other hand, the unscrutinised smaller companies manage to generate larger capital gains through multiple expansion. Operational metrics do not show a clear trend.

Being the SMCP buyout a mid-cap transaction, the next figure compares its value creation factors with those of all Mid-cap LBOs in the sample, regardless of geography, industry or exit year. In this sense, the Group's LBO is well aligned with the mid-cap median of 33% IRR *(Figure 76)*.

Figure 79: Value creation comparison, Mid-cap.TM and % of factor contribution
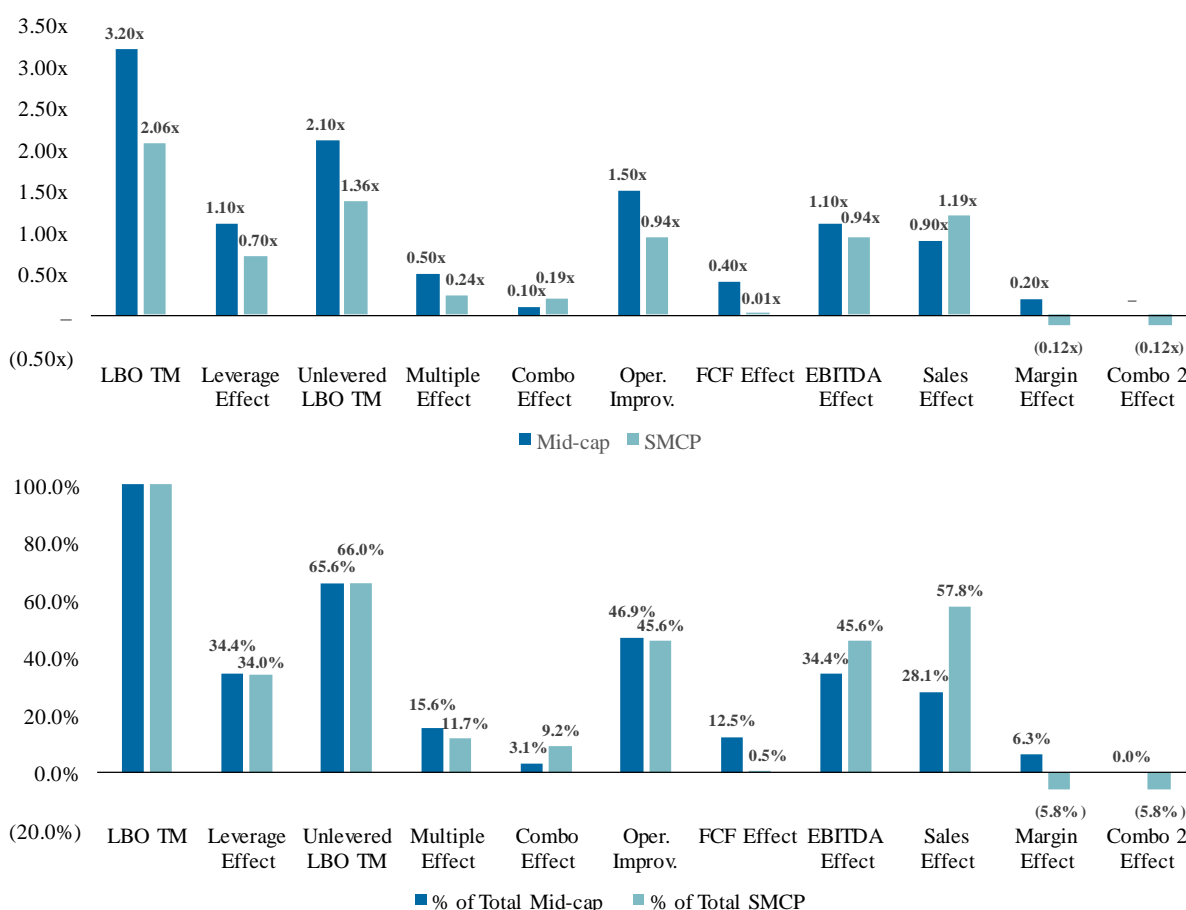
Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

In terms of percentage contribution of each factor within the Mid-cap category, again SMCP's transaction coincides in a high degree with the characteristics of the rest of buyouts in all extra-operational metrics (Leverage, Multiple and Combo effects). Also note how the main differences in the operational factors have the same trends as the ones presented in the comparison by geography and industry, and for the same underlying reasons (the most

important being the large difference in sales effect). In the non-operational effects, the null creation through FCF keeps standing as an outlier.

By exit year

As previously mentioned, the exit year of the transactions in the reference document also bears that essential characteristics such as returns, or leverage could be very different across eras. As exposed in Section I of this Thesis, trends for the study sample comply with the historical direction of returns depending on the corresponding PE era. Boom and pre-crisis LBO result in both higher returns and higher use of leverage while using market trends as a larger value creation method in proportion, while post-2008 buyouts rely more on Operational Improvements as a capital gain lever for the overall LBO *(A 26)*.

Focusing more on the post-crisis deals and how SMCP compares to them, the Group's transaction achieves a substantially larger IRR (34% against a sample median of 25%), largely driven by a much shorter holding period than that of the sample median as explained previously *(Figure 76)*.

Figure 80:Value creation comparison, 2009-2013.TM and % of factor contribution
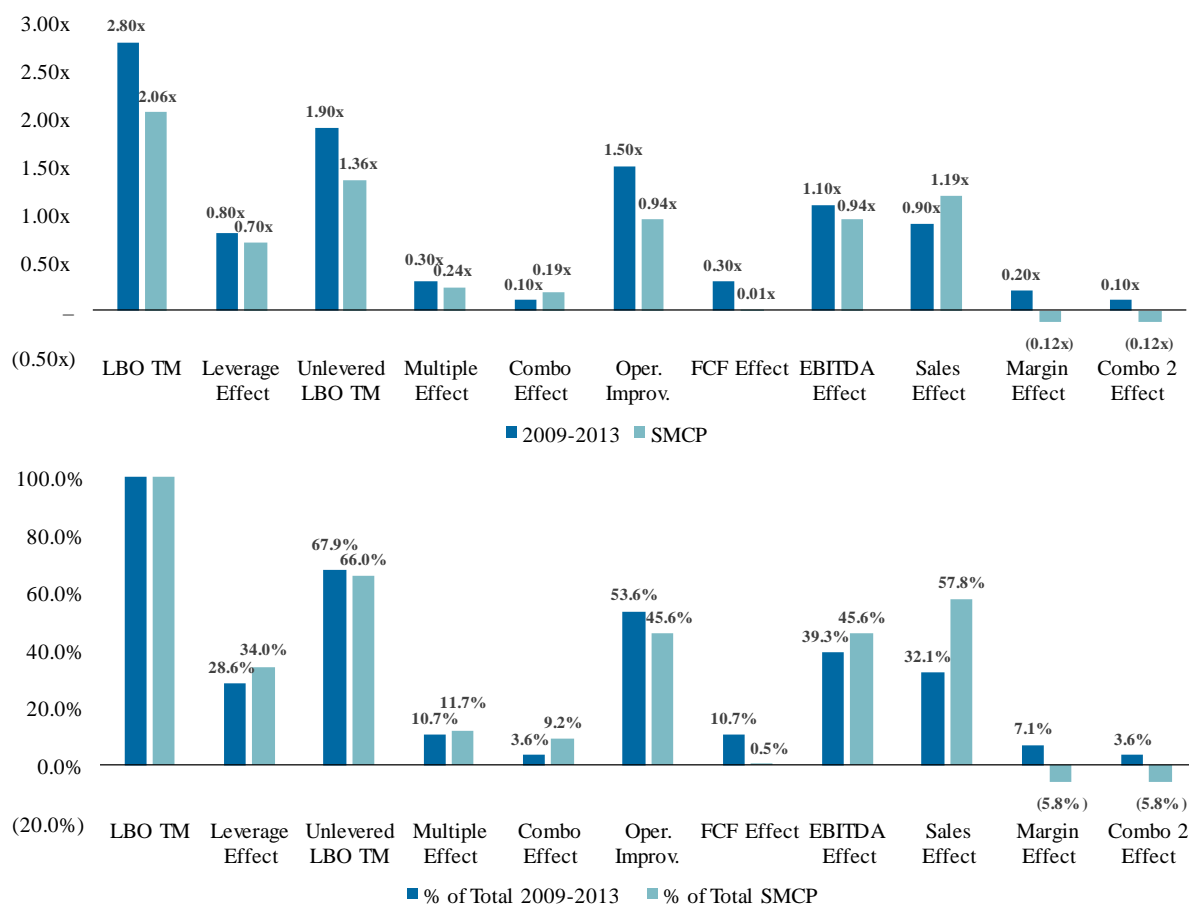
Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

In terms of the contribution of each of the factors, the Group's LBO again ratifies the tendency presented in the earlier narrower sample graphs: non-operational contribution is mostly in line with the post-2008 sample, while it is evident that SMCP relied more in the Sales effect and its drivers than its transaction peers, once more.

Comparison conclusion

By analysing the comparisons above and the reference study data compiled in Appendices *(A 23 to A 26),* a few clear common characteristics can be drawn from the SMCP LBO.

Firstly, the company is graphed as having less TM value creation consistently, this is not due to fewer returns (IRR of 34%), but rather due to a shorter holding period than any of the categories of the sample transactions show (KKR's main exit is executed after 2.8 years, while only two of the groupings in the original study have a median holding period lower than 4 years, and none lower than 3 years). Secondly, it is evident that the operational strategy put in place by KKR indeed relies on revenue expansion and the development of its drivers (international expansion, e-commerce development, diversification into accessories and menswear) ultimately trickling down its effect to an increase in EBITDA. As seen in all Figures and Appendices, the EBITDA and Sales effect proportion of value creation is consistently higher than those of the various samples in all categories. This though, is undermined by negative margin evolution (decrease in EBITDA margin between exit and entry) and an almost null contribution from the FCF effect, given that most LBOs tend to repay some part of debt financing in the interim, while KKR does not. Additionally, the Group does not issue any dividends, nor increases capital to the business during the LBO (2013-2016). Thirdly, the deal shows reasonable levels of value created due to leverage compared to all sub-samples, signalling the soundness of the operation, even if KKR had no intention of redeeming a part of its debt and reducing its debt position in the buyout interim. Lastly, note that leverage contributes a higher percentage of value creation than the median LBO post-2008. On the other hand, while Sales and EBITDA do carry most of the weight of the value creation, these are dragged down by the negative margin effect, effectively leaving the KKR LBO with a lower percentage of the gains contributed by operational improvements *(A 23 to A 26).*

e. Social value created

Due to the lack of detailed ESG related information during the LBO period, the focus of the alternative value creation analysis has been centred around social development figures to the Group's workforce/employees.

Employment growth

When looking at the evolution of employment levels during the LBO period it can be seen that, indeed, SMCP's huge international expansion was backed by considerable growth on its employment figures. The number of employees grew at 17.9% CAGR between 2013 and 2015 from 2,787 to 3,876.

Figure 81: Number of employees by category and total growth, 2013-2015
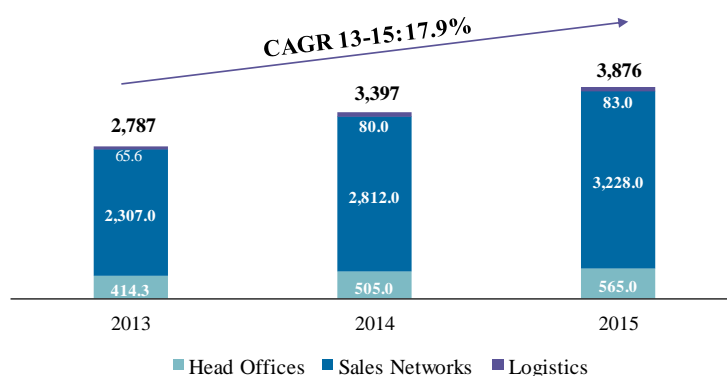
Source: Company data

The specified 17.9% CAGR is significantly greater than the 12.1% in compounded growth in SMCP's store network during the same period (2013-2015) and is also greater than the 12.6% rate for DOS growth, in which most of sales personnel are deployed. Classified by categories, the Sales Networks employee numbers showed the highest growth at 18.3% CAGR in the reported years. Head offices staff grew at a compounded 16.8% and logistics personnel increased at a 12.5% CAGR rate (note that more than 80% of the workforce is composed by Sales Networks employees). This is a logical consequence of the Group aggressively growing internationally in points of sale, while maintaining storage (outside Europe) and logistics subcontracted for the most part. Moreover, company data shows that density of employees deployed in directly operated points of sale (DOS) increased at a 5% CAGR during the LBO period.

