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RETAIL

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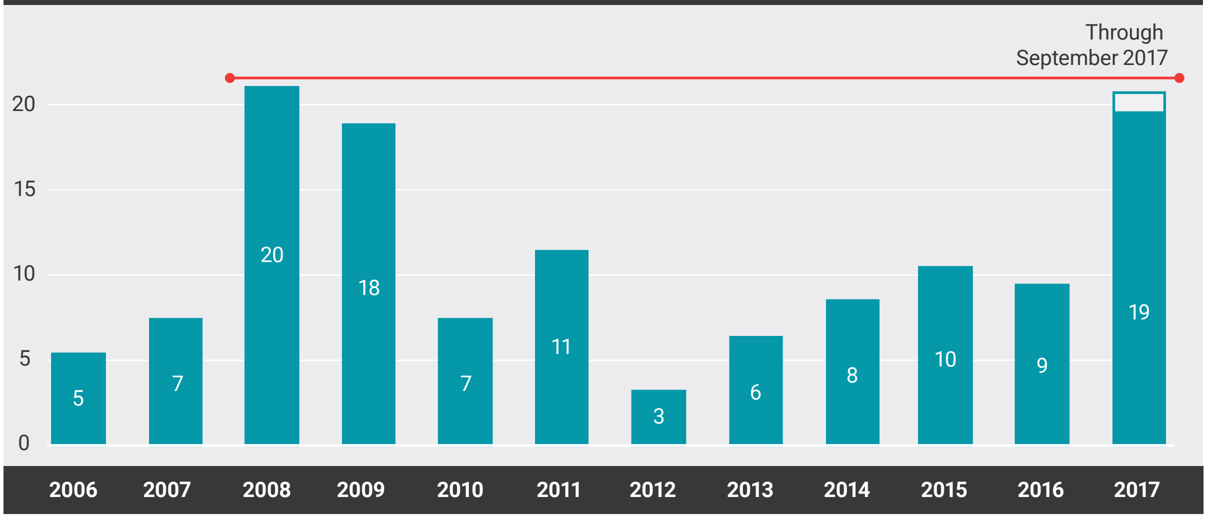
AlixPartners retail bankruptcy study: why so many retailers liquidate—and how to improve the odds

A record number of retailers have filed for bankruptcy as of September 2017, with 19 Chapter 11 filings in the first nine months of the year (figure 1). That exceeds the number of retailers that have filed for bankruptcy in any full year since 2009—and there's a significant possibility that we will surpass the Great Recession's record, 20 filings in 2008. First-half sales have been soft in most categories, and with many retailers moving into the most-capital-intensive period of the year, filings may even accelerate.

For the most part, the challenges traditional retailers face are obvious to any shopper: the rise of e-commerce and the resulting declines in brick-and-mortar foot traffic. Those obstacles have caused a self-perpetuating spiral as more stores close, leaving consumers with fewer and fewer reasons to venture into shopping malls. Even some of the strongest retail management teams have struggled to respond, hamstrung by the challenges of adapting store portfolios and supply chain infrastructures to keep pace with rapidly evolving shopping habits.

For several years, we have actively tracked retail bankruptcies to better understand how to best preserve value for our clients—and our research results are stark: since 2006, almost half of all retailers that have filed for bankruptcy have ultimately liquidated (figure 2), compared with less than 10% across nonretail industries. With no signs of an abatement in retail headwinds, it's worth exploring the causes of that high liquidation rate, as well as the steps distressed retailers could take to save themselves from the same fate.

FIGURE 1: RETAIL BANKRUPTCY FILINGS BY YEAR



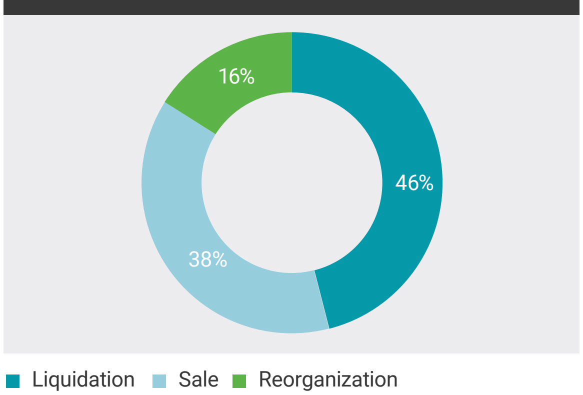
Sources: AlixPartners analysis, The Deal.
AlixPartners' analysis includes retail bankrucptcy filings from January 1, 2006 to September 2017 that had more than $50 million in liabilities.

