DON'T LEAVE ME THAT WAY THE INSOLVENCY OF ESCADA AND A LACK OF CONSEQUENCE IN DIVESTING A SUBSIDIARY

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Abstract
Over the course of only some twenty years, Munich-based ESCADA AG became one of the most renowned brands in the luxury fashion industry and generated almost €1bn in sales at its peak. During an ongoing crisis in the new millennium which finally led to the company's bankruptcy in 2009, ESCADA missed an optimal point in time to divest itself of its non-core segment PRIMERA AG which accounted for roughly one third of its total sales. In this paper we explain the causes of management's disposal hesitation with behavioral finance phenomena such as loss aversion, escalating commitment and status quo bias. This case study therefore illustrates the strong influence that psychological effects and a non-efficient market for corporate control can exert on financing decisions in a real-life corporate scenario.

JEL classifications: D03 · G34 · L67
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1. Introduction

During the first two decades since its foundation in 1976, Munich-based haute couture and prêt-à-porter luxury fashion brand ESCADA AG participated repeatedly in the takeover market to support its growth strategy, creating a diversified portfolio of ladies' fashion brands and product lines. While revenues grew steadily, the company's profitability became weak. Due to a series of operating and strategic deficits as well as macroeconomic crises at the beginning of the 21st century, management agreed upon a corporate refocusing on ESCADA's core competencies in the luxury fashion market.

While most of the company's non-core segments were in fact soon divested, management for some reason adhered to PRIMERA AG, the company's single most important mid-price ladies' fashion business line. Upon the decision for the refocusing strategy in fiscal year 2000/2001, PRIMERA AG which included the four brands apriori, BiBA, cavita and Laurèl accounted for roughly one quarter of ESCADA's total sales. In spite of management's continuous assurance of its divesture plans for PRIMERA, ESCADA invested heavily in the non-core segment and kept hold of it for almost an entire decade. The final divesture process was not initiated until ESCADA finally faced serious financial distress at the end of 2008.

Since management realized the positive implications of a potential disposal at an early stage and broker reports consented on a lucrative value range of between €150m and €200m for the PRIMERA segment, it is difficult to view management's behavior as an unbiased rational financial decision process. To describe and understand management non-actions we refer to some insights of behavioral finance. We show how core findings of behavioral finance such as loss aversion, status quo bias and escalating commitment can help to explain ESCADA's heavily belated disposal policy. These psychological components in financial decision making significantly altered management's assessment of the PRIMERA business and led to a prolonged disposal hesitation that seriously affected ESCADA's liquidity. In addition to the absence of an efficient market for corporate control, this can be seen as one of the most important reasons for the company's bankruptcy in 2009.

The paper proceeds as follows. Section 2 gives an overview of the behavioral finance literature. It focuses mainly on the implications of loss aversion and status quo bias for corporate decision-making processes. Section 3 describes the PRIMERA divestment case during the years 2000 to 2009 in a distinctive three-phase pattern. We use evidence from ESCADA annual reports and ad-hoc announcements to illustrate the relevance of decision-making biases that can be observed in this divesture. Section 4 summarizes our findings and concludes.

2. Literature overview

One of the central assumptions of neoclassical economic theory is rational behavior of all participants in the market. Accordingly, individuals make choices based on rational preferences to maximize individual utility while firms use rational choices to maximize cash flows e.g. in investment decisions such as M&A activities. A series of major economic events such as various stock market crashes, corporate bankruptcies and excessive acquisition premiums paid in the takeover market led to the conclusion, however, that this assumption does not always describe managers' behavior in financial decision-making and that market participants also follow subjective and sometimes irrational rules (Shiller, 2000). Since the beginning of the second half of the 20th century the influence of psychological effects on investment and financing decisions has therefore been intensively analyzed.

Early criticism of the rational behavior hypothesis was offered by Allais (1953). Allais argued that the expected utility hypothesis does not represent a realistic model to describe human behavior in decision-making processes under uncertainty and that "objective" probabilities could be significantly altered by subjective expectations of market participants. In what was later named the "Allais paradox", he described a decision problem that foreshadowed one of the central insights of behavioral finance, the S-shaped value function and the thereby implied different perception of gains and losses by individuals. Among others such as Becker (1962), Allais marked an important critique of the prevalence of rational individual behavior and paved the way for the further development of behavioral finance theory.

Kahneman & Tversky (1979) introduced prospect theory, an alternative model to expected utility theory that is based on Allais' ideas. They assume that people perceive possible outcomes of a decision problem rather as gains and losses relative to a specified reference point rather than final states of wealth. The value function of prospect theory is determined by two effects. The certainty effect, describes the tendency to prefer certain positive outcomes with lower utility levels to uncertain (or risky) positive outcomes with higher expected utilities. This effect is also known as risk aversion and determines the concave part of the value function above the reference point (>0 or "gains").

The reflection effect, mirrors this certainty effect below the reference point (<0 or "losses") and therefore determines a convex course of the value function. This functional form implies that people prefer higher uncertain (or risky) losses to lower certain losses. This effect can therefore also be described as risk seeking. Due to these two effects, the value function of prospect theory follows an S-shaped course. The implications of this model have been further discussed e.g. by Barberis *et al.* (2006) and Barberis *et al.* (2001).

The concept of loss aversion was subsequently discussed in greater detail by Thaler (1980), who describes loss aversion as a basic human inadequacy to deal with experienced losses and the difficulty of admitting personal failures. As an important factor in decision problems, Thaler points out the influence of sunk costs. Although sunk costs should be irrelevant in the evaluation of an investment opportunity (since they cannot be retrieved), people tend to value goods or services higher if there are sunk costs involved. The sunk costs effect can also be applied to decision situations concerning the continuance or termination of corporate projects, as Statman & Tyebjee (1985) as well as Statman & Sepe (1989) exemplified.

As an important cause for the existence of loss aversion, Thaler mentions the psychological factor of regret as a powerful decision enabler which prevents individuals from the realization of actual losses in favor of maintaining the assets at a paper or book loss instead. This phenomenon has been called endowment effect or divesture aversion and implies the tendency to attribute a higher value to an asset once it has been acquired. A subsequent disposal of such an asset would therefore only be conducted if a higher purchase price than the one that had been paid to acquire the asset could be gained. The difference between these two prices has been labeled “willingness to pay (WTP)” and “willingness to accept (WTA)” and their substantial variation has been empirically supported by several experimental studies such as Carmon & Ariely (2000), Hanemann (1991) and Shogren *et al.* (1994).