Figure 82: Total DOS and sales employees per DOS (2013-2015)
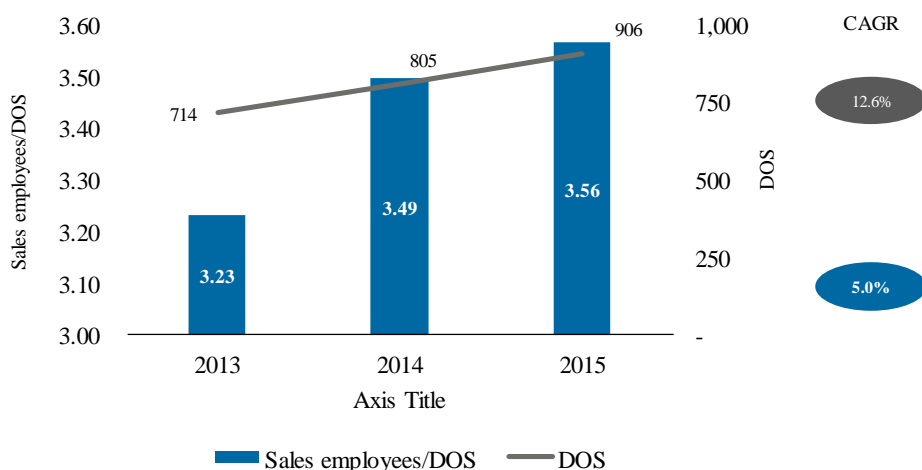
Source: Company data

This substantial growth signals the eagerness of the Group to deploy a higher density of store personnel instead cutting down the workforce (a topic for LBOs, especially in France). This is beneficial for both customers and communities, as well as the overall economy, as more employee's contribute income taxes and are employed per the same space compared with pre-LBO figures.

Gender ratios and leadership

In terms of gender equality and opportunities, analysing the Group's workforce in France, which at the time accounted for more than half of the Group's employees, it can be seen how the proportion of women managers was very high at 76% in 2014, and increased 200bps to 78% in 2015. In other non-managerial positions, the proportion of women stayed also way above the 50% rate during the whole LBO period. While this may seem common in a women-centred fashion business, note that even with the aggressive rise of Sandro Homme in all metrics possible, the mentioned ratios have been mostly stable.

Figure 83: Women proportions in the workforce, managers and supervisors (%)
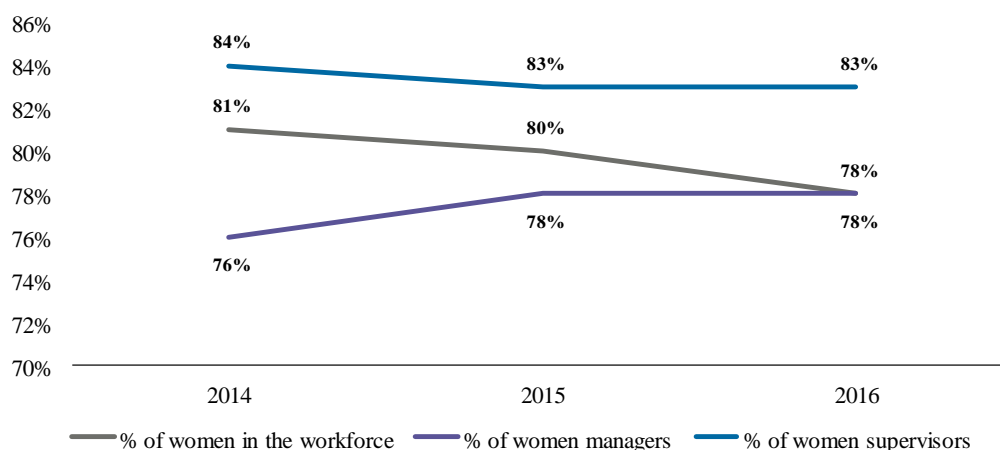
Source: Company data

Apart from these women-empowering numbers, at LBO exit, SMCP womenswear products were designed by teams led by women (founders Evelyne Chetrite and Judith Milgrom) while also being top executives. In contrast, fewer than 50% of well-known womenswear brands are designed by women, and only 14% percent of major brands have female executives in top management.[53]

Employment remuneration

Although limited data is publicly available for a complete remuneration evolution study, SMCP's total payroll expense represented €147.4mm compared to €118.3mm in 2014. The payroll corresponds to the sum of all gross salaries and employer social security charges, as well as employee profit-sharing and incentive plans. The top four executives (Daniel Lalonde, Evelyn Chetrite, Judith Milgrom and Ylane Chetrite), on the other hand, earned an aggregate of €5.4mm in 2015 (all included) compared to €2.48mm in 2014. Subtracting the top executive's compensation to the gross amount, and computing it the remaining number of employees, the average gross salary per employee increased a 7.3%, from €34.1k to €36.6k, in the final two LBO years (2014-2015). Indeed, top four executives all included pay went up by a staggering 118.7% in the same period. Most of this increase is due to objective-based compensation, or variable pay, set by KKR to align the Fund's objectives with those of top management, and most probably these agreements were one of many terms of the deal struck between management, founders, and KKR, at entry.

[53] According to McKinsey & Company (2018)

Figure 84: Employee remuneration excluding top four executives, 2014-2015 (€)
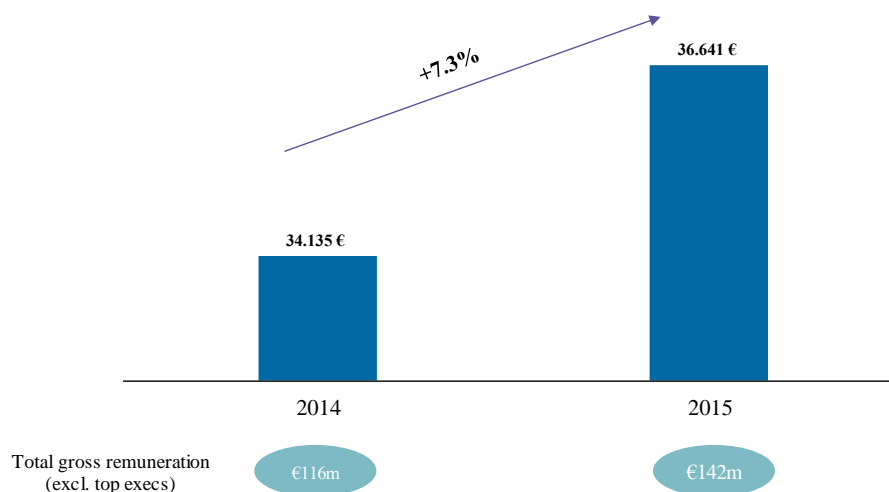
Source: Company data

In a similar way, KKR set up a performance-driven compensation structure for its salesforce incorporating a variable component based on sales objectives. Hence, considering the huge increase in sales during the 3-year period, this incentive mechanism could have been one of the main drivers of this enhancement in employee remuneration, as it was for executive compensation. Controversy is served after the LBO in this regard, and especially in France, given that the % increase gap between plain employees and top management is not insignificant. Nevertheless, recall that the terms of agreement struck between KKR and executives of the group as part of the initial purchase are not known, which could well accounts for the bulk of such enormous differences. A common method used in recent years to reflect the so called "pay gap inequality" as far as intra-company position goes, is to compare the ratio of CEO pay to average worker compensation. In this sense, SMCP Group CEO Daniel Lalonde earned 21.5x and 50.14x than the average in 2014 and 2015, respectively. Although high, this is less than the median public French companies' ratio in 2012 (around 100x)[54], or top consumer companies in both the UK (median 166x) or the US (where the worst paid S&P 500 CEO in the retail sector earns 50x times the median employee salary).

Employee training

In 2013, KKR created the SMCP school, a training school to educate store managers and regional heads about sales skills, product training and brand storytelling. Since 2013, the Group

[54] According to The Economist

expanded its school from France to the United Stated and Asia, substantially increasing the number of training hours per employee. The amount spent in training as well as the total number of training hours per employee also increased during the whole LBO period. Specific data is only available for the two final full years of operations, in which average training hours per employee almost doubled, as per the figure below.

Figure 85: Average training hours/employee (2014-2015)
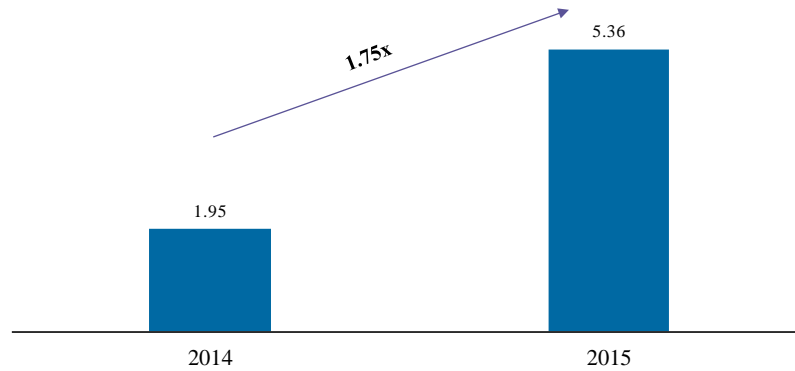
CONCLUSIONS

As indicated in the introduction, the purpose of this paper was to study the role of Private Equity and LBOs in value creation within the retail industry, and more specifically, to identify drivers of value creation in the buyout of retailer SMCP Group by KKR.

Section I starts with an overview of the current and future situation of both retail and PE sectors. When analysing the retail/apparel industry, it has been shown how the channel shift to online is the main driver of the industry and how the changes in customer behaviour, demanding more convenience, newness and immediacy, are pushing the sector into omnichannel retailing and into fast fashion in the case of apparel. As with other industries, growth in emerging markets and technological disruption have also been clear drivers of the industry. Finally, as described, retail has been one of the most affected markets, in both positive and negative ways, by the current COVID-19 crisis. This could have major implications for the sector as a clear shift to online and digital purchasing is awaited while, as in any economic downturn, consumer spending is expected to decrease and shift to value for money.

Under the PE industry overview, it has been clearly shown how the asset-class has historically presented, across its eras, a very attractive appeal in terms of risk-return profile for investors. Risks and potential issues ingested in the last decade post-2008 are also explored. Curiously enough, these issues are presented as being tested right now, given the present COVID-19 health and economic crisis and its potential implications, as described. This could be especially acute in retail PE, which presents a riskier profile than other buyouts, even more so when some levels of distress have already been in place in the last years, as demonstrated in this Thesis.

In the last part of Section I, an understanding of the notion of value creation in the buyout context been provided. Hence, a framework presented by Gottschalg has been adapted to be able to differentiate between value capturing and value creation drivers and to further split them into main levers such as multiple expansion, financial engineering, operational improvements or strategic refocus. After introducing the main drivers of value creation in LBOs, the standard metrics used to measure the returns for the different stakeholders have been presented. Closing Section I, an introduction and rationale on the method of value creation measurement of the reference paper used, mentioned below, is presented.

In Section II, and in order to better understand the drivers of value creation and their effects at a company and fund level, a real LBO has been selected as a case study. A detailed analysis on

the SMCP's buyout by KKR has been completed. In order to properly breakdown the value gained, the mentioned academic paper, currently in literature, has been used ("International Evidence on Value Creation in Private Equity Transactions" by Puche, Braun and Achleitner). The applied methodology of this paper has allowed for the separation of the capital gains to the investment fund in several factors, and the comparison of the contributions of these effects versus 2,000+ similarly analysed LBOs.

The conclusions of this study and comparison have been clearly outlined. Firstly, an early majority stake exit allows KKR's fund to realize phenomenal returns in a very short holding period (an IRR of 34% with a majority holding period of 2.8 years, while total fund TM was 2.38x). Secondly, KKR majorly relied on its means of expanding the Group's sales for value creation. Almost half of the value created to the Fund comes from such effect, while more than 57% of the gains from the LBO (excluding side investments) are due to revenue expansion. Thirdly, the mentioned buyout gains generally comply with standard buyout characteristics in non-operational metrics, and their proportion of overall value creation. That is, gains resulting from leverage and market conditions in SMCP and the sample of the reference study are indeed proportionally alike. These proportions, however, wildly differ when focusing in operationally related value creation. Sales expansion in groupings of the sample normally account for around 30% of the value added, while the case's expansion resulted in the mentioned 57%, highlighting the excellent execution from KKR in their presented strategies (international expansion, e-commerce development, diversification into accessories and menswear). As a result of it, EBITDA was also majorly increased in absolute values. In relative terms, on the other hand, margins present a value destructive result, while being normally value creative in all the comparison's subcategories.

