



AMERICAN
BANKRUPTCY
INSTITUTE

VALCON 2018

Issues in Retail Valuations

Robert F. Jordan, Moderator

KCC; New York

Jeffrey N. Pomerantz

Pachulski Stang Ziehl & Jones LLP; Los Angeles

Durc A. Savini

Guggenheim Securities; New York

Dr. Israel Shaked

The Michel-Shaked Group; Boston

Understanding Retail Bankruptcy: The Case of Payless ShoeSource Inc.

VALCON 2018

Presentation by Professor Israel Shaked

The Michel-Shaked Group & Boston University Questrom School of Business

May 16 – May 18, 2018



www.michel-shaked.com

Summary of Qualifications: Retail & Bankruptcy Experience

- A select list of retail assignments on which MSG has worked on include the following:

The Michel-Shaked Group's Retail Experience:			
7-Eleven	Dairy Mart	Maxi Drug	Rite Aid
Abercrombie & Fitch	Fabricenters	Merry-Go-Round	Southwest Supermarkets
Builders Square	Fleming	Munford	Stop & Shop
Caldor Corporation	Floors Today	Parisian	Weibolt
Cascade International	Hechinger	Payless ShoeSource	Winn Dixie
Cumberland Farms	J-Crew	Petco	World Bazaar

- MSG has worked on many bankruptcy assignments that have spanned across a wide range of industries, and have represented many different parties, including Defendants and Plaintiffs. A select list of MSG's bankruptcy assignments is shown below:

The Michel-Shaked Group's Bankruptcy Experience:			
Adelphia Communications	Duro Industries	M4 Environmental	Raytech Corporation
Air Transport International	Enron	Merry-Go-Round	Refco
American Chain Link Fence	Enron Global Power & Pipelines	MGM/UA Communications	Saftey-Kleen
Belle Casinos	Enstar Group	Mirant	Smurfit-Stone
Bennet Funding Group	Flintkote	Mirant Americas Energy Marketing	Solar Cosmetic Labs
Bike Athletic	FoxMeyer	Morse Tool	Stone & Webster
Boston Chicken	Halliburton	Mortgages Limited	Styling Technology Corporation
Caesars Entertainment	Hayes Lemmerz International	Munford, Inc.	Telecom Argentina
Caldor Corporation	Hechinger	NetFax	Tribune Company
Carleton Woolen Mills	Home Insurance	North Manchester Foundry	United Companies Financials
Cascade International	Jones Trucking Lines	OneStar Long Distance	Vencor
Congoleum	Lady Luck Gaming	Payless ShoeSource	Ventas Realty
Dade Behring Holdings	Laminate Kingdom	Polaroid	Vetta Sports
Diet Center	Lernout & Hauspie	Quadrax	Weiboldt
Dragon Systems	Lincoln North Partnership	Quigley	World Bazaar

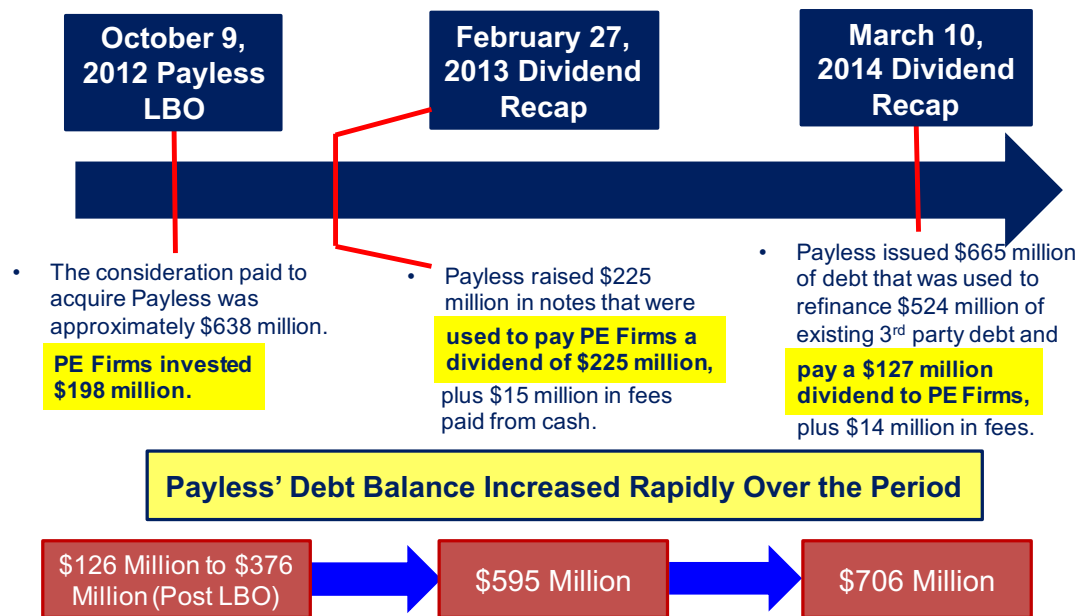
Private Equity Investments in Retail

Entity	Private Equity Firm
Charlotte Russe, Inc.	Advent International Corp.
Charming Charlie LLC	TSG Consumer Partners LLC THL Credit Group LP Hancock Park Associates, Inc.
Claire's, Inc.	Apollo Global Management LLC Tri-Artisan Capital Partners LLC
Cole Haan LLC	Apax Partners (UK) Ltd.
David's Bridal, Inc.	Clayton Dubilier & Rice LLC Leonard Green & Partners LP AlpInvest Partners BV Crescent Capital Group Hartford Mezzanine & PE Group Stockwell Capital LLC TPG Growth LLC
Eddie Bauer LLC	Golden Gate Private Equity, Inc.
J. Crew Group Inc. (JCG)	Leonard Green & Partners LP NB Alternatives Advisers LLC TPG Capital LLC
Neiman Marcus Group, Inc.	Ares Private Equity Group Canada Pension Plan Investment Board Pantheon Ventures (UK) LLP aPriori Capital Partners LP Leonard Green & Partners LP TPG Capital LLC Warburg Pincus LLC
Nine West Holdings, Inc.	Sycamore Partners Management LP CNL Fund Advisors Co.
Payless Holdings LLC	Golden Gate Private Equity, Inc. Blum Capital Partners LP
TOMS Shoes LLC	Bain Capital Private Equity LP
True Religion Apparel, Inc.	TowerBrook Capital Partners LP
Vince Holding Corp.	Sun Capital Partners, Inc.

Note: Certain PE firms have already exited their positions on this list.