The decision not to terminate certain projects, no matter whether they are loss-making and value-destructive or not of real use to the investor anymore, was further examined by Samuelson & Zeckhauser (1988). Contrary to traditional utility theory, they attributed a high degree of importance to the possibility of preserving the status quo in decision problems and explained this “status quo bias” with a number of possible reasons. While replicating prior choices can in some situations in fact be rational (e.g. because transaction costs to change the situation would be too high), there are also cognitive misperceptions and psychological commitment as possible causes. These reasons could persist in a human need for consistency, a reason that is frequently cited as one of the most important barriers of change, or, once again, in regret avoidance and sunk costs effects (Kahneman *et al.*, 1991).

Having dealt with the causes of loss aversion, it is also important to point out the consequences of this behavioral pattern. One of the most important implications that have been empirically detected in individual as well as managerial behavior is the occurrence of escalating commitment, i.e. the unwillingness of an individual to give up a once-chosen project even under bad circumstances or pessimistic future outlooks, as Brockner (1992) pointed out. Even though this pattern was identified by most participants that were holding on to a failing course of action for too long, they nevertheless did not alter their previous approach.

A striking consequence of this behavioral pattern is the fact that people would rather start to invest heavily into a distressed project than to terminate it in a timely manner instead (Shefrin & Statman, 1985). This effect has been frequently called “throwing good money after bad” or, in an attempt to describe the human need to get even with a losing project with personal involvement, “get-evenitis”. An often-cited example for this phenomenon was Apple Computer’s pilot PDA project “Newton” that was not terminated for more than ten years although it generated significant losses for the company and was afflicted with serious technical problems Apple was never able to fully eliminate despite large investments (Shefrin, 1999).

Staw (1976) conducted an experiment with 240 undergraduate business students to test the effects of escalating commitment in a hypothetical business situation where the students had to choose between the financing of two corporate projects. The results strongly confirm the prevalence of escalating commitment in decision situations where the participants feel they have a high personal responsibility for a project’s success. The allocation of resources to previously chosen losing projects was significantly higher in the test group with high personal responsibility than in the comparison group with low responsibility. This experiment substantiates the effects illustrated in the corporate example of Apple Computer.

Besides these situations, there are also projects that are based on systematically biased project forecast estimates and managerial over-confidence (Gervais & Odean, 2001). A wide-spread phenomenon among managers is hubris and the empire-building hypothesis that refers to the desire to operate larger companies. The reasons for this behavior might be obvious, since managers of large corporations are likely to receive higher compensation and more public attention in the media. In order to increase their companies' size, managers tend to participate excessively in the takeover market and in a variety of corporate projects that are associated with large investments (Heaton, 2002). In an illusion of control, these managers pay over-priced acquisition premiums and systematically alter project forecasts with elevated revenue and underrated cost estimations (Shefrin, 2001).

Other important aspects of behavioral finance theory are mass psychology effects that affect individual behavior as depicted e.g. by Bikhchandani *et al.* (1998). Phenomena such as herding behavior have been known for a long time and can be exemplified by the observation of media hypes or stock market bubbles (Baker & Wurgler, 2007). The unwillingness to step out of the crowd and the corresponding tendency to rather imitate the behavior of his peers therefore seems to be in the nature of man and can also be observed in investment decisions. Scharfstein & Stein (1990) develop a model that is able to explain herding phenomena in individual behavior in the stock market as well as in corporate decision-making processes. Individuals also measure their own gains and losses relative to those of other market participants. In what is often called a "sharing-the-blame hypothesis", individual losses are perceived as less painful in situations of general economic distress (e.g. in stock market crashes) compared to losses suffered by an individual in a climate of an economic upswing.

Previous studies have identified and analyzed a wide array of psychological components influencing corporate decision-making processes and concluded that expected utility theory is not a realistic model of economic behavior (Rabin & Thaler, 2001). In the following chapter, we will demonstrate how several of these aspects can be closely applied to the case of ESCADA AG's belated disposal of its non-core segment PRIMERA AG and its subsequent insolvency of 2009. We briefly illustrate ESCADA's historical background before we describe the PRIMERA divestment process in a three-phase pattern. For each phase, we point out the behavioral finance implications that can be observed in the behavior of ESCADA management and analyze how these psychological effects significantly biased the decision to sell off the subsidiary and to focus on its core competences.

3. Behavioral finance and ESCADA's disposal of PRIMERA AG

a. Historical background of ESCADA AG (1976-2000)

ESCADA was founded by German businessman Wolfgang Ley and his wife Margaretha, a former Swedish top model, in 1976 and headquartered in Munich. Due to its strong positioning and unique fashion style with an emphasis on strong colors and baroque era resemblance, ESCADA quickly rose to the top of the luxury women's ready-to-wear market, also accoutering many international celebrities on prestigious occasions such as the Academy Awards. The company's success story led to its 1986 IPO on the Frankfurt Stock Exchange as well as the gathering of numerous fashion awards (e.g. the Dallas Fashion Award in 1987 and the European Fashion Diamond Award in 1989). The death of co-founder and creative director Margaretha Ley in 1992, however, marked a turning point in ESCADA's history.

Under the leadership of CEO Wolfgang Ley and new creative director Brian Rennie, ESCADA focused on a growth and diversification strategy throughout the 1990s, establishing

ESCADA Beaute (in 1990), ESCADA Sport (1994), ESCADA Eyewear (1998), ESCADA Accessories and ESCADA Diamond Jewelry Collection (both 2000). Some further acquisitions such as St. John (divested in 1993), Kurt Neumann GmbH (divested in 1998) as well as Badgley Mischka (sold to Iconix Brand Group in 2004) were rather negligible in terms of company size and significance within the ESCADA Group.

In 1987, ESCADA acquired Muenster-based fashion house Schneberger Textilvertriebs GmbH which specialized in mid-price segment women's ready-to-wear apparel and which would later be the basis for the company's non-core segment PRIMERA AG. The Schneberger brand was renamed to cavita fashion GmbH in 1999. A second brand named apriori Textilvertriebsgesellschaft mbH was established as a fully-owned subsidiary of Schneberger as early as 1989. Duisburg-based BIBA Mode GmbH was acquired as a third brand for the PRIMERA universe in three steps over the course of the years 1998 to 2005. The fourth and last brand was Laurèl which was originally established by ESCADA as a more affordable fashion line alongside the ESCADA Collection flagship brand in the 1980s. Laurèl was spun-off as a judicially independent company in 2001 and integrated into PRIMERA AG in 2003.

