

## **THE MALL: Zale's Jewels Can Entice Buyers**

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NEW YORK/LONDON (Dow Jones Investment Banker)—Zale Corp., once the largest jewelry retailer in the U.S., is struggling to regain its sparkle amidst an industry downturn that's forced some of its peers to fold. Its troubles, however, could be an opportunity for others to expand or enter the U.S. jewelry market.

Zale's troubles go beyond just a tough market. It has already seen three chief executives come and go in the last four years. To be fair, during that period, the company had to contend with a frugal consumer and mass inventory liquidations at bankrupt rivals (such as Friedman's) that forced it to match their cutthroat prices. Still, Zale has done poorly in comparison with its main competitor Signet Jewelers Ltd., which operates Kay and Jared jewelry stores in the U.S. Its sales and operating margins have significantly lagged those of Signet, largely due to a poor merchandising strategy. Zale's share price has underperformed that of Signet's by 64% in the past three years.

With negative cash flows and almost \$465 million in debt, Zale recently hired investment bank Peter J Solomon to look at financing options. But an outright sale or a break-up are possibilities. The group has some unique assets that could appeal to potential suitors and help it survive, but it must manage its restructuring plan right, notes Michael O'Hara, founder of Consensus Advisors, who has executed a number of jewelry restructurings in recent years, including that of Friedman's.

### **ZALE'S DIAMONDS IN THE ROUGH**

Zale's \$250 million Canadian business, which operates under the Peoples and Mappins brands, could be an ideal fit for Signet, which despite being the largest specialty jewelry retailer in the world has little presence in Canada and can easily pony up the cash to strike a deal.

Then there is Zale's kiosk business, Piercing Pagoda, which sells low-priced jewelry and accessories and generates sales of \$230 million from over 600 kiosks in malls across the country. It could appeal to teen accessories retailers such as Claire's Stores Inc. owned by Apollo Management, and Dress Barn Inc., a \$1.25 billion enterprise value company.

While Claire's may be a bit stretched given its levered balance sheets - as reflected in its bonds trading at 70 cents on the dollar— it can potentially reach into the deep

pockets of Apollo to get cash. Dress Barn, on the other hand, is financially strong and has done opportunistic acquisitions of distressed targets in the past, such as the \$400 million purchase of cash-strapped retailer Tween Brands in November 2009. Elsewhere, Swiss giant The Swatch Group could be a potential suitor for either all of Zale or just its U.S. fine jewelry business. Swatch has a limited presence in the U.S. and has been criticized by some analysts for a lack of a clear strategy in jewelry. Zale currently sells fashion watches from DKNY, Diesel, Armani and Fossil in its stores, and Swatch's own mid-priced brands—such as Tissot, Calvin Klein, Mido and Hamilton— could replace these.

Any deal with Zale would give Swatch a truly global footprint with over 1,700 distribution points—1,100 across North America alone—up from its current 600 retail outlets.

Meanwhile, Swatch has also recently formed a joint venture with Tiffany & Co. and has been talked of as a potential buyer for the larger New York-based jewelry chain. Enticing as it may seem, however, an acquisition of Tiffany, with its \$5.5 billion enterprise value, would force Swatch to take on debt, something the company's management has historically been averse to. By contrast, Zale's \$500 million enterprise value would be a bolt-on deal for the \$15 billion Swiss behemoth. Zale's could also attract private equity interest given its current depressed valuation, for if the company can regain its historical Ebitda margins of around 10%, its equity could be worth multiples of the paltry \$60 million at which it currently trades.

Whoever ends up owning it, Zale has plenty of levers to regain its pride in the hands of a capable buyer.

—Jacob Plieth, columnist with Dow Jones Investment Banker in London, contributed to this analysis.

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