January 31, 2021

2021 OUTLOOK

Retail Turnarounds

Retail has been at the forefront throughout the COVID-19 pandemic. In the spring, consumer companies had to adapt given changing consumer behavior and lockdown provisions. This urgency was felt across companies of all sizes and sub-sectors, and ultimately led to about 50 retail bankruptcies, from legacy brands to small, local businesses. As revenue plummeted, leverage levels began to look increasingly dangerous, all while needing to innovate at speeds one could never imagine. In other words, the retail industry has had a tough year, while tech giants posted record-breaking earnings.

The following report will cover:

1. Breakdown of the retail industry
2. Recent developments causing retail distress
3. Case studies of successful retail turnarounds
4. Case studies of unsuccessful retail turnarounds
5. Outlook on retail businesses / characteristic traits of strong retail businesses

Special Situations Team

Edward Huang
Sr. Portfolio Manager

Shu Lei Wu
Portfolio Manager

Martin Borrero
Analyst

Breakdown of the Retail Industry

Segmentation:

The consumer products and retail industry has been seeing dramatic changes throughout the last couple of years, primarily driven by shifting consumer habits, technology innovation, changing demographics, and globalization. These trends create opportunities for different companies to differentiate themselves and become increasingly more competitive. Companies in this industry create a business-to-consumer experience, ultimately generating revenue by selling a finished product or service. Albeit having general similarities, they can be segmented in two primary ways: consumer and retail.

Consumer:

The product or service which companies sell, or in other words, "consumer goods", can be divided into consumer staples and consumer discretionary. The difference between the two is that consumer staples are non-cyclical, whereas consumer discretionary products are cyclical. By understanding the fundamental sales drivers and the exposure that those sales have to different external catalysts, the better one can evaluate comparable companies.

Consumer Staples	Consumer Discretionary
Walmart	amazon
PHILIP MORRIS INTERNATIONAL	ARITZIA
Coca-Cola	HUDSON'S BAY
P&G, Unilever	TOYOTA, rbi restaurant brands international

Well-know consumer staples companies are Walmart, Proctor & Gamble, Unilever, and Philip Morris. These businesses have stable revenues because the pricing and volume sold is not closely correlated with the economy. Well-known consumer discretionary companies are Amazon, Toyota, the Hudson Bay Company, Aritzia, and Restaurant Brands International. In contrast to consumer staples, consumer discretionary businesses are heavily influenced by the state of the economy, therefore, resulting in cyclical revenues.

Retail:

Rather than categorizing companies by the product or service that they sell to customers, one could also categorize by the establishment used to execute this transaction. In other words, differentiate them by the type of "marketplace" which they use. This is important as it gives insights into different competitive dynamics, price sensitivity, and product specialization. These include the following:

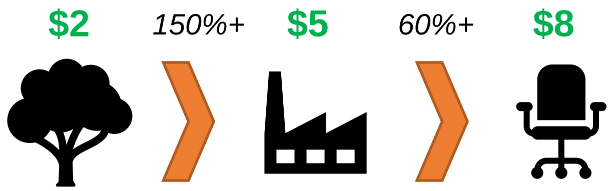
1. **Convenience Stores:** variety, high prices, food-oriented, open long hours
2. **Specialty Stores:** specialize, single type of merchandise, high level of service
3. **Department Stores:** large, many sections, compartments, average prices
4. **Supermarkets:** primarily food, wide selection of products, 20k – 40k sq. ft.
5. **Discount Stores:** low service, cut-rate prices, "self-service", low fashion
6. **Multichannel Stores:** mail order, telemarketing, internet, non-store

Sources: Technofunc, Sell Side Handbook, KPMG

Traditional Business Model

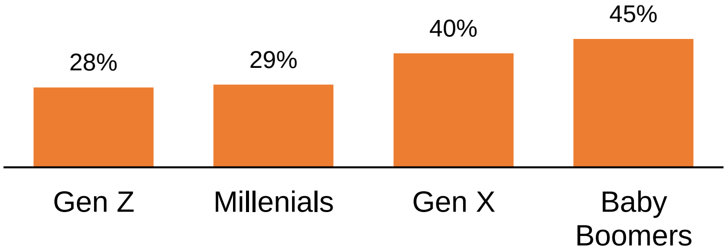
Revenue has traditionally been a function of the volume of goods sold times the price of the respective items. As businesses begin to innovate, they have taken on membership subscription models (on a monthly or annual basis), and credit card partnerships. Price can be influenced by cross-selling (buy one get one free) and promotions and discounts. From a volume perspective, this can come from brick-and-mortar stores or online mediums.

