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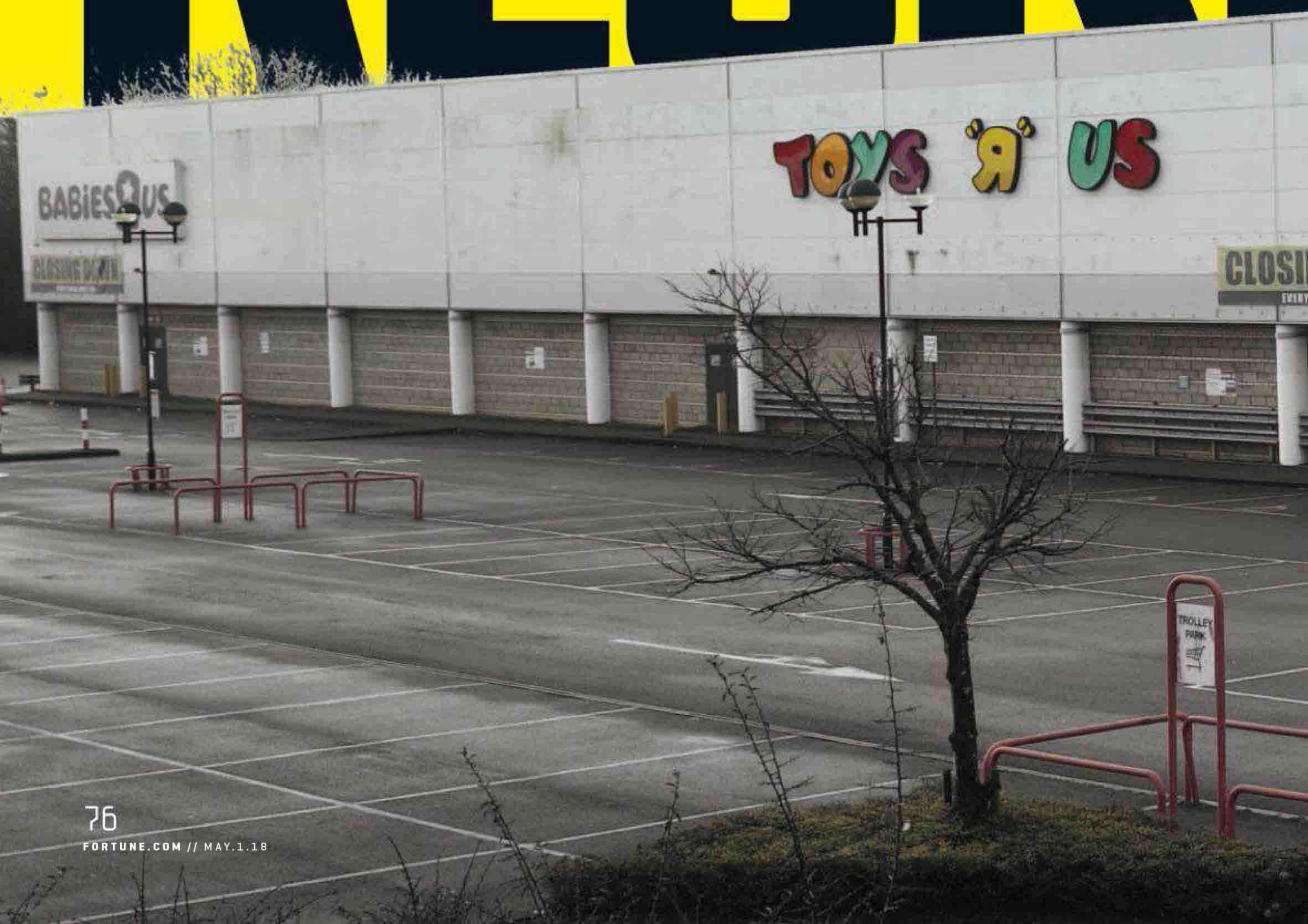

By PHIL WAHBA

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PRIVATE EQUITY HAS INVESTED HUGELY IN THE RETAIL SECTOR—BOOSTING SOME BRANDS AND CRUSHING OTHERS. HERE'S HOW THESE INVESTORS ARE REMAKING YOUR MALL.

