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Private Equity Has a Retail Problem



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By nearly all accounts, 2017 was a solid year for U.S. private equity (PE). Leveraged buy-out (LBO) deal counts and debt-financing totals had their best year since 2007. Money inflows into new buyout funds were also strong. However, one aspect of the PE world sputtered with relatively little attention: PE-owned companies have accounted for an increasing share of all large chapter 11 filings since early 2016, which is mostly attributable to their disproportionate share of failed retailers.

There is a fair amount of research (though much of it was conducted prior to 2010) devoted to evaluating the relative default rates of PE-owned companies compared to default rates for the rest of the corporate speculative-grade universe, with most studies (including a June 2014 report from Moody's) concluding that historical default rates of PE-owned companies are not greater than that of similarly rated firms that are not sponsor owned. That is not the purpose of this article, however; rather, all large chapter 11 filings since mid-2011 will be analyzed, along with identified notable trends and characteristics of PE-owned and non-PE-owned filers.

There were some distinct differences by industry sector. Non-PE-owned chapter 11 filers had significantly more exposure to the energy, metals and mining, and real estate and lodging sectors, which collectively accounted for 35 percent of their chapter 11 filings versus 14 percent for corresponding PE-owned filers. However, the retail sector has been another story, accounting for 17 percent of chapter 11 filings by PE-owned companies since 2011 versus 7 percent for non-PE-owned filers.

While the travails of the U.S. retail sector have been covered exhaustively by the business media, little of this coverage has focused on the fact that many of the reorganizing retailers were owned by PE sponsors. In 2017 alone, Payless ShoeSource, Gymboree, Toys 'R Us, rue21 and True Religion

were some prominent retailers that filed for bankruptcy — and all were PE-owned. Furthermore, there are several other PE-owned retailers on the brink that will likely have to reorganize in 2018.

In an industry beset by unprecedented challenges to its fundamental business, highly leveraged retailers would have to be considered among its most likely casualties. Clearly, it is the wrong time to be a leveraged retailer. So how did we get to this moment?

The authors queried *The Deal Pipeline* and identified 481 large chapter 11 filings (liabilities in excess of \$100 million at filing) from mid-2011 through mid-2017. Here are the findings:

- Approximately 25 percent of these 481 filings over this six-year period were PE-owned companies, but that percentage moved appreciably higher in 2016 and 2017 (as shown in the exhibit), with 40 percent of chapter 11 filers in 2017 (through September) being PE-owned companies (26 of 65).
- Overall, 55 percent (24 of 44) of chapter 11 filings by retailers since 2011 occurred in 2016 or 2017, but for PE-owned retailers, 80 percent (16 of 20) of such filings occurred in 2016 or 2017.
- Two-thirds (16 of 24) of chapter 11 filings by retailers in 2016 and 2017 were sponsor-owned/controlled companies. Six of these 16 PE-owned retail filings in 2016-17 were buyouts done in 2005-08, two were done in 2010, and eight were done in 2012-15. On average, these chapter 11 filings occurred 6.3 years after a buyout was consummated, with a median time of 5.5 years.
- The retail sector accounted for a disproportionate share of LBO busts. LBOs of retailers accounted for 9 percent of all large LBO transactions (>\$50 million) completed in the last decade, yet accounted for 17 percent of chapter 11 filings by PE-owned companies in the most recent six-year period. In short, private equity appears to have a retail problem.

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

Private Equity and Retail: So Happy Together?

Generally speaking, the attraction of retailers to PE sponsors is something of a curiosity, and more so in recent years as the sector's performance has deteriorated. Retailing is widely regarded as a highly cyclical, low-growth, low-margin business — not exactly qualities that would be considered compelling to buyout sponsors — selling mostly commodity-type goods to fickle customers. Moreover, the migration of sales from stores to the online channel at an accelerating rate has further weakened traditional retailers to varying degrees. Earnings before interest, tax, depreciation and amortization (EBITDA) margins that were typically in the low-to-mid teens range a decade ago have frequently slumped by several hundred basis points in recent years.

