AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Value & Cents

By Dr. Israel Shaked and Brad Orelowitz[1]

Understanding Retail Bankruptcy

Dr. Israel Shaked
The Michel-Shaked Group; Boston

Brad Orelowitz
The Michel-Shaked Group; Boston

Dr. Israel Shaked is the managing director of The Michel-Shaked Group and a professor of finance and economics at Boston University Questrom School of Business. Brad Orelowitz, CPA is a senior vice president with the firm and has more than 25 years of experience in finance and accounting.

Over the past year, newspapers and financial websites have been full of articles discussing the distress happening with retail companies. The number of store closures and employee layoffs is increasing every week. This year, the number of distressed retail companies has been far greater than any other year in recent history. For example, a select list of doomsayer articles on retail distress includes:

- "Retail Distress Shows No Sign of Abating, Record Store Closures Anticipated";[2]
- "The Retail Bubble Has Now Burst: Which Retailers Are in the Most Trouble?";[3]
- "The Running List of 2017 Retail Apocalypse Victims";[4]
- "2017 Retail Bankruptcies Are Piling Up (and There's No End in Sight)";[5]
- "22 Retailers That Are at Serious Risk of Bankruptcy";[6]
- "Moody's: Number of Distressed Retailers Tops Total During Financial Crisis";[7]
- "From a Risk-of-Bankruptcy Standpoint, the Retail Business Is the New Oil and Gas";[8]
- "Rise of Amazon Leaves Even More Retailers in Intensive Care";[9] and
- "Retail Is Crumbling: This Data on the Industry's Health Hasn't Been this Bad Since Great Recession."[10]

Surprisingly, this retail distress does not reflect the state of the U.S. economy. The unemployment rate is at a 16-year low, housing prices have increased steadily since 2011, and the stock markets have been hitting record levels this year.

Reasons for Financial Distress

There are two primary reasons for the financial distress. First, there is an obvious shift in consumption patterns away from brick-and-mortar stores to online stores. Department stores nationwide are losing ground to online retailers. For example, the U.S. Commerce Department reported that department store sales for December 2016 declined by 7.2 percent over the prior year and experienced 23 consecutive months of year-over-year declines. In contrast, non-store retailers (including internet and catalog sales) gained 10.4 percent over the prior December, and experienced double-digit gains in six months of the prior year.[11]

Further, quarterly retail e-commerce sales for the second quarter of 2017 increased by 16.2 percent over the second quarter of 2016. Retail sales excluding e-commerce sales increased by only 3.1 percent over this time period. In contrast, for 31 consecutive quarters, quarterly year-over-year e-commerce sales have increased by an average of 15.2 percent. Over this same time period, retail sales excluding e-commerce companies have increased by an average of 3.6 percent.[12]

The second reason causing financial distress is the level of debt at the retailer. In general, retail companies typically have lower levels of debt than most other industries. However, this does not tell the full story.

Retail companies have the fixed commitment of leases. Lease agreements for retail stores are typically operating leases in which the lessor transfers the right to use the property to the lessee. At the end of the lease agreement, the property is returned to the lessor. There is no asset or liability recognized on the lessee's balance sheet, and the lessee deducts the full operating lease payment on its income statement.

1 Dr. Shaked also served for 20 years as a coordinating editor for the *ABI Journal* and is a co-author of *A Practical Guide to Bankruptcy Valuation, Second Edition* (ABI 2017), available for purchase at store.abi.org.
2 *ABL Advisor*, June 22, 2017.
3 Douglas A. McIntyre, 24/7 Wall St., April 18, 2017.
4 Corinne Ruff and Ben Unglesbee, RetailDive.com, July 5, 2017.
5 Daniel B. Kline, *The Motley Fool*, May 19, 2017.
6 Brad Tuttle, Time.com, June 13, 2017.
7 Kevin McCoy, *USA Today*, June 9, 2017.
8 Tonya Garcia, MarketWatch, March 9, 2017.
9 Matt Egan, CNN Money, March 9, 2017.
10 Kaya Yurieff, TheStreet, March 5, 2017.
11 Jordan Yadoo, "Retail Sales Figures Bear Out America's Storefront-to-Online Shift," Bloomberg, Jan. 13, 2017, *available at* bloomberg.com/news/articles/2017-01-13/retail-sales-figures-bear-out-america-s-storefront-to-online-shift (last visited Sept. 21, 2017).
12 U.S. Census Bureau, Monthly and Annual Retail Trade, Latest Quarterly E-Commerce Report, *available at* census.gov/retail/mrts/www/data/excel/tsadjustedsales.xls (last visited Oct. 4, 2017).