Dividend Recapitalizations: Too Big To Swallow

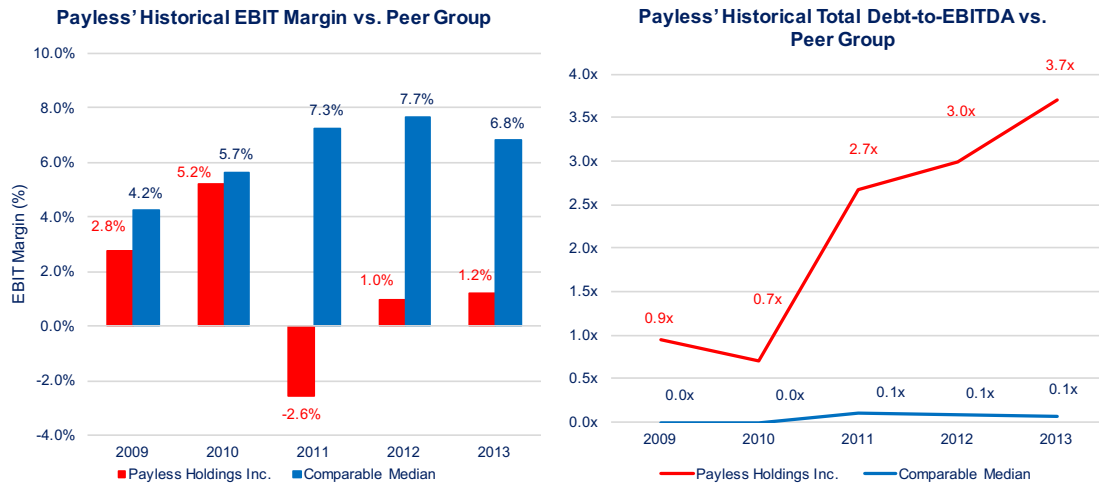
Payless Transaction Timeline



Knew or Should Have Known

Payless' Historical Performance vs. Peer Group

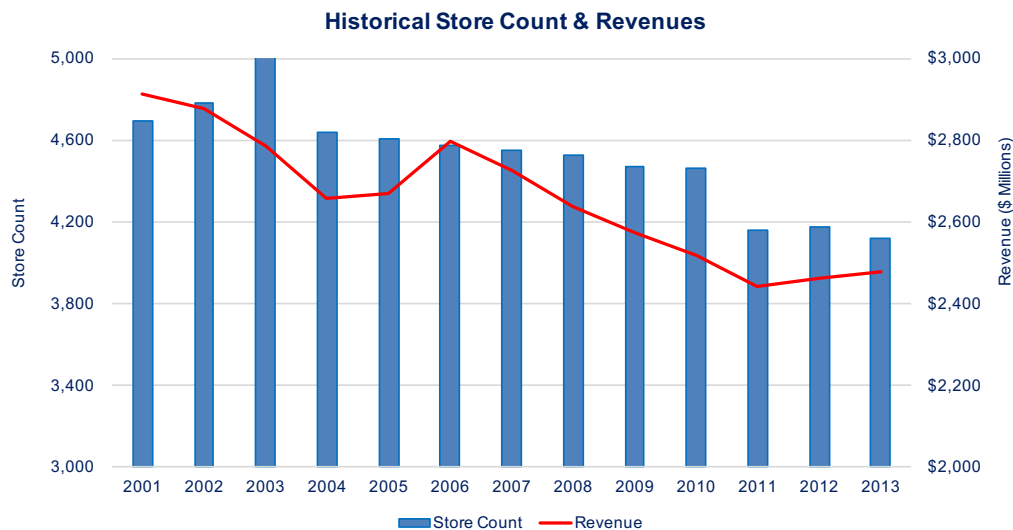
- Historically, Payless' operating performance had differed from the peer group in the following areas: same-store sales ("SSS") growth, profitability, liquidity, and leverage.



MSG

7

Payless' Historical Store Count & Revenues

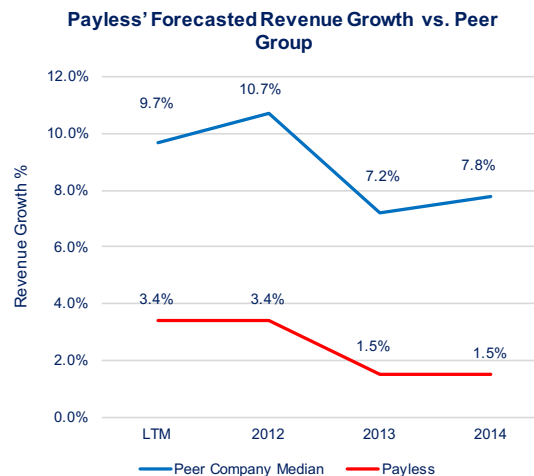
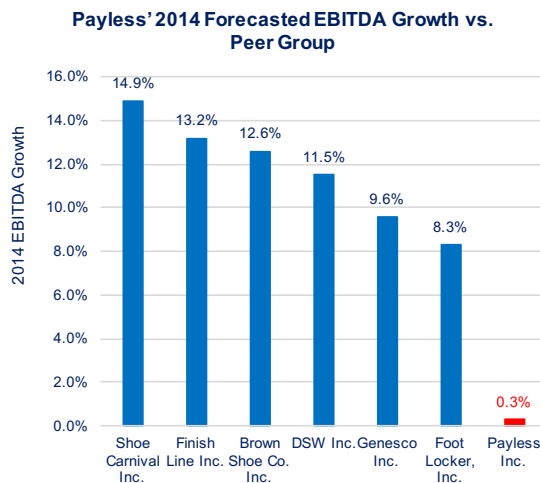


MSG

8

Payless' Forecasted Growth vs. Peer Group

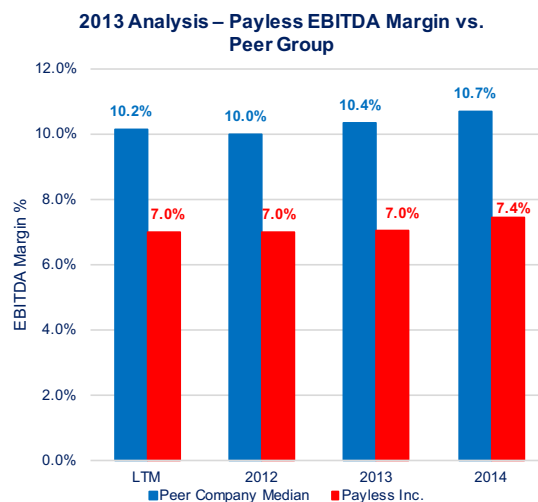
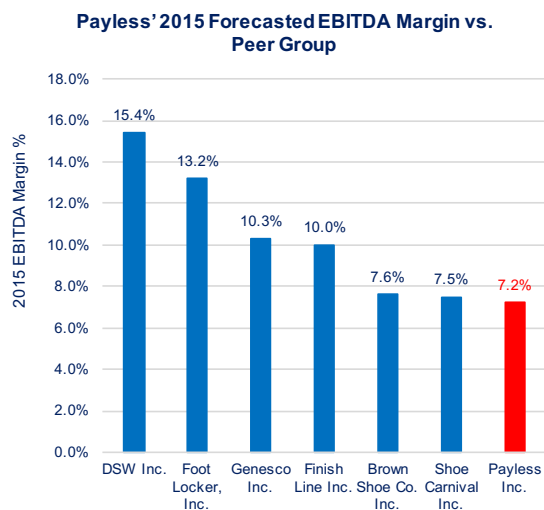
- Payless' forecasted revenue growth and EBITDA growth was significantly lower than the peer group.



9

Payless' Forecasted Profitability vs. Peer Group

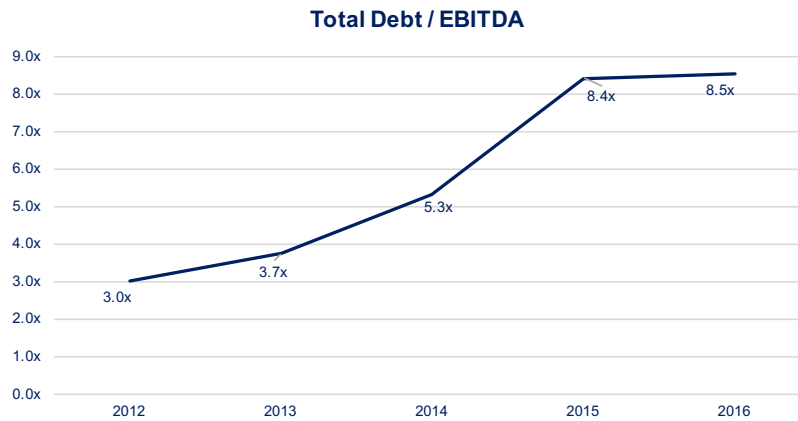
- Payless' forecasted profitability, as measured by EBITDA margin was significantly lower than the peer group.



