

Bain Capital And Guitar Center, A Tale Of Unmet Expectations

A complex debt for equity swap, detailed elsewhere in this issue, has transferred control of Guitar Center to Ares Management from Bain Capital, the private equity firm that owned the retailer since late 2007. With the completion of the deal, Bain becomes the latest in a long list of sophisticated investors whose foray into the music products industry proved costly. It's too early to determine exactly how much Bain lost by surrendering 60% of its equity in Guitar Center to Ares to gain the debt forgiveness necessary to avoid a trip to bankruptcy court, but it's safe to say that most of Bain's original \$500 million-plus investment has been wiped out.

Bain's Guitar Center loss was essentially a bet on rapid sales growth that misfired. Guitar Center posted solid operational results throughout the nearly seven years of Bain stewardship: it's just that they weren't enough to support \$1.5 billion in acquisition-related debt. On one level, disappointing investments like this are so commonplace; they're what journalists refer to as a "dog bites man" story. Anywhere you look, it's easy to find businesses large and small struggling with investments that were based on bum forecasts. What makes the Bain saga of interest is what it says about the confidence, or perhaps even hubris, of a certain class of investors, and the distinctive characteristics of the music products industry.

The \$2.1 billion Bain paid for Guitar Center in October of 2007 represented a rich valuation: about 23 times trailing 12 months earnings. To put it in perspective, Bed, Bath, & Beyond, the very successful housewares chain, is valued at a comparatively modest 14 times earnings; leading sporting goods chain Dick's fetches just 12 times earnings, and the PetSmart chain trades at just 11 times earnings. Bain's valuation was based on the assumption that Guitar Center revenues would rise from \$2.0 billion in 2007 to around \$3.0 billion by 2012. It was also underpinned by a belief that Bain's managerial magic could ratchet up Guitar Center's margins and overall profitability.

Much of the failure to achieve these optimistic goals can be chalked up to the 2008 financial crisis and the ensuing economic stagnation. Bain management can be forgiven for failing to anticipate these events. However, their purchase price was sufficiently lofty, it made no allowance for even the slightest setback. A much milder recession could have pushed Bain's investment into the red. On the operational front, however, Bain's "improvements" didn't deliver as promised. The attempt to reduce overhead expense by integrating the Musician's Friend mail order division into the Guitar Center organization backfired, with the unfortunate result that Musician's Friend revenues declined at a time when most other online merchants were posting robust growth. Trimming operating expenses at the store level on the backs of the front line sales staff took a heavy toll on morale and customer serv-

ice, and prompted an unwanted unionization drive. New CEO Mike Pratt is currently in the process of reversing these decisions, reestablishing Musician's Friend as an independent operating unit, and raising base salaries at the Guitar Center stores by an estimated \$8.0 million in the recent quarter.

We attribute Bain's misadventures with Guitar Center to a fundamental misreading of the music products industry. Bain Capital, and similar financial firms, employ a cadre of sharp analysts who spend their days wading through data in search of "underperforming" companies; in other words, enterprises that could benefit from the application of their strict managerial discipline. Given the relatively modest profit margins the music products industry affords, most of the companies within it fit that description.



Unfortunately, the application of this managerial discipline doesn't always provide the desired results. The first reason for this has to do with the subjective nature of music. The difference between a store environment that's inviting to musicians and one that's not is something that defies easy quantification, and no amount of spreadsheet skill is a substitute for an intuitive grasp of what feels right. Then there's the question of our customer base, which includes a large number of serious musicians, who by definition do not reside in the upper economic echelons, and are extremely price-sensitive. The financial realities of this large and important customer group put a limit on gross profit. Finally, the industry is a cyclical one: a multi-decade, inflation-adjusted graph of industry revenues looks like a Rocky Mountain vista with lots of peaks and valleys.

Taken together, this combination of a subtle, hard-to-define competitive advantage, unavoidable margin constraints, and sales cycles creates a hostile environment for richly valued, highly leveraged acquisitions. This is why, nearly three decades ago, conglomerates like CBS, Norlin, and Gulf & Western exited the music industry—selling, respectively, Fender, Steinway, Gemeinhardt, and Rodgers Organ; Gibson guitars; and Korg USA. They discovered the hard way that they couldn't justify their investments in the face of the industry's stubborn realities. Ironically, when they offloaded these companies at fire sale prices, they created tremendous opportunities for a succession of future managements and investors. How Ares fares with its Guitar Center investment remains to be seen, but they have the benefit of acquiring a productive asset at a much more reasonable price. As Mark Twain noted, "history doesn't repeat itself, but it often rhymes."

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