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Contacts

Raya Sokolyanska 212-553-7415
VP-Senior Analyst
raya.sokolyanska@moodys.com

Derek A Gluckman 212-553-8925
VP-Senior Covenant Officer
derek.gluckman@moodys.com

Christina Boni 212-553-0514
VP-Senior Analyst
christina.boni@moodys.com

Charles O'Shea 212-553-3722
VP-Sr Credit Officer
charles.o'shea@moodys.com

Manoj Chadha 212-553-1420
VP-Sr Credit Officer
manoj.chadha@moodys.com

Michael M. Zuccaro 212-553-4596
AVP-Analyst
michael.zuccaro@moodys.com

Daniel A Altieri 212-553-4701
AVP-Analyst
daniel.altieri@moodys.com

Enam Hoque 212-553-3939
VP-Senior Covenant Officer
enam.hoque@moodys.com

Russell Solomon 212-553-4301
Associate Managing Director
russell.solomon@moodys.com

Janice Hofferber, CFA 212-553-4493
MD-Corporate Finance
janice.hofferber@moodys.com

U.S. Retail and Apparel

As Stressed Retailers Weigh Asset Transfers, Recovery Rates Risk Taking Hit

- **As retailers seek to bolster liquidity or reduce leverage, secured lenders face the risk of impaired recovery.** Asset transfers outside of restricted subsidiaries have been rare until recently. J. Crew Group, Neiman Marcus and Claire's Stores have all transferred valuable assets to unrestricted subsidiaries outside their credit agreement restricted groups, effectively stripping collateral from their secured lenders. These transfers allow companies to raise new debt at the transferee level secured by those assets. The new debt can be used simply as a cash infusion that buys time for operational improvement, or for a debt exchange that reduces leverage and/or takes out a near-term maturity. In either case, this maneuver harms existing secured lenders because it lowers the recovery value of their loans in a potential bankruptcy. This report helps investors assess the risk of such moves across the 25 retail and apparel companies rated B3 and lower.

- **Apart from inventory, intellectual property is often the most valuable asset for retailers.** Most retailers own insubstantial hard assets (apart from inventory, in which ABL revolver lenders have a first priority claim), and depend on intangibles such as brand names for term loan or bond collateral. Only in rare cases, such as Sears, is there material asset value in owned real estate (stores, warehouses and headquarters buildings), under market leases or independently run operations.

- **The covenant provisions permitting asset transfers are both commonplace and substantial.** Of the 25[1] retail and apparel companies we rate B3 negative and below, 83% permit asset transfers to unrestricted subsidiaries. We found that only Sears Holdings, Bon-Ton Stores Inc., Tops Holding and one private filer had no ability to do so. A review of the loan terms of public retail filers within our rated portfolio reveals that sizable capacity for asset transfers to unrestricted subsidiaries is the norm.

- **Retailers with good brands and deleveraging potential pose a greater risk of transferring assets**. An asset transfer is most likely if proceeds from the new debt are large enough to either reduce leverage with a debt exchange or solve a temporary liquidity problem. This requires having a valuable brand, against which a lender can provide a meaningful amount of new financing. It also requires a path to achieving a refinanceable capital structure. Setting aside specific capital structure and credit agreement capacity considerations, we believe that a number of stressed retailers are in this position. Those with good brand names and a possible path to deleveraging include Cole Haan, VINCE and TOMS Shoes.

Secular declines in store traffic, pricing pressure and transitions to omnichannel business models are increasing stress on a number of already troubled retailers. Companies rated B3 negative and below currently represent 16% of the 148 rated retail and apparel companies (as of May 30, 2017). In this environment, stressed/distressed retailers are using creative options to generate liquidity, reduce leverage or push out maturities. Given several recent collateral transfer transactions, we provide a risk assessment of other retailers' abilities to execute such moves, along with a case study of J. Crew (page 6) and a road map for evaluating credit agreement clauses (page 7).

