

## **Managing the Magic: The *Business* of Fashion**

Michelle Moorehead, Sally Pofcher, and Jennifer Sturman

During most of the 1990s, many major branded apparel manufacturers grew at phenomenal rates and earned strong returns. Today, the reality is that many of them are hitting the wall. It's harder now than ever before to outpace the competition and generate shareholder value.

To become industry leaders – the "superleaguers" with high growth and lofty value – these apparel companies must move beyond managing all the magic of product design and brand image they can muster. They must also have aggressive and sophisticated *business* strategies to nurture a strong, multiple brand portfolio. To do this they must make wise acquisitions and truly capture the value from the deals. They also need to manage the nuts and bolts of the back end of the business skillfully to make money.

### **Success Stories of the 1990s**

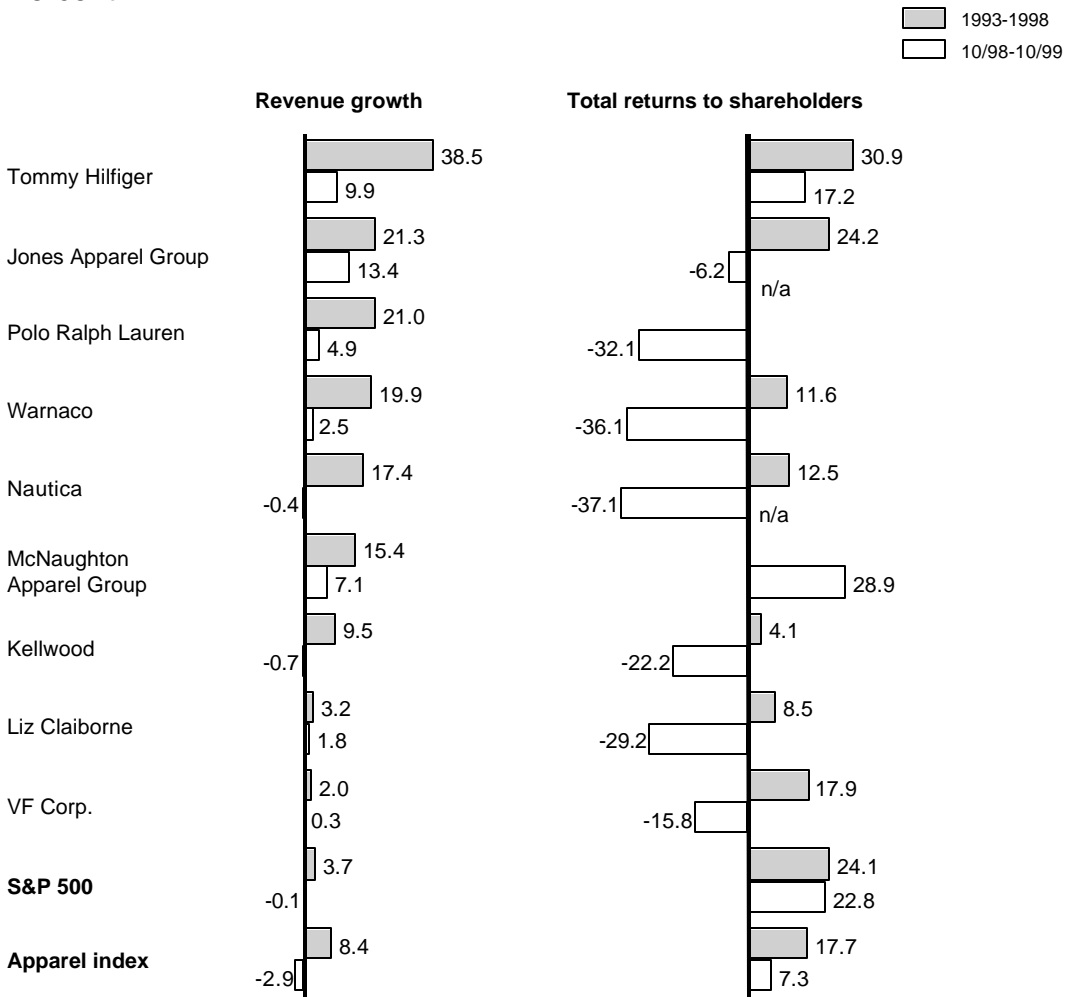
During the last decade, many of the major manufacturers of branded apparel for both department and chain store channels transformed themselves from niche companies into larger more profitable players. And many ventured into new branded categories to strengthen their portfolios, with great success.