From a cost perspective, supply chains are very important as integration and vendor relationships play a significant role on margins. Raw materials trade at commodity prices and are sold to manufacturers who assemble a multitude of parts to create a product. This manufacturer then charges the retailer a premium for the good. A retailer can minimize this premium by becoming vertically integrated, buying in bulk, or developing strong relationships with their vendors.



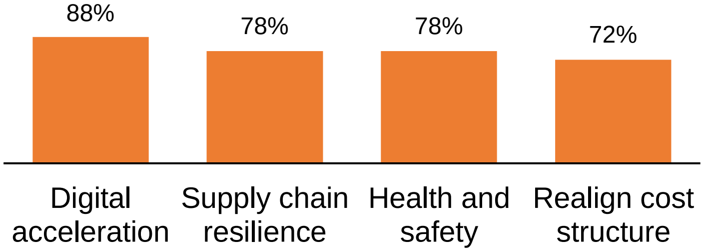
Omnichannel Strategy

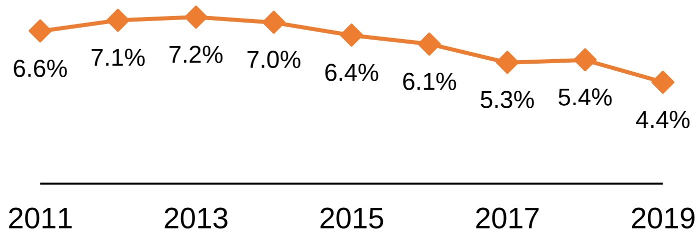
E-commerce is flooding the headlines with respect to consumer retail. It is becoming increasingly important for consumer companies to have a strong digital infrastructure and presence, yet research shows that in-person, brick-and-mortar shopping continues to be vital for success. Research shows that customers who purchase from a business both in-store and online have a 30% higher lifetime value over the ones who shop through only one channel. Furthermore, among digital shoppers, 72% of them consider the in-store experience as the most important channel when buying a product. The graph below shows the percentage of consumers (by age group) that consider the ability to touch or try on an item as the primary reason to go to a physical store. It was the highest amongst all generations, particularly the older age groups.



How is it Changing?

The stay-at-home orders throughout the world have only accelerated the urgency underlying digital transformation. Digital integration is not a competitive advantage nor is it the industry average; it is a necessity to survive. To be truly competitive, companies need to start thinking about their optimal portfolio of assets, consistently meet privacy concerns, seek out top-tier talent, fortify every link within the supply chain, and derive the full potential of data.





Sources: Sell Side Handbook, Ivesp, Deloitte Insights

Drivers of Default

Rise of Discounter Competition:

Discount players, including supercenters, off-price, dollar stores and hard discounters, have taken significant share over the past two decades by competing on the basis of price. While discounter inventory spans many areas, the rise of the discounter industry has most significantly impacted general merchandise and grocery retailers. As a result, the grocery industry is one of the most represented subsectors in bankruptcy filings.

E-Commerce:

E-commerce's effect on the brick-and-mortar industry is well documented. In fact, many retail debtors that filed for bankruptcy emerged as a business solely focused on online sales. BEBE, a women's clothing brand, closed all of its physical stores in 2017 and pivoted the to e-commerce. Intellectual property is now a big part of retail bankruptcies. For example, The Limited announced in early 2017 that it was closing all 250 of its physical locations in 42 states. Sycamore Partners then bought The Limited's brand and website, relaunching as an e-commerce firm in 2017 to continue to cater to loyal customers.

Declining Mall Traffic:

Consumers are shifting away from shopping at malls and are spending less discretionary time and money at these locations. As a result, there has been a decline in the appeal of department stores in favour of specialty stores.

The confluence of these factors, including the high fixed cost nature of these businesses due to unsustainable rent levels, has made the retail sector vulnerable to bankruptcy.