Secured lenders face risk of impaired recovery from asset transfers

While asset sales and sale-leasebacks have featured in retailers' arsenals for a while, asset transfers outside of restricted subsidiary groups have been rare until recently. In 2016, Claire's obtained a $130 million loan collateralized with transferred intellectual property to support a distressed exchange. In March 2017, J. Crew proposed exchanging its unsecured HoldCo notes into new notes backed by the J. Crew brand intellectual property that was recently transferred to an unrestricted subsidiary. In March 2017, Neiman Marcus moved My Teresa and three stores to an unrestricted subsidiary.

Once collateral is transferred to an unrestricted subsidiary, that subsidiary can borrow against the assets without being subject to restrictions against debt incurrence and lien grants. This allows the unrestricted subsidiary to issue debt secured by the full value of the transferred proceeds. The new debt can be used to reduce total leverage via a debt exchange by negotiating an exchange offer (as in the J. Crew case) or buying debt in the open market at a significant discount. The proceeds can also be used to take out a near-term maturity, or simply to get a cash infusion in order to fix a temporary liquidity problem. In either case, this maneuver harms existing secured lenders because it creates a new class of secured debt, which in bankruptcy has a superior claim on the relocated assets that originally collateralized the existing lenders. The move can also hurt other unsecured lenders who originally had pari-passu status with the former unsecured lenders that are now secured and will come ahead in a bankruptcy.

From a ratings perspective, once the new debt is put in place we would reassess the existing instrument ratings to reflect impaired recovery value. If the maneuver involves a distressed debt exchange, we would consider that exchange an event of default and assess ratings in the post-transaction capital structure.

Intellectual property is often the most valuable asset for distressed retailers

For most retailers, intellectual property is the most valuable collateral for secured term loan and secured notes holders. In bankruptcy, asset-based revolver lenders typically benefit from inventory liquidation proceeds, since they have first lien priority on inventory and accounts receivable. This leaves the secured term lenders reliant mainly on brands and customer lists to provide collateral value. Selected retailers also have owned real estate (such as distribution centers and headquarters buildings), under-market leases, or independent healthy smaller operations that can be monetized (for instance J. Crew's Madewell chain).

The value of a brand is highly dependent on the company's operations and is therefore difficult to assess. In Exhibit 1, page 3, we estimate key assets among the 25 stressed/distressed retail and apparel issuers rated B3 and below.

Exhibit 1

Key Assets for 25 Stressed or Distressed Issuers in Our Rated Retail/Apparel Universe

Company	Rating	Outlook	Moody's view of key assets
99 Cents Only Stores LLC	Caa1	Stable	Some value in owned real estate; 99 Cents brand name has limited value outside retail operations
Boardriders SA	Caa1	Positive	Meaningful brand equity in Quiksilver, Roxy and DC Shoes
Bon-Ton Stores Inc., (The)	Caa1	Stable	Some value in owned real estate and customer data; Brand name has limited value outside retail operations
Charlotte Russe, Inc.	Caa1	Negative	Brand name has limited value outside retail operations
Charming Charlie Inc.	Caa1	Negative	Brand name has limited value outside retail operations
Claire's Stores, Inc.	Ca	Negative	Brand name has limited value outside retail operations
Cole Haan / Calceus Acquisition, Inc.	Caa1	Stable	Meaningful brand equity in Cole Haan name
David's Bridal, Inc.	Caa1	Stable	Brand name and individual collection brand names (Galina, Oleg Cassini, Melissa Sweet) have limited value outside retail operations
Eddie Bauer / Everest Holdings, LLC	Caa2	Stable	Meaningful brand equity in Eddie Bauer
Fairway Group Holdings Corp.	Caa1	Stable	Brand name has limited value outside retail operations
FullBeauty Brands Holdings Corp.	B3	Negative	Some brand equity in Roaman's, Jessica London, Woman Within, Swimsuits For All, King Size and Brylane, as well as customer lists
Gymboree Corporation (The)	Caa3	Negative	Meaningful brand equity in Gymboree and Janie&Jack. Separable Janie&Jack and Crazy 8 operations also have value
J. Crew / Chinos Intermediate Holdings A, Inc.	Caa2	Negative	Meaningful value in separable Madewell operation and brand name; J. Crew customer lists
Lands' End, Inc.	B3	Negative	Meaningful brand equity; some value in customer lists from online and catalog businesses
Neiman Marcus Group LTD LLC	Caa2	Negative	Significant value in owned stores (except for ground leases), favorable leases, meaningful brand equity and customer data
Nine West Holdings, Inc.	Caa3	Stable	Some brand equity in Nine West, LEI Jeans and Kasper
NYDJ Apparel, LLC	Caa3	Negative	Some brand equity in NYDJ
Savers / Evergreen AcqCo 1 LP	Caa1	Negative	Savers, Value Village and Village de Valeurs brand names have limited value outside retail operations
Sears Holdings Corp.	Caa2	Stable	Significant remaining value in owned stores, favorable leases, customer data, Kenmore and Diehard brands
TOMS Shoes, LLC	Caa1	Stable	Meaningful brand equity in TOMS; some value in customer lists given extensive e-commerce operations
Tops Holding II Corporation	Caa1	Stable	Brand name has limited value outside retail operations
Totes Isotoner / Indra Holdings Corp	Caa2	Stable	Some brand equity in Totes and Isotoner, limited value in Acorn and Manzella
True Religion Apparel Inc.	Ca	Negative	Some brand equity in True Religion
Velocity Pooling Vehicle, LLC	Caa2	Negative	Some brand equity in Vans&Hines, Kuryakyn and others
VINCE, LLC	Caa1	Stable	Meaningful brand equity in VINCE