Both "lifestyle" and "classification" brands enjoyed fast-paced sales growth. And, while not every company was a good bet for its shareholders, many delivered attractive shareholder returns (Exhibit 1).

Exhibit 1

## BRANDED APPAREL COMPANIES' GROWTH AND RETURNS SLOWED IN PAST YEAR

Percent



Source: Compustat; Bloomberg

### Slowdown or impasse?

By the late 1990s, however, growth in the industry had stalled. In fact, today, charting a growth path in the fashion business has never been more challenging, and the current slowdown could turn into a serious impasse in the industry.

The downturn can be explained by a host of reasons. Existing brands are reaching a saturation point. There's little room for expansion in department stores, where most major "lifestyle" branded manufacturers would have to achieve between 6 and 22 percent growth in annual department store sales between 1998 and 2003. The difficulty is that analysts expect overall growth in

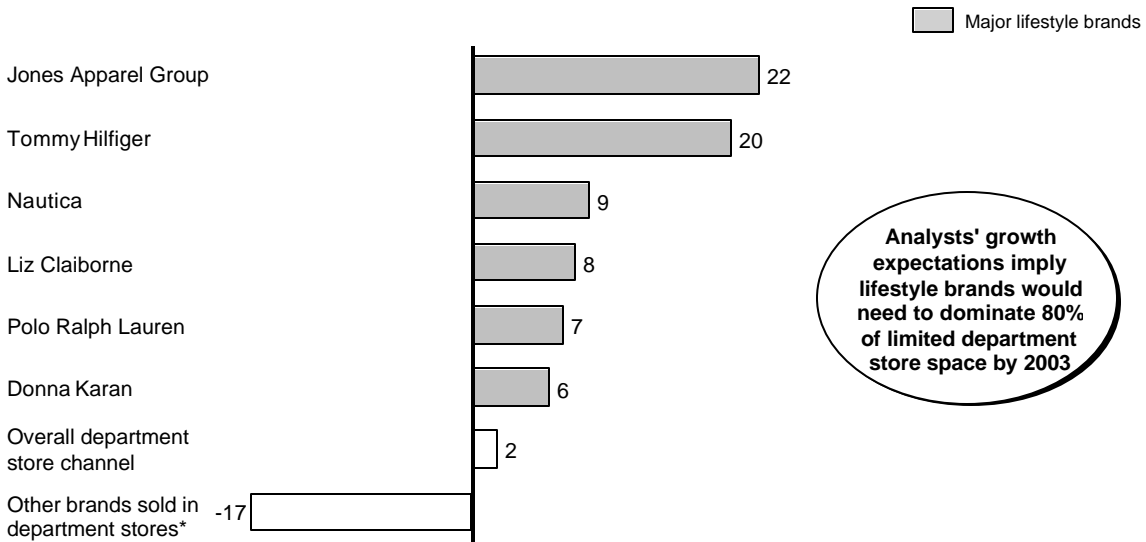
brands sold in department stores to remain at only 2 percent over the period (Exhibit 2).

Exhibit 2

## ANALYSTS' GROWTH EXPECTATIONS REQUIRE GREATER DOMINANCE IN DEPARTMENT STORES FOR LIFESTYLE BRANDS

Analysts' expected annual growth rates, 1998-2003

Percent



\* Derived from analysis  
Source: NPD; Goldman Sachs; Credit Suisse First Boston; McKinsey analysis