10

Payless' Total Debt-to-EBITDA

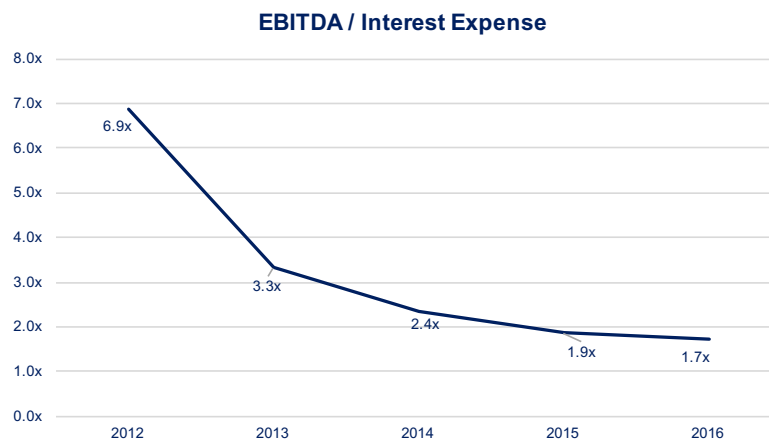
- Total debt more than doubled over the period, while EBITDA decreased more than 20%.



11

Payless' EBITDA Interest Coverage

- Similar to Total Debt-to-EBITDA, EBITDA to Interest Expense had deteriorated in the years following the dividend recapitalizations due to a steady increase in debt and a dramatic decrease in EBITDA.



12

Rating Agency Downgrades (As of February 15, 2018)

Entity	Date	Moody's		Date	S&P		
		Rating	Rating Note		Rating	Rating Note	Outlook
Bon-Ton Stores, Inc.	2/8/2018	WR	Bankruptcy	2/5/2018	D	Downgrade	-
	2/5/2018	Ca	Affirm	12/19/2017	SD	Downgrade	-
	1/17/2018	Ca	Downgrade	11/22/2017	CCC	Downgrade	Negative
	11/21/2017	Caa3	Downgrade				
Charlotte Russe Holding, Inc.	12/18/2017	WR	Reorganization	2/5/2018	SD	Downgrade	-
	12/15/2017	Ca	Downgrade	12/15/2017	CC	Downgrade	Negative
	5/25/2017	Caa1	Downgrade	9/21/2017	CCC-	Downgrade	Negative
Charming Charlie LLC	12/13/2017	WR	Bankruptcy	12/13/2017	D	Downgrade	-
	12/12/2017	Ca	Downgrade	10/19/2017	CCC	Downgrade	Negative
Claire's Stores, Inc.	10/3/2016	Ca	Downgrade	10/4/2016	CC	Upgrade	Negative
Cole Haan LLC	5/11/2017	Caa1	Downgrade				
David's Bridal, Inc.	2/9/2018	Caa3	Downgrade	1/12/2018	CCC	Downgrade	Negative
	9/11/2017	Caa2	Downgrade	3/24/2017	CCC+	Downgrade	Negative
J. Crew Group, Inc.	7/18/2017	Caa2	Reinstated	7/14/2017	CCC+	Upgraded	Negative
				7/12/2017	SD	Downgrade	-
				6/14/2017	CC	Downgrade	Negative
Neiman Marcus Group LTD LLC	3/15/2017	Caa2	Downgrade	6/30/2017	CCC	Downgrade	Negative
Nine West Holdings, Inc.	1/19/2018	Ca	Downgrade	5/12/2017	CCC-	Downgrade	Negative
Quiksilver, Inc.				1/5/2018	CCC+	-	Positive
				6/28/2017	CCC+	Downgrade	Negative
Sears Holdings Corporation	1/26/2018	Ca	Downgrade	1/24/2018	CC	Downgrade	Negative
	11/16/2017	Caa3	Downgrade	1/17/2018	CCC-	Downgrade	Negative
				10/27/2017	CCC	Downgrade	Negative
TOMS Shoes, LLC	12/14/2017	Caa3	Downgrade	8/15/2017	CCC+	Downgrade	Negative
Toys R Us, Inc.	9/21/2017	WR	Bankruptcy	1/23/2018	NR	Withdrawn	Not Rated
				9/19/2017	D	Downgrade	-
				9/18/2017	CCC-	Downgrade	Negative
				9/7/2017	CCC+	Downgrade	Negative
				6/19/2017	B-	-	Negative
True Religion Apparel, Inc.	7/7/2017	WR	Withdrawn	8/7/2017	NR	Withdrawn	Not Rated
	7/6/2017	Ca	Affirm	7/5/2017	D	Downgrade	-
Vince, LLC	6/22/2017	Caa2	Downgrade				
	4/20/2017	Caa1	Downgrade				

Sources: Moody's data obtained from Moody's website. S&P data obtained from FactSet.



The End Result



Select List of Recent & Planned Store Closures

January 1, 2017 through February 15, 2018

<u>Company</u>	<u>Store Closings</u>	<u>Company</u>	<u>Store Closings</u>
RadioShack	1,000	GameStop	150
Payless	800	J.C. Penney	148
Walgreens	600	BCBG	120
Sears & Kmart	524	American Apparel	110
Rue21	400	Michael Kors	100
Teavana	379	Charming Charlie	97
Gymboree	350	Macy's	79
Ascena Retail Group	268	Staples	70
The Limited	250	Perfumania	64
Family Christian	240	Sam's Club	63
hhgregg	220	Abercrombie & Fitch	60
Gap + Banana Republic	200	Vitamin World	51
Toys R Us	182	Vera Bradley	50
Bebe Stores	180	J. Crew	50
Wet Seal	171	Bon-Ton	42
Crocs	160	True Religion	27
Guess	160	Total Closings	7,365

Sources: Information obtained from www.clark.com and www.businessinsider.com.

Value & Cents

BY DR. ISRAEL SHAKED AND BRAD ORELOWITZ¹

Understanding Retail Bankruptcy



Dr. Israel Shaked
The Michel-Shaked
Group; Boston



Brad Orelowitz
The Michel-Shaked
Group; Boston

Dr. Israel Shaked is the managing director of The Michel-Shaked Group and a professor of finance and economics at Boston University Questrom School of Business. Brad Orelowitz, CPA is a senior vice president with the firm and has more than 25 years of experience in finance and accounting.

Over the past year, newspapers and financial websites have been full of articles discussing the distress happening with retail companies. The number of store closures and employee layoffs is increasing every week. This year, the number of distressed retail companies has been far greater than any other year in recent history. For example, a select list of doomsayer articles on retail distress includes:

- “Retail Distress Shows No Sign of Abating, Record Store Closures Anticipated”;²
- “The Retail Bubble Has Now Burst: Which Retailers Are in the Most Trouble?”;³
- “The Running List of 2017 Retail Apocalypse Victims”;⁴
- “2017 Retail Bankruptcies Are Piling Up (and There’s No End in Sight)”;⁵
- “22 Retailers That Are at Serious Risk of Bankruptcy”;⁶
- “Moody’s: Number of Distressed Retailers Tops Total During Financial Crisis”;⁷
- “From a Risk-of-Bankruptcy Standpoint, the Retail Business Is the New Oil and Gas”;⁸
- “Rise of Amazon Leaves Even More Retailers in Intensive Care”;⁹ and
- “Retail Is Crumbling: This Data on the Industry’s Health Hasn’t Been this Bad Since Great Recession.”¹⁰

Surprisingly, this retail distress does not reflect the state of the U.S. economy. The unemployment rate is at a 16-year low, housing prices have increased steadily since 2011, and the stock markets have been hitting record levels this year.

