REPRINT FINANCIER WORLDWIDE MAGAZINE

TALKINGPOINT

Distress in the retail sector

REPRINTED FROM
APRIL 2018 ISSUE

© 2018 Financier Worldwide Limited.
Permission to use this reprint has been granted by the publisher.

FINANCIER WORLDWIDE corporatefinanceintelligence

BANKRUPTCY & RESTRUCTURING

Distress in the retail sector

FW moderates a discussion on distress in the retail sector between James Alt at Huron, Nicole Greenblatt at Kirkland & Ellis LLP and Van C. Durrer II at Skadden, Arps, Slate, Meagher & Flom LLP.

THE PANELLISTS

James Alt
Managing Director
Huron
T: +1 (312) 583 8735
E: jalt@huronconsultinggroup.com

James Alt is a managing director who leads the US retail and consumer goods industry sector for Huron's business advisory business, assisting companies in their transformation or restructuring to ensure long-term sustainability. Prior to joining Huron, he served as an adviser to CEOs and private equity firms for several national retailers, and also recently served as business president for Sears Holdings, and is a former executive at Kozmo.com and Target.

Nicole Greenblatt
Partner
Kirkland & Ellis LLP
T: +1 (212) 446 4664
E: nicole.greenblatt@kirkland.com

Nicole Greenblatt represents debtors, creditors, equity holders and investors in all aspects of complex corporate restructurings, including Chapter 11 cases, out-of-court restructurings and special situation investments or acquisitions. Her practice includes advising clients with respect to business operations in Chapter 11, advising senior managers and boards of directors of financially troubled companies with respect to restructuring strategies, negotiating and structuring financings and other commercial transactions, and advising clients seeking to purchase assets out of Chapter 11 proceedings.

Van C. Durrer II
Partner
Skadden, Arps, Slate, Meagher & Flom LLP
T: +1 (213) 687 5200
E: van.durrer@skadden.com

Van C. Durrer II regularly represents public and private companies, major secured creditors, official and unofficial committees of unsecured creditors, investors and asset-purchasers in troubled company M&A, financings and restructuring transactions, including out-of-court workouts and formal insolvency proceedings.

FW: How would you describe the general performance of companies operating in the retail sector over the last year or so? What major challenges is the sector battling to overcome?

Alt: Overall performance continues to vary widely by company and within different retail sectors, but the general environment seems to have improved slightly after the 2017 holiday season. Retailers that have less debt and positive cash flows have been able to avoid the distress wave by making smart investments in stores, capabilities or technology platforms to adapt to a more complex environment. Still, competitive, customer and internal culture challenges – beyond Amazon – continue to plague the industry. The rise of e-commerce brands investing in physical stores and subscription services for everything from clothes and food to cosmetics are disrupting retailers' equilibrium. Faced with these headwinds, many companies are scrambling for short-term fixes rather than staying focused on consumers' needs.

Greenblatt: Over the last 18 months, there has been a significant uptick in restructuring activity and distress among a broad-based set of retailers. Recent Moody's data listed 26 US retail companies with credit ratings of CAA or lower and, in the first 11 months of 2017, more than 30 retailers filed for bankruptcy protection. There were more than twice as many announced retail store closings during the first three quarters of 2017 than announced retail store openings during the same period. The primary challenge facing the retail sector is a general shift in consumer preference away from brick-and-mortar stores in favour of e-retail.

Durrer: Retail companies are experiencing an overall decline in revenues, largely a result of reduced brick-and-mortar store traffic. Less revenue per square foot forces retailers to close storefronts even before they reach the point of distress. The retail sector is battling to overcome sky-high rents and the 'Amazon effect' – the rise of e-commerce and resulting shift in consumer preferences for online shopping.

FW: Broadly speaking, what restructuring strategies are being adopted by underperforming and distressed retailers?

Greenblatt: There is no one-size-fits-all strategy. Instead we have seen underperforming and distressed retailers

willing to take any and all measures to remain competitive and viable in a distressed and shifting environment, using a variety of strategies, both in and out of court. Operationally, retailers are focused on revamping their business plans and securing investments, or allocating capital expenditures, to grow their e-commerce and omnichannel platforms while simultaneously reducing costs by closing or renegotiating leases on unprofitable stores or partnering with suppliers on vertical integration and fulfilment strategies.

Durrer: Faced with liquidity issues and overleveraged balance sheets, underperforming retailers have begun to take advantage of existing loopholes in the form of unrestricted subsidiaries in their financing agreements and related indentures. If the transfer meets the definition of a 'permitted investment', retailers can transfer assets to the unrestricted subsidiary. Because the unrestricted subsidiary is free to issue debt of its own, these assets can then be used as collateral for new debt, which can be used to effect an exchange with the retailer's near-term maturing debt. This allows the company to extend its runway to continue operations and delay a potential, but possibly eventual, default.