On the other hand, in a capital lease, the risks of ownership are transferred to the lessee. At the end of the lease, the lessee owns the property. In this lease, the lessee recognizes the asset and the liability on the balance sheet, and deducts depreciation and the interest component of the lease payment (if the lease life exceeds 75 percent of the life of the asset, ownership transfers at the end of the lease, there is an option to purchase the asset at the end of the lease at a bargain price, and the present value of the lease payments is greater than 90 percent of the fair-market value of the asset).

When analyzing the fixed commitments of a debtor, it is irrelevant whether the leases are capital or operating leases. This is an accounting distinction on whether to capitalize or expense the lease. However, all stakeholders have to understand that from economic and credit-risk perspectives, the distinction is irrelevant, as the company in both types of leases has a fixed obligation that must be met. Even though operating leases do not appear on the balance sheet, it is critical to account for these fixed obligations when analyzing a company's creditworthiness.

A common rule-of-thumb method of analyzing leasehold commitments is to multiply the current rent by eight to provide a rough estimate of capitalized leases. An analyst can then add this estimated amount to the on-balance-sheet debt. This serves as a proxy for total debt.

These excessive levels of debt (as well as the pressure from online retailers) are changing the retail landscape. In 2017, the number of retail bankruptcies has been substantially higher than in previous years. There are also many retailers facing distress, and as indicated in Table 1, they are closing record numbers of stores in 2017. The list is current as of September 2017; however, the number of store closures varies by source, and these estimates are changing frequently.

Furthermore, consider the following list of rating agencies' opinions, as shown in Table 2. The struggles facing these retailers have led to an overall deterioration in credit rating.

In general, these companies have excessive debt and/or are facing stiff competition from Amazon and other successful online retailers. Retail distress as a result of a high level of leverage is not new. For example, consider the classic case of Macy's.

Retail Distress Is Not a New Phenomenon

On Oct. 21, 1985, the senior management of R.H. Macy & Co. Inc. announced a plan to take the retailer private in a $3.58 billion leveraged buyout (LBO). Macy's operated 83 stores in 12 states containing approximately 22.3 million square feet of store space and employed more than 54,000 workers. The proposal, the first LBO proposal for a major retailer, offered shareholders $70 per share, an amount that represented about 19 times the 1985 earnings and 2.7 times book value. Following the announcement, the stock, which had closed at 47-and-1/8th the previous day, surged 16-and-1/8th per share to close at 63-and-1/4th. In making the buyout announcement, Macy's Chair/CEO Edward S. Finkelstein and President/COO Mark S. Handler indicated that their new management group would include "an unusually large number" of Macy's executives. In fact, the desire to retain top-management talent was one of the major reasons for the buyout proposal. Equally important was management's desire to free itself from the pressures of the short-term performance that is typically required in a public company. At the time of the announcement, details of the financing structure were not yet finalized.

Two months after the initial buyout news, financing difficulties forced the management group to lower its offer to $68 per share. The company's board approved this proposal the following month.

From 1980-84, Macy's net operating margins and profit margins were significantly better than its peer groups, averaging 11.2 versus 7.2 percent and 4.9 versus 3.4 percent, respectively. Furthermore, Macy's sales per square foot, a rough measure of productivity, averaged $137 during this five-year period, compared to an average of $108 for the peer group. Macy's management attributed the company's historical growth and profitability to strategies of store expansion and modernization, innovative merchandising, productivity and cost control, and management development. Under Finkelstein's stewardship, Macy's emerged to become one of the nation's most successful department store chains. Its management was considered one of the best in the industry, and its expansion program was considered highly successful.

However, the LBO placed a significant debt-repayment burden on the company. Prior to the LBO, Macy's debt-to-equity ratio was 0.14:1 (for every dollar of equity, the company had 14 cents of debt). Following the LBO, this ratio increased to 10:1. In other words, for every dollar of equity, the company had $10 of debt. And this was *before* considering the fixed commitments of its leases.

Prior to the LBO, Macy's Beta (*i.e.*, Macy's stock volatility relative to the overall market) was 1.10. Following its LBO, Macy's Beta, reflecting its new level of debt, was 6.15. This is an extremely high level of market risk, and any downturn in the market is exacerbated by a company's high level of debt.

Following the LBO, the company improved operationally. However, with debt levels as significant as Macy's were, there was very little margin to weather any decline in finan-

Table 1

Company	Store Closings	Company	Store Closings
RadioShack	1,000	Gordmans Stores	106
Ascena Retail Group	667	Michael Kors	100
Payless Shoe Source	512	Staples	70
rue21	400	Macy's	68
Gymboree	350	Perfumania	64
The Limited	250	Abercrombie & Fitch	60
Family Christian	240	G-III Apparel Group	60
hhgregg	220	Guess Inc.	60
Gap Inc.	200	Vitamin World	51
Bebe Stores	180	Gander Mountain	30
Sears and Kmart	180	True Religion	27
Wet Seal	171	Eastern Mountain Sports	27
Crocs	160	American Eagle Outfitters	25
Game Stop	150	Bob's Stores	21
J.C. Penney	138	Tailored Brands	11
BCBG Max Azria	120	Neiman Marcus	10
American Apparel	110	**Total Closings**	**5,838**

cial performance. Macy's filed for bankruptcy in January 1992, during the first recession following its LBO.