Source: Moody's Investors Service

Covenant provisions allowing asset transfers are commonplace and substantial

To assess the risk of an unrestricted subsidiary asset transfer, investors will look first to determine whether the company may designate subsidiaries as unrestricted, and then identify and measure the carve-outs that allow asset transfers to the unrestricted subsidiaries. While each debt document is distinct and certain variations may arise, on page 7 (see *How investors assess transfer risk*) we provide a broadly applicable framework for assessing whether a "J. Crew trade" is possible and measuring the potential risk. There are four primary investment covenant carve-outs that provide such capacity: (1) the general investment carve-out, (2) the non-guarantor investment carve-out, (3) the income basket (a.k.a. the "builder basket") carve-out, and (4) any portion of the permitted acquisition carve-out which can be invested in unrestricted subsidiaries.[2] Exhibit 2, page 4 shows which of these baskets provide capacity in the public loans from our survey.

Of the 25 retail and apparel companies we rate B3 negative and below, 83% (excluding Fairway's exit facility) have meaningful investment baskets that permit asset transfers outside the restricted group. We found that only Sears, Bon Ton, Tops and one non-public issuer had no ability to do so.

Of the ten public filers within our rated retail portfolio that can execute or already have executed such transactions, seven show sizable capacity to do so based on their credit documents (see Exhibit 2, below), suggesting this risk to investors is not only widespread but large where it arises.

Exhibit 2

Investment Covenant Carve-Outs Permitting Unrestricted Subsidiary Asset Transfers

Sample: Public Filers with ability to transfer assets outside restricted subsidiaries

		Individual Carve-Outs Permitting Asset Transfers			
Company	Total Asset Transfer Capacity	General Investment Basket	Non-Guarantor or Foreign Subsidiary Basket	Available Amount (Income Basket)	Unrestricted Subsidiary Capacity in Acquisition Basket *
J Crew / Chinos Intermediate Holdings B, Inc.	$250m + income basket	greater of $100m and 3.25% of total assets	greater of $150m and 4% of total assets	✓ ($27m disclosed by company)	N/A
Claire's Stores, Inc.	$300m + income basket + $150m of acquisition capacity	greater of $150m and 5.0% of total assets	greater of $150m and 5.0% of total assets	✓	greater of $150m and 4.5% total assets
Neiman Marcus Group LTC LLC	$250m + income basket	greater of $150m and 1.75% of total assets	greater of $100m and 1.15% of total assets	✓	N/A
Gymboree Corporation (The)	$115m + income basket + $75m acquisition capacity (subject to ratio)	greater of $90m or 2.75% of total assets	$25m	✓	$75m, subject to pro forma total leverage and interest coverage levels
99 Cents Only Stores LLC	$55m + $50m acquisition capacity (subject to ratio)	greater of $40m and 2.0% of total assets	$15m	N/A	greater of $50m and 2.75% of total assets, subject to pro forma leverage
Lands' End, Inc.	$20m + income basket	$20m	N/A	✓	N/A
VINCE, LLC	$20m + income basket + uncapped investments by non-guarantors	$15m	(i) Uncapped investments by non-guarantor subsidiary in a non-guarantor subsidiary; (ii) investments in non-guarantors ≤ $5m	✓	N/A

