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U.S. Retail Debt Recoveries Likely To Be Below Average Amid Sector Challenges And Rising Defaults

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With default levels and default risk rising in the retail sector, it's critical that retail creditors assess the risk of loss in a default scenario. A review of S&P Global Ratings' recovery ratings suggests that default-related losses for creditors to U.S. retailers are likely to be higher than in other sectors, especially for creditors that are either unsecured or have junior lien positions. Still, a company's debt and organizational structure and the terms of its debt instruments matter, so investors need to look beyond debt types to fully understand the recovery prospects and risks of the debt they hold, which can be materially above or below the typical recoveries on "similar debt".

Our recovery ratings provide debt instrument-specific estimates of post-default recovery rates, and generally assume companies are able to reorganize (or be sold) and continue as going concerns--consistent with what we've observed after rated companies have defaulted. Such scenarios usually produce a higher valuation and better recovery rates for creditors.

That said, several recently defaulted retailers (mostly unrated) have largely closed shop and liquidated their assets (including The Limited, American Apparel, Wet Seal, and Sports Authority). Recovery prospects in a liquidation scenario are often dramatically lower than when a company continues to operate. (See “U.S. Retail Recovery Prospects: Liquidation Could Lead To Worse Recovery Outcomes,” to be published on RatingsDirect separately.) This is especially true in the retail sector because most retailers are asset light--meaning most creditors are highly dependent on profitability and cash flow as a source of repayment.

Signs of Credit Stress Are High In Retail; Further Bankruptcies Appear Likely

Credit conditions in retail stand in stark contrast to those in most other sectors. The overall credit environment is generally improving amid mostly favorable economic conditions, including modest but steady GDP growth, low unemployment, tame inflation, and healthier household balance sheets. This environment--and more stable oil and gas prices--has contributed to a sharp decline in the speculative-grade default rate, which has dropped from 5.1% at the end of 2016 to 3.8% at the end of June, and now stands below the historical long-term average of 4.3%.

In contrast, distress and default levels are rising in retail as firms struggle with secular changes related to:

- Difficulty adapting to online retailing and rising competition;
- Shifting consumer tastes and spending habits;
- Overbuilt store bases;
- Slow and inefficient supply chains; and
- Competition for discretionary spending with big ticket items (autos, health care, housing, technology) and leisure.

Inclusive of recognizable retail companies that weren't rated, bankruptcy filings by U.S. retailers have already reached double digits this year (see Appendix 1). Further, sector downgrades (excluding restaurants) in 2017 through early-July

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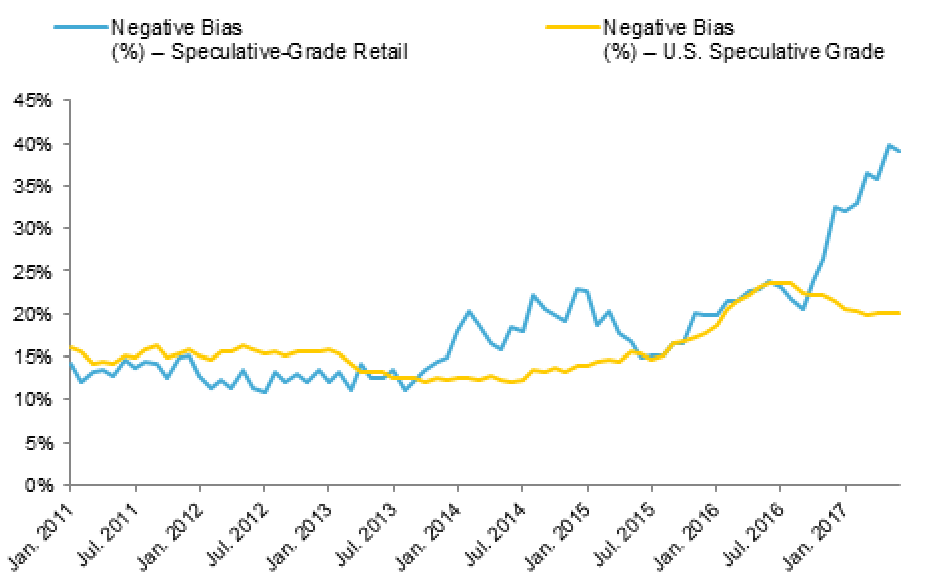
have totaled about 31 on a base of 112 rated retailers (about 28%).