Reasons for Financial Distress

There are two primary reasons for the financial distress. First, there is an obvious shift in consumption patterns away from brick-and-mortar stores to online stores. Department stores nationwide are losing ground to online retailers. For example, the U.S. Commerce Department reported that department store sales for December 2016 declined by 7.2 percent over the prior year and experienced 23

consecutive months of year-over-year declines. In contrast, non-store retailers (including internet and catalog sales) gained 10.4 percent over the prior December, and experienced double-digit gains in six months of the prior year.¹¹

Further, quarterly retail e-commerce sales for the second quarter of 2017 increased by 16.2 percent over the second quarter of 2016. Retail sales excluding e-commerce sales increased by only 3.1 percent over this time period. In contrast, for 31 consecutive quarters, quarterly year-over-year e-commerce sales have increased by an average of 15.2 percent. Over this same time period, retail sales excluding e-commerce companies have increased by an average of 3.6 percent.¹²

The second reason causing financial distress is the level of debt at the retailer. In general, retail companies typically have lower levels of debt than most other industries. However, this does not tell the full story.

Retail companies have the fixed commitment of leases. Lease agreements for retail stores are typically operating leases in which the lessor transfers the right to use the property to the lessee. At the end of the lease agreement, the property is returned to the lessor. There is no asset or liability recognized on the lessee’s balance sheet, and the lessee deducts the full operating lease payment on its income statement.

On the other hand, in a capital lease, the risks of ownership are transferred to the lessee. At the end of the lease, the lessee owns the property. In this lease, the lessee recognizes the asset and the liability on the balance sheet, and deducts depreciation and the interest component of the lease payment (if the lease life exceeds 75 percent of the life of the asset, ownership transfers at the end of the lease, there is an option to purchase the asset at the end of the lease at a bargain price, and the present value of the lease payments is greater than 90 percent of the fair-market value of the asset).

When analyzing the fixed commitments of a debtor, it is irrelevant whether the leases are capital or operating leases. This is an accounting distinction on whether to capitalize or expense the lease. However, all stakeholders have to understand that from economic and credit-risk perspectives, the dis-

¹ Dr. Shaked also served for 20 years as a coordinating editor for the *ABI Journal* and is a co-author of *A Practical Guide to Bankruptcy Valuation, Second Edition* (ABI 2017), available for purchase at store.abi.org.

² *ABL Advisor*, June 22, 2017.

³ Douglas A. McIntyre, 24/7 Wall St., April 18, 2017.

⁴ Corinne Ruff and Ben Unglesbee, *RetailDive.com*, July 5, 2017.

⁵ Daniel B. Kline, *The Motley Fool*, May 19, 2017.

⁶ Brad Tuttle, *Time.com*, June 13, 2017.

⁷ Kevin McCoy, *USA Today*, June 9, 2017.

⁸ Tonya Garcia, *MarketWatch*, March 9, 2017.

⁹ Matt Egan, *CNN Money*, March 9, 2017.

¹⁰ Kaya Yurieff, *TheStreet*, March 5, 2017.

¹¹ Jordan Yadoo, “Retail Sales Figures Bear Out America’s Storefront-to-Online Shift,” *Bloomberg*, Jan. 13, 2017, available at bloomberg.com/news/articles/2017-01-13/retail-sales-figures-bear-out-america-s-storefront-to-online-shift (last visited Sept. 21, 2017).

¹² U.S. Census Bureau, *Monthly and Annual Retail Trade, Latest Quarterly E-Commerce Report*, available at census.gov/retail/mrts/www/data/excel/tsadjustedsales.xls (last visited Oct. 4, 2017).

tion is irrelevant, as the company in both types of leases has a fixed obligation that must be met. Even though operating leases do not appear on the balance sheet, it is critical to account for these fixed obligations when analyzing a company's creditworthiness.

A common rule-of-thumb method of analyzing leasehold commitments is to multiply the current rent by eight to provide a rough estimate of capitalized leases. An analyst can then add this estimated amount to the on-balance-sheet debt. This serves as a proxy for total debt.

These excessive levels of debt (as well as the pressure from online retailers) are changing the retail landscape. In 2017, the number of retail bankruptcies has been substantially higher than in previous years. There are also many retailers facing distress, and as indicated in Table 1, they are closing record numbers of stores in 2017. The list is current as of September 2017; however, the number of store closures varies by source, and these estimates are changing frequently.

Furthermore, consider the following list of rating agencies' opinions, as shown in Table 2. The struggles facing these retailers have led to an overall deterioration in credit rating.

In general, these companies have excessive debt and/or are facing stiff competition from Amazon and other successful online retailers. Retail distress as a result of a high level of leverage is not new. For example, consider the classic case of Macy's.

Retail Distress Is Not a New Phenomenon

On Oct. 21, 1985, the senior management of R.H. Macy & Co. Inc. announced a plan to take the retailer private in a \$3.58 billion leveraged buyout (LBO). Macy's operated 83 stores in 12 states containing approximately 22.3 million square feet of store space and employed more than 54,000 workers. The proposal, the first LBO proposal for a major

retailer, offered shareholders \$70 per share, an amount that represented about 19 times the 1985 earnings and 2.7 times book value. Following the announcement, the stock, which had closed at 47-and-1/8th the previous day, surged 16-and-1/8th per share to close at 63-and-1/4th. In making the buyout announcement, Macy's Chair/CEO Edward S. Finkelstein and President/COO Mark S. Handler indicated that their new management group would include "an unusually large number" of Macy's executives. In fact, the desire to retain top-management talent was one of the major reasons for the buyout proposal. Equally important was management's desire to free itself from the pressures of the short-term performance that is typically required in a public company. At the time of the announcement, details of the financing structure were not yet finalized.

Two months after the initial buyout news, financing difficulties forced the management group to lower its offer to \$68 per share. The company's board approved this proposal the following month.

From 1980-84, Macy's net operating margins and profit margins were significantly better than its peer groups, averaging 11.2 versus 7.2 percent and 4.9 versus 3.4 percent, respectively. Furthermore, Macy's sales per square foot, a rough measure of productivity, averaged \$137 during this five-year period, compared to an average of \$108 for the peer group. Macy's management attributed the company's historical growth and profitability to strategies of store expansion and modernization, innovative merchandising, productivity and cost control, and management development. Under Finkelstein's stewardship, Macy's emerged to become one of the nation's most successful department store chains. Its management was considered one of the best in the industry, and its expansion program was considered highly successful.

However, the LBO placed a significant debt-repayment burden on the company. Prior to the LBO, Macy's debt-to-equity ratio was 0.14:1 (for every dollar of equity, the company had 14 cents of debt). Following the LBO, this ratio increased to 10:1. In other words, for every dollar of equity, the company had \$10 of debt. And this was *before* considering the fixed commitments of its leases.

Prior to the LBO, Macy's Beta (*i.e.*, Macy's stock volatility relative to the overall market) was 1.10. Following its LBO, Macy's Beta, reflecting its new level of debt, was 6.15. This is an extremely high level of market risk, and any downturn in the market is exacerbated by a company's high level of debt.

Following the LBO, the company improved operationally. However, with debt levels as significant as Macy's were, there was very little margin to weather any decline in financial performance. Macy's filed for bankruptcy in January 1992, during the first recession following its LBO.

