NOVEMBER 2015

AlixPartners retail bankruptcy study

Since the 2005 changes to the US Bankruptcy Code, a staggering 55% of retail bankruptcies have ultimately ended in liquidation.[1] This is in marked contrast to other industries, wherein as few as one in 20 debtors faces the same fate;[2] and it is a trend that shows no sign of abating. Indeed, according to a recent AlixPartners study, in the past 18 months only six debtors successfully reorganized or were sold – the other 10 were liquidated.[3]

There are clear causes for the high level of retail liquidations, but retailers can take several effective steps to improve their odds for successful turnarounds.

THE ROOT CAUSE OF RETAIL LIQUIDATIONS: A SHORT RUNWAY

The reasons retailers enter bankruptcy are varied and complex, but the primary reason they struggle to avoid liquidation is consistent and simple: bankruptcy gives retailers only a very short time frame to execute a reorganization or sale.

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

[1] AlixPartners' analysis includes all resolved retail bankruptcy filings from January 1, 2006, to June 30, 2015, that had more than $50 million in liabilities. Restaurants and grocers are excluded. Repeat filings are included even if liabilities were less than $50 million in the second filing. Study comprises 93 filings and 80 companies (Thirteen companies entered bankruptcy twice during the study period.)

[2] Fitch Ratings, April 2013: Based on bankruptcy case study database of 86 total US corporate bankruptcy cases, which includes 14 liquidations; 20 cases and 11 liquidations were retailers.

[3] Eighteen months, from January 1, 2014, to June 30, 2015.

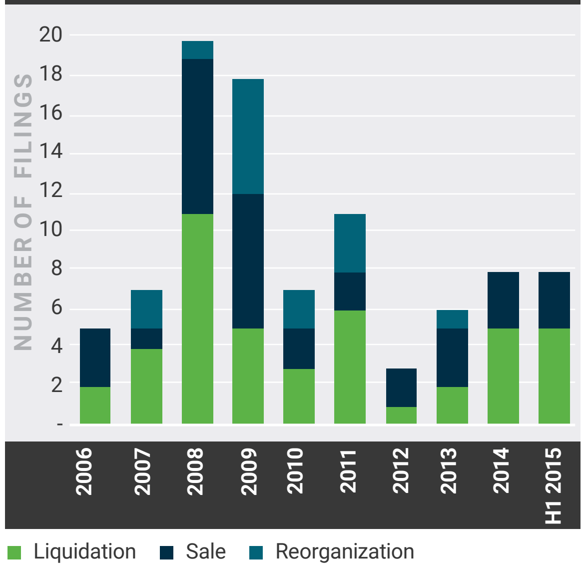
the 2005 Bankruptcy Code dramatically altered that timeline, effectively giving retailers only a *few months* to obtain approval for a sale or reorganization before getting forced into liquidation. This accelerated time is most clearly visible in the 16 full reorganizations in our study. (The other 33 going concerns took the form of Section 363 sales). Only Nebraska Book Co., Shane Co., and Hancock Fabrics, Inc., took more than 200 days between filing and plan confirmation; the other 13 reorganizations took an average of only 120 days to obtain plan confirmation.

The driver of that accelerated timeline is Section 365(d)(4) of the code, which provides a maximum of just 210 days before unassumed store leases are deemed assumed—absent individual landlord approvals. Given that rejecting leases *before* they are assumed creates a general unsecured claim that sits below senior lenders but that rejecting leases *after* they are assumed creates an administrative claim above senior lenders, senior lenders will typically enforce a timeline that ensures all unwanted leases get 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, senior lenders frequently attempt in as little as 120 days to mandate a decision on whether to liquidate or reorganize a debtor. For example, when Ritz Camera filed for bankruptcy on June 22, 2012, the provisions of its debtor-in-possession loan required it to have a stalking-horse bidder (an initial bidder chosen by the debtor to buy its assets ahead of a possible auction) by August 16 (just 55 days later), an auction by September 6 (76 days later), and a sale complete by September 14 (84 days later).

OTHER CHALLENGES RETAILERS FACE: A HIGH BAR TO EMERGE

Within such a short window of time, a retailer must also jump over a high bar to successfully emerge from bankruptcy. The height of the bar is driven largely by the liquid nature of a retailer's assets. In contrast to other industries that are heavy in fixed assets, retailers typically have asset bases that are heavy in easy-to-sell inventory. Inventory can make up as much as 50% of a typical retailer's assets and can usually be sold 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—a much higher bar whereby liquidation can be accomplished easily and with good returns.

