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PARIS RIGHT NOW

"Whatever's going to happen right now will happen without me planning it." DONNA KARAN

PMC

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Retail's Burning Question

Do recent American Apparel and Quiksilver bankruptcies portend trouble at specialty stores?

By ARTHUR ZACZKIEWICZ

Although the individual paths to bankruptcy tell different stories, the recent Chapter 11 filings of American Apparel and Quiksilver Inc. share one thing in common: Being a specialty apparel retailer is a tricky business under current market conditions.

While American Apparel carved its niche via sexually provocative advertising for its slinky L.A.-made T-shirts, Quiksilver's surf, turf and snow action sports offerings garnered an equally strong following. But tastes change – and Millennials are aloof when it comes to brand loyalty. So what's hot now becomes too cold to sustain itself, say analysts and industry observers.

Moreover, these bankruptcy filings also portend unforgiving market realities that could lead other companies down the same path – especially specialty apparel retailers. American Apparel and Quiksilver join other recent Chapter 11s over the past two years, including Wet Seal, Caché Inc., Deb Shops and Delia's.

While American Apparel and Quiksilver are each operating under debtor-in-possession financing, it is unclear if both will emerge. Possible scenarios could include successful re-emergence following a restructuring, re-emergence as a new entity after a private-equity sale or complete liquidation.

Caché, for example, filed for Chapter 11 in February after being crushed by weak sales and earnings. It then lined up a joint venture with Tiger Capital Group LLC and SB Capital Group LLC, which would serve as a stalking horse bidder to conduct a liquidation sale. In the end, Great American Group LLC won out with an $18 million bid for the retailer's inventory, fixtures and intellectual property, among other assets. The retailer shuttered all of its stores as a result, but with the sale of its intellectual property – including its brand name – it could re-emerge down the road. The retailer's idle Facebook page says that, "All Caché stores have closed. Please stay in touch while we explore next steps for the future."

For niche-category retailers such as American Apparel and Quiksilver, the mercurial behavior of their target consumer had as much to do with their downfalls as the two companies' over-leveraged debt load, bankers, analysts and attorneys said.

"I don't think that it is isolated to action sports," said J Spencer, president of manufacturer Dragon Crowd, in regard to Quiksilver's filing. "American retail, in general, is extremely difficult. The growth is almost non-existent outside of activewear and if you're looking at sportswear as a category then it's extremely price-sensitive and brand-sensitive. It's a problem across the board."

Dragon Crowd, which works with several young men's and women's brands along with retailers, is listed in court documents as one of the largest creditors in the Quiksilver bankruptcy filing. The action sports company owes Dragon Crowd $3.24 million, according to the filing.

In the American Apparel filing, liquidity troubles can be traced back to 2009, while behavioral, legal and managerial issues with chief executive officer and founder Dov Charney added perhaps even more complexity. Charney was fired in December of last year for misconduct, and the ceo had filed numerous lawsuits against the company, which may have delayed the bankruptcy filing.

Moody's Investment Services senior analyst Charlie O'Shea said American Apparel's filing was not surprising, even though new ceo Paula Schneider had repeatedly laid out a turnaround plan. "They had an unsustainable capital structure and it was a company that was underperforming," O'Shea said, adding that it is important to see the company as having three legs: the business; the debt load, and the governance or ownership.

"It was hard for the company to hold up with only one leg," O'Shea explained. "The debt was too much and then there was the lack of governance over the executive. It was over 8-times leveraged, and it was going to take some work for it to work within the capital structure. A lot of things had to go right and they didn't. The plan is to cut the debt by over half. At a reasonable debt level they can move on and they have a chance. There is some substance there."

That substance includes $90 million in debtor-in-possession financing approved by the bankruptcy court as well as a $70 million capital infusion, which will be used to finance the turnaround. Moreover, the Chapter 11 will cut the debt to $135 million from about $300 million while also trimming interest payments by $20 million annually. Freedom from the heavier debt will allow Schneider to refocus business efforts "on the execution of our turnaround strategy as we look to create new and relevant products, launch new design and merchandising initiatives, invest in new stores, grow our e-commerce business," among other initiatives, the ceo said.

