

Liz Claiborne: Sample Valuation

1. Reproduction Value

Estimating tangible asset value

Item	Book	Fraction of Book	Adjustment	Reproduction
Assets:				
Cash & Marketable Securities	393.4	1		393.4
Accounts Receivable	432	1		432
Inventory	541	0.5		270.5
Other	142.4	1		142.4
<u>Total Current Assets</u>	<u>1508.8</u>			<u>1238.3</u>
PPE: Land & Buildings	140	0.5	70	140
PPE: Furniture and Fixtures	192	0.5		96
PPE: Machinery and Equipment	345	0.5		172.5
PPE: Leasehold Improvements	357	1		357
PPE: Less Depreciation and Amortization	-560	0		0
<u>Net PPE</u>	<u>474</u>			<u>765.5</u>
<u>Other Assets</u>	<u>9</u>	<u>1</u>		<u>9</u>
Liabilities:				
Short Term Borrowings	56	1		56
Accounts Payable	260	1		260
Accrued Expenses	288	1		288
Income Taxes Payable	33	1		33
Deferred Income Taxes	49	1		49
<u>Non-Debt Current Liabilities</u>	<u>686</u>			<u>686</u>
Net Tangible Assets	<u>1305.8</u>			<u>1326.8</u>

See Appendix A for details

Valuing the Intangibles

The value of intangibles is understandably hard to estimate. Let us try several methods to approximate it:

Using comparable companies: intangibles/sales

In 2003, LIZ acquired Juicy Couture, a company with 2002 sales of \$47 mln¹, for approximately \$143.8mln (\$53.8mln in cash and an estimated \$100mln in future payments, discounted at 10%). The value of the trademark alone was estimated at 27.3mln, or 59% of previous years' sales and 19% of the purchase price; the value of customer relations was not separately estimated in the annual report, a most conservative estimate here would be zero. In 2004, LIZ acquired ENYCE, whose intangibles (both

¹ See Appendix D

trademark and customer relations) were estimated at about 47% of 2003 sales and 34% of the purchase price.

Applying these sales multiples to LIZ's 2004 sales, we get an approximate value of about 2.2-2.5 bln for the value of LIZ's customer relations and trademark assets. Adding 10% of sales to account for other intangibles, such as organizational know-how, supplier relations, etc., we arrive at an estimate of between **2.6 and 3.2 bln.** for all intangibles that are required to support LIZ's sales.

We should also notice that, even without the adjustments for other intangibles, these numbers come to between 43 and 53% of LIZ market capitalization of 5,100 mln at the end of 2004. For comparison, the estimated value of the intangibles for ENYCE was at $(45/132)=34\%$ and for Juicy Couture at $(27/143)=19\%$.

The reason is that LIZ is currently valued at about 110% of annual sales, while it purchased Juicy Couture at 306% and ENYCE at 139% of their sales. Acquisition premia are one reason for this difference: it is always more costly to acquire an entire company compared to current market value based on the price of publicly traded shares, so these company values are not directly comparable.

Brand value estimation through costs

Here we try to compute the costs that a new company would have to spend to obtain brand value comparable to that of LIZ's products:

- Brand creation per \$ sales
 - \$0.20 - \$ 0.40
- Probability of success
 - 1/2 - 1/3
- Cost per achieved \$ of Sales
 - Between $\$.20 \times 2 = .40$ and $\$.40 \times 3 = \1.2
 - Midpoint \$ 0.80
- Discount of brand age = 25%
- Net brand value per \$ sales = $\$.80 \times (100\% - 25\%) = \$ 0.60$
- Revenue = \$4,632
- Brand Value = $\$4,632\text{mln} \times 0.6 = \mathbf{\$2.8bn}$

SGA Approximation

- Liz Claiborne spent between 27% and 33% of sales on SGA expenses:

Year	Sales, net	SGA	SGA/sales
2000	3104	832.11	0.27
2001	3449	978.99	0.28
2002	3718	1126.22	0.30
2003	4241	1314.69	0.31
2004	4633	1514.49	0.33
Average	3829	1153.3	0.30

Source: Compustat North America

Since the ratio has been steadily increasing, it is reasonable to take the most recent figure of SGA of 1.5 bln as an indicator of the current costs that a new company would have to face.