Three decades after Macy's LBO, excessive debt is still plaguing retailers. In 2005, Toys "R" Us was taken private by Kohlberg Kravis Roberts, Bain Capital Private Equity and Vornado Realty Trust. Before its LBO, its debt on the balance sheet was $2.3 billion. With an EBITDA of more than $800 million, its ratio of debt-to-EBITDA was under 3x. At the end of 2016, its debt was approximately $4.8 billion, with EBITDA dropping to a little more than $600 million. Its debt-to-EBITDA ratio soared to 7.6x. Similarly, its interest-coverage ratios (EBITDA divided by interest — a measure of how easily a company can pay its interest expense) decreased from over 6x prior to its LBO to 1.4x in 2016. Toys "R" Us filed for bankruptcy in September 2017. When accounting for its lease obligations, the ratio of total debt (including an estimate for capitalized operating leases)-to-EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) almost doubles between the LBO and the end of 2016.

Are Retailers Good LBO and Dividend-Recapitalization Candidates?

One wonders whether retailers in general are good LBO and dividend-recapitalization candidates. In their investment banking book, Rosenbaum and Pearl discuss the ideal LBO target:

Characteristics of a Strong LBO Candidate:

- Strong Cash Flow Generation;
- Leading and Defensible Market Positions;
- Growth Opportunities;
- Efficiency Enhancement Opportunities;
- Low Capex Requirements;
- Strong Asset Base; [and]
- Proven Management Team.[13]

While the authors routinely observe many retail LBOs, retail is not the ideal LBO candidate. For example, retail is cyclical, so strong cash-flow generation is not consistent. Brick-and-mortar retailers are facing tremendous market pressure from online retailers, which dilutes market share and impacts growth opportunities. Retailers with multiple locations require capex for store improvements, which are usually an ongoing (and expensive) process. Furthermore, retailers do not have a strong asset base. Typically, their only asset of any value is inventory, as they lease their stores. While many retailers do have intellectual property, this is usually not sufficient collateral for an LBO. Therefore, retailers are not ideal targets for an LBO.

Nevertheless, the retail industry has long been a favorite industry for private-equity (PE) investors. Over the past several years, PE firms have invested in thousands of deals. A select list of PE involvement in distressed retailers is shown in Table 3.

13 Joshua Rosenbaum and Joshua Pearl, *Investment Banking: Valuation, Leveraged Buyouts and Mergers & Acquisitions*, p. 168 (John Wiley & Sons 2009).

Table 2

	Moody's			S&P			
Entity	Date	Rating	Rating Note	Date	Rating	Rating Note	Outlook
Charlotte Russe Holding Inc.	05/25/17	Caa1	Downgrade	02/06/17	CCC+	Downgrade	Negative
Charming Charlie LLC	12/22/16	Caa1	Downgrade	02/10/17	CCC+	Downgrade	Negative
Claire's Stores Inc.	10/03/16	Ca	Downgrade	10/04/16	CC	—	Negative
				08/18/16	CC	Downgrade	—
				05/11/16	CCC-	—	Negative
Cole Haan LLC	05/11/17	Caa1	Downgrade				
David's Bridal Inc.	09/19/16	Caa1	Affirm	03/24/17	CCC+	Downgrade	Negative
J.Crew Group Inc.	07/18/17	Caa2	Reinstated	07/14/17	CCC+	Upgrade	Negative
				06/14/17	CC	Downgrade	Negative
				12/13/16	CCC-	Downgrade	Negative
Neiman Marcus Group Inc.	03/15/17	Caa2	Downgrade	06/30/17	CCC	Downgrade	Negative
				02/09/17	CCC+	Downgrade	Negative
Nine West Holdings Inc.	01/19/17	Caa3	Downgrade	05/12/17	CCC-	Downgrade	Negative
	08/26/16	Caa2	Downgrade	08/26/16	CCC	Downgrade	Negative
Quiksilver Inc.				06/28/17	CCC+	Downgrade	Negative
Sears Holding Corp.	01/20/17	Caa2	Downgrade				
TOMS Shoes LLC	07/17/17	Caa2	Downgrade	08/15/17	CCC+	Downgrade	Negative
True Religion Apparel Inc.	07/07/17	WR	Withdrawn	08/07/17	NR	Withdrawn	Not Rated
	07/06/17	Ca	Affirm	07/05/17	D	Downgrade	—
	01/13/17	Ca	Downgrade				
Vince Holding Corp.	06/22/17	Caa2	Downgrade				
	04/20/17	Caa1	Downgrade				
	10/28/16	B3	Downgrade				

Historically, retailers have been attractive targets for PE firms for a number of reasons. Many of the retailers targeted by PE firms are household names. For these companies, it is easier to convince lenders as to the company's long-term viability. Through dividend recapitalizations, PE firms are able to limit their downside risk.

