Business Recovery Services industry insights – Retail

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For many companies in the retail industry—a sector of the U.S. economy already facing significant uncertainty and growing distress—the holiday shopping season is causing anxiety. Despite historically low interest rates, a slowly recovering housing market, and relatively low energy prices, consumer spending has not rebounded strongly. Even as the job-creation picture slowly improves, a combination of minimal wage growth, limited household disposable income, and low consumer confidence (exacerbated, of late, by fears about whether large retailers are capable of protecting credit card data) has created an uneasy environment for consumer spending. Indeed, major retailers including Wal-Mart Stores, Inc., Best Buy Co., Inc., and Target Corp. have forecast another holiday season of weak consumer demand and price-cutting pressures.

While the holiday season is always a critical time for retailers, 2014 will be especially so for those "at risk" from either operational or financial distress. While the entire U.S. retail industry (including major national department store chains) continues to draw the watchful eye of lenders, trade creditors, and restructuring professionals, specialty retailers (those focusing on a single product or category such as consumer electronics or apparel) are at especially high risk for both operational and financial distress and could fall victim to a continuing shakeout of U.S. retailers heading into 2015.

The 2014 Holiday Outlook

A recent publication by Strategy&, *2014 Holiday Outlook: Top trends, consumer behaviors, and implications for retailers*, contains several findings indicating how challenging this year's holiday season promises to be for U.S. retailers:

- 72% of consumers believe the economic environment is the same or worse than it was in 2013;
- 84% plan to spend the same or less than in 2013;
- overall holiday spend is projected to decrease from $735 per household in 2013 to $684 in 2014;
- 84% of shoppers cite best prices as the main reason for choosing a place to purchase gifts—up from 74% in 2013;
- 43% of shoppers will shop based on frequency and quality of seasonal deals like doorbusters and "BOGO" (buy one, get one free).

Besides having to satisfy consumers who will be keeping a tight grip on their wallets, retailers with heavy investments in brick & mortar stores will confront a continuing increase in online shopping: 50% of spending will occur in physical stores (down from 55% in 2013), while 43% of spending will be online (up from 42% in 2013).

Source: Strategy&, 2014 *Holiday Outlook: Top trends, consumer behaviors, and implications for retailers*

{http://www.pwc.com/us/en/retail-consumer/publications/retail-consumer-2014-holiday-outlook.jhtml.]

Pace of U.S. retail bankruptcy filings continues

Through October 2014, there were 23 U.S.-based retailer bankruptcy filings (Chapter 11 and Chapter 7) for the calendar year. This is slightly behind the rate for 2013, which saw 36 retailer filings. Notable or well-known U.S. retailer Chapter 11 or Chapter 7 bankruptcy filings since 2013 include:

ALCO Stores, Inc.
Big M, Inc. (Mandee's)
Brookstone Inc.
Coldwater Creek Inc.
Crumbs Bake Shop, Inc.
Dots, LLC
Fresh & Easy Neighborhood Market, Inc.
Kid Brands, Inc.
Loehmann's Holdings Inc.
Love Culture, Inc.
Orchard Supply Hardware Stores Inc.

Source: S&P Capital IQ

Common examples of operational distress among retailers

Heavy reliance on discounts and promotions to drive sales. Ever since the Great Recession, consumers have been so bombarded with sales promotions that they have come to expect significant discounts or “BOGO” (buy one, get one) as part of “everyday” pricing. As a result, retailers that have relied heavily on discounts and promotions to boost sagging same-store sales—even to the point of sacrificing critical margins—are finding it increasingly difficult to wean customers off promotions without a return to spiraling same-store sale declines. It’s quite the vicious cycle. Increasing pricing competition, especially from mass market online retailers like Amazon, has further intensified the pressure on retailers to continue with year-round promotional strategies to drive sales, thus squeezing margins and cash flow even more.

Static or inflexible “open to buy” plans resulting in suboptimal inventory mix. Many retailers facing declining same-store sales likely find themselves with suboptimal inventory mixes—understocked with their fastest-moving and/or highest-margin products and overstocked with slow-moving and low-margin items—thus requiring further promotions (and further declining margins) in order to move out this excess or unprofitable inventory. Having a flexible and adaptable “open to buy” plan that gets the “right” product into the “right” stores—especially in time for super-critical selling seasons—is therefore essential for successful retailers. While most retailers establish their “open to buy” order plans at the beginning of each year, unwillingness or inability to modify buying plans, especially in the face of declining sales or suboptimal inventory mixes, can lead to deeper and deeper operational distress.

