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

Turnaround Topics

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Why Are U.S. Retail Reorganizations So Hard?

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The bankruptcy and ultimate demise of The Sports Authority earlier this year has once again stirred up conversation in restructuring circles about the strong tendency of failed retailers to end in liquidation rather than emerge as reorganized businesses. It has become an accepted storyline that troubled retail chains, more than other industry sectors, face an uphill battle to successfully reorganize absent a near-consensual RSA or plan among key creditor classes upon a chapter 11 filing and/or an accelerated auction process.

Once leading names in their respective categories, retailers such as Circuit City and Linens 'n Things preceded The Sports Authority as failed reorganizations that disappeared from the retail landscape. This has seemingly become more the rule than the exception. The Sports Authority, once the dominant sporting goods chain throughout the 1990s and still a formidable competitor in the category, went to considerable lengths to avoid such a fate but was nonetheless left with little choice but to liquidate. It had intended to pursue a dual-track bankruptcy, closing nearly one-half of its 465 stores and reorganizing around the remainder via an auction sale. It was not to be for a host of reasons, not the least of which was a lack of interest from potential going-concern buyers. Such an outcome increasingly seems to be the path of least resistance for many failed retailers.

Those who believe this theme tend to pin the blame on key provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) that favor the interests of certain creditors over a debtor, especially so when the debtor is a retailer, and thus makes reorganization less likely. The provisions most often cited by critics of BAPCPA pertain to a shortened timeframe for a debtor to make lease-rejection decisions to a maximum of 210 days absent a lessor's written consent pursuant to § 365(d)(4), and the treatment of goods received by a debtor in the ordinary course of business within 20 days of a filing date as administrative-expense claims that must be paid in full upon emergence pursuant to § 503(b)(9). But can this be proven empirically? This article will measure the degree to which failed retailers liquidate more frequently than other filers, to ascertain whether BAPCPA has impacted this trend, and analyze some pre-filing quantitative distinctions between debtors that liquidated and those that reorganized.

S&P Capital IQ's bankruptcy database was searched for chapter 11 filings that occurred between Jan. 1, 2000, and June 30, 2016, where a debtor had at least $100 million in debt or assets at the time of filing, as well as publicly available financial statements in the periods preceding the filing. This search criteria might have introduced selection bias since they produced larger size cases — 633 in total — where we could perform comparative financial analyses on these debtors in their respective pre-filing periods. Of these 633 chapter 11 cases, 75 (12 percent) were identified as retailers and 558 were classified as other industry sectors.

Identifying liquidation outcomes is not as straightforward as it may seem. Outcomes for these debtors both in terms of their bankruptcy case dispositions and their business statuses were evaluated, which allowed us to define "liquidation" outcomes in two distinct ways: those debtors that liquidated as a chapter 11 case outcome, and others that emerged from bankruptcy only to go out of business in subsequent years. This is a subtle — but material — distinction.

1 The views expressed herein are those of the authors and are not necessarily the views of FTI Consulting, Inc. or its management, subsidiaries, affiliates or other professionals.

A company such as Deb Shops, which filed for bankruptcy in 2011 and was sold in auction to a creditor who operated it for a couple of years before finally liquidating it, is technically a successful reorganization despite its ultimate fate as an extinct business. There were other similar outcomes within the group. In total, 159 companies (25 percent) that liquidated as a chapter 11 outcome were identified, but 201 (32 percent) were classified by S&P's Capital IQ as "liquidated/out of business" (meaning that 42 companies emerged from chapter 11 only to later fail in subsequent years). The appropriate categorization (either as reorganized or liquidated) of these 42 companies was debated in this study before it was decided that the data would be tabulated twice and presented both ways.

