Hilco Global
Asset Smarter

SMARTER PERSPECTIVE: DISTRESSED INVESTMENT

Distressed Business Investment Insights Amid a Volatile 2024

By The Hilco Global Distressed Investment Team

Much of what is ailing many businesses at the current time directly relates to interest rate levels, the cost of capital, and the difficulty of refinancing. This article is a topline look at these and other factors contributing to distress among companies across a range of industries, with a focus on what it means for those interested in the disposition or acquisition of related assets.

RETAIL

Many retailer balance sheets are currently stressed, including those which were in relatively good shape following the pandemic when margin tailwinds from inventory scarcity and increased consumer demand bolstered financials. What shifted?

1. The belief that COVID-level demand would continue to persist post-pandemic has turned out to be unfounded. Many retailers now simply have too much inventory on hand and some of what they do have is the wrong merchandise located in the wrong places.

2. The continued tight employment market has proven difficult. After payroll cuts during COVID, many are still operating with tighter budgets. Further, the people retailers are attracting are less experienced and proficient than those they had access to prior to the pandemic. As a result, training employees, effectively managing store merchandise, and servicing shoppers well have become more challenging.

3. The ongoing soft level of consumer demand remains a challenge. While retail sales headline figures show increases, it is important to realize that inflation-adjusted sales are actually down, as are overall units. Customers are buying less and trading down to less costly alternatives.

4. Brick and mortar has seen a surprising resurgence. Despite a massive investment in the online channel, almost 80% of most retailers' sales are still attributed to stores, which also support better margin. Now, even retailers reported as distressed in the news are looking to expand their brick-and-mortar footprints. They are seeking incremental capital and refinancings to support those initiatives.

5. The buyer pool for intellectual property has contracted due to interest rates. Despite a similar buyer pool, opportunities must be more compelling for acquirors to act. More

expensive financing has dampened the appetite for IP buyers to take risks.

6. Digitally native brands (those without brick-and-mortar locations) are capital constrained. Along with their growth, these brands are also experiencing the impact of high customer-acquisition cost and less robust margins. Many are now looking to open physical stores.

7. Increases in shrink continue to challenge retailers, with levels remaining well above pre-COVID-19 norms.

As a result of these factors, many retailers and direct-to-consumer brands are looking to refinancing their debt while obtaining incremental capital. This is occurring in a couple of contexts:

1. Refinancing incident to loan maturity/ breaking a covenant, with banks anxious to de-risk from questionable credits.

2. Exploring and leveraging direct credit options willing to stretch further on assets, even though those have a higher cost of capital than traditional conforming bank lenders.

As noted previously, the overall goal in most situations is to refinance the entire capital structure to achieve a reasonable blended cost of capital while obtaining incremental financing to fund operational and strategic needs, including stretched payables. This is proving difficult in situations where assets are generally collateralized and free cash flow may not justify the stretch. Many retailers are also looking to owned real estate; intellectual property; furniture, fixtures, and equipment; and non-traditional AR as sources of financing where opportunities allow.

In order to achieve these goals from a structural standpoint, paid-in-kind interest and healthier fees, rather than cash pay interest, are becoming the norm.

MANUFACTURING/INDUSTRIAL

Manufacturing and general industrial businesses right now are a contrasting story of the haves and the have-nots.

The haves are well capitalized and are enjoying consistent production. Healthy supplier and customer relationships have been able to effectively absorb the notably increased labor costs.

Conversely, the have-nots are experiencing inefficient and slowing production levels, poor capitalization after many did not take advantage of low interest rates when available, strained customer/supplier relationships, increased raw materials costs, and a strained labor scenario. These are leading to:

- Complete plant closures are taking place via both liquidation and consolidation. These typically have involved tired facilities containing early model equipment with little to no use case within secondary markets.

- Distressed divestitures are on the rise with institutional investors who have ignored problems over an extended period, now looking to essentially dump portfolio company assets and entire portfolio companies to raise fresh capital.

- Family-owned businesses that did not sell when their prospects were more favorable are looking to monetize under duress after a lackluster post-COVID recovery. Companies that did not effectively integrate acquisitions post-2020 are looking to cut bait, particularly those still manufacturing or distributing consumer products in the U.S.

- In automotive, specifically, softening end-user demand for new EVs—due to slow infrastructure expansion and a range of other contributing factors—is resulting in many OEMs pulling back on investment into the sector.

- Companies are once again taking a hard look at their operational footprint to determine what is truly essential. Everything from the sale of certain divisions to just the sale of surplus properties or equipment is being considered.

OFFICE & MULTIFAMILY REAL ESTATE

A high percentage of commercial office properties, particularly those in urban centers, have become significantly distressed assets, with recovery levels now notably lower than they were before work from home and hybrid work models were first broadly adopted in the spring of 2020. Loan maturities and an inability to refinance have left many owners in difficult situations.

Overbuilding of multifamily in certain markets has resulted in excess supply coupled with stagnant to deflating rents that do not support the financial projections upon which the properties were developed and purchased.

Construction costs and floating rates have made many new development projects impractical or impossible. Many developers of both residential and commercial projects are facing difficult decisions.

These plans take time to develop and put into action and cost-cutting measures may be delayed in hitting profit and loss statements. For these reasons, even companies not experiencing liquidity issues would be well advised to undertake these measures as it is alarming how quickly liquidity can change under turbulent macro market conditions and, in particular, given the current high cost of capital. Being proactive could be the difference between effectuating a turnaround and experiencing insolvency.

CONCLUSIONS

There is ultimately a minimum cost to running a bankruptcy process. This presents a challenge for lenders to lower/middle market companies with less robust working capital where the asset base, minimum excess availability covenants, or reserves leave insufficient availability to fund a process.

Several deals in the market over the past 12 months with companies involving fatigued lenders that are looking to be taken out of their position. Where smaller asset bases are present, however, other lenders are only stepping in for a takeout when existing lenders take a significant haircut to enable enough cushion to fund a process.

In these situations, we advise that second-lien lenders focus on intercreditor provisions around asset-based lending over advance provisions and allowable debtor-in-possession financing amounts to ensure they are not pushed further back in the collateral waterfall.

In terms of account payable issues, one of the most popular and frequently undertaken measures to preserve liquidity is deferring payments to vendors. This approach presents risks and claims in a bankruptcy process, further adding to costs and alienating key partners should the company emerge from its plan.

New, tailored solutions can benefit businesses across multiple industries, such as retail, where an innovative retail inventory consignment facility may be effective for operators where the situation allows.

Looking at real estate portfolios, optimizing occupancy costs of a company's real estate portfolios can generate/preserve liquidity for business across the industries toplined in this article. Lease restructuring, sale leaseback transactions, and the sale of owned surplus properties are all excellent ways to help with liquidity issues. While retailers are in a strong position to renegotiate terms with box landlords in the current environment, the same can be done for those across office, manufacturing, transportation, and other industries. Large restructurings for non-retail users in the shared office, data center, and hospitality industries have popped up in the past year.

Management needs to develop contingency plans. Leadership teams across industries should be as proactive as possible right now in identifying areas to cut costs by developing and continuously updating break-glass-in-case-of-emergency plans.

A version of this article previously appeared in the Turnaround Management Association's Journal of CORPORATE RENEWAL *and includes perspective from experts across Hilco Global's more than 20+ operating companies, with direct contributions from the Hilco Global Distressed Investment Team.*

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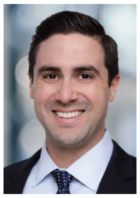

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