After the value gains breakdown is compared, Section II is concluded with an analysis of the social value created during the buyout for SMCP's employees and related social agents. While having some conflictive points, the available data clearly show that employees also benefit from this operation (i.e. increasing levels of compensation or training).

All in all, this Thesis clearly demonstrates that retailers can create value while under PE ownership. Retail LBOs can indeed be successful in both realizing shareholders returns and creating value for its employees and other social agents. In the case of SMCP, its revenue expansion strategy held the key to this achievement.

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APPENDICES

A 1: KKR European Funds detail

KKR European Funds	
Name	KKR&Co.
Total AUM ($bn)	$208.40
Total Funds managed	53
Total European PE Funds	5
KKR European Fund I ($bn)	$3.10
Vintage	1999
KKR European Fund II (€bn)	€4.50
Vintage	2005
KKR European Fund III ($bn)	$6.79
Vintage	2008
KKR European Fund IV (€bn)	€3.54
Vintage	2015
KKR European Fund V (€bn)	€5.80
Vintage	2019

Source: Private Equity International

A 2: KKR European Fund III Limited Partners detail

	LPs				
Name	**Instituion Type**	**Comm ($mm)**	**Comm (€mm)**	**Headquarters**	**Country**
ACE&Co	Investment Firm	NA	NA	Geneva	Switzerland
California Pulbic Employees Retirement System	Public Pension Fund	$327.74	€482.23	Sacramento	US
Canada Pensions Plan Investment Board	Public Pension Fund		€109.60	Toronto	Canada
Florida Retirement System Trust Fund	Public Pension Fund	NA	NA	Tallagassee	US
Ilmarinen Mutal Pension Insurance Company	Insurance Company	NA	NA	Helsinki	Finland
Kentucky Teachers' Retirement Sytstem	Public Pension Fund	NA	NA	Frankfort	US
Kuwait Fund for Arab Economic Development	Government Investment Organisation	NA	NA	Kuwait City	Kuwait
Leland Fikes Foundation	Foundation/Endowment	NA	NA	Dallas	US
Maryland State Retirement&Pension System	Public Pension Fund	NA	NA	Baltimore	US
Oregon Public Employees' Retirment System	Public Pension Fund	$412.10	€606.35	Tigard	US
Oregon State Treasury	Public Pension Fund	$412.10	€606.35	Salem	US
Partners Group	Independent Firm (PE)	NA	NA	Baar-Zug	Switzerland
State of Michigan Retirement Systems	Government Investment Organisation	NA	NA	Lansing	US
State of Wisconsin Investment Board	Public Pension Fund	NA	NA	Madison	US
Washington State Investment Board	Public Pension Fund	$606.00	€891.65	Olympia	US

Source: Private Equity International

A 3:Entry Prospect details, Sources&Uses (€mm)

Company Financials 2012	
Adj. EBITDA	59.5
Cash and liquid assets	13.0
Long-term debt	142.0
Short-term debt (Revolver)	6.0
Minority interests	-
Associates (€mm)	-
Off Balance Sheet Items (€mm)	na

Entry Assumptions	
Entry Year	**2013**
Exit Year	
Purchase EV (incl. inter-company bonds)	896.6
Offer Equity Value (70.2%) (incl. inter-company bonds)	534.6
Offer Equity Value (100%) (incl. inter-company bonds)	761.6
Entry EV/EBITDA (incl. inter-company bonds)	15.07x
Equity % purchased	70.2%
Purchase EV (excl. inter-company bonds)	718.5
Offer Equity Value (70.2%) (excl. inter-company bonds)	409.6
Offer Equity Value (100%) (excl. inter-company bonds)	583.5
Entry EV/EBITDA (exc. Inter-company bonds)	12.08x
Other managers Equity % purchased	3.6%
Total Equity % purchased	73.8%

Equity (KKR) (incl. inter-company bonds, €125mm	**391.3**
Debt	**290.0**
Total	**681.34**
% Equity	**57.4%**
% Debt	**42.6%**

Sources&Uses

Excluding inter-company bonds (Issued before acquisition)

Equity	280.0	Repayment of Debt	135.0
Senior Secured Notes	290.0	Financing & Transaction Fees	25.4
		Equity purchase (70.2%) & Others	409.6
Total	**570.0**	**Total**	**570.0**

Fees amortization

Item	Amount imposable	Fee %	Fee	Amortizaion/year	tion period
Senior Secured Notes	290.0	4.8%	14.0	2.1	6.8 years
Convertible Bonds	125.0	4.8%	6.0	0.6	10.0 years
Transaction Fees	534.6	1.0%	5.3	0.5	10.0 years
Total	**949.6**		**25.4**	**3.2**	

Source: SMCP Registration Document (15 September 2017); PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Entry Prospect")

A 4: Revolving Credit Facility details - Tranche 0₅₅ (€mm)

Revolving Credit Facility - Tranche 0			
Issue date	16/09/2013	**Covenants**	
Expiry date	9/30/2018	**Applicable only when minimum drawn (%)**	25.0%
Principal amount (€mm)	70.0	**Applicable only when minimum drawn (€mm)**	17.5
Interest type	Floating	*Maximum Cons. Debt/Cons. EBITDA*	
Benchmark	3m LIBOR on debt currency	*31/12/2014*	8.5x
Spread	Ratchet (see below)	*31/03/2015*	7.9x
Yearly Fees (% of applied spread)	35.0%	*30/06/2015*	7.8x
Junior to	Operating non-financial debt	*30/09/2015*	7.7x
Garantors pledge	Target shares	*31/12/2015*	7.8x
	Same interest terms that those	*31/03/2016*	7.3x
Major assumption	**given to SMCP in 2016 "New RCF**	*30/06/2016*	7.6x
	Facility", 2013 RCF data NA	*30/09/2016*	7.5x
		31/12/2016	7.6x
Spread on LIBOR		*31/03/2017*	7.6x
Leverage Ratio	**Spread**	*&Thereafter*	
≥2.5x	2.50%		
<2.5x and ≥2.0x	2.25%		
<2.0x and ≥1.5x	2.00%		
<1.5x and ≥1.0x	1.75%		
<1.0x and ≥0.5x	1.50%		
<0.5x	1.25%		

Source: SMCP Registration Document (15 September 2017); PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Debt Struct & Specifications")

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55 Assumption mentioned: Revolving Credit Facility terms were not available in the Registration Document of 2017 or any other document. Therefore, similar terms to a New RCF issued in 2016 after the Shandong Ruyi stake purchase (explored later in this Thesis), have been assumed. This New RCF was committed under much more stable operating conditions for SMCP Group than those of 2012-2013, but for a significantly larger amount (€250m).

A 5: Senior Secured Notes detail - Tranche 1(€mm)[56]

Senior Secured Notes - Tranche 1	

		Covenants	
Issue date	16/09/2013	*Minimum Fixed Charge Coverage*	2.0x
Expiry date	15/06/2020	*Maximum Senior Secured Levarge*	4.0x
Principal amount (€mm)	290.0	*Testing Frequency*	Quarterly, LTM basis
Interest %	8.875%	*Negative pledge*	Yes
Interest type	Fixed	*Maximum Dividend Payout Ratio*	50.0%
Cash/Accrued	Cash	*Asset sale limitations*	
PIK	No	>5€mm sale used to reduce principal outstanding	
Interest payments/year	2	>75% of any asset sale in cash or liquid securities	
Interest payment date I	feb-14	*Carve out of less than 5% of assets can be non-cash)	
Interest payment date II	ago-14		
Interest payment amount (€mm	25.7		

Issuance fees cost (€mm)	14.0	Interest Schedule	
Amortization period	81 months	2/1/2014	25.7
Junior to	Operating non-fin. debt, RCF	8/1/2014	25.7
Garantors pledge	Target Shares	2/1/2015	25.7
Bookrunners	Credit Suisse	8/1/2015	25.7
	Goldman Sachs	2/1/2016	25.7
	KKR CM	8/1/2016	25.7
	UBS	2/1/2017	25.7
Amortizatoin/Bullet	Bullet	8/1/2017	25.7
Cash sweep available	No	2/1/2018	25.7
		8/1/2018	25.7
		2/1/2019	25.7
		8/1/2019	25.7
		2/1/2020	25.7

	Moody's Rating			S&P Rating	
Parent Credit Rating		B2	**Parent Credit Rating**		B
SMCP		B3	**SMCP**		B
Downgrade rating		Caa1	**Downgrade rating**		B-
Downgrade conditions			**Downgrade conditions**		
Adj. Debt/EBITDA above		**5.5x**	*Ad. Debt/EBITDA above*		NA
Upgrade rating		B2	**Upgrade rating**		B+
Upgrade conditions			**Upgrade conditions**		
Consistent FCF above (€mm)		-	*Consistent FCF above (€mm)*		NA
Adj. Debt/EBITDA below		**4.5x**	*Ad. Debt/EBITDA below*		NA
EBITA/Interest expense above		**2.5x**	*EBITA/Interest expense above*		NA

Moody's report for strategic conditions for upgrade/downgrade

Source: SMCP Registration Document (15 September 2017); PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Debt Struct & Specifications"), Moody's, S&P Global, Société Générale Cross Asset Research / Credit

A 6: Convertible Bonds detail, fully subscribed by KKR societies (€mm)[57][58]

Convertible Bonds - Tranche 2			
Issue date	20/06/2013	Convertible at trigger events	
Expiry date	20/06/2023	*Initial Public Offering*	
Principal amount (€mm)	125.0	*30 days prior to expiration*	
Interest %	8.00%		
Interest type	Fixed	Interest Schedule	
Cash/Accrued	Accrued	6/30/2014	10.0
PIK	No	6/30/2015	10.0
Interest payments/year	1	6/30/2016	10.0
Interest payment date I	6/30/2014	6/30/2017	10.0
Interest payment amount (€mm)	10.0	6/30/2018	10.0
Issuance fees cost (€mm)	6.0	6/30/2019	10.0
Amortization period	120 months	6/30/2020	10.0
Junior to	Operating non-fin. debt, RCF, Senior Secured	6/30/2021	10.0
Amortizatoin/Bullet	Bullet	6/30/2022	10.0
Cash sweep available	No	6/30/2023	10.0
Convertible Bonds fully subscribed by societies in full KKR & Management control			

Source: SMCP Registration Document (15 September 2017); PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Debt Struct & Specifications")

A 7: Main LBO Prospect modelling assumptions in each scenario (%)[59][60]

Item	Bull	Base	Bear	Step	Limit
Sales Growth	19.0%	17.0%	15.0%	0.25%	21.5%
Comissions as % of Sales	15.0%	16.1%	17.1%	(0.5%)	14.0%
COGS as % of Sales	24.5%	26.0%	27.5%	0.00%	23.0%
SG&A as % of Sales	39.8%	40.8%	41.8%	(0.25%)	38.0%
Capex as % of Sales	8.0%	9.0%	10.0%	0.50%	11.0%
D&A as % of Capex	50%	55.0%	60.0%	5.0%	50.0%
Amortization of Intangibles a % of Sales	0.4%	0.5%	0.6%	0.0%	0.3%
Tax Rate	33.3%	33.3%	33.3%	-	na
Minority Interests & Associates (% NI)	0.0%	0.0%	0.0%	-	na
Other fixed assets (incl. DTAs) as % of Sales	0.0%	0.0%	0.0%	-	na
Inventory DSO	55.0	58.1	61.0	(1.0)	50.0
Accounts recievable&equivalents DSO	26.1	29.1	32.1	-	24.0
Payables&Other DO	300.4	303.4	306.4	-	315.0
DTLs as % of Sales	0.0%	0.0%	0.0%	-	na
Minimum Cash Required (€mm)	7.5	7.5	7.5	na	na
Rental Expense/Leases as % os Sales	8.5%	9.5%	10.5%	0.00%	11.00%

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Income and BS Statements")

[57] Debt Amortization Period assumed to be months until expiration, in line with industry standards

[58] Issuance fees for Convertible Bonds assumed to be same % as fees imposed in Secured Notes Issuance