Looking forward, the risk of further defaults and downgrades for retailers is high. About 18% of U.S. retail ratings are in the 'CCC' category or lower, about double the level at the beginning of the year (see Appendix 2 for a list of these issuers). In addition, at the end of June the U.S. retail sector had the second-highest negative bias, at 35% (or 39% for speculative-grade companies), trailing only the still-beleaguered oil and gas sector. Negative bias represents the percentage of rated companies in the sector with a negative outlook or negative CreditWatch, which indicates at least a one-in-three chance of a downgrade within one year. Negative bias for speculative-grade retailers has been climbing rapidly, up 15 percentage points since August. By contrast, the overall U.S. corporate speculative-grade negative bias is at 20%, down 4 percentage points over the same period (see chart 1).

Chart 1

U.S. Retail Sector Speculative-Grade Bias



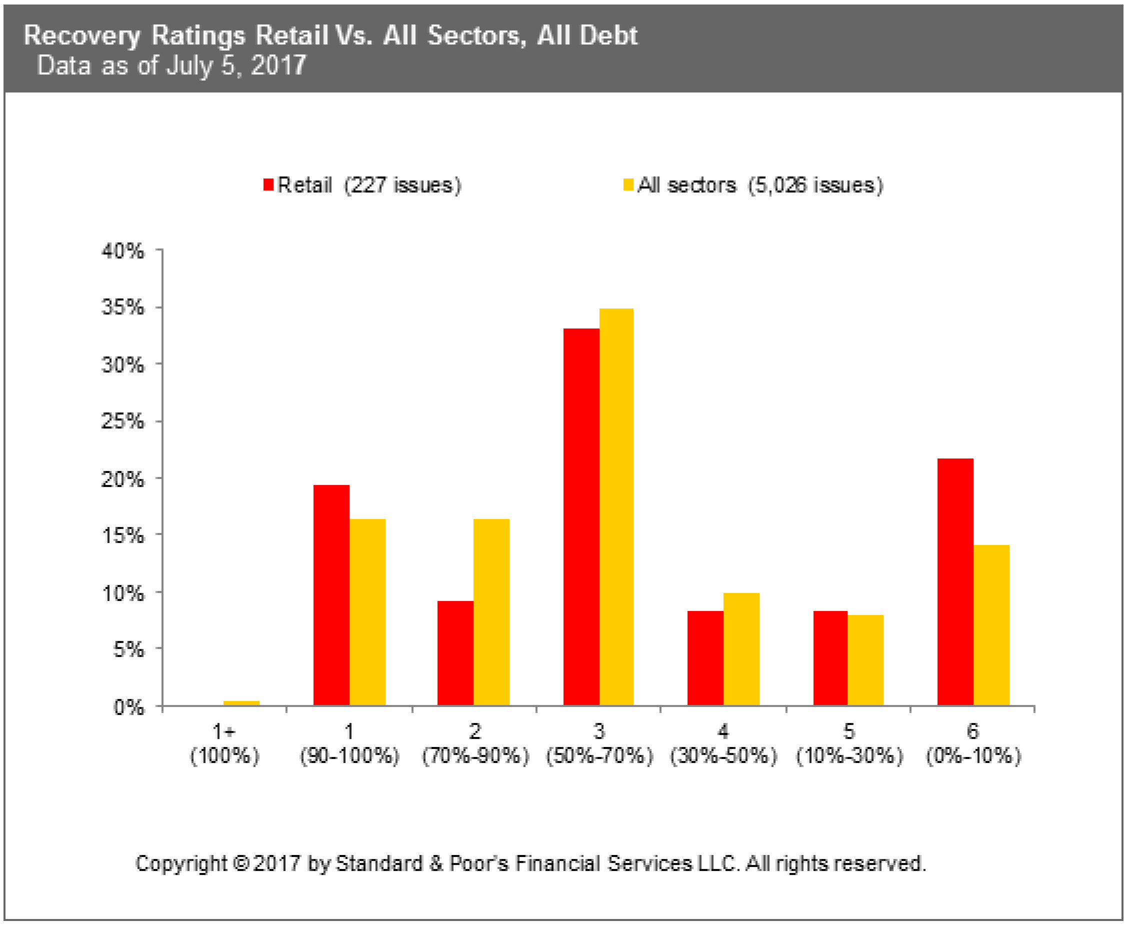
*Note: Retail sector includes apparel and textile companies, excludes restaurants. Data as of June 30, 2017. Source: S&P Global Fixed Income Research.