- Assume about 50% of the SGA expenditure is needed each year to build up the intangibles
- Assume it takes about 4-5 years to come up with the level of intangibles for a new entrant to the industry
- The intangible value of 3 – 3.75 billion.

Total replication value

Combining our estimates of tangible and intangible value, we can arrive at a replication value of between 3.9 bln and 4.699 bln for the entire company. On average these methods produce a intangibles value of around 3.1 bln.

Method	Intangibles	Total	Equity
SGA Approximation (high)	3.8	5.1	4.6
SGA Approximation (low)	3.0	4.3	3.8
Brand-related costs	2.8	4.1	3.6
Intangibles/Sales: Juicy C.	3.2	4.5	4.0
Intangibles/Sales: ENYCE	2.6	3.9	3.4
<i>High</i>	<i>3.8</i>	<i>5.1</i>	<i>4.6</i>
<i>Low</i>	<i>2.6</i>	<i>3.9</i>	<i>3.4</i>
<i>Average</i>	<i>3.1</i>	<i>4.4</i>	<i>3.9</i>

Adding 1.3 bln of tangible assets and subtracting \$500 mln of long-term debt, we compute the replication value of Liz Claiborne equity at between 3.4 and 4.6 bln, with an average estimate of 3.9 bln.

2. Earnings power value

As can be seen from the table below, the adjusted earnings after taxes for a hypothetical all equity LIZ is \$331 million in 2004. We assume an optimal capital structure of 1/3 debt and 2/3 equity – with cost of debt at 6% and cost of equity at 10% and tax rate of 36%. That gives a WACC of 8%. The corresponding value of the enterprise based on earnings power is $331/0.08 = \$4.1$ billion. The assumption is that the firm will recapitalize at some future time to realize the benefits from using higher amount of debt in its capital structure. If 100% equity is the optimal capital structure, then the earnings power value of the firm is $331/0.1 = \$3.3$ billion.

We used a nominal cost of capital to capitalize the adjusted earnings – the assumption is that the adjusted earnings will stay at the same nominal level i.e., will depreciate in “real dollars,” and not grow at the expected inflation rate implicit in the nominal cost of capital numbers we used. This is a very conservative assumption.

In arriving a 10% rate (nominal, inflation is built into it) for cost of equity capital, we assume a long bond rate of 6% plus an equity premium of 4%¹.

EBIT	\$503		
Taxes @ 36%	\$181		
NOPAT	\$322		
Restructuring charge (+5mm , net tax = \$3mm)	\$325	Have had other restructuring charges in the past, (may not be extraordinary), but took ½ the charge and added it back	
+ Depreciation Adjustment (Depreciation – Zero Growth Capex)			
+ Depreciation – [(Capex)-((PPE/Sales) * Δ Sales)]			
+ \$116Million – [(\$146)-(((\$475 / \$4,632) * \$391Mil)]			
Depreciation & Amortization =	\$116	(\$96+\$20)	
PPE/Sales =	.10	\$475 / 4,632	
Δ Sales =	\$391		
Growth Capex =	\$40		
Capex =	\$146		
Maintenance Capex	\$106		
Excess Depreciation =	\$10		
Tax @36% =	(\$4)		
Excess Depreciation AT =	\$6		
Adjusted Earnings	\$331		

3. Valuing growth

LIZ has grown substantially during the past several years, increasing sales by almost 50% from 3.1 bln in 2000 to 4.6 bln in 2004. Liz grew faster than the industry and that led to a substantial increase in market share:

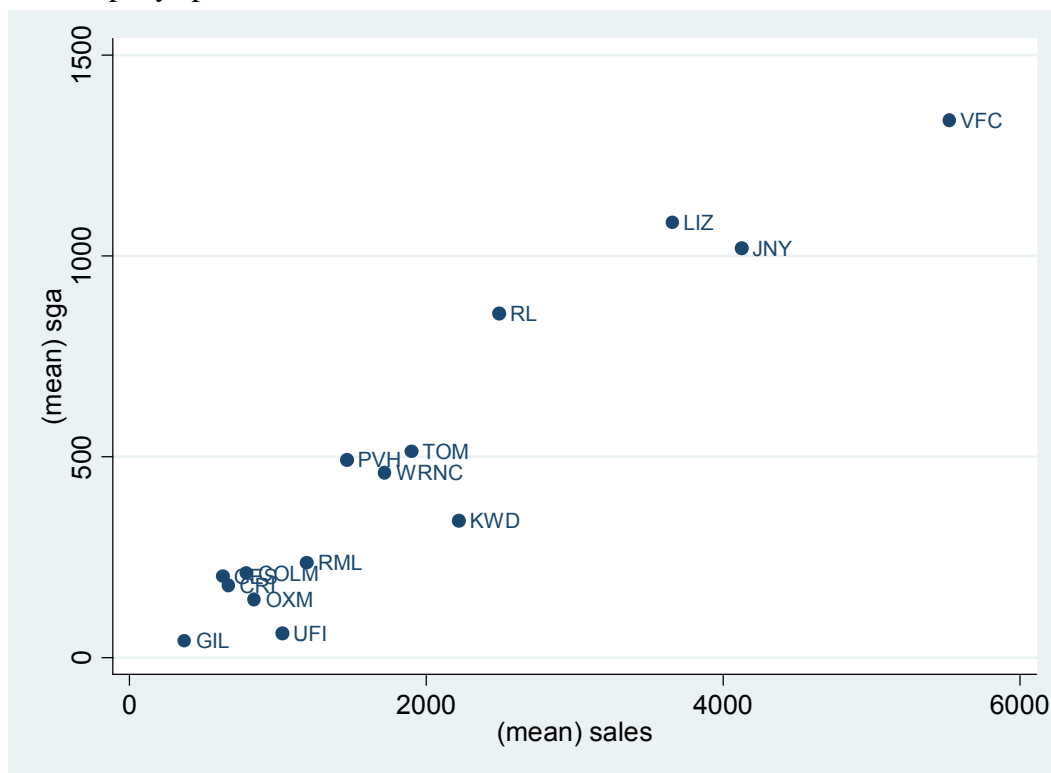
Year	Sales (industry ²)	Sales (LIZ)	Market share
2000	28140.55	3104.14	11.03%
2001	27925.2	3448.52	12.35%
2002	27742.57	3717.5	13.40%
2003	29535.96	4241.12	14.36%
2004	29458.72	4632.83	15.73%

Much of this growth came from acquisitions.

The main questions we are interested in here are:

- Will the company be able to at least keep its' market share
- How profitable will potential growth be?

If we look at the data, we can see that there is an almost straight line relation between the amount a company spends on SG&A and its'



sales:

LIZ enjoys slightly higher margin $[(Sales - CG \text{ sold}) / Sales]$ than the other two companies of comparable size (VFC and JNY), but to achieve that LIZ spends a higher fraction of sales on SGA. After we take that into account there are no appreciable differences as can be seen from the table below:

	LIZ	VFC	JNY
Sales (1)	4632	4650	6054
Cost of Goods Sold (2)	2490	2847	3517

² Using all Value Line comparable companies for the industry comparison. Data from Compustat (see Appendix B)

SGA (3)	1514	1168	1677
Margin (=1-3)/1)	46%	39%	42%
SGA/Sales (=2/1)	33%	25%	28%
Margin-SGA/Sales (=1-3-2)/1)	14%	14%	14%

There is a strong (t-stat=3.8) relationship between past SGA expenditures relative to the industry and the current market share: an increase (decrease) in SGA relative to the rest of the industry by 10% results, on average, in a 3% increase (decrease) in market share (see Appendix F) -- suggests that a reduction in SGE, or even failing to increase SGE on par with the competition, will most likely result in a drop of the market share. It is not going to be easy to grow at a rate that exceeds the industry average without sacrificing profitability.

