Tiffany case

Tiffany& Company concluded an agreement with its Japanese distributor, Mitsukoshi Ltd. that would fundamentally change its business in Japan. Under the new agreement, Tiffany's wholly owned subsidiary, Tiffany& Company Japan Inc. (Tiffany-Japan), assumed management responsibilities in the operation of 29 Tiffany &Company boutiques previously operated by Mitsukoshi in its stores and other locations in Japan.

Tiffany looked forward to the new arrangement, as it was now responsible for millions of dollars in inventory that it previously sold wholesale to Mitsukoshi, resulting in enhanced revenues in Japan derived from higher retail prices. It was also apparent, however, that fluctuations in the yen/dollar exchange rate would now affect the dollar value of its Japanese sales, which would be realized in yen. Since Japanese sales were large and still growing, it seemed evident such fluctuations substantial impact on Tiffany's future financial performance.

Founded in New York in 1837, Tiffany ; Company was an internationally renowned-retailer, designer, manufacturer , and distributor of luxury goods . The famous blue-box company found its initial success in fine jewelry, most notably diamonds, but had since expanded its product line to include timepieces, china, crystal, silverware, and other luxury accessories. In the fiscal year ending January 31, l993 (FY1992), Tiffany earned $15. 7million on revenues of $486. 4million and had total assets of$419. 4 million. Recent financial statements are provided in Exhibits 1and 2.

An historical summary of operations is provided in Exhibit 3. After more than a century of independence, Tiffany was acquired by Avon Products, Inc. in 1979. For the next several years, Avon, a nationwide door-to-door cosmetics

marketer, worked to expand Tiffany's product line to reach beyond its traditional affluent customer base to the larger middle market. While this diversification strategy resulted in enhanced sales for Tiffany from $84million in l979to $124million in l983, operating expenses as a percentage of sales grew inordinately from 34%to 43% in 1978and l983, respectively.

Avon soon realized that Tiffany's traditional market niche was substantially different than its own and, in l984, decided to put the company up for sale. The most attractive offer came from Tiffany's own management, who agreed to buy back Tiffany's equity and the Fifth Avenue store building for a total of $135. 5 million. In what ultimately took the form of a leveraged buyout (L B O), the terms of the deal distributed virtually all of the equity shares to three key investor groups. Management ended up with 20% of total equity shares.

Investcorp, the Bahrain-and London-based merchant bank that backed management in the deal, received 49. 8%of total equity shares. The third player, General Electric Credit Corporation(GECC), ended up with 25. 7%of total equity shares. 1t was through an $85 million credit arrangement with GECC that management was able to refinance a substantial portionof the purchase price. The aftermath of the LBO was marked by very tight free cash flow coupled with significant growth potential on the horizon.

After the company had once again become profitable and realizing that the company's growth prospects demanded more cash than could be generated internally, in 1987, management offered Tiffany stock to the public at approximately $15 a share(adjusted for a subsequent stock split). In l989, Mitsukoshi purchased l. 5 million shares of Tiffany's common stock from

GECC. As of January31, 1993, Mitsukoshi owned approximately 14% of Tiffany stock, the largest percentage of any single institutional investor.

Three other institutional investors collectively owned approximately 26% of the stock, followed by all Tiffany executive officers and directors as a group at 4. 9%. In l993, Tiffany was organized into three distribution channels: U. S. retail, direct marketing, and international retail. U. S. retail included retail sales in Tiffany-operated stores in the United States and wholesale sales to independent retailers in North America. The l6 stores in this channel accounted for 50% of total sales in FY 1992 Direct marketing, representing the smallest channel of distribution, consisted of corporate and catalog sales .

In FY 1992, its sales represented 18% of Tiffany’s total sales. International retail, which included retail sales through Tiffany-operated stores and boutiques, corporate sales, and wholesale sales to independent retailers and distributors, primarily in the Far East and Europe, accounted for 32% of total sales in FY1992. Jewelry sales from all three channels accounted for 65% of 1993 sales, making jewelry the most significant product line. Exhibit 4 provides financial results of Tiffany’s domestic and foreign operations.

