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CASE STUDIES

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by

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***Any faculty user of this case in a college or university setting may contact Dr. Raymond H. Lopez, Department of Finance, Lubin School of Business, Pace University, 1 Martine Avenue, White Plains, NY 10606-1932, for the solution manual.**

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In a 1992 interview with *Business Week*, Donna Karan stated "my astrologist sees me doing something in 1997 that is very, very different from what I'm doing now. It has nothing to do with fashion. I'm dying to know what it is."¹ Ignorance is bliss. In the early months of 1996, Donna Karan found herself contemplating a major financing decision. The implications of this decision could produce the event forecasted by her astrologist.

BACKGROUND

Donna Karan had ties to the fashion industry from her early childhood. Her father, Gabby Faske, was a tailor who died when Donna was three years old. Donna's mother, Helen, was a showroom model in Manhattan. After high school, Donna attended Parson's School of Design to further her interest in fashion. She left Parson's before graduating to join Anne Klein & Company. After only a few months on the job, she was fired because of her relationship with a boutique owner, Mark Karan. After marrying Mr. Karan, she was hired once again by Anne Klein.

Donna quickly became an asset to the Anne Klein organization. Over the next 15 years, she became a top designer, launching Anne Klein II (a slightly less expensive clothing line) in 1983. She divorced her husband and married Stephan Weiss, a sculptor, in 1983. Takiho Inc., major partners and financial managers of Anne Klein, disagreed with Donna's plans for the company, so they fired her. However, they urged Donna to open her own company, which she did in 1985 with \$3 million of funding from Takiho (owned by Messrs. Taki and Mori). From this humble beginning, Donna Karan built her design company into a major player on Seventh Avenue.

In 1993, Donna Karan made plans for an initial public offering (IPO) that did not materialize. Primary motivators for this deal included her desire to diversify into men's and children's wear, as well as cosmetics. Sources close to the company reported that internal friction between Takiho (Messrs. Taki and Mori) and Donna and her husband led to the disintegration of the IPO. Donna Karan and her Japanese partners could not agree on the amount of restricted stock Donna would receive from the IPO. In addition, Takiho wanted Donna Karan to follow industry norms and license the beauty supply and fragrance division. Donna Karan and her husband preferred to maintain creative control over the division and therefore kept it in-house. The company denied these claims and cited that a weakening apparel market and slower-than-expected sales forced the cancellation of the stock offering. "We don't believe that our offering would receive a valuation that truly reflects the company's long-term potential for growth and profitability."²

Industry analysts cited fundamental issues with the IPO structure itself. For example, principals in the company would get royalties from the revenue stream. In addition, only 14 percent of the money raised in the IPO would go to fuel the company's future growth; the remaining 86 percent was to be used to pay off partners and reduce debt. There was also industry concern over the management team — because Messrs. Mori and Taki would have smaller roles (they had the expertise of building apparel companies), and Donna Karan and her husband had limited financial management experience. Mr. Charles Ronson, publisher of the

IPO Value Monitor, said "Once this turmoil ends, they will presumably be able to present a unified face to the public and seek to go public again."³

To attain that goal, Donna Karan hired a CFO, David Golden, in mid-March 1994. He was charged with implementing cost containment policies and ensuring that the bottom line of the company was such that it could move forward to increase its credit lines and/or succeed in its private debt placement. Mr. Golden was fired six weeks into his employment, on April 29, 1994. He charged "...that the financial health of Donna Karan International was significantly worse than what was perceived by the financial markets." Donna Karan fired back, stating that "Mr. Golden was negligent in preparing contingency plans needed by Citibank when renewing credit lines. He put the company in technical default."⁴ This all came at a time when DKI was trying to sell a private placement of debt to decrease its reliance on its expiring short-term line of credit.

THE BUSINESS OF DONNA KARAN INTERNATIONAL

By 1995, Donna Karan International, Inc. was one of the world's leading international fashion design houses. That same year, the Oprah Winfrey show featured an hour-long program with Donna Karan and a live fashion show. The program was topped off by a conversation between Karan and Barbra Streisand who phoned in from an exotic movie location. "Hey, honey!" Oprah then asked, "OK, Barbara, what's your favorite Donna outfit?" Barbara's response "Ooh, it's the dresses she does that hide my fanny!"⁵ Karan's designs focused on comfortable, practical yet sensual, hip-slimming clothes that accentuate the positive and eliminate the negative.

Product Lines

The company designed, contracted for the manufacture of, marketed, and distributed "designer" and "bridge" collections of men's and women's clothing, sportswear, accessories and shoes. Women's apparel was the primary focus of the company. Labels included *Donna Karan New York* (the higher-end signature collection) and *DKNY* (the casual, more moderately priced collection).

The original *Donna Karan New York* Collection was based on the concept of seven easy pieces: bodysuit and tights, dresses, skirts, blouses, jackets, pants, and accessories. When layered in combinations, these items achieved a varied but consistent high-fashion look. The *Donna Karan New York* Collection represented high-fashion apparel, made primarily with exclusively developed luxury fabrics and designed with an emphasis on comfort and fit.

DKNY was launched in 1989 as a "bridge" collection that consisted of women's apparel and accessories. It was established as a separate brand name to attract a broader customer base and to create a distinct and more casual fashion identity at lower prices, while retaining an association with the *Donna Karan New York* designer image. This line included jeans, activewear and classic designs and was based on the seven easy piece concept that complimented all aspects of a women's lifestyle, including "desk-to-dinner" wear.

Men's apparel lines, first introduced in 1991, followed the *Donna Karan New York* and *DKNY* genre. Accessories and shoes were sold within the two distinct collections. Children's wear was launched in late 1995, offered under the *DKNY* label as *DKNY Kids*.

DKI's beauty division was established in 1992 to further leverage the strong brand name and image that the company had developed. The strategy was to provide the consumer with beauty products consistent with the *Donna Karan New York* "head to toe" philosophy. This product line began with fragrances and expanded into bath and body treatments (cleansing lotions and body creams) for both men and women. However, the beauty division had not provided a positive contribution to DKI's overall operating profits since its inception. From 1992 through 1995, it incurred cumulative losses of \$20.4 million. Ms. Karan believed that to insure her beauty products were of highest quality and to best manage the brand, the company had to control all aspects of its beauty division, including product development, package design, production, and marketing. In contrast, Messrs. Taki and Mori believed that Donna Karan's foray into beauty supplies should follow the pattern of the industry: licensing the rights out to a company with marketing and production expertise.⁶ In addition, a November 29, 1993 *Business Week* article cited quality problems and production glitches in the perfume division.

Licensing Agreements/Trademarks

While employed by Anne Klein, Donna Karan saw the negative effect of licensing. "I came out of Anne Klein, and have seen how a business gets diffused through licensing...I saw how difficult it was to maintain continuity and quality and consistency and how the message can get mixed."⁷ When DKI utilized licensing, licensees met the company's design and quality standards, while management took an active role in the design, quality control, advertising, marketing, and distribution of each licensed product. In most cases DKI obtained minimum sales level and advertising agreements with each licensee. In 1996 Donna Karan had licenses for hosiery, intimate apparel, eyewear, children's apparel, handkerchiefs and face towels, and design patterns.