[59] SG&A includes Personnel, Rental, External, Other tax, and Other charges

[60] Statutory Tax Rate assumed at 33%, as of French law in 2013. No tax consolidation advantages in line with the legal structure presented has been accounted for

A 8:Income Statement and Debt Schedule Prospect summary, Bull Case (1)

Income Statement

(figures in €mm except per share data)

Fiscal year	Entry 2013E	2014E	2015E	2016E	2017E	2018E	Exit 2019E	CAGR 2013-2019
Sales before commissions	**403.4**	**481.1**	**574.9**	**688.4**	**826.1**	**993.4**	**1,197.0**	*16.4%*
% change YoY	*19.0%*	*19.3%*	*19.5%*	*19.8%*	*20.0%*	*20.3%*	*20.5%*	
Adj. EBITDA	**83.7**	**103.5**	**127.9**	**154.9**	**188.0**	**228.5**	**278.4**	*17.9%*
% change YoY	*40.7%*	*23.6%*	*23.7%*	*21.1%*	*21.3%*	*21.6%*	*21.8%*	
as % of Sales before commissions	*20.8%*	*21.5%*	*22.3%*	*22.5%*	*22.8%*	*23.0%*	*23.3%*	
D&A and Provisions	(17.8)	(27.6)	(36.6)	(48.5)	(64.3)	(85.4)	(113.3)	
Adj. EBIT	**66.0**	**75.8**	**91.4**	**106.5**	**123.6**	**143.1**	**165.0**	*13.8%*
Attributable Net Profit	**44.0**	**26.7**	**37.1**	**47.1**	**58.6**	**71.6**	**86.2**	
% change YoY	*107.4%*	*(39.3%)*	*38.9%*	*27.1%*	*24.3%*	*22.2%*	*20.4%*	
as % of Sales before commissions	*10.9%*	*5.6%*	*6.5%*	*6.8%*	*7.1%*	*7.2%*	*7.2%*	

Debt Schedule

	2013E	2014E	2015E	2016E	2017E	2018E	2019E	
Senior Secured Notes								
Senior Secured Notes EOP	**290.0**	**290.0**	**290.0**	**290.0**	**290.0**	**290.0**	**290.0**	
Interest	-	*25.7*	*25.7*	*25.7*	*25.7*	*25.7*	*25.7*	
Convertible Bonds								
Convertible Bonds EOP	**125.0**	**135.0**	**145.0**	**155.0**	**165.0**	**175.0**	**185.0**	
Interest	-	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*	
Minimum Cash Requirements	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	
Revolver drawdawn	(5.4)	-	-	-	-	-	-	
Revolver repayment	-	5.4	-	-	-	-	-	
Revolver EOP	**(5.4)**	**-**	**-**	**-**	**-**	**-**	**-**	
Revolver Interests	*0.02*	*0.02*	-	-	-	-	-	
Dividends	**-**	**10.3**	**18.6**	**23.6**	**29.3**	**35.8**	**43.1**	
Dividend payout ratio	*0.0%*	*38.6%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	
Cash BOP	**-**	**7.5**	**7.5**	**13.3**	**22.6**	**36.7**	**57.2**	
Change in cash	-	-	5.8	9.3	14.1	20.5	25.9	
Cash EOP	**7.5**	**7.5**	**13.3**	**22.6**	**36.7**	**57.2**	**83.1**	
Total Interest	**(0.02)**	**(35.76)**	**(35.74)**	**(35.74)**	**(35.74)**	**(35.74)**	**(35.74)**	

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Income and BS Statements", "Debt Schedule")

A 9: Income Statement and Debt Schedule Prospect summary, Base Case (2)

Income Statement

(figures in €mm except per share data)

Fiscal year	Entry 2013E	2014E	2015E	2016E	2017E	2018E	Exit 2019E	CAGR 2013-2019
Sales before commissions	**396.6**	**465.0**	**546.4**	**643.4**	**759.2**	**897.8**	**1,063.9**	14.8%
% change YoY	*17.0%*	*17.3%*	*17.5%*	*17.8%*	*18.0%*	*18.3%*	*18.5%*	
Adj. EBITDA	**68.2**	**83.4**	**102.1**	**125.1**	**153.3**	**184.0**	**220.7**	17.6%
% change YoY	*14.6%*	*22.4%*	*22.4%*	*22.5%*	*22.6%*	*20.0%*	*19.9%*	
as % of Sales before commissions	*17.2%*	*17.9%*	*18.7%*	*19.4%*	*20.2%*	*20.5%*	*20.7%*	
D&A and Provisions	(21.6)	(32.0)	(41.5)	(53.7)	(69.6)	(86.7)	(108.0)	
Adj. EBIT	**46.6**	**51.4**	**60.7**	**71.4**	**83.7**	**97.3**	**112.7**	14.0%
Attributable Net Profit	**31.0**	**10.3**	**16.5**	**23.7**	**32.0**	**41.1**	**51.3**	
% change YoY	*46.2%*	*(66.7%)*	*60.1%*	*43.4%*	*34.7%*	*28.5%*	*25.0%*	
as % of Sales before commissions	*7.8%*	*2.2%*	*3.0%*	*3.7%*	*4.2%*	*4.6%*	*4.8%*	

Debt Schedule

	Entry 2013E	2014E	2015E	2016E	2017E	2018E	Exit 2019E	
Senior Secured Notes								
Senior Secured Notes EOP	290.0	290.0	290.0	290.0	290.0	290.0	290.0	
Interest	*-*	*25.7*	*25.7*	*25.7*	*25.7*	*25.7*	*25.7*	
Convertible Bonds								
Convertible Bonds EOP	125.0	135.0	145.0	155.0	165.0	175.0	185.0	
Interest	*-*	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*	
Minimum Cash Requirements	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	
Revolver drawdawn	(18.7)	-	-	-	-	-	-	
Revolver repayment	-	0.4	5.7	12.5	0.1	-	-	
Revolver EOP	**(18.7)**	**(18.2)**	**(12.5)**	**(0.1)**	**-**	**-**	**-**	
Revolver Interests	*0.08*	*0.16*	*0.13*	*0.06*	*0.00*	*-*	*-*	
Dividends	**-**	**-**	**-**	**-**	**16.0**	**20.5**	**25.7**	
Dividend payout ratio	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*50.0%*	*50.0%*	*50.0%*	
Cash BOP	-	7.5	7.5	7.5	7.5	12.4	24.2	
Change in cash	-	-	-	-	4.9	11.8	20.5	
Cash EOP	**7.5**	**7.5**	**7.5**	**7.5**	**12.4**	**24.2**	**44.7**	
Total Interest	**(0.08)**	**(35.90)**	**(35.87)**	**(35.79)**	**(35.74)**	**(35.74)**	**(35.74)**	

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Income and BS Statements", "Debt Schedule")

A 10: Income Statement and Debt Schedule Prospect summary, Bear Case (3)

Income Statement

(figures in €mm except per share data)

	Entry						Exit	
Fiscal year	2013E	2014E	2015E	2016E	2017E	2018E	2019E	CAGR 2013-2019
Sales before commissions	**389.9**	**449.3**	**518.9**	**600.7**	**696.8**	**810.0**	**943.7**	13.2%
% change YoY	*15.0%*	*15.3%*	*15.5%*	*15.8%*	*16.0%*	*16.3%*	*16.5%*	
Adj. EBITDA	**53.1**	**64.6**	**78.5**	**95.4**	**115.9**	**140.8**	**171.1**	17.6%
% change YoY	*(10.7%)*	*21.6%*	*21.5%*	*21.5%*	*21.5%*	*21.5%*	*21.5%*	
as % of Sales before commissions	*13.6%*	*14.4%*	*15.1%*	*15.9%*	*16.6%*	*17.4%*	*18.1%*	
D&A and Provisions	**(25.7)**	**(36.6)**	**(46.3)**	**(56.4)**	**(68.7)**	**(83.8)**	**(102.3)**	
Adj. EBIT	**27.4**	**28.0**	**32.2**	**39.0**	**47.2**	**57.0**	**68.8**	16.1%
Attributable Net Profit	**18.2**	**(8.0)**	**(4.0)**	**1.8**	**7.2**	**13.8**	**21.8**	
% change YoY	*(14.2%)*	*(144.2%)*	*(50.6%)*	*(145.8%)*	*297.8%*	*90.8%*	*57.7%*	
as % of Sales before commissions	*4.7%*	*(1.8%)*	*(0.8%)*	*0.3%*	*1.0%*	*1.7%*	*2.3%*	

Debt Schedule

Senior Secured Notes								
Senior Secured Notes EOP	**290.0**	**290.0**	**290.0**	**290.0**	**290.0**	**290.0**	**290.0**	
Interest	*-*	*25.7*	*25.7*	*25.7*	*25.7*	*25.7*	*25.7*	
Convertible Bonds								
Convertible Bonds EOP	**125.0**	**135.0**	**145.0**	**155.0**	**165.0**	**175.0**	**185.0**	
Interest	*-*	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*	*10.0*	
Minimum Cash Requirements	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	**(7.5)**	
Revolver drawdawn	(31.0)	(16.4)	(12.3)	(5.3)	-	-	-	
Revolver repayment	-	-	-	-	2.2	11.8	24.0	
Revolver EOP	**(31.0)**	**(47.3)**	**(59.7)**	**(64.9)**	**(62.7)**	**(51.0)**	**(27.0)**	
Revolver Interests	***0.14***	***0.34***	***0.47***	***0.55***	***0.56***	***0.50***	***0.34***	
Dividends	**-**	**-**	**-**	**-**	**-**	**-**	**-**	
Dividend payout ratio	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	
Cash BOP	**-**	**7.5**	**7.5**	**7.5**	**7.5**	**7.5**	**7.5**	
Change in cash	-	-	-	-	-	-	-	
Cash EOP	**7.5**	**7.5**	**7.5**	**7.5**	**7.5**	**7.5**	**7.5**	
Total Interest	**(0.14)**	**(36.08)**	**(36.21)**	**(36.28)**	**(36.30)**	**(36.23)**	**(36.08)**	

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Income and BS Statements", "Debt Schedule")

A 11: Covenants Prospect compliance summary

Bull Case

Fiscal year		2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revolving Credit Facility									
Covenant	Leverage Ratio								
Applicable when minimum drawn	17.5								
Leverage Ratio EOP			5.02x	4.11x	3.40x	2.87x	2.42x	2.03x	1.71x
Covenant Ratio			na	8.46x	7.82x	7.58x	7.58x	7.58x	7.58x
Covenant Compliance			na	na	na	na	na	na	na
Senior Secured Notes									
Covenant 1	Fixed Charge Coverage								
Fixed Charge Coverage Ratio EOP			4.14x	1.66x	1.85x	1.99x	2.12x	2.23x	2.32x
Covenant Ratio			2.00x	2.00x	2.00x	2.00x	2.00x	2.00x	2.00x
Covenant 1 Compliance			OK	Breach	Breach	Breach	OK	OK	OK
			Breach does not trigger default for this covenant						
Covenant 2	Senior Secured Leverage								
Senior Secured Leverage Ratio EOP			3.37x	2.73x	2.16x	1.73x	1.35x	1.02x	0.74x
Covenant Ratio			4.00x	4.00x	4.00x	4.00x	4.00x	4.00x	4.00x
Covenant 2 Compliance			OK	OK	OK	OK	OK	OK	OK
Covenant 3	Maximum Payout Ratio								
Payout Ratio			0.00%	38.61%	50.00%	50.00%	50.00%	50.00%	50.00%
Covenant Ratio			50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%
Covenant 2 Compliance			OK	OK	OK	OK	OK	OK	OK
Moody's Rating EOP			B3	Stable B3	Upgrade B2	Upgrade B2	Upgrade B2	Upgrade B2	Upgrade B2