A SHORT RUNWAY...

Changes to the United States Bankruptcy Code in 2005 dramatically altered the timeline for retail restructurings, effectively giving companies only a *few months* to obtain approval for a sale or reorganization before being forced into liquidation. The specific driver of that accelerated timeline involved modifications to Section 365(d)(4), which limited the period for rejecting leases to a maximum of 210 days, absent individual landlord approvals.

The accelerated timeline is most clearly visible in the 18 full retail reorganizations that have occurred since 2006 (the other 45 going-concern reorganizations took the form of asset sales). Of those 17 examples, only 5 debtors took more than 200 days between filing and plan confirmation, and the remaining 12 debtors took, on average, only 130 days to secure a confirmed plan.

FIGURE 2: RETAIL BANKRUPTCY OUTCOMES



Note: Percents do not sum to 100 because of rounding.
Sources: AlixPartners analysis, The Deal.
Analysis includes retail bankruptcy filings from January 1, 2006 to September 2017 that had more than $50 million in liabilities. Excludes filings whose outcomes are not yet known.

Rejecting leases *before* they are assumed creates a general unsecured claim that sits below senior lenders, but rejecting leases *after* they are assumed creates an administrative claim above senior lenders. As a result, it is typical for lenders to enforce a timeline that ensures that all unwanted leases are rejected well in advance of the 210-day deadline. And because it can take up to 90 days to run in-store going-out-of-business sales, lenders frequently attempt to mandate in less than 120 days the decision on whether to liquidate or reorganize a debtor.

As an example, when H. H. Gregg filed for bankruptcy in March 2017, the terms of its debtor-in-possession financing required the company (1) to file a motion approving bidding procedures for a sale process within 3 days, (2) to select a stalking-horse bidder (an initial bidder chosen by the debtor to buy its assets ahead of a possible auction) within 14 days, and (3) to conduct an auction within 49 days.

Prior to the 2005 changes, retailers typically spent several years in bankruptcy—time they could use to test merchandising changes, turn around marginal stores, and try out new concepts during a holiday season.

...AND A HIGH BAR

In contrast to many other businesses that hold a substantial amount of fixed assets, retailers typically have significant capital tied up in easy-to-sell inventory. Inventory can make up as much as 50% of a typical retailer's assets and can usually be sold rapidly and at attractive prices. For example, liquidators paid 111% of cost for Anna's Linens' inventory in 2015 and 97% for Coldwater Creek's in 2014. This is problematic for a retailer looking to reorganize, because to emerge from bankruptcy, a debtor must pass the best-interests test, proving that each class of creditor does better under a plan of reorganization than if the company liquidated.

When a liquidation can be accomplished easily and with good returns, it can be difficult for debtors to achieve consensus for a recapitalization or sale that delivers results superior to the recovery hurdle that the liquidation value of the debtor's inventory implicitly sets. The challenge becomes even greater when restructuring timelines are as short as 120 days.

For retailers, the challenges of effectuating a successful restructuring are further compounded by another 2005 change to the Bankruptcy Code: the introduction of Section 503(b)(9). This provision gives administrative-priority status to vendor claims for the value of goods sold in the 20 days leading up to a bankruptcy filing. Administrative priority claims must be paid in cash on the effective date of a plan of reorganization, meaning that a retailer must pay for goods subject to Section 503(b)(9) in order to emerge from bankruptcy as a reorganized going concern. Circuit City's 2008 slide into liquidation offers a prime example: its wind-down was almost certainly hastened by the $350 million of 503(b)(9) claims that were filed with the Bankruptcy Court.

IMPROVING THE ODDS

If experience tells us that the best-case scenario for a retailer filing for bankruptcy is only three or four months before liquidation becomes almost inevitable, then prepetition planning is imperative. Accordingly, distressed retailers should consider taking the following steps to improve their prospects for a successful turnaround.

1. Buy time

Distressed retailers need the longest runway possible to achieve an out-of-court turnaround or a successful bankruptcy. A critical first step is to develop a detailed understanding of the business's liquidity position, debt covenants, and other potential filing triggers. At the same time, to maximize the runway available, the company should urgently implement a variety of liquidity-generating initiatives such as the curtailment of capital expenditures, reductions in general and administrative expenses, and actions to optimize its borrowing base.