Amounts reflect capacity before any use, including for asset transfers
* Only relevant if asset transfer structured as an acquisition
Source: Credit agreements, Moody's Investors Service analysis

Companies with good brands, deleveraging potential run higher risk of transfers

An asset transfer is most likely if proceeds from the new debt are large enough to either reduce leverage with a debt exchange or solve a temporary liquidity problem. This requires having a valuable brand, against which a lender can provide a meaningful amount of new financing. It also requires a path to achieving a refinanceable capital structure. Setting aside specific capital structure and credit agreement capacity considerations, we believe that a number of stressed retailers are in this position. Those with good brand names and a possible path to deleveraging include Cole Haan, VINCE and TOMS Shoes.

Exhibit 3

Leverage and Maturity Schedules of Retailers Rated B3 Negative and Below

Company	Debt/ EBITDA [1]	2017	2018	2019	2020	2021+
99 Cents Only Stores LLC	37.6x			$591mm 1st Lien Term Loan B2 $250mm Sr. Unsec. 11% Notes		$160mm 1st Lien ABL
Boardriders, SA	na	Euro18mm 8.875% Unsec. Notes			Euro150mm 9.5% Notes	$140mm ABL $50mm Delayed Draw Term Loan
Bon-Ton Stores Inc., (The)	7.4x					$350mm 2nd Lien 8% Notes $730mm Tranche A Sr. Sec ABL $150mm Tranche A-1 Sr. Sec ABL
Charlotte Russe, Inc.	na		$75mm 1st Lien ABL	$216mm 1st Lien Term Loan B		
Charming Charlie Inc.	na			$137mm 1st Lien Term Loan B	$60mm 1st Lien ABL	
Claire's Stores, Inc.	11.6x	$18mm Sr. Sub. 10.5% Notes		$1,131mm 1st Lien 9% Notes $222mm 2nd Lien 8.875% Notes $50mm Secured Term Loan $40mm Unsecured Term Loan $75mm ABL Facility $75mm Revolver	$210mm 1st Lien 6.125% Notes $217mm Sr. Unsec. 7.75% Notes	$31mm 1st Lien 9.0% Term loan $101mm Secured 9.0% Term Loan $46mm Unsecured 9.0% Term Loan
Cole Haan / Calceus Acquisition, Inc.	na				$110mm ABL $320mm 1st Lien Term Loan	
David's Bridal, Inc.	na			$491mm 1st Lien Term Loan B	$270mm Sr. Unsec. 7.75% Notes	$125mm ABL
Eddie Bauer / Everest Holdings, LLC	na				$250mm ABL	$218mm Term Loan
Fairway Group Holdings Corp.	na				$55mm First Out Exit Term Loan $45mm Last Out Exit Term Loan	$39mm Unsec. Subordinated Loan
FullBeauty Brands Holdings Corp.	na				$100mm ABL	$811mm 1st Lien Term Loan $345mm 2nd Lien Term Loan
Gymboree Corporation (The)	10.6x	$225mm 1st Lien ABL A (Springing)	$769mm 1st Lien Term Loan $171mm Sr. Unsec. 9.125% Notes			
J. Crew / Chinos Intermediate Holdings A, Inc.	11.0x			$350mm 1st Lien ABL $563mm Sr. Unsec. 7.75% Notes		$1,539mm 1st Lien Term Loan B
Lands' End, Inc.	12.6x			$175mm 1st Lien ABL		$501mm 1st Lien Term Loan
Neiman Marcus Group LTD LLC	9.7x				$2,854mm Sr. Sec. TL	$900mm ABL $600mm 8.75% / 9.50% Sr PIK Notes $123mm 7.125% Sr Debentures $960mm 8.00% Sr Cash Pay Notes
Nine West Holdings, Inc.	na			$275mm 1st Lien ABL $433mm 1st Lien Term Loan B $28mm Sr. Unsec. 6.875% Notes $426mm Sr. Unsec. 8.25% Notes	$297mm Sr. Unsec. Term Loan	$250mm Sr. Unsec. 6.125% Notes
NYDJ Apparel, LLC	na			$12mm 1st Lien Revolver	$143mm 1st Lien Term Loan	$1mm 2nd Lien Term Loan
Savers / Evergreen AcqCo 1 LP	na			$60mm 1st Lien Revolver $683mm 1st Lien Term Loan C		$297mm Sr. Unsec. Notes
Sears Holdings Corp.	-5.0x	$44mm Sr. Unsec. 6.875% Notes	$729mm 1st Lien Term Loan B $303mm 2nd Lien 6.625% Notes $400mm 8% Secured Loan	$625mm Sr. Unsec. 8% Notes	$1,500mm 1st Lien Extended ABL $554mm Sr. Sec Term Loan $300mm 2nd Lien Term Loan $500mm 8% Secured Loan	$284mm Sr. Unsec. Sears Roebuck Notes (various)
TOMS Shoes, LLC	na			$80mm 1st Lien ABL	$300mm 1st Lien Term Loan B	
Tops Holding II Corporation	5.5x		$86mm Sr. Unsec PIK 8.75% notes			$150mm ABL Facility $560mm 8% Sr. Sec Notes
Totes Isotoner / Indra Holdings Corp	na					$100mm 1st Lien ABL $232mm 1st Lien Term Loan $80mm 2nd Lien Term Loan
True Religion Apparel Inc.	na		$60mm 1st Lien ABL	$386mm 1st Lien Term Loan	$85mm 2nd Lien Term Loan	
Velocity Pooling Vehicle, LLC	na			$150mm 1st Lien ABL		$288mm 1st Lien Term Loan B $85mm 2nd Lien Term Loan B
VINCE, LLC	4.6x			$45mm 1st Lien Term Loan	$80mm 1st Lien ABL	