The past several years for Tiffany were marked by a trend of international expansion, beginning in1986 when it opened a flagship retail store in London. Additional flagship stores were then opened in Munich and Zurich in 1987 and 1988, respectively. In 1990, the Zurich store was expanded. Stores were opened in Hong Kong at the Peninsula Hotel and at the LandmarkCenter in August 1988 and March 1989, respectively. Taipei saw

the opening of a store in1990, as did Singapore (at the Raffles Hotel), Frankfurt, and Toronto in 199l. Also in l991, the London store was expanded.

In l992, Tiffany opened five new boutiques in Japan, and two new boutiques were opened by an independent retailer in Korea. Early 1993 saw continued international growth, with the opening of two more boutiques in Japan, a second store in Singapore's NgeeAnnCity, two boutiques by independent retailers in Saipan and the Philippines, and the expansion of the Peninsula Hotel store in Hong Kong. Exhibit 5 shows the growth in the number of Tiffany stores and boutiques around the world from 31 to 79, implying a 250% increase from 1987 to 1993.

These 79 retail locations included l6stores in the United States, 56 stores in the Far East, 6stores in Europe, and l store in Canada, all of which ranged in size from700 to 13, OOO gross square feet, with a total of approximately 127, OOO gross square feet devoted to retail purposes. Tiffany's worldwide capital expenditures were $22. 8 million in FY l992. compared with $41. 4 million in FY 1991. These expenditures were primarily for the opening of new stores and boutiques and the expansion of existing stores.

Management anticipated capital expenditures to drop further to $18. O million in FY l993 before rebounding to approximately $25. O million in FY 1994. Management also expected to open four or five new stores per year in the foreseeable future. To support future expansion plans, and fluctuations in seasonal working capital needs, management planned to rely upon internally generated funds and a $100 million noncollateralized revolving credit facility available at interest rates based upon Eurodollar rates, a prime rate, certificate of deposit rates, ormoneymarket rates.

As in the past, cash dividends were expected to be maintained at a relatively moderate level, which would permit the company to retain a majority of its earnings. Impetus for Change in the Japanese Operations While Tiffany found new market potential across the globe, nowhere was let as promising as in Japan, where Tiffany’s sales accounted for only 1% of the $20 billion Japanese jewelry market. The thriving Japanese economy of the late l980s and very early 1990s stimulated a booming demands for certain types of expensive and glamorous Western goods.

Among these were Tiffany products, principally those of the fine jewelry line marketed toward older women. However, as the Japanese economy finally slowed and Japanese consumers became more cautious in their spending, the demand for Tiffany's luxury items also slumped. In response to soft consumer demand in Japan, Mitsukoshi cut back on Tiffany inventory levels. Mitsukoshi’s wholesale purchases from Tiffany-Japan declined from 23%of Tiffany's total sales in FY 199l to 15%in FY1992. Declining wholesale shipments were also accompanied by a small decline in gross margin from 49. %in FY1991 t0 48. 7%in FY 1992. Despite lackluster consumer demand in the first half of FY 1993, however, Tiffany continued to believe that Japanese sales had attractive long-run growth potential. It was for this reason that Tiffany sought greater control over its future in Japan and ultimately decided to restructure its Japanese operations. From 1972 through July1993, Mitsukoshi acted as the principal retailer of Tiffany products in Japan, purchasing selected goods from Tiffany-Japan on a wholesale basis.

Mitsukoshi sold the products on a retail basis to the Japanese consumer, realizing profits in the form of relatively higher retail prices. Since the

wholesale transactions were denominated entirely in dollars, fluctuations in the yen/dollar exchange rate did not represent a source of volatility for Tiffany's expected cash flows. Instead, Mitsukoshi bore the risk of any exchange rate fluctuations that took place between the time it purchased the inventory from Tiffany and when it finally made cash settlement.

Typically, Tiffany merchandise sold by Mitsukoshi was priced at a substantial premium (l00% in some cases) over the domestic U. S. retail price for such merchandise. The new agreement between the two companies, however, fundamentally changed both companies' financial situations. In repurchasing the merchandise previously sold by Tiffany to Mitsukoshi, Tiffany-Japan assumed newresponsibilityfor establishing yen retail prices, holding inventory in Japan for sale, managing and funding local advertising and publicity programs, and controlling local Japanese management.