Key Constituents In Bankruptcy Cases

Landlords / REITs

Landlords are a key player in any bankruptcy case. In 2005, a section of the bankruptcy code was adjusted to reduce the amount of time firms have to decided whether to assume or reject a lease. Recently, there have been many instances in which large landlords have eventually assumed control of bankrupt firms.

Lenders

As retail PE blossomed in the early 2010s, many companies acquired an unsustainable capital stack. As retail debtors reach insolvency, recent trends have indicated that alternative lenders (i.e., hedge funds) have become increasingly active in the distressed debt and post-petition financing space.

Trade Vendors

Trade vendors typically have lower priority claims, but can exercise power if they are critical to a debtor's operations. They can then demand immediate payments in full, or may assert consignment claims designed to retain ownership of delivered goods until sold. Rights of vendors to assert administrative priority and reclamation rights are also crucial.

Intellectual Property

As brick-and-mortar locations decline in value, a retailer's brands, licenses, and associated IP rights act as important sources of value. Cases present an opportunity to acquire trademarks, customers, and copyrights to relaunch through an optimized, lower cost platform. The J. Crew move has become synonymous with the IP process in retail.

What Makes Retail Bankruptcies Unique?

Liquidation Much More Common:

In a case study conducted by Fitch, half of retail bankruptcies (15 of 30) were resolved as liquidations, compared to 17% seen across all industries. Retail bankruptcies often result competitors offering similar merchandise at more attractive prices, or from brand degradation. These factors can result in permanent traffic declines and cause the firm to lose its place in the market. Retailers often respond by cutting spending on marketing, which can exacerbate the issue of revenue declining. As such, a retailer's value as a going concern is very limited.

Impediments to Continued Operations:

Changing consumer preferences, heightened competition, persistent traffic declines, and an inability to improve positioning causes many retailers to find themselves in bankruptcy. Their weak position relative to landlords and vendors can inhibit bankrupt retailers from emerging as going concerns.

Outstanding Secured Debt Recovery:

In Fitch's case study, all but one of the retailers had outstanding recoveries for first-lien claims, generally due to overcollateralized asset-backed loan (ABL) facilities, with balances limited under a working capital-focused borrowing base. Given their place in the capital structure, ABL creditors were generally paid in cash soon after the petition filing date. On the other hand, unsecured claims had below-average recoveries (25% average), in part due to high revolver borrowings, constrained multiples due to limited going concern value, significant administrative claims and large lease rejection claims.

Lower Going Concern Multiples:

Median EV/EBITDA multiples for 11 retailers in Fitch's case study that emerged as going concerns was 5.4x, lower than the 6.0x cross-industry median multiple.

Selected Reorganization Multiples for Going Concern Reorganizations

Company	EV/Forward EBITDA
Harry & David Holdings	4.2x
Winn-Dixie	4.2x
BI-LO	4.5x
Brookstone	4.8x
Great Atlantic and Pacific Tea Company	5.4x
Fairway Group Holdings	6.1x
BSCV	6.6x
Penn Traffic Company	7.0x
American Apparal	7.7x
Quiksilver	8.4x
Loehmann's Holdings	37.1x
Median	**5.4x**

Ascena Retail Case Study

Ascena filed a petition for bankruptcy protection on July 23rd, 2020 in the Eastern District of Virginia and entered into a restructuring support agreement with lenders holding 68% of their $1.6 billion secured term loan facility and $311.8 million in DIP financing secured. Ascena brands include:

ANN TAYLOR CACIQUE LANE BRYANT

LOFT LOU & GREY CATHERINES

Prepetition Capital Structure

Ascena Retail Group, Inc. Capitalization

(In USD mm)	Maturity	Coupon	Amount
Secured Debt			
$500mm Revolving Credit Facility	2/27/2023	L + 125	$230.0
$1.27bn First Lien Term Loan	8/21/2022	L + 450	$1,270.0
Total Debt			**$1,500.0**
Less: Cash and Cash Equivalents			($433.7)
Net Debt			**$1,066.3**
Plus: Market Capitalization			$6.1
Enterprise Value			**$1,072.4**

