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Why PE Isn't The Real Reason Retailers Are Going Bankrupt

By **Benjamin Horney**

Law360 (April 4, 2018, 8:07 PM EDT) -- The idea that private equity backers are to blame for the demise of well-known retailers like Toys R Us, Payless and Claire's is overblown, experts say, and the reality is that the companies fell into bankruptcy because they failed to adapt their business models to combat disruptive and technologically savvy competitors like Amazon.

The narrative that private equity players should be held responsible for the bankruptcies of a number of iconic retailers has picked up steam in recent weeks in the wake of the announcement that Toys R Us Inc. will shutter or sell all of its U.S. stores. That revelation came after Payless ShoeSource Inc. closed hundreds of its stores last year as a result of going bankrupt. The American operations of Claire's Stores Inc., meanwhile, filed for Chapter 11 protection last month, and the jewelry and accessories retail chain is currently in the process of trying to figure out how it can avoid significant store closures.

The sentiment in the public sphere is that when PE investment funds bought into these and other retailers, they saddled them with debt, for which the retailers became responsible. Then, when the debt and other costs associated with the PE-backed leveraged buyouts became too overbearing, the companies declared bankruptcy.

That's not the whole story, however.

"I generally think far too great of a black hat is placed on PE in these deals," Michael Fieweger, chairman of Baker McKenzie's global private equity practice, told Law360.

At the end of the day, if it was strictly a matter of the retail companies being overleveraged but having sound business prospects going forward, they would be getting restructured, Fieweger explained.

"That's not the case," he said. "They are liquidating, and that's the truest tell of the fact that the market is looking at a company and business model and saying that it doesn't make sense anymore."

While there is truth to the notion that PE-backed leveraged buyouts typically add a significant amount of debt to the target's balance sheet, the primary reason for this rash of retail bankruptcies is a total shift in how the sector works, attorneys say.

"When you look at the retail business, there have been significant disruptors in the industry over the last 10 years," Howard Berkower, a partner in the corporate practice of McCarter & English LLP, told

Law360.

The main disruptor is Amazon.com Inc., a business that has completely pulled the rug out from under the rest of those in retail, although there are many other companies that have torn up the old retail playbook, innovated by moving their businesses mostly online, and made life more difficult for those trying to stick to the old game plan of having a host of brick-and-mortar stores. FreshDirect, for example, allows customers to grocery shop online and have items delivered to their doorstep, while Wayfair Inc. gives people the ability to buy furniture and other home goods on their computer, phone or other smart device.

"It's all internet-related," Fieweger said.

It's easy to place all the blame on a private equity backer that provided a retailer with an infusion of capital along with a mountain of debt, though it makes sense that the sentiment has gotten some play considering the PE industry's money-hungry reputation. Attorneys seeking to properly advise PE or retail clients should have a full understanding of why some retailers are failing and what can be done to avoid bankruptcy.

"It's primarily an issue where you have a disruption in the marketplace for these companies," Fieweger said. "You have large, fixed costs in the way of leases, owned property and inventory, and absent a big disruption, these things are actually amenable to being leveraged."

The big retail disruption in the wake of internet sales means it is the management teams of these companies that should be shouldering the responsibility of figuring out a way to stay relevant in this new age.

"These disruptors are very, very serious," Berkower said. "This is like the perfect storm. It's like there's a hurricane that's coming for the whole retail sector."

It is possible to weather and survive that storm and even thrive in the aftermath, but only if private equity professionals, retail businesses and their advisers learn lessons from the downfall of businesses past. Take Blockbuster, for instance, which was a true behemoth of the video and DVD industry until Netflix came along, or Borders, which was once a haven for readers but went bankrupt because it was unable to adapt.

"Businesses have to be more nimble, and management has to be smarter," Berkower said. "You always have to be the master of your own domain."

Another issue that has been touted as part of the reason for some of these retailers' struggles is the fact that private equity funds charge a variety of fees to portfolio companies, including management, performance and monitoring fees. But the claim that such fees are among the main culprits causing certain companies to go under is a false flag, experts say.

It's important to recognize that private equity professionals put real money at risk when they invest in these retailers, and while fees associated with PE deals are certainly part of the equation, the intent from PE fund managers is not to suck a portfolio company dry by extracting fees, according to Jonathan Bender, a corporate partner at Wilk Auslander LLP.

"They're investing their clients' money and looking to turn these companies around and get a return on

their investment," Bender said. "They are not making it on the management fees. That's not what they're getting rich on. If all they pull out is a management fee, that’s not going to make their investors happy."

Retailers struggling to make the profits they desire can and should still turn to the private equity industry, according to J.B. Dollison, a managing director at Crutchfield Capital Corp., a private investment banking firm that serves the middle market.

That's because the PE industry is actually quite effective at helping companies create jobs, especially when you zoom out and look at the big picture as opposed to pointing to a handful of cases like Toys R Us. Between 2008 and 2015, U.S. businesses of all stripes supported by private equity — meaning not just those in retail — saw jobs grow by 17.4 percent, whereas jobs in the broader economy grew by just 8.6 percent, according to data from GrowthEconomy.org.

The PE industry's ability to help companies create jobs comes because private equity players are able to assist with the implementation of processes and systems that promote growth. For example, private equity backers often invest in sales teams and proper advertising and can help management teams better understand exactly what customers need in terms of products and services.

"That type of discipline is so critical in creating value and increasing jobs," Dollison, who is also chairman of the board at the Association for Corporate Growth, or ACG Global, told Law360.

"It's easy to find a scapegoat and not look at the broader picture," Dollison said. "PE doesn't always get it right, and there are misses. But [PE] is also growing jobs by twice the national average."

Toys R Us will not be the last private equity-backed, name-brand retailer to go under, meaning people will likely again attack the PE industry for having supposedly ruined a once-great company without understanding that the reasons retailers go bankrupt are far more complicated and involve more than merely the debt they take on during a private equity buyout.

"We see it again and again: If a private equity-backed company fails, everyone says it's PE's fault," Fieweger said. "If it succeeds because they grow, have additional capital and create wealth for shareholders, nobody seems to trumpet the involvement of private equity."

--Editing by Katherine Rautenberg and Alyssa Miller.

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