THE M&A ADVISOR SYMPOSIUM REPORT

Featuring

Van Durrer II
Partner
Skadden, Arps, Slate, Meagher
& Flom LLP

Steven Fleming
Partner
PwC

Perry Mandarino
Partner
Leader of Business Recovery Services
PwC

Anthony Polazzi
Managing Director
Sun Capital Partners

STALWARTS ROUNDTABLE
SHOPPERS, IT'S 3:15 PM AND THIS STORE IS NOW CLOSING: AN UPDATE ON THE RETAIL SECTOR

Executive Summary

The viability of many retailers – especially those in the popularly priced fashion business – is coming under scrutiny by equity and debt holders as managers struggle to satisfy faster-changing consumer tastes driven by e-commerce and social media.

This session, drawing on the insights of four retailing experts, touched on several challenges currently facing retailers:

- The need for managers to incorporate technology in order to create new ways to compete
- Location, and why it's less important today than in the past
- Why liquidity and capital are competitive assets that often trump management skill
- How retail leasing has changed
- The unintended consequences of changes in the bankruptcy code for retail operations

The panelists also gave their outlook for restructuring and discussed why the future will likely see fewer retail reorganizations.

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From The M&A Advisor

The problems faced by our nation's merchants came up in many conversations at our recent 2015 Distressed Investing Summit in Palm Beach, Florida. It was particularly timely, therefore, that we devoted an entire Stalwarts Roundtable to retailing at the Summit, the highlights of which are covered in this Symposium Report presented by PwC. In this compelling session, our panel of experts delved deeply into retailers' problems, looking at the challenges facing today's managers, lenders, equity owners and others involved in the capital structure of our nation's storekeepers.

As in so many areas of business, the Internet — and in the case of retailing specifically, the increasing power of social media — is transforming the way in which consumers interact with vendors. For fashion-oriented retailers, for instance, this means being able to successfully and profitably satisfy the mercurial fashion demands of teenagers glued to their smartphones — no easy task!

For insights, we turned to some of the leaders in retailing finance. Like participants in the eight other Conversations, Roundtables and a special Case Study that constituted this annual Summit — and the attendees at our 9th Annual Turnaround Awards presentation, which followed the full-day program — our retailing Roundtable session moderator and our three Stalwart panelists are stars in their field. We thank moderator Steven Fleming of PwC and panelists Van Durrer II of Skadden, Arps, Slate, Meagher & Flom LLP, Perry Mandarino of PwC, and Anthony Polazzi of Sun Capital Partners for taking part. The M&A Advisor is delighted to share their informed perspectives.

David Fergusson
President and Co-Chief Executive Officer
The M&A Advisor

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Retail's Problem

The session began with Van Durrer II identifying the "new" problem in retailing — e-commerce in general, and social media in particular.

"E-commerce continues to outperform brick-and-mortar by multiples, and the ability to harness that power and growth is a new challenge to senior management, particularly when they are my age or older and not tweeting as much as they should — or still trying to figure out what a tweet is exactly," Durrer said.

"It's easier to be a good manager if you have money."
– Perry Mandarino

"One of the retail segments that's in tremendous trouble right now is specialty fashion," he added. "A lot of these retailers are so called 'fast fashion.' If they're not completely plugged into social media and reacting literally instantly to new trends, they quickly lose their demographic."

But, noted Perry Mandarino, the challenge is not just about keeping up with social media — it's about getting the hottest merchandise onto store shelves before the heat dies down. "I know of a few retailers who are actually opening up manufacturing facilities in Honduras, for example, which cuts the turnaround from China in half," he said.

Acknowledging that the pace of change in retailing has accelerated, moderator Steven Fleming asked whether the action or inaction of management in response to the faster tempo is responsible for some of the recent retail bankruptcies or business failures.

"Management is key, of course, but it's easier to be a good manager if you have money. When you look at big public companies like Bed, Bath & Beyond Inc. that have a gazillion dollars in cash on their balance sheets, it's easy to be able to squeeze your vendors, get good talent, and invest in IT," Mandarino said.

"If you have a great team and you're swimming upstream, you may be able to delay the tide for a while, but it's hard to swim upstream forever," noted Anthony Polazzi, who added that poor management may make things worse, "but it's hard to blame the management team entirely in a lot of these situations."

