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How to Keep a Retailer Out of Bankruptcy

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Retailers throughout the United States have been facing significant challenges. Looking back at 2016, there were a number of well-known retail names (e.g., American Apparel, Pac Sun, Sports Authority, Aeropostale) that met their demise; while holiday season sales increased 4% and full-year sales increased 2.4% , a significant portion of that growth was driven by online sales. As of the first quarter of 2017, several national retailers have announced plans to close a large number of stores during the year (e.g., Macy's, Sears, BCBG), more well-known retailers have filed for bankruptcy (Limited Stores, Wet Seal, Eastern Mountain Sports, Bob's Stores), and almost 15% of all retailers covered by Moody's are rated Caa or Ca, the highest proportion since 2009.

The challenges facing store-based retailers, the focus of this article, are significant and are likely to continue throughout 2017, and possibly beyond. They include:

- Competition from newer, on-line retailers – E-commerce's share of U.S. retail sales has increased from 5% in 2010 to almost 12% in 2016, and is projected to reach 15-17% by 2020. Online retail sales grew 15.6% in 2016, the fastest pace in three years, largely due to Amazon, which accounted for approximately two-thirds of that growth.
- Complex supply chains – Retailers have vendors in all corners of the globe, which makes the logistics of getting products in the hands of consumers where and when they want them daunting, especially considering potential disruptions to transportation (e.g., port strikes, shipping company bankruptcies, trade tensions, etc.)
- Increasing labor costs – The national unemployment rate, which was 4.8% in January 2017, has been steadily declining over the last few years and is leading to competition for employees and increasing wage costs. Another driver has been higher minimum wages legislated by some municipalities and proposed by others to address concerns about economic inequality.
- Changes in consumer spending habits – Consumers have been shifting their spending from tangible personal products to services, such as travel, restaurants, and fitness. In addition, telecommunications is taking up a larger share of household budgets, particularly for teens and younger adults – the average U.S. household spends approximately $2,500 per year to be connected to TVs, smartphones and computers. Further, many consumers were scarred by the financial impact of the Great Recession and have remained cautious about both consumer debt and discretionary spending.
- Heightened pricing pressure and competition, for both online and store-based retailers – Walmart and Amazon, both low priced retailers with enormous economies of scale, have dominant positions in their respective strongholds (brick and mortar and e-commerce, respectively), and drive pricing decisions for many of their competitors. Pricing pressure is exacerbated by the pricing transparency that the Internet offers to consumers. Competition has also intensified as foreign retailers (e.g., Zara, H&M, Uniqlo) have successfully entered and are expanding in the U.S., e-commerce and brick and mortar retail specialists are invading each other's turf, and "made-to-measure" upstarts provide customized products at affordable prices.
- Competing demands for capital – there are numerous investments that retailers need to make just to keep pace with their competition, including store renovations and refurbishments, website maintenance (including online stores and mobile accessibility), and software applications (such as inventory management/ optimization, data analytics, supply chain management, and point-of-sale systems). In addition, there has been pressure building on store-based retailers to provide consumers with a more engaging shopping experience to set them apart from online retailers, and an investment in technology is often required to facilitate it.

Be Proactive

Given the strategic, operational and financial challenges retailers face, the potential for financial stress or distress is real. Therefore, it is incumbent upon retailers to identify and implement operational improvements that can materially improve liquidity and financial performance. The following analyses and action steps can be helpful approaches in driving improved financial performance.

Inventory – analysis and reporting of what is selling (and is not selling) by category and SKU ensures that retailers are purchasing only the items that need to be replenished and selling those that are excess or obsolete (E&O). E&O is a major source of liquidity and a process should be in place to sell it regularly; there is a robust secondary market in the U.S. for E&O and there are a number of advisors that can assist retailers in monetizing it. In addition, sophisticated forecasting tools have been developed which, when combined with a well thought out supply chain, further enable retailers to maintain lower inventory levels and reduce their working capital requirements.

4-Wall Analysis – EBITDA for each location, excluding corporate and support expenses, is calculated to identify negative EBITDA locations. Further analysis is conducted to diagnose the reasons for poor performance (poor store-level employee and/or inventory management, bad location or lease, excessive discounting, etc.). Healthy or stressed retailers may have time to rehabilitate negative EBITDA stores, but those in financial distress would close them quickly to stem the bleeding and improve cash flow.