Base Case

Fiscal year		2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revolving Credit Facility									
Covenant	Leverage Ratio								
Applicable when minimum drawn	17.5								
Leverage Ratio EOP			6.36x	5.31x	4.38x	3.56x	2.97x	2.53x	2.15x
Covenant Ratio			na	8.46x	7.82x	7.58x	7.58x	7.58x	7.58x
Covenant Compliance			na	OK	na	na	na	na	na
Senior Secured Notes									
Covenant 1	Fixed Charge Coverage								
Fixed Charge Coverage Ratio EOP			2.89x	1.24x	1.36x	1.47x	1.58x	1.67x	1.76x
Covenant Ratio			2.00x	2.00x	2.00x	2.00x	2.00x	2.00x	2.00x
Covenant 1 Compliance			OK	Breach	Breach	Breach	Breach	Breach	Breach
			Breach does not trigger default for this covenant						
Covenant 2	Senior Secured Leverage								
Senior Secured Leverage Ratio EOP			4.14x	3.39x	2.77x	2.26x	1.81x	1.44x	1.11x
Covenant Ratio			4.00x	4.00x	4.00x	4.00x	4.00x	4.00x	4.00x
Covenant 2 Compliance			Breach	OK	OK	OK	OK	OK	OK
Covenant 3	Maximum Payout Ratio								
Payout Ratio			0.00%	0.00%	0.00%	0.00%	50.00%	50.00%	50.00%
Covenant Ratio			50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%
Covenant 2 Compliance			OK	OK	OK	OK	OK	OK	OK
Moody's Rating EOP			B3	Stable B3	Stable B3	Stable B3	Upgrade B2	Upgrade B2	Upgrade B2

Bear Case

Fiscal year		2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revolving Credit Facility									
Covenant	Leverage Ratio								
Applicable when minimum drawn	17.5								
Leverage Ratio EOP			8.39x	7.31x	6.30x	5.35x	4.47x	3.67x	2.93x
Covenant Ratio			na	8.46x	7.82x	7.58x	7.58x	7.58x	7.58x
Covenant Compliance			na	OK	OK	OK	OK	OK	OK
Senior Secured Notes									
Covenant 1	Fixed Charge Coverage								
Fixed Charge Coverage Ratio EOP			1.97x	0.88x	0.95x	1.03x	1.13x	1.22x	1.31x
Covenant Ratio			2.00x	2.00x	2.00x	2.00x	2.00x	2.00x	2.00x
Covenant 1 Compliance			Breach	Breach	Breach	Breach	Breach	Breach	Breach
			Breach does not trigger default for this covenant						
Covenant 2	Senior Secured Leverage								
Senior Secured Leverage Ratio EOP			5.32x	4.37x	3.60x	2.96x	2.44x	2.01x	1.65x
Covenant Ratio			4.00x	4.00x	4.00x	4.00x	4.00x	4.00x	4.00x
Covenant 2 Compliance			Breach	Breach	OK	OK	OK	OK	OK
Covenant 3	Maximum Payout Ratio								
Payout Ratio			0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Covenant Ratio			50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%
Covenant 2 Compliance			OK	OK	OK	OK	OK	OK	OK
Moody's Rating EOP			B3	Stable B3	Stable B3	Stable B3	Stable B3	Stable B3	Stable B3

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Covenants Compliance")

A 12: Exit Prospect detail (€mm)[61]

Company Financials 2017	
Adj. EBITDA	125.1
Cash and liquid assets	7.5
Long-term debt	290.0
Short-term debt (Revolver)	0.1
Convertibles	155.0
Minority interests	-
Associates (€mm)	-

Exit Transaction Assumptions	
Entry Year	**2013**
Exit Year	**2017**
Purchase EV	1,510.7
Offer Equity Value (70.2%)	753.4
Offer Equity Value (100%)	1,073.2
Exit EBITDA	12.076x
Selected Case (1=Bull; 2=Base; 3= Bear)	2
Select exit case EV isomultiple	Excl. inter-company bonds

KKR Returns	
Entry Equity	**391.3**
Direct Equity	266.3
Convertible Debt	125.0
Exit	**908.4**
Direct Equity Sale	753.4
Convertible Debt (incl. accrued int.)	155.0

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Exit Prospect")

[61] Assuming Iso-Multiple Entry/Exit equal to 12.08x (multiple on sale excluding Convertible Bonds fully subscribed by KKR in June 2013)

A 13: Ownership evolution (%) and transaction summaries

0 — Shareholding structure 2007 - Sept. 2010 (Initial Partnership)

Frederic Biousse	12.5%
Elie Kouby	12.5%
Evelyne Chetrite	37.5%
Judith Milgrom	37.5%
Total	*100.0%*

Transaction details

Executives Frederic Biousse and Elie Koibyu, seniors from prestigious retial firm Comptoir des Cottoniers, purchase a 25% in SMCP for around €11.2mm

Revenues 2007 (€mm)	48.0
Multiple 2010	0.93x
Equity Value (€mm)	44.7
Stake purchased	25.0%
Offer price (€mm)	11.16

1 — Shareholding structure Sept.2010 - Jun. 2013 (1st LBO)

LF Invest	51.0%
Frederic Biousse	6.1%
Elie Kouby	6.1%
Evelyne Chetrite	18.4%
Judith Milgrom	18.4%
Total	*100.0%*

Transaction details

LF Invest, 50/50 JV of L Capital and Florac, purchases a 51% stake in SMCP, value at around €200mm

Revenues 2010 (€mm)	215.0
Equity Value 2010 (€mm)	200.0
Multiple	0.93x
Stake purchased	51.0%
Offer price (€mm)	102.0

2 — Shareholding structure Jun. 2013 - Apr. 2014 (2nd LBO I)

Frederic Biousse	4.3%
Elie Kouby	2.8%
Evelyne Chetrite	10.0%
Judith Milgrom	9.1%
Ylane Chetrite	1.9%
Other managers	1.7%
KKR&Co.	70.2%
Total	*100.0%*

Transaction details

KKR purchases a 70.2% stake from LF Invest, and partly from executives and founders, using high yield bonds, equity, and indirect equity in the from of convertible bonds completely purchased by KKR for an EV of of around XXX

Capital Increase (€mm)	280.0
Bond issuance @2020 (€mm)	290.0
Convertible Bonds fully purchased by KKR (€mm)	125.0
Total Uses	695

3 — Shareholding structure Apr. 2014 - Apr. 2016 (2nd LBO II)

Frederic Biousse	4.3%
Elie Kouby	2.8%
Evelyne Chetrite	10.0%
Judith Milgrom	9.1%
Ylane Chetrite	1.9%
Daniel Lalonde	0.5%
Other managers	1.7%
KKR&Co.	69.7%
Total	*100.0%*

Transaction details

Daniel Lalonde, CEO appointed by controling shareholder KKR, enters LBO with a 0.45% stake, sold by KKR at a value of around 1.9€mm

4 — Shareholding structure Apr. 2016 - Oct. 2017 (Shandong + KKR)

Shandong Ruyi&Co	81.5%
Evelyne Chetrite	3.2%
Judith Milgrom	2.9%
Ylane Chetrite	0.6%
Daniel Lalonde	0.5%
Other managers	1.7%
KKR&Co.	9.6%
Total	*100.0%*

Transaction details

Shandong Ruyi, a chinese conglomerate, and its co-investors, purchase an 81.5% from KKR (left with 10%) and partly from executives and founders (all stake of old executives is sold). Offer value is around 950€mm

Acquisition of shares	949.4
Early Repayment of 2020 LBO HY Bonds Ppal (€mm)	290.0
Early Repayment penalty and accrued interest (€mm)	17.8
Others (€mm)	95.3
Total Uses	1,352.5

5 — Shareholding structure Oct. 2017 Post-IPO

Shandong Ruyi&Co	57.0%
Free Float	34.0%
Evelyne Chetrite	3.2%
Judith Milgrom	2.9%
Ylane Chetrite	0.6%
Daniel Lalonde	0.5%
Other managers	1.7%
Total	*100.0%*

Transaction details

The Group IPOs offering XXX€mm at €22.0 per share. KKR completely sells down its stake, along with a partial sale of Shandong's holdings. There is an additional XXX capital increase of new shares sold

Capital increase of (mm€)	127.0
Sale of Shandong stake (mm€)	261.0
Sale of KKR 10% (mm€)	**148.0**
Sale of some of Managers stake	5.9
Global offering amount (mm €)	541.9

Source: PEREZ Rafa and HERRERA Enrique Prospect LBO Model ("Ownership Evolution")

A 14: Actual SMCP Group Income Statement (2012-2016)

Income Statement					
(figures in €mm except per share data)					
Fiscal year	*2012A*	*2013A*	*2014A*	*2015A*	*2016A*
Fiscal year end	*12/31/2012*	*12/31/2013*	*12/31/2014*	*12/31/2015*	*12/31/2016*
Sales before commissions	**339.0**	**417.4**	**508.6**	**675.4**	**786.3**
% change YoY		*23.1%*	*21.8%*	*32.8%*	*16.4%*
% LFL		*4.0%*	*1.4%*	*11.0%*	*7.1%*
Commissions	**(58.0)**	**(66.0)**	**(75.0)**	**(94.0)**	**(105.0)**
as % of Sales before commissions	*17.1%*	*15.8%*	*14.7%*	*13.9%*	*13.4%*
Net sales net of commissions	**281.0**	**351.4**	**433.6**	**581.4**	**681.3**
% change YoY		*25.1%*	*23.4%*	*34.1%*	*17.2%*
Sales cost (COGS)	**(83.0)**	**(96.0)**	**(118.0)**	**(160.0)**	**(186.0)**
as % of net sales	*29.5%*	*27.3%*	*27.2%*	*27.5%*	*27.3%*
Gross margin	**198.0**	**255.4**	**315.6**	**421.4**	**495.3**
% change YoY		*29.0%*	*23.6%*	*33.5%*	*17.5%*
Gross margin % of net sales	*70.5%*	*72.7%*	*72.8%*	*72.5%*	*72.7%*
Gross margin excl. comissions	*75.5%*	*77.0%*	*76.8%*	*76.3%*	*76.3%*
Personnel expenses	**(74.0)**	**(88.0)**	**(118.0)**	**(147.0)**	**(167.0)**
as % of Sales before commissions	*21.8%*	*21.1%*	*23.2%*	*21.8%*	*21.2%*
Rental charges	**(21.0)**	**(32.0)**	**(51.0)**	**(69.0)**	**(85.0)**
as % of Sales before commissions	*6.2%*	*7.7%*	*10.0%*	*10.2%*	*10.8%*
External charges	**(26.0)**	**(32.0)**	**(41.0)**	**(50.0)**	**(60.0)**
as % of Sales before commissions	*7.7%*	*7.7%*	*8.1%*	*7.4%*	*7.6%*
Taxes	**(4.0)**	**(3.0)**	**(4.0)**	**(7.0)**	**(8.0)**
as % of Sales before commissions	*1.2%*	*0.7%*	*0.8%*	*1.0%*	*1.0%*
Others charges	**(15.0)**	**(26.0)**	**(29.0)**	**(41.0)**	**(46.0)**
Adj. EBITDA	**59.5**	**72.9**	**73.8**	**106.5**	**129.6**
% change YoY		*22.5%*	*1.2%*	*44.3%*	*21.7%*
as % of Sales before commissions	*17.6%*	*17.5%*	*14.5%*	*15.8%*	*16.5%*
Adj. EBITDAR	**80.50**	**104.90**	**124.80**	**175.50**	**214.60**
as % of Sales before commissions	*23.7%*	*25.1%*	*24.5%*	*26.0%*	*27.3%*
D&A and provisions	**(9.5)**	**(20.5)**	**(26.8)**	**(38.1)**	**(37.9)**
Adj. EBIT	**50.0**	**52.4**	**47.0**	**68.4**	**91.7**
as % of Sales before commissions	*14.7%*	*12.6%*	*9.2%*	*10.1%*	*11.7%*
Restructuring charges	(0.5)	(1.8)	(5.5)	(4.5)	(6.5)
Impairment of assets	(0.5)	(0.2)	(2.9)	(1.4)	NA
Free shares					
Asset disposals	(0.1)	(0.3)	0.3	0.3	NA
Other	(0.2)	(0.1)	(0.4)	(5.4)	(24.8)
Non-current operating income	**(1.3)**	**(2.4)**	**(8.5)**	**(11.0)**	**(31.3)**
EBIT	**48.7**	**50.0**	**38.5**	**57.4**	**60.4**
as % of Sales before commissions	*14.4%*	*12.0%*	*7.6%*	*8.5%*	*7.7%*
Cost of debt	**(13.5)**	**(13.5)**	**(40.4)**	**(38.8)**	**(28.9)**
Financial result/average net		*28.9%*	*21.0%*	*8.4%*	*6.0%*
Currencies charges	(0.1)	(0.2)	1.6	4.3	-
Others	0.3	0.8	4.8	(1.7)	(49.2)
Financial result	**(13.3)**	**(12.9)**	**(34.0)**	**(36.2)**	**(78.1)**
Taxation	**(15.0)**	**(14.0)**	**(11.8)**	**(13.4)**	**39.9**
Tax rate	*42.4%*	*37.7%*	*262.2%*	*63.2%*	*NA*
Associates	0.8	5.7	-	-	-
Net profit	**21.2**	**28.8**	**(7.3)**	**7.8**	**22.2**
% change YoY		*35.8%*	*(125.3%)*	*(206.8%)*	*184.6%*
Minority interests	-	-	-	-	-
Attributable net profit	**21.2**	**28.8**	**(7.3)**	**7.8**	**22.2**
% change YoY		*35.8%*	*(125.3%)*	*(206.8%)*	*184.6%*
as % of Sales before commissions	*6.3%*	*6.9%*	*(1.4%)*	*1.2%*	*2.8%*