Three decades after Macy's LBO, excessive debt is still plaguing retailers. In 2005, Toys "R" Us was taken private by Kohlberg Kravis Roberts, Bain Capital Private Equity and Vornado Realty Trust. Before its LBO, its debt on the balance sheet was \$2.3 billion. With an EBITDA of more than \$800 million, its ratio of debt-to-EBITDA was under 3x. At the end of 2016, its debt was approximately \$4.8 billion, with

Table 1

Company	Store Closings	Company	Store Closings
RadioShack	1,000	Gordmans Stores	106
Ascena Retail Group	667	Michael Kors	100
Payless Shoe Source	512	Staples	70
rue21	400	Macy's	68
Gymboree	350	Perfumania	64
The Limited	250	Abercrombie & Fitch	60
Family Christian	240	G-III Apparel Group	60
hhgregg	220	Guess Inc.	60
Gap Inc.	200	Vitamin World	51
Bebe Stores	180	Gander Mountain	30
Sears and Kmart	180	True Religion	27
Wet Seal	171	Eastern Mountain Sports	27
Crocs	160	American Eagle Outfitters	25
Game Stop	150	Bob's Stores	21
J.C. Penney	138	Tailored Brands	11
BCBG Max Azria	120	Neiman Marcus	10
American Apparel	110	Total Closings	5,838

continued on page 72

Value & Cents: Understanding Retail Bankruptcy

from page 21

EBITDA dropping to a little more than \$600 million. Its debt-to-EBITDA ratio soared to 7.6x. Similarly, its interest-coverage ratios (EBITDA divided by interest — a measure of how easily a company can pay its interest expense) decreased from over 6x prior to its LBO to 1.4x in 2016. Toys “R” Us filed for bankruptcy in September 2017. When accounting for its lease obligations, the ratio of total debt (including an estimate for capitalized operating leases)-to-EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) almost doubles between the LBO and the end of 2016.

Are Retailers Good LBO and Dividend-Recapitalization Candidates?

One wonders whether retailers in general are good LBO and dividend-recapitalization candidates. In their investment banking book, Rosenbaum and Pearl discuss the ideal LBO target:

Characteristics of a Strong LBO Candidate:

- Strong Cash Flow Generation;
- Leading and Defensible Market Positions;
- Growth Opportunities;
- Efficiency Enhancement Opportunities;

- Low Capex Requirements;
- Strong Asset Base; [and]
- Proven Management Team.¹³

While the authors routinely observe many retail LBOs, retail is not the ideal LBO candidate. For example, retail is cyclical, so strong cash-flow generation is not consistent. Brick-and-mortar retailers are facing tremendous market pressure from online retailers, which dilutes market share and impacts growth opportunities. Retailers with multiple locations require capex for store improvements, which are usually an ongoing (and expensive) process. Furthermore, retailers do not have a strong asset base. Typically, their only asset of any value is inventory, as they lease their stores. While many retailers do have intellectual property, this is usually not sufficient collateral for an LBO. Therefore, retailers are not ideal targets for an LBO.

Nevertheless, the retail industry has long been a favorite industry for private-equity (PE) investors. Over the past several years, PE firms have invested in thousands of deals. A select list of PE involvement in distressed retailers is shown in Table 3.

¹³ Joshua Rosenbaum and Joshua Pearl, *Investment Banking: Valuation, Leveraged Buyouts and Mergers & Acquisitions*, p. 168 (John Wiley & Sons 2009).

Table 2

Entity	Date	Moody's		Date	S&P		
		Rating	Rating Note		Rating	Rating Note	Outlook
Charlotte Russe Holding Inc.	05/25/17	Caa1	Downgrade	02/06/17	CCC+	Downgrade	Negative
Charming Charlie LLC	12/22/16	Caa1	Downgrade	02/10/17	CCC+	Downgrade	Negative
Claire's Stores Inc.	10/03/16	Ca	Downgrade	10/04/16	CC	—	Negative
				08/18/16	CC	Downgrade	—
				05/11/16	CCC-	—	Negative
Cole Haan LLC	05/11/17	Caa1	Downgrade				
David's Bridal Inc.	09/19/16	Caa1	Affirm	03/24/17	CCC+	Downgrade	Negative
J.Crew Group Inc.	07/18/17	Caa2	Reinstated	07/14/17	CCC+	Upgrade	Negative
				06/14/17	CC	Downgrade	Negative
				12/13/16	CCC-	Downgrade	Negative
Neiman Marcus Group Inc.	03/15/17	Caa2	Downgrade	06/30/17	CCC	Downgrade	Negative
				02/09/17	CCC+	Downgrade	Negative
Nine West Holdings Inc.	01/19/17	Caa3	Downgrade	05/12/17	CCC-	Downgrade	Negative
	08/26/16	Caa2	Downgrade	08/26/16	CCC	Downgrade	Negative
Quiksilver Inc.				06/28/17	CCC+	Downgrade	Negative
Sears Holding Corp.	01/20/17	Caa2	Downgrade				
TOMS Shoes LLC	07/17/17	Caa2	Downgrade	08/15/17	CCC+	Downgrade	Negative
True Religion Apparel Inc.	07/07/17	WR	Withdrawn	08/07/17	NR	Withdrawn	Not Rated
	07/06/17	Ca	Affirm	07/05/17	D	Downgrade	—
	01/13/17	Ca	Downgrade				
Vince Holding Corp.	06/22/17	Caa2	Downgrade				
	04/20/17	Caa1	Downgrade				
	10/28/16	B3	Downgrade				

Historically, retailers have been attractive targets for PE firms for a number of reasons. Many of the retailers targeted by PE firms are household names. For these companies, it is easier to convince lenders as to the company's long-term viability. Through dividend recapitalizations, PE firms are able to limit their downside risk.

In *Payless ShoeSource*, a case in which the authors were involved, the company's leverage was tripled at the time of the LBO.¹⁴ Moreover, only four months following the LBO, a dividend of \$225 million was paid to the company's PE owners, almost as much as their equity investment just four months earlier. The full amount was financed by the issuance of new

¹⁴ All information regarding Payless ShoeSource (or any other company mentioned in this article) is strictly from publicly available data sources.

Table 3

Entity	Private-Equity Firm
Charlotte Russe Inc.	Advent International Corp.
Charming Charlie LLC	TSG Consumer Partners LLC
	THL Credit Group LP
	Hancock Park Associates Inc.
Claire's Stores Inc.	Apollo Global Management LLC
	Tri-Artisan Capital Partners LLC
Cole Haan LLC	Apax Partners (UK) Ltd.
David's Bridal Inc.	Clayton Dubilier & Rice LLC
	Leonard Green & Partners LP
	AlpInvest Partners BV
	Crescent Capital Group
	Hartford Mezzanine & PE Group
	Stockwell Capital LLC
Eddie Bauer LLC	TPG Growth LLC
	Golden Gate Private Equity Inc.
J.Crew Group Inc.	Leonard Green & Partners LP
	NB Alternative Advisers LLC
	TPG Capital LLC
Neiman Marcus Group Inc.	Ares Private Equity Group
	Canada Pension Plan Investment Board
	Pantheon Ventures (UK) LLP
	aPriori Capital Partners LP
	Leonard Green & Partners LP
	TPG Capital LLC
Nine West Holdings Inc.	Warburg Pincus LLC
	Sycamore Partners Management LP
Payless Holdings LLC	CNL Fund Advisors Co.
	Golden Gate Private Equity Inc.
TOMS Shoes LLC	Blum Capital Partners LP
	Bain Capital Private Equity LP
True Religion Apparel Inc.	TowerBrook Capital Partners LP
Vince Holding Corp.	Sun Capital Partners Inc.

