Navigating Liquidity in Retail Restructurings

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Throughout a retail restructuring, from the prefiling period through the winddown of the proceedings, debtors and their professionals face unique challenges that arise from the nature of retail operations and the resulting direct impact on liquidity management. Although not an exhaustive recitation of the issues facing a distressed retailer, this article takes a closer look at data, liquidity, and cash management challenges facing a distressed retailer in each stage of the restructuring process. A successful restructuring requires navigating these challenges.

Prior to Restructuring

At the outset, it is important to assess and understand available data, and at a granular level. Due to historic store expansion and bolt-on acquisitions, retail companies commonly have data challenges. These may arise from operating under multiple accounting systems that are relics of predecessor retail operations; utilizing differing point-of-sale systems across a brick-and-mortar footprint; having multiple and often regional depository institutions in a cash management system; experiencing shortfalls in certain areas of data, such as incomplete lease information; or possessing a disparate vendor base with wide-ranging and nuanced terms.

The result may be incomplete information or financial data that is not available in an organized fashion "off the shelf." These challenges, and others like them, tend to create a need to aggregate and decipher data long before a retail debtor has even embarked on the restructuring process, and likely impact the company's liquidity directly in multiple ways.

To manage liquidity, retail capital structures typically utilize an asset-based lending (ABL) facility that is supported by a borrowing base calculation. The borrowing base calculation determines the availability of the ABL by utilizing advance rates on inventory levels and other assets and is therefore directly informed by the availability of financial data. Challenges in data availability and cash management organization may require workarounds in preparing the inputs for a borrowing base calculation.

Inventory levels, asset ownership and values, vendor payables, etc., may all be components of the borrowing base calculation and require timely and accurate information. Incorrect data can cut both ways. Underreporting of owned in-transit inventory, for example, can reduce ABL availability and therefore liquidity. Lack of invoicing or accruals for certain types of carve-out deductions may overstate the calculated availability.

Wide-ranging supply chain circumstances can present issues with respect to how a company accounts for inventory and invoices. This can create roadblocks, particularly for midmarket retailers with vendors that rely on paper invoices, such as delivery services for furniture, appliances, or other large goods sold through retail store showrooms. These smaller, often localized, delivery vendors typically have a significant lag time in submitting their invoices to a retailer. In the context of a bankruptcy proceeding, or the period leading up to one, this delay can make it difficult to accurately estimate and reconcile vendor claims.

If the debtor's products are made or sourced outside of the United States, differing vendor terms and delays that involve sourcing, delivery, and invoicing can add other obstacles to reconciling outstanding invoices and determining liquidity. Data will have to be assessed thoroughly at a granular level to account for considerations such as when title is taken for goods and whether the payable creates a carve-out in the borrowing base calculation.

In the context of a retail case that includes foreign activity in the supply chain, the power and influence that U.S. Customs and Border Protection can exert over the delivery of a product can be draconian. That can become a significant issue for nearly every aspect of a retail case, particularly if the retailer is seeking a valuation for the purposes of a sale or a debtor-in-possession (DIP) financing. Without the

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ability to ensure that retail goods can get through customs, retailers cannot include them in their valuation and they may be excluded from a borrowing base calculation. Letters of credit play a critical role in facilitating these issues as does having a strong handle on the financial management systems that are aligned with the supply chain issues.

In addition to managing the total pool of liquidity, there are potential challenges with the management of actual cash. It is common for retail companies to have small, low-balance bank accounts spread among numerous institutions and also numerous geographies. Due to bolt-on acquisitions or other expansionary strategies, retail locations may still operate in an almost stand-alone manner and may not be incorporated into the broader liquidity management process. As a result, retailers can have multiple cash management systems operating in silos.

During the prefiling period, these disparate bank accounts and systems can be consolidated to make the transition to bankruptcy as smooth as possible. To complicate matters, it is often common for the depository institutions to participate in the company's ABL facility.

Entering a Restructuring or Chapter 11 Filing

As companies and their professionals devise a strategy for a potential bankruptcy filing, addressing the underlying data can lay the foundation for a smooth transition. This typically requires a significantly more detailed view of otherwise routine operations, such as the use of individual cash accounts, forecast assumptions, and borrowing base calculation components. These efforts may apply to a variety of divisions within the business, from accounting and financial planning and analysis (FP&A) to supply chain and legal.

As brief examples, companies can streamline their bank accounts and review opportunities for centralization. To ensure accuracy, cash reconciliations can also be performed more frequently than perhaps they were in the past. Ensuring that the liquidity lifeline is accurate and well-planned prevents potential surprises that can, in turn, impact operations.

Certainly, these steps benefit the more "administrative" requirements of a Chapter 11 filing, such as the drafting of a cash management motion. Importantly and more impactful to the overall restructuring process, these steps can assist in providing for timely visibility into liquidity. Notably this includes "runway," or the life expectancy of existing liquidity, as well as identifying both the duration and scope of any potential liquidity need.