The *Donna Karan New York* and *DKNY* trademarks were licensed to DKI through Gabrielle Studios, a personally owned company of Ms. Karan and her husband, Mr. Weiss. Terms and conditions stated that each license could be terminated by Gabrielle Studios upon the occurrence of a change of control of DKI at the senior management level (involuntary). Another condition of the license was that if Donna Karan was not CEO and chief designer, or chairman of the board and chief designer (voluntary) then DKI retained the right to use the *Donna Karan New York* and *DKNY* trademarks only in industry segments in which the trademarks were previously used.

Employees/Board of Directors

In 1996 the company had 1,580 employees (1,410 in the U.S.). Its Board was comprised primarily of internal DKI employees and equity partners: Donna Karan (chairman, CEO and

chief designer), Stephan Weiss (vice-chairman and director), Stephen Ruzow (president, COO, and director), Tomio Taki (director), and Frank Mori (director).

Distribution Channels

Donna Karan International sold its products through a limited number of better department stores and specialty stores including Bloomingdale's, Macy's, Sak's Fifth Avenue, Neiman Marcus, Bergdorf Goodman, and Nordstrom. Internationally, the company had free-standing stores and boutiques. In the United States, the only freestanding stores the company operated were its 37 outlet stores, located in 22 states.

Advertising/Marketing

All worldwide advertising, public relations programs, and marketing programs were managed on a centralized basis through the company's creative services and public relations departments located in New York. This ensured a consistent global image for DKI and its products. DKI advertised principally in print and outdoor media but also used video for point of purchase displays, as well as mailers, newsletters, and catalogs. In addition, Ms. Karan used celebrities in her ads. This was possible because of her own celebrity status, but cost the company millions of dollars.

The company marketed its *Donna Karan New York* brand name and image through its "Woman to Woman" newsletter. This newsletter was a dialogue between the company, the designer, and the consumer. DKI used feedback from the newsletter to improve and focus the company's marketing program.

Operating Strategies

In order to achieve its current status as one of the world's leading international fashion design houses, DKI had implemented a number of operating strategies. The firm built the global name recognition and distinctive brand image of *Donna Karan New York* in the exclusive designer market. For the larger bridge market, they established the *DKNY* brand.

DKI had established successful designer collections and then leveraged the success of these collections and the depth of its design talent into the larger bridge market. This approach was first utilized with the *DKNY* women's apparel division. Subsequently, the firm successfully implemented this approach to the men's apparel division and the shoe division. The beauty division was expected to be next in this process of brand leveraging.

Worldwide expansion had been an integral component of the firm's strategies since its inception. International sales had been expanding rapidly and the firm was committed to developing the necessary infrastructure to support these sales. In addition, licensing of free-standing retail stores in international markets should enhance the company's competitive position in its industry.

In order to maintain brand exclusivity, DKI employed coordinated global advertising and marketing, selective licensing arrangements, and controlled retail distribution. These activities were managed on a centralized basis through the company's Creative Services and Public Relations Departments. To reinforce its exclusive image and appeal, the company sold through a limited number of stores: better department and large specialty stores such as Bloomingdale's, Macy's, Saks Fifth Avenue, Neiman Marcus, and Nordstrom; and better boutiques catering to fashion-conscious customers. Consistent with its operating philosophy, DKI had been and would continue to be selective in pursuing licensing opportunities. The firm had also maintained strict control over design, quality, advertising, marketing, and distribution in all of its product licensing arrangements.

Finally, the company offered a "head-to-toe" assortment of complementary luxury product categories designed to satisfy the lifestyle needs of its customers. Over the last five years, DKI had expanded its product offerings in the following business segments:

<u>Line</u>	<u>Market Segment</u>
<i>Donna Karan New York</i> Essentials	Women
<i>DKNY</i> Essentials	Women
<i>Donna Karan New York</i> Signature	Men
<i>DKNY</i> Jeans and Petite	Women
<i>Donna Karan New York</i> Beauty Products	Women
<i>DK Men</i> Beauty Products	Men
<i>DKNY</i> Shoes	Women
<i>DKNY</i> Shoes	Men

Each of these strategic initiatives expanded and extended the firm's product lines, as well as contributing to strengthening of the brand in consumer markets.

Growth Strategies

The company's goals have been and continue to be the leveraging of its strong brand name and image in the consumer marketplace. It has expanded its product offerings and increased its presence in domestic and international markets.

In order to support these goals, DKI has identified a number of strategies. One of these initiatives is to selectively increase the "number of doors" through which its more recently introduced products will be sold, both domestically and internationally. More specifically, the firm planned to approximately double the 1995 sales level of its *DKNY* men's wear business in 1996.

In international markets, DKI planned to open 10 free-standing retail stores in 1996. In addition, the firm was considering the opening of full-price, free-standing retail stores by or in arrangements with third parties in select locations in the United States.

Product segmentation and expansion were expected to provide greater “head-to-toe” assortments to better satisfy the lifestyle needs of existing customers, as well as to appeal to new customers. Over the next two years, the following areas had been identified for expansion:

<u>Line</u>	<u>Market Segment</u>
<i>Donna Karan New York</i> ® Fragrance Line	Women
<i>Donna Karan New York</i> ® Casual Sportswear	Men
<i>DKNY</i> ® Activewear	Women
<i>Donna Karan New York</i> ® - expand the Essentials collection under a new Signature label	Women

The company had plans to target broader market segments at lower price points than its apparel products. This would include marketing additional luxury products in categories such as beauty and accessories.

Since DKI brands had successfully been established worldwide, the firm planned to expand its licensing efforts through the selective granting of new product licenses. Some areas targeted for this initiative included jeanswear and related apparel, swimwear, *DKNY*® underwear, watches, and home furnishings.

Characteristics of Publicly-Owned Competitors

The fashion industry has always been and is expected to continue to be extremely competitive. DKI competed with numerous designers and manufacturers of apparel and accessory products, both domestic and foreign. Although no one firm enjoyed a significant percentage of total industry sales, some were significantly larger and had substantially greater resources than DKI. In addition, with appropriate financial support, talented designers could evolve into competitors within several years of establishing a new label.

Three publicly held firms have been identified as having similar size and competitive position to DKI: Liz Claiborne, Inc.; Polo Ralph Lauren Corporation; and Jones Apparel Group, Inc. Their business characteristics are described below.

Product Lines

Liz Claiborne had three major product areas. The first, *LIZ CLAIBORNE*, included professional career wear with desk to dinner versatility, and the accessories group, which featured handbags and jewelry. Also encompassed in this segment was the *LIZ NIGHT* label, which featured special occasion dresses. The second category was the menswear division, which offered men's business and casual wear, sportswear, and furnishings under the *CLAIBORNE* brand name. Lastly, the cosmetics division offered fragrance and bath and body care products under the *LIZ CLAIBORNE* and *CLAIBORNE FOR MEN* trademarks.

Polo Ralph Lauren Corporation consisted of four integrated operations: Wholesale, Home Collection, Direct Retail, and Licensing Alliances. The Wholesale Division was broken up into

two categories: Polo Ralph Lauren Menswear and Polo Ralph Lauren Womenswear. The Womenswear segment included, but was not limited to, *Ralph Lauren Collection*® and *Collection Classics*® and *RALPH/Ralph Lauren*®. The former expressed the Company's up-to-the-moment fashion vision for women and also played an important strategic role by reinforcing the Polo Ralph Lauren image of style and high fashion. The latter consisted of classic and fashion items ranging from career wear to casual weekend apparel. This label was younger in attitude and lower in price. The Menswear Division included *Polo by Ralph Lauren*®, *Polo Sport*®, *Ralph Lauren/Purple Label Collection*®, and *Polo Golf*® brands. Polo Ralph Lauren, which introduced The Home Collection in 1983, was one of the first major apparel designers to extend its designer principles and brands to a complete line of home furnishings.