IT WAS THE DISTINCTIVE PATCH that caught his attention. Boston was enduring a particularly brutal winter in 2013 when Ryan Cotton began to notice a trend on his daily walk to work near Copley Square: the suddenly growing number of sharp-looking parkas with a logo showing a polar cap surrounded by flaming red maple leaves.

Craning his neck for a closer look one day, Cotton, a managing director overseeing investments in consumer brands at the private equity firm Bain Capital, was intrigued all the more by the reference on the logo to an "Arctic Program." What was this brand, he wondered?

As fate would have it, the Canadian investment bank Canaccord Genuity got in touch with Cotton soon after in search of financing for a client—a small, Toronto-based winter-wear manufacturer called Canada Goose that was growing fast and had ambitions to go global. Cotton quickly recognized it as the company behind the parkas with the cool patches. He flew to Toronto for a dinner meeting with Canada Goose CEO Dani Reiss at a trendy restaurant called North 44. Months later, Bain took a 70% stake in Canada Goose.

Canada Goose possessed the two key attributes Cotton looks for when investing in retail: a strong brand identity and a unique niche. Parkas had long been seen as functional rather than fashionable, but Canada Goose managed to make them hip while retaining high performance. Founded by Reiss's Polish immigrant grandfather in 1957 to produce snowmobile suits, Canada Goose established its reputation by outfitting explorers to Mount Everest and the South Pole. Then celebrity fans like actor Daniel Craig and model Kate Upton gave it cachet. "*You* don't go to Antarctica, but since Canada Goose outfits people who do, the brand has credibility," says Cotton.

The investment has been both a grand slam for Bain and a transformative deal for Canada Goose. Since Canada Goose went public just over a year ago, listing its shares on the Toronto Stock Exchange and New York Stock Exchange, the company's share price has more than doubled—giving it a market value of some $3.5 billion. In the nine months ended Dec. 31, Canada Goose's revenues rose 32.2%, to $370 million, while merchandise profit margins shot up 5.5 percentage points, to 57.8%. Bain, which still owns 44% of Canada Goose's shares, is well positioned to add to its returns if the hot streak continues. And for Canada Goose, the dream of selling its $1,000 parkas to high-end consumers globally has been realized.

If this happy tale reads like an exception to the rule—to some extent, it is.

In most stories about retail these days, private equity is depicted as the bad guy—dooming operators by piling on debt. And not without reason. Buyout firms have been behind many of the industry's biggest bankruptcies. In fact, 10 of the 14 biggest retail bankruptcies since 2012—as measured by liabilities at the time of Chapter 11 filing—were buyout-backed chains. Topping that list is the $7.9 billion filing, in September, of Toys "R" Us (which Bain owned as part of a consortium that included KKR and Vornado Realty Trust). But the roster of buyout busts includes a host of familiar brands such as another Bain investment, Gymboree ($1.4 billion filing), as well as Sports Authority ($1.5 billion), Payless ShoeSource ($1 billion), and Nine West Holdings ($1.4 billion).

More carnage is on the way. In March, Moody's said it expected a wave of new retail defaults this year, with a surge in debt maturities coming due in 2019 and 2020 and rates on the rise. The credit rating agency's current watch list of 18 retailers deemed "distressed"—with a debt rating of Caa1 or worse—includes PE-owned names such as J. Crew, Guitar Center, and Neiman Marcus. The retail reckoning continues.

But as the example of Canada Goose shows, private equity investors can offer retailers a huge boost when things go right. PE firms have helped speed up the evolution of dozens of companies in ways that now seem to be helping them stay competitive in the much-changed, Amazon-disrupted landscape.

The bottom line: When you go to your local shopping center, there's a good chance that the finance whizzes of private equity have had a hand in the empty spaces left by defunct retailers, as well as in the ones that are surviving and thriving. Here's how they're reshaping the mall.