[1] Debt/EBITDA reflects funded debt leverage as of the most recent reported period , based on total gross debt and management adjusted EBITDA. Provided only for public filers
Source: Credit agreements, financial statements, press releases, Moody's Investors Service

J. Crew Case Study: Transfer used $250 million of capacity, with $27 million remaining

J. Crew is currently negotiating a debt exchange in an attempt to lower leverage and push out its nearest maturity from 2019 to 2021, in order to provide more runway for improving operations. If completed at terms close to the recent proposal, the debt exchange will lower leverage by about 1.25x from 11.0x currently. J. Crew is in litigation with the term loan holders regarding the validity of the intellectual property transfer under the term loan agreement. It is unclear whether an exchange will be completed. However, we believe that the exchange will still leave the company with unsustainable leverage and uncertainty regarding its ability to stabilize and recover earnings. In addition, the exchange will reduce cash flow generation by the amount of licensing fees that will fund the new debt's interest payments. The terms of the cash royalty payments have not been established, but the total impact on annual cash flow will be meaningful. If J. Crew completes a debt exchange on terms similar to those currently proposed, the term loan's recovery value would be impaired and could result in a downgrade of its Caa1 rating.

In March 2017, J. Crew offered holders of its 7.75%/8.5% HoldCo PIK Toggle notes due 2019 ("HoldCo notes" with outstanding amount of $567 million) to exchange their debt for new $200 million 9% notes due 2021 ("IPCo notes") backed by the intellectual property (IP) of the J. Crew brand that had recently been transferred to an unrestricted subsidiary, as well as 5% common equity in Chinos Holdings Inc. The HoldCo noteholders made a counter offer that was significantly more advantageous to them, and the parties did not reach an agreement.

In April, J. Crew made a new proposal, with a consideration of $250 million new IpCo notes at 10% cash and 2% PIK interest rate, and $150 million preferred equity with 5% cash and 2% PIK dividend rate. The noteholders' counter proposal was this time closer to that of J. Crew, but again no agreement was reached.