Note: Certain PE firms have already exited their positions on the list.

debt, which greatly reduced their downside risk. A year later, the company borrowed an additional \$145 million to declare a dividend of approximately \$127 million. These three transactions, the LBO and the two dividend recapitalizations, backed by solvency opinions, increased the company's debt from \$126 million to \$706 million in only 17 months. However, not one single penny of the new borrowing went to the company's benefit, as the loan proceeds went to selling shareholders and the company's PE owners, and to cover the transaction costs. All of this was done at a time when Payless's same-store sales (a measure of growth in stores that have been open for more than one year) was declining. This left Payless with very little equity cushion to weather the storm in bad times.

When a retailer retains an investment bank to explore an LBO, the investment bank typically approaches multiple potential investors, including strategic investors and financial investors. This also attracts the interest of multiple PE firms, and a bidding war ensues. Therefore, it is often the case that the price paid is high. This high price results in an equity investment from the PE firms and a large amount of debt from lenders. As a result, the PE firms are under pressure to realize returns as soon as possible. This can be done through an exit (e.g., an IPO or a sale). An IPO and a sale are complicated and lengthy processes.

A dividend is the easiest way to get a return on investment. However, if a company does not have the liquidity to pay the dividend, it can do a dividend recapitalization (borrowing funds to declare out as dividends) with support from banks and capital markets.

The Dividend-Recapitalization Puzzle

The puzzle is, if this is so risky, why is this done? There are multiple stakeholders at these companies, such as PE firms and other equityholders, lenders, management, employees, landlords and vendors. As previously discussed, the PE firms and equityholders minimize their future risk through dividends. Lenders have client relationships with PE firms. They earn significant fees from these firms, and typically syndicate the loans, thereby reducing their risk. Management often has an equity stake in the company post-LBO, and benefits as the PE firms and equityholders benefit. However, at risk are employees, landlords and vendors, all of whom have had no say in dividend recapitalizations.

Potential Preemptive Measures

Management and financial advisors are in a continuous search for preemptive measures that will minimize the likelihood of distress. A proactive management team can mitigate some of these risks by continuously analyzing store profitability and cost-cutting measures. Management should attempt to close the less-profitable stores as soon as their lease agreements allow.

It is important for management to understand the risks associated with dividend recapitalizations and communicate these risks to stakeholders (including PE firms). There is no fair consideration in these transactions, and they expose key players such as significant shareholders, lenders and board members to fraudulent conveyance claims. **abi**

Copyright 2017 American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.



VALCON 2018: Cutting-Edge Valuation Solutions

Issues in Retail Valuation

Leveraged Buyouts:

Potential Claims Against Private Equity Firms, Individual Directors/Managers and Lenders and their Agents Involved in an LBO and its Aftermath

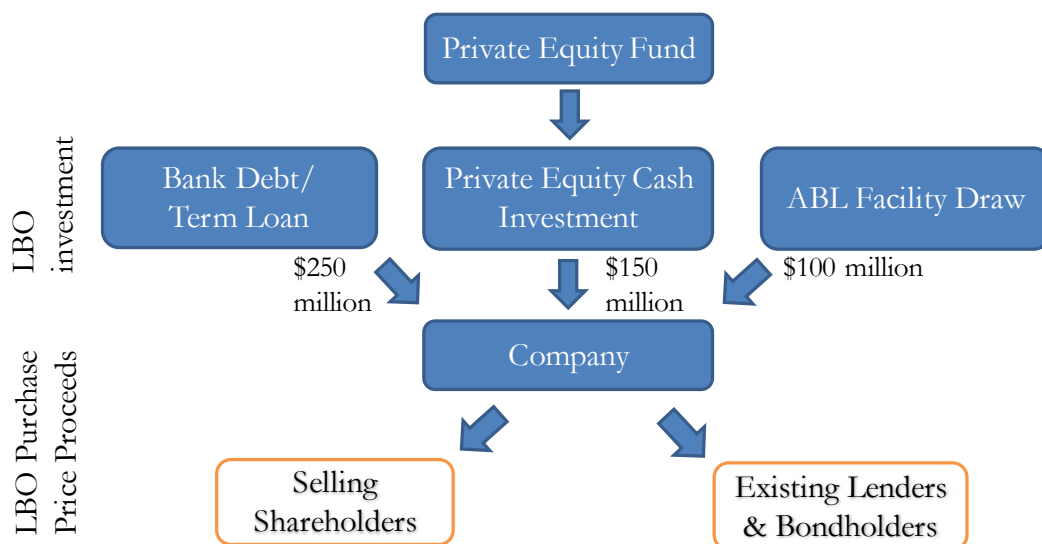
May 17, 2018
Las Vegas, Nevada

Jeffrey N. Pomerantz

Pachulski Stang Ziehl & Jones LLP; Los Angeles, CA

PACHULSKI
STANG
ZIEHL
JONES

The October 2015 Leveraged Buyout



Debtors' 2016 Dividend Payments



February 2016: \$150 Million Dividend Paid to PE, LLC

Results of 2015 LBO and 2016 Dividend

Value to:

Company X

= \$150 Million equity infusion,
PE expertise in growing revenue
and shrinking expenses



Value to:

PE, LLC

= Over \$500 Million in Stock,
Dividends & Fees



Overview of Typical Leveraged Transaction

Leveraged Buy-Out

- On October 1, 2015, Company X and its subsidiaries (collectively the “Debtors”) are acquired by private equity firm PE, LLC (“PE”) for \$500 million. To fund the acquisition, the Debtors incurred \$350 million of new debt. The new debt incurred by the Debtors consisted of (i) \$250 million under a Term Loan, and (ii) \$100 million drawn on an ABL Facility (the “ABL Draw”).

Purchase Price Consideration	
Term Loan Proceeds:	\$250 million
ABL Draw:	\$100 million
PE Equity:	\$150 million
Total Purchase Price Consideration:	\$500 million

Overview of Typical Leveraged Transaction

Leveraged Buy-Out (Cont'd)

- The Debtors incurred \$10 million of fees in connection with the 2015 LBO, \$3 million of which was paid to PE for “financial advisory” work.
- In addition, the Debtors entered into an advisory/management agreement with PE providing for payment of approximately \$3 million each year.

Overview of Typical Leveraged Transaction

Dividend Recapitalization

- On February 1, 2016, the Debtors borrowed an additional \$150 million under the Term Loan, which flowed upstream from Company X, as the lead borrower, and ultimately was paid as a dividend to PE.
- The Debtors incurred an additional \$8 million in fees for the 2016 Term Loan Add-On, which was paid with cash from the Debtors' balance sheet. Of the total fees, \$2.5 million was paid to PE.
- At the time of the 2016 dividend, the Board of Company X had five members: (i) the CEO of Company X, and (ii) four PE designees, three of whom also sit on the Board of PE. The amount and timing of the dividend to PE was determined by the vote of a majority of the Board, including the PE designees.

The Debtors' Chapter 11 Filings

- The Debtors became increasingly unable to meet their obligations as they came due through 2017.
- The Debtors filed chapter 11 cases on January 15, 2018 (the "Petition Date").