Comparing the Frequencies of Liquidation Outcomes

This analysis produced two unambiguous findings: The proportion of retail debtors that liquidate is indeed far greater than the proportion of non-retailer debtors, but, perhaps surprisingly, this proportion has not changed appreciably since BAPCPA's effective date — for neither retailers nor nonretailers. Regardless of how we define "liquidation," large retailers liquidated at least twice as frequently as nonretailers over the 15-year period that was analyzed. When restricting the definition of "liquidation" to only those debtors that liquidated in the context of a chapter 11 case, Exhibit 1 (Measurement 1) indicates that nearly one-half of 75 retailers that filed for chapter 11

Exhibit 1: Evaluation of Large Chapter 11 Case Outcomes Since 2000

			Nonretail			Retail			Total	
			# of Cases	% of Cases		# of Cases	% of Cases		# of Cases	% of Cases
Measurement 1:[A]										
	Pre-BAPCPA									
		Reorganized or Acquired	175	76.1		17	53.1		192	73.3
		Liquidation	55	23.9		15	46.9		70	26.7
		Total	230	100.0		32	100.0		262	100.0
	Post-BAPCPA									
		Reorganized or Acquired	260	79.3		22	51.2		282	76.0
		Liquidation	68	20.7		21	48.8		89	24.0
		Total	328	100.0		43	100.0		371	100.0
	Total									
		Reorganized or Acquired	435	78.0		39	52.0		474	74.9
		Liquidation	123	22.0		36	48.0		159	25.1
		Total	558	100.0		75	100.0		633	100.0
Measurement 2:[B]										
	Pre-BAPCPA									
		Reorganized or Acquired	155	67.4		9	28.1		164	62.6
		Liquidation or Out of Business	75	32.6		23	71.9		98	37.4
		Total	230	100.0		32	100.0		262	100.0
	Post-BAPCPA									
		Reorganized or Acquired	249	75.9		19	44.2		268	72.2
		Liquidation or Out of Business	79	24.1		24	55.8		103	27.8
		Total	328	100.0		43	100.0		371	100.0
	Total									
		Reorganized or Acquired	404	72.4		28	37.3		432	68.2
		Liquidation or Out of Business	154	27.6		47	62.7		201	31.8
		Total	558	100.0		75	100.0		633	100.0

Notes:
[A] Measurement 1 only counts chapter 11 cases with liquidation outcomes.
[B] Measurement 2 counts chapter 11 cases with liquidation outcomes, as well as reorganized/emerged companies whose status is listed as "out of business" or "liquidating" per S&P's Capital IQ.

- Data set consists of 633 chapter 11 cases since 2000 where the debtor had assets or liabilities of at least $100 million at the time of filing and had public financial statements prior to filing.
- Cutoff date for Pre-/Post-BAPCPA catorgorizations is Oct. 1, 2005.

Source: S&P's Capital IQ and FTI Consulting analyses.

liquidated compared to less than 25 percent of 558 nonretailers. This is a statistically significant difference in the proportions between these two groups.

As for BAPCPA's purported negative impact on chapter 11 outcomes, the statistics are not very persuasive. (Approximately 41 percent of the 633 cases occurred pre-BAPCPA, and 59 percent were post-BAPCPA filings.) The frequency of retailer liquidations increased only slightly (from 47 percent to 49 percent) since BAPCPA's effective date and decreased for nonretailers (24 percent to 21 percent). This analysis provides little, if any, evidence that changes to the Bankruptcy Code arising from BAPCPA have caused liquidation outcomes to increase notably for large debtors — retailers or not — as is widely believed.

When defining liquidation more broadly, as previously discussed (Measurement 2 in Exhibit 1), the frequency of liquidations has actually decreased sharply in the post-BAPCPA period, namely due to 28 debtors that reorganized in the early 2000s and later went out of business — but in all fairness, they had more time to "re-fail" than post-BAPCPA reorganizations, of which only 14 have since re-failed. Such a pronounced decrease in post-BAPCPA liquidation frequency using this broader measurement is a highly counterintuitive result that leads us to conclude that this narrow definition of liquidation (Measurement 1 in Exhibit 1) is the more appropriate measure to use when estimating liquidation frequencies; to reiterate, here we see little change in liquidation rates between the pre- and post-BAPCPA periods.