Source: Société Générale Cross Asset Research

A 15: Actual SMCP Group summarized Cash Flow Statement (2012-2016) (€mm)

Cash Flow Statement					
Fiscal year	*2012A*	*2013A*	*2014A*	*2015A*	*2016A*
Fiscal year end	*12/31/2012*	*12/31/2013*	*12/31/2014*	*12/31/2015*	*12/31/2016*
Adj. EBITDA	**59.5**	**72.9**	**73.8**	**106.5**	**129.6**
Financial interest paid (cash)	**(3.7)**	**(9.2)**	**(31.4)**	**(23.6)**	**(78.3)**
Tax paid with (cash)	**(11.8)**	**(22.8)**	**(29.6)**	**10.6**	**(9.7)**
Others	**-**	**-**	**-**	**-**	**5.0**
Change in working capital	**(7.0)**	**(22.0)**	**(29.0)**	**(18.0)**	**(16.0)**
Operating Cash Flow	**37.0**	**18.9**	**(16.2)**	**75.5**	**30.6**
Capital expenditure	**(30.0)**	**(52.0)**	**(39.0)**	**(37.0)**	**(39.0)**
Expansion	(18.0)	(43.0)	(20.0)	(20.0)	(21.0)
Infrastructure and other capex	(6.0)	(4.0)	(10.0)	(14.0)	(10.0)
Store refurbishment	(6.0)	(5.0)	(9.0)	(3.0)	(8.0)
Disposals	*2.0*	*(1.0)*	*-*	*-*	*-*
Investing Cash Flow	*(28.0)*	*(53.0)*	*(39.0)*	*(37.0)*	*(39.0)*
Increase in capital	**-**	**-**	**2.0**	**-**	**29.0**
Financial investments/disposals	**-**	**(8.0)**	**(5.0)**	**-**	**-**
Dividend	**-**	**-**	**-**	**-**	**-**
Others	**-**	**-**	**-**	**(14.0)**	**(50.0)**
Financing Cash Flows	**-**	**(8.0)**	**(3.0)**	**(14.0)**	**(21.0)**
Net cash inflows	*9.0*	*(42.1)*	*(58.2)*	*24.5*	*(29.4)*

Source: Société Générale Cross Asset Research

A 16: Actual SMCP Group summarised Balance Sheet Statement (2012-2016) (€mm)[62]

Balance Sheet					
Fiscal year	*2012A*	*2013A*	*2014A*	*2015A*	*2016A*
Fiscal year end	*12/31/2012*	*12/31/2013*	*12/31/2014*	*12/31/2015*	*12/31/2016*
Plant, property and equipment	36.0	55.0	64.0	69.0	65.0
Goodwill	44.0	58.0	336.0	337.0	630.0
Brands	140.0	140.0	236.0	236.0	600.0
Other intangible assets	57.0	71.0	122.0	116.0	120.0
Investments	1.0	-	10.0	13.0	15.0
Other financial assets	7.0	8.0	2.0	-	1.0
Deferred taxes	9.0	12.0	18.0	20.0	55.0
Total fixed assets	**294.0**	**344.0**	**788.0**	**791.0**	**1,486.0**
Cash and liquid assets	13.0	13.0	16.0	27.0	57.0
Inventories	54.0	79.0	98.0	126.0	147.0
Accounts receivable	18.0	22.0	31.0	36.0	41.0
Other debtors	9.0	55.0	40.0	34.0	27.0
Others	-	-	-	-	-
Total current assets	**94.0**	**169.0**	**185.0**	**223.0**	**272.0**
Total assets	**388.0**	**513.0**	**973.0**	**1,014.0**	**1,758.0**
Short-term debt	6.0	1.0	89.0	60.0	6.0
Payables	36.0	47.0	52.0	79.0	102.0
Other debt	33.0	202.0	41.0	59.0	81.0
Debt on assets to be sold	-	-	-	-	-
Total short-term liabilities	**75.0**	**250.0**	**182.0**	**198.0**	**189.0**
Long-term debt	76.0	3.0	278.0	282.0	448.0
Convertibles	66.0	-	141.0	152.0	-
PIK Loan	-	-	-	-	305.0
Deferred taxation	47.0	46.0	100.0	104.0	197.0
Provisions	-	1.0	2.0	2.0	2.0
Provisions	2.0	1.0	4.0	3.0	4.0
Minority interests	-	-	-	-	-
Other	-	-	-	-	-
Total long-term liabilities	**191.0**	**51.0**	**525.0**	**543.0**	**956.0**
Total Liabilites	**266.0**	**301.0**	**707.0**	**741.0**	**1,145.0**
Share capital	78.0	145.0	85.0	85.0	58.0
Reserves	44.0	67.0	181.0	188.0	555.0
Total shareholders' equity	**122.0**	**212.0**	**266.0**	**273.0**	**613.0**

Source: Société Générale Cross Asset Research

[62] KKR acquisition led to the creation of a new holding company, which became the group's new consolidating entity. The 2013 accounts were drawn up to the basis that the old holding was still the parent, and therefore does not reflect the impact of KKR's acquisition of the group. The bond debt reported at FY 2013 (Dec 31) is that of the old group, and does not include the 290€mm nor the 125€mm of issued bonds

A 17: Realized Debt Schedule extract (€mm)

	Entry 2013A J-13	2013A J-13	2013A A-13	2013A S-13	2013A O-13	2013A N-13	2013A D-13	2014A J-14	2014A F-14	2014A M-14	2014A A-14	2014A M-14	2014A J-14
Senior Secured Notes (inc. fees contra-balance)													
Senior Secured Notes BOP	-	-	-	-	276.0	276.1	276.3	276.4	276.5	276.7	276.8	276.9	277.1
Amortization of fees	-	-	-	-	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
Accumulated Amortization of fees	-	-	-	-	0.13	0.27	0.40	0.53	0.67	0.80	0.93	1.07	1.20
Mandatory debt amortization	-	-	-	-	-	-	-	-	-	-	-	-	-
Senior Secured Notes EOP	-	-	-	276.0	276.1	276.3	276.4	276.5	276.7	276.8	276.9	277.1	277.2
Interest	-	-	-	-	-	-	-	25.7	-	-	-	-	-
Cash	-	-	-	-	-	-	-	25.7	-	-	-	-	-
Accrued	-	-	-	-	-	-	-	-	-	-	-	-	-
PIK	-	-	-	-	-	-	-	-	-	-	-	-	-
Monthly Accruance of interests (for exit purposes)					4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Principal amount	-	-	-	290.0	290.0	290.0	290.0	290.0	290.0	290.0	290.0	290.0	290.0
Convertible Bonds (excl. fees contra-balance)													
Convertible Bonds BOP	-	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0
Mandatory debt amortization	-	-	-	-	-	-	-	-	-	-	-	-	-
Convertible Bonds EOP	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0
Interest	-	-	-	-	-	-	-	-	-	-	-	-	10.0
Cash	-	-	-	-	-	-	-	-	-	-	-	-	-
Accrued	-	-	-	-	-	-	-	-	-	-	-	-	10.0
PIK	-	-	-	-	-	-	-	-	-	-	-	-	-
Monthly Accruance of interests (for exit purposes)		0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83
Principal amount	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0
Payouts													
Dividend	-	-	-	-	-	-	-	-	-	-	-	-	-

Source: : PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Realised Debt Schedule")

A 18: Summary of Actual Covenants compliance[63][64]

Fiscal year		2013A	2014A	2015A	2016A
Revolving Credit Facility					
Covenant	Leverage Ratio				
Applicable when minimum drawn	17.5				
Leverage Ratio EOP		**5.53x**	**6.67x**	**4.38x**	**3.06x**
Covenant Ratio		**na**	**8.46x**	**7.82x**	**7.58x**
Covenant Compliance		**na**	**OK**	**OK**	**na**
Senior Secured Notes					
Covenant 1	Fixed Charge Coverage				
Fixed Charge Coverage Ratio EOP		**1.85x**	**1.07x**	**1.27x**	**1.55x**
Covenant Ratio		**2.00x**	**2.00x**	**2.00x**	**2.00x**
Covenant 1 Compliance		**Breach**	**Breach**	**Breach**	**Breach**
		Breach does not trigger default for this covenant			
Covenant 2	Senior Secured Leverage				
Senior Secured Leverage Ratio EOP		**3.61x**	**3.55x**	**2.39x**	**3.02x**
Covenant Ratio		**4.00x**	**4.00x**	**4.00x**	**4.00x**
Covenant 2 Compliance		**OK**	**OK**	**OK**	**OK**
Covenant 3	Maximum Payout Ratio				
Payout Ratio		**0.00%**	**0.00%**	**0.00%**	**0.00%**
Covenant Ratio		**50.0%**	**50.0%**	**50.0%**	**50.0%**
Covenant 2 Compliance		**OK**	**OK**	**OK**	**OK**
Moody's Rating					
Adj. Net Debt / EBITDA Ratio EOP		**5.97x**	**7.36x**	**5.03x**	**3.72x**
EBITA/Total Interest Ratio EOP		**na**	**na**	**na**	**na**
Upgrade/Downgrade			*na*	*na*	*na*
Moody's Rating EOP (only 1 criteria)		**B3**	**Stable B3**	**Stable B3**	**Stable B3**

Source: : PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Covenants Compliance Realised")

[63] Breach of covenant in Senior Secured Notes Fixed Charge Coverage Ratio does not trigger bond default, according to Société Générale Credit Research Report. Nevertheless, it is unclear on any side effects of this event, as no consequences or actions taken in this respect are public

[64] Moody's rating at End Of Period considered Stable when there is limited visibility on parameters (i.e. only one of the criteria needed to be analysed)

Investor Name		J-07	J-07	A-10	S-10	M-13	A-13	M-16	A-16	O-17
LF Invest	*Inflows*	-	-	-	-	-	-	-	-	-
	Outflows	-	-	-	(102.0)	-	-	-	-	-
	Net	**-**	**-**	**-**	**(102.0)**	**-**	**-**	**-**	**-**	**-**
Frederic Biousse	*Inflows*	-	-	-	6.5	-	-	-	49.5	-
	Outflows	(5.6)	-	-	-	-	-	-	-	-
	Net	**(5.6)**	**-**	**-**	**6.5**	**-**	**-**	**-**	**49.5**	**-**
Elie Kouby	*Inflows*	-	-	-	6.5	-	-	-	33.1	-
	Outflows	(5.6)	-	-	-	-	-	-	-	-
	Net	**(5.6)**	**-**	**-**	**6.5**	**-**	**-**	**-**	**33.1**	**-**
Evelyne Chetrite	*Inflows*	5.6	-	-	19.5	-	-	-	79.0	-
	Outflows	-			-				-	-
	Net	**5.6**	**-**	**-**	**19.5**	**-**	**-**	**-**	**79.0**	**-**
Judith Milgrom	*Inflows*	5.6	-	-	19.5	-	-	-	72.3	-
	Outflows	-			-				-	-
	Net	**5.6**	**-**	**-**	**19.5**	**-**	**-**	**-**	**72.3**	**-**
Ylane Chetrite	*Inflows*	-	-	-	-	-	-	-	14.8	-
	Outflows	-	-	-	-	-	-	-	-	-
	Net	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**14.8**	**-**
Daniel Lalonde	*Inflows*	-	-	-	-	-	-	-	-	-
	Outflows	-	-	-	-	-	-	-	-	-
	Net	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Other managers	*Inflows*	-	-	-	-	-	-	-	-	-
	Outflows	-	-	-	-	-	-	-	-	-
	Net	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
KKR&Co.	*Inflows*	-	-	-	-	-	-	-	700.6	313.0
	Outflows	-	-	-	-	-	(125.0)	-	-	-
	Net	**-**	**-**	**-**	**-**	**-**	**(125.0)**	**-**	**700.6**	**313.0**
Shandong Ruyi&Co	*Inflows*	-	-	-	-	-	-	-	-	378.2
	Outflows	-	-	-	-	-	-	-	-	-
	Net	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**378.2**