> THE RETAIL SECTOR IS BATTLING TO OVERCOME SKY-HIGH RENTS AND THE 'AMAZON EFFECT'.
>
> VAN C. DURRER II
> Skadden, Arps, Slate, Meagher & Flom LLP

Alt: Most retail restructurings today still rely on the old playbook – close stores, eliminate stock keeping units (SKUs) and cut administrative expenses and capital investments. However, most restructurings never address the most fundamental issue: What is our purpose? Why would a customer want to shop with us? Store and expense reductions may help in the near term, but they typically prove damaging in the long run. Fixed costs can linger due to higher inefficiencies that result from less store density and volume, and the lack of investment in infrastructure proves damaging to the brand. As a consequence of this traditional approach, some retailers head into repeat Chapter 11 filings. Retail leaders need to differentiate between short-sighted financial engineering and actions that position their organisations to own their future. This means identifying cross-industry partnerships or adjacencies, rethinking where retail happens and harnessing technology that supports the brand purpose.

FW: Are retailers finding it difficult to access loan markets and refinance existing debt in the current climate?

Durrer: As a result of the spike in leveraged buyouts of retailers during the financial crisis, many major retailers are severely overleveraged. With increasingly speculative credit ratings, it has become harder for retailers to refinance. Even profitable companies are running out of cash to service these massive debt-loans. Take Toys R Us, for example. Increasing interest rates can further compound the problem.

Alt: Good companies with good balance sheets never have a problem attracting capital. Retailers that are highly leveraged and performing poorly face the most obstacles in attracting new or replacement capital. For those in the middle of these two scenarios, refinancing is possible, but certainly not at the low interest rates of the past. We are also seeing leverage ratios come down in new refinancing, forcing equity capital to be diluted. Additionally, the recently passed US federal tax legislation will create future stress on retailers with large debt loads due to the loss of interest deductibility, if certain ratios are exceeded. The result may be more trouble ahead for these retailers.

Greenblatt: Given the cyclical nature of the retail business, many retailers depend on asset-based revolving loans, which are readily available and are less susceptible to changes in the market. Because asset-based lenders (ABLs) have a low tolerance for risk, they typically hold first lien security interests on all inventory and lend against this inventory on a formula basis that ensures the liquidation value of the inventory will always be sufficient to pay the lenders back. Accordingly, as long as retailers are operating and have inventory in their stores or distribution centres, they should have access to this inventory-based financing – and ABLs are typically comfortable rolling these loans into 'post-petition' facilities for retailers that utilise Chapter 11, although generally with very tight milestones to ensure adequate time for liquidating inventory if necessary. The availability of fresh capital to supplement ABL financing or refinance existing funded debt is much harder to attract in the retail space and is largely dependent on investor confidence in the particular business.

FW: Could you provide some insight into the operational issues that should be addressed when attempting to turn a retail business around?

Alt: Retail leaders cannot be afraid to look beyond the historical rules of restructuring. Traditional tactics, including an outsized focus on reducing back-office costs, can be detrimental to the business over time. Retailers need to devote energy to understanding today's consumer, as well as tomorrow's, from an omnichannel perspective, identifying why they choose a particular brand, product or store. With those insights in hand, retailers can pivot from defence to offence. That means not simply closing unprofitable stores or cutting inventory, but getting ahead of demand with new store experiences, channels or creative brand collaborations.

Greenblatt: Although operational issues are often specific, and vary from business to business, most retail turnarounds involve some level of focus on three areas. First, developing some form of revised business plan, including sizing and sourcing the required investment into e-commerce and omnichannel improvements. Second, supply chain management. Third, real estate rationalisation. It should come as no surprise, therefore, that many retailers are taking advantage of the restructuring tools available through the Chapter 11 process to assist in those specific areas. Chapter 11 can be helpful for attracting financing for investment, given the high priority afforded to loans that support a debtors' turnaround. Supply chain issues can vary but often require retailers to streamline their existing supplier base to obtain greater volumes from fewer suppliers to secure pricing improvements, or move to direct supplier relationships to remove the costs associated with intervening factors.

Durrer: Retailers often have valuable intellectual property (IP) assets that can be put to creative use in markets where the retailer has less of a presence. For instance, developing new international franchises where investors may be more willing and able to provide capital infusions. Retailers looking to expand e-commerce and reduce their physical presence should not overlook the opportunity to negotiate with landlords that may be more willing to settle while retailers are still in a position to offer better deals than landlords can get in bankruptcy.

FW: To what extent have you seen an increase in distressed M&A and consolidation in the sector? Does the current market present attractive opportunities to potential acquirers and investors?

Greenblatt: We have not seen a general increase in M&A activity among distressed retailers. However, we are seeing creative solutions and new forms of financing transactions emerging in the distressed retail space. The current market is presenting attractive opportunities for operators, liquidators and licensors that are interested in purchasing certain assets of distressed retailers to operate as going concerns. In addition, we are seeing certain retailers come up with other ways to raise money off their IP. For example, J. Crew recently completed a transaction in which it transferred certain of its IP assets to an unrestricted subsidiary, creating an IPCo to finance its ongoing business.

Durrer: Despite the challenges of operating in the retail sector, M&A activity has not slowed. Retail giants like Target and Walmart have acquired numerous e-commerce brands. These acquisitions illustrate the potential for a varied array of attractive synergistic opportunities. Walmart used the acquisitions to expand its online presence and close thousands of stores, whereas Target started selling the products of its e-commerce acquisition in its physical stores.

