Positioning The Buyer For A Fact-Based Bid On And Subsequent Rapid Savings Capture At A $700+MM Direct Marketing Company:
Operational Due Diligence At CatalogCo

The Challenge: CatalogCo, a PE-owned catalog company, was being considered for acquisition by a mega buyout firm. A growth story with attractive margins, CatalogCo was being sold in a hotly contested auction involving multiple potential PE buyers. Operational effectiveness/efficiency was a critical driver of CatalogCo's financial success and valuation. The target had 2 million square feet in warehouse space, sourced 85% of its items from >1,800 Asian suppliers, had significant outbound freight and catalog printing costs, and was holding high levels of inventory. At the time of the auction, CatalogCo was undergoing a major warehouse facilities upgrade and a growth in the volume of web orders (vs. phone orders). The potential PE buyer asked Gotham to quickly gain an understanding of the company's operations and related risks and potential opportunities in order to help it prevail in the auction.

The Partnership:
Analysis: Given the short timeframe for the operational due diligence effort (4 weeks), Gotham first created an issue tree to focus our investigation by deconstructing and analyzing the P&L from the top down. We segmented and reality-checked fixed and variable costs to understand the true cost of each business function (e.g., sourcing, warehousing/fulfillment operations) and its cost trends in recent years. Once the costs for the company were outlined and prioritized, Gotham focused on detailing potential areas of opportunity by modeling operational scenarios and assessing current rates against benchmark rates.

To supplement the limited information available on CatalogCo's operations (observations from 1 site visit, 2 management calls, and the selective operational information contained in the investment memorandum and data room), Gotham reverse-engineered and modeled the cost structure for multiple aspects of CatalogCo's business. For example, by modeling the outbound parcel freight expense and discount rates, we were able to quantify the scope of opportunity for future savings from implementation of such practices as zone skipping and from a more optimized network where regional distribution centers would be located closer to areas of high customer concentration. We also modeled and quantified the impact of expected postal rate increases based on different circulation rates and catalog sizes by analyzing CatalogCo's catalog mailing schedule and catalog page counts. Other modeling included estimations of cost savings associated with: the establishment of an Asian sourcing office; and reductions in required warehouse capacity that would be achievable with lower levels of the right inventory.

Inventory Reduction: Improved Turns Of 2.25 Would Likely Make Warehouse 3 Unnecessary

Storage Space Sensitivity Analysis
($MM)

	2006	2007	2008	2009
Pallet Capacity				
• Warehouse 1	68,155	110,000	110,000	110,000
• Warehouse 2	48,171	48,171	48,171	48,171
• Warehouse 3	38,217	38,217	38,217	38,217
• **Total**	**154,543**	**196,388**	**196,388**	**196,388**
• Projected Peak Inventory ($000)	$96,140	$103,796	$110,475	$119,708

	# of Pallet Locations Required				Projected Fixed Warehouse Costs*: ($000)			
	2006	2007	2008	2009	2006	2007	2008	2009
• Current Turns (~1.7)	143,500	154,927	164,897	178,678	$9,649	$10,414	$12,658	$13,258
• 2 Turns	115,073	126,080	138,044	151,071	$9,649	$9,558	$11,723	$13,258
• 2.25 Turns	102,287	112,071	122,706	134,285	$8,632	$9,558	$11,723	$12,262
• 2.5 Turns	92,059	100,864	110,435	120,857	$8,632	$9,558	$11,723	$12,262
• 2.75 Turns	83,690	91,694	100,396	109,870	$8,632	$8,096	$11,723	$12,262
• 3 Turns	76,716	84,053	92,030	100,714	$8,632	$8,096	$10,143	$12,262
• 4 Turns	57,537	63,040	69,022	75,535	$7,064	$8,096	$10,143	$10,585
• 5 Turns	46,029	50,432	55,218	60,428	$7,064	$8,096	$10,143	$10,585
• 6 Turns	38,358	42,027	46,015	50,357	$7,064	$8,096	$10,143	$10,585

Warehouses 1, 2, and 3
Warehouses 1 and 2 only
Warehouse 1 only

To quantify opportunities associated with upcoming contract renegotiations (CatalogCo was in the process of renegotiating contracts with several key suppliers), Gotham combined modeled costs with operational benchmark data developed from our experience with similar operations. We identified realistic targets/freight discount rates for use in negotiations to capture cost savings.

Findings: Gotham split the savings achievable into: Level I savings (inventory, sourcing, and warehouse) which management subsequently acknowledged were achievable with some assistance; and Level II savings (catalog cost, warehouse automation, and call center productivity) which warranted further investigation to confirm feasibility/clarify the magnitude of the potential impact. Gotham estimated Level I savings as ranging from $19-29MM (sourcing, freight, and catalog opportunities), with another $26-37MM possible from inventory reduction. Level II opportunities could deliver another $6-11MM in savings. All cost reduction ranges covered conservative-to-aggressive estimates for each opportunity, and Gotham prioritized each opportunity based on effort required to capture versus size of impact.

The Outcome: In pinning down/quantifying risks and opportunities, Gotham helped the potential PE buyer's deal team ensure their overall valuation models were more robust, and the buying PE firm leveraged Gotham-identified savings opportunities to win the auction. In fact, the opportunities identified were so impressive and considered realistic by the selling PE firm, that it took the rare step of deciding to retain a significant minority ownership stake in the company. After the acquisition, the CatalogCo management team captured $9MM in savings through contract re-negotiations, and asked Gotham to help them realize the full scope of savings.

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