Although all of PRIMERA's brands pursued individual business strategies and had slightly different target groups, they all shared some distinctive characteristics that set them apart from the group's core business segments. While ESCADA was an international high-price luxury brand, the PRIMERA brands were essentially focused on the German and some minor European markets with their price levels classifying them as representatives of the upscale mid-price segment. Furthermore, PRIMERA used a multi-channel distribution strategy including self- and franchise-operated shops, shop-in-shop corners and multi-brand retailers in many German cities whereas ESCADA products were mainly distributed via flagship shops and selected department stores in international metropolises. This positioning resulted in a complete lack of synergies between ESCADA and PRIMERA, a fact that was also confirmed by management during the structured disposal process at the end of 2008.

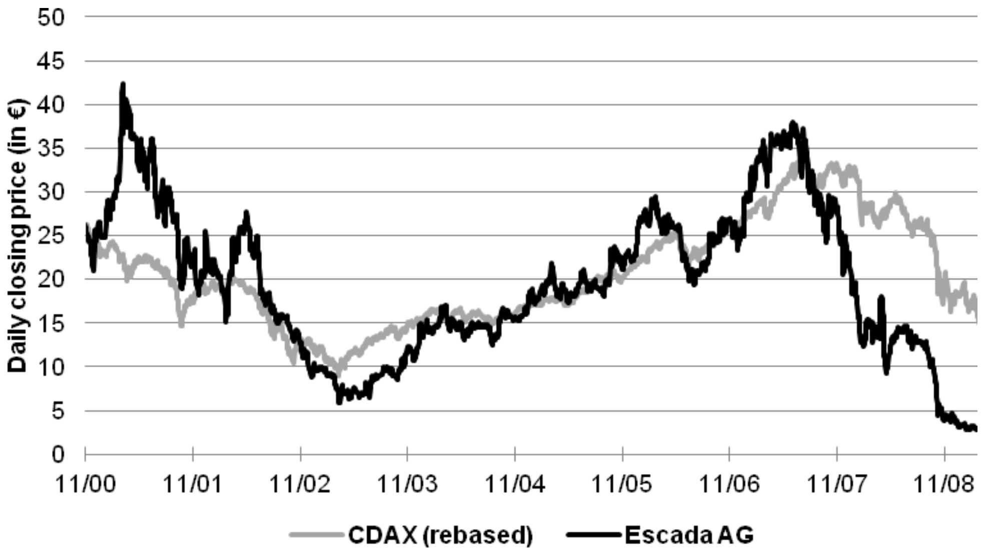

Figure 1: Share price performance of ESCADA AG's common stock (source: Bloomberg)

While ESCADA's sales still rose by high one-digit to low two-digit numbers per year throughout the 1990s, the company's profitability started to erode by the end of the decade. The development of ESCADA AG in the following years from 2000 until its bankruptcy in

August 2009 as well as the PRIMERA divestment process will be illustrated in a distinctive three-phase pattern in the following chapters.

b. Phase I (2000-2003)

The beginning of the 21st century was characterized by a period of general economic distress due to the bursting of the dot-com bubble and the subsequent stock market crash in 2000. Furthermore, a series of macroeconomic events such as the SARS epidemic, the 9/11 US terror attacks as well as the wars in Afghanistan and Iraq heavily influenced international tourism and travel activity, creating a weak consumption climate especially for the luxury fashion markets. ESCADA AG, therefore, was also seriously affected by these events and fell into a state of crisis over the course of these years.

(in €m)	Fiscal year 2000/2001	Fiscal year 2001/2002	Fiscal year 2002/2003
Total sales	846.2	772.9	620.8
Gross margin	*60.4%*	*61.3%*	*58.8%*
EBITDA	21.0	55.0	8.4
EBITDA margin	*2.5%*	*7.1%*	*1.4%*
EBIT	(17.1)	25.1	(19.6)
EBIT margin	*(2.0%)*	*3.2%*	*(3.2%)*
Net profit / loss	(24.2)	4.4	(77.7)
Net debt	314.6	264.7	190.0
Equity ratio	*15.3%*	*17.0%*	*20.8%*

Table 1: Key figures of ESCADA AG for fiscal years 2000/2001 to 2002/2003[1]

In fiscal year 2000/2001, the company reached a sales peak of €846.2m and employed more than 5,000 members of staff, both figures ESCADA was never able to exceed anymore. The company's profitability, however, hit a low point during this period, resulting in a net loss of €24.2m in the same year. Over the course of the next two fiscal years, sales fell drastically to €620.8m in fiscal year 2002/2003 (negative CAGR of (14.3%)) when ESCADA also suffered another fierce net loss of €77.7m. The company's stock mimicked its operational performance (see figure 1), falling by 86.0% from a peak of €42.40 on 6 March 2001 down to €5.93 on 14 March 2003, underperforming the corresponding CDAX by (20.1%).

Following ESCADA's serious net loss of fiscal year 2000/2001, management and the supervisory board decided on a shift in direction away from the growth and diversification strategy pursued throughout the 1990s. The new corporate refocusing strategy on ESCADA's core competences in the luxury ladies' fashion segment was publicly communicated in the company's annual report of fiscal year 2000/2001, stating

> *"In concurrence with the Supervisory Board, the Executive Board decided to concentrate ESCADA resources on the core business in the fiscal year 2000/2001. ESCADA AG therefore intends to sell interests in the Beauté Group (100%), in the Primera Group (90.1%), in the Laurèl business sector and an additional business sector. In*

[1] All financial statement data on ESCADA AG and PRIMERA AG in this paper are taken from the respective quarterly and annual reports of ESCADA AG as published on the company's website.

