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US bookstore retailers face challenges from intense competition

by Yu Ning

Bankruptcies among US retailers reached a six year high in 2017 as more consumers shop online and foot traffic at shopping malls declined. Some of the largest household names in traditional retailing, including Toys R US and Aerosoles have filed for bankruptcy. Barnes & Noble, the largest bookstore chain in the US could shut stores and cut jobs as holiday revenues plunged 6.4% from a year ago. The downward trend in brick-and-mortar bookstores appears to be nationwide. According to the US Census Bureau, bookstore sales in 2017 decreased to USD 10.73bn from USD 11.14bn in 2016.

Our survey of 178 US retailers lists Barnes & Noble and Barnes & Noble Education as the only two publicly listed firms where bookstore sales make up more than 95% of their revenues. The term structures of the RMI-CRI Forward 1-year Probability of Default (Forward PD) for the two bookstores are shown in Figure 1. The term structure shapes for Barnes & Noble and Barnes & Noble Education suggest that, based on the market information on Feb 16, the credit profiles of the firms could deteriorate faster than the aggregate credit profile of the US retail sector in the following 6 months.

The Forward PD computes the credit risk of a company in a future period, which is interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

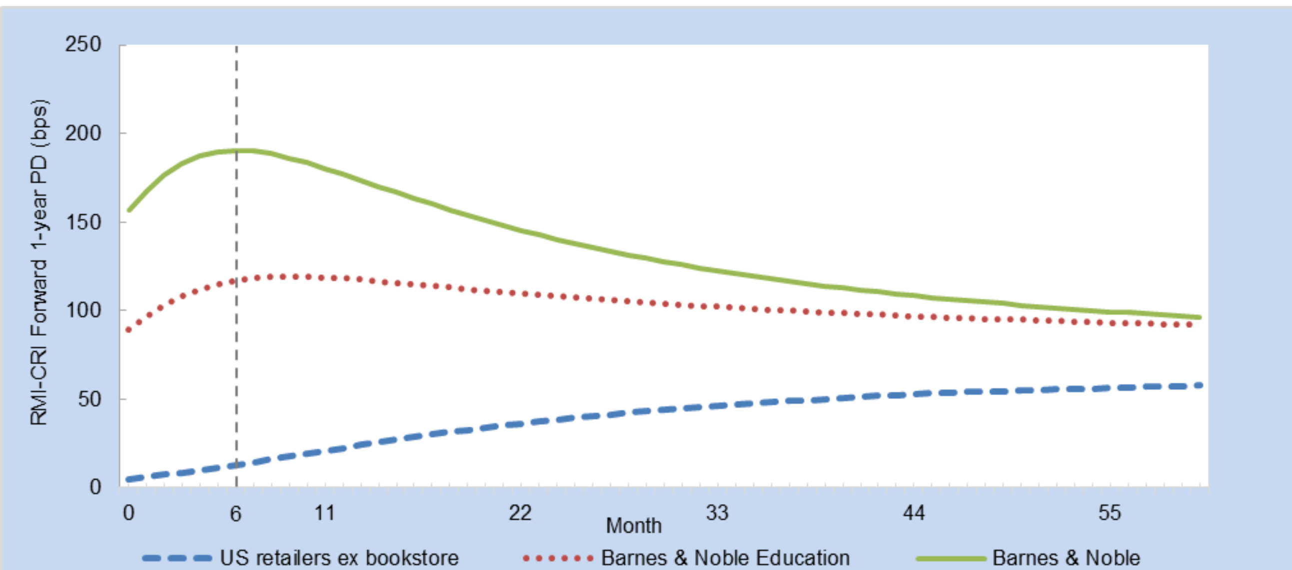

Figure 1: RMI-CRI Forward 1-year PD term structures for retailers and bookstores in the US on Feb 16, 2018. *Source: RMI-CRI*

As the leading retailer of content, digital media and educational products in the US, Barnes & Noble has been struggling with declining revenues in a year dubbed as the "retail apocalypse". The firm's credit quality, tracked by the RMI-CRI Probability of Default, deteriorated considerably on the day after Barnes & Noble announced disastrous holiday season sales.

