The coming catastrophe

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On a Sunday afternoon earlier this month, Stephen Gray strolled through the upscale mall in the affluent Boston suburb of Chestnut Hill. "First off, it was empty," he relates. "Second, there were five or six closed stores out of maybe 20 or 25 stores in the whole place."

According to Gray, the closed outlets ran from furniture to clothing to luggage. "That really shocked me," he says. "This is not subprime kind of territory. ... This is where people are supposed to be spending money."

Gray's interest is more than just one of a casual window-shopper. A Boston-based managing director with the restructuring and turnaround firm **CRG Partners Group LLC**, he is on the front lines of distressed retailing; he's currently serving as chief restructuring officer of liquidating computer retail chain **CompUSA Inc.** Gray knows the economic realities. Real estate values are down, and energy costs are up. With the belief that a recession is upon us and that the near-term economic future is bleak, consumer confidence has been in free fall. That gloom has put a screeching halt to spending on much more than essentials. "When **Wal-Mart** gift cards are being used for food, it's not a good sign," says Rob Vanderbeek, a New York-based managing director of **Huron Consulting Group Inc.**

What Gray, Vanderbeek and others in restructuring see is an acutely vulnerable retail environment getting slammed harder than at any time for almost two decades. "Tangible leading indicators suggest we're looking at gale-force winds in terms of retail," says Anders Maxwell, a managing director at New York investment banking firm **Peter J. Solomon Co.** Like many others, he predicts that this year will be the worst retail environment since the recession of 1990-91. In fact, Maxwell says many retailers are much worse off than is apparent by just looking at their balance sheets. "They have all this off-balance-sheet debt," he says. "We're seeing the tip of the iceberg."

What is far less certain is how all this distress will play out in the market and the courts. Some, like Maxwell, believe a rash of bankruptcy filings is inevitable by the second half of this year. Others, such as retail consultant Adam Hartung, argue that this year will feature more distressed sales, with the real jump in bankruptcies coming next year. Still others suggest that some retailers and their creditors will opt for out-of-court restructurings resulting in a number of quick liquidations.

What's clear to most observers is that many chains under stress will break. When they succumb exactly, will be determined by when their debt comes due. No longer willing to shore up flagging operations, current lenders — themselves under considerable stress from the credit crunch — will demand some sort of immediate action. When alternative financing sources have pretty much dried up, retail chains are no longer in a position to resist. As a result, bankruptcies, liquidations and forced sales will sweep across the landscape this year and next. "It's hard to predict the timing," says Henry Miller, chairman, managing director and co-founder of investment bank **Miller Buckfire & Co. LLC**. "We just see pent-up trouble looking for release."

The distressed nature of retail these days speaks volumes about consumer confidence and spending. Less obvious, it also underscores the fallout of the once plentiful, sometimes recklessly generous, financing supporting the chains. "Instead of fixing the problems, they raised more capital," says Vanderbeek. "Easy money allowed a number of retailers more time to turn the business around. Some did. Others delayed the inevitable."

Too often, more financing simply papered over operational flaws and deficiencies. It gave struggling retailers extra breathing room but, in the long run, made them progressively weaker, their assets more encumbered, their problems unresolved. "In a different time, they would have been forced to file in 2005, 2006, 2007," says Bob Duffy, a senior managing director at the corporate finance practice of **FTI Consulting Inc.** "Instead, they got an extra $5 million, $10 million, $50 million, which meant staying in business an extra six months, 12 months, 24 months. Fundamentally, many retailers were in trouble a couple years ago. They needed to shift. They haven't."

Often, the loans issued by eager lenders — including by many hedge funds — had very few covenants. As a result, lenders may have little say until retailers are pretty much busted. "Because of covenant-lite loans, a chain could run out of cash before it triggers a default," says Bradley Dietz, another managing director with **Peter J. Solomon Co.**

That lack of an early warning system gives everyone less time to work through alternatives. And it makes quick sales or liquidations much more likely. "The yellow warning light is much closer to the cliff," says Vanderbeek. "By the time everyone sees it, it's too late. Over the cliff they go."

And so retailers face a world where liquidity has dried up, hedge funds and others willing to finance junior debt and second liens have retreated and, as a last resort, private equity buyers have become defensive. Gone are complex convertibles and loan-to-own strategies. "We were financing [restructuring] deals, retail and otherwise, with phone calls. You call 10 people, you get three or four offers. Now, you make 10 phone calls. Nine are, 'What? Are you kidding?' " Gray says. Capital "is just not there. It seems to be getting tighter by the day."

So overleveraged retailers find themselves in ever more desperate straits. To keep alive, many are spending what little available cash they have from the past Christmas season. "It's like playing the slot machine. You hope it hits before you run out of dollars," says Gregory Segall, managing partner of Philadelphia distressed private equity firm **Versa Capital Management Inc.** "The debt holders have run out of dollars. They're playing with house money."

And then there's the calendar. Retailers are exceptionally vulnerable just as the head into the traditional lean months that lead up to the heaviest consumer-buying season around the year-end holidays. "They lose $10 million over the next six months. Where is the capital going to come from to fund the next season?" asks Gray.