Interesting Notes About the RSA

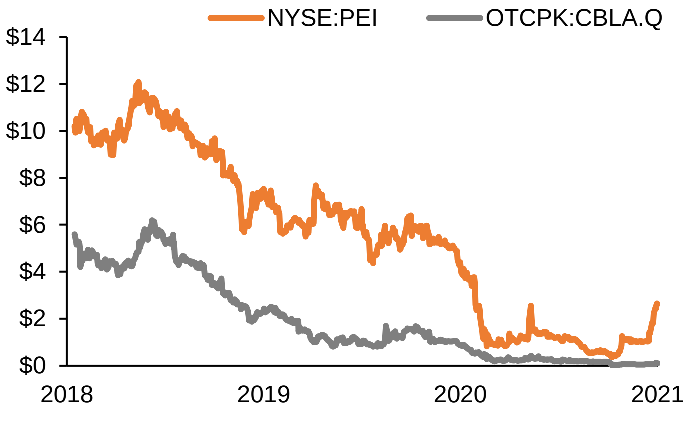
Through the RSA and bankruptcy process, Ascena planned to:

- Repay ABL loans in full or refinanced by a $400 million exit ABL
- Give term lenders the opportunity to participate in a $75 million interim DIP financing, second out exit term loan facility, and 55.1% of reorganized equity (subject to management incentive plan)
- Provide holders of unsecured general claims $500,000 if they voted to accept the plan
- Reduce store count to ~1,200 from 2,800, depending on landlord rent concessions
- Sell the IP of Catherines to City Chic Collective, which would transition the Catherines brand into an e-commerce subsidiary
- Transform the debtor’s Justice brand into a wholly online corporation

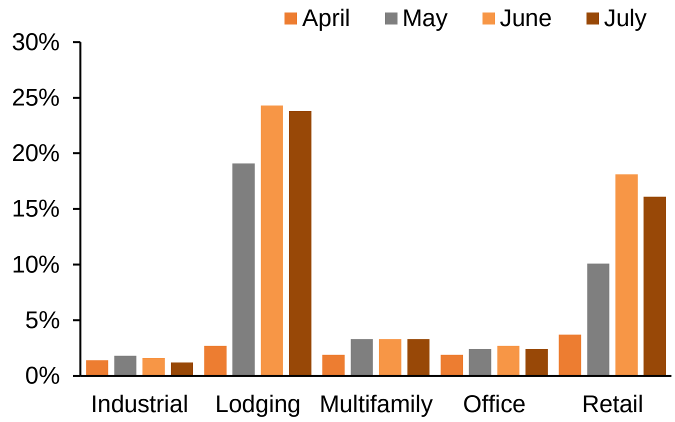
Major Repercussions for Real Estate

The troubles for retail began well before the pandemic struck, as the disruption of e-commerce put pressure on companies with significant brick-and-mortar operations. The pandemic accelerated this digital adaptation, but also hindered the businesses that relied on physical, in-person shopping. This magnification has deepened the crisis and pushed mall landlords and REITs into bankruptcy. In November, CBL & Associates and Pennsylvania Real Estate Investment Trust declared Chapter 11 bankruptcy. As rent continued to fall and occupancy rates declined, these mid-sized public companies rushed to try and restructure their balance sheet. These efforts were unsuccessful, leading to bankruptcy.

This is quite uncommon, given that most REIT assets are physical properties, and their debt is collateralized. As well, since real estate typically appreciates in value over time, debt payments and other expenses can be fulfilled by selling these properties fairly quickly, reducing their exposure to bankruptcy.



REITs also have conservative debt levels, and their revenue is made up of multi-year contracts. Despite this protection, retail real estate saw a significant rise in delinquency rates, much greater than other property types such as industrial and office. Research from McKinsey says that retail shopping saw a significant rebound near the end of 2020, whereas the real estate markets have seen very moderate rebounds. From a return standpoint, prior to COVID-19, these real estate investment trusts posted returns greater than treasuries and bonds, making them attractive investments. As the risk significantly increases, particularly as stimulus dries up, these firms have a very uncertain outlooks both on a short- and long-term basis.



CBL was able to reach an agreement with its unsecured debtholders, which would reduce the company's debt and preferred stock obligations by approximately $1.5 billion. In exchange, the unsecured debtholders were receiving 90% of the post-reorganization CBL and new secured debt of lower face value. The current shareholders are seeing significant dilution, as they will be entitled to only 10% of their equity upon emergence from bankruptcy.