Analysis of Promotions and Discounts – promotions and discounts have become pervasive in retail and are often seen as a necessary evil to drive traffic. However, given today's sophisticated software, it is possible to analyze the impact and effectiveness of discounts and promotions by region, store, product category, and SKU, among many other variables. This enables retailers to deploy promotions and discounts judiciously and bring much needed dollars to the bottom line.

Analysis of Corporate Overhead – in good times, corporate headcount and other overhead expenses can balloon. An analysis of general and administrative overhead to identify and eliminate non-value added positions, delegate activities to the store level where possible, and reduce other costs is prudent.

In The Event of Distress

In the event of financial distress, a retailer must work closely with its vendors, landlords, lender, board of directors, owner, counsel and financial advisor – its advisors and key parties-in-interest – to turn around the business and stay out of bankruptcy. What are the other key drivers of a successful restructuring? They include:

Short-term liquidity to buy time for analysis, development of a plan and negotiations with constituents. For many retailers, one bad holiday season can lead to liquidity issues; yet diagnosing the issues, and developing and implementing a turnaround plan, can take much longer. Without adequate liquidity, the risk of running out of time increases dramatically. Following are potential sources of liquidity that retailers can tap to buy time.

- Liquidation of E&O inventory – as noted earlier, selling E&O inventory through the secondary market can quickly bring in much needed cash
- Trade support – obtaining trade support depends upon the outcome of negotiations with individual firms or with a group of firms, but the likelihood of receiving support is much higher if the retailer and its vendors have maintained good relationships despite the financial stress on both sides, and if vendors believe that they benefit more from the retailer continuing as a going concern than if it liquidates
- Pledge the brand – some retailers have not tapped their brand name as a specific source of value. However, the credit markets are much more knowledgeable about brand value than they used to be since there are a number of recognized appraisal firms that service the market.
- Encumber unencumbered assets, if any – companies that have not encumbered certain assets, such as real estate or their brand names, can buy time by using those assets as collateral for incremental borrowing
- Support from owner and/or lender – lenders are often reluctant to be THE solution to a liquidity issue; however, they are more likely to work with a borrower when there is shared pain/participation (e.g., owner is willing to provide an equity infusion; the management team pledges to reduce overhead and store level expenses; vendor and landlord constituencies will be part of the solution, etc.), and there is transparency with respect to the borrower's plan and ongoing implementation efforts

Transparency for the parties-in-interest who will be involved in negotiations regarding their indebtedness. Without information, indebted parties will have a difficult time accepting a retailer's restructuring proposal. For example, if a retailer requests a rent deferral or reduction, providing store profit and loss statements to the landlord which indicate a location issue is critical to getting agreement on the proposal. Similarly, vendors that are asked to agree to a discount on their outstanding balances and to continue shipping to a retailer will want to see a plan that illustrates the company's ability to pay for new shipments and pay off the outstanding balance. Further down the road, sharing information on a turnaround plan's progress, even if the progress is slow, engenders much needed good will.

A 4-wall analysis that identifies the locations that will be part of the company in the future. As described previously, this fact-based analysis is critical for retailers to objectively identify stores which are cash drains, provide a road map for the future of the organization, and provide direction in analyzing store support and overhead costs.

Development of a comprehensive plan to put the company on the right path to meet its obligations going forward. A comprehensive turnaround plan enables a retailer to sell its restructuring concept to its parties-in-interest and helps management manage the turnaround process. In addition to financial information, a turnaround plan should include action steps, timelines and people responsible for each element of implementation so that both the company and individuals are held accountable. Management should also include a schedule for reporting so that interested parties are continually informed.

Long-term financing, if significant capital expenditures are required. Retailers with outdated stores, lack of operational and financial information, and a limited online presence will likely be in need of significant investment, either in the form of equity or debt capital, in order to remain competitive in the long term.

Conclusion

Brick and mortar retailers will be facing formidable issues in 2017 and beyond. While many companies have continued to thrive in this difficult environment, others have had a harder time and will need to be proactive in diagnosing and addressing their financial and operational issues. Retailers that take a thoughtful approach to planning and implementation of a turnaround plan and bring their advisors and parties-in-interest into the conversation will be much more likely to stay out of bankruptcy, remain viable and hopefully, flourish.