"It's too late. Their backs are against the wall," adds Kenneth Simon, a managing director at the turnaround shop **Loughlin Meghji + Co.** "If they go into Chapter 11, there's barely enough liquidity to get through the process. The best they can hope for is to create a competitive bidding environment."

The chain of woe is long and self-reinforcing. Suppliers spooked by retailers going bust may tighten up on terms for other weak customers, necessitating even more cash when little is available. Distress spreads. "Vendors will get hammered by the first wave," Maxwell says. "They'll create the second wave."

For all of that, the inherently unhealthy nature of retailing isn't something that developed overnight. Says Maxwell: "A lot of retailers have limped along for a long time. They've had flawed strategies for years. What's remarkable to me is that you haven't had more collapses."

True, a small number of retailers have already called it quits and retail-related bankruptcy filings are up. The list of recent retailer Chapter 11s includes furniture retailer **Wickes Holdings LLC**, luxury retailer **Fortunoff Fine Jewelry and Silverware LLC** and catalog retailer **Lillian Vernon Corp.**

However, there is another large factor that could make things, if not worse, at least uglier: The nature of Chapter 11 has changed. Gone are the days when a retailer could file just after a poor Christmas season — when cash was up and inventory was down — and expect at least an entire year in bankruptcy to get its act together. The bankruptcy process now makes quick sales or liquidations almost inevitable in all but the rarest of cases. Duffy, who has been involved in many of the most visible retail bankruptcies over the past year, including a stint as COO of Fortunoff and CRO of bankrupt retailer Levitz Furniture, says he's now seeing bankruptcies in which the entire process is completed within two months. "That's unreal," he says.

A new bankruptcy law took effect in October 2005. It has provisions that all but preclude a classic reorganization. Most notably, retailers have just 210 days to either accept or reject leases. Under the old bankruptcy regime, retailers such as Kmart Holdings Corp. could wait for a year or more on real estate decisions, casting off the worst stores first, then holding out to see which of the remaining outlets would do better. "You want to wait until the very last moment," says Miller. "The single-most crucial decision is your store base."

Now, retailers must make decisions on real estate almost immediately, when, as some in the restructuring trade maintain, management and the board are still in a state of shock.

Forward planning and early action are absolutely critical. However, even that may not be enough. Simon gives a laundry list of what's necessary before a Chapter 11 filing: "You should have a strategy in place: What do you get out of Chapter 11? Which stores are being closed? Which products move? What do you do differently? Has the board looked seriously at replacing executive management and downsizing headquarters?" But he cautions that even after all this preparation and with debtor-in-posession financing in place, "there's still a chance you'll get to the point where there won't be enough liquidity."

Add to this overhanging issues of leverage that may make lending in bankruptcy problematic. Adequate DIP financing has long been a given. Not anymore. "It's a question of dry powder," says Duffy. "The difference today is that companies are so levered up, if they go into bankruptcy, instead of $15 million available, now there's $2 million to $3 million available." In 2004, Duffy says, creditors were leading at 80% of the appraised value of assets. Today he's seeing 95% value.

"Retail companies have always been great beneficiaries of Chapter 11," says Segall. "But now, with so many levels of debt, [distressed retailers] chewed into the muscle. There's not enough left for a DIP."

The resistance of retailers themselves to radical change also impedes chances of a successful turnaround.

Those in restructuring describe executives and boards too often wedded to outdated or flawed concepts and a belief that better days are just one selling season ahead. "A vast majority of retailers are in denial," says Hartung, who heads consultancy **Spark Partners**.

A combination of this kind of never-say-die optimism coupled with plentiful funding opportunities in the period that extended from 2004 until the first half of last year delayed the day — or year — of reckoning. When the time comes, the retailer itself is far weaker and less able to reorganize.

Take specialty retailer **Sharper Image Corp.** That the company filed for bankruptcy last month should have surprised no one. The chain had been losing both money and customers steadily since 2005, upended after Consumer Reports blasted the chain's best-selling product, a line of expensive air filters, followed quickly by class actions. But instead of retooling and recasting, management spent funds repurchasing shares. Meanwhile, receivables were crashing. Inventory was stacking up. "They were doing all these dumb things," says Vincent Lambiase, a managing director with business advisory firm **BBK**, who studied the chain in 2005. "We saw it coming back then."

The retailer refused to overhaul the way it did business and what products it offered. It became a poster child for an almost suicidal kind of stubbornness. "As Sharper Image showed, people in retail tend to defend these things to the very death," Hartung says.

The bigger issue is why the home of the Ionic Breeze, Body Massage Lounger and Wowwee Roboquad Interactive Robot didn't fall sooner. The answer, Lambiase says, is simple: "Sharper Image bought time with its creditors."

Since filing for Chapter 11, Sharper Image has said it will close 96 of 184 stores and has moved quickly to implement its plan to downsize. But it's still highly doubtful that the chain can successfully reorganize in the next six months. More likely, it will simply be offloaded in what is known as a Section 363 sale.

