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HOW TEXAS PACIFIC CLEANED UP AT J. CREW

The private equity firm reaped many times its investment by giving the preppy retailer the freedom that few public companies enjoy

Not so many years ago, the Gap was a trend-setting retailer and J. Crew was a small also-ran. In recent years, however, their roles have reversed.

Gap fired Chief Executive Paul Pressler in January, as the company struggled in vain to find its place in a crowded retail environment. Meanwhile, J. Crew has prospered under the leadership of CEO Mickey Drexler, the former CEO of Gap. J. Crew's stock has risen 87%, to $37.47, since its June initial public offering (see *BusinessWeek.com*, 6/28/06, "J. Crew's Smart-Looking IPO"). Gap shares are up 16% during the same period, with much of the increase due to speculation that Gap could be sold (see *BusinessWeek.com*, 1/8/07, "Gap on the Block").

What accounts for the difference in the fortunes of the two retail chains? The answer may very well be that J. Crew has benefited from a leveraged buyout by private equity investor **Texas Pacific Group**. The Gap has labored and wheezed as a publicly held company. "The J. Crew investment has worked out as a classic private equity play," says Phillip Phan, professor of management at Rensselaer Polytechnic Institute, an engineering school in Troy, N.Y.

TPG is one of a handful of elite "mega funds" that have the resources to make big deals and consistently get top results. It's the world's sixth-largest private equity fund, with $31.2 billion in assets under management, according to Private Equity Intelligence, a London researcher.

THE PRIVATE EQUITY ADVANTAGE

The number of private equity deals has surged during the past few years (see *BusinessWeek.com*, 12/28/06, "Private Equity's Big Winners"). **TPG**'s investment in J. Crew is a good example of why capital from pension funds and other huge investors is pouring into the private market.

Big private equity firms such as **TPG** generate huge returns on investment. **TPG** and J. Crew declined to comment for this story. As a private investor, **TPG** isn't obligated to report results to the Securities & Exchange Commission the way that mutual funds or other big, publicly traded funds are. But Phan, who has studied **TPG** and the J. Crew deal in particular, estimates that **TPG** made an annual return of about 32%. By stringing together one such deal after another, private equity firms can soundly beat the market. The average annual return for the Standard & Poor's 500-stock index is 8.65%, according to S&P (see *BusinessWeek.com*, 1/19/07, "A 'Public LBO' for the Tribune?").

Here's a look at how **TPG** was able to make the deal pay off: The firm bought 56% of J. Crew for about $125 million in 1997. Management owned the rest of the company (see *BusinessWeek.com*, 1/31/07, "Texas Pacific Has Great Run with J. Crew"). J. Crew's fortunes wavered during the next few years, but as a private investor, TGP was able to take several steps that public shareholders might not have understood.

PRUNING TO SPARK NEW GROWTH

First, it hired Drexler not long after he stepped down from Gap in 2002, after spending 19 years with the company. The Gap was performing poorly and Drexler had taken much of the blame, but **TPG** had faith in Drexler's ability as a visionary retailer. It hired him to run J. Crew and gave him a huge incentive in the form of a 12% stake in the company. "Texas Pacific turned J. Crew management into entrepreneurs," Phan said. It's hard to imagine that public shareholders would ever stand for awarding a CEO 12% of a company, especially one who had previously presided over a troubled business.

Texas Pacific also cut back on the number of J. Crew stores. It had built up the number over the years, from around 80 to more than 200. But faced with the need to cut costs, it closed about 20% of the locations, according to Phan. Today the company has about 175 retail sites. Again, that would have been hard for the management of a publicly held company to do. "No CEO wants to be head of a shrinking business," Phan said. But as a smaller company, J. Crew wasn't obligated to sell me-too fashion to the masses.

With the freedom to find a niche, J. Crew experimented with its product lineup. It moved beyond the basic, preppy look without drifting too far over the edge. Many retail experts believe Gap has failed to take enough risks, and has lost its edge to rivals such as Abercrombie & Fitch.

SLOW AND STEADY

Most important, Texas Pacific gave J. Crew something it never would have found as a turnaround company in the public markets: time and patience. It didn't have to show the same kind of quarterly improvements that are expected of public-held companies.

There was a slow, but steady return to growth. Operating losses narrowed in 2003 and 2004, until the company began producing operating profits toward the end of that year. Profit margins steadily increased from the 30s to the 40s, as unprofitable stores were closed and debt with interest rates of 14% or more was refinanced. For the third quarter of 2006, J. Crew reported that revenues rose 23%, to $275 million, and that comparable store sales (sales of units open at least a year) were up 3% and Internet and catalog sales were up 18%. Net income was $26 million, reversing a slight loss in the third quarter of 2005.

TPG took J. Crew public again last summer. About one-third of the company was offered to the public in an IPO that raised about $400 million and valued the entire company at $1.2 billion. **TPG**'s stake was worth nearly $700 million. As J. Crew's stock has surged, the value of **TPG**'s gains, both realized and unrealized, have increased to about $1 billion.

As for Drexler, his 12% stake is worth several hundred million dollars. Such profits may provoke outcry in the public sector, where extravagant CEO pay is controversial. But with the success of J. Crew, Drexler certainly has the backing of the largest shareholder, **TPG**.

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