Bloated overhead costs and retail store count. While developing a growing online presence, most specialty retailers continue to rely heavily on a brick-and-mortar footprint to reach their customer base. While there can be good reasons for this—in apparel, for example, where the consumer wants to feel the fabric and try on the product for fit and fashion—continuing retail pricing pressures and the shift to online shopping are forcing many retailers to critically evaluate their operating cost structures and deal with bloated overhead via measures such as corporate headcount reductions and analyzing store leasing costs. When reexamining their entire store footprint with a focus on key consumer markets, distressed retailers are often faced with the prospect of extensive store-count rationalization. However, due to consolidation of mall and retail center landlords at both the regional and national levels, distressed companies are finding themselves increasingly without leverage to negotiate more favorable terms or early lease exits at underperforming locations, which is stymying meaningful store rationalization attempts in out-of-court turnarounds.

Common causes of financial distress among retailers

Lack of adequate cash forecasting tools. In instances of deepening financial distress, many retailers find themselves without a realistic cash forecasting or planning tool, even though these can be critical for identifying upcoming periods of strained liquidity. The ability to anticipate and navigate through significant liquidity events (loan payments, monthly rent payments, taxes, etc.) can prove essential to a distressed retailer’s survival.

Borrowing base and covenant limitations. Due to a high degree of seasonality and the resulting working capital fluctuations, retailers typically rely on a senior secured revolving line of credit with availability of funds subject to a calculated borrowing base of accounts receivable and inventory as well as other loan covenants. Maintaining a healthy borrowing base and liquidity is especially critical during periods of operational distress that can eventually result in financial distress. In many instances, retailers involved in a turnaround may even be hesitant to enact much-needed operational improvements, such as closing stores, for fear of the negative short-term liquidity implications under the company's borrowing base and/or covenants under certain loan agreements—thus risking further financial distress.

Dwindling working capital trends. During periods of growing financial stress for a retailer, fretful vendors may ask for tighter payment terms or even require the posting of letters of credit in order to continue shipping product. This can create a further liquidity drain by negatively impacting either working capital or the borrowing base. As a result, retailers in a turnaround situation often find themselves on a tightrope, trying to maintain an uninterrupted inventory flow while preserving the necessary liquidity.

How PwC Business Recovery Services can help

PwC has extensive experience advising retailers in various stages of both operational and financial distress. Our restructuring advisory services include the following areas:

- *Cash analysis and forecasting*: Analyzing immediate and near-term cash flow needs of the business and advising on management's preparation of a 13-week cash flow forecast that are grounded in reality and considers current covenants and borrowing base restrictions. Management's presentation of a credible cash forecast to lenders and other key stakeholders can prove critical in executing a successful turnaround or restructuring strategy.
- *Store profitability analyses*: Advising on the preparation of "4-wall" analyses of individual stores to help identify underperforming stores that may require further turnaround initiatives, including eventual exit. Identifying terms and termination costs to be considered in any store rationalization strategy.
- *Inventory analyses*: Analyzing historical inventory turns and margin metrics by major inventory category or type to identify potential inventory mix issues with negative impacts on margins.
- *Cost containment and working capital improvement initiatives*: Analyzing overhead costs by type and function to identify potential run-rate cost savings. Analyzing current payment terms with vendors to identify ways to improve overall working capital.
- *Negotiations with lenders and other key stakeholders*: Advising on management's discussions with lenders, critical vendors, and other key stakeholders. When faced with a situation of potential covenant non-compliance and dwindling liquidity, coordinating communication with lenders and other stakeholders is essential. A qualified restructuring advisor can guide you through these difficult situations in order to help ensure a successful turnaround or restructuring strategy.

PwC Business Recovery Services also has experience advising the various stakeholders of distressed retailers including unsecured creditors and potential buyers.

Business Recovery Services is part of the PwC's Deals Practice which helps corporate and financial sponsors achieve their growth initiatives from deal strategy through value capture. PwC's Deals professionals support clients on a wide range of transactions including domestic and cross-border acquisitions, divestitures and spin-offs, capital events such as IPOs and debt offerings, as well as bankruptcies and other types of business reorganizations. For more information, visit: [www.pwc.com/us/deals.](http://www.pwc.com/us/deals)

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