Despite a bubbling US consumer confidence and a healthy job market during the Christmas season, Barnes & Noble reported that total sales plunged by 6.4% compared to a year ago. Comparable store sales, a key industry metric, was also down 6.4%. Half of the deterioration in revenue was attributable to top-line declines in music and DVDs, indicating that the decision to move sales beyond books that started in 2016 did not pay off. The bookstore giant subsequently lowered its EBITDA forecast to the range of USD 140mn to USD 160mn for the fiscal year 2018, which is lower than 2017's EBITDA of USD 189.2mn. The disappointing holiday sales forced

Barnes & Noble to cut jobs. On Feb 12, the company laid off nearly 6.9% of employees, which is expected to save the firm USD 40mn in operating expenses, after taking a USD 11mn charge for severance payments.

Barnes & Noble's printed book sales are down more than 10% from a decade ago and are likely to remain under pressure over the long time. Print sales may not improve significantly as Amazon, the largest Internet retailer in the world, has stepped into the physical bookstore market in 2015. With an efficient book-shopping process and effective inventory strategies, Amazon is expanding in the US market with over a dozen of bookstores under its management. The competition has forced Barnes & Noble to close nearly 40 stores in the past few years and plan to shut down 197 stores by 2022. Barnes & Noble lost about USD 1.3bn in the last six years on the Nook business, the company's digital platform launched in 2009. Sales of the Nook device fell from USD 933.5mn in 2012 to USD 146.5mn in 2017.

Quarter ending	Apr 29 2017	Jul 29 2017	Oct 28 2017
Trailing 12-Month (TTM) Net Income (USD mn)	30.3	24.3	14.8
Net Debt (USD mn)	52.9	72.1	231.5
Net Debt/Equity (%)	9.21	12.98	44.85
TTM Free Cash Flow (USD mn)	49.0	36.3	-3.6
TTM Free Cash Flow[1] / TTM Interest Expense (%)	9.1	6.3	-0.6

Table 1: Financial Data for Barnes & Noble Inc. *Source: Bloomberg*

Even though the company is profitable, Barnes & Noble's rising financial leverage and falling free cash flow remain a pressing issue. Trailing 12-month (TTM) net income dropped to USD 14.8mn while its net debt to equity ratio increased to 44.85% from 9.21%. However, the company did not generate enough free cash flow to cover the interest expense. The ratio of TTM free cash flow over interest expense turned negative by October 2017.

In 2015, Barnes & Noble completed the separation of its Retail and College businesses. Barnes & Noble Education, Inc. became an independent, publicly traded company, focusing on the broader educational services market. Operated as one of the largest textbook wholesale distribution channels in US, Barnes & Noble Education enhances the academic and social purpose of educational institutions, serving more than 5mn college students and faculty members on 777 campus stores nationwide.

Nonetheless, the textbook market is volatile. Students tend to find the cheapest study materials, looking at other options including rental books and e-books. Barnes & Noble Education competes with textbook rental platforms, which offer low book prices and provide students an alternative to purchasing study texts. In 2017, textbook publisher Pearson's reduction of e-book rental prices negatively impacted distribution margins. Barnes & Noble Education saw its TTM net income dropped to USD 5.4mn in fiscal 2017 from USD 19.1mn in fiscal 2015.

Brick-and-mortar US bookstores like Barnes & Noble may need to generate brand value and build loyalty among customers who are shopping with their smartphones with a new set of expectations in an increasingly digital age. The firm's strategic turnaround plan to cut costs may not be enough to fend off the new competition – Walmart, Amazon, and Apple who have been expanding onto the bookstore's turf. Barnes & Noble downplayed the threat from its competitors, but time will tell if its new loyalty and café strategies will bring back the shoppers.

Credit News

Coal chief warns against 'green' failure to back industry

Feb 18. The World Coal Association has warned that the boycotts of coal projects by western financial institutions will be counterproductive if they discourage investment to reduce power station emissions. To tackle climate change and air pollution, institutions should work with the industry to develop cleaner coal-fired power plants as coal is going to continue to play a big role in the global energy system especially in emerging markets. The shift in investment to cleaner renewable power would not be sufficient to meet surging demand for electricity in developing regions especially Asia. According to analysts, Asia would require USD 250bn of investment in coal power investment over the next decade and part of the capital should be used to develop newer technology to help reduce carbon dioxide emissions. (FT)

[1] Free cash flow represents the cash that a company can generate after laying out the money required to maintain or expand its asset base.

