INTELLIGENCE

What the Bankruptcy Onslaught Means for the Future of Retail

BY CATHALEEN CHEN

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Filing for Chapter 11 looks different now. Here's what retailers and their partners need to know.

NEW YORK, United States — When Modell's Sporting Goods filed for Chapter 11 Bankruptcy in March, it was supposed to be a standard liquidation: the New York-based retailer would conduct going-out-of-business sales at its 134 locations and then close the stores. The proceeds would go to creditors.

Just days later, many US states went into lockdown. Modell's stores closed, making going-out-of-business sales impossible. On March 27, a New Jersey bankruptcy judge granted Modell's a month-long reprieve, which was later extended to the end of May.

Retailers are caught in an unusual, if not unprecedented situation: they are starting to go bankrupt because the economy is shut down, but the bankruptcy process itself is a casualty of the lockdowns.

The repercussions go far beyond a few delays: in the US, companies use the bankruptcy process to reduce unmanageable debt loads, wiggle out of orders for unsellable clothes and cancel onerous store leases. Those benefits are difficult to realise when stores are closed and the legal system has slowed to a crawl.

"In a normal bankruptcy process, the path forward is clear: there's reorganisation and a cleaned up balance sheet," said Matt Kaden, managing director at financial services firm MMG Advisors. "So much of a bankruptcy is based on being able to liquidate assets, but what happens now when that's impossible?"

In fashion, the list of bankrupt brands is growing longer by the day: it includes large retailers Neiman Marcus, plus smaller brands including True Religion, John Varvatos. A filing by J.C. Penney is expected soon. Credit agency Moody's is expecting the default rate for retail and apparel companies to surge between now and next year, from a pre-Coronavirus estimate of 6 percent to 17.2 percent.

J.Crew and Neiman Marcus both filed for Chapter 11 bankruptcy protection last week, complete with plans for how they could emerge from the process with healthy finances in the space of a few months.

Some financial experts argue that filing for bankruptcy makes more sense than ever as retailers can be protected from economic uncertainty for a few months. A backlogged bankruptcy court could mean that a judge would be more deferential toward the company's management decisions, said Susheel Karpalani, partner at law firm Quinn Emanuel.

Companies may be able to count on their investors to keep them afloat by exchanging debt for increased ownership stakes, Karpalani said. The investors would be gambling that their stakes would generate higher returns than the portion of their loans they would be able to collect from a bankrupt retailer.

J.Crew effectively handed the reins to its top creditors, including hedge fund Anchorage Capital, agreeing to convert $1.7 billion of debt into equity. Pier 1 Imports took this approach as well after the worsening pandemic dimmed the furniture retailer's chances of finding a buyer in a bankruptcy auction.

Nothing is certain in bankruptcy, however, and the stakes are high. Companies must indicate a recovery is possible within six months of filing, or creditors can urge a bankruptcy judge to force a liquidation. Covid-19 has made this process even more unpredictable, as even the most meticulous recovery plans could be derailed if the economic climate turns out to be worse than expected, or new outbreaks force stores to close again.

"The ultimate goal of a chapter 11 plan is to file a plan of reorganisation, which will be voted on by creditors," said Joseph Lemkin, partner at law firm Stark & Stark. "In order to be approved by the court, the plan must be feasible. Given the uncertainty in retail, it may be difficult for retailers to come up with...a [feasible] proposed plan."

Get the Money Up Front

When a corporation files for Chapter 11 bankruptcy, it typically follows one of three scenarios: liquidation (Roberto Cavalli), reorganisation (J.Crew) or sale (Barneys New York), though some level of liquidation is likely to take place in every case.

In each scenario, companies need financing to keep operating while they work through the bankruptcy process. This money is known as a debtor-in-possession, or DIP, loan, typically backed by a retailer's assets. Neiman Marcus, for example, was in negotiation with its lenders for weeks leading up to its filing on May 7. Before it had secured its current $675 million in financing, a challenger group of investors, including distress-focused investment firm Mudrick Capital Management L, submitted a $700 million DIP proposal pushing for Neiman to sell itself.

Retailers must normally liquidate some assets to secure DIP funding in order to guarantee the lenders at least some of their cash back. Often part of any bankruptcy proceeding, brands and store operators have to monetise their existing inventory in order to continue operating during the bankruptcy. Rent, for instance, is still an expense during the course of restructuring. Liquidation will be hard to do as long as stores are closed.

Early bankruptcy filers have another advantage though: banks still have plenty of money to lend to distressed retailers. That may not be true if a wave of large brands file for Chapter 11 all at once.

Retailers, healthy and distressed alike, have tapped their credit lines with banks, which are now "overextended and cautious about the sector," said Danielle Garno, the head of the fashion, beauty and luxury goods practice at law firm Cozen O'Connor.

"If everyone files at the same time, they'll be fighting for the same fewer dollars," she said.

It might be smart to file for bankruptcy sooner rather than later to avoid the crush, according to Karpalani. "In the airline industry, those that were in bankruptcy early and emerged early were on a stronger footing – maybe it'll be similar in retail," he said.

The Takeover Opportunity

Hedge funds with existing stakes in struggling retailers see bankruptcy as a way to acquire companies at bargain prices, such as in the case of J.Crew and its hedge fund debtor, Anchorage Capital. Neiman Marcus has a similar arrangement where creditors have exchanged its $5 billion of debt for equity in the company, though it's unclear which types of firms are leading the deal.

Many funds were already in the market for acquisitions, and they see opportunities in the plunging valuations for once-hot direct-to-consumer brands and struggling mall retailers alike.

"Hedge funds have been sitting on a fair amount of cash and now they figure the returns they can generate by providing fairly secure financing [to bankrupt retailers] exceeds what they can get in other places," said Karpalani of Quinn Emanuel.

Bankruptcies Upon Bankruptcies

Investors will likely have their pick of retailers to buy.

When a big box retailer like J.C.Penney goes under, there will be a ripple effect in the retail landscape, starting with vendors and neighbouring stores in the mall.

"People can hate on J.C.Penney all they want but that is an anchor store at a mall, and the mall will be a dead mall unless they add something else to fill that space," said Gabriella Santaniello, founder of consultancy A Line Partners.

Some vendors rely on one retailer for the bulk of their business. When that business is unable to pay its bills and liquidates, these suppliers find themselves at the back of the line for repayment, behind DIP lenders.

This kind of loss could trigger bankruptcies of their own. After Barneys went bankrupt, for instance, a number of emerging jewellery brands lost 50 percent or more of their business.

The Survivor Opportunity

As more incumbents fail to measure up, those that do adapt to the new normal will end up thriving, said Mickey Chadha, vice president of Moody's Investors Service. They'll also benefit from having fewer competitors. Case in point? The demise of Barneys paved the way for Saks Fifth Avenue and Neiman Marcus to be the only two national luxury retail department store chains in the US.

"The stronger players going into the crisis will take more market share when they come out," he said.

For some retailers, bankruptcy may be the only path to joining the ranks of survivors. Neiman Marcus and J.Crew are both successfully refinanced their debt and are on the restructuring trajectory, rather than liquidation. Because of the uncertainties in retail ahead and the temporary impossibility of liquidation, stakeholders in the industry have reason to be optimistic about recovery, according to Jonathan Treiber, chief executive of retail management platform RevTrax.

"Sometimes the situation is so bad that the retailer actually has leverage, and right now I think that's true because they're facing unprecedented risk," he said. "This requires lenders to be much more flexible than before, when liquidation was still an option."

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