> *addition, interests in the Kemper Group (90.1%) are to be transferred to the Féraud GmbH."*[2]

In the following two years, ESCADA first sold its Beauté division to Darmstadt-based Wella Group in 2002 for an undisclosed amount. A long-term license agreement to produce and distribute cosmetic products and fragrances under the ESCADA brand label was negotiated by management. Secondly, the Kemper Group that included various business segments in the mid-price ladies' fashion sector (inter alia the manufacturing of womenswear under the well-known Cerruti 1881 label) was brought in to the Féraud GmbH, a joint venture between ESCADA and the Dutch Secon Group that had been established in 2001. The Féraud joint venture was subsequently divested to German investor Bavaria Modeholding AG in November 2003. The plan to divest itself of the remaining non-core segments was further emphasized by a statement from an ad hoc announcement dated from 4 June 2002:

> *"As already announced, the ESCADA GROUP will continue to successively divest itself of its non-core businesses Laurèl, Kemper and Primera-Group."* [3]

The company's financial distress became increasingly threatening until fiscal year 2002/2003 when private equity investor HMD Capital Partners, a spin-off of Texas Pacific Group, acquired a 27% minority stake in ESCADA's equity for an amount of €45m. The proceeds from HMD's entrance via a capital increase were used for a reduction in the net debt position from €264.7m (fiscal year 2001/2002) down to €190.0m (fiscal year 2002/2003). By this means, ESCADA was saved for once from its downward spiral and was able to focus on a cost-reduction and efficiency program for its financial and operational restructuring strategy. The decision to divest itself of its remaining non-core segments, PRIMERA AG and the then-stand-alone Laurèl GmbH, however was put on hold for the time being in the wake of HMD's entrance. In its annual report for fiscal year 2002/2003, management announced

> *"The weakness of the textile markets and the adverse environment for M&A transactions slowed the progress of the project, inaugurated the year before, to divest all activities not belonging to the ESCADA brand: the Féraud Group, the Primera Group and the Laurèl Group."* [4]

Laurèl GmbH was consolidated with PRIMERA AG in November 2003 in order to realize the potential of the promised synergies between Laurèl and PRIMERA's existing portfolio of mid-price ladies' fashion brands including apriori, BiBA and cavita. Still, management at this point in time insisted on its willingness to sell off the PRIMERA business after its future turnaround and return to profitability:

> *"Even though the PRIMERA Group will remain part of the ESCADA Group for the time being, ESCADA is still holding firm to its goal of focusing entirely on the ESCADA brand within the medium term."* [5]

[2] ESCADA Group annual report for fiscal year 2000/2001, p. 138

[3] ESCADA Group ad hoc announcement from 4 June 2002 (as disclosed on http://www.investor-relations.escada.com)

[4] ESCADA Group annual report for fiscal year 2002/2003, p. 131

[5] ESCADA Group annual report for fiscal year 2002/2003, p. 33

(in €m)	Fiscal year 2000/2001	Fiscal year 2001/2002	Fiscal year 2002/2003
Total sales	207.6	209.5	200.6
EBITDA	n.d.	5.2	(4.6)
EBITDA margin	*n.d.*	*2.5%*	*(2.3%)*
EBIT	(2.8)	2.8	(10.6)
EBIT margin	*(1.3%)*	*1.3%*	*(5.3%)*
Net profit / loss	(5.3)	(2.0)	(17.9)
ESCADA Group total capex	42.8	22.5	22.6
thereof: PRIMERA AG	7.1	5.4	4.0

Table 2: Key figures of PRIMERA AG for fiscal years 2000/2001 to 2002/2003

In fiscal year 2002/2003, PRIMERA AG had sales of €200.6m and therefore accounted for 32.3% of ESCADA Group's total sales volume. It suffered a severe net loss of €17.9m in that same fiscal year after having incurred further net losses in the two preceding fiscal years (see Table 2). This marks a starting point for behavioral finance-based explanations of failed divestment decisions in the case of PRIMERA. It has been shown empirically that losses that were preceded by previous losses are considerably more painful than losses following prior gains. This loss aversion shows parallels to Apple's Newton project. The human tendency to evaluate decision situations considering previous events rather than on a stand-alone basis becomes obvious (Barberis & Huang, 2001). Since ESCADA as well as PRIMERA suffered a series of net losses during the period of 2000 until 2003, only low purchase prices for PRIMERA could have been expected. This would have inflicted further losses upon the group and shows that the disposal hesitation is in line with the according literature.

It is further known that foregone gains are more likely to be accepted in a decision situation than actually realized losses. This is one possible explanation for the divestment hesitation during ESCADA's period of financial distress. In addition, the justification of the disposal deferral concerning the "adverse environment for M&A transactions" signals a difference between the potential buyers' willingness to pay and ESCADA management's willingness to accept for the first time. This reason for the delay of the PRIMERA disposal has been stated repeatedly by management in official publications as can be seen in the following. It becomes evident that management and especially founder Wolfgang Ley have become personally involved with the PRIMERA segment over the course of its existence. We can therefore observe the difference between WTP and WTA in the case of ESCADA by looking at the redundant claim for an adequate purchase price for the PRIMERA segment by management.

c. Phase II (2003-2007)

Following HMD's entrance, ESCADA started a phase of a partially successful corporate restructuring which was accompanied by a general upswing in the economy and international stock markets. The consumption climate in general as well as in the luxury fashion markets started to catch up, also due to a strong increase in international tourism and travel activity. Stock markets finally regained strength after the crash of 2000 until they finally reached all-time peaks in the year 2007.

Management implemented a rigorous cost-cutting and efficiency program at the beginning of this second phase that included the closing of numerous unprofitable stores as well as the layoffs of about 850 employees. A steady, even though not competitive sales growth was achieved over the course of these years until the company reached another peak in sales of €695.2m in fiscal year 2005/2006 (CAGR of 3.9% starting from fiscal year 2002/2003). ESCADA's profitability started to slowly increase as well, resulting in a peak in EBITDA of €74.1m (10.7% of sales) and EBIT of €52.9m (7.6% of sales) in the same fiscal year. Fiscal years 2003/2004 until 2005/2006 were also characterized by a series of three consecutive net profits as well as a constant level of net debt and strengthened equity ratio (see Table 3).

