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Zombie retailers' debt in the junk bin

Burlington Coat, Claire's among sector's walking dead

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Heart-encrusted bangle bracelets and cheap plastic earrings aren't the only things in the bargain bin at teen retailer Claire's Stores Inc. With the accessories chain's bonds trading at junk level, investors are signaling their belief that the company is in danger of going bankrupt. And Burlington Coat Factory, which specializes in off-price apparel, may not be far behind.

It's no secret that the recession has been especially harsh on retailers, claiming as its victims home goods purveyor Linens 'n Things, West Coast department store chain Mervyn's and, most recently, Long Island-based discounter Steve & Barry's. But the string of liquidations is far from over. With Black Friday ushering in what is expected to be one of the worst holiday sales seasons in decades, many are wondering which companies will be next.

“There have been a number of [bankruptcy] filings already this fall, and it is conventional wisdom that there will be a slew more for retailers before the end of the year,” says Anders Maxwell, a managing director with investment banking advisory firm Peter J. Solomon Co.

Investors in both Claire's, which has about 10,600 employees, and Burlington Coat Factory, which has nearly 28,000, are worried. As of last week, the former had some debt trading at a mere 18 cents on the dollar, while some of Burlington's bonds were priced near 23 cents, according to bond trading firm MarketAxess.

By no means are they the only retailers facing difficulties. Discounter Loehmann's Holdings Inc., which emerged from bankruptcy four years ago, and Kmart, owned by Sears Holding Corp.—which filed for Chapter 11 protection in 2002—are on the watch list for insolvency.

But Claire's is closer. The value-priced jewelry chain was virtually debt-free in March 2007, when it was privatized in a \$3.1 billion buyout by Apollo Management, the same firm that drove Linens 'n Things to bankruptcy. Claire's, which has 11 New York locations and is headquartered in Pembroke Pines, Fla., is now saddled with \$2.4 billion of long-term debt.

Retail savior

"The retail model doesn't do well with a lot of leverage on the balance sheet," says Michael Appel, managing director of Quest Turnaround Advisors.

Because accessories are considered the savior of retail—during tough times, women are more likely to indulge in jewelry and handbags than clothing—Claire's should be doing better.

Instead, same-store sales dropped 5.8% in the second quarter and net sales fell 1.5% from the year-earlier period, to \$360 million. Claire's has been losing market share to rivals offering better discounts. Burdened with such debt, Claire's cannot be aggressively competitive on price.

In the past month alone, prices for some of Claire's bonds have fallen more than 60%.

"What these bond levels are telling you is that Claire's is toast," Mr. Maxwell says. The company declined to comment.

Similarly, Burlington Coat Factory was bought by Bain Capital for just over \$2 billion in 2006 and the New Jersey-based discounter now carries nearly \$2.3 billion in debt. Bond prices for the \$3.4 billion retailer, which has three locations in the city, have skidded 68% since late August. Some say the merchandise mix has improved—Burlington posted a 0.2% uptick in same-store sales for its most recent quarter—but many investors are still avoiding it.

"[Burlington] was bought on leverage," says Jack Hendler, president of Net Worth Solutions. "Everyone having an issue now was bought on leverage."

Buy now, pay later

Like Burlington, Kmart caters to less affluent customers and recently introduced its "pay later" campaign. But the venture has frightened investors rather than increased confidence.

"It tells you their customers have no money—otherwise, they could use a credit card," Mr. Appel says. Kmart, whose bonds are trading at about 73 cents on the dollar, is losing a significant portion of sales to Wal-Mart Stores Inc.

Other value retailers are losing out to the competition, as well. Bronx-based Loehmann's, which still holds substantial debt from a buyout in 2004, is struggling against lowered prices and promotions from such competitors as J.C. Penney and TJ Maxx. Loehmann's, which operates about 65 stores, is at risk of default, according to a Standard & Poor's report released late last month.

EARLY WARNING SIGNS

RETAILERS THAT ARE somewhat loss endangered, though still troubled, include Duane Reade and Macy's. The local drugstore company was recently downgraded by Moody's Investors Service. Though it is burdened with more than \$550 million in total debt and posted a third-quarter loss of \$22.3 million, most analysts predict that the 245-unit chain will survive because it carries necessities like toothpaste and deodorant.

In fact, Duane Reade, which Oak Hill Capital Partners purchased four years ago in a \$653 million buyout, reported a 5% spike in same-store sales in the third quarter.

“Retailers that will be impacted less in this economy are supermarkets, drugstores and dollar stores,” says Carla Casella, a retail analyst with J.P. Morgan. “Duane Reade does fall into that basket.”

Meanwhile, Macy's, whose bonds are trading at about 67 cents on the dollar, maintains a \$2 billion credit line from Bank of America and J.P. Morgan Chase through 2012. The retailer's stock price has declined 75% over the past 12 months.

Though it rates Macy's “negative,” Standard & Poor's says the company has a solid share of the nation's department store market and a stable reputation.

“Macy's has tended to set the standard for success in the moderate-to-better department store sector,” Standard & Poor's analyst Diane Shand wrote in a recent research report.