Acknowledging the possibility that the selection bias previously mentioned might be coming into play here, smaller retail chains that did not make the size cut might have experienced greater liquidation rates than large chains since the passage of BAPCPA, as they may not have possessed the clout with landlords or trade creditors to avoid liquidation (or the IT systems and other resources needed to assess store performance, negotiate with landlords and make timely lease-rejection decisions). For larger chains,

Exhibit 2: Comparative Financial Ratio Averages of Debtors Prior to Filing

		Nonretail			Retail			Total	
Outcome		**Reorg.**	**Liq.**		**Reorg.**	**Liq.**		**Reorg.**	**Liq.**
# of Companies	Period	435	123		39	36		474	159
Debt to Assets	FY	83.4%	57.9%		52.9%	41.9%		80.6%	54.0%
	FY-1	64.2%	47.5%		47.5%	33.3%		63.0%	44.1%
	FY-2	58.3%	43.9%		43.6%	33.7%		57.4%	41.7%
Adj. Debt to Adj. Assets	FY	85.4%	64.4%		70.0%	71.5%		84.0%	65.4%
	FY-1	68.3%	54.8%		69.1%	64.3%		68.4%	56.3%
	FY-2	62.9%	51.8%		66.3%	65.9%		63.2%	55.4%
EBITDA Margin	FY	9.1%	-7.2%		2.3%	-0.4%		8.6%	-6.5%
	FY-1	11.0%	-5.9%		4.3%	2.4%		10.7%	-1.9%
	FY-2	12.5%	-8.0%		6.1%	4.1%		12.3%	-2.7%
EBITDAR Margin	FY	12.2%	-4.3%		7.8%	6.6%		11.9%	-2.6%
	FY-1	13.7%	-2.8%		10.4%	8.6%		13.7%	2.0%
	FY-2	15.1%	-4.6%		11.8%	10.2%		15.2%	1.5%
EBITDA to Debt	FY	8.7%	-6.0%		7.9%	-4.3%		8.7%	-6.2%
	FY-1	13.3%	-0.5%		15.2%	21.8%		13.5%	3.3%
	FY-3	16.6%	6.8%		20.9%	58.6%		17.1%	16.8%
EBITDAR to Adj. Debt	FY	9.3%	0.5%		10.0%	9.9%		9.3%	2.3%
	FY-1	13.1%	2.3%		13.2%	13.7%		13.2%	4.7%
	FY-2	15.3%	9.6%		15.8%	15.9%		15.4%	11.1%
Accounts Payable to Assets	FY	5.7%	8.8%		7.3%	7.6%		5.8%	8.6%
	FY-1	5.6%	8.3%		7.6%	8.1%		5.8%	8.3%
	FY-2	5.7%	8.2%		7.4%	8.0%		5.8%	8.1%

Notes:
- FY is the nearest fiscal year end prior to the debtor's filing date, FY-1 is the fiscal year prior to that, etc.
- Rent expense was multiplied by 8 for purposes of capitalizing operating leases, a common convention used by the rating agencies.
- EBITDAR is EBITDA plus rent expense.
- Adjusted Debt is total debt plus rent expense x 8.
- Leverage metric is the reciprocal of total debt to EBITDA (or adjusted debt to EBITDAR) because summary statistics used with these standard metrics are distorted by companies with negative EBITDA.

Source: S&P's Capital IQ and FTI Consulting analyses.

the analysis certainly indicates that liquidation frequency has not changed appreciably since October 2005 despite BAPCPA's revisions to the Bankruptcy Code that would seem to diminish the likelihood of a successful reorganization, especially for retailers.

Notable Distinctions Between Debtors that Lived to Fight Another Day and Those that Went Away

Are there discernable pre-filing financial characteristics among those debtors that reorganized and those that liquidated? There are, as seen in Exhibit 2, where select financial ratio averages in the three years prior to a filing for the two groups are compared.

These ratios were adjusted wherever appropriate to effectively capitalize operating leases and characterize them as debt, a common practice among rating agencies and one especially relevant to retailers, which tend to have significant operating lease obligations in the form of rent expenses. These adjustments make ratio comparisons between retailers and nonretailers more meaningful. We also used the reciprocal of the traditional debt-to-EBITDA metric (and adjusted debt-to-EBITDAR) when measuring leverage in order to properly capture the impact of companies with negative operating income on these ratio averages.

Hardly surprising, nonretail debtors that liquidated were far less operationally profitable and far more leveraged in the three-year period prior to filing than those that reorganized, suggesting irreparable operating deficiencies and the inadequacy of debt relief to restore financial soundness and business viability. In fact, those that liquidated were (on average) operationally unprofitable in all three years prior to filing. With respect to EBITDA margins and EBITDA-to-debt ratios, there was a significant divide in these metrics between those that liquidated and those that reorganized.