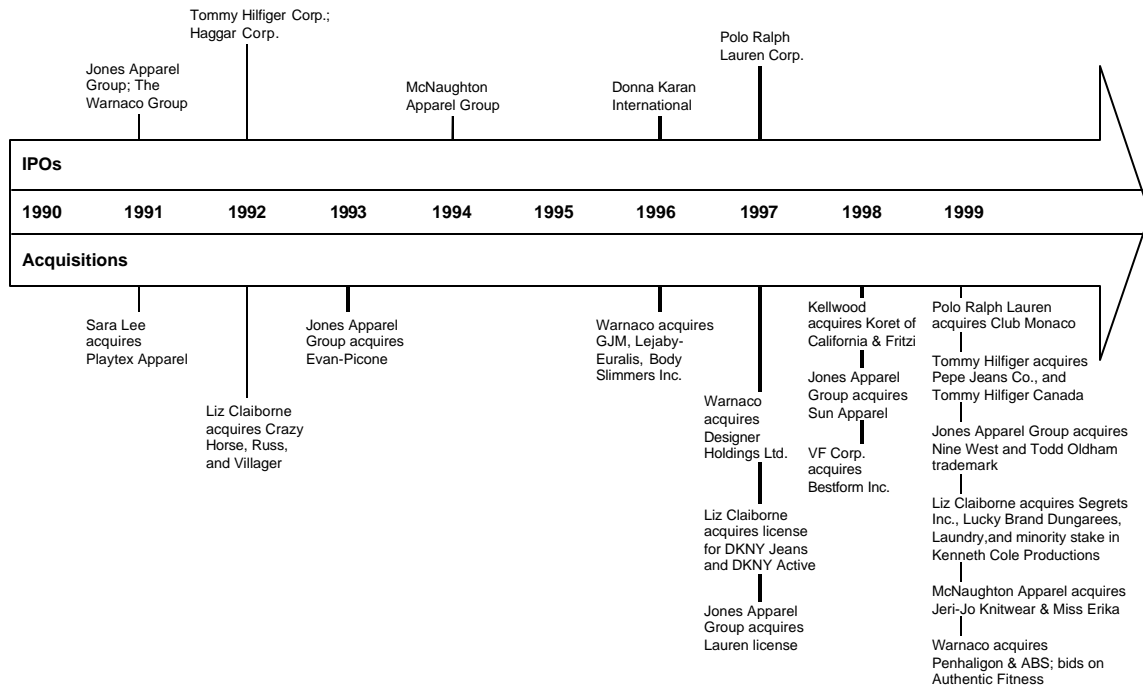
Worse still, the competition for consumer spending will continue to intensify as strong vertically integrated retailers like The Gap, Inc. – led by Old Navy and Banana Republic earnings – Abercrombie and Fitch, and The Limited capture a big chunk of apparel spending. And department and chain stores are bolstering private labels, undermining established brands.

Faced with slowing growth trajectories, branded manufacturing companies all appear to be heading in the same direction. They are creating multiple brand portfolios through acquisitions and licensing arrangements. In the last 24 months, for example, many major "lifestyle" brands have been involved in important deals to expand their existing brands and add new brands. Not to be outdone, "classification" players are also seeking to acquire and license brands that will round out and leverage their brand portfolios (Exhibit 3).

Exhibit 3

**SELECTED IPO AND M&A ACTIVITY AMONG MAJOR APPAREL PLAYERS**

**1990-99**



Source: Mckinsey analysis

**Bigger, but not necessarily better**

Recent results for public apparel companies in the United States tell us that these growth strategies aren't working. While two companies – Tommy Hilfiger and Jones Apparel Group – beat the S&P between 1993 and 1998, in the last year only the McNaughton Apparel Group has outperformed the market. Except for Tommy Hilfiger, the rest have actually destroyed shareholder value.

*What's the problem?*

McKinsey's strategic control map for major branded apparel players suggests an answer (Exhibit 4).