Meanwhile, the market is also signaling concern. The distress ratio, which is the share of spec-grade issues with option-adjusted spreads more than 1,000 basis points (bps) above Treasuries, has risen to 21% (based on the number of issues) for the retail sector (as of June 19 and including restaurants), well above that of the oil and gas sector, which has the next-highest distress ratio for a nonfinancial sector at 14%.

Recovery Prospects Generally Weaker For U.S. Retail Creditors

Overall recovery prospects for creditors to U.S. retailers are somewhat lower than those for the greater domestic corporate universe (see chart 2). Relative to the full corporate universe, the recovery ratings for the retail sector have a notably lower concentration of '2' recovery ratings, which indicate our expectation for a substantial recovery (70%-90%) in a default scenario, and a much higher concentration of '6' recovery ratings, indicating our expectation for negligible recovery (0-10%).

Chart 2



Recovery For Secured Creditors Are Similar In Retail Vs. Other Sectors, But Still Weaker

When focusing only on secured debt, the distribution of recovery ratings for retailers is fairly similar to the wider corporate universe (see charts 2 and 3). The primary differences are a somewhat higher concentration of '1' and '4' recovery ratings for retailers and '2' for all corporates. Even so, the percent of first-lien debt instruments with projected recoveries below 50% are materially higher in retail at about 11%, which is about double the level across all sectors. In part this reflects the asset-light nature of many retailers, but also the high to excessive debt levels at certain retailers, including:

- Term loans to retailers that have recently filed for bankruptcy to reduce their debt levels and restructure their operation (Payless Inc., Rue21 Inc., and Gymboree Corp.; all of which had '4' recovery ratings);
- Term loans to retailers in the 'CCC' category with debt structures we view as unsustainable, such as Everest Holdings LLC d/b/a Eddie Bauer ('5' recovery rating), J. Crew Group Inc. ('5' recovery rating pending the completion of a planned distressed exchange), and Charlotte Russe Inc. ('4' recovery rating); and
- Secured bank loans and notes to highly leveraged retailers in the 'B' category, including Leslie's Poolmart Inc., National Vision Inc., Toys "R" Us Inc. subsidiary TRU Taj LLC, Beverages & More, Inc., New Academy Holding Co. LLC, and Lands' End Inc. (all of which had '4' recovery ratings).

We note that the expected '5' recovery rating on J. Crew's term loans also reflects the expected impairment of recovery prospects resulting from the pending transfer of the domestic rights to the J. Crew Brand to an unrestricted subsidiary that will have some priority debt as part of an out-of-court restructuring (scheduled to be completed on July 13, 2017).

Also notable in the retail and overall data sets is that the vast majority of secured debt instruments with poor recovery prospects (recovery ratings of '5' and '6', indicating the expectation for a recovery of less than 30%) have junior liens. Even so, you need to look beyond "debt labels" and "lien priority" to understand recovery prospects. In the retail sector there are three second-lien debt instruments with relatively strong recovery prospects of 70% or higher. These ratings relate to second-lien debt for Rite Aid Corp. (two bank loans with '1' recovery ratings) and Sears Holdings Corp. (one note issue with a '2' recovery rating) where there is sufficient collateral and a junior debt cushion to produce favorable recovery prospects.