Source: : PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Stakeholders Cash Flows")

[65] Specific dates of injection of capital from first contributors, managers Frederic Biousse and Ellie Kouby, wer not publicly available (only the year, 2007). For simplicity purposes, it has been assumed that the injection was made in mid-year 2007 (June)

A 20: Actual two-phase exit data (€mm)

1			Sale to Shandong Ruyi				
Shareholding pre-acquisition		**Ownership Change**			**Exit Year**		**2016**
Frederic Biousse	4.3%	Frederic Biousse	(4.3%)		**Assumed Exit date**		**4/15/2016**
Elie Kouby	2.8%	Elie Kouby	(2.8%)				
Evelyne Chetrite	10.0%	Evelyne Chetrite	(6.8%)				
Judith Milgrom	9.1%	Judith Milgrom	(6.2%)				
Ylane Chetrite	1.9%	Ylane Chetrite	(1.3%)				
Daniel Lalonde	0.5%	Daniel Lalonde	0.0%				
Other managers	1.7%	Other managers	0.0%				
KKR&Co.	69.7%	KKR&Co.	(60.1%)				
Total	**100.0%**	Shandong Ruyi&Co	81.5%				
Shareholding post acquisition		**Transaction Data**			**Financial Data at Exit**		
Shandong Ruyi&Co	81.5%	Acquisition of shares	949.4		Adj. EBITDA		106.5
Evelyne Chetrite	3.2%	Early Repayment of 2020 LBO HY Bonds	290.0		Cash and liquid assets		27.0
Judith Milgrom	2.9%	Early Repayment penalty and accrued in	17.8		Convertibles		-
Ylane Chetrite	0.6%	Others (€mm)	95.3		Long-term debt		282.0
Daniel Lalonde	0.5%	**Total Uses**	1,352.5		Short-term debt		60.0
Other managers	1.7%	**Implied Equity Value**	**1,165.3**		Minority interests		-
KKR&Co.	9.6%	**Implied EV**	**1,480.3**		Associates (€mm)		-
Total	**100.0%**	**Implied EV/EBITDA**	**13.90x**		Off Balance Sheet Items (€mm)		-

2			Initial Public Offering				
Shareholding pre-IPO		**Ownership Change**			**IPO Year**		**2017**
Shandong Ruyi&Co	81.5%	Shandong Ruyi&Co	(24.5%)		**Assumed IPO Date**		**10/20/2017**
Evelyne Chetrite	3.2%	Evelyne Chetrite	0.0%				
Judith Milgrom	2.9%	Judith Milgrom	0.0%				
Ylane Chetrite	0.6%	Ylane Chetrite	0.0%				
Daniel Lalonde	0.5%	Daniel Lalonde	0.0%				
Other managers	1.7%	Other managers	0.0%				
KKR&Co.	9.6%	KKR&Co.	(9.6%)				
Total	**100.0%**	Free Float	34.0%				
Shareholding post-IPO		**Transaction Data**					
Shandong Ruyi&Co	57.0%	Capital increase of (mm€)	127.0				
Free Float	34.0%	Sale of Shandong stake (mm€)	261.0				
Evelyne Chetrite	3.2%	Sale of KKR 10% (mm€)	148.0				
Judith Milgrom	2.9%	Sale of some of Managers stake	5.9				
Ylane Chetrite	0.6%	Global offering amount (mm €)	541.9				
Daniel Lalonde	0.5%	**Implied Market Cap**	**1,545.7**				
Other managers	1.7%						
Total	**100.0%**						

Source: : PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Exit&Returns")

A 21: Value creation data (€mm)

Entry Data	
Date	6/30/2013
Year	2013
Implied EV	690.2
Implied Equity Value	555.2
Stake purchased (KKR)	70.2%
Sales 2012	339.0
EBITDA 2012	59.5
EBITDA Margin % 2012	17.6%
EV / EBITDA	11.6x
Capital Structure of Sources of Fund	
Senior Secured Loan	290
Convertible Bond	125
Equity	280
% Debt	41.7%
% Equity	58.3%
ND / Equity of Investment	103.6%
Total Equity KKR Investment	**405**

Holding Period Data	
Dividends	-
Capital Injections	-
Intermediate Sales	2.9
Total Holding Net Flows	**2.9**

Interest Rate and Cost of Debt	
Senior Secured Notes Interest	8.9%
Holding Period (years)	2.8
CoD	27.2%
Average Fund D/E	64.2%
Holding Period (months)	34.0
Holding Period (years)	2.8

Exit Data	
Exit 1 (loss of control in 1Q 2016)	
Date	4/15/2016
Year	2016
Implied EV	1,480.3
Implied Equity Value	1,165.3
Debt Outstanding	315.0
Stake Sold bby KKR	60.6%
Sales 2015	675.4
EBITDA 2015	106.5
EBITDA Margin % 2015	15.8%
EV / EBITDA 2015	13.9x
Remaining Capital Structure of Fund	
Senior Secured Loan	290.0
Convertible Bond	125.0
Equity	277.1
% Debt	41.9%
% Equity	58.1%
ND / Equity	24.9%
Total Inflow of funds	**706.5**

Exit 2 (IPO)	
Date	10/20/2017
Year	2017
Stake Sold	9.6%
Inflow at IPO	148.0
Inflow of Convertible bonds	165.0
Total Inflow of funds	**313.0**

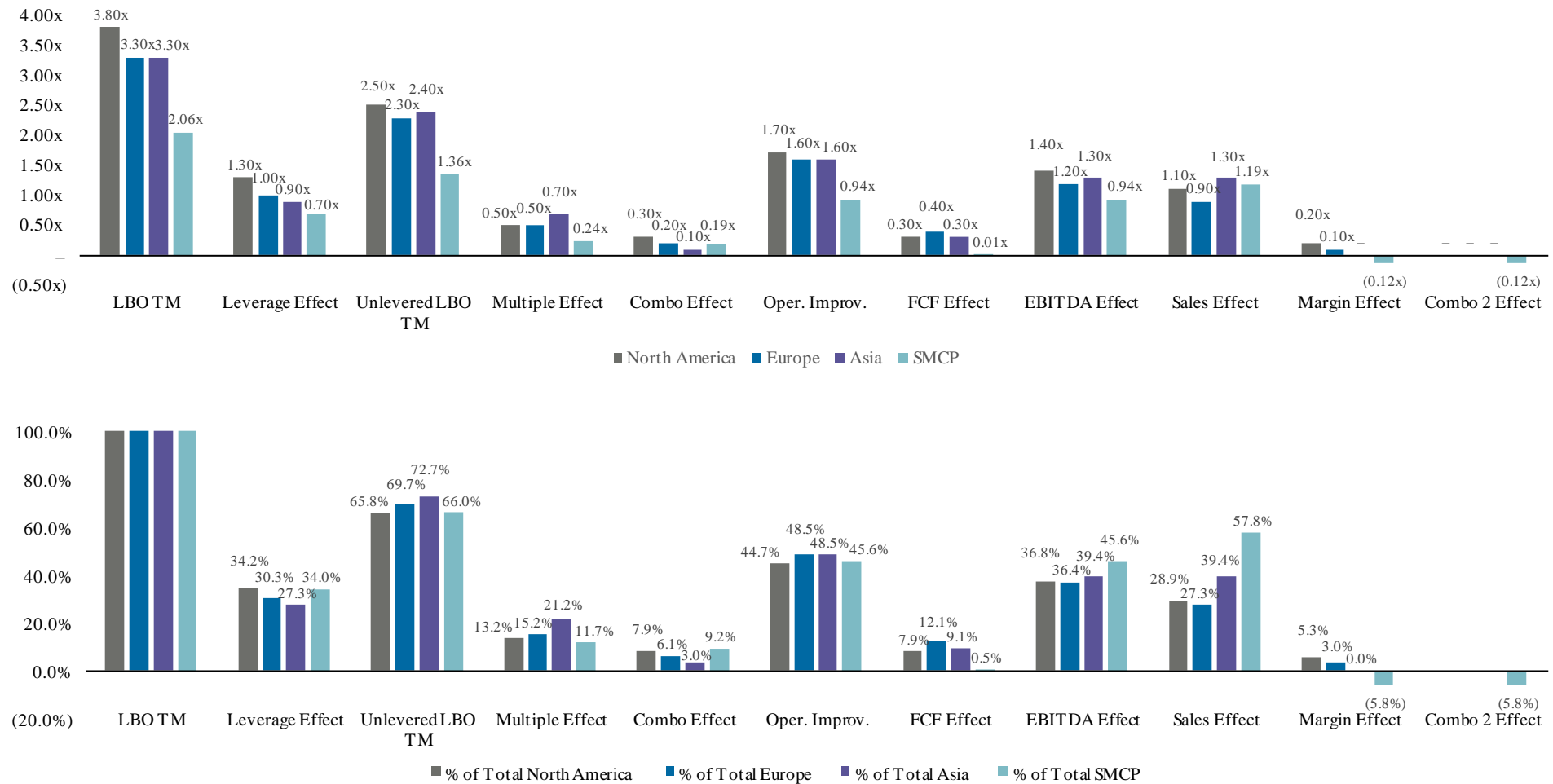Source: : PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

A 22: Value creation computation breakdown (€mm)

Z	Convertible Bonds	
Invested on Bonds		125.0
Inflowon Bonds		165.0
Net Capital Gains		**40.0**
Converble Bonds TM		**0.32x**

1	Leverage Effect (excl. Convertible Bonds)	
Fund TM		2.06x
Cost of Debt		27.2%
Average ND/Equity		64.2%
Unlevered TM		1.36x
Leverage Effect		**0.70x**

3	Operating Improvements Effect	
EV / EBITDA at entry		11.6x
EBITDA at entry		59.5
EBITDA Margin % at entry		17.6%
Debt at entry		290.0
Sales at entry		339.0
EV / EBITDA at exit		13.9x
EBITDA at exit		106.5
EBITDA Margin % at exit		15.8%
Debt at exit		290.0
Sales at exit		675.4
Dividends		-
Capital Injections		-
Intermediate Sales		2.9
FCF Effect		**0.005x**
EBITDA Effect		**0.94x**
Sales Effect		**1.19x**
Margin Effect		**(0.12x)**
Combo 2 Effect		**(0.12x)**

0	LBO TM (excl. Convertible Bonds)	
Net Capital Gains		577.4
Total Invested		280.0
LBO TM (excl. Convertible Bonds)		**2.06x**

2	Multiple & Combo Effect (Market Effect) (excl. Convertible Bonds)	
EV / EBITDA at entry		11.6x
EBITDA at entry		59.5
EV / EBITDA at exit		13.9x
EBITDA at exit		106.5
Multiple Effect		**0.24x**
Combo Effect		**0.19x**
TM left for Operating Improvements		*0.94x*