Jones Apparel Group participated in four principal segments of the women's apparel market: career sportswear, casual sportswear, suits, and dresses. The company's success was enhanced by its ability to maintain a designer image through marketing its name brands in the women's "better" market. Its labels included *Jones New York*®, *Evan Picone*®, *Picone Evening*®, *Saville*®, and *Lauren Ralph Lauren*®, which it licensed from the Polo Ralph Lauren Corporation. The company offered consumers an extensive range of better sportswear geared primarily for the career woman's working needs. A line of evening dresses under the *Picone Evening*® label was launched in 1996.

Licensing Agreements/Trademarks

Each of these three companies used licensing agreements extensively, principally in their non-core businesses. For example, Liz Claiborne had six licensing agreements for its eyewear collection, home furnishing products, men's tailored clothing, and women's watches. Polo Ralph Lauren's strategy was to seek out the premier producer in the field it was licensing. Some of the product lines it licensed included children's apparel, Home Collection, and fragrance and skin care products. Jones Apparel Group utilized licensing agreements more extensively than the other firms in this peer group. Over 35 licensing agreements existed for the Jones New York brand and 14 agreements were used for the Evan Picone label. These agreements covered men's clothing, women's intimate apparel, footwear, and accessories.

Board of Directors

In all three cases, the companies in this peer group had boards with a large percentage of outside directors. These board members had extensive industry experience and made their knowledge available to their firm's management teams.

Distribution Channels

Liz Claiborne, Inc. had retail stores and outlets both in the U.S. and abroad (83 outlets in 1996). The Company's wholesale activities were through department stores and specialty and chain stores. In early 1996, Liz Claiborne introduced Liz Edge and Liz View, in-store maintenance programs designed to enhance the way the company's products appeared on the selling floor.

Polo Ralph Lauren used the "shop within a shop" boutique distribution method in better department stores. In addition, the company had 67 outlet stores and 28 Polo stores. These distribution channels were located in the U.S. and overseas.

Jones Apparel Group distributed its products through approximately 1,550 customers, including department stores, specialty retailer accounts, and direct mail catalog companies throughout the U.S. and Canada. The company had 196 factory outlets and four full-price stores. Jones' outlets sold company merchandise, as well as products from its licensees. Jones Apparel Group used in-house sales specialists to enhance its retail sales in a manner similar to Liz Claiborne, Inc.

Advertising/Marketing

The fashion industry utilized primarily print ads developed through in-house advertising and public relations departments for the marketing of its wares. The practice of in-house development of advertising campaigns ensured consistency across product lines.

INDUSTRY TRENDS

The Fashion Industry

The fashion industry has always been an extremely competitive segment of the much broader apparel industry. It has its own unique characteristics that determine the ways in which participating firms compete. Generally, the most important factors that lead to success in the marketplace for both companies and their head designers are fashion, image, quality, and service. Price does not seem to be a major component of the business strategy of successful firms in this industry.

It has been said that fashion is about seduction, even though this sounds a bit crass. Dressing to be sexually seductive is quite obvious, but that is not the main theme for either firms or designers. Rather, the point being made is that fashion exists to seduce customers into buying the product.

In contrast, clothing is another matter. Children need clothing as they grow up, and men and women need clothing for work, leisure, and play time. Fashion is more like the icing on the cake, the non-essentials that designers seek to make "essential" for those who can and will make these purchases. These are the garments that are coveted by the consumer, primarily because they seem irresistible. This is what the designer of fashion must accomplish, in contrast to a manufacturer of clothing.

The artist creates paintings or sculptures to satisfy an inner drive. Fashion does not inhabit such an exalted level. The glamour and hype of the industry are focused on a more practical goal, not only to design, but also to market and sell its creations. When designers forget these aspects of their profession and simply churn out "the basics," or make the opposite mistake of getting caught up and swept away in some farfetched, unrealistic dream, their customers will not always follow with their interest and their purchases. The successful designer is one who

balances the elements of design with creative marketing. They will be the ones who generate value for their companies and themselves over time. Merging function with fashion is a formula for success.

The fashion industry talks about aspirational apparel — a wardrobe that embodies a way of life that a customer craves for and “must have.” Most of the major designers follow this mantra.

The Apparel Industry

Shifts in demographics and changes in consumer buying habits over the last decade created challenges of a creative and financial nature for the fashion industry. As the baby boom generation approached their half century mark, they are mobilizing their financial resources for college tuitions and their own retirement years. Expensive suits and evening wear have felt this change in buying patterns. In addition, more women in the work force means fewer shopping trips. Less time to shop results in more targeted trips — shopping “smarter” rather than a leisurely stroll down the aisles to “see what’s there” — less impulse buying.

Between 1989 and 1995 personal consumer expenditures in the United States increased by 37 percent. In contrast, the apparel industry experienced a more subdued record. Men’s apparel sales grew by only 16 percent in this same period, while women’s apparel sales actually declined by 13 percent, from \$84 billion to \$73 billion.

In a 1994 survey by Glamour Magazine, 34 percent of its readers had increased their shopping at off-price stores. Consumers have also been spending less on apparel and clothing as a percent of their incomes. In 1960 this ratio was 8.1 percent and by 1980 it was down to 6.1 percent. In the 1990s the ratio continued to decline, reaching 5.3 percent in 1993. Contributing factors were consumers “waiting for price reductions on sale items,” as well as the “relaxed look” that does not need to be replaced every season.⁹

The “dressing down” phenomenon has also taken hold in the workplace. Close to 90 percent of American workers dress down at least some of the time. And, in a study supported by Levi Straus & Company, 7 percent of workers were allowed to “dress casually” every day, in 1992. By 1995, the figure was up to 33 percent and they projected a 75 percent rate in the year 2000.

It seems quite clear that value is replacing fashion as the prime concern of price-conscious consumers. And, the number of price-conscious consumers continues to increase. Unless some reason for change occurs in the near future, it seems likely that these patterns of consumption will continue to influence the direction of the apparel industry.

FINANCIAL HISTORY OF DONNA KARAN INTERNATIONAL

The revenues of DKI had grown at a compound average annual rate of 35 percent from 1989 through 1995. While this rate was significantly higher than the overall fashion and apparel industry, the firm’s sales were growing even faster outside the U.S. In 1995 net revenues in

Japan, Europe, and the Middle East and other parts of Asia represented 14.1 percent, 12.4 percent and 5.1 percent, respectively, of net revenues (excluding net revenues generated from outlet stores and licensing). International sales increased from 14.4 percent of net revenues in 1991 to 33.9 percent of net revenues in 1995. Management believed that this trend would continue over the next few years and, therefore, was continuing to build the infrastructure to support worldwide demand for the Donna Karan brand.

The company engaged both domestic and foreign contractors for the production of its products. In fiscal 1995, approximately 47 percent of direct purchases of raw materials, labor, and finished goods for its apparel, accessories, shoes, and beauty products were produced in Hong Kong, Taiwan, South Korea, and other Asian countries. In contrast, 28 percent were produced in the United States and 23 percent in Europe.

Although revenues grew rapidly in the 1990s, a turning point for profits was reached in 1993, when the company's expenses ballooned at an even more rapid rate and profits gradually shrunk. In 1994 inventories were bloated and orders had slipped. Advertising and other media expenses more than doubled from 1993 to 1994. In 1993 alone, the menswear and cosmetics divisions lost \$20 million. All of these factors put increased pressure on profits.

