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The Retail Meltdown—How You can Help Your Brick-and-Mortar Clients Thrive

BY JEFFREY POMERANCE

Your client is in retail. Perhaps your client runs a brick-and-mortar business, or is a supplier to a brick-and-mortar retailer. In evaluating how best to help your client, you can't help but notice that the entire retail industry is experiencing a major disruption. The retail mall -- once the hub of the United States shopping experience – is undergoing significant transformation, with Credit Suisse predicting closures of between 20% and 25% of the nation's shopping malls in the next 5 years. Store closings are becoming prevalent, with major national retailers such as Macy's, JC Penney and Sears scheduled to close numerous stores within the near future. Dick's Sporting Goods seems to be the only remaining sporting goods retailer, with Sports Authority and Sports Authority closing their doors in 2016. The apparel industry, in particular, seems to be very hard hit—with clothiers such as American Apparel, Gymboree and Wet Seal, among others, seeking bankruptcy relief, with more on the way. In fact, the number of companies filing Chapter 11 bankruptcy cases, especially in the retail space, is looking to outpace 2008 levels.

What makes this even more ominous for clients such as yours is the recognition that, according to AlixPartners, since 2005, 55% of the retailers that filed for bankruptcy ultimately liquidated their businesses (compared to 5% of bankruptcy debtors in other industries). There are many reasons why bankruptcies and liquidations are prevalent—certainly evolving buyer habits (the growth in e-commerce giants such as Amazon) and a shrinking appetite for retail purchasing (with clothing purchases representing less than 4% of every dollar now being spent, compared to 8% of every dollar spent in the mid-1990's) plays a part. However, addressing these ''whys'' does not seem to offer any tenable solutions to help your client. What can you recommend to your client to either prevent a bankruptcy from occurring or, in the event a bankruptcy is needed, to help your client come out of bankruptcy as a viable business?

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Brick-and-Mortar Retailers. While there is no simple ''one-size-fits-all'' solution, there are a number of steps that you can recommend that your brick-and-mortar client implement to help them remain or return to viability. Here are just a few strategies to consider:

1. <u>Manage Cash Effectively</u>: Cash is generally the lifeblood of a business. Too often, retailers seek to regain their footing simply by cutting costs. This is short-sighted and can lead to further problems. Rather, the goal should be to conserve cash by managing it effectively. Reliance on the ability to secure a competitive line of credit, even at a time with historically low interest rates, or seeking additional outside financing in today's market has led many retailers to incur exorbitant levels of debt and subject themselves to large interest payments that result in competitive problems. Rather, care should be taken to ensure that the appropriate available funds are set aside to retire high interest rate debt and for creative marketing and advertising, both traditional and online, and for the education and training of the retailer's sales force. Care should be taken towards capital expended for inventory. Successful retailers offer a good product mix to effectively meet market demand, yet balance the amount of inventory on hand—an intelligent warehousing and distribution strategy can significantly enhance profitability. Best Buy, for example, replaced CD's and DVD's with other more profitable electronic items. To the extent possible, inventory should be obtained on consignment or on account to best manage cash outflows.

2. <u>Revisit Your Client's Lease</u>: The significant dislocation in the retail sector permits opportunities to revisit and renegotiate terms, most notably as it relates to one of your client's biggest fixed expense—its rent. Care should be taken in this regard; landlords concerned about the retail meltdown may view a renegotiation as an opportunity to replace an existing retailer with another, better funded, retailer or another business. Rather, retailers should use the retail meltdown as an opportunity to align landlord and retailer/tenant issues. For example, most leases prevent subleasing; yet suc-

cessful retailers have found that allowing for pop-up stores can have a very positive effect. For example, Best Buy subleases a portion of its space to companies such as Samsung, Microsoft and Verizon—in essence creating a store within a store, which has been very successful. Working with the landlord to shape the shopping experience by offering onsite services that a customer cannot experience when purchasing products on the internet benefits both the retailer and the landlord; find a win-win for both parties.

3. Challenge Your Client to Compete Using Its Competitive Advantage: In this environment, competition based solely on cost may not be a brick-and-mortar retailer's best strategy, especially against e-commerce giants such as Amazon. This is not to suggest that cost is not important; rather, encourage management to engage customers on a number of fronts so that cost is not the sole determinant of sales. Emphasize the opportunity not found in e-commerce to touch and feel products and to interact directly with a well-educated sales force to enlighten customers. Encourage your clients to make it a shopping experience rather than a purchase—entertain and provide experiences that either enhance the purchase or enhance the customer. In fact, fight fire with fire—use modern technology to gain a competitive advantage over online retailers. Some retailers are employing 360° changing room mirrors with video-playback facilities and screens which track what people are trying and suggesting alternative outfits, 3D body scanning to help customers find the right size/shape of clothing, and ''magic mirrors'' which allow customers to try on items virtually.