FIGURE 1: RETAIL BANKRUPTCY OUTCOMES BY FILING YEAR (ADJUSTED FOR REPEATS, JANUARY 2006 TO JUNE 2015)



Source: AlixPartners

In addition, another important 2005 change to the Bankruptcy Code was the introduction of Section 503(b)(9), which gives "administrative priority" status to vendor claims for the value of goods sold in the 20 days immediately preceding a bankruptcy filing. That effectively means a retailer must pay for those goods in their entirety in order to leave bankruptcy, because administrative-priority claims must be paid in cash on the effective date of a plan. That change raises a significant hurdle for many retailers' emergence. For example, Circuit City's 2008 slide into liquidation was certainly hastened by the $350 million of 503(b)(9) claims that had been filed with the court.

The importance of planning

If a best-case scenario for a retail debtor gives the debtor only three or four months before liquidation becomes almost inevitable, then prebankruptcy-petition planning is imperative. As such, distressed retailers should consider the following steps to potentially improve their prospects for a successful turnaround.

1 Buy time

Distressed retailers need the lengthiest runway possible to achieve an out-of-court turnaround or a well-planned bankruptcy. A critical first step is to develop a detailed understanding of the retailer's liquidity position, debt covenants, and other potential filing triggers. At the same time, so as to maximize the runway available, the company should also implement a variety of liquidity-generating initiatives such as curtailment of capital expenditures, reductions in general and administrative expenses, and optimization of borrowing base. The runway is important both because it provides 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 in order 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

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 or through a debt refinancing or through a pickup in sales that never materializes; then it enters bankruptcy planning to close only its lowest-performing stores; and next, it announces that a reorganization couldn't be orchestrated 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 right. But if a filing seems unavoidable, then preserving cash may help fund an in-court turnaround.

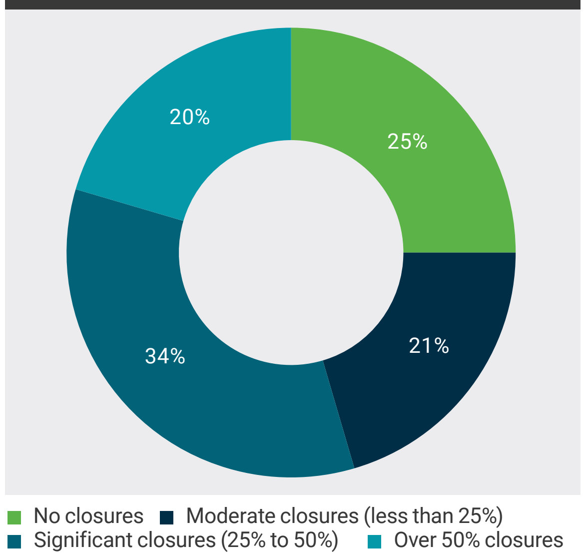
3 Understand the market

An understanding of viable capital markets options is a pillar of a sound plan. There are relatively few distressed retail investors, and based on a viable restructuring plan, it's vital to begin a dialogue with them well in advance of a filing. As time progresses, retailers should also make sure they consult existing lenders both to explore the potential structure of debtor-in-possession financing and to assess the lenders' appetite to support reorganization. The goal is to secure either a stalking-horse bidder or support for a prearranged plan prior to the point of filing. The importance of this is clear from the fact that in our study, every successful reorganization of a debtor with more than $500 million in liabilities was based on either a prearranged or a prenegotiated plan.

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 ability to reject store leases is perhaps the most valuable of the tools, and store closures were used as part of almost every successful restructuring in our study. Of 44 store-based retailers that emerged as going concerns (5 of the 49 going concerns were online or catalog-based retailers), 33 of them closed stores in bankruptcy, and 24 closed more than 25% of their stores (figure 2). 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 potential go-forward lease expenses. In addition to store closures, the ability to reject other executory contracts is a powerful tool for renegotiating and improving marketing, logistics, transportation, and other third-party agreements.

FIGURE 2: EXTENT OF STORE CLOSURES IN BANKRUPTCY (SALES AND REORGANIZATIONS ONLY, EXCLUDES LIQUIDATIONS)



Source: AlixPartners

PLAN, DON'T PERISH

Long after the Great Recession has ended, labor cost increases, declining mall traffic, spotty consumer demand, and the continued growth of e-commerce will ensure that retail remains a tough business. Indeed, retail bankruptcies have been on the rise since 2012, and *as many retailers filed for bankruptcy in the first six months of 2015 as in all of 2014*.

For retailers looking to manage the challenges associated with a potential filing, the key lies in planning. As tough as retail bankruptcies can be, almost half of all retailers in our study emerged as going concerns. Retailers that want to be able to do the same in the future should begin planning long before the bankruptcy filing date, should file with either a stalking-horse bidder or a prearranged plan, and should embrace a restructuring that incorporates significant operational improvement. **A**

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