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Navigating the **Retail Apocalypse**

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The substantial stress facing the retail industry has caused thousands of store closures over the last several years, and dozens of retail bankruptcies. The "retail apocalypse" is not over, and numerous factors and circumstances suggest that retailers' struggles and difficulties will persist. Some have prognosticated that brick and mortar is dead; it is not dead, although the physical shopping experience is changing.

State of the Industry

There have been nearly 20 large retailer bankruptcies as of mid-2019 including Barney's, Payless Shoes, and Gymboree, compared to 25 such bankruptcies in 2018, 37 in 2017, and 18 in 2016. Based on *Debtwire* data, from 2016 to mid-2019, more than 100 larger retailers ($50 million+ in liabilities) filed for bankruptcy.

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Various circumstances point to retailers' rough times continuing at least in the short run. According to a recent S&P Global analysis, the credit ratings of 17% of retailers covered by S&P Global are at distressed levels. Further, retailers and observers are wary of potential negative repercussions of tariffs and international trade tensions that could lead to higher inventory costs and lower earnings. Many of the large retailer bankruptcies in 2018 and so far in 2019 were of private equity owned or formerly private equity backed companies (e.g., Payless, Sears, Toys R Us, Shopko, Claire's, to name a few).

Generally, statistics are not on the side of successful retailer reorganizations. For example, between 2006 and most of 2017, nearly half of retail bankruptcies with more than $50 million in liabilities ultimately ended in liquidation, as opposed to a reorganization or going concern sale; in contrast, according to AlixPartners Retail Bankruptcy Study, less than 10% of larger debtors in other industries ended in similar manner. In some cases, the retailer Chapter 11 started out with an eye towards reorganization, but then ended up

as a liquidation (e.g., The Sports Authority, hhgregg).

Causes of Distress In the Retail Industry

There are two main reasons for the current financial distress in the retail industry. First, there is a substantial shift in consumption patterns away from brick-and-mortar stores to online stores and e-commerce. The second primary reason causing financial distress is the level of retailers' debt. Overall, retailers typically have lower levels of debt compared to most other industries. However, as many of the recent retailer bankruptcy cases evidence, excessive debt (including debt stemming from LBO and dividend recapitalization transactions) was and remains a problem among larger retailers.

Beyond these causes, there are other causes of distress, too, such as the slowness in management at reaching out to their landlords and supply chain to seek reasonable concessions; the focus on cost-cutting, rather than top line growth; or reluctance to right-size the retailer's footprint by closing poorly-performing stores; or simply misreading consumer preferences (a la Gymboree or Aeropostale). In the end, if these issues are not addressed head-on, they will lead to significantly diminished liquidity that will leave the retailer significantly distressed with few options.

Bankruptcy Costs And Benefits

Filing for bankruptcy protection offers various benefits for struggling retailers, including authorizing the sale of retailers' going concern business or specific assets such as store locations, free and clear of liens and encumbrances, and the rejection of poorly performing or otherwise undesirable store leases.

Rejection of Unfavorable Leases and Contracts. The Bankruptcy Code gives a retailer the ability to assume or reject unexpired leases, as well as executory contracts. Assumption means the debtor (i.e., retailer) agrees to perform under the terms of the lease, provided it cures prior defaults and provides adequate assurance of future performance, while rejection means that the lease will end as a practical matter as of the date of rejection. Generally, the retailer debtor will assume the leases for stores or locations where business operations are profitable, and reject those that do not contribute to the debtor's profitability or fit within the debtor's go-forward business plan. Thus, the retailer will be able to right-size its store footprint and extricate itself from unfavorable leases, as well as extricate itself from unfavorable logistics, transportation, and marketing contracts more efficiently.

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Importantly, the size of the debtor's go-forward, post-bankruptcy store footprint must be reasonably justified based on the debtor's go-forward business plan, projections, access to funding, and other circumstances. If the store footprint is not rationalized, the retailer may be in the same or similar financial distress in the future. For instance, various retailers have filed for "Chapter 22" bankruptcy—a euphemism referring to a company's second Chapter 11 bankruptcy—like American Apparel, Wet Seal, and Payless.

Asset Sales Free and Clear of Encumbrances and Releases. In the past several years, the substantial majority of retailer bankruptcy filings were sale cases where a pre-filing sale process was undertaken or started, or "free fall" emergency filings. Further, according to *Debtwire*, during the past several years, Bankruptcy Code §363 sales of the debtor's business or substantial assets were among the most common strategies to exit bankruptcy.

Sales of retailers' assets pursuant to Code §363 (or pursuant to a plan of reorganization) may provide a number of benefits to a purchaser, including (1) obtaining the assets free and clear of liens, (2) protection against certain liabilities

and certainty with respect to the enforceability of the transaction documents as provided in the bankruptcy court's order, (3) relief from the need to obtain consent to the assignment of certain leases and contracts, (4) exemption from certain state laws, including stockholder approval requirements. Depending on all of the relevant circumstances, such benefits may come at a higher purchase price, redounding to the benefit of the retailer's estate and creditors. If the sale is contemplated to be effectuated through a plan of reorganization, the sale not only would have the benefits just mentioned, but also, among other things, provide the protective benefit of getting a release in favor of directors and officers, lenders and any equity sponsor.