As we mentioned earlier, if LIZ is able to maintain the earnings that we calculated in our Earnings Power computations, then at a weighted average cost of capital of 8% (assuming that recapitalization to get to optimal capital structure some point in the future) it could be valued at $\$331/.08=4.1$ bln. Suppose Liz grows at a steady long term equivalent rate, g. Then, by definition:

$$IV \text{ with growth} = (\text{Earnings} - \text{Growth Related Spending}) / (r - g)$$

What is a reasonable value for Growth Related Spending?

EP value = \$ 4.1 bln. Market value of the firm = \$ 4.6 bln. If we need a margin of safety of 1/3, the total value (EP value + value of growth) should equal $4.6 / (1 - 1/3) = \$ 6.8$ bln. So, value of growth should be $6.8 - 4.1 = \$ 2.7$ bln, i.e., \$26/sh.

The adjusted earning of LIZ in 2004 was \$331 mil. The total replacement value of assets (including intangibles) was about \$4.4 bln. We get, Adjusted Earnings / Total Assets = 7.5%. Since the return on capital is about the same as the WACC, the industry is in equilibrium unless there is a major shift in tastes. So the growth that is profitable is likely to come from growth of the industry itself; with there being no need for incumbents to spend any additional amount in SGA but potential new entrants having to spend a disproportionately large amount to get in. The best case: Assume a growth rate of about 3% per year without the need to spend any additional amount in SGA and other growth related expenses; i.e., the adjusted earnings will grow at the expected inflation rate built into the cost of capital we use. That would give an IV with growth of $331 / (0.08 - 0.03) = \$6.6$ bln. In that case, LIZ is close to a fair buy at \$42 per share allowing for a 1/3rd margin of safety. On the other hand, we assumed a WACC of 8% whereas the cost of equity capital is 10%. If the recapitalization does not materialize, then the relevant cost of capital should be closer to 10% and not 8% -- there is insufficient margin of safety for a value investor.

Appendix A: Computing Tangible Assets

The source of numbers for the tangible asset calculation:

Item	Note
Assets:	
Cash & Marketable Securities	p.63: 385.6 cash + 7.8 marketable securities
Accounts Receivable	p.63
Inventory	p.63
Other	p.63: 51.1 deferred income taxes + 91.3 other CA
PPE: Land & Buildings	p.75. The PPE adjustment from the footnotes 6, page F-13 of 2004 10K. The section is entitled "other significant accounting policies".
PPE: Furniture and Fixtures	p.75
PPE: Machinery and Equipment	p.75
PPE: Leasehold Improvements	p.75
PPE: Less Depreciation and Amortization	Depreciation already accounted for
<u>Other Assets</u>	p.63
Liabilities:	
Short Term Borrowings	p.63
Accounts Payable	p.63
Accrued Expenses	p.63
Income Taxes Payable	p.63
Deferred Income Taxes	p.63

Appendix B: Obtaining data from Compustat

A detailed tutorial on accessing the historical data from CRSP, Compustat and other online databases via WRDS is available at

<http://www.kellogg.northwestern.edu/researchcomputing/docs/wrds-web.pdf>

To download the data used in this exercise, one can do the following:

1. Go to the WRDS website (<http://wrds.wharton.upenn.edu>)
2. Select the Compustat North America page, Industrial Annual
3. Chose³:
 - a. Frequency: Annual
 - b. Beginning: 1995, Ending: 2004
 - c. Search by: SMBL
 - d. Create a text file with the tickers of the Value Line comparables (see Appendix C). Sometimes tickers won't work and you'll have to use the Code Lookup link, but in this case they are sufficient
 - e. Pick the data items of interest. in this case, these are:
 - i. DATA12: Net Sales
 - ii. DATA41: Cost of Goods Sold
 - iii. DATA189: Selling, General and Administrative Expenses
 - f. Output format: comma-delimited text
4. Press "Submit request"; once it is ready you'll be able to download the file and open it in Excel or Stata.