(in €m)	Fiscal year 2003/2004	Fiscal year 2004/2005	Fiscal year 2005/2006
Total sales	625.5	648.6	695.2
Gross margin	*60.6%*	*62.8%*	*62.4%*
EBITDA	47.3	65.1	74.1
EBITDA margin	*7.6%*	*10.0%*	*10.7%*
EBIT	25.2	45.6	52.9
EBIT margin	*4.0%*	*7.0%*	*7.6%*
Net profit / loss	3.8	13.7	6.9
Net debt	208.7	207.7	188.7
Equity ratio	*20.0%*	*23.5%*	*26.4%*

Table 3: Key figures of ESCADA AG for fiscal years 2003/2004 to 2005/2006

ESCADA's stock was able to benefit both from the general upswing in international stock markets and the company's own return to profitability. During this second phase, the stock reached a peak of €38.00 on 1 June 2007. During this period (starting with HMD's entrance on 30 June 2003 and ending with the dismissal of CEO Frank Rheinboldt on 30 May 2007), ESCADA's stock even outperformed the also-recovering CDAX by a considerable 196.8%.

Although ESCADA's restructuring measures had positive implications for the company and led to a series of proper results, a number of issues paved the way for the company's next crisis. Troubles arose with the acquisition of HMD by Swiss-based investor group Finartis and its main shareholder Rustam Aksenenko. His operational interference and ongoing controversies about ESCADA's strategy led to a wave of personnel changes in top management positions. CEO Wolfgang Ley and CFO Georg Kellinghusen resigned on 31 January 2006 and 31 December 2005, respectively, and were succeeded by former members of the supervisory board Frank Rheinboldt and Marcus Schuerholz. Being dissatisfied with Rheinboldt, Aksenenko replaced him only 16 months later with former LVMH vice president Jean-Marc Loubier. In addition, creative director Brian Rennie was succeeded by Damiano Biella. Finally, Loubier was also replaced by Bruno Saelzer, the former CEO of Hugo Boss in July 2008.

The different management teams tried to implement a new business strategy and a restructuring program, but were not able to eliminate some of ESCADA's key operating issues such as its weak performance in the important accessories collection (accessories made up for less than 10% of total ESCADA sales throughout the 2000s whereas peers such as Hermès and Louis Vuitton generated a lion's share of their total sales volume with highly profitable accessories collections) as well as a completely unstructured sales and distribution strategy (sales density was at a disastrous €7,000/sqm in 2007 whereas Hermès and Louis Vuitton were well above €30,000/sqm at the same time). These issues were addressed as top priority measures in a restructuring program called "ESCADA Excellence" which was implemented in June 2007 by CEO Jean-Marc Loubier.

(in €m)	Fiscal year 2003/2004	Fiscal year 2004/2005	Fiscal year 2005/2006
Total sales	205.8	211.5	227.4
EBITDA	13.3	18.1	20.1
EBITDA margin	*6.5%*	*8.6%*	*8.8%*
EBIT	8.7	13.9	15.6
EBIT margin	*4.2%*	*6.6%*	*6.9%*
Net profit / loss	9.1	5.0	8.0
ESCADA Group total capex	18.6	21.5	31.3
thereof: PRIMERA AG	2.0	4.7	7.5

Table 4: Key figures of PRIMERA AG for fiscal years 2003/2004 to 2005/2006

In line with ESCADA's positive sales and earnings development, PRIMERA's operational performance also started to improve significantly. From fiscal year 2002/2003 to 2006/2007, sales increased by a CAGR of 5.4% from €200.6m to €247.7m. A series of net profits was generated throughout these years and EBITDA as well as EBIT margins caught up to solid levels of 8-9% and 6-7%, respectively. Capital expenditures in the amount of €22.8m were invested in the non-core segment during this period that were mainly used for the improvement of PRIMERA's retail network, especially for the BiBA and Laurèl brands (including both the refurbishment of existing as well as the opening of new stores).

Further investments were made for the IT infrastructure used in the retail network and the purchase of concessions. Since these were mostly investments for operational improvements, it appears that management tried to achieve a successful turnaround of PRIMERA and to get even with its non-core segment. The phenomenon of "get-evenitis" that is well-known in empirical behavioral finance studies can therefore be well applied to this case. It will become even more obvious in the subsequent fiscal years when management increased capital expenditures in the PRIMERA segment even further.

While ESCADA ostensibly insisted on its willingness to pursue the divesture plans for PRIMERA after its imminent return to profitability, it can be seen from various statements in annual reports and ad hoc announcements that management yet gradually dismissed these plans over the course of this second phase. While the core brand ESCADA and the PRIMERA business were still distinctively differentiated as two independent segments throughout ESCADA Group's annual reports and ad hoc announcements and PRIMERA was sometimes only referred to as a "successful financial investment"[6], there were also a lot of indications that management would completely abort the originally intended disposal plan. For example, CEO Frank Rheinboldt quoted:

> *"The PRIMERA Group will also continue its course and gradually position itself as vertical provider in the premium and mid-price segment with a strong international focus."* [7]

[6] ESCADA Group annual report for fiscal year 2006/2007, p. 8
[7] ESCADA Group annual report for fiscal year 2005/2006, p. 10

Further hints for the dismissal of the divesture process included references to PRIMERA's successful turnaround and its strong contribution to ESCADA Group's sales and earnings growth during these years:

> *"According to the final figures of the Group's Annual Financial Statement now available, Group sales were up by 3.7% to EUR 648.6 million (vs. EUR 625.5 million in 2003/2004). Currency adjusted the plus comes to 4.3%. Both business areas, ESCADA as well as the PRIMERA Group, contributed toward this growth."* [8]