Chart 3

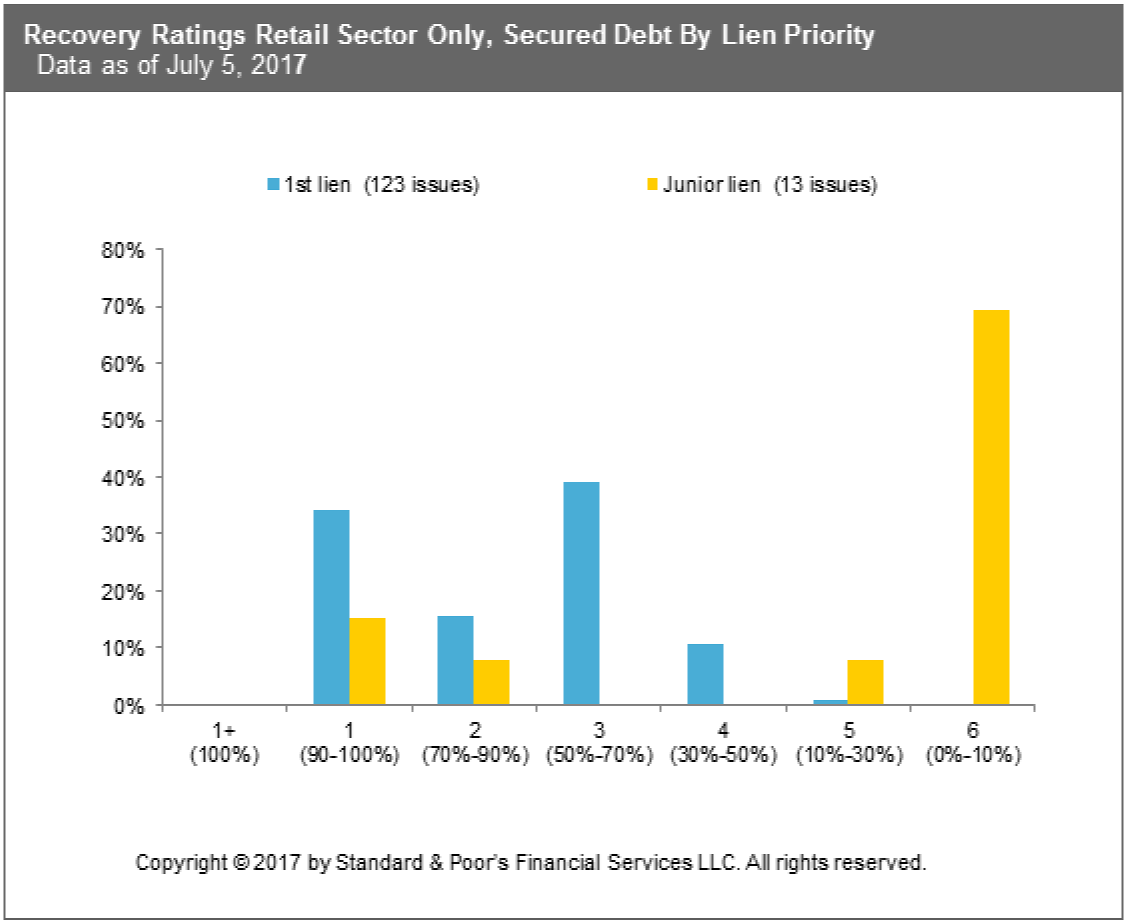

Recovery Ratings Retail Sector Only, Secured Debt By Lien Priority
Data as of July 5, 2017
1st lien (123 issues)
Junior lien (13 issues)
80%
70%
60%
50%
40%
30%
20%
10%
0%