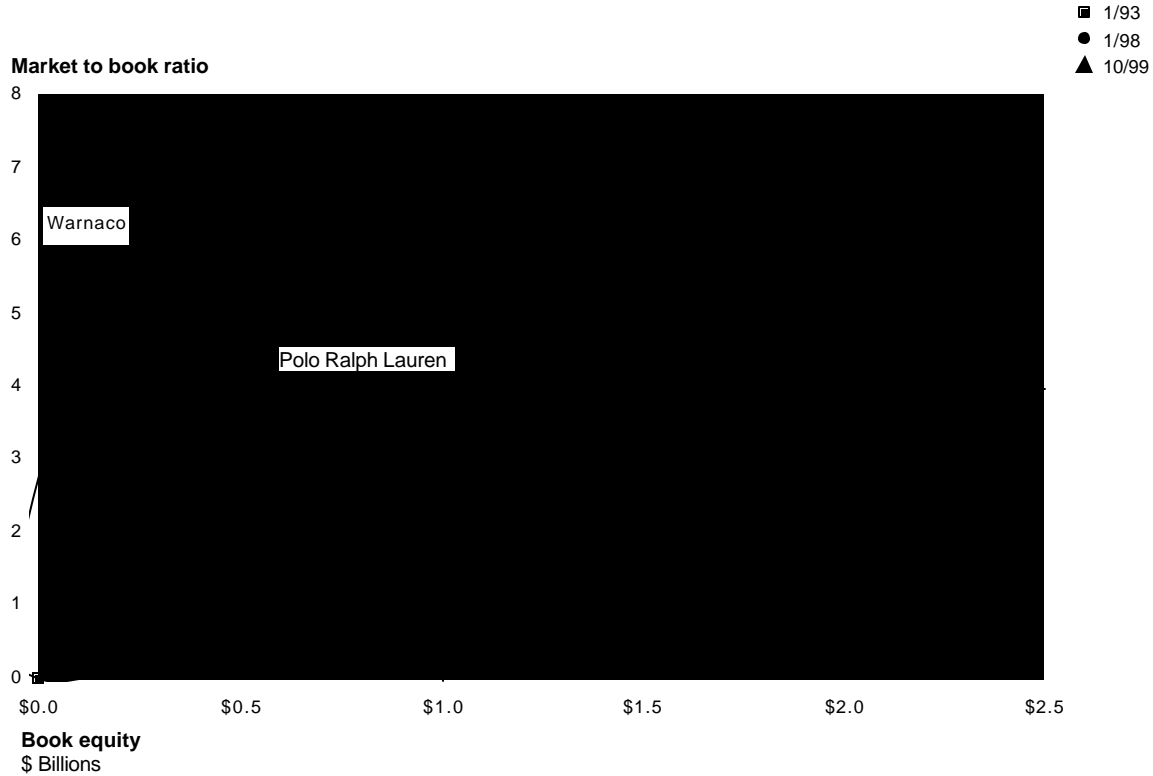
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Exhibit 4

## BRANDED MANUFACTURERS PERFORMANCE TRENDING LOWER

1993-99

Market value in billions



Source: McKinsey analysis

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Ranked on two dimensions – size (defined by book equity) and performance (defined by market-to-book ratio) – companies are categorized as incumbent, integrator, expert, or superleaguer. While players can pursue different strategies, for most, their ultimate goal should be to move to the superleaguer position. That's where they will have the most control over the market and their own destinies.

Unfortunately, few U.S. apparel companies are on a decisive path toward becoming high-performing superleaguers. Most are getting bigger but are providing only similar, or frequently lower, returns to shareholders. Only Jones Apparel Group appears to have momentum this year, reflecting market bets that the Nine West merger will result in performance synergies that other companies' earlier acquisitions have yet to demonstrate.

## Superleaguer 2000 and beyond

Clearly, it's as important as ever for companies to keep their core brands vital and growing. But the key to becoming a superleaguer is to make multiple brand acquisitions work and to squeeze more value from every nook and cranny of the business.

### *Make acquisitions work*

It's no secret that most mergers and acquisitions destroy shareholder value. A big part of the problem is that, at today's premium prices, it's extremely hard to make brand acquisitions pay off. They often require huge improvements in earnings just to break even.