Sharper Image may have been vulnerable after its lead product was hammered, and it may have made many mistakes, but it also exemplifies a retailer whose fortunes are wedded to discretionary spending or, as one of Lambiase's colleagues says, "selling stuff none of us really needs." Particularly now.

But retailers peddling frivolous goods aren't the only ones under siege. The first batch of retailers to wipe out in this current wave tend to be dependent on new home sales, whether they sell furniture, appliances or home furnishings. So far, every one of them has been forced to liquidate. Witness Wickes, which was driven to begin dismantling itself late last month after receiving no bids to continue as a going concern. Bombay Co. filed in September and awarded a liquidation contract in October. Levitz, whose actual name was PLVTZ Inc., went bust in November and liquidated the next month. Smaller chain Scan International Inc. filed for bankruptcy just after Christmas and immediately began to liquidate. So did Sofa Express Inc.

Other sectors expected to crack are consumer electronics, jewelry chains and regional department stores. Two small jewelry chains, **Derco Inc.** and **Lexington Jewelers Exchange Inc.**, filed right after Christmas. The much larger Crescent Jewelers Inc. and parent **Friedman's Inc.** both followed in late January. Upscale audio and video retailer **Harvey Electronics Inc.** filed at the end of December. See related chart: Retail busts
Expect more.

The weaker apparel chains are in danger. Even supermarkets will feel the pinch of a cutback in consumer spending, although they may bottom out later than others, says Frank Badillo, senior economist of consulting firm **TNS Retail Forward**.

It's easy enough to spot many of the chains that are struggling. In downgrading **Linens 'n Things Inc.**, for example, **Moody's Investors Service** noted that the soft-goods company last year accelerated the drawing down of its revolving credit facility to cover cash flow deficits. This situation will likely continue through this year, Moody's noted, adding that the company, with its "weak operating performance" and its "history of mispositioned product offering," will have difficulty raising more money in the marketplace.

Then there's **Wilsons The Leather Experts Inc.**, which, as the name implies, peddles leather, although not for long. Last month, the retailer announced it would shutter as many as 160 of its mall-based stores and convert the remaining 100 stores into women's fashion accessories emporiums called Studio.

It may be too late for such a radical makeover. Wilsons has also been losing sales steadily since 2002. It's lost money for six of the past seven years, the result of poorly planned store expansion into warm-weather locations not known for extensive wearing of heavy leather coats. In February, lenders, led by **GE Capital Corp.**, slapped severe borrowing restrictions on Wilson's credit line, tightening its covenants and its reporting requirements.

Wilsons' share price now hovers at about 50 cents and the company faces a Nasdaq delisting.

Wilsons typifies the mall-based specialty retailer. As Gray can attest, some malls themselves are in trouble,

and that can have a cascading effect on retailers. The situation becomes particularly critical when an anchor tenant closes down.

Take a huge department store retailer such as **Macy's Inc.**, which bought May Department Stores Co. in 2005 and converted all acquired stores to the Macy's brand the following year. In late December, the retailer announced it would close nine underperforming locations. "When Macy's closes stores in nine malls, that's nine malls that are going to have trouble," says Peter Zisser, a New York-based senior counsel in **Holland & Knight LLP'**s bankruptcy and creditors' rights practice group. "For them, closing a store in an Akron mall means little. For others, it's the kiss of death."

Many of those retailers that have filed for bankruptcy are mall-based, Zisser adds. They are shutting down stores almost overnight. How can other retailers survive in a mall with so many shuttered operations? he asks.

This kind of retail environment has some pulses quickening. For both well-heeled buyers of distressed assets and well-capitalized strategics, this is a great year to be in the market for deals. "There's been an enormous uptick of retail-related distressed activity since Labor Day. It accelerated in the fall, really through Christmas, then the wheels feel off," Segall says. "There are tons of deals out there. We could do one every day if we want to."

Whether the deals get done and, if so, when, is quite another matter. Hartung, for one, says many retailers — especially regional players — need to consolidate and do so quickly. "You don't want to be the third guy to merge. If you get out, you want to be the first guy through the door."

But even Hartung admits that time is on the side of stronger retailers with good cash flow and healthy balance sheets. They can "cherry pick" potential acquisition candidates, he says, adding, buyers "don't want to be too eager."

Segall and others in distressed buyouts caution patience as well, believing that cheap assets could be much cheaper in the months ahead. "We don't know how far and how deep the recession will be," he says. "It's the falling-knife syndrome."

What's more, until very recently sellers have had unrealistic expectations of how much they can get for their assets. That's great for buyers such as Segall. "As good as it is in 2008, in 2009 and 2010, it will be much better," he predicts.

Not surprisingly, restructuring firms are finding themselves increasingly busy. "We need to be very nimble. We have to be incredibly fast," says Duffy. "The work is far more intense than even a couple years ago. The same things are getting done, but we are consolidating them in two to three months. Restructuring shops are looking at more happy days ahead. "This is a great environment for us," says Lambiase. "We have to move very, very quickly. So many companies are in trouble."