4. Challenge Your Client to Reinvent Itself: Encourage your client to see itself as more than just a brick-and-mortar retailer. Best Buy and other successful brick-and-mortar retailers have fought back against e-commerce competition by engaging a multichannel effort to generate sales rather than relying solely on physical stores. Use the internet to reach customers and develop innovative and successful marketing and advertising programs. Along these lines, encourage your client to reinvent itself to find new sources of revenues that may even enhance sales of its products. Successful brick-and-mortar retailers appear to be offering complementary and supplementary services and support for product sales. Best Buy, for example, offers in-house advisory services through its Geek Squad support function, which generates additional revenues, enhances the customer experience and may in fact lead to new product sales. Service warranties have become extremely valuable, especially in the purchase of technology products and large durable goods. Customers may in fact pay more money for a product if they know that they are also purchasing a service warranty from a retailer with whom they regularly do business. This only further cements the relationship, and can lead to follow-up sales and product placement.

5. Re-examine Your Client's Capital Structure: Sometimes, even the best cash management and creative ideas cannot overcome a mountain of debt. Since 2008, many retailers have incurred or been saddled with significant debt, which can significantly hamper a retailer's ability to compete in the present retail environment. This requires your client to take a very serious look at its balance sheet, and see if it may be possible to align debt holders interests with the long-term goals of the company. Too often, the cash that is used to make interest payments is the cash that, if properly applied, might permit a retailer to successfully perform in a tough retail environment. If it is possible to get everyone on the right side of the balance sheet to reach a possible consensus, advise management to restructure its capital structure and free up cash to provide for more working capital. If this fails to occur, then begin the process of preparing for a bankruptcy that will allow your client to pro-offer a plan of reorganization that might accomplish what your client hoped to accomplish in a pre-bankruptcy restructuring. Helping your client prepare for bankruptcy is itself an involved process and beyond the scope of this article; suffice to say that management needs to immediately speak with its critical vendors and secured lenders and seek debtor-in-possession financing before filing for bankruptcy to ensure that it remains viable in bankruptcy while it works through its issues.

Retail Suppliers. The concerns that your supplier clients face will, in many instances, be different and even diametrically opposite of some of the concerns facing their retailer counterparts. Regardless, there are also a number of strategies that you can recommend that your supplier clients implement to help them maintain their viability. Here are just a few to consider:

1. Challenge Your Client To Protect Its Investment: Successful retailers want to secure the right mix of inventory at competitive prices. In turn, suppliers want to fill orders at prices that permit it to maximize sales and profitability. In an ideal retailer world, a retailer will seek to obtain and sell its inventory without paying for the goods—the ultimate customer's payment will be used to compensate the supplier for its goods. Consequently, from a retailer's perspective, obtaining inventory without paying cash is the best way to proceed. However, from the supplier's viewpoint, its most immediate need should be to protect its investment. Of course, from the supplier's perspective, COD is ideal. This approach, unfortunately, severely impairs sales, as it is generally dismissed immediately by retailers. Suppliers are thereby forced to provide inventory ''on account.'' While beneficial for the retailer, the supplier is fully exposed. The retailer can defer the payment on goods provided on account until they are sold, and even use the goods so provided to help the retailer enhance its borrowing base under typical inventory revolving loan facilities; when said goods are sold, the receivable generated thereby can then be applied towards the retailer's account balances in its account receivable/factoring loan facility—in essence, the goods and accounts generated thereby are secured, and the supplier is left with an open account and unsecured claim.

Consequently, in recognition that inventory will need to be advanced to retailers on account, suppliers should seek to protect their interests by providing inventory to retail clients either in a manner under which the supplier retains a purchase money security interest, or PMSI, in the inventory, or via consignment. Although the specifics of providing goods subject to a PMSI or via consignment are beyond the scope of this article, the end result in either case is that the retailer does not have to pay cash to obtain the goods, and the supplier is given, at least as to the inventory provided, a claim that rivals or is superior to the claims of other creditors of the retailer. Whenever possible, suppliers should also attempt to negotiate terms associated with expediting

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payment on accounts (especially when sold via credit card or in connection with a cash transaction), or request that the retailer segregate at least a portion if not all of the sale proceeds associated with such goods into a deposit account that the supplier controls under the Uniform Commercial Code. Of course, suppliers should also always attempt to secure third party commitments (whether in the form of guaranties or stand-by letters of credit) and other credit enhancements whenever possible. Successful suppliers appear to be turning more and more towards credit insurance to further help them protect their investment in their goods sent on account, or at least limit the downside exposure if the retailer seeks bankruptcy relief. Of course, this means that your supplier client should both price this type of insurance carefully, and make sure that the coverage obtained fits their unique situation to avoid spending money on insurance premiums for insurance that does not offer proper coverage.