Additional runway is important both because it creates time to negotiate a turnaround or planned restructuring and because it gives the flexibility to choose the best time to file—for instance, possibly before the winter holidays, so as to maximize the ease of selling excess inventory, or after the holidays, when retailers are likely to have more cash on hand.

2. Be realistic

In the same way that retail *turnaround successes* have advance planning in common, retail *turnaround failures* share a predictable sequence of missteps. First, a company believes it can avoid a bankruptcy filing through an amendment to its existing debt facilities, through a debt refinancing, or through a pickup in sales, which never materializes. Then it files for bankruptcy, planning to close only its lowest-performing stores. Next, it announces that a reorganization couldn't be orchestrated in the time available, and going-out-of-business sales begin at all stores.

Perhaps the most important element of a successful turnaround is the development of a truly feasible plan from the start. If there's a prospect of achieving an out-of-court turnaround, then a strategy based on store closures, marketing optimization, and merchandising transformation may be the right one. But if a filing seems unavoidable, then preserving cash may provide the best footing for an in-court turnaround, thereby reducing reliance on lenders for debtor-in-possession financing and limiting the leverage that lenders can exert to mandate an unrealistically aggressive bankruptcy timeline.

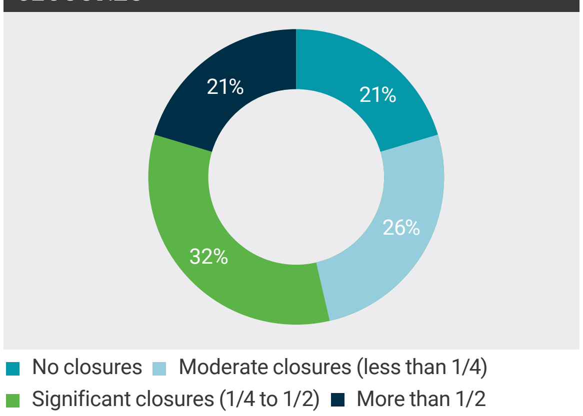
3. Understand the market

An understanding of viable capital-market options is essential to any sound plan. There are relatively few distressed retail investors, so once a retailer has a realistic and credible restructuring plan in hand, it's vital to begin a dialogue with the capital markets well in advance of when a filing becomes necessary. Retailers should also make sure they consult existing lenders—both to explore their lenders' appetite to support a reorganization and to evaluate alternatives and pricing for potential debtor-in-possession financing. The goal is to secure either a stalking-horse bidder or support for a prearranged plan prior to the point of filing. Our research illustrates the importance of that goal: since 2006, all but one successful reorganization of a retailer with more than $500 million in liabilities were based on either prearranged or a prenegotiated plans.

4. Focus on operations

Even though retail bankruptcies have become tougher since 2005, the bankruptcy process still offers valuable and otherwise unavailable tools for retail turnarounds. The right to reject store leases is perhaps the most valuable of those tools. In fact, store closures have been undertaken in the vast majority of successful restructurings since 2006. Of store-based retailers that emerged from bankruptcy as going concerns (some were online or catalog-based retailers), four out every five of them closed stores in bankruptcy, and more than half closed more than a quarter of their prefiling store base (figure 3).

FIGURE 3: RETAIL BANKRUPTCY STORE CLOSURES



Source: AlixPartners analysis, The Deal.
Includes retail bankruptcy filings from January 1, 2006 to September 2017 that had more than $50 million in liabilities. Excludes non-store-based retailers and filings whose outcomes are not yet known.

A retailer should conduct a four-wall profitability analysis well in advance of a filing, and in many cases, also initiate rent negotiations with landlords against the backdrop of a potential filing—both to achieve rent savings and to inform store closure decisions with an understanding of likely go-forward lease expenses.

In addition to store closures, the right to reject other executory contracts is a powerful tool for the renegotiation of marketing, logistics, transportation, and other third-party agreements, and it can provide leverage with vendors—even before a filing.

FINAL THOUGHTS

Against the backdrop of a more restrictive Bankruptcy Code and increasingly challenging retail conditions, successful retail restructurings are arguably more difficult than ever. But viable restructuring alternatives that can preserve significant value still exist. Just look at the other half of retail Chapter 11 filings that resulted in successful reorganizations.

The good news for management teams, sponsors, and lenders is that—at least in our experience—the ultimate success of a retail restructuring rests largely in the hands of the main stakeholders. In many cases, acting early, strategically, and decisively can make all the difference. A

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