Alt: It is surprising that there has not been more collaboration by retailers – not just M&A, but also joint ventures or product and store partnerships – to either add capabilities, brands and customers or reduce operational inefficiencies. There has never been a greater and more urgent need to do this as there is today. Walmart, Target and Amazon have been the most aggressive in seeking new partners to extend their reach, but most other retailers seem to look to do this organically. As evidenced by recent deals in the healthcare space, retailers' biggest untapped opportunity may be cross-industry investments. Integrating with a technology, lifestyle or even media brand gives retailers the opportunity to think outside one-off sales and become a true platform company.

FW: What opportunities and challenges does real estate present for retailers in distress?

Durrer: The 2005 BAPCPA amendments shortened the time for debtors to assume or reject non-residential leases to an initial 120-day period, which can be extended by up to 90 days with court approval and without landlord consent. Landlords often demand consent fees and other concessions to extend past the 210-day period, but landlords seem to be losing some of this leverage. As more and more storefronts close, at least two healthy retailers have found themselves in a position to demand concessions from landlords. Nike negotiated to have its lease at Trump Tower taken over by its new landlord. Tom Ford received a $12m improvement allowance when signing its new Madison Avenue lease. It remains to be seen whether distressed retailers will be able to flip the script.

> MANY RETAILERS DEPEND ON ASSET-BASED REVOLVING LOANS, WHICH ARE READILY AVAILABLE AND ARE LESS SUSCEPTIBLE TO CHANGES IN THE MARKET.
>
> NICOLE GREENBLATT
> Kirkland & Ellis LLP

Alt: Over the past couple of years, retailers have had chances to maintain their footprint while both reducing rent and maintaining flexibility through shorter lease commitments. These actions benefit the landlords that limit vacancies, along with retailers that avoid the challenges of reducing their store count. Retailers that fail to address systemic operational challenges will be forced to shutter stores; those that are future-focused organisations will get creative. Just as developers are reimagining the mall as a place for not just shopping but amusements, fitness and residential space, retailers should be expanding their real estate horizons. Pop-ups, store-within-a-store concepts and vacant space in non-retail venues, for

example hospitals and health centres, each present new opportunities.

Greenblatt: Retailers typically lease their stores, which leads to the critical assumption and rejection determinations for retailers in Chapter 11. Both in and out of Chapter 11, retailers have been reducing their store footprints to match new business realities. There were 6752 announced retail store closings in the first three quarters of 2017 in the US, compared to just 3044 announced retail store openings over that same period. Whether the current retail distress cycle and associated continued store closings will lead to a real estate distress cycle is the subject of significant speculation. In response, to maintain tenants and traffic and avoid a 'domino' effect, landlords are becoming more flexible with respect to rent concessions.

FW: What trends do you expect to see in the retail sector over the next 12-18 months? Is the so-called 'bricks to clicks' shift set to dominate business strategies?

Alt: First, there will be a major shift in how retailers approach restructuring, fuelled by lender and creditor pressure. Given the poor outcomes many retailers have experienced, even after exiting bankruptcy, they have no choice but to rethink the process of transformation. Second, expect an uptick in cross-industry M&A. Now that there is a precedent for non-traditional dealmaking, it is retail's turn to follow suit. In some instances, this may be a way for retailers to avoid the debt burdens associated with private equity ownership, one of the main factors that has contributed to today's industry distress. The underlying theme is that all retailers, even those that are healthy today, must be willing to change if they expect to compete. There is no one-size-fits-all formula; just because a digital-first strategy works for one incumbent does not mean it is the right choice for another. Distressed retailers tend to look inward, getting tunnel vision around the balance sheet or profit and loss statements. But to ensure the longevity of their brands, they need to broaden their view.

Greenblatt: The shift toward omnichannel and e-commerce businesses is expected to continue, but we do not expect to see an elimination of brick-and-mortar retail in its entirety. In today's market, e-commerce provides shoppers with a fast, efficient and often cheaper alternative to brick-and-mortar shopping, and many consumers are looking for multiple channels to examine and purchase products. It is also expected that retailers will continue to develop their online presence by increasing funding for online development and e-commerce fulfillment.

Durrer: The retail sector can expect to see M&A activity levels consistent with 2017. At the same time, bankruptcy filings will likely continue to increase as they have in the past few years as debt maturities head toward record levels. For retailers that have already completed a successful reorganisation, the second time around will probably result in liquidation. Although the 'Amazon effect' is here to stay, there is an increasing number of exceptions. Retailers that started online, like Warby Parker and Zappos, have been opening physical locations for years. That trend saw an uptick in 2017 with several smaller e-commerce retailers opening stores and Amazon now controlling hundreds of Whole Foods locations across the US. ■

"THE UNDERLYING THEME IS THAT ALL RETAILERS, EVEN THOSE THAT ARE HEALTHY TODAY, MUST BE WILLING TO CHANGE IF THEY EXPECT TO COMPETE."

JAMES ALT
Huron