Mitsukoshi on the other hand, would no longer be an independent retailer of Tiffany products but would still receive fees equaling 27% of net retail sales in compensation for providing boutique facilities, sales staff, collection of receivables, and security for store inventory. With greater control over retail sales in its Japanese operations, Tiffany looked forward to long-run improvement in its performance in Japan despite continuing weak local economic conditions. However, increased sales and profits were not the only changes that Tiffany could anticipate as a result of the new agreement.

Tiffany now faced the risk of foreign currency fluctuations previously borne by Mitsukoshi. Past history warned Tiffany that the yen/dollar exchange rate could be quite volatile on a year-to-year and even month-10-month, basis. Exhibit 6 illustrates the significant strengthening of the yen against the dollar

during the l O years ending in 1993. While a continuation of this strengthening would enhance the dollar value of Tiffany's yen denominated cash inflows, there was the distinct possibility that the yen might eventually become overvalued and crash suddenly, just as the U. S dollar in 1985. Indeed, there was some evidence that the yen was overvalue against the dollar in 1993 (see Exhibit 7) Hedging to Manage Foreign Exchange Risk The possibility of sharp, unexpected movements in the yen/dollar exchange rate had prompted Tiffany’s management to study the desirability of engaging in a program to manage exchange rate risk. To reduce exchange rate risk on its yen cash flows, Tiffany had two basic alternatives available to it. One was to enter into forward agreements to sell yen for dollars at a predetermined price in the future.

The other was to purchase yen put options. The terms at which Tiffany could purchase forward contracts and put options, along with other financial market data, are shown in Exhibit 8. Before committing Tiffany to a hedging program, management wanted to be sure it understood what the potential risks and rewards were for each of these so-called " derivative" instruments. Perhaps more importantly, it was essential to determine whether or not a risk management program was appropriate for Tiffany, what it objectives should be, and how much, if any, exposure should be covered. pic] This included a $ 75 million secured revolving credit facility; a $10 million, 16% subordinated note due in 1992; and common stock warrants to purchase approximately 25% of the company’s equity on a fully diluted basis. Prior to Mitsukoshi’s purchase of Tiffany’s common stock from GECC, Tiffany and Mitsukoshi entered into an agreement by which Mitsukoshi agreed not

purchase in excess of 19. 9% of Tiffany's issued and outstanding common shares. This agreement would expire on September 31, 1994.

Due to the significant number of Tiffany boutiques already operating in Japan, future openings there were expected to occur only at very modest rate, if at all, in the near-term future. Tiffany's business was seasonal in nature, with the fourth quarter typically representing a proportionally greater percentage of annual sales, income from operations, and net income. In FY 1992, net sales totaled & 107, 238, 000, $120, 830, 000, $105, 897, 000, and $152, 431, 000 for the first, second, third, and fourth quarters, respectively. Management expected this pattern to continue in the future.

Tiffany management believed that a retail price reduction in Japan of 20% to 25% would likely result in a substantial increase in unit volume of jewelry sales. The repurchase of inventory by Tiffany necessitated the reversal of $115 million in sales and related gross profit previously recognized on merchandise sold to Mitsukoshi. Accordingly, Tiffany recorded a gross profit previously recognized $57. 5 million reserve to provide for product returns. , which reduced the second fiscal quarter's (ended July 31, 1993) net income by approximately $32. 7 million, or $2. 7 per share. Of the $115 million of sales being reversed, only $52. 5 million of inventory held in Mitsukoshi boutiques was actually repurchased during the month of July 1993 (Mitsukoshi agreed to accept a deferred payment on $25 million of this repurchased boutique inventory, which was to be repaid in yen on a quarterly basis with interest of 6% per annum over the next 4 1/2 years). Approximately $62. 5 million of Tiffany & Company inventory maintained in

Mitsukoshi warehouses would be repurchased throughout the period ending February 28, 1998.