1+ (100%)
1 (90-100%)
2 (70%-90%)
3 (50%-70%)
4 (30%-50%)
5 (10%-30%)
6 (0%-10%)
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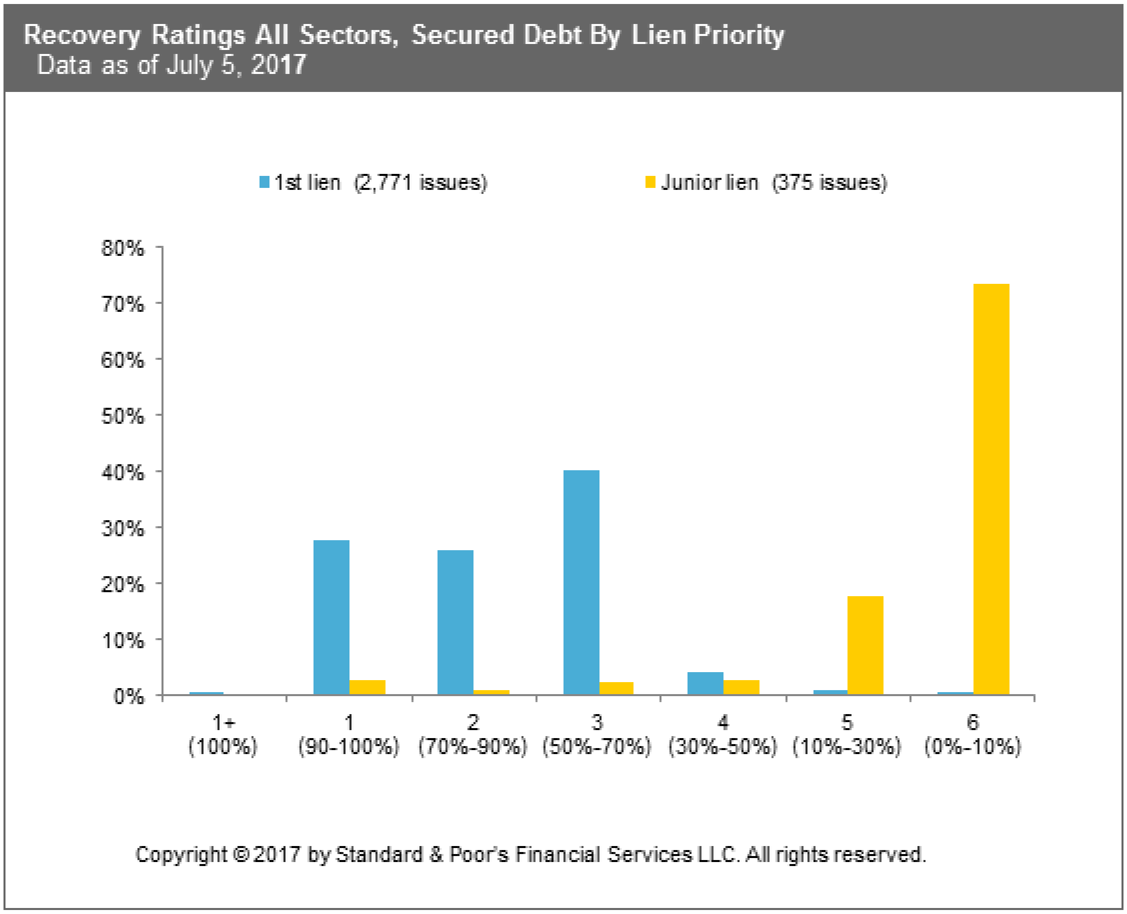
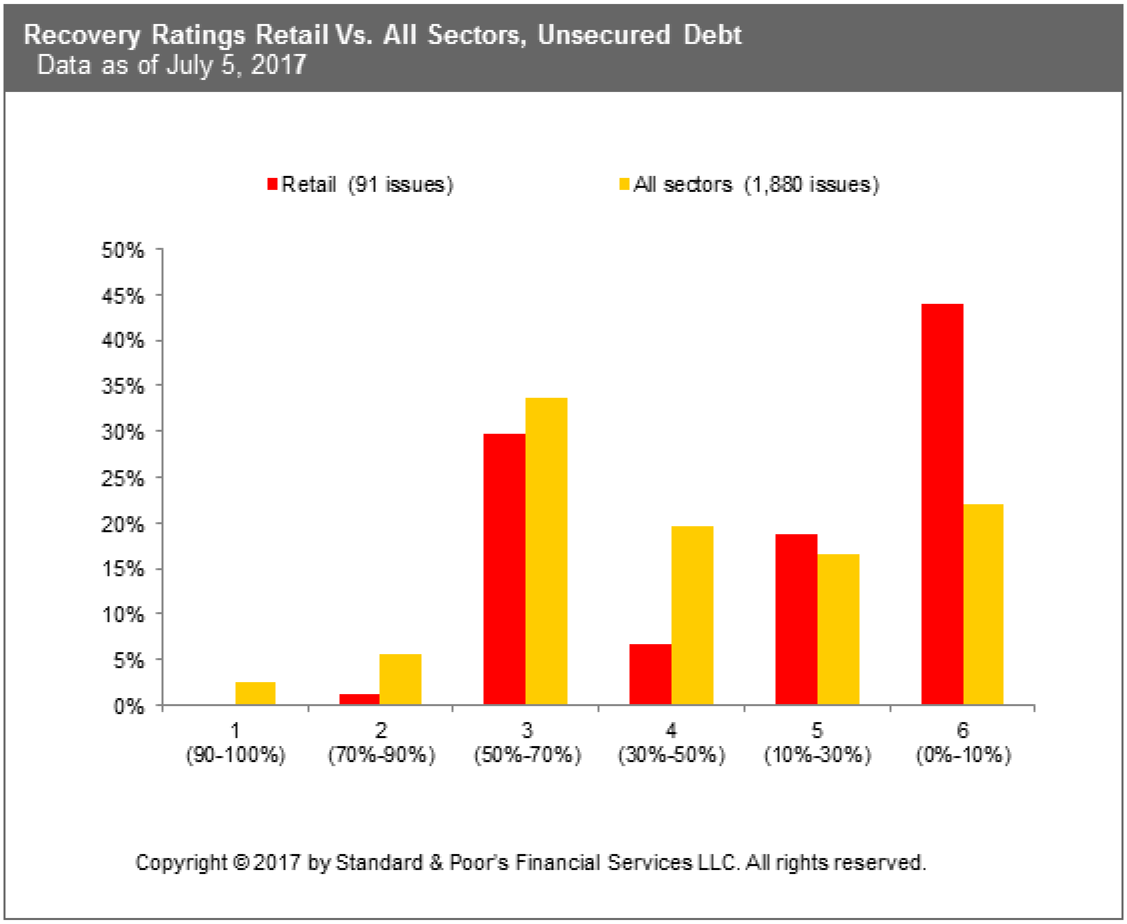
Chart 4