But management should be coming up with new strategies, added Durrer. For example, he said, they must come up with new ways to compete against "showrooming", a relatively recent concept. This is the growing trend in which customers shop at a brick-and-mortar store to see an item up close, but then order it on their phone from Amazon for less.

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Assessing Management

Given the importance of innovation, Fleming asked how buyers in distressed situations can assess whether a management team has the requisite turnaround skills.

"To be sure, it's hard to determine exactly what caused the problem," said Polazzi. "Was it the locations, e-commerce intrusion, lack of capital, a bad owner? All these things can play into how

the business got in trouble. But when we look at management teams, what we're really looking for is a certain decisiveness, a certain set of actions."

"In distressed retail situations, we've seen many cases where management gets disenfranchised at a certain point and they're either not engaged or start making decisions where they shoot for home runs," Polazzi continued. "Other times, they've got ideas and ways to implement, but they're too far behind the 8-ball by the time they have a chance to act. You're trying to piece apart those two dynamics and see if you can pick which one is the overriding driver."

"When we look at management teams, what we're really looking for is a certain decisiveness."
– Anthony Polazzi

Why So Few Retail Reorganizations?

In recent retail distressed situations, Fleming noted, there have been many liquidations or quick sales under the rules of Section 363 of the Bankruptcy Code, but few reorganizations. He asked the panelists for their views on why this is the case.

"It's really about enterprise value," said Mandarino. "In retail, most of the leverage is through asset-based loans. And the collateral for those loans eats into enterprise value."

"If there's no liquidity, a buyer won't come in with new capital," Polazzi said.

"Exactly," said Mandarino. "But there are exceptions. One that's notable is Brookstone, which had a plan, a stock bidder and an incredible auction. It was one of the few, true reorganizations. Trade claims were paid 100% and all leases were assumed. It was truly unique."

Polazzi then noted that retailing has certain similarities to restaurants, but also its own unique dynamics.

"In restaurants, problems tend to get dealt with earlier because lenders know that if things go bad, they could have real troubles. In retail, lenders may let things go on longer if they're covered from a collateral perspective. But when they start to worry about collateral, then they move very quickly," he said. "To get a going concern more involved requires that the lender take risks that their collateral might diminish over time. And that push/pull makes doing a retail restructuring more difficult."

Van Durrer attributed the increase in faster liquidations and decline in restructurings to the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005.

"It shrank the time a retailer could decide whether to assume or reject leases. The window went from forever, theoretically, to 210 days. Landlords insisted on this and it changed the way retailing is financed," Durrer said. "Debtor-in-possession loans mature in 180 days as a result of BAPCPA, so a retailer really has only about 90 days to put forward a plan that has a reasonable chance of being confirmed. Otherwise, the DIP lender will pull the trigger and you have a going-out-of-business situation, which is exactly how Circuit City went down."

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Before BAPCPA, added Durrer, new management would be brought in to reconnect with its demographic. It would test its new approach over two Christmases.

"Your first would be to build cash to file. You'd file in January, you implement your ideas, and when you got to Christmas No. 2, you'd see if it worked," he said. "If it worked, you reorganized; if it didn't, you'd liquidate. Now, if you stretch your cash to get to July so you can restock for Christmas, the world is going to know what's happening and you'll have no ability to execute — which has made retail reorganizations all but impossible."

"You've got to have something to grab the public's attention."
– Van Durrer II

Since volume peaks occur at different times of the year for different kinds of retailers, Mandarino noted that having liquidity and a real business plan are the most important elements. "Maybe it's just that the world is changing and there is no need for 50 different retailers in the same hallway in the mall that all sell the same thing," he said.

"I agree with that," Polazzi said. "But from the buyer's perspective it means you have to go into a bankruptcy with an exact idea of what the business will look like afterward — and there's not a whole lot of time to figure that out."

The Importance of Retail Brands

Switching gears, Fleming asked panelists for their views on the importance of having a meaningful brand.

"There are now huge companies — Authentic Brands [which owns Juicy Couture, Hickey Freeman and Judith Leiber] and Sequential Brands Group [Ellen Tracy, Avia, Heelys and The Franklin Mint] — that snap up brands," said Durrer. "They're a good indication that a company can survive solely on a brand and have no operations, no brick-and-mortar stores and no people. That tells me you've got to have something to grab the public's attention."