THE CLASSIC PLAYBOOK for private equity is to buy a company using an ample dose of borrowed money, then unlock value either by getting more efficient operationally or selling off units, or both. Typically, the PE investors will look to unload the company after three to five years via a public offering (with the proceeds often used to pay down debt) or a sale. The debt involved acts as a lever that boosts returns when things go well, but it can be an albatross when things are going south. The borrowing can also help finance the large management fees and dividends that often represent a big chunk of a buyout firm's returns.

An unsentimental view of this debt-powered approach is that it merely hastens the demise of chains that are doomed to fail. Such was probably the case for some of the recent retail bankruptcies. "Many of them would have gone out of business anyway," says Erik Gordon, a professor at the University of Michigan's business school and faculty adviser to the university's venture capital fund.

Indeed, the retail fails in recent years have been disproportionately concentrated among mall-based apparel chains, such as Wet Seal, American Apparel, and Aéropostale, in a

PREVIOUS SPREAD: HANNAH MCKAY—REUTERS

Shoppers browsing Canada Goose's signature parkas at the brand's flagship store in Manhattan. Its iconic logo (below) has become ubiquitous in major urban markets.

sector in which few companies are thriving, or retailers that were slow to build an online presence, like Sports Authority or outdoor-gear purveyor Gander Mountain.

The sheer number of struggling retailers linked to private equity today, however, reflects a burst of optimism about retail in the PE industry more than a decade ago. Between 2006 and 2008—before the global financial crisis tanked the markets and e-commerce hit critical mass—private equity firms sat on record amounts of money pumped in by gigantic investors like pension funds and wealthy individuals. So they went shopping. The rationale was that buyout firms could make a mint by getting retailers leaner—and that soaring real estate prices limited the risk. Chains could always sell well-located stores to raise cash if needed. The result was a historic retail buyout boom: In 2006 and 2007, PE firms made $108 billion worth of acquisitions involving 300 U.S. retailers of various sizes, according to Dealogic. That's 10 times the dollar value of PE retail acquisitions made in any other two-year period since the 2001 recession. A decade later, the 2016–17 combined deal volume was a mere $13 billion.

"PE IS GOOD IN THAT IT CAN BRING CAPITAL AND MAKE TOUGH DECISIONS," SAYS ONE RETAIL EXPERT.

A handful of major successes emerged from the cascade of deals in the mid-aughts. Case in point: the $6.9 billion, KKR-led acquisition in 2007 of Dollar General, now the biggest U.S. chain by store count. Dollar General went public again two years later with a hugely successful 2009 offering, and now has a market cap of $26 billion. But a disproportionate number of retailers ended up languishing in PE firms' portfolios for years.

What went wrong? For all their financial savvy, back in 2006 the big private equity firms proved no better than the retailers themselves in anticipating major changes that would roil retail.

Probably the single biggest disruptive factor has been the consumer's unexpectedly rapid embrace of e-commerce—taking customers out of stores and forcing retailers who want to survive to ramp up spending on technology. E-commerce generated 13% of total retail sales in 2017, up from 7.9% just five years earlier, according to Department of Commerce

▲ PHOTOGRAPH BY **ALEXANDRA SCIMECCA**

data, and 3.2% in 2007. Remove groceries from the equation, and the percentage of online retail sales is much higher. At Neiman Marcus, for instance, e-commerce accounted for fully 34% of sales last quarter.

The seemingly unstoppable ascent of Amazon has forced retailers to deploy better apps, build new state-of-the-art distribution facilities, and reconfigure stores so they can serve as nodes in a distribution network. The move online has simultaneously increased expenses and slashed profit margins across the industry.

That in turn has piled on extra pressure for retailers in private equity portfolios. Carrying a ton of debt while trying to fundamentally revamp your business is a precarious balancing act. "If you don't have money to invest online, invest in your store, invest in your people, invest in price, you're in deep trouble," says Charlie O'Shea, a senior Moody's analyst.

The imperative to make their numbers has led many retailers to play it safe, focusing on sure bets and cost savings. That in turn has led to poor service and a lack of merchandise distinctiveness at many struggling chains. All of which is a formula for failure. As Joel Bines, cohead of AlixPartners' retail practice, puts it: "When it's not about the customer anymore, you're dead."