Unsecured Recovery Prospects Are Materially Worse In Retail Compared To Other Sectors

Looking at recovery potential for unsecured debt (including subordinated debt), we see that projected recoveries for retail creditors are significantly lower than for the full corporate universe (chart 5). For retailers, almost half of all unsecured debt carries our lowest recovery rating of '6' (recovery of 0-10%), which is about double the frequency for unsecured debt overall.

Chart 5



There are a few fundamental reasons why unsecured debt to retailers tends to have materially lower recovery prospects. First, most spec-grade retailers are highly leveraged and have a significant level of secured debt; typically an asset-backed lending facility (ABL) with a first lien on working capital assets and additional secured debt with priority liens on all other assets (including a second lien on working capital). We note that our recovery ratings also take into account situations where key assets are carved out of the collateral package, including the transfer of certain valuable assets by Claire's Stores Inc., The Neiman Marcus Group Inc., and J. Crew Group Inc.

Second, given that most retailers are asset light and have very few assets that are not pledged as collateral (for example, in other industries there can be substantial equity value in foreign subsidiaries, and 35% of this is typically not pledged as collateral), there is often little value available to unsecured creditors.

Third, the industry is fragmented and highly competitive, which tends to squeeze profit margins and cash flows. These factors contribute to relatively low historical sector trading multiples, which translates into a 5x EBITDA multiple as our base assumption for the sector (at the low end of our range of EBITDA multiples under our recovery methodology). Our methodology allows the use of higher or lower recovery multiples when analytically appropriate; however, nearly two-thirds of our recovery ratings for retailers use a multiple of 5x or lower. In particular, multiples of 5x or lower are more common in our analysis of apparel and department store companies, which represent a disproportionate share of companies with low spec-grade issuer ratings, since they are most affected by the secular changes disrupting the industry (See Appendix 3) (17 of 25 spec-grade apparel and department store firms where we use an EBITDA multiple valuation approach have 5x multiples and three have 4.5x multiples).

Even So, Some Unsecured Recoveries In Retail Are Relatively Favorable

Nonetheless, roughly one-third of our unsecured recovery ratings (28 of 91) are at '3' or better, which indicates our expectation for a recovery of at least 50%. Of the 28 recovery ratings assigned to unsecured debt, 20 are on debt issued by seven companies in the 'BB' category (which includes 'BB-' and 'BB+'). The relatively favorable recovery ratings on this debt reflect that all seven of these issuers have relatively light leverage, and that we use a favorable 6x EBITDA multiple for five of the six companies where we use an EBITDA multiples approach based on the relatively favorable business profiles and cash flow prospects for these companies. (We caution, however, that eight of these ratings relate to unsecured debt of Liberty Interactive LLC that are on CreditWatch negative reflecting the potential lowering of our issue and recovery ratings--to 'BB-' and '5', respectively--if the company completes its plan to acquire General Communications Inc., combine this entity with Liberty Ventures Group, and then spin off the combined business.)

Of the remaining eight issues at lower rated retailers, one is an unsecured term loan at Toys R Us Property Co. I LLC ('B-' issuer rating and '2' recovery rating), which holds some of Toys R Us' owned real estate and does not guarantee the company's operating company debt. As a result, this unsecured loan has a structurally senior claim to certain real estate value relative to operating company creditors. The other seven issues are for unsecured notes issued by Sears Roebuck Acceptance Corp. ('CCC+' issuer rating and '3' recovery rating), which has significant levels of excess collateral and unpledged assets to which these notes have a structurally senior claim relative to other unsecured creditors.