In 1996 the idea of an IPO for Donna Karan was resurrected. The company was having difficulty sustaining its growth with internal financing and/or costly short-term debt. Stephen Ruzow, president, said "the company will try to keep its sales increase to 10 percent so it will not exceed its ability to finance its growth."¹⁰ The company did not adhere to his plan, as net revenue growth was 21 percent from 1994 to 1995. In 1994, all attempts at a private long-term debt placement failed, but the company had successfully negotiated a \$125,000,000 credit line with Citibank through 1998, although this cost DKI \$1.6 million in up-front fees. Interest was payable at the bank's prime rate (currently 8.25%) or, at the option of the company, a fixed margin (ranging from .5% to .75%) over LIBOR.

Industry analysts speculated on three major forces that led to Donna Karan attempting another IPO in 1996:

- (1) A cash infusion was needed to reduce the high debt levels;
- (2) Due to differences in management style and vision for the company, Takihyo wanted to sever its relationship with DKI. This was a very expensive decision for Donna Karan: she would lose not only Takihyo's initial financial investment but would have to repay the profits they reinvested into the company over the last 10 years. She would also lose their business expertise; and
- (3) Donna and her husband wanted to withdraw their earnings retained by the company over the past 10 years. The financial markets looked upon the Donna Karan IPO not as a means of achieving financing for the growth of the company, but as a way for the partners to cash out of the business. Stephen Weiss, Donna Karan's husband, said "Look, if someone comes along with \$1 billion to buy this business, I'm out of here."¹¹

The Financial Environment in 1996

In contrast to the economy of 1993, conditions in early 1996 contributed to much more optimism concerning the potential success of a Donna Karan IPO. Donna Karan competed primarily in the luxury retail business segment of the apparel marketplace. These activities were intrinsically tied to the overall health of the economy. The United States economy had been growing strongly for almost five years, since the end of the last recession in March of 1991.

In consultation with their lead underwriters, Morgan Stanley & Co., Inc., and Bear Stearns & Co., Inc., management concluded that the time was right to pursue an initial public offering. This was a time of strong demand on the part of investors for “retail stars.” There seemed to be an everlasting faith in the selling power of luxury goods. Data below show the success of recently sold IPO’s of companies in the “luxury retail” market. Since Donna Karan’s operations were in this category, investor demand was expected to pave the way for a successful offering.

Stock Market Performance of Luxury Market IPO’s

<u>Name</u>	<u>IPO Date</u>	<u>Offering Price</u>	<u>Stock Price June 20, 1996</u>	<u>Percentage Gain</u>
Gucci	Oct. 1995	\$22	\$66.62	+202.8
Estee Lauder	Nov. 1995	\$26	\$39.88	+ 53.4
Revlon	Feb. 1996	\$24	\$28.88	+ 20.3
Saks	May 1996	\$25	\$32.12	+ 28.5

In the underwriting business, public perceptions as well as company fundamentals may cause stock prices to soar or plunge. The current market environment for IPO’s had been quite strong. Almost 600 firms went public in 1995, approaching the record levels of 1984 and 1987 (Exhibit 14). Early in 1996 public estimates showed a record \$15 billion worth of IPO’s were scheduled for the second quarter of that year.

Investors were especially interested in firms with strong “brand names” that were recognizable worldwide, which would contribute to the success of an IPO in the after-market. In “brand-conscious” times these names have power and an element of mystique that contribute to stock market performance.

Another positive aspect of the DKI offering was the potential of spreading the Donna Karan name to a wider variety of product categories in coming years. On a preliminary basis, the underwriters estimated a selling price range for DKI shares of \$20-\$23.

The Offering

On June 27, 1996, Donna Karan planned to offer 10,750,000 shares of common stock to the public at \$24 each and have those shares listed on the New York Stock Exchange. The proposed disposition of the proceeds was detailed in a *New York Times* article dated June 29, 1996:

Number of shares offered	10,750,000	
Issue price	\$ 24	
Total gross proceeds	\$258,000,000	100.0%
Less underwriting fees	\$ 15,480,000	6.0%
Net proceeds realized by DKI	\$242,520,000	94.0%

Disposition of Proceeds

Donna Karan/Stephan Weiss	\$ 58,000,000	22.5%
Takihyo Partners	\$ 58,000,000	22.5%
Gabrielle Studios*	\$ 5,000,000	2.0%
Debt paydown	\$ 80,000,000	31.0%
President bonus	\$ 5,000,000	2.0%
General corporate purposes	\$ 36,520,000	14.0%

* Gabrielle Studios was a company Ms. Karan owns personally which licensed the Donna Karan name to Donna Karan International (DKI).

Donna Karan International's success hinged on implementation of its operating and growth strategies. The operating strategies centered around the importance of the Donna Karan brand. They included building a global name and image, brand leveraging, worldwide growth, maintaining brand exclusivity, and "head to toe" dressing. The growth strategies of the company were to increase the number of sale locations (including free-standing retail stores), to continue product segmentation and expansion, to broaden the customer base, and to expand licensing efforts. In order to implement these strategies, DKI needed funds to finance its growth. In the past, the company had relied on cash flow from operations, bank lines of credit, and term loans for its capital requirements. Private debt placement options had been exhausted. Because of the previously stated growth and operational strategies, the company required a capital infusion to achieve its goals. Current operations could not support the growth anticipated by the firm.

MANAGEMENT'S CHALLENGE

Donna Karan and her management team faced a major decision point in the life of the firm. Was this the right time for an IPO? They had tried two years ago and were not successful. From a business perspective, funds are needed more than ever to carry out the firm's plans.

The underwriters had discussed the structure of the IPO with DKI management. Repayment of debt was approximately 33 percent, at the high end of the range of many recent IPO's. Fees in the 6 percent range were in line with IPO transactions. However, the more than 50 percent of net proceeds being distributed to owners had raised a number of questions with potential investors. Under these varied market conditions and potential shareholder concerns, what is likely to be the acceptance of this IPO initially as well as over time? The day before the offering was scheduled, the underwriters decided to raise their price range to \$23-\$25 per share. This action implied high potential demand for the shares, at least in the short run. However, longer-term considerations, and the nature of both business and financial markets, also had to be incorporated into the final decision.