IT'S EASY TO SCAPEGOAT private equity for retail's woes. But it's important to remember that some of the most successful retailers of the past few years are, or were, owned by PE firms and came out much better for it. That group includes the aforementioned Dollar General; discounter Burlington Stores; and At Home, a big-box retailer thriving in one of retail's hottest areas—home goods.

What do these successful chains have in common? They're in corners of the retail world that have thus far remained relatively impervious to Amazon. The "off-price" segment—as represented by the Ross Stores and Marshalls of the world—barely gets 1% of sales online, but it has been physical retail's biggest success story for the past decade. Dollar stores, meanwhile, have thrived thanks to their bargain-basement prices and their proximity to shoppers.

Having an Amazon buffer is huge. But successful retailers in 2018, says Bain's Cotton, must also convey with absolute clarity to the consumer what value they offer.

That's one area where private equity can help because the buyout firms bring expertise galore. Bain, for example, has in-house experts focused on everything from optimizing supply-chain operations to choosing store locations. And the same is true of its big rivals: Cerberus has an in-house management consulting unit called Cerberus Operations and Advisory Co., KKR has a similar group named Capstone, and L Catterton's unit is known as Vault. These organizations are packed with operational experts, including more than a few former retail executives, as well as investment bankers and management consultants.

When things are going right for a retailer, these SWAT teams can add huge value. Leading up to Dollar General's 2009 IPO, for example, KKR installed a management team that included a former drugstore CEO and a Starbucks senior exec. And profits soared after the company, under KKR's guidance, added more private-label products with their higher margins, stripped out duplicative items, and expanded into new geographic markets.

Another example is Restoration Hardware. PE firm L Catterton took it private for $175 million in 2008 with other investors, pushing it to build up its e-commerce capacity and to pull out of dozens of faltering malls. The markets rewarded the firm richly: Restoration Hardware returned to the stock market in 2012 with a $520 million valuation. Not bad for four years' work.

Then there's Burlington Stores, formerly known as Burlington Coat Factory and one of Bain's biggest home runs ever. Under the guidance of Bain's experts, Burlington became much more efficient in buying in-season merchandise from vendors, helping it better compete with T.J. Maxx and inflicting further pain on department stores.

Private equity investors can bring a ruthlessly objective point of view to evaluating what's working—and what's not. "PE is good in that it can bring capital and make tough decisions like dropping business lines and closing stores," says Anand Raghuraman, a partner at EY. Many PE deals don't hinge on a big turnaround: Firms will often target a company that's just below No. 1 in its category—like, say, BJ's Wholesale Club, which ranks below Costco and Sam's Club—but also doesn't require an expensive overhaul. In that kind of scenario, a bit of fine-tuning can make all the difference.

THREE PRIVATE EQUITY RETAIL FAILS

Three of the four biggest retail bankruptcies in the past five years, ranked by liabilities at time of filing, had PE owners.

TOYS "R" US
- Size of bankruptcy: **$7.9 billion**
- Taken private: **2005**
- Bankruptcy filing: **Sept. 2017**
- Private equity owners: **Bain Capital, KKR, Vornado**

SPORTS AUTHORITY
- Size of bankruptcy: **$1.5 billion**
- Taken private: **2006**
- Bankruptcy filing: **March 2016**
- Private equity owner: **Leonard Green Partners**

NINE WEST HOLDINGS
- Size of bankruptcy: **$1.4 billion**
- Taken private: **2014**
- Bankruptcy filing: **April 2018**
- Private equity owner: **Sycamore Partners**

WHEN BAIN MADE its investment in Canada Goose, Cotton knew that his firm needed to tread carefully. The last thing he wanted to do was mess with the company's successful formula. Plus, Cotton had pledged to Canada Goose CEO Reiss that the firm would respect his company's values.

And while Reiss was eager to see what he could do with Bain's capital and support, the CEO had sought reassurances that he'd stay in control of the company founded by his grandfather. Remaining a Made-in-Canada brand, too, was a sine qua non condition for a deal. Both Canada Goose and Bain wanted to avoid exhausting the brand or, worse yet, cheapening it. "It was really important to me that they believe in our core beliefs," says Reiss.