2. Challenge Your Client to Reinvent Itself: Protecting goods sold on account is even more important for suppliers when the retailer involved is struggling, as are so many retailers today. What is the credit risk associated with this account? Challenge your supplier clients to see that providing goods on account means that the supplier is both a provider of goods and a lender. Lenders tend to not lend to those companies that will have difficulty timely repaying the credit advance. Accordingly, encourage your supplier to evaluate its accounts. Sales decisions (especially on account) should require input from both the sales and the accounting functions to best ensure that payment is received on goods provided on account. Make ''credit-worthiness'' an important factor in product placement. In addition, undertake steps to address credit risk—by way of example, advise your supplier clients that their supply agreements should require reasonable access to and disclosure of a retailer's financial affairs. Stress that your supplier clients then spend the time to carefully examine what the financials say. Careful review of a retailer's financial condition can be invaluable. For example, pursuant to Article 2 of the Uniform Commercial Code of most states, suppliers providing goods on account have the right to demand assurance of future performance prior to further shipping (advancing credit) to the extent that there is a legitimate reasonable concern about a retailer's ability to pay for its inventory. This exercise can lead to your client postponing shipment of its goods to a troubled retailer on account until appropriate assurances are given that payment will indeed be made.

3. Challenge Your Client to Compete: Retail is a very competitive business—products with competitive or distinctive advantages ensure that retailers will select your client's products over another suppliers. Your clients will want to provide their goods to the best retailers, both to enhance any brand recognition associated with your client's products and to ensure that your client's account is paid. Creativity is a premium here. Some successful suppliers offer warranties or other services that make their product more desirable to end users—this can be beneficial both in enhancing cash flows (through offering a complimentary service) and provide for a distinctive advantage over other goods. Some suppliers seek to invest heavily in creating a distinctive, unique brand designed to create value irrespective of specific goods. Other suppliers, such as Microsoft and Samsung, have used pop-up stores to further enhance their products. These pop-up stores highlight brand recognition and generally lead to a more enjoyable sales experience by a generally more knowledgeable sales force (as to the supplier's products). The pop-up store process involves legal legwork to ensure that a sublease is permitted and that the supplier has the necessary legal protections as both a supplier of goods, a sublandlord and, in some instances, an employer.

The results, when successful, appear to far outweigh the risks, as evidencing by companies such as Microsoft and Samsung that have developed this model successfully in promoting their products in Best Buy stores. Feedback on these pop-up stores in Best Buy suggests that, among other things, consumers get the added benefit of a more knowledgeable sales staff which enhances customer satisfaction (and presumably sales). Successful retailers also prefer suppliers who can timely provide the right product mix efficiently to meet market demand—encourage your supplier client to make sure that they have adopted an intelligent warehousing and distribution strategy to enhance profitability and the desirability for their particular products.

4. Prepare For Retail Bankruptcies: ''Hope for the best, yet plan for the worst'' may prove sage advice to suppliers of goods in today's retail industry. Successful suppliers, recognizing the dislocation in the brick-and-mortar retail industry and the increase in retail bankruptcies, should anticipate potential bankruptcy filings involving their product on account and seek to implement protections ahead of the bankruptcy filing to maximize their opportunity for recovery. Along these lines, in addition to securing PMSI and/or consignment terms to provide for a potentially higher priority level of recovery for goods provided on account, successful suppliers should take the steps necessary to establish themselves as critical vendors whenever possible, as well as stay on top of potential preference defenses for moneys paid on open accounts. A significant amount of planning and preparation in analyzing a supplier's open account holders with competent insolvency advisors prior to notice of the filing may well mean the difference between your client having a priority claim, a seat at the table, and/or a right to recover on its open accounts once the bankruptcy commences.

In conclusion, your retail clients, whether brick-and-mortar retailers or suppliers to brick-and-mortar retailers, can significantly enhance their ability to face the ever-increasing liquidations occurring in today's retail environment and remain viable if not become more profitable. The key is to help them to get out in front of the problem, to manage their business effectively and, wherever possible, build in protections designed to increase the likelihood of sales and profitability. It is a big challenge, but a challenge that is surmountable with good planning and proper execution.