Polazzi then responded. "When I joined Sun Capital Partners 12 years ago, a lot of retail was location, location, location," he said. "Even if you didn't have a great business model, if there was a lot of traffic you'd be fine. But once you're outside the top malls, how do you drive traffic? The only way to get people in the door if you don't have a powerful brand is to have something uniquely experiential."

How does Polazzi evaluate the strength of a company's brand?

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"That can be difficult," he said. "Has the brand gone weak and stopped resonating with the consumer? Let me give you a restaurant example. We own Friendly's, [a restaurant] which a lot of people in the New York area know well. But its delivery method just doesn't resonate in the same way it used to because fewer people eat at diners. Still, the brand is strong, and people love Friendly's ice cream — which they now buy at the supermarket."

"Do you see any distinction between retailers who control their own brand, such as Zara, H&M and Apple, for example, and those who don't?" asked Fleming.

Perry Mandarino responded first. "Yes, because it's about margin. They're making the procurement process cheaper because they don't have factories skimming off the top. That's worth maybe 7 margin points, if not more."

Polazzi then added, "I think the retailers in trouble are the ones in the middle. You either have to be all things to everyone or be very niche with a very powerful brand."

"Today, it's cheaper to open a store than it used to be."
– Van Durrer II

Retail Real Estate

In one of the final questions of the session, Fleming asked panelists for thoughts on the strategies a retailer can pursue to ensure that their locations remain relevant over the life of their leases.

"If you're a big-box retailer, you almost have to have a 'treasure find' kind of mentality," said Polazzi. "If you're on the smaller side, you want to be neat and nimble and maybe get down to 3,000 or even 1,500 square feet — just enough to show a little bit of product and drive people to an online site. If you're in an A-plus mall, you can probably feel comfortable signing up for 10 years because the mall will probably stay great. In B and C malls, we're encouraging people to push a lot harder for kick-out clauses and the ability to change square footage so they have flexibility."

"How do you reconcile that with H&M and Forever 21, which are opening 10,000, 12,000 and 15,000 square foot stores, often once a week?" Fleming asked.

"It's going to be a great strategy for them for three years, but we'll come back in 10 years and see whether they are paying for some of those mistakes," said Mandarino.

"Today, it's cheaper to open a store than it used to be," said Durrer. "American Apparel is really good at it; they can open a store for $15,000, just because of the fixtures they use. If you execute really well in your core strategies, you're going to be able to push the envelope in other areas — like opening or abandoning stores — when others can't."

"That's the key discipline — abandoning stores," said Polazzi. "It's hard to have that discipline and take a $20 million charge, but retailers like Wal-Mart have been smart about rationalizing their footprint all along the way."

Teenagers and the Mall

One final question from Fleming: Do teenagers still go to malls?

"I have teenage sons and they couldn't care less about the mall," Mandarino said. "But that being said, the notion that brick-and-mortar is dead is exaggerated. The A malls and the B-plus malls will be survivors."

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"I've got four kids between 18 and 23," said Durrer. "The two eldest only shop online; the two youngest still go to the mall."

"There's a reason for brick-and-mortar to exist; it's experiential. People still need entertainment and a reason to go out," said Polazzi. "They still need something to do when they don't want to sit at home. But you have to give them a reason to come to your location."

Video Interviews

To watch exclusive M&A Advisor interviews with these retailing industry experts, click on the following images:

Van Durrer II

Partner
Skadden, Arps, Slate, Meagher & Flom LLP

Steven Fleming

Partner
PwC

Perry Mandarino

Partner
Leader of Business Recovery Services
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Anthony Polazzi
Managing Director
Sun Capital Partners

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Symposium Session Video

To watch the Stalwarts Roundtable – "Shoppers, It's 3:15 PM and This Store Is Now Closing: An Update on the Retail Sector" – click on the following image:

Shoppers, It's 3:15 PM and This Store Is Now Closing: An Update on the Retail Sector

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Symposium Participant Profiles