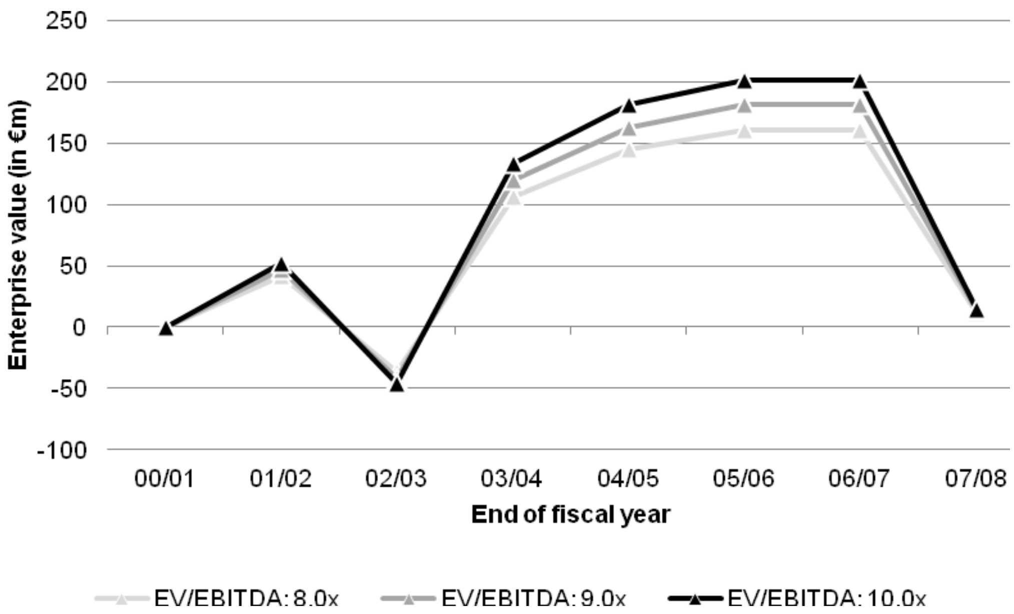

Figure 2: EV/EBITDA multiple valuation of PRIMERA AG

During this second phase of the intended divesture process, the implied value of the business segment started to increase due to PRIMERA's good operational performance, its sales growth and the net profits it generated. Figures 2 and 3 illustrate the implied enterprise value development of PRIMERA using industry average EV/EBITDA multiples of 8.0x to 10.0x and EV/EBIT multiples of 10.0x to 12.0x[9]. After three fiscal years of small to negative valuations, PRIMERA's implied enterprise value sharply increased during the phase from fiscal year 2003/2004 until it peaked in fiscal year 2006/2007 when reaching consistent values between €150m and €200m. This implied value range had also been confirmed independently by numerous broker reports on ESCADA AG, some of which were also based on more detailed and insightful DCF valuation methodologies.

[8] ESCADA Group ad hoc announcement from 3 March 2006 (as disclosed on http://www.investor-relations.escada.com)

[9] Industry average EV/EBITDA and EV/EBIT multiple ranges have been taken from broker reports on ESCADA AG as well as the fashion market in general. Sources of broker reports included Aurel Leven, Bankhaus Lampe, Berenberg Bank, Deutsche Bank, DZ Bank, HVB/UniCredit and Sal. Oppenheim.

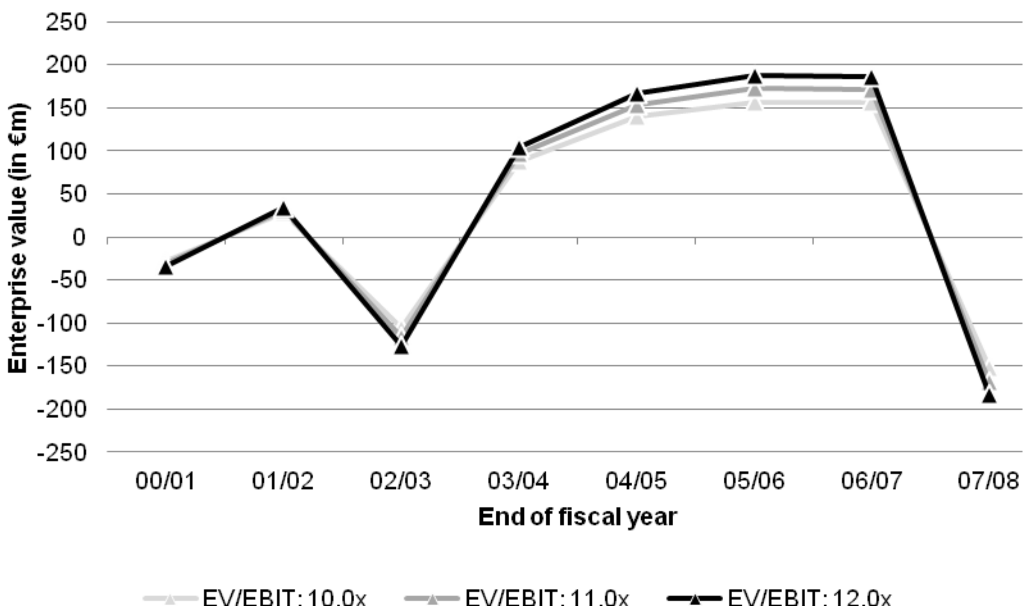

Figure 3: EV/EBIT multiple valuation of PRIMERA AG

The illustrated values represent a significant proportion of ESCADA AG's net debt position throughout these years, while in fiscal years 2005/2006 as well as 2006/2007 they would have even exceeded it by up to €36.4m. These years can therefore be viewed as an optimal time window for the long-intended disposal of the PRIMERA business. Net proceeds in the amount discussed before would have helped ESCADA significantly to strengthen its balance sheet, restructure its core brands ESCADA Collection, ESCADA Sport and, most importantly, the weak ESCADA Accessories business line and to cover up almost its entire indebtedness. Although it has been rumored by analysts and the media that ESCADA never received an appropriate offer for its PRIMERA business, the virtually non-existent communication about the proceedings of the disposal process leads to the conclusion that management did not actively pursue divesture negotiations during this period.

Instead of pursuing the PRIMERA divestment despite the perspective of lucrative purchase prices, ESCADA adhered to the subsidiary and in March 2005, issued a €200m junk bond (seven-year maturity, 7.5% coupon, rated BB-/B2) and a €90m syndicated loan for refinancing matters instead. This is another clear indication for ESCADA management's strong disposal hesitation.

Regret is assumed to be one of the most powerful emotions concerning the decision of project terminations or divesture activities. First, in an ex ante examination, management would have had to admit its own shortcomings in the restructuring process of PRIMERA if they had sold the business segment before its return to profitability. This assumption would certainly apply to the first phase of fiscal years 2000/2001 until 2002/2003 when PRIMERA incurred net losses and sales were decreasing.

A second way in which regret influences divesture decisions derives from an ex post point of view. In the case of an accomplished disposal, the further development of PRIMERA under new ownership would still have been easily observable for ESCADA. This way, regret would have resulted from the achievement of a successful turnaround initiated by the new owners. This fact would apply to fiscal years 2003/2004 until 2006/2007 when PRIMERA started to generate small net profits and sales growth again. The unwillingness to accept its own incapability to restructure PRIMERA therefore seems to be one of the most important causes of management's divesture aversion.