ENDNOTES

- ¹ Zinn, Laura, "The Empress of Seventh Avenue," *Business Week*, 28 September 28 1992: 84.
- ² Strom, Stephanie, "Donna Karan Shelves Stock Offering," *The New York Times*, 18 November 1993: D20.
- ³ Agins, Teri and Sara Calian, "Donna Karan Suspends Plan For Public Offer," *The Wall Street Journal*, 18 November 1993: A3.
- ⁴ Agins, Teri, "Karan Counters Former Officer's Claims of a Deteriorating Financial Condition," *The Wall Street Journal*, 8 June 1994: B6.
- ⁵ Sieder, Jill Jordan, "Donna Karan's Chic Design for Success," *US News & World Report*, 18 December 1995: 59.
- ⁶ Agins, Teri, "With IPO in the Wing, Is Donna Karan in Fashion," *The Wall Street Journal*, 16 August 1993: B4.
- ⁷ Strom, Stephanie, "Fortunes Turn For a Fast-Rising Fashion Star," *The New York Times*, 20 June 1994: D3.
- ⁸ Ibid.
- ⁹ McGraw, Dan and David Fischer, "Designing for Dollars," *US News & World Report*, 14 November 1994: 103
- ¹⁰ Strom, Stephanie, "Donna Karan Says Sales Improved in 2d Quarter," *The New York Times*, 17 August 1994: D3.
- ¹¹ Strom, Stephanie, "Fortunes Turn For a Fast-Rising Fashion Star," *The New York Times*, 20 June 1994: D3

EXHIBITS

Exhibit 1

Donna Karan International Inc. Income Statement and Debt Levels (in thousands)

	December 28 <u>1991</u>	January 2 <u>1993</u>	January 2 <u>1994</u>	January 1 <u>1995</u>	December 31 <u>1995</u>
<u>Income Statement</u>					
Net Revenues	\$ 196,570	\$ 259,947	\$ 364,705	\$ 420,164	\$ 510,126
Cost of Sales	<u>132,074</u>	<u>167,638</u>	<u>234,230</u>	<u>271,172</u>	<u>330,689</u>
Gross Profit	\$ 64,496	\$ 92,309	\$ 130,475	\$ 148,992	\$ 179,437
Selling, General and Administrative Expenses	<u>\$ 54,544</u>	<u>\$ 63,933</u>	<u>\$ 102,748</u>	<u>\$ 119,995</u>	<u>\$ 136,906</u>
Operating Income	\$ 9,952	\$ 28,376	\$ 27,727	\$ 28,997	\$ 42,531
Other Income (expense)					
Equity and Earnings of Affiliate	-	-	-	-	2,519
Interest Expense	(82)	(892)	(4,063)	(8,862)	(7,650)
Interest Income	-	-	-	-	-
Other Expense	-	-	(2,980)	(2,651)	-
Gain on Sale of Interests in Affiliates**	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>18,673</u>
Income Before Income Tax	\$ 9,870	\$ 27,484	\$ 20,684	\$ 17,484	\$ 56,073
Provision for Income Tax	<u>2,187</u>	<u>3,522</u>	<u>1,312</u>	<u>1,139</u>	<u>2,398</u>
Net Income	\$ 7,683	\$ 23,962	\$ 19,372	\$ 16,345	\$ 53,675

* Other Expense represents costs associated with proposed IPO (1993) and proposed debt offering (1994).

** Gain on sale of affiliate:

In March 1995 Donna Karan International sold 70% of its interest in Donna Karan Japan to a nonaffiliated party.

Source: Donna Karan International Inc. Annual Reports, various years.

Exhibit 2

Donna Karan International Inc. Balance Sheet (in thousands)

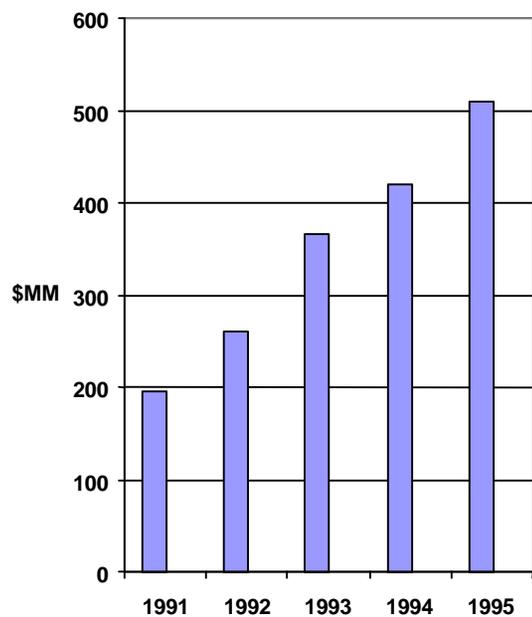
	<u>1994</u>	<u>1995</u>
ASSETS		
<u>Current Assets</u>		
Cash	\$ 3,728	\$ 12,153
Accounts Receivable, net of allowances of \$22,507 @ 12/95 and \$15,013 @ 12/94	49,879	62,231
Inventories	63,606	85,655
Prepaid Expenses and Other Current Assets	<u>8,241</u>	<u>9,946</u>
Total Current Assets	\$125,454	\$ 169,985
Property and Equipment, at Cost-Net	24,467	\$ 22,505
Deposits and Other Non-current Assets	<u>7,083</u>	<u>11,485</u>
Total Assets	\$157,004	203,975
LIABILITIES AND STOCKHOLDERS' EQUITY AND PARTNERS' CAPITAL		
<u>Current Liabilities</u>		
Short-term Borrowing Under Revolving Credit Facility	\$ 11,214	\$ -
Accounts Payable	29,153	53,825
Accrued Expenses and Other Current Liabilities	17,374	15,766
Current Portion of Long-term Debt	<u>15,424</u>	<u>7,759</u>
Total Current Liabilities	73,165	77,350
Long-term Debt	<u>36,002</u>	<u>45,779</u>
Total Liabilities	\$109,167	\$123,129
<u>Stockholders' Equity and Partners' Capital</u>		
Common Stock	1,146	1,146
Retained Earnings and Partners' Capital	46,886	79,748
Cumulative Translation Adjustment	<u>(195)</u>	<u>(48)</u>
Total Stockholders' Equity and Partners' Capital	\$ 47,837	\$ 80,846
Total Liabilities and Stockholders' Equity and Partners' Capital	\$ 157,004	\$203,975

Source: Donna Karan International Inc. Annual Reports, various years.

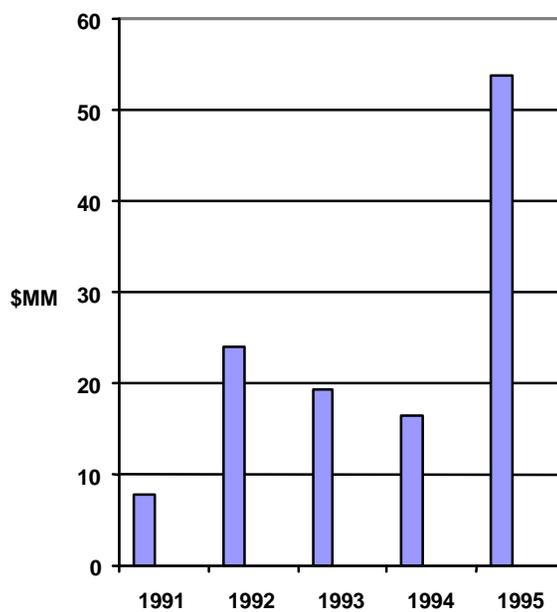
Exhibit 3

Donna Karan International

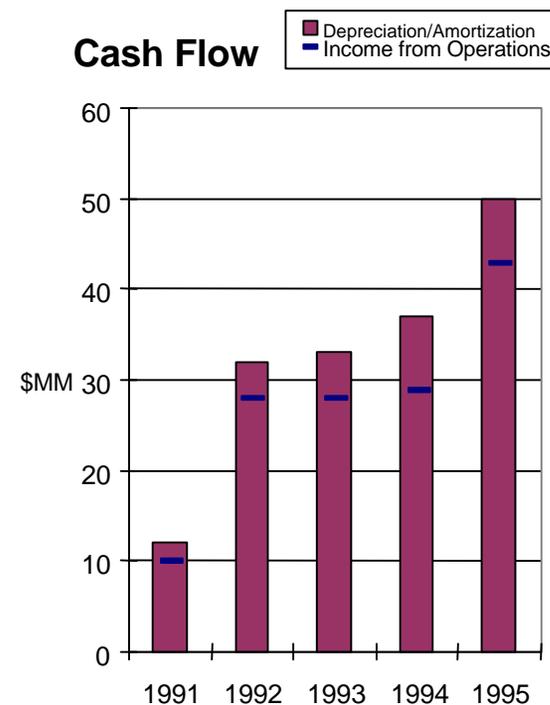
Net Revenues



Net Income



Cash Flow



Financial Results of the Company, In fiscal years

Source: *Donna Karan International Prospectus*, June 27, 1996 and *The New York Times*, June 20, 1994, page D3.