Debt-to-assets proved to be an inadequate measure of leverage and a poor indicator of case outcomes, as debtors that reorganized consistently showed higher leverage by this metric than those that liquidated. Leverage is best measured relative to operating performance than as a balance-sheet ratio.

Lastly, nonretail debtors that liquidated had a notably higher proportion of accounts payable relative to total assets. This suggests that trade vendors, suppliers and other sources of unsecured debt might have had an upper hand in these outcomes.

Perhaps most striking were the results for retail debtors, where ratio averages for those that liquidated and those that reorganized were mostly similar — just slightly worse for retailers that liquidated — in sharp contrast to the findings for nonretailers, where such differences were stark. For retail debtors, there were few clear financial distinctions between the wheat and chaff, and the difference between those that went on to emerge and those that went away could not be detected merely from these ratios. This suggests that other factors, presumably nonquantitative ones, likely played an outsized role in these case outcomes. A debtor's bankruptcy preparedness in advance of a filing, its relations and dialogues with suppliers and other creditor groups and its relative size and importance to the retail community all undoubtedly play key roles in its fate, and this appears to be especially critical for retail debtors.

Why Is It Hard to Reorganize a Retail Debtor?

One plausible explanation as to why retail debtors have historically liquidated with greater frequency than nonretailers is that liquidation values for failed retailers have improved markedly over the last decade or so, making it harder for opportunistic going-concern buyers to prevail in an auction process. Auction sales for a retailer often receive multiple bids from professional liquidators, sometimes acting in tandem. For example, only two qualified bids were received during the official auction process for The Sports Authority, both from liquidator groups.

Bids from liquidators often guarantee that a debtor will nearly or fully recover the cost value of their inventory. Moreover, intellectual property of retailers, such as customer lists, trademarks, websites, IT and real estate assets, have become valuable assets that are bid on aggressively by bidders not identified as going-concern buyers. All told, the liquidation value of the estate of a retail debtor often exceeds the going-concern value of the bids received for select clusters of stores. Moreover, the timeline to complete a retail liquidation is typically shorter today than it was a decade or two ago. It is an expeditious process that brings large sums of money into the estate fairly quickly — and senior creditors like that.

Lease obligations also present a daunting challenge for retailers hoping to reorganize, as they typically represent sizeable financial commitments that cannot be expunged in bankruptcy in the same manner that funded debt often is. Retailers are not thought of as highly leveraged businesses, and they rarely are with respect to funded debt, but when operating leases are "brought on balance sheet," they typically increase leverage metrics materially. Unlike unsecured and undersecured debt, whose scheduled interest and principal payments are suspended during the duration of bankruptcy, post-petition rent obligations must be paid timely and in full during the pendency of the case until a lease is rejected, meaning that the cash-flow relief provided by chapter 11 to debtors with funded debt does not similarly extend to debtors with material lease obligations.

Leases can be shed by a debtor, often at a manageable cost, via lease rejection pursuant to §§ 365(a) and 502(b)(6), a process that enables a debtor to extricate itself from unfavorable leases and/or underperforming stores. For leases assumed by a debtor, these obligations will survive intact unless a landlord agrees to contractual concessions, which is far from certain, especially for desirable store locations. For a sizeable retail debtor, addressing store leases can be a protracted, time-consuming and contentious process with many disparate landlord groups, some of whom would prefer to take back their space rather than make concessions to a struggling tenant. In short, lease obligations are a uniquely burdensome form of debt for failed retail chains and arguably create a higher hurdle for reorganizing (than would an equivalent amount of funded debt) due to their treatment in bankruptcy.

Lastly, debtor-in-possession (DIP) lenders to retailers in chapter 11 are providing shorter time frames, less new money and more aggressive event milestones in their financing agreements than they did in the pre-recession era. Retailers with DIP financing are on a tight leash, and a debtor's inability to run within these parameters can suddenly send a reorganization effort hurdling toward a grim outcome.

Unfortunately, the harsh reality that the American retail landscape is overstored seems to have finally set in as the online channel continues to take sales and market shares from traditional stores. Many marginally profitable or unprofitable mid-sized retail chains that have struggled to stay relevant for years are vulnerable and arguably expendable. These developments do not bode favorably for the reorganization prospects of retail debtors — especially those in "freefall" chapter 11 filings — and it is unlikely that current bankruptcy outcome trends will reverse anytime soon. abi

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