Reducing Prepetition Debt. A primary reason causing financial distress for many retailers is excessive debt—typically secured ABL (asset based loan) financing. In the retailer's Chapter 11 case, such debt is often reduced through paydown with bankruptcy sale proceeds, inventory liquidation proceeds, or at times through a debt-for-equity swap implemented in a reorganization plan.

In addition to secured financing claims, retail debtors also use the bankruptcy process to address their suppliers' significant prepetition claims; such claims are typically general unsecured claims that often receive relatively small recoveries under a Chapter 11 plan. An important qualification to the foregoing is that the retail debtor must pay all Code §503(b)(9) claims (i.e., claims arising from good provided to the retailer within 20 days of the petition date), in their entirety (unless the supplier agrees otherwise), to emerge from bankruptcy, since administrative priority claims must be paid in cash on the effective date of a plan (if not earlier if ordered by the court).

Post-Confirmation Fresh Start. Post-bankruptcy, the retailer may have a significant challenge in obtaining favorable trade terms from its suppliers post-confirmation; some vendors may demand COD or CIA and some may just jump ship and cut off business relations with the retailer, and a retailer cannot continue for long on a COD/CIA basis or if it develops an inventory shortage. In some retailer reorganization cases, the debtor may try to incentivize its vendors to give favorable trade terms after emergence from the bankruptcy by, for example, the estate agreeing to waive potential avoidance actions and claims against such vendors, or giving those vendors an incentive payment. Further, the retailer having an appropriate exit financing facility should ameliorate many vendors' post-confirmation concerns as it can demonstrate it is well-capitalized.

Disadvantages of Filing for Bankruptcy. The larger and more complex the bankruptcy case, the greater the fees will likely and should be. Further, cost criticisms ignore or downplay the significant value that case professionals often add to the retailer during the pendency of its Chapter 11 case by minimizing uncertainty, maximizing value and preserving jobs.

Another major disadvantage is how the retail debtor will be subject to myriad restrictions; operating in bankruptcy may be viewed as "living in a fishbowl." The Bankruptcy Code and other applicable orders, rules and requirements may hinder the retailer's operations, business plan, and transactions in some material respects, and the bankruptcy court, creditors' committee, the U.S. Trustee, and other key players will closely monitor the debtor and its activities.

Management of a stressed retailer is faced with daily challenges, but those challenges pale in comparison to the challenges faced by management of a distressed retailer. One concern of any distressed retailer is the loss of key employees who are needed for a successful reorganization. In order to keep the management team incentivized, it is important for the Board to consider structuring a proper incentive program that will motivate management to get the best outcome.

What Should a Retailer Do When in Stress?

In general, a troubled retailer must act immediately and aggressively; denial of the business' financial

and operational predicament and the concomitant delay in addressing the retailer's problems will be value destructive. The stressed retailer must undertake realistic, expeditious, proactive strategies including the following:

Candid, Comprehensive Review: The retailer should evaluate all areas of the company including inventory management, brand strategy, and store footprint, and undertake a SWOT analysis (Strengths, Weaknesses, Opportunities, and Threats) to formulate an action list.

Attention to Top Line Growth in Addition to the Bottom Line: The retailer should focus on both the top line and the bottom line. It is instinctive for management to focus on the bottom line and cost cutting of rent, capital expenditures, employee head count and the like to improve performance, and often place inadequate focus on top line growth. Management should ask, among other questions, does the current business model work, or does a new model (e.g., expanding product lines, product improvements, store improvement, revised footprint, new advertising campaigns, incorporating new technologies, etc.) need to be employed to boost flat sales?

Workable Debt Level: The retailer should review and right-size its debt level where possible. As noted above, many distressed retailers have been overly burdened with LBO, dividend recap, or other related debts, which makes a reorganization challenging. Even some apparently successfully reorganized retailers remain highly leveraged (3-4 or more times projected EBITDA) and vulnerable in an extremely competitive business environment.

Transparency/Consensus: The retailer should be transparent with the key stakeholders such as major secured creditors, equity sponsors, suppliers, store landlords, and unions. As noted above, a key factor in many successful retailer bankruptcies (such as True Religion and Gymboree) is the speed with which the Chapter 11 case is prosecuted and administered; transparency and proactively working with the key players will usually facilitate consensus and the reorganization process.

Advisor Assistance: The retailer should promptly hire and utilize the appropriate legal and financial advisors to assist with the retailer's analysis and action list, and to provide independent, expert advice. Most management are not familiar with the challenges of stress or distress and bringing on the right advisors early can help to avert what otherwise could be an inevitable bankruptcy.

To not only survive, but to be able to thrive, retailers must undertake a forthright analysis and convert their analysis into tailored strategies taking into account, among other concerns:

- customers' changing and different demands and dynamics (g., Millennials' desire for convenience, on-demand economy, etc.);
- effective e-commerce operations;
- omni-channel expansion and integration;
- supply chain and distribution management/network issues (in response to Amazon Prime shipping, customers' demands for convenience, etc.);
- active monitoring of the retailer's real estate portfolio and store design;
- consumer data issues;
- labor issues; and
- other macroeconomic issues including potential inflationary pressures, rising wages, U.S. immigration policies, and international trade and tariff wars.

There may continue to be high numbers of retailers filing for bankruptcy protection in the short term, based on macroeconomic and industry-specific developments, but retailers that are proactive and comprehensive in their approach will be much more likely to avoid being a part of the "Retail Apocalypse."

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