Exhibit 4

**Donna Karan International
Net Revenue of Company Activities
(in millions)**

Business Activity	1995	1994	1993
Donna Karan New York ^R collections for women (apparel, accessory, shoe collections)	\$77	\$79	\$75
DKNY ^R collections for women (apparel, accessory, shoe collections)	271	232	193
Donna Karan New York ^R collections for men (apparel, accessory, shoe collections)	40	28	18
DKNY ^R collections for men (apparel, accessory, shoe collections)	37	18	22
Beauty Products	30	17	8
Outlet Stores and Licensing	55	46	49
TOTALS	510	420	365

Source: *Donna Karan International Prospectus*, June 27, 1996, page 35.

Exhibit 5

Liz Claiborne, Inc. Income Statement (in thousands) (for the years ended)

	<u>December 31, 1995</u>	<u>December 31, 1994</u>
Net Revenues	\$ 2,081,630	\$2,162,901
Cost of Sales	<u>1,290,929</u>	<u>1,407,694</u>
Gross Profit	\$ 790,701	\$ 755,207
Selling, General and Administrative Expenses	600,471	604,421
Restructuring Charge	<u>-</u>	<u>30,000</u>
Operating Income	190,230	\$ 120,786
Other Income (expense)		
Investment and Other Income, net	<u>12,884</u>	<u>10,663</u>
Income Before Income Tax	\$ 203,114	\$ 131,449
Provision for Income Tax	<u>76,200</u>	<u>48,600</u>
Net Income	\$ 126,914	\$ 82,849

Exhibit 6

Liz Claiborne, Inc. Balance Sheet (in thousands)

	<u>December 31, 1995</u>
ASSETS	
<u>Current Assets</u>	
Cash	\$ 54,722
Marketable Securities	383,128
Accounts Receivable, net of allowances	126,053
Inventories	393,363
Deferred Income Tax	30,235
Other Current Assets	<u>77,710</u>
Total Current Assets	\$1,065,211
Property and Equipment, at cost-net	239,467
Other Noncurrent Assets	<u>24,565</u>
Total Assets	\$1,329,243
LIABILITIES AND STOCKHOLDERS' EQUITY	
<u>Current Liabilities</u>	
Accounts Payable	\$ 138,000
Accrued Expenses and Other Current Liabilities	155,449
Income Tax Payable	<u>12,648</u>
Total Current Liabilities	\$ 306,897
Long-term Debt	1,115
Deferred Income Tax	7,722
Commitment and Contingency	<u>25,283</u>
Total Liabilities	\$ 341,017
<u>Stockholders' Equity</u>	
Common Stock	\$ 88,219
Paid-in-Capital in excess of Par	35,075
Retained Earnings	1,255,325
Cumulative Translation Adjustment	(1,256)
Common Stock in Treasury at cost	<u>(389,137)</u>
Total Stockholders' Equity	\$ 988,226
Total Liabilities and Stockholders' Equity	\$1,329,243

Exhibit 7

Polo Ralph Lauren Corporation
Income Statement
(in thousands)
(for the years ended)

	<u>March 30, 1996</u>	<u>April 1, 1995</u>
Net Revenues	\$1,019,873	\$ 846,635
Cost of Sales	<u>583,546</u>	<u>474,999</u>
Gross Profit	\$ 436,327	\$ 371,636
Selling, General and Administrative Expenses	<u>309,207</u>	<u>261,506</u>
Operating Income	\$ 127,120	\$ 110,130
Other Income (Expense)		
Interest Expense	(16,287)	(16,450)
Equity in Net Loss of Affiliate	<u>(1,101)</u>	<u>(262)</u>
Income Before Income Tax	\$ 109,732	\$ 93,418
Provision for Income tax	<u>10,925</u>	<u>13,244</u>
Net Income	\$ 98,807	\$ 80,174

Exhibit 8

Polo Ralph Lauren Balance Sheet (in thousands)

	<u>ASSETS</u>	<u>March 30, 1996</u>
<u>Current Assets</u>		
Cash & Cash Equivalents		\$ 13,568
Accounts Receivable Net of Allowance		144,999
Inventories		269,113
Prepaid Expenses and Other Current Assets		<u>31,886</u>
Total Current Assets		\$ 459,566
Property and Equipment, at Cost-Net		48,980
Investment in and Advances to Affiliate		21,710
Other Assets		<u>33,417</u>
Total Assets		\$ 563,673
LIABILITIES AND STOCKHOLDERS' EQUITY AND PARTNERS' CAPITAL		
<u>Current Liabilities</u>		
Notes and Acceptances Payable – Banks		\$ 73,731
Accounts Payable		74,244
Accrued Expenses and Other Liabilities		36,982
Current Portion of Long-Term Debt		<u>11,765</u>
Total Current Liabilities		\$ 196,722
Long-Term Debt		70,149
Other Non-Current Liabilities		15,149
Subordinated Notes		<u>44,000</u>
Total Liabilities		\$ 326,020
<u>Net Worth</u>		
Partners' Capital		237,541
Cumulative Translation Adjustment		<u>112</u>
Total Partners' Capital		\$ 237,653
Total Liabilities and Partners' Capital		\$ 563,673

Exhibit 9

Jones Apparel Group, Inc.
Income Statement
(in thousands)
(for the years ended)

	<u>December 31, 1995</u>	<u>December 31, 1994</u>
Net Revenues	\$ 776,365	\$ 633,257
Cost of Sales	<u>546,413</u>	<u>438,575</u>
Gross Profit	\$ 229,952	\$ 194,682
Selling, General and Administrative Expenses	139,135	115,307
Licensing Income	<u>(10,314)</u>	<u>(8,487)</u>
Operating Income	\$ 101,131	\$ 87,862
Other Income (expense)		
Investment Income	\$ 445	\$ 695
Interest Expense	<u>(1,908)</u>	<u>(1,212)</u>
Income Before Income tax	\$ 99,668	\$ 87,345
Provision for Income tax	<u>\$ 36,183</u>	<u>32,425</u>
Net Income	\$ 63,485	\$ 54,920

Exhibit 10

**Jones Apparel Group, Inc.
Balance Sheet
(in thousands)**

ASSETS

December 31, 1995

Current Assets

Cash	\$ 16,864
Accounts Receivable, Net of Allowances	113,230
Inventories	176,626
Deferred Taxes	12,265
Prepaid Expenses and Other Current Assets	<u>12,480</u>
Total Current Assets	\$331,465

Property and Equipment, at Cost-Net	36,657
Intangibles	26,585
Deferred Taxes	120
Other Non Current Assets	<u>6,132</u>
Total Assets	\$400,959