Appendix C: Value Line Comparables

You may paste these tickers into a text file and use to get the data as described above:

VFC
JNY
LIZ
PVH
OXM
RML
KWD
GES
TOM
RL
COLM
GIL
WRNC
UFI
CRI

³ Click on "Documentation" to get a list of all the data items, and on "Data manuals" to get the data definitions (see Chapter 5).

Appendix D: ENYCE press release

Information on the acquired companies is often available in the official company press releases. Please go to LIZ Claiborne corporate page at

<http://www.lizclaiborneinc.com/default.asp> and follow the link to Investor Relations: http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=LIZ&script=2100

This particular press release is located at

http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=LIZ&script=460&layout=0&item_id=469639

Liz Claiborne Inc. Agrees to Acquire ENYCE HOLDING LLC

NEW YORK, Nov. 12 /PRNewswire-FirstCall/ -- Liz Claiborne Inc. (NYSE: LIZ) announced today that it has agreed to purchase all of the equity interest in ENYCE HOLDING LLC ("ENYCE") for a purchase price of approximately \$114 million, including the retirement of debt at closing.

Based in New York City, ENYCE is a designer, marketer and wholesaler of fashion forward streetwear for men and women through its ENYCE(R) and Lady ENYCE(R) brands. ENYCE is projected to generate net sales of approximately \$95 million in fiscal 2003. Consummation of the transaction is subject to review under the provisions of the Hart-Scott-Rodino Act and other customary closing conditions. The transaction is expected to close in the fourth quarter of 2003.

ENYCE sells its products primarily through specialty store chains, better specialty stores and select department stores. Currently, men's products account for approximately 84% of net sales while women's products account for the remaining 16% of net sales. Men's and women's products include a variety of denim-based lifestyle products, outerwear, athletic-inspired apparel, casual tops and knitwear.

Commenting on the announcement, Paul R. Charron, Chairman and Chief Executive Officer of Liz Claiborne Inc., said: "For some time now, we have indicated our interest in adding a young men's brand to our portfolio. Today's announcement of our agreement to acquire ENYCE provides us with one of the best positioned, strongest trending streetwear brands in this sector. With its appeal to the fashion conscious young consumer, ENYCE further diversifies our portfolio, enhancing our ability to offer apparel and accessories across a wide range of consumer lifestyles and tastes. ENYCE also provides additional channel diversification through its specialty store chain and better specialty store distribution. We feel there is considerable organic growth potential in the men's line, in addition to growth opportunities in the recently launched Lady ENYCE(R) line. Further, brand extensions into non-apparel categories, company-owned specialty retail and outlet stores and licensing offer additional growth potential."

Mr. Charron continued: "We are pleased that Evan Davis and the ENYCE senior management team will remain with the Company. This will ensure that ENYCE's clear and focused vision and brand position will remain intact. We have developed a proven track record of successfully integrating privately held, design-oriented companies like Lucky Brand, Sigrid Olsen, Laundry, Mexx, Ellen Tracy and most recently, Juicy Couture. We look forward to working with the ENYCE management team to maximize their performance and realize their potential within Liz Claiborne."

Mr. Charron concluded: "We expect this transaction to have no impact on fiscal 2003 earnings per share and to be accretive to fiscal 2004 earnings per share by approximately \$0.05. Accordingly, for fiscal 2004, we are adjusting our sales guidance from an increase of

3 - 6% to an increase of 5 - 8% and our EPS guidance from a range of \$2.65 - \$2.72 to a range of \$2.70 - \$2.77."