Large retailers have long recognized that their businesses were not well suited for high leverage and are usually conservatively capitalized. On average, publicly owned retail chains carry funded debt at approximately two times EBITDA, even with recently weaker operating results — considerably lower than leverage employed in other industry sectors. Many public retailers have minimal amounts of funded debt other than revolving lines of credit for seasonal borrowing needs. Others have resisted activist overtures to monetize owned real estate via sale-leaseback transactions that would likely ratchet up leverage — with Macy's and Dillard's among those not yielding to such calls.

The retail sector's experimentation with high leverage back in the early 1990s did not end well, and the history of large LBO failures dating back three decades is well represented by retailers, most famously Federated Department Stores and Revco Drug Stores, and most recently Toys 'R Us. Despite these considerations, the allure of retailers as buyout targets has persisted over the years, albeit with diminished interest of late. An evaluation of 85 large (>\$50 million) retail LBOs since 2007 (whether they have filed for bankruptcy or not) sheds some light on this incongruity.

Key Findings

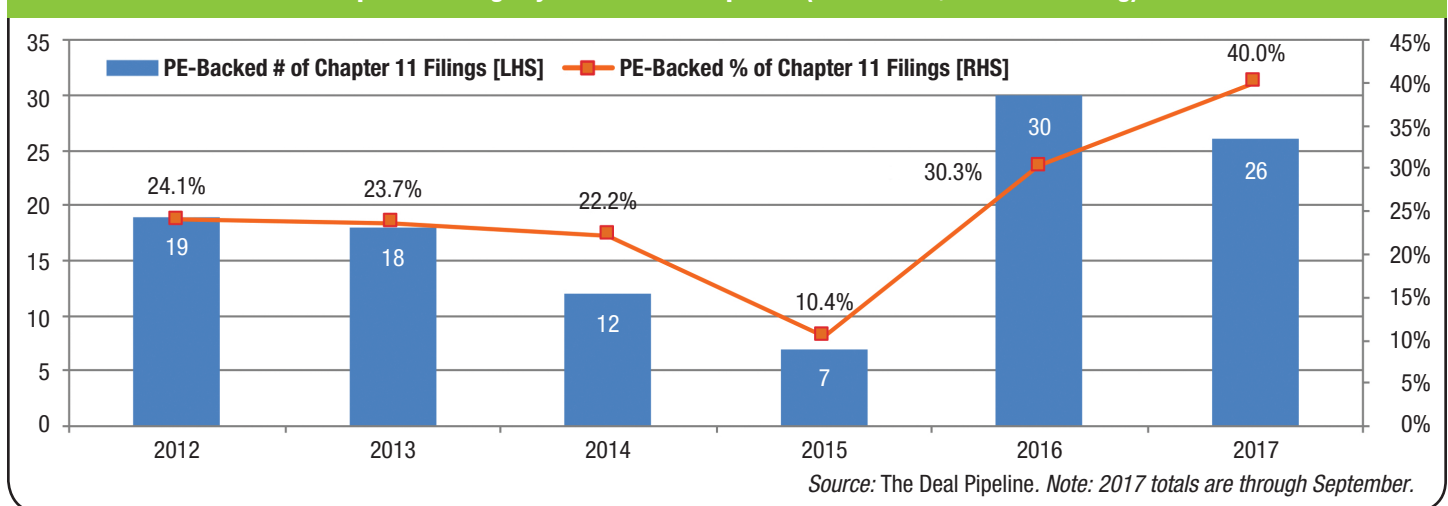
Nearly 40 percent of retail LBOs of the last decade happened in 2007 or 2008 at the height of the big LBO wave that

preceded the 2008 financial crisis. These were transactions done at the top of the market and included some of the worst deals done at high-valuation multiples with excessive leverage. Sponsors paid an average multiple of 10 times EBITDA for retail buyouts done in this two-year period. The online channel's share of retail sales was less than one-half of what it is today, with online retail sales now having tripled since 2008. If overpaying for targets were not bad enough, the retail landscape has profoundly changed since this flurry of deals happened. This cohort of 2007-08 buyouts generally has not fared well; "top of the market" transactions rarely do.