In the case for PREIT, they attempted an out-of-court restructuring that fell through. Despite filling for Chapter 11, they managed to gain a 95% approval in a pre-packaged plan which will allow all lenders to keep their full principal value. Old debt will be converted into new debt that allows for more financial flexibility in the near-term, but more protection to lenders. Common and preferred shares will face no dilution.

Best Buy Case Study: Focusing on the Customer Experience

Best Buy, an electronics retailer, was a business in significant decline which managed to pull a successful retail turnaround. The stock traded at around ~$11 in January 2013 and now is currently $104 as of January 2021.

Background

From 2009 to 2014, comparable store sales were falling at Best Buy driving down operating profits from ~$2.5 billion in 2008 to ~$1.2 billion in 2012. The key issues were:

1. **Showrooming** caused by inflated prices compared to other retailers like Walmart and Costco, and online retailers like Amazon. *Why would anyone buy goods at Best Buy when they can go to a Best Buy, test out the products, and then purchase the same one at a cheaper price?*
2. **Unprofitable international expansion** created by years of unsuccessful M&A resulting in complex operations and no value creation. From 2009 to 2013, they attempted to break into the UK market through organic expansion, a 50% acquisition of Carphone Warehouse, which turned out to be a failure. Similar unprofitable ventures occurred in China (JiangSu Five Star) and Canada (Future Shop)

Country	2012 Store Locations	2018 Store Locations
Canada	261	185
China	211	0
United Kingdom	872	0
Europe (Not including UK)	1517	0

Turnaround Strategy

In late 2012, Best Buy hired a new CEO, Hubert Joly, who previously ran a hospitality business. To address many of the key issues that Best Buy was facing, he did the following:

1. **Address showrooming:** In order to remain competitive with online prices, Best Buy launched a price-matching policy on their electronics to avoid showrooming
2. **Enhance the convenience of purchasing electronics:** With 70% of Americans living 15 minutes away from a Best Buy, implementing an In-Store Pickup system drastically enhanced Best Buy's value proposition. Rather than waiting 2-3 days to get an item, going to a Best Buy proved to be more convenient
3. **Cutting costs:** Reducing employee turnover by improving working conditions and shedding non-core assets such as their operations in China, UK and Canada
4. **Improving in-store experience:** Best Buy acquired mindSHIFT Technologies, which was rebranded to GeekSquad to provide their customers with exceptional support

Takeaways

Best Buy was able to leverage its product expertise to develop a loyal customer base where it is clearly insulated from threats of e-commerce. By providing exceptional product expertise and service, leveraging its in-store locations to enhance customer convenience, and simplifying its business model, Best Buy experienced an extremely successful retail turnaround.

Future Outlook for Brick-and-Mortar Stores

The entrance of e-commerce players has clearly taken a toll on the brick-and-mortar industry. Accelerated by COVID-19 closures, brick-and-mortar stores are at an inflection point right now that requires substantial change. For players that offer commoditized goods that do not require a high degree of physical touch, enhancing omnichannel strategies that include features such as in-store pickup, delivery and refunds in physical locations will be essential.

Retail players that decide to double down on their physical presence will need a clear value proposition for customers to shop at their stores. For these products, simply displaying them for sale is not enough; retailers will need to have distinct experiences and service to meet the demands of consumers.

While COVID-19 has accelerated e-commerce trends, the pandemic has also reiterated the value of in-store shopping. Whether it is convenience, customer service, the shopping experience, new product discovery or physically interacting with goods, in-store shopping clearly fulfills many of the average customer's needs.

Restoration Hardware (RH) has revolutionized their store experience by implementing features like bars and restaurants in their showrooms. RH's stock price has increased by ~800% over the past 5 years

Identifying Investment Opportunities for Retail Turnarounds

Attractive Characteristic Traits of Retail Businesses	
Product Offerings	High touch products that require a greater degree of interaction before purchase decisions are more attractive because e-commerce cannot replicate the physical experience
Pricing Power	Commoditized goods where the brand does not add any significant value can be purchased online. A high degree of brand loyalty from customers, superior or differentiated products, and brand equity will separate losers (Macy's) from winners (RH)
Customer Experience	In-store experience improvements will be necessary for customers to see value in-person. Either product expertise, service, (e.g., Aritzia's style consultants) or a superior shopping experience (e.g., RH, Nordstrom) will be necessary.