Recovery Expectations Below Average For Retail Creditors, But Debt Structure And Terms Matter

A review of our recovery ratings shows that debt recoveries for retail creditors are expected to be below average across the various debt types, with the weaknesses most pronounced for debt that is unsecured or has a junior lien position. Even so, there are instances of expected recoveries that are materially above or below the typical recoveries on "similar debt". This highlights the importance of understanding the terms of individual debt instruments relative to the overall debt and organizational structure, which are key elements factored into our recovery analysis. It's also important to note that retailers may be more prone to liquidation than companies in other sectors, and that this may lead to even worse recovery prospects, even for secured lenders.

Appendices

1: Notable Bankruptcies 2017:

Appendix 1

Notable Bankruptcies 2017
Payless Inc., April 4
Rue21 Inc., May 15
The Gymboree Corp.--missed interest payment on June 1; 'D' on June 2; Chapter 11 on June 12
BCBG Max Azria Group Inc., March 1
The Limited, Jan. 17
hhgregg Inc., May 17
Wet Seal, Feb. 2
Eastern Outfitters (EMS and Bob's Stores), Feb. 5
Gander Mountain, March 10
Gordman's, March 13 (buyer may keep 50% of stores)
General Wireless Operations Inc. dba Radio Shack, Feb. 5 (also Ch. 11 in 2015)
True Religion Apparel, Inc., July 5

2: Retailers In The 'CCC' Category Or Lower

Appendix 2

Issuers 'CCC+' And Below (Ex. Restaurants)	
The Neiman Marcus Group Inc.	CCC
J. Crew Group Inc.	CCC+ *
Claire's Stores Inc.	CC
Sears Holdings Corp.	CCC+
BI-LO LLC	CCC+
The Bon-Ton Stores Inc.	CCC+
David's Bridal Inc.	CCC+
Guitar Center Holdings Inc.	CCC+
Tops Holding LLC	CCC+
The Gymboree Corp.	D
99 Cents Only Stores	CCC+
Charlotte Russe Inc.	CCC+
Evergreen AcqCo1 LP d/b/a Savers	CCC+
True Religion Apparel, Inc.	D
Rue21 Inc.	D
Charming Charlie LLC	CCC+
Everest Holdings LLC	CCC+
FULLBEAUTY Brands Holdings Corp.	CCC+
Payless Inc.	D
Bluestem Brands Inc.	CCC+
Total retail issuers (excluding restaurants)	112
% 'CCC+' and Below	17.9%

*Expected issuer rating following the completion of the distressed exchange.

3: Multiples For Apparel

Appendix 3

Apparel And Department Store Firms Where We Use An EBITDA Multiple Valuation Approach In Our Recovery Analysis

	Subsector	Recovery EBITDA Multiple
Charlotte Russe Inc.	Apparel	4.5
Rue21 Inc.	Apparel	4.5
True Religion Apparel Inc.	Apparel	4.5
Abercrombie & Fitch Co.	Apparel	5
Ascena Retail Group Inc.	Apparel	5
Caleres Inc.	Apparel	5
Charming Charlie LLC	Apparel	5
David's Bridal Inc.	Apparel	5
Everest Holdings LLC (d/b/a Eddie Bauer)	Apparel	5
HT Intermediate Holdings Corp.	Apparel	5
J. Crew Group Inc.	Apparel	5
Jill Holdings LLC	Apparel	5
Kate Spade & Co.	Apparel	5
Lands' End Inc.	Apparel	5
Payless Inc.	Apparel	5
The Bon-Ton Stores Inc.	Apparel	5
The Gymboree Corp.	Apparel	5
The Talbots Inc.	Apparel	5
Claire's Stores Inc.	Apparel	5.5
Tailored Brands Inc.	Apparel	5.5
Foot Locker Inc.	Apparel	6
L Brands Inc.	Apparel	6
The Gap Inc.	Apparel	6
Belk Inc.	Dept. Store	5
The Neiman Marcus Group Inc.	Dept. Store	5

Source: "Key Recovery Criteria Assumptions And Outcomes For The U.S. Retail, Restaurants, And Real Estate Industries," published on RatingsDirect on Feb. 9, 2017.