Approximately 33 percent of retail LBOs happened in 2011-13, as credit markets thawed and buyouts could get done again, and as it appeared that the U.S. consumer economy was coming back to life. Purchase price multiples for retail LBOs contracted to a more reasonable 8.3 times EBITDA in this period, but in retrospect, a consumer spending revival did not materialize as expected, and the disruption of the online channel started to gain critical mass. PE sponsors targeting retailers in this period likely underestimated the full-spectrum impact of online shopping — particularly, the huge popularity of mobile/online shopping and the attendant diminished pricing power of most retailers. Retail buyouts in this period have generally had disappointing performances despite more reasonably priced deals and lower-leverage multiples than pre-crisis transactions. Several likely reorganizations in 2018-19 are retail buyouts done in this post-recession period.

Only 14 percent of retail LBOs were done in 2015-17, as flagging same-store sales and deteriorating operating performance metrics throughout the retail sector discouraged sponsors and lenders from committing to transactions in the sector. Several transactions were bottom-fishing deals, with certain sponsors opportunistically buying into highly distressed situations or taking control of reorganizing retailers. PE sponsors recognized wrenching structural changes impacting nearly all retailers, and new deal activity in the sector slowed considerably despite rock-bottom valuations for many public retailers and a more robust consumer economy since 2016. The \$8 billion buyout of Staples in mid-2017 was a standout exception to the dour market mood for retail plays and demonstrates that a large (and risky) retail deal can still get through as long as credit market conditions remain

Chapter 11 Filings by PE-Backed Companies (Liabilities >\$100 mm at Filing)



benign, but new retail LBOs were sparse despite stronger buyout activity generally, especially in 2017.

A Respite or Retreat from Retail?

It seems doubtful that sponsors and capital markets will support going-private transactions of retailers as they once did until there are better optics around the industrywide dislocations caused by the migration of sales from stores to online. Recession-like market valuations for many public retailers did not spur deal activity in 2017 for this very reason. Few retail executives can honestly say that they have strong convictions about what their business will look like in five years. Such opacity is not conducive to leveraged deal-making.

Several months ago, the Nordstrom family that controls the eponymous chain said that it was considering taking the company private — only to see such intentions soon put on the backburner when it became evident that financing for such a transaction could not be lined up. They will revisit a buyout in 2018 once the results are in for the holiday season. Similarly, Barnes & Noble's stock recently popped when an activist investor expressed interest in taking the ailing bookstore chain private — and incurring significant debt in the process. Skeptics abound on that prospective deal and the feasibility of tacking on debt to a struggling retailer.

The temptation for sponsors to rummage through the retail wreckage is understandable. With many profitable retail chains currently trading at distressed-type multiples in the range of 3-5 times EBITDA, hypothetical deals priced at 5-7 times EBITDA could provide respectable premiums to shareholders while still getting transactions done at prices well below historical industry norms. These deals might work on paper, but leveraged credit markets (as buoyant as they are) are likely not anxious to finance them unless targets are asset-rich or until there is improved earnings visibility, as the online transition and its many implications for retailing remain very much a story in progress.

As for failed retail buyouts that will need to reorganize in 2018, the basic playbook remains unchanged: Negotiate a consensual plan with key creditors far in advance of filing, convert debt to equity, close lousy stores and renegotiate leases — and do it posthaste. Retailers that successfully reorganized in 2017 did so quickly, with the cases of Payless ShoeSource, True Religion and rue21 each taking about four months from filing to emergence. In each instance, first-lien lenders were equitized and debt was reduced substantially. Post-emergence leverage remains fairly high for Payless and True Religion — in the range of 3-4 times projected EBITDA — and still above industry norms. Despite their laudable accomplishments in bankruptcy, these reorganized retailers remain vulnerable as they confront a business environment that is as competitive and complex as ever. **abi**

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