In *Payless ShoeSource*, a case in which the authors were involved, the company's leverage was tripled at the time of the LBO.[14] Moreover, only four months following the LBO, a dividend of $225 million was paid to the company's PE owners, almost as much as their equity investment just four months earlier. The full amount was financed by the issuance of new debt, which greatly reduced their downside risk. A year later, the company borrowed an additional $145 million to declare a dividend of approximately $127 million. These three transactions, the LBO and the two dividend recapitalizations, backed by solvency opinions, increased the company's debt from $126 million to $706 million in only 17 months. However, not one single penny of the new borrowing went to the company's benefit, as the loan proceeds went to selling shareholders and the company's PE owners, and to cover the transaction costs. All of this was done at a time when Payless's same-store sales (a measure of growth in stores that have been open for more than one year) was declining. This left Payless with very little equity cushion to weather the storm in bad times.

When a retailer retains an investment bank to explore an LBO, the investment bank typically approaches multiple potential investors, including strategic investors and financial investors. This also attracts the interest of multiple PE firms, and a bidding war ensues. Therefore, it is often the case that the price paid is high. This high price results in an equity investment from the PE firms and a large amount of debt from lenders. As a result, the PE firms are under pressure to realize returns as soon as possible. This can be done through an exit (*e.g.*, an IPO or a sale). An IPO and a sale are complicated and lengthy processes.

A dividend is the easiest way to get a return on investment. However, if a company does not have the liquidity to pay the dividend, it can do a dividend recapitalization (borrowing funds to declare out as dividends) with support from banks and capital markets.

The Dividend-Recapitalization Puzzle

The puzzle is, if this is so risky, why is this done? There are multiple stakeholders at these companies, such as PE firms and other equityholders, lenders, management, employees, landlords and vendors. As previously discussed, the PE firms and equityholders minimize their future risk through dividends. Lenders have client relationships with PE firms. They earn significant fees from these firms, and typically syndicate the loans, thereby reducing their risk. Management often has an equity stake in the company post-LBO, and benefits as the PE firms and equityholders benefit. However, at risk are employees, landlords and vendors, all of whom have had no say in dividend recapitalizations.

Potential Preemptive Measures

Management and financial advisors are in a continuous search for preemptive measures that will minimize the likelihood of distress. A proactive management team can mitigate some of these risks by continuously analyzing store profitability and cost-cutting measures. Management should attempt to close the less-profitable stores as soon as their lease agreements allow.

It is important for management to understand the risks associated with dividend recapitalizations and communicate these risks to stakeholders (including PE firms). There is no fair consideration in these transactions, and they expose key players such as significant shareholders, lenders and board members to fraudulent conveyance claims. abi

Reprinted with permission from the ABI Journal, Vol. XXXVI, No. 11, November 2017.

The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit abi.org.

Table 3

Entity	Private-Equity Firm
Charlotte Russe Inc.	Advent International Corp.
Charming Charlie LLC	TSG Consumer Partners LLC
	THL Credit Group LP
	Hancock Park Associates Inc.
Claire's Stores Inc.	Apollo Global Manangement LLC
	Tri-Artisan Capital Partners LLC
Cole Haan LLC	Apax Partners (UK) Ltd.
David's Bridal Inc.	Clayton Dubilier & Rice LLC
	Leonard Green & Partners LP
	AlpInvest Partners BV
	Crescent Capital Group
	Hartford Mezzanine & PE Group
	Stockwell Capital LLC
	TPG Growth LLC
Eddie Bauer LLC	Golden Gate Private Equity Inc.
J.Crew Group Inc.	Leonard Green & Partners LP
	NB Alterative Advisers LLC
	TPG Capital LLC
Neiman Marcus Group Inc.	Ares Private Equity Group
	Canada Pension Plan Investment Board
	Pantheon Ventures (UK) LLP
	aPriori Capital Partners LP
	Leonard Green & Partners LP
	TPG Capital LLC
	Warburg Pincus LLC
Nine West Holdings Inc.	Sycamore Partners Management LP
	CNL Fund Advisors Co.
Payless Holdings LLC	Golden Gate Private Equity Inc.
	Blum Capital Partners LP
TOMS Shoes LLC	Bain Capital Private Equity LP
True Religion Apparel Inc.	TowerBrook Capital Partners LP
Vince Holding Corp.	Sun Capital Partners Inc.

Note: Certain PE firms have already exited their positions on the list.

14 All information regarding Payless ShoeSource (or any other company mentioned in this article) is strictly from publicly available data sources.