Evan Davis, President of ENYCE, said: "We are excited that by partnering with Liz Claiborne, Enyce, which has enjoyed great success over the last seven years, will be able to continue to grow and reach all of our goals. To have access to this kind of guidance and expertise, while remaining autonomous and doing what we do best, is a win-win for everyone."

Liz Claiborne Inc. designs and markets an extensive range of women's and men's fashion apparel and accessories appropriate to wearing occasions ranging from casual to dressy. The Company also markets fragrances for women and men. Liz Claiborne Inc.'s brands include Axxess, Bora Bora, Claiborne, Crazy Horse, Curve, Dana Buchman, Elisabeth, Ellen Tracy, Emma James, First Issue, J.H. Collectibles, Juicy Couture, Laundry by Shelli Segal, Liz Claiborne, Lucky Brand, Mambo, Marvella, Mexx, Monet, Monet 2, Realities, Sigrid Olsen, Spark, Trifari and Villager. In addition, Liz Claiborne Inc. holds the exclusive, long-term license to produce and sell men's and women's collections of DKNY(R) Jeans and DKNY(R) Active, as well as CITY DKNY(R) better women's sportswear in the Western Hemisphere. The Company also has the exclusive license to produce women's wear under the Kenneth Cole New York, Unlisted and Reaction Kenneth Cole brand names.

Founded in 1996 by Fila USA, ENYCE designs and sells fashion forward streetwear for men and women through its ENYCE(R) and Lady ENYCE(R) brands. Men's and women's products include a variety of denim-based lifestyle products, outerwear, athletic-inspired apparel, casual tops and knitwear. ENYCE sells its products predominantly through specialty store chains, better specialty stores and select department stores in the United States. The Company also has agreements with international distributors in Germany, Canada and Japan.

Statements contained herein that relate to the Company's future performance, including, without limitation, statements with respect to the Company's anticipated results of operations or level of business for 2003 or any other future period, are forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements are based on current expectations only, and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or projected. Among the factors that could cause actual results to materially differ include changes in regional, national, and global micro- and macro- economic conditions, including the levels of consumer confidence and spending and the levels of customer traffic within department stores, malls and other shopping and selling environments; risks related to retailer and consumer acceptance of the Company's products; risks associated with competition and the marketplace, including the financial condition of, and consolidations, restructurings and other ownership changes in, the apparel (and related products) industry and the retail industry, the introduction of new products or pricing changes by the Company's competitors, the Company's ability to effectively remain competitive with respect to product, value and service; risks associated with the Company's dependence on sales to a limited number of large department store customers, including risks related to customer requirements for vendor margin support, and those related to extending credit to customers; the Company's ability to correctly balance the level of its commitments with actual orders; the Company's ability to effectively distribute its product within its targeted markets; risks associated with acquisitions, licensing and the entry into new markets, including risks relating to integration of acquisitions, retaining and motivating key personnel of acquired businesses and achieving projected or satisfactory levels of sales, profits and/or return on investment; risks associated with the possible

inability of the Company's unaffiliated manufacturers to manufacture and deliver products in a timely manner, to meet quality standards or to comply with the Company's policies regarding labor practices; risks associated with changes in social, political, economic, legal and other conditions affecting foreign operations, sourcing or international trade, including foreign currency exchange rate fluctuations; risks associated with war, the threat of war and terrorist activities; work stoppages by suppliers or service providers; risks relating to protecting and managing intellectual property; and such other economic, competitive, governmental and technological factors affecting the Company's operations, markets, products, services and prices as are set forth in our 2002 Annual Report on Form 10-K, including, without limitation, those set forth under the heading "Business-Competition; Certain Risks" and under the heading "Statement Regarding Forward-Looking Statements". The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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Appendix E. Juicy Couture press release

http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=LIZ&script=460&layout=0&item_id=398766

Liz Claiborne, Inc. (ticker: LIZ, exchange: New York Stock Exchange (.N)) News Release - 4/7/2003

Liz Claiborne Inc. Completes Acquisition of Juicy Couture

NEW YORK, April 7 /PRNewswire-FirstCall/ -- Liz Claiborne Inc. (NYSE: LIZ) announced today that it has completed the purchase of 100 percent of the stock of Travis Jeans, Inc. which owns the assets comprising Juicy Couture.