The potential to pledge the IP to holders of the proposed IPCo notes was facilitated by the December 2016 transfer of 72% of the total company's IP (valued at $250 million by an independent advisor) to a wholly-owned unrestricted subsidiary, J. Crew Domestic Brand, LLC. The company made the asset transfer with investment capacity in a $100 million general investment carve-out, a $150 million non-guarantor restricted subsidiary investment carve-out, an available amount basket (with disclosed $27m of accumulation), and a pass-through carve-out, allowing non-guarantor restricted subsidiaries to make investments in unrestricted subsidiaries to the extent financed with proceeds received from any of these carve-outs.

The company specified that it currently has $27 million of remaining unrestricted subsidiary investment capacity after using $250m of the $277m detailed above. While this remaining amount is not large enough to allow material additional unrestricted subsidiary asset transfers, we believe J. Crew's Madewell segment has material value both in its entirety (including 113 stores), and as intellectual property only (which has been valued by independent financial advisors at $97 million).

How investors assess transfer risk

Investors should first determine whether all subsidiaries of the issuer are subject to the loan and bond covenants, or whether the issuer's subsidiaries are divided into restricted and unrestricted subsidiary groups. Only restricted subsidiaries are bound by the covenants of the debt documents; unrestricted subsidiaries are free to act without being subject to covenant limitations, which is why they are able to incur debt and grant liens against assets. If all subsidiaries are bound by the covenants in the debt documents, and there is no capacity to deem, create or acquire unrestricted subsidiaries in the future, then this type of transaction is structurally impossible and presents no risk to investors. If the debt documents do create or otherwise permit an unrestricted subsidiary group, then the risk exists and is governed by applicable negative covenants.

In order to transfer assets from the borrower or any restricted subsidiary to an unrestricted subsidiary, issuers must comply with multiple covenants restricting investments, asset dispositions and transactions with affiliates. Practically speaking, however only the investment covenant[3] serves as any real limitation on this capacity. The asset disposition covenants and affiliate transaction covenants are broadly permissive and typically allow any permitted investment, so investors should not look to these covenants to provide protection in these circumstances.

The investment covenant, which prohibits investments by the company or restricted subsidiaries, will have various carve-outs permitting investments in unrestricted subsidiaries. The combined value of such carve-outs reflects the total risk. Depending on the drafting of the covenants, the investments may be made in a single step (with investments made directly in the unrestricted subsidiary) or in a two-step transaction (with investments first in non-guarantor restricted subsidiaries, and a second investment which allows investments in an unrestricted subsidiary so long as such investment is financed with the proceeds of the first step). In terms of the risk to investors, there is no practical difference between the two approaches since the same results can be achieved either way; only the aggregate carve-out capacity matters (although these differing documentary restrictions may require different approaches in how the issuer structures the transaction).

To measure the dollar value of this risk, investors should look primarily[4] to the capacity under (1) the general investment carve-out, (2) the non-guarantor investment carve-out, (3) the income basket carve-out, and (4) the permitted acquisition carve-out (acquisition carve-outs generally have a non-guarantor sublimit which may or may not allow investments in unrestricted subsidiaries, and may also be conditioned upon pro forma compliance with absolute leverage or coverage ratio levels or ratio-neutral effects). In a credit agreement requiring a two-step transaction, the carve-out permitting investments in unrestricted subsidiaries specifically permits investments financed with proceeds of some or all of the carve-outs detailed above.

The total potential risk will be the sum of these carve-out capacities (less any amounts already applied). The general investment, non-guarantor investment and non-guarantor acquisition sublimit are fixed amounts or easily determined as a percentage of reported financial measures. The income basket amount, if applicable, may or may not be publicly reported by the issuer. Amounts already applied will no longer be available in most cases, although loans with reclassification provisions raise the additional concern that basket amounts could have been used in the past and subsequently refreshed.

This report was included in Inside Africa: July 2017.

Endnotes

1 For our statistical analysis here the denominator is 24 companies, after excluding Fairway's exit facility from the population.

2 The permitted acquisition carve-outs typically have a sublimit amount which can be used to invest in non-guarantors. This non-guarantor sublimit may include or exclude unrestricted subsidiary acquisitions.

3 In a loan this is typically a stand-alone covenant, although permitted investments may alternatively be governed by the restricted payments covenant. In bond indentures, permitted investments are governed by the restricted payments covenant.

4 The risk may arise in other covenants, so investors should conduct their own review of the documents.

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