**LIABILITIES AND STOCKHOLDERS EQUITY
AND PARTNERS' CAPITAL**

Current Liabilities

Current Portion of Long-term Debt	\$ 71
Current Portion of Capital Lease Obligations	2,256
Accounts Payable	59,077
Income Tax Payable	2,427
Accrued Expenses and Other Current Liabilities	<u>6,781</u>
Total Current Liabilities	\$ 70,612

Long-term Debt	\$49
Obligations under Capital Leases	<u>10,102</u>
Total Liabilities	\$ 80,763

Excess of Net Assets Acquired Over Cost	\$ 5,221
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Stockholders Equity

Common Stock	\$ 263
Paid-in-Capital in excess of Par	84,172
Retained Earnings	236,318
Cumulative Translation Adjustment	(1,140)
Treasury Stock	<u>(4,638)</u>
Total Stockholders Equity	\$ 314,975

Total Liabilities and Stockholders Equity	\$400,959
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Exhibit 11
Donna Karan International
Comparative Data on Peer Group Companies*

	Liz Claiborne		Jones Apparel Group		Donna Karan
	<u>1995</u>	<u>1994</u>	<u>1995</u>	<u>1994</u>	<u>1995**</u>
Stock Price: High	\$ 30.00	\$ 26.63	\$ 17.88	\$ 17.88	\$ 24.00
Stock Price: Low	\$ 14.38	\$ 15.38	\$ 11.38	\$ 11.00	n/a
Earnings Per Share	\$ 1.69	\$ 1.06	\$ 1.20	\$ 1.04	\$ 0.91
Weighted-Avg. Shares Outstanding	75,003,000	78,527,000	52,130,000	51,656,000	15,968,000
Book Value Per Share at Year-End	\$ 13.41	\$ 12.77	\$ 6.04	\$ 4.82	\$ 5.06
P/E Ratio High	18	25	17	17	26
P/E Ratio Low	9	15	9	11	n/a
Market Value (High)/ Book Value	2.24	2.08	3.29	3.71	4.74
Market Value(Low)/Book Value	1.07	1.20	1.88	2.28	n/a

Source: *Standard & Poors' Stock Reports, 1997, Donna Karan International Prospectus, June 27, 1996.*

* Polo Ralph Lauren data not available for 1994 and 1995. The firm was a partnership.

** DKI information obtained from Predecessor Combined Statement of Income, on a pro-forma basis using the proposed IPO stock price.

Exhibit 12

Personal Consumption Expenditures (in the United States)

<u>Items</u>	<u>1996</u>		<u>1995</u>		<u>1994</u>	
Food & Tobacco	806	15%	784	16%	762	16%
Clothing	336	6.5%	323	6.5%	313	6.6%
Personal Care	76	1.0%	72	1%	68	1.0%
Housing	1,379	26%	1313	26%	1,248	26%
Medical Care	913	18%	872	18%	826	18%
Personal Business	421	8%	389	8%	370	8%
Transportation	602	12%	572	12%	542	11%
Recreation	431	8%	403	8%	370	8%
Education	120	2%	112	2%	105	2%
Other	<u>124</u>	<u>2%</u>	<u>118</u>	<u>2%</u>	<u>113</u>	<u>2%</u>
Total	5,208	100%	4,958	100%	4,717	100%

Source: *Survey of Current Business*, November 1997, page 29.

Exhibit 13

Donna Karan Product Lines and Major Competitors

<u>DKI Line</u>	<u>Competitors</u>	<u>DKI Line</u>	<u>Competitors</u>	<u>DKI Line</u>	<u>Competitors</u>
<i>The Designer Segment</i>		<i>The Bridge Market</i>		<i>Beauty Divison</i>	
Donna Karan New York® Collection for women	Armani Borgonuovo Jil Sander Escada	DKNY® Womens Apparel	CK by Calvin Klein Polo/Ralph Lauren Dana Buchman Ellen Tracy Emmanuel Anne Klein II	Donna Karan New York® Fragrance for women	Chanel Calvin Klein Giorgio Armani Boucheron
Donna Karan New York® Essentials for women	Armani Le Collezion Calvin Klein Michael Kors	DKNY® Mens Collection	CK by Calvin Klein Guess Mondo Nautica Polo/Ralph Lauren Tommy Hilfiger Versace Classic V2	DK Men™ Fragrance and Grooming Products for men	Issey Miyake Tiffany
Donna Karan New York® Black Label for men Donna Karan New York® Signature for men	Giorgio Armani Hugo Boss Calvin Klein Valentino Vestimenta Ermenegildo Zegna	DKNY® Accessories for women	By Paloma Coach Dooney & Bourke Ferragamo		
Donna Karan New York® Accessories for women	Prada Bottega Veneta Calvin Klein	DKNY® Shoes for women	Anne Klein II Bis (Charles Jourdan) Freelance Polo/Ralph Lauren VS (Via Spiga)		
Donna Karan New York® Shoes for women	Giorgio Armani Gucci Prada Calvin Klein Robert Clergerie	DKNY® Shoes for men	Cole Haan Kenneth Cole Paraboot Polo/Ralph Lauren		
Donna Karan New York® Shoes for men	Dolce & Gabbana Giorgio Armani Gucci Fenestria Ralph Lauren				

Exhibit 13

Donna Karan Product Lines and Major Competitors, Continued

Licensed Products

<u>Licensed Marks</u>	<u>Products</u>	<u>Licensee</u>
Donna Karan New York™ DKNY®	Women's pantyhose, knee high stockings, tights and socks	Hanes Hosiery, a division of Sara Lee Corp.
Donna Karan New York™	Women's intimate apparel	Wacoal America, Inc.
Donna Karan New York™ DKNY®	Sunglasses, optical frames, magnifiers, and eyewear accessories	The Lantis Corporation
DKNY® DKNY® KIDS	Children's apparel	Albert S.A.
Donna Karan New York™ DKNY®	Paper patterns and knitting patterns	Butterick Company, Inc. (Vogue Patterns)

Source: *Donna Karan International Prospectus*, June 27, 1996, pp. 44-51.