Judge approves Takata's U.S. bankruptcy plan

Feb 18. Takata and its US unit, TK Holdings Inc, filed for bankruptcy in 2017 after the largest automotive recall in history. Its air bags, which inflated with too much force and sprayed metal fragments, are linked to hundreds of injuries and at least 22 deaths. The unit finally received court approval for its bankruptcy exit plan, according to a plaintiffs' law firm. The reorganization plan will pave way for the USD 1.6bn sale of Takata assets and provision of funds to compensate for those injured by the air bangs. (Reuters)

Malaysia's high interest payments on debt raise concern

Feb 16. The high interest paid to service Malaysia's MYR 685.1bn government borrowing as of 2017 has raised concerns despite the amount forming only 50.9% of Malaysia's economy, which was still relatively favorably when compared against that of other countries. In 2017, Malaysia used 12.5% of its income on interest payment, an increase from the 2009 when the percentage was less than 9%. The state expects to pay MYR 31bn in interest in 2018, which almost equates to all the personal income tax the Malaysian government expects to collect for the year. Rating agencies have flagged interest payments and low government revenue as a challenge for Malaysia. Moody's have also commented that if Malaysia fail to make improvements in revenue collections, debt affordability is likely to remain a drag on the country's overall fiscal metrics. (Straits Times)

More banks joining USD 14bn debt for Blackstone's TR unit buy

Feb 15. US private equity firm Blackstone Group's USD 14bn acquisition of a majority stake in the Financial and Risk business of Thomson Reuters Corp is attracting more banks to join, especially for roles in relation to the lucrative underwritten leveraged loan and high yield bond financing. Bank of American Merrill Lynch, Citigroup and JP Morgan are leading the financing and talks with other banks have started, with the likes of Barclays, Deutsche Bank, Goldman Sachs, HSBC and RBC all showing interest. Once the bank group is finalized, the USD 14bn financing, which is expected to take on a structure of 60% loans and 40% bonds, will launch for wider syndication to institutional investors in March 2018. However, due to recent market volatility destabilizing the debt market, the three lead banks may wait until market conditions are more stable to launch the deal. (Channel NewsAsia)

US inflation rise sparks bond market sell-off

Feb 15. Investor fears of an overheating US economy had pushed the 10-year Treasury yield to its four-year high of over 2.9%. Subsequent to the financial market turmoil caused by the jump in US wages and prices in the first week of February, the bond market sell-off intensified from February 8 when the US government reported that consumer prices in January rose faster than expected, with the annual rate of headline inflation hitting 2.1%. In addition, the potential big tax cut reinforced sentiment that the Fed might press the brakes on the US economy harder than previously signaled. By contrast, US equity markets, which bore the brunt of the market volatility in early February, proved more resilient. (FT)

China's debt-laden dealmakers eyed by restructuring firms (Bloomberg)

Cracks appear in credit funds as investors head for the exit (Bloomberg)

Regulatory Updates

ARRA issues another warning on risky investor loans

Feb 14. Australian Prudential Regulation Authority (APRA) highlighted the risks to financial stability from the high level of property investor debt on February 14 in a paper. The proportion of Australians who own an investment property has risen from 8% in the late 1990s to 11% in 2014-15, and more than half of these properties' costs exceed rental income. Although Australian banks have generally had low loss rates from property loans under normal economic conditions, the same cannot be guaranteed in the future especially in a nationwide economic downturn. In response, APRA flagged plans to counter risks in the home loan market. Such plans may force banks to set aside more capital against mortgages to property investors and homebuyers who are only paying interest. (The Sydney Morning Herald)

RBI's new diktat on bank default

Feb 13. The Reserve Bank of India (RBI) has initiated a complete overhaul of the stressed asset resolution mechanism to ensure a uniform recognition of non-performing assets and its resolution. Defaulters will have to pay up within the 180-day deadline or they will face insolvency under the Insolvency and Bankruptcy Code (IBC). The RBI also upgraded the 'Change of Ownership' clause to align with Section 29A of the IBC, which require banks to ensure that the resolution applicants are not willful defaulters, or any holding company that is related. The new framework is expected to lead more companies going into liquidation if defaults are not resolved properly. (Financial Express)

In boost to reform, Saudi Arabia's cabinet approves bankruptcy law (Reuters)

UK aims to keep financial rules close to EU after Brexit (FT)

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