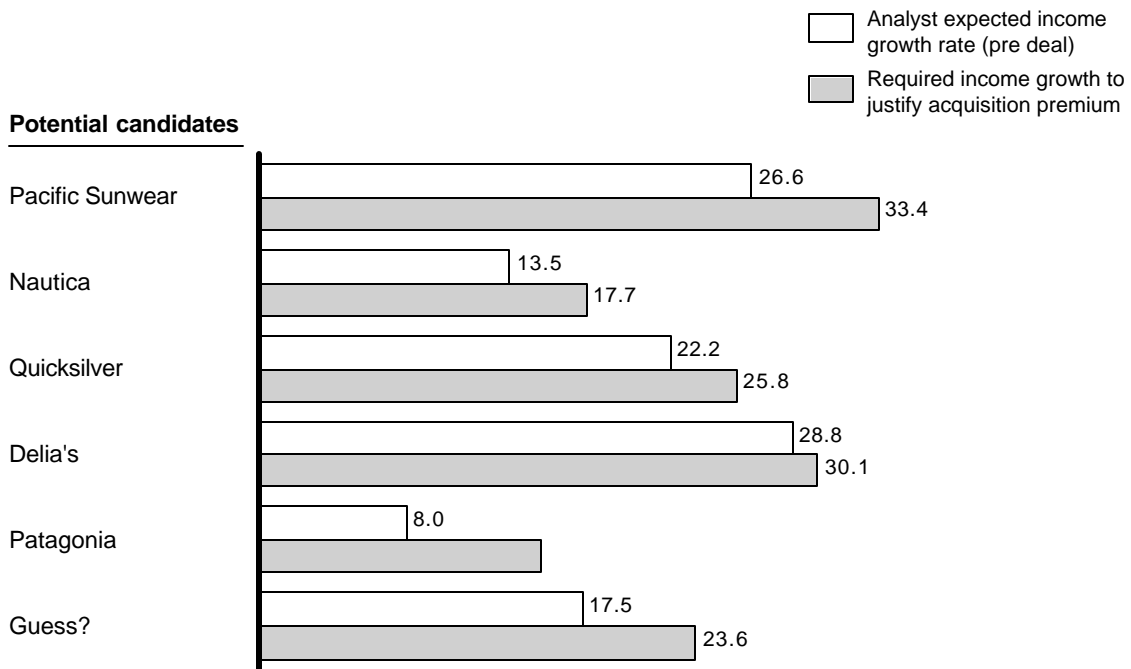
Companies need to be brutally honest about the growth required to offset the acquisition premiums and whether they can achieve that target – which can sometimes be a real stretch. Often, for example, new companies need to make incremental earnings gains of up to 7 percentage points over current aggressive market expectations for their growth rates (Exhibit 5).

Exhibit 5

### **ACQUISITIONS CAN REQUIRE AGGRESSIVE GROWTH TO ADD VALUE**

#### **Required incremental earnings growth to justify 12/99 market capitalization plus 30 percent acquisition premium**

Percent



Source: SEC filings; I/B/E/S; analysts' reports; McKinsey analysis

That said, the "keys" to success are well known. They are all about identifying the "right" opportunities, ruthlessly negotiating and structuring the deal, actively identifying the synergies between the companies, and then proactively managing the integration after the deal is done.

Acquirers must also actively manage and integrate the acquired company, since business "as usual" rarely generates the value necessary to pay for the deal. In the apparel world, given that the CEO is often the lead designer, changing the management approach can be difficult, and shuffling senior managers can erode brand strength because the brand essence is often tied to the designers. Similarly, changing "how things are done" to capture synergies can also be unpopular in a business known for eccentric personalities.

### *Squeeze more value from the business*

Managing the back end of the business more aggressively can lead to higher profitability for branded manufacturers. Many areas – including sourcing and purchasing, logistics, and marketing – are frequently underexploited, since companies usually focus on the design and marketing of fashion. They can also be the keys to extracting value from acquisitions. For example, our work shows that:

- Branded manufacturers can likely reduce the cost of goods sold by up to 5 percent with better apparel sourcing. These improvements can come from a variety of places, including better decision-making and negotiating as managers deepen their understanding of supplier and product costs through better information and cross-functional viewpoints.
- In another case, improving inventory planning is forecast to lower one branded manufacturer's inventory levels by 12 to 15 percent, with substantial cost savings.
- Sales operations can also be upgraded. Our work in packaged goods companies has repeatedly shown that using cross-functional teams – involving sales, finance, and operations, for example – allows companies to determine the real cost of serving clients and can dramatically improve profitability.

More rigorous financial and portfolio management strategies will also be the order of the day. As the mix of brands and assets grows and changes, it's critical to assess the returns on various pieces of the business and ensure that the portfolio is continuously being optimized. Not only does this require greater analytical skills as the complexity of the business increases, but management must also make the tough calls about brands and the business that often evoke strong passions among those involved in the magic of the apparel world.

Capturing these opportunities will likely involve changes in practices and personnel. In many cases, higher performance will be difficult to achieve without leveraging other industry knowhow and selectively adding managers with specific skills and experience throughout the organization. This evolution can already be seen at several companies where incumbent leaders are being replaced with individuals who have more extensive expertise to manage the business of fashion.

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While name brand manufacturers in the apparel industry enjoyed great results during most of the 1990s, they now face a much tougher environment. The true winners will gain in both size and value to become the industry superleaguers. What it takes is a strong multiple brand portfolio, achieved through "must have" skills to capture value from acquisitions and wise management that is focused on high performance across the new company. Then the magic and the *business* will be posed to reap market rewards.