Source: : PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

A 23:Value creation comparison by Geography. TM and % of factor contribution

Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

A 24: Value creation comparison by Industry. TM and % of factor contribution

Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

A 25: Value creation comparison by Size. TM and % of factor contribution

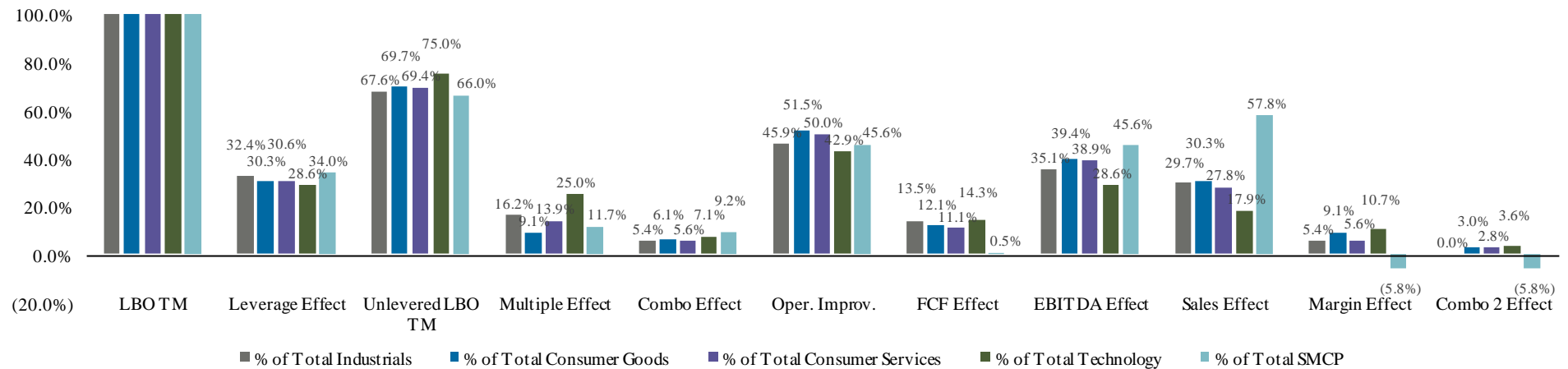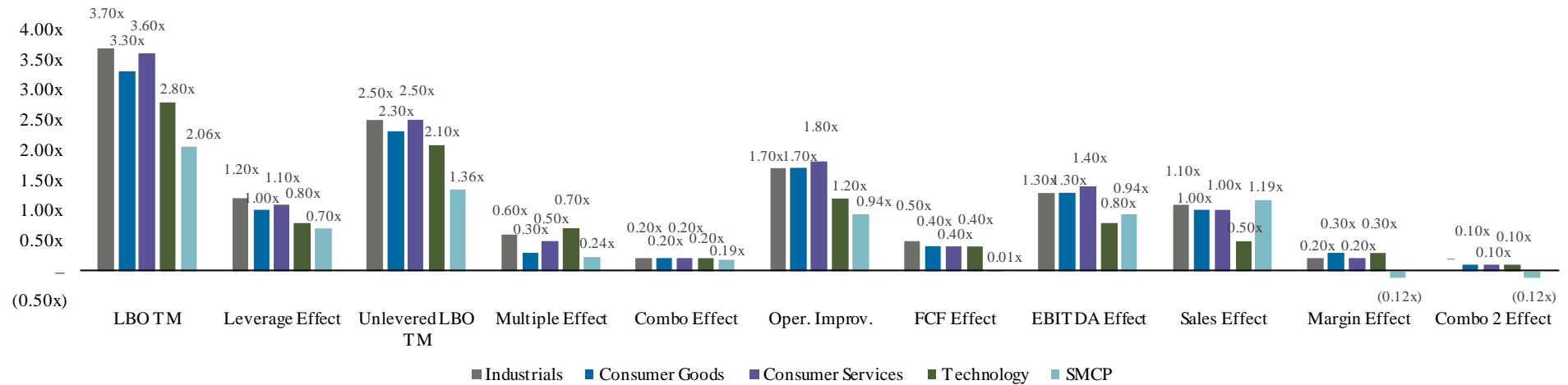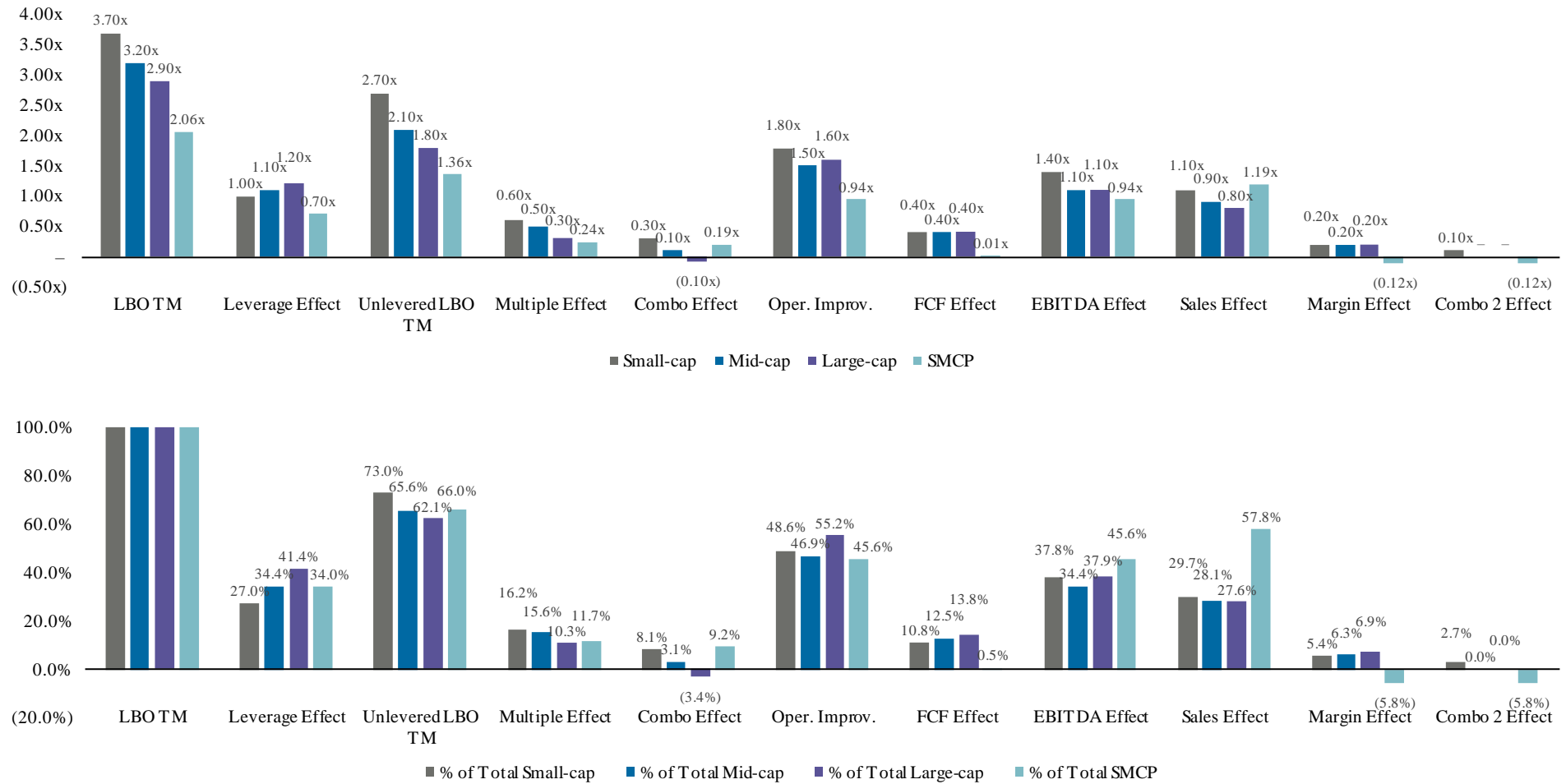Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")

A 26: Value creation comparison by Exit Year. TM and % of factor contribution

Chart 1 (TM values):

Factor	1987-2000	2001-2008	2009-2013	SMCP
LBO TM	4.30x	3.60x	2.80x	2.06x
Leverage Effect	1.50x	1.10x	0.80x	0.70x
Unlevered LBO TM	2.80x	2.50x	1.90x	1.36x
Multiple Effect	0.90x	0.50x	0.30x	0.24x
Combo Effect	–	0.30x	0.10x	0.19x
Oper. Improv.	2.00x	1.70x	1.50x	0.94x
FCF Effect	0.70x	0.40x	0.30x	0.01x
EBITDA Effect	1.30x	1.30x	1.10x	0.94x
Sales Effect	0.90x	1.10x	0.90x	1.19x
Margin Effect	0.40x	0.20x	0.20x	(0.12x)
Combo 2 Effect	–	–	0.10x	(0.12x)

Legend: 1987-2000 ■ 2001-2008 ■ 2009-2013 ■ SMCP

Chart 2 (% of Total):

Factor	1987-2000	2001-2008	2009-2013	SMCP
LBO TM	100.0%	100.0%	100.0%	100.0%
Leverage Effect	34.9%	30.6%	28.6%	34.0%
Unlevered LBO TM	65.1%	69.4%	67.9%	66.0%
Multiple Effect	20.9%	13.9%	10.7%	11.7%
Combo Effect	0.0%	8.3%	3.6%	9.2%
Oper. Improv.	46.5%	47.2%	53.6%	45.6%
FCF Effect	16.3%	11.1%	10.7%	0.5%
EBITDA Effect	30.2%	36.1%	39.3%	45.6%
Sales Effect	20.9%	30.6%	32.1%	57.8%
Margin Effect	9.3%	5.6%	7.1%	(5.8%)
Combo 2 Effect	0.0%	0.0%	3.6%	(5.8%)

Legend: % of Total 1987-2000 ■ % of Total 2001-2008 ■ % of Total 2009-2013 ■ % of Total SMCP
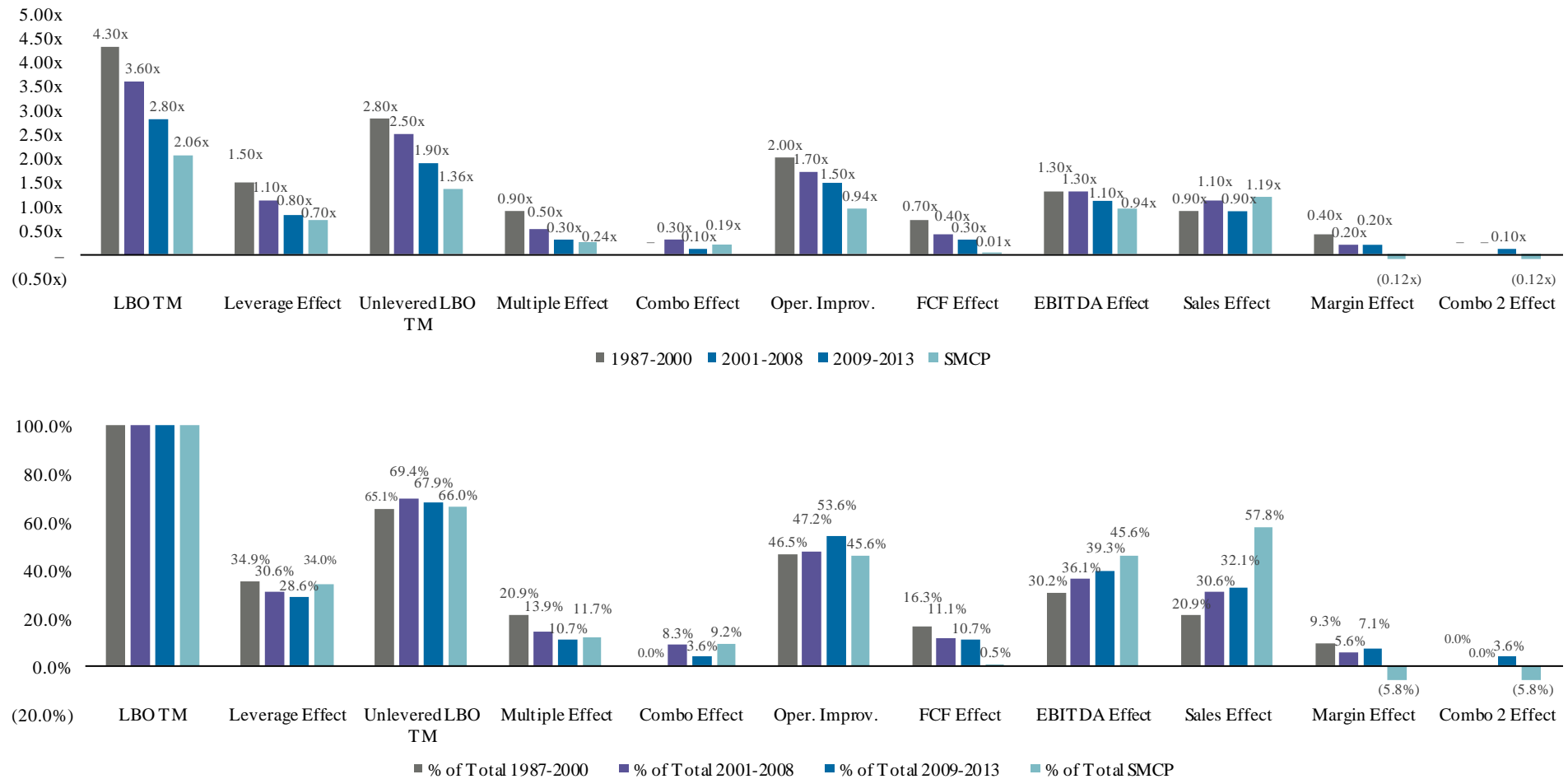
Source: International Evidence on Value Creation in Private Equity Transactions, 2015 (Puche, Braun, Achleitner); PEREZ Rafa and HERRERA Enrique KKR LBO Model ("Value Creation Breakdown")