Van Durrer II
Partner
Skadden, Arps, Slate, Meagher & Flom LLP

Van Durrer II is a Partner at Skadden, Arps, Slate, Meagher & Flom LLP, where he leads the firm's corporate restructuring practice in the western United States and advises clients in restructuring matters around the Pacific Rim. He regularly represents public and private companies, major secured creditors, official and unofficial committees of unsecured creditors, and investors and asset-purchasers in troubled company M&A, financings and restructuring transactions, including out of-court workouts and formal insolvency proceedings. Selected industries in which Mr. Durrer has provided restructuring advice include financial services, gaming, health care, hospitality, information technology, logistics, manufacturing, real estate, retail and telecommunications. His work has been recognized in the 2011 Financial Times "U.S. Innovative Lawyers" report; he consistently has been named a "leading lawyer" by Chambers USA: America's Leading Lawyers for Business, and received the "Chapter 11 Reorganization of the Year (Upper Middle Market)" as part of M&A Advisor's 6th Annual Turnaround Awards. Mr. Durrer has moderated panels and participated as a guest speaker for the Association of Insolvency & Restructuring Advisors, Turnaround Management Association, American Bankruptcy Institute, Los Angeles Bankruptcy Forum, Practising Law Institute and other organizations globally.

Steven Fleming
Partner
PwC

Steven Fleming is a Partner in the New York office of PricewaterhouseCoopers Restructuring & Recovery Services. During his more than 17 years of business advisory experience with PwC, he has been assigned to the firm's London, New York and Dubai offices, giving him a truly global perspective on transaction advisory. Mr. Fleming has provided financial advisory services to many of local and international clients, spanning the entire deal spectrum from devising acquisition/ disposal strategies, to performing valuations and due diligence reviews, and identifying and negotiating with potential investors. In addition, he has assisted several distressed companies in the development of pro forma financial statements, the preparation and analysis of business plans and strategic alternatives, analysis of cash flow and working capital management, identification of liquidity enhancing activities, and the identification and execution of cost savings and operational reviews. Mr. Fleming holds an M.B.A. from Columbia Business School and a B.S. in Finance from Lehigh University. He is a member of the Association of Insolvency & Restructuring Advisors from which he holds a Certification in Distressed Business Valuation and a designation as a Certified Insolvency and Restructuring Advisor.

Perry Mandarino
Partner
Leader of Business Recovery Services
PwC

Perry Mandarino is a Partner at PwC U.S. and is the leader of its Business Recovery Services practice. Mr. Mandarino has over 24 years of experience specializing in areas of strategic planning, complex debt restructurings, preparation of turnaround and business plans, cash flow analyses, preference investigations, fraud and fraudulent conveyance investigations, collateral evaluation and claims resolution. He has assisted numerous clients in the negotiation, development and implementation of Plans of Reorganization. He has a broad range of restructuring and bankruptcy industry experience, including retail, distribution, communications, business services, manufacturing, healthcare, construction and real estate companies. Mr. Mandarino served as the Chief Restructuring Officer of several entities, including Hoop Holdings, Inc. d/b/a/The Disney Stores, and served as the Examiner in the Polaroid, Inc. and Summit Global Logistics Chapter 11 cases. He has represented lending institutions, creditors' committees and investors in restructuring matters, and has extensive experience in the Bankruptcy Courts in the Districts of Delaware, New Jersey and New York, where he has testified and been qualified as an expert in matters related to financial viability, valuation, general reorganization and financing. Mr. Mandarino received a B.S. from Seton Hall University. He has lectured to various groups on corporate and municipal bankruptcy issues and the reorganization process.

Anthony Polazzi
Managing Director
Sun Capital Partners

Anthony Polazzi is a Managing Director at Sun Capital Partners, has spent more than a decade working in private equity and leveraged finance. Prior to joining Sun Capital Partners in 2003, Mr. Polazzi worked as an Associate in the Leveraged Finance Group of CIBC World Markets. He received dual Bachelor of Arts degrees in Economics and Mathematics from Claremont McKenna College.

About the Sponsor

PwC

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Emerging Leaders Summit - London, UK - September 29, 2015
M&A Advisor Summit - New York, NY - November 17, 2015
International Financial Forum - London, UK - December, 2015
Distressed Investing Summit - Palm Beach, FL - February, 2016

For additional information about The M&A Advisor's leadership services, contact Liuda Pisareva at lpisareva@maadvisor.com.