Based in Southern California, Juicy Couture is a premium designer, marketer and wholesaler of sophisticated basics for women, men and children and is recognized around the world as a leading contemporary brand of casual lifestyle clothing. Juicy had sales of approximately \$47 million in 2002.

Juicy sells its products predominantly through select specialty stores such as Scoop, Barney's, Bergdorf Goodman, Henri Bendel and Fred Segal. Department store distribution is limited to upscale purveyors such as Neiman Marcus, Saks Fifth Avenue, Bloomingdale's, Marshall Field's and Nordstrom. The Company also has agreements with international distributors in Europe, Canada and Asia. Juicy products are available in over 840 specialty stores and approximately 280 department stores throughout the United States, as well as over 300 stores internationally. Juicy primarily targets the fashion-conscious woman between the ages of 18 and 45, as well as aspirational teens and baby boomers.

Travis Jeans, Inc., doing business as Juicy Couture, is a designer, marketer and wholesaler of men's and women's sportswear and accessories which are sold through wholesale showrooms and sales representatives to customers in the retail fashion industry throughout the United States, Canada, Europe and Japan.

Liz Claiborne Inc. designs and markets an extensive range of women's and men's fashion apparel and accessories appropriate to wearing occasions ranging from casual to dressy. The Company also markets fragrances for women and men. Liz Claiborne Inc.'s brands include Axxess, Bora Bora, Claiborne, Crazy Horse, Curve, Dana Buchman, Elisabeth, Ellen Tracy, Emma James, First Issue, J.H. Collectibles, Laundry by Shelli Segal, Liz Claiborne, Lucky Brand, Mambo, Marvella, Mexx, Monet, Monet 2, Russ, Sigrid Olsen, Trifari and Villager. In addition, Liz Claiborne Inc. holds the exclusive, long-term license to produce and sell men's and women's collections of DKNY(R) Jeans and DKNY(R) Active, as well as CITY DKNY(R) better women's sportswear in the Western Hemisphere. The Company also has the exclusive license to produce women's wear under the Kenneth Cole New York, Unlisted and Reaction Kenneth Cole brand names.

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Appendix F. Past SGA and market share

We consider all Value line comparable companies since 1995. The dependent variable is change in current market share (measured as the fraction of total sales a company achieved within a particular year less the same fraction a year before); the independent variable is the change in the share of total industry SGA expenditure attributable to the company a year before.

Source	SS	df	MS	Number of obs =	110
Model	.001501303	1	.001501303	F(1, 108) =	14.67
Residual	.01105427	108	.000102354	Prob > F =	0.0002
				R-squared =	0.1196
				Adj R-squared =	0.1114
Total	.012555573	109	.000115189	Root MSE =	.01012

relesalesD	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
relsgaLD	.309409	.0807889	3.83	0.000	.1492713 .4695467
_cons	.0008735	.0009656	0.90	0.368	-.0010406 .0027875

ⁱ See “The Equity Premium,” by Eugene Fama and Kenneth French, *Journal of Finance*, 2002 and “The Declining Equity Premium,” by Ravi Jagannathan, Ellen McGrattan and Anna Scherbina, *Quarterly Review of the Federal Reserve Bank of Minneapolis*, Fall 2000 (http://minneapolisfed.org/research/common/pub_detail.cfm?pb_autonom_id=848) for reasons why we may want to use a lower equity premium number going forward.