Many retailers in recent cases have found themselves in liquidity-challenged situations. Improved visibility informs management of key levers as they review strategic options and illustrates opportunities to take specific actions. In many cases, improvements to cash management prior to a restructuring can also help improve total liquidity. At a minimum, these types of preparatory improvements will benefit the company even if it later decides not to file for Chapter 11.

The Restructuring Period

As retail companies enter the filing period, they can face unique challenges in getting the support of their lenders or other investors for their restructuring process, whether it be Chapter 11, an out-of-court restructuring, or a sale. In the retail space, these lenders tend to be depository banks and institutions that can accommodate ABLs, which are needed by retailers to support fluctuating inventory costs and massive capital outlays during peak holiday, sale, and other seasonal periods. As existing lenders already within the capital structure of the company are typically looking to protect their initial investment, they will likely have significant influence over the type of restructuring and deleveraging process that the company undertakes.

This desire for influence is exacerbated due to some of the types of claims that can arise as part of a Chapter 11 and result in an overadvance on the ABL facility, which creates a high level of discomfort for the lender group. These include obligations under Bankruptcy

Section 503(b)(9), which concern vendors that supply goods to a debtor in the ordinary course of business within 20 days before a bankruptcy filing, and the Perishable Agriculture Commodities Act (PACA)/Packers and Stockyard Act (PASA). Often, distressed retailers going through a restructuring without incremental liquidity pursue asset sales as an alternative to a full-scale reorganization to resolve their balance sheet issues. These asset sales may create even more claims and expenses that further strain the position of lenders.

For example, employee obligations related to the Worker Adjustment and Retraining Notification (WARN) Act and severance and other benefits, such as healthcare and paid time off, are often not included in the borrowing base calculation. If store closures are required, rent and related obligations, even for periods when the store is no longer operating, create additional claims and further impact liquidity. Accurately estimating these claims must be accomplished in a timely manner to ensure adherence to a navigable path through restructuring.

Regardless of which direction the company may take in its restructuring process, it's critical for professionals and their debtors to communicate with their deposit institutions. Especially since they may also be lenders, deposit institutions are the players in the process that should be least surprised by a bankruptcy filing or restructuring. These institutions should be aware that a company is going to file and be informed regularly of the progress of the filing and the impact of and proposed resolution to borrowing base calculation challenges. Open communication can help ensure liquidity is not disrupted. In any situation where there are foreign accounts, additional coordination is required to ensure the restructuring process runs smoothly.

Closing Out the Process

The most common initial bifurcation that resolves the restructuring process is whether the company will reorganize or pursue a sale (where a sale may also include a liquidation). Given the limited cash position of most retail companies, the decision must be made quickly and, as seen in recent cases, can often lead to a sale situation.

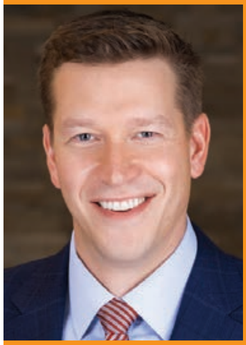
With the necessity of granular detail leading up to this point of a restructuring, it should come as no surprise that accurate and granular detail is necessary again at the closure of the process. While a reorganization or an outright sale may be more akin to an industry-agnostic restructuring—think of a restructuring support agreement or asset purchase agreement—in a store-sale situation, a retailer's data plays a central role in determining the allocation of economics. Even under a reorganization or outright sale, it is common that at least a portion of a store fleet could be sold separately or liquidated.

The sale and liquidation of stores requires insight into the financial aspects of the day-to-day operations. For example, a debtor needs to consider the cash on hand and cash in a regional or local bank. The debtor also needs to understand lease terms and the permissions sought from the court in terms of financial obligations to landlords. If a store or lease is sold, a debtor will need to calculate various prorations, such as utility expenses. Each of these, and many others, circle back to the need to review data availability and cash management practices on the front end.

In proceeding with an asset sale, debtors and professionals may be in the position of needing to establish bank accounts, and in doing so, they should keep in mind some key best practices. It's important to pay close attention to the drafting of the escrow agreement to ensure that all involved parties are satisfied with the outcome and to ensure that the funds are not tied up within the account for longer than necessary.

In seeking a banking partner, debtors should pay close attention to the interest rate environment to secure a competitive rate and should only work with reputable U.S. Trustee-approved institutions to hold escrow-related funds to guarantee that funds are insured from loss. Timing can be critical in some instances, so bank accounts should be established early on in the sale process to avoid unneeded stress, mistakes, and potentially missed deadlines.

Whatever course is ultimately determined by retail debtors and their advisors, it's beneficial to approach the financial aspects of the transactions strategically and with thorough attention to detail. The use of financial and operating information will underpin the entire restructuring. Ensuring an accurate and timely view of this information can help ensure an accurate view of liquidity that can be efficiently managed. ■



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