Another explanation for management's disposal hesitation that applies especially to this second period of 2003 to 2007 is herding behavior. While a disposal of PRIMERA during these years presumably would have supplied the company with sufficient liquidity for a successful restructuring of its core brand, it would also have significantly decreased ESCADA Group's company size in terms of sales and employees. As we already pointed out, managers tend to prefer large companies to small ones due to higher compensation and public attention which is described by the empire-building hypothesis. Since PRIMERA accounted for roughly one third of ESCADA's total sales over the course of this second phase, a disposal would have reduced the company's revenue basis and its range of business lines.

On the one hand, a divestment would have been a rather unusual step in an industry where the most dominant and successful companies such as LVMH, PPR and Richemont are large in scale as well as diversified in the scope of their product portfolios. On the other hand, it would also have made ESCADA an easier target for takeover activities in a market where consolidation is quite customary. Management's conviction that PRIMERA could be successfully restructured and be held as a strong second foothold (which can be seen from the statements mentioned above) therefore can well be seen as a sign of newly-found (over-) confidence during a period of improving operational performance.

d. Phase III (2007-2009)

The third and last phase of ESCADA's development is characterized by the worldwide financial crisis with its beginning in the sub-prime mortgage crisis of 2007. The international stock markets in general and the business-sensitive luxury fashion markets in particular were also heavily affected by these macroeconomic developments, starting with the year 2008. Due to its prevailing operational and strategic issues, these external events significantly intensified ESCADA's worsening situation and also played an important role in the company's declaration of bankruptcy in August 2009.

(in €m)	Fiscal year 2006/2007	Fiscal year 2007/2008	Q2 of FY 2008/2009
Total sales	686.1	582.1	248.1
Gross margin	*63.4%*	*63.6%*	*64.4%*
EBITDA	68.2	19.5	2.2
EBITDA margin	*9.9%*	*3.3%*	*0.9%*
EBIT	47.1	(23.7)	(8.1)
EBIT margin	*6.9%*	*(4.1%)*	*(3.3%)*
Net profit / loss	(27.3)	(70.3)	(91.7)
Net debt	164.7	177.1	187.6
Equity ratio	*19.5%*	*17.5%*	*(5.2%)*

Table 5: Key figures of ESCADA AG for fiscal year 2006/2007 to Q2 2008/2009

Although luxury goods markets were still booming in ESCADA's fiscal year 2006/2007, the company was not able to participate in this positive development due to unusually high one-time expenses that can be attributed to extensive restructuring measures of the "ESCADA

Excellence" program. Sales fell only slightly by 1.3% down to €686.1m, but the group suffered a net loss of €27.3m. In fiscal year 2007/2008, the situation went from bad to worse due to the impending financial crisis and sales fell drastically to €582.1m with a corresponding net loss in the amount of €70.3m. Net debt which had been reduced constantly over the course of the preceding years due to high free cash flow levels increased again from €164.7m to €177.1m. In the second quarterly report of fiscal year 2008/2009 (the last one that was published right before the company's insolvency), ESCADA had already accumulated a negative EBIT of €8.1m and a net loss of €91.7m.

The company's downward spiral as well as the general downturn in the worldwide economy was also echoed by the performance of ESCADA's stock that incurred a steep decline in value. Share prices fell down to €0.70 on 13 August 2009 when the company's bankruptcy was publicly announced which represents a 98.1% loss in value compared to the price of €37.70 at which the stock was trading on 31 May 2007, the day after Frank Rheinboldt's replacement by Jean-Marc Loubier as CEO was announced. Despite the strong underperformance of ESCADA's stock compared to the CDAX of (63.4%), no public takeover bid was made for the company which indicates a weak market for corporate control in Germany.

The operational and strategic improvements that were promised by the "ESCADA Excellence" program were moderate at best and did not strengthen the company's performance. In addition, the first collections of new creative director Damiano Biella failed to attract the old customer basis due to his use of significantly darker colors and slimmer dress cuts, resulting in sharply declining pre-collection orders. Furthermore, the constant wave of personnel changes led shareholders, employees as well as other stakeholders to lose faith in the company. Private equity investor Apax Partners, for example, dismissed its interest of participation in ESCADA AG due to the company's weak share price performance in April 2008.[10]

In June 2008, the wealthy German Herz brothers Wolfgang and Michael each acquired a 12.45% stake in the group via a capital increase to strengthen the company's equity capital base. The proceeds were used mainly for the refinancing of the €90m syndicated loan granted to ESCADA in 2005 whereas the repayment of the principal for the outstanding €200m notes due in 2012 became increasingly threatening. In June 2009, a bond exchange offer was issued in which bondholders would have had to agree on a 60% value write-off in exchange for two kinds of newly-issued notes and a small cash payment. Most likely in anticipation of better conditions, the bondholders' majority did not agree on the exchange offer even after a slight amendment was handed in one month later. As a consequence, ESCADA's board of directors filed for insolvency on 13 August 2009. On 5 November 2009, ESCADA was acquired by a trust held by Indian steel magnate's daughter Megha Mittal and is supposed to pursuit its previous strategy implemented by CEO Dr. Bruno Saelzer ever since.

PRIMERA's performance differed slightly from ESCADA's during this third and last period. While ESCADA's sales decreased in fiscal year 2006/2007, PRIMERA generated a sales growth of 8.9% up to €247.7m. With an EBITDA of €20.1m (8.1% of sales), an EBIT of €15.6m (6.3% of sales) and a net profit of €9.5m (3.8% of sales), the subsidiary achieved the best result in its history. At a time when its mother company ESCADA was already facing financial distress, a divestment would have made all the more sense given PRIMERA's implied enterprise value of between €150m and €200m at the time (see figures 2 and 3). Not until fiscal year 2007/2008, PRIMERA's performance started to deteriorate as sales fell by (14.8%) down to €211.0m.