But both sides saw the potential for Bain to kick-start Goose's growth. Once the deal was inked, the PE firm deployed more than a dozen of its battle-hardened retail veterans to help guide the company. Bain's team helped Canada Goose navigate the supply-chain challenges of meeting booming demand and keeping its wholesale clients happy. While matters such as selecting the right locations for Canada Goose stand-alone stores might have been a prosaic consideration for a more established chain, it was a crucial and an unfamiliar exercise for the family-run business—and one for which Bain was able to offer expertise.

Bain pushed Canada Goose to connect with customers more directly. In 2014, Canada Goose's closest rival, Moncler, got 80% of sales from its own stores or website, which are more profitable avenues. In contrast, Canada Goose sold virtually all of its merchandise via wholesalers like high-end department stores Barneys New York and Saks Fifth Avenue. That is down to 64% of sales so far this fiscal year, thanks to Bain's push for better e-commerce and Canada Goose stores, and a big reason that Canada Goose's profit margins are way up.

The Bain team also helped the company pull back on items that were less profitable, narrowed the coat assortment to ones that are quicker to make, and expanded the Canada Goose assortment, notably adding knitwear, like $650 sweaters. "Their problem wasn't knowing what they could do but what they should do," says Cotton, who sits on Canada Goose's board. And while Canada Goose prices are high, above those of say, the North Face, they are below those of Moncler, whose focus is more on fashion than function compared with Canada Goose.

THREE PE-BACKED RETAIL SUCCESS STORIES

Private equity has had some big wins in retail over the past decade, with Dollar General leading the way.

DOLLAR GENERAL

- Value when taken private in 2007: **$6.9 billion**
- Value at IPO in 2009: **$7.2 billion**
- Recent market value: **$26 billion**
- Private equity owner: **KKR**

BURLINGTON STORES

- Value when taken private in 2006: **$2.1 billion**
- Value at IPO in 2013: **$1.8 billion**
- Recent market value: **$9.34 billion**
- Private equity owner: **Bain Capital**

RESTORATION HARDWARE

- Value when taken private in 2008: **$175 million**
- Value at IPO in 2012: **$520 million**
- Recent market value: **$1.9 billion**
- Private equity owner: **L Catterton**

DESPITE SOME SUCCESS STORIES, no one should expect another feverish private equity surge into retail. And indeed so far in 2018, according to Dealogic data, private equity acquisitions of retailers are below even the anemic pace of 2016 and 2017, and are more on par with levels last seen in the early 2000s.

Retailers of all stripes still have to convince investors that they can now hold their own online. "The e-commerce shakeout is not done yet, and unless there is an easy win in terms of quick fixes that improve margins, PE will avoid retail," says Wharton finance professor David Wessels.

The IPO market, meanwhile, has cooled to retail brands, so only the most promising companies can squeeze through. In the past couple of years, that group has included Canada Goose, Floor & Decor, and At Home, which have all soared since going public. Shares of much-hyped fashion brand J. Jill, by contrast, have swooned post-IPO—as if to remind investors of retail's ongoing perils. "The IPOs that are working are by the retailers that aren't going to get Amazoned," says Kathleen Smith, principal of IPO ETF manager Renaissance Capital.

As PE pulls back, retail market dynamics are shifting. There are plenty of retailers that might prosper with relatively minor fixes, and that could benefit from the guidance a buyout firm can offer. But the days of $7 billion megadeals, like Sycamore's buyout of Staples last year, are over—at least for now, say private equity executives. Instead, expect more strategic acquisitions of retailers by other retailers. (Think Walmart buying Jet.com and Bonobos, or Coach parent Tapestry buying Kate Spade.) At the same time, there will almost certainly be salvageable companies in PE portfolios that are allowed to die as firms look to cut their losses and move on.

Private equity won't abandon the retail sector, agree industry observers. It will just be more cautious going forward. "There's a right and a wrong side to history," says Bain's Cotton. "What we're living through at the moment is the most tumultuous and transformative period ever [for retail]." That means more risk in retail for companies unable to really stand out from the competition and outflank rivals. Then again, it also means more opportunities.