Summary of the Debtors' Claims

As detailed below, the Debtors (or those litigating on the estates' behalf) will argue as follows:

- Between October 1, 2015 and the Petition Date the Debtors suffered losses in excess of \$524.75 million, through transactions primarily for the benefit of PE and the Debtors' secured lenders.
- The Debtors were insolvent at the time of each component transaction, or rendered insolvent thereby.
- At the direction of PE, and through an abdication of their fiduciary duties, the Debtors' management allowed PE to extract from the Debtors more than their initial equity investment in the Debtors.
- This was accomplished by layering borrowings on the Debtors, which increased the Debtors' secured debt by \$500 million between the time of the LBO and the Petition Date.

Summary of Responses/Defenses to the Debtors' Claims

The primary responses/defenses by the targets of the Debtors' claims (including PE, lenders and the Debtors' directors and managers) include the following:

- The Debtors were solvent at all relevant times, (often) as established by "fairness opinions" indicating that Company X was solvent both prior to and following each transaction. (The fairness opinion will often be a primary focus of litigation.)
- The Debtors' financial problems were caused by external factors (*e.g.*, online competition) and not by the additional debt incurred to effectuate the 2015 LBO and the 2016 dividend.
- PE contributed substantial equity and brought important expertise to the Debtors' business.
- Dividends and management fees are a customary part of the corporate experience.

The Debtors' Claims

Overview of Damages

- The Debtors arguably suffered damages and otherwise incurred recoverable losses between October 1, 2015 and the Petition Date that exceeded \$500 million, as follows (\$ in millions):

	LBO Financing	Dividends & Add'l Debt	Transaction Fees	Mgmt. Fees	Total Per Year
2015	\$350	--	\$10	\$0.75	\$360.75
2016	--	\$150	\$8	\$3	\$161
2017	--	--	--	\$3	\$3
	\$350	\$150	\$18	\$6.75	\$524.75

The Debtors' Claims

Overview of Damages (Cont'd)

- The amounts shown above do not include (i) the value of the liens the Debtors can avoid, or (ii) the amounts of payments (in excess of fees) made by the Debtors in connection with the 2015 Term Loan and the 2016 Term Loan Add-On.
- As specified on the following slides, damages and other losses which can be proven may be recoverable primarily from PE, the individual directors/managers of the Debtors, and the lenders and their agents for the 2015 Term Loan and the 2016 Term Loan Add-On.

The Debtors' Causes of Action

Avoidance & Recovery in Connection with the 2015 LBO as a Fraudulent Transfer

Potential Claims

- The 2015 LBO should be avoided as a constructively fraudulent transfer under applicable state law, assuming it can be proven that the Debtors were insolvent immediately following the incurrence of the \$350 million of secured debt which financed PE's purchase of Company X, because the Debtors did not receive reasonably equivalent value in exchange for the debt incurred and the liens granted.
- The 2015 LBO is subject to avoidance and recovery as an actual fraudulent transfer under applicable state law. Badges of fraud include, among other things, that (i) the LBO benefitted only PE, (ii) the Debtors did not receive reasonably equivalent value in exchange for it, and (iii) the Debtors were rendered insolvent by the LBO.

The Debtors' Causes of Action

Avoidance & Recovery in Connection with the 2015 LBO as a Fraudulent Transfer (Cont'd)

Potential Defendants

- Lender, as the beneficiary of the debt incurred and the liens granted by Company X to partially fund the LBO, and PE, as the initial transferee and beneficiary of the stock of Company X it received.

Potential Damages

- \$350 million, plus applicable interest.

The Debtors' Causes of Action

Avoidance & Recovery in Connection with the 2015 LBO as a Fraudulent Transfer (Cont'd)

Potential Responses/Defenses

- The Debtors were neither insolvent nor rendered insolvent by the LBO, as evidenced by the fairness opinion obtained in connection therewith.
- The Debtors received reasonably equivalent value: a \$150 million equity infusion and PE's expertise in turning around a troubled company (or enhancing revenues and reducing expenses of a healthy company).
- The Debtors' financial problems resulted from (for example) competition from online competitors and/or high labor costs.

The Debtors' Causes of Action

Avoidance & Recovery of the 2016 Dividend as a Fraudulent Transfer (Cont'd)

Potential Claims

- The 2016 dividend should be avoided as a constructively fraudulent transfer under applicable state law and, having occurred within two years of the Petition Date, under Bankruptcy Code §548(a)(1), assuming it can be proven that the Debtors were insolvent at the time of the dividend, because the Debtors did not receive reasonably equivalent value in exchange for the dividend.
- The 2016 dividend is subject to avoidance and recovery as an actual fraudulent transfer under applicable state law and under Bankruptcy Code §548(a)(1). Badges of fraud include that (i) the dividend was paid to an insider, (ii) the Debtors did not receive reasonably equivalent value in exchange for the dividend, (iii) the Debtors were insolvent, (iv) the dividend was paid shortly after the Debtors incurred significant debt, and (v) the dividend was not reasonably discoverable by unsecured creditors.

The Debtors' Causes of Action

Avoidance & Recovery of the 2016 Dividend as a Fraudulent Transfer (Cont'd)

NOTE: Under the collapsing doctrine, the upstream payment of the dividend will be viewed as a phase of a single transaction that began with the borrowings by Company X and other Debtors and ended with the dividend payment to PE.

Potential Defendants

- Lender, as the beneficiary of the debt incurred and the liens granted by Company X to fund the dividend, and PE, as the initial transferee and beneficiary of the dividend.

Potential Damages

- \$150 million, plus applicable interest, without duplication of any recovery of the same \$150 million as an illegal dividend (see following slides).

The Debtors' Causes of Action

Avoidance & Recovery of the 2016 Dividend as a Fraudulent Transfer (Cont'd)

Potential Responses/Defenses

- The Debtors were neither insolvent nor rendered insolvent by the 2016 Term Loan Add-On, as evidenced by the fairness opinion obtained in connection therewith.
- Among others, the lender vetted this transaction and believed in the Debtors' solvency following the 2016 Term Load Add-On.
- No actual fraud. There is nothing inherently improper with Company X paying dividends to its shareholders and a dividend recapitalization is a common way to distribute equity.

The Debtors' Causes of Action

Recovery of the 2016 Dividend as an Illegal Dividend

Potential Claims

- The 2016 dividend should be recovered as an illegal dividend under the laws of most states. Under the collapsing doctrine, the upstream payment of the dividend will be viewed as a phase of a single transaction that began with the borrowings by Company X and other Debtors and ended with the dividend payment to PE.
- The 2016 dividend was illegal (i) under the Delaware Limited Liability Company Act, because Company X was insolvent at the time of the dividend, and (ii) under Delaware's General Corporation Law, because Company X lacked sufficient surplus or net profits, and was otherwise insolvent, at the time of the dividend.
- Applicable statutes of limitations may be extended under equitable tolling doctrines.

The Debtors' Causes of Action

Recovery of the 2016 Dividend as an Illegal Dividend (Cont'd)

Potential Defendants

- PE, as the recipient of the 2016 dividend, and the five members of the Board of Directors and any managers who authorized the 2016 dividend.

Potential Damages

- \$150 million, plus applicable interest, without duplication of any recovery of the same \$150 million as a fraudulent transfer (see preceding slides).

Potential Responses/Defenses

- Will argue that insolvency and the other prerequisites under the Delaware statutes did not exist at time of 2016 Term Loan Add-On and dividend.

The Debtors' Causes of Action

Avoidance & Recovery of the 2015-2017 Fees as Fraudulent Transfers

Potential Claims

- The financial advisory fees paid to PE in connection with the 2015 LBO and the 2016 dividend recapitalization should be avoided as constructively fraudulent transfers and actual fraudulent transfers under applicable state law, as the Debtors benefitted from neither. These claims are similar to the Debtors' claims to avoid and recover the 2016 dividend.
- The financial advisory fees paid to PE in connection with the 2016 dividend (*i.e.*, within two years of the January 15, 2018 Petition Date) should also be avoided under section 548 of the Bankruptcy Code.
- Annual advisory/management fees paid to PE should be avoided under the same theories and statutes since PE did not provide reasonably equivalent value to Company X in exchange for them.

The Debtors' Causes of Action

Avoidance & Recovery of the 2015-2017 Fees as Fraudulent Transfers (Cont'd)

Potential Defendants

- PE, and other financial advisors involved in the 2015 LBO and/or the 2016 dividend recapitalization, as the initial transferees and beneficiaries of the fraudulent transfers.

Potential Damages

- A maximum of \$24.75 million, plus applicable interest. This amount includes approximately \$6.75 million paid in ongoing advisory/management fees, and approximately \$18 million paid as "transaction" fees.

The Debtors' Causes of Action

Avoidance & Recovery of the 2015-2017 Fees as Fraudulent Transfers (Cont'd)

Potential Responses/Defenses

- With respect to transaction-related fees, PE (and other advisors) will argue the defenses noted above in connection with the underlying transactions.
- With respect to ongoing management fees, PE will argue, and provide examples and evidence of, beneficial changes it brought to Company X (e.g., new, cheaper suppliers of raw materials, marketing campaigns).

The Debtors' Causes of Action

Claims Against the 2015 and 2016 Lenders and their Agents

Potential Claims

- The obligations incurred by the Debtors, the liens granted by the Debtors and any payments made by the Debtors under the 2015 Term Loan, 2015 ABL Draw and 2016 Term Loan Add-on should be avoided as constructively fraudulent transfers and actual fraudulent transfers under applicable state law, and under Bankruptcy Code §548 for those relating to the 2016 Term Loan Add-On. The facts that establish these claims are similar to the facts that establish the Debtors' claims to avoid the 2015 LBO and the 2016 dividend.

The Debtors' Causes of Action

Claims Against the 2015 and 2016 Lenders and their Agents (Cont'd)

- The secured claims of the 2015 Term Loan and 2016 Term Loan Add-On lenders and its agents, if any (typically the investment banking firm involved in structuring the transaction) should be equitably subordinated if they are not disallowed. Facts that would establish inequitable conduct include, among other things, the lenders' and agents' knowledge that (i) the 2015 LBO and the 2016 dividend were structured by PE for its benefit, and (ii) the Debtors received nothing of reasonably equivalent value in exchange for the liens, obligations and payments incurred or made by the Debtors.

Potential Damages and Other Relief

- Avoidance of the 2015 and 2016 loan obligations incurred by the Debtors and avoidance and recovery of payments made to or for the benefit of the lenders and/or agents in connection with such obligations.

The Debtors' Causes of Action

Claims Against the 2015 and 2016 Lenders and their Agents (Cont'd)

Potential Responses/Defenses

- The lenders (and their agents) will primarily argue the same defenses as noted above which PE will put forth in connection with the claims to avoid the 2015 LBO and the 2016 dividend.
- The lenders will further argue that (i) they would not have lent had they not believed that the Debtors were solvent and could service their debt, and (ii) they had no knowledge of facts which would establish actual fraud.

The Debtors' Causes of Action

Damages for Breach of Fiduciary Duty & Aiding and Abetting Breach of Fiduciary Duty

Potential Claims

- The Debtors' directors and managers breached their fiduciary duties by, among other things, authorizing the 2015 Term Loan, the 2015 ABL Draw and the 2016 Term Loan Add-On, declaring the 2016 dividend and authorizing the fees paid to PE and others.
- PE and its officers and managers who participated in and/or directed the 2015 Term Loan, the 2015 ABL Draw and the 2016 Term Loan Add-On and dividend aided and abetted the breaches of fiduciary duties by the Debtors' directors and managers.
- The Debtors' directors or managers will not be entitled to protection under the business judgment rule in connection with the 2016 dividend because three of the five Board members also sit on PE's Board and thus were not disinterested.
- Applicable statutes of limitations may be extended under equitable tolling doctrines.

The Debtors' Causes of Action

Damages for Breach of Fiduciary Duty & Aiding and Abetting Breach of Fiduciary Duty (Cont'd)

Potential Defendants

- Those who participated in and/or directed the transactions in questions, including potentially directors, officers and managers of the Debtors and of PE.

Potential Damages

- Without limitation, damages may include the amounts of the 2015 Term Loan (\$250 million), the 2015 ABL Draw (\$100 million), the 2016 dividend (\$150 million), up to the amounts of the 2015-2017 fees paid to PE (approximately \$24.75 million), and amounts paid to or for the benefit of the lenders under the 2015 Term Loan, the 2015 ABL Draw and the 2016 Term Loan Add-On.

The Debtors' Causes of Action

Damages for Breach of Fiduciary Duty & Aiding and Abetting Breach of Fiduciary Duty (Cont'd)

Potential Responses/Defenses

- The underlying transactions will be defended as above.
- The directors, officers and managers will argue that the business judgment rule applies in connection with the 2015 LBO, but the business judgment rule is likely inapplicable to the components of the 2016 dividend as they were not authorized by a disinterested Board.

Key Issue: Insolvency

In order to successfully recover under any of the theories described above, a plaintiff must establish the Debtors' insolvency at the time of each transaction in question between October 1, 2015 and the Petition Date.

- Evidence establishing insolvency will most commonly be set forth in detail in an expert report which may be based on findings that, for example, immediately following the LBO, Company X's equity value was negative and therefore Company X was insolvent.
- Typically Company X will have received a fairness opinion in connection with both the 2015 LBO and the 2016 dividend purporting to establish solvency and the Debtors' ability to service the debt incurred. A significant focus of litigation will likely be a "battle of experts" in connection with the methodology utilized in the fairness opinions and the accuracy of the findings contained therein.

If you have any questions, please contact:

Jeffrey N. Pomerantz

Pachulski Stang Ziehl & Jones LLP; Los Angeles, CA

310.277.6910

jpomerantz@pszjlaw.com



Mr. Pomerantz is a member of the firm's management committee and a co-chair of the firm's creditors' committee practice. Mr. Pomerantz is past president of the American Bankruptcy Institute, the largest restructuring organization in the United States. His practice includes representing companies, creditors' committees, and private equity funds in complex financial restructurings and merger-and-acquisition transactions both in and out of court. Mr. Pomerantz has particular expertise in restructurings in the energy, manufacturing, restaurant and retail sectors. He also frequently represents private equity funds in asset- acquisition transactions.

pszjlaw.com

Los Angeles | Costa Mesa | San Francisco | New York | Wilmington

31

LOS ANGELES

10100 Santa Monica Blvd. 13th Fl.
Los Angeles, CA 90067
Tel: (310) 277-6910
Fax: (310) 201-0760

COSTA MESA

650 Towne Center Dr., Ste. 1500
Costa Mesa, CA 92626
Tel: (310) 277-6910

SAN FRANCISCO

150 California St., 15th Fl.
San Francisco, CA 94111
Tel: (415) 263-7000
Fax: (415) 263-7010

NEW YORK

780 Third Ave., 34th Fl.
New York, NY 10017
Tel: (212) 561-7700
Fax: (212) 561-7777

WILMINGTON

919 North Market St., 17th Fl.
Wilmington, DE 19801
Tel: (302) 652-4100
Fax: (302) 652-4400



pszjlaw.com

Los Angeles | Costa Mesa | San Francisco | New York | Wilmington

32