[10] ESCADA Group ad hoc announcement from 9 April 2008 (as disclosed on http://www.investor-relations.escada.com)

(in €m)	Fiscal year 2006/2007	Fiscal year 2007/2008	Q2 of FY 2008/2009
Total sales	247.7	211.0	98.9
EBITDA	20.1	1.5	(12.8)
EBITDA margin	*8.1%*	*0.7%*	*(12.9%)*
EBIT	15.6	(15.2)	(16.2)
EBIT margin	*6.3%*	*(7.2%)*	*(16.4%)*
Net profit / loss	9.5	n.d.	(73.9)
ESCADA Group total capex	33.8	35.4	12.7
thereof: PRIMERA AG	4.6	9.6	8.7

Table 6: Key figures of PRIMERA AG for fiscal year 2006/2007 to Q2 2008/2009

Following a profit warning in June 2008 which was mainly attributed to the "poor performance" of the "business-sensitive fast fashion segment of the PRIMERA brands"[11], management finally started to concentrate again on the PRIMERA disposal considerations. The official start of the structured divesture process was disclosed on 5 December 2008 via an ad hoc announcement also claiming

> *"There are no synergies with the core business of the ESCADA brand."* [12]

Three days later management released yet another ad hoc announcement that was a direct response to a critical article published in the German journal "Focus" in which the editors speculated about a connection between the announced disposal plans and the company's financial troubles. The ad hoc announcement said

> *"The fact that ESCADA announced last Friday that the process of selling its subsidiary PRIMERA AG is starting now has nothing to do with alleged liquidity problems but constitutes a principal decision of company strategy. This step has been preceded by extensive consultations in the Management and Supervisory Board, reaching back as far as the year 2007. To term this a "hasty sale" as the "Focus" does is therefore incorrect."* [13]

Although the structured process had now been started, management still hesitated to quickly follow through with the disposal as can be observed by a quotation from the annual report of fiscal year 2007/2008:

> *"If it proves to be impossible to obtain an adequate sales price in line with market conditions, the earnings situation of ESCADA Group and ESCADA AG could be further adversely affected. Alternatively, it cannot be ruled out that the Board of Management should decide not to sell the subsidiary or not at the present time."* [14]

[11] ESCADA Group ad hoc announcement from 20 June 2008 (as disclosed on http://www.investor-relations.escada.com)
[12] ESCADA Group ad hoc announcement from 5 December 2008 (as disclosed on http://www.investor-relations.escada.com)
[13] ESCADA Group ad hoc announcement from 8 December 2008 (as disclosed on http://www.investor-relations.escada.com)
[14] ESCADA Group annual report for fiscal year 2007/2008, p. 82

PRIMERA was then finally sold off in two transactions in May and June 2009, respectively. While Munich-based German private equity investor mutares AG took over the apriori, cavita and Laurèl brands (announced on 26 May 2009), German ladies' fashion house GELCO GmbH & Co.KG with headquarters in Gelsenkirchen acquired the remaining BiBA brand which was announced on 5 June 2009. Once again, ESCADA management insisted that

> *"The divesture is a key element in the Group's ongoing strategic reorientation and financial restructuring."* [15]

Although purchase prices were not disclosed in both transaction announcements, the quarterly financial report for the first half of fiscal year 2008/2009 reported net proceeds from the divesture of the PRIMERA business in the amount of €10m. This amount represents less than 10% of the enterprise value estimations for PRIMERA during the period of fiscal years 2004/2005 to 2006/2007. Considering the fact that the capital expenditures spent on the PRIMERA business in the first half of fiscal year 2008/2009 right before the divestment amounted to €8.7m, there were basically no positive proceeds from the disposal at all that could have been used for the financial restructuring of ESCADA. It can be clearly observed that the optimal timing choice for a disposal of PRIMERA has been missed by management.

Over the course of fiscal year 2006/2007 to the first half of fiscal year 2008/2009, ESCADA invested another €22.9m in the PRIMERA business. The phenomenon of "get-evenitis" that we had already identified throughout the second phase becomes even more evident in this period when PRIMERA's performance also started to deteriorate. It can be said that management threw good money after bad in its struggle to return the non-core segment to profitability by all means necessary. This kind of escalating commitment can also be explained by the sunk costs effect which was also observable in the Apple Newton case. Since ESCADA invested a total of €53.6m in the PRIMERA business over the course of the decade, it becomes abundantly clear that management wanted to retrieve these foregone gains via a disposal which is illogical by the methodology of NPV project valuation techniques that correctly do not factor in sunk costs, but only future cash flows. The claim for an "adequate purchase price" for PRIMERA that was made again immediately preceding ESCADA's bankruptcy underlines management's strong unwillingness to give up the subsidiary without being able to retrieve the money invested in it over the course of the previous years.

Finally, we also see this as a form of a strong status quo bias, since it appears that management did not see sufficient incentives to change the predominant situation with PRIMERA as a second business line. The illusion of being able to attain a high acquisition premium for a disposal of PRIMERA prevented management to settle for a realistic purchase price at a fair value even during the second period when a considerable amount of money of between €150m and €200m could have been received. Management, however, insisted on its own (overly optimistic) price range that was subjectively altered by the inclusion of sunk costs due to high investments and the personal feeling of responsibility for the non-core segment by management. Therefore, retaining the status quo, even though PRIMERA started to incur losses in the end as well, was perceived as less painful than realizing actual losses via a disposal for a seemingly inadequate purchase price.

[15] ESCADA Group ad hoc announcement from 26 May 2009 (as disclosed on http://www.investor-relations.escada.com)

4. Conclusion

Given its lack of synergies with ESCADA's main business in the luxury fashion industry as well as its implied value range, a disposal of PRIMERA at the optimal point in time would have been an important and reasonable decision to focus on ESCADA's core business. The proceedings from a divesture would have endowed the company with enough liquidity to significantly strengthen its balance sheet and refinance its outstanding debt. Furthermore, it would have given ESCADA sufficient financial headroom for important restructuring measures such as the implementation of new sales and distribution strategies as well as an improvement of the accessories business line. Despite the undeniable advantages of a disposal, management apparently suffered from a strong case of loss aversion and status quo bias and deferred the long-anticipated divesture of PRIMERA for almost an entire decade.

This case study represents an astonishing exemplification of the importance of psychological effects on corporate finance decisions. It shows that a company's management can get seriously entrapped with losing projects that hold a high degree of personal involvement and responsibility. As the example of ESCADA AG illustrates, these effects can lead to the deferral of project termination decisions up until the point where they seriously endanger a company's survival. With its new owners and only its core brand left after its insolvency, ESCADA now has the opportunity to alter its approach and to regain its position among the world's leading brands in the luxury fashion market.

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