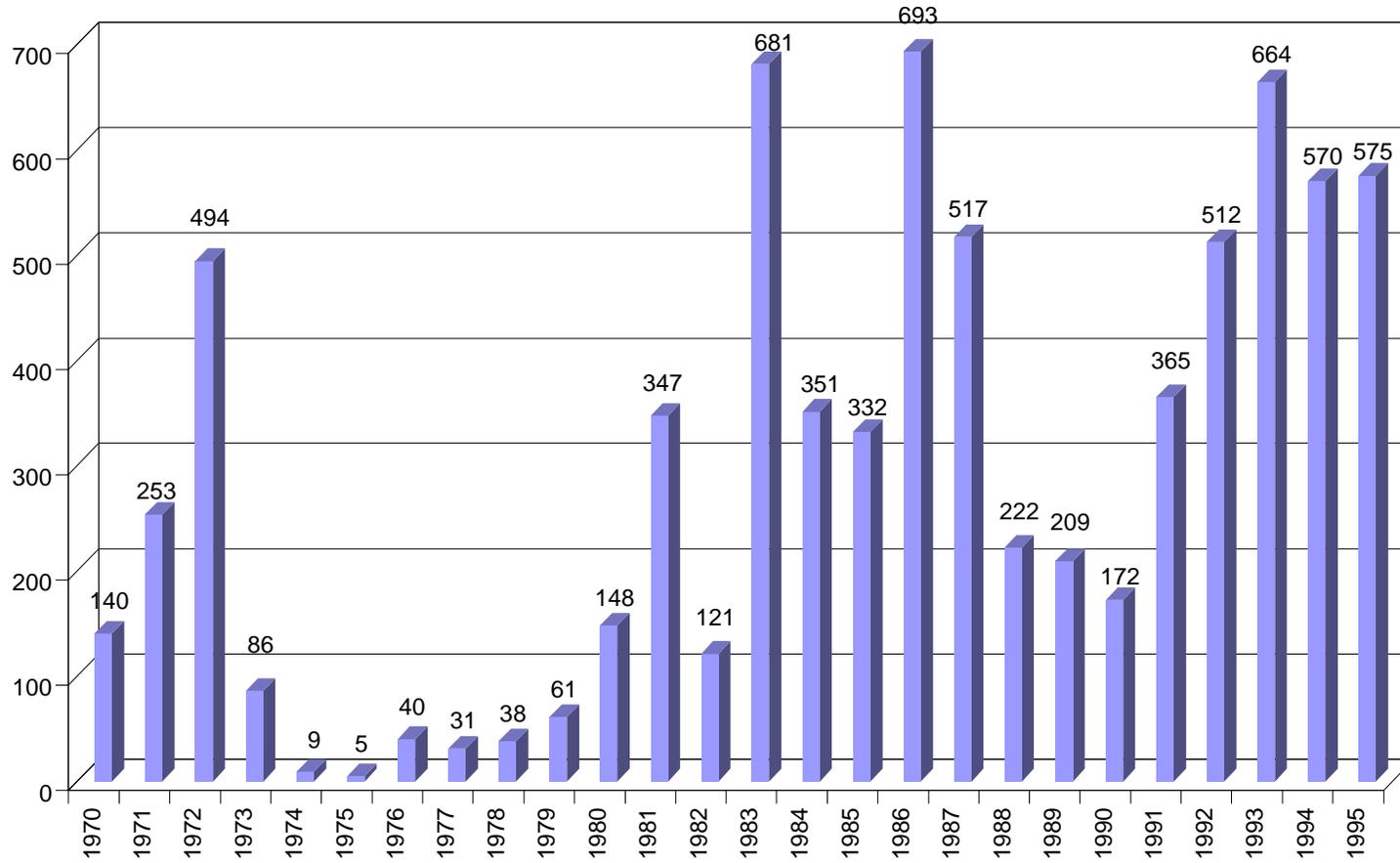
Exhibit 14

Selected Financial Markets Data

	<u>April-96</u>	<u>May-96</u>	<u>June-96</u>
<u>Treasury Rates:</u>			
Secondary Market for Bills:			
90 days	4.95	5.02	5.09
6 Months	5.06	5.12	5.25
Notes and Bonds:			
1 Year	5.54	5.64	5.81
5 Year	6.30	6.48	6.69
10 Year	6.51	6.74	6.91
30 Year	6.79	6.93	7.06
<u>Bonds:</u>			
Corporate Bonds			
AA	7.68	7.77	7.87
A	7.83	7.94	8.02
BBB	7.95	8.08	8.21
BB	8.47	8.62	8.77
Composite			
Long Term	6.94	7.08	7.20
AA	7.48	7.61	7.76
A	8.15	8.24	8.41
BBB	8.63	8.77	8.98
<u>Floating Rates:</u>			
Prime Rate	8.25	8.25	8.25
Commercial Paper	5.38	5.42	5.57

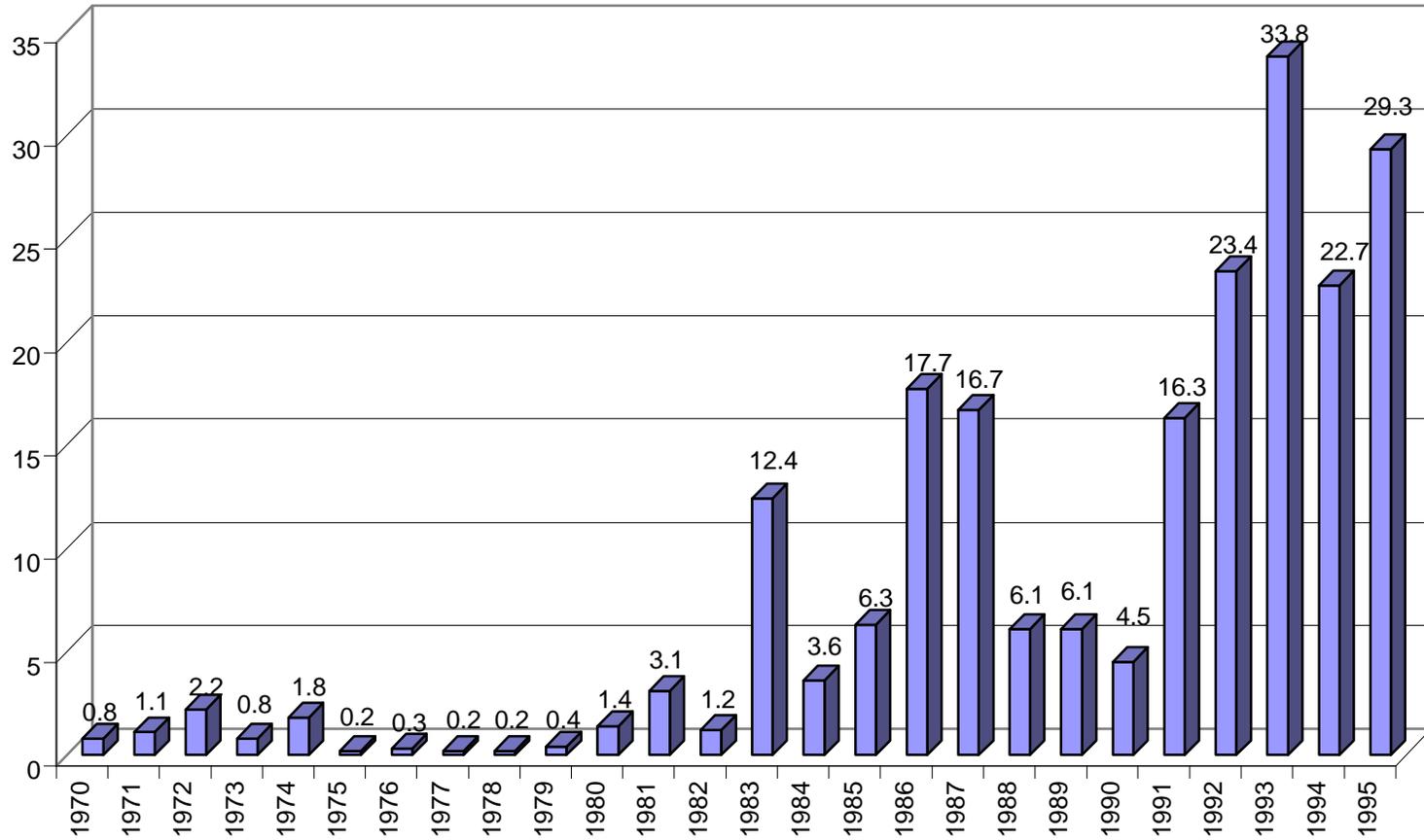
Source: *Federal Reserve Bulletin*
Standard & Poors' Bond Guide

Exhibit 15
Total Number of Initial Public Offerings (IPO's)
in United States Markets



Source: Securities Data Co.

Exhibit 16
Total Proceeds of Initial Public Offerings (IPO's)
in United States Markets (in billions)



Source: Securities Data Co.