In August, American Apparel had warned Wall Street that it was strapped for cash. Being a vertical retailer also created additional strains on the company as market trends shifted. Last week, the New York Stock Exchange warned that the company's share price was not in compliance. Aéropostale, a struggling mall-based tween retailer, was also warned by the NYSE that its low stock price was not in compliance. The company said it would consider a stock split.

For other specialty retailers facing slumping sales and profits, a growing concern is real estate and location.

Michael McGrail, chief operating officer at Tiger Capital Group in New York, said that with mall traffic declining and showing no signs of coming back, "I expect a long, steady flow of retailer bankruptcies. Today's younger consumers were practically born learning to shop online; many are simply not mall shoppers. Amid these pressures, lower-tier malls will continue to struggle to keep strong retailers interested in space, which will further dampen traffic in those properties."

McGrail added that, without citing specific retailers, "Generally speaking, certain tween retailers and others that cater to the younger crowd will continue to see sales shrink in the coming years and, thus, be candidates for bankruptcy."

Attorney Jasmin Yang, from Snell & Wilmer, agreed and said she expects more filings down the road. "The way people shop is increasingly less driven by brick-and-mortar stores and is moving increasingly online," she said adding that retailers who are overstored are more vulnerable, and that retailers "have to make more strategic real estate decisions and have to adapt well to the ever-changing social media landscape if they are going to survive."

Anjee Solanki, national director of retail services at Colliers International, also sees trouble ahead for many retailers. "As teens move away from logo-driven retailers – Abercrombie, etc. – we will see more store closures that will lead to Chapter 11 filings," Solanki said. "Consumers are spending more of their dollars towards restaurants rather than apparel – with the exception of athletic and casual wear. Also, the upper-middle class is slowing down in spending compared to the aspirational customers."

Regarding consumer behavior and response to brands, Steve Wybo, senior managing director at Conway MacKenzie, where he specializes in insolvency and bankruptcy matters, M&As, turnarounds and crisis management, said it is now more common "for retailers targeting Millennials to lose market share quickly," citing troubles at Abercrombie & Fitch and the Gap Inc., among others.

"Due to availability of social media and e-commerce, trends change quickly and young consumers have the ability to quickly change buying preferences," Wybo said. "Quiksilver funded a risky pivot strategy – going from summer wear and growing into winter wear – through debt, and when the strategy failed, it couldn't service its debt load."

> "I expect a long, steady flow of retailer bankruptcies."
>
> **Michael McGrail**, Tiger Capital Group

Wybo said when companies such as Apple Inc. and Microsoft launch new businesses or technologies, it's done with "little to no debt."

"Another major error was that Quiksilver attempted to go direct to the consumers to retain more of the margin, but alienated its distribution channels," Wybo said. "In specialty/trendy retail products, the retail brick-and-mortar stores are especially important as compared to commodity or everyday wear (jeans, for example). Quiksilver may have picked up some margin in the interim, but lost significant top-line volume and revenue as a result of this strategy."

McGrail said filing for Chapter 11 can give troubled companies such as Quiksilver and American Apparel some breathing room as they sort things out. But timing is critical. "It's smart to file for Chapter 11 early if cash flow projections show you ultimately filing down the line," McGrail said. "Getting ahead of the process will help you to preserve some assets like profitable stores and, thus, give you a much better chance of emerging from bankruptcy. Today, too many companies over-leverage and file bankruptcy at the last minute, which accelerates the process of a complete liquidation. Under those conditions, there is simply not enough time or liquidity to restructure."

In turn, McGrail said the biggest pitfall is to "wait too late and not have enough liquidity to survive. Bankruptcies are expensive. There are turnaround professionals and lawyers representing all parties preparing the necessary court documents. This all adds up to a